

2009

Status: Exposure draft**Effective date:**

To be confirmed

Accounting impact:

Significant changes proposed for financial instrument accounting



International Financial Reporting Bulletin

Financial Instruments: Classification and Measurement

Background

The International Accounting Standards Board has issued for comment an Exposure Draft (ED) of proposed changes to the accounting for financial instruments. The exposure draft is intended to simplify the approach in comparison to the current requirements set out in IAS 39.

The ED reflects discussions of the Financial Crisis Advisory Group (FCAG), which was set up in October 2008 as part of the IASB's joint approach with the US standard setter, the Financial Accounting Standards Board (FASB) to dealing with issues arising from the global financial crisis. The ED also draws on input that the IASB obtained from discussions with other interested parties, in particular from three public round tables which were held towards the end of 2008 to discuss reporting issues that arose from the financial crisis, and from recommendations and suggestions received in response to the 2008 Discussion Paper *Reducing Complexity in Reporting Financial Instruments*.

The IASB's and the FASB's projects to replace their existing financial instruments standards have been accelerated in response to calls from the G-20, the Financial Stability Board and other constituents.

The ED is the first of three exposure drafts that the IASB will issue as proposals to replace IAS 39. The other two, which will deal with impairment of financial assets and hedge accounting, will be published in the fourth quarter of 2009.

The IASB plans to finalise a new standard covering the classification and measurement of financial instruments before the end of 2009, in time for it to be adopted early for December 2009 year end reporting. The new requirements will not be required to be adopted for some time, with the first year of mandatory adoption currently anticipated as being periods commencing on/after 1 January 2012.

Proposals

Scope

It is proposed that the scope of IAS 39 would be carried forward unchanged. The IASB considers that the issue of scope should be addressed comprehensively as a separate project, rather than only in the context of classification and measurement.

Classification and measurement

The ED proposes that on initial recognition, all financial assets and financial liabilities would be classified into one of two measurement categories:

- Amortised cost; or
- Fair value.

The proposals eliminate the Held to Maturity (HTM), Available for Sale (AFS) and Loans and Receivables categories. In addition, the exception that requires equity instruments and related derivatives to be measured at cost rather than fair value, where the fair value cannot be reliably determined, has been eliminated with fair value measurement being required for all of these instruments.

A financial asset or financial liability would be measured at amortised cost only if it meets two criteria, being:

- The instrument has basic loan features; and
- The instrument is managed on a contractual yield basis.

All other instruments would be required to be measured at fair value. The ED also retains the current requirement for financial instruments that are held for trading to be recognised and measured at fair value through profit or loss, including all derivatives that are not designated in a hedging relationship

Basic loan features

Basic loan features are contractual terms that give rise on specified dates to cash flows that are payments of principal and of interest on the principal outstanding. Interest represents consideration for the time value of money, and for the credit risk associated with the principal amount that is outstanding over a specified period of time.

The Application Guidance to the proposals notes that the following types of return are considered to be basic loan features:

- A fixed amount (eg a zero coupon bond)
- A fixed rate of return over the life of the instrument
- A variable return based on a single quoted or observable interest rate (eg LIBOR)
- A combination of a fixed and variable return (eg LIBOR plus 50 basis points), including debt instruments issued at a discount and fixed rate debt instruments with one or more interest rate resets at pre-specified rates and times.

Contractual terms that combine fixed and variable returns, which might be separable embedded derivatives under IAS 39 (such as interest rate caps, floors and collars), are also viewed as being basic loan features, meaning that instruments with those features would be measured at amortised cost in their entirety.

Contractual provisions that permit either the borrower or the lender to require early repayment qualify as basic loan features, provided that the contractual provisions are not contingent on future events and the repayment amount substantially represents unpaid amounts of capital and interest. For the purposes of this test, terms of early repayment provisions that protect the lender from credit deterioration of the borrower are not considered to be contingent on future events.

An instrument that is subordinated to others may still have basic loan features. However, certain financial instruments include arrangements where payments to holders of financial assets are prioritised through multiple subordinated interests (ie tranches) in a 'waterfall' structure where payments to senior debt holders are prioritised over those to other tranches. In such cases, any subordinated tranche that provides credit protection to a more senior tranche will fail to qualify as having basic loan features, as the cash flows are considered to include compensation for the provision of credit protection as well as principal and interest.

Managed on a contractual yield basis

Financial instruments are managed on a contractual yield basis only if they are managed, and their performance evaluated by key management personnel, on the basis of the contractual cash flows that are generated when the instruments are held or issued. Key management personnel are as defined in IAS 24 *Related Party Disclosures*.

This means that instruments are not assessed on an individual basis with regard to management intentions, instead being assessed on the basis of the overall business model. The ED acknowledges that an entity may have separate units that are managed in different ways (for example, a bank may have units with different models where one might deal with investment business and another with retail business).

Financial assets that are acquired at a discount are not considered to be managed on a contractual yield basis. The basis for conclusions notes that this is because an investor acquiring such an instrument at a discount believes that the actual losses will be less than are reflected in the purchase price and, in consequence, the variation in cash flows that relates to that discount does not represent interest

Contracts which contain embedded derivatives

As noted above, contracts with basic loan features include those which contain certain embedded derivatives, such as interest rate floors, caps and collars, and early repayment features. These contracts are measured at amortised cost and the embedded features are not separated and accounted for separately.

Other contracts will contain more complex embedded features, which IAS 39 would typically require to be accounted for separately at fair value through profit or loss, with the host contract remaining either at amortised cost or at fair value with changes in value, other than impairment and certain foreign currency movements, being recorded in equity. For those contracts where the host contract is a financial

instrument within the scope of IAS 39, the ED proposes that embedded derivatives would not be accounted for separately. Instead, the entire contract would fail to qualify as having basic loan features, and would be recorded at fair value in its entirety.

Where the host contract is not within the scope of IAS 39, either not being a financial instrument or a financial instrument which is scoped out of the standard, the current guidance in IAS 39 would continue to be applicable to the analysis and accounting treatment of embedded derivatives.

Fair value option

The ED includes an election, similar to that of IAS 39, which permits an entity, on an optional basis, to classify a financial instrument at fair value through profit or loss where that financial instrument would otherwise be measured at amortised cost. This election, which can be applied on an individual financial instrument basis or to a group of financial instruments, is made at initial recognition and is irrevocable.

In a change from IAS 39, the option is only available if the designation results in the elimination of, or significant reduction in, a measurement or recognition inconsistency. IAS 39 also permits the fair value option to be applied to financial instruments that are managed on a fair value basis, and to those instruments that contain an embedded derivative that would be required to be accounted for separately but the entity elects to measure the entire contract at fair value. Both of these latter criteria are eliminated by the proposals in the ED, as financial instruments that are managed on a fair value basis are required to be measured on that basis and the separation of embedded derivatives is eliminated, with contracts containing such embedded features being required to be measured at fair value in their entirety unless the instrument qualifies to be measured at amortised cost.

Reclassification

The classification of financial assets and liabilities is made on initial recognition. Reclassification after initial recognition is not permitted under any circumstances.

Investments in equity instruments

Investments in equity instruments do not meet the conditions to be measured at amortised cost because they do not have basic loan features (see above for the proposals of what would represent basic loan features). Consequently investments in equity instruments are measured at fair value.

For investments in equity instruments which are not held for trading (for example, those held for strategic purposes), it is proposed that an entity could, on initial recognition, make an irrevocable election to recognise all changes in fair value and all dividend income in Other Comprehensive Income (OCI). There would be no transfers from OCI to profit or loss (that is, no recycling) and hence no impairment requirements.

In a change from IAS 39, the exposure draft has no exemption from fair value measurement for those instruments for which fair value cannot be reliably measured. The IASB notes in its Basis for Conclusions that IAS 39 requires those investments measured at cost to be monitored for impairment, and that this approach has been criticised because it effectively requires fair value measurement to be adopted for the purposes of impairment. While it is accepted that for some entities, a requirement to measure all equity instruments at fair value will impose additional costs, it is also noted that some preparers have indicated that the impairment calculation is no more reliable, or less costly, than fair value measurement.

Disclosure and consequential amendments to other accounting standards

The proposals set out in the exposure draft would result in consequential amendments being made to a wide range of other accounting standards and interpretations. These include significant changes to IFRS 7 *Financial Instruments: Disclosures*, including new disclosures for any equity instruments where changes in their value are recorded in OCI, and to IAS 1 *Presentation of Financial Statements* which would require separate disclosure on the face of the income statement of gains or losses arising on the sale of financial instruments measured at amortised cost.

Effective date and transition

The IASB anticipates that the final standard will be mandatory for accounting periods commencing on/after 1 January 2012. However, it is proposed that it will be issued in time to permit early adoption for December 2009 year end financial statements. The final standard will be capable of being adopted during an accounting period as well as from the start of an accounting period.

The new requirements are proposed to be applied on a retrospective basis in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, subject to extensive transitional provisions. A summary of the proposed provisions is as follows:

- In determining whether a financial asset or financial liability is to be measured at amortised cost or fair value, the assessment of whether it is managed on a contractual yield basis is made as at the date of initial application of the new standard. That measurement basis is then applied on a fully retrospective basis.
- A financial asset or a financial liability can be designated as at fair value through profit or loss if that designation eliminates or reduces significantly an accounting mismatch. This designation is made on the basis of circumstances as at the date of initial application of the new standard, with the fair value measurement then being applied on a retrospective basis.

- The previous optional designation of a financial asset or financial liability as at fair value through profit or loss in accordance with IAS 39 may be revoked on the basis of facts and circumstances as at the date of initial application of the new standard, and is required to be revoked if the eligibility criterion for such designation is not met. The applicable measurement basis is then applied on a fully retrospective basis.
- If a hybrid contract (ie one containing an embedded derivative as defined in IAS 39) is required to be measured at fair value, but that fair value has not been determined in previous accounting periods, the hybrid contract is measured in comparative periods using the sum of the fair value of the components (ie the host contract and embedded derivative(s)). At the date of initial application of the new standard, the entire (combined) contract is measured at fair value, with any difference between that fair value and the combined fair value of the component parts being recognised in opening retained earnings of the reporting period of initial application of the new standard.
- Equity investments held at the date of initial application of the new standard can be designated as at Fair Value through Other Comprehensive Income if they are not held for trading (as defined). The assessment is made as at the date of initial application of the new standard and the recognition basis is then applied on a fully retrospective basis.
- If a hedge accounting relationship accounted for in accordance with IAS 39 no longer qualifies for hedge accounting as a consequence of the new classification approach, the hedge cessation rules in IAS 39 are applied from the date of initial application of the new standard.
- If an instrument previously measured at fair value is reclassified to be measured at amortised cost and it is impracticable (as set out in IAS 8) for the effective interest rate and impairment requirements of IAS 39 to be applied on a retrospective basis, then the amortised cost of the financial instrument, or any impairment of the financial asset, is determined on the basis of the fair value of the financial instrument at the end of each comparative period. The fair value of the instrument as at the date of initial application of the new standard then becomes its new deemed amortised cost.
- Investments in unquoted equity investments (or derivatives linked to, and required to be settled by delivery of, such instruments) that were measured at cost under IAS 39, are remeasured to fair value as at the date of initial application of the new standard. Any difference between that fair value and the previous carrying amount is recognised in opening retained earnings of the reporting period of initial application of the new standard.
- Entities which prepare interim financial reports in accordance with IAS 34 *Interim Financial Reporting* are not required to restate comparative information if such restatement is impracticable (as set out in IAS 8).

On initial application of the new standard, the disclosures required by IAS 8 will be required. These include, to the extent practicable (as set out in IAS 8) the effect on each financial statement line item and on basic and diluted earnings per share for the current and prior period(s) presented.

In addition, if the new standard is adopted early, the following disclosures are required for each class of financial assets and financial liabilities at the date of initial application:

- The original measurement category and carrying amount, determined in accordance with IAS 39;
- The new measurement category and carrying amount, determined in accordance with the new standard;
- The amount of any financial assets and financial liabilities that have been designated as at fair value through profit or loss under the new standard, together with their original measurement basis and presentation method; and
- The amount of any financial assets or financial liabilities that were designated as at fair value through profit or loss under IAS 39 that are no longer so designated, with separate disclosures being required for those that the new standard requires to be redesignated and those which have been redesignated on an optional basis.

This information would be required to be presented in tabular format, together with a narrative explanation of how the classification requirements of the new standard have been applied, and the reasons for any designation or revocation of the designation of financial assets and liabilities as at fair value through profit or loss

Comment period The IASB has requested the submission of comments on its proposals by 14 September 2009.



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