

November 2009

Project Summary and Feedback Statement

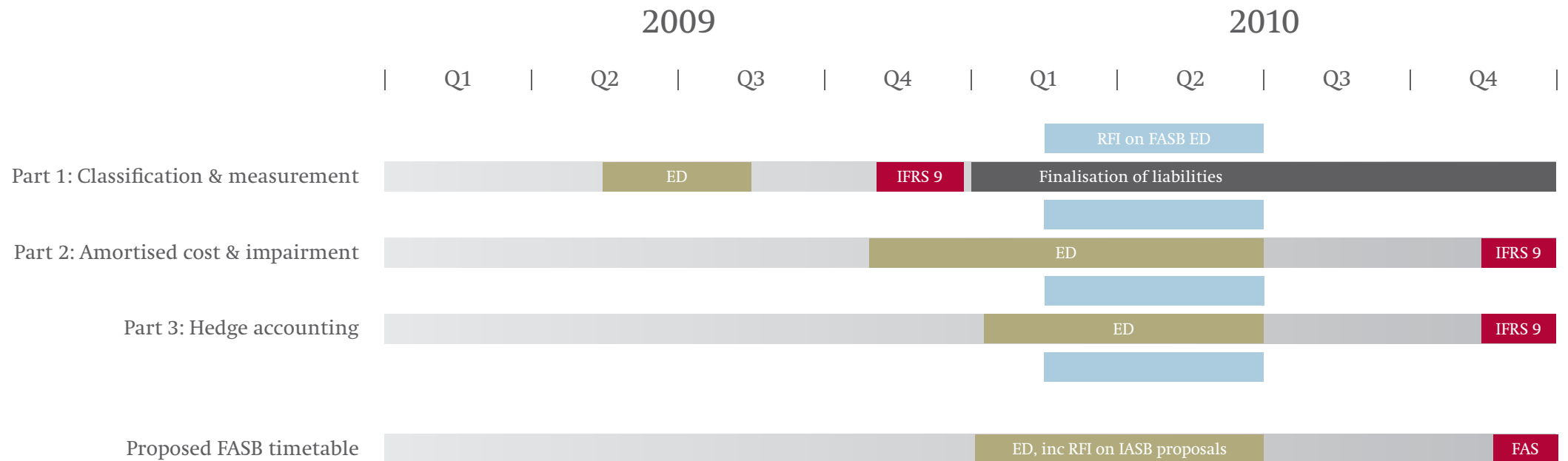
# IFRS 9 *Financial Instruments*

Part 1: Classification and measurement



International  
Accounting Standards  
Board®

# Planned reform of financial instruments accounting



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# At a Glance

We, the International Accounting Standards Board (IASB), issued IFRS 9 *Financial Instruments* in November 2009. IFRS 9 prescribes the classification and measurement of financial assets and completes the first phase of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*.

The initial classification requirements in IFRS 9 provide the foundation on which the reporting of financial assets is based, including how they are measured and presented in each reporting period.

The scope of IFRS 9 has been limited to financial assets. It does not change the classification and measurement requirements of financial liabilities that are set out in IAS 39. In the near future, we intend to consider further the accounting for financial liabilities.

The second and third phases of the project to replace IAS 39, now in progress, are concerned with the impairment of financial instruments and hedge accounting. We are also continuing our work on the derecognition of financial instruments, fair value measurement as well as consolidation.

The objective of this part of the project to replace IAS 39 has been to make it easier for users of financial statements to assess the amounts, timing and uncertainty of cash flows arising from financial assets. IFRS 9 achieves this objective by aligning the measurement of financial assets with the way the entity manages its financial assets (its 'business model') and with their contractual cash flow characteristics.

As a consequence the IASB has reduced the complexity associated with IAS 39 in the following manner:

- the number of classification and measurement categories has been reduced and there is a clearer rationale for the new categories;
- the complex and rule-based requirements in IAS 39 for embedded derivatives have been eliminated by no longer requiring that embedded derivatives be separated from financial asset host contracts;
- the 'tainting rules' that forced entities to reclassify to fair value all instruments in a class that had been classified as held to maturity in the event that one of those instruments is sold have been eliminated; and
- there is a single impairment method for all financial assets not measured at fair value, and impairment reversals are permitted for all assets, eliminating the many different impairment methods used by IAS 39 and its inconsistent requirements on impairment reversal.

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# Why we undertook the project

Our predecessor body, the International Accounting Standards Committee (IASC), issued the original version of IAS 39 in 1999. Many users of financial statements and other interested parties have told us that the requirements in IAS 39 are difficult to understand, apply and interpret. They have urged us to develop a new standard for the financial reporting for financial instruments that is principle-based and less complex.

This project is our response to a need we have long recognised to improve and simplify the financial reporting for financial instruments. It is the first fundamental reassessment of IAS 39 since it was issued.

In March 2008 we joined with the US Financial Accounting Standards Board (FASB) in publishing a discussion paper *Reducing Complexity in Reporting Financial Instruments*.

The global financial crisis brought an even sharper focus onto the project. In October 2008, as part of our joint approach to dealing with the reporting issues arising from the crisis, we set up, with the FASB, the Financial Crisis Advisory Group (FCAG). As a result of that group's recommendations, published in July 2009, and those of the G20 leaders we divided our project into three main phases so that we could make progress as quickly as possible, while also undertaking wide consultation.

Taking a phased approach has enabled us to provide entities with the opportunity to adopt the new requirements early for classification and measurement in 2009 year-end financial statements. Entities must apply the new requirements no later than for financial years beginning on or after 1 January 2013.

The remaining two phases of this project are in progress. We published in November 2009 an exposure draft *Financial Instruments: Amortised Cost and Impairment*. In early 2010 we expect to publish an exposure draft proposing improvements and simplifications to hedge accounting requirements.

## Next steps for this and other related projects

We expect to have completed our replacement of IAS 39 by the end of 2010. The remaining phases involve the classification and measurement of financial liabilities, impairment and hedge accounting.

We are also developing new requirements specifying when entities must remove financial assets and financial liabilities from their statement of financial position—referred to as *derecognition*. We published an exposure draft on this topic in March 2009. We have also developed new requirements for *consolidation*, which solidify the accounting for financial structures such as special purpose entities and structured investment vehicles.

We also expect to complete our work on fair value measurement in 2010. That work clarifies how to determine fair value, but does not specify when fair value should be used.

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# Summary of the main changes from the exposure draft

- The new classification and measurement requirements are for financial assets only, rather than financial assets and financial liabilities as proposed in the exposure draft.
- IFRS 9 requires entities to classify financial assets on the basis of the objective of the entity's business model for managing the financial assets and the characteristics of the contractual cash flows. It points out that the entity's business model should be considered first, and that the contractual cash flow characteristics should be considered only for financial assets that are eligible to be measured at amortised cost because of the business model. It states that both classification conditions are essential to ensure that amortised cost provides useful information.
- Additional application guidance has been added on how to apply the conditions necessary for amortised cost measurement.
- IFRS 9 requires a 'look through' approach for investments in contractually linked instruments that effect concentrations of credit risk. The exposure draft had proposed that only the most senior tranche could have cash flows that represented payments of principal and interest on the principal amount outstanding.
- IFRS 9 requires (unless the fair value option is elected) financial assets purchased in the secondary market to be measured at amortised cost if the instruments are managed within a business model that has an objective of collecting contractual cash flows and the financial asset has only contractual cash flows representing principal and interest on that principal even if such assets are acquired at a discount that reflect incurred credit losses.
- IFRS 9 requires that when an entity elects to present gains and losses on equity instruments measured at fair value in other comprehensive income, dividends are to be recognised in profit or loss. The exposure draft had proposed that those dividends would be recognised in other comprehensive income.
- IFRS 9 requires reclassifications between amortised cost and fair value classifications when the entity's business model changes. The exposure draft had proposed prohibiting reclassification.
- For entities that adopt IFRS 9 for reporting periods before 1 January 2012 the IFRS provides transition relief from restating comparative information.
- IFRS 9 requires additional disclosures for all entities when they first apply the IFRS..

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# Convergence with US GAAP

The FASB has been developing proposals to replace the equivalent requirements in US Generally Accepted Accounting Principles (GAAP), which it plans to publish for public comment in the first quarter of 2010.

The boards are concerned that the difference in timetables is creating a risk that they will develop different requirements for some financial instruments. Such an outcome would be inconsistent with the goal of providing investors with information that is both of high quality and comparable irrespective of whether the reporting entity is applying IFRSs or US GAAP.

Although it would have been preferable to have had common time lines with the FASB on financial instruments, we gave more weight to the international commitments that we made to deliver the first phase of this project.

In October 2009 the boards met and agreed on a set of principles for working to achieve a common solution on accounting for financial instruments. The principles are designed to achieve comparability and transparency, as well as consistency of credit impairment models, and reduced complexity of accounting:

- Any requirements the boards issue should enhance comparability of information for the benefit of investors.
- Financial reporting of financial instruments should provide information that helps investors assess the risks associated with those instruments.
- For financial instruments that have highly variable cash flows or are part of a trading operation, prominent and timely information about the fair values of those instruments is important.
- For financial instruments with principal amounts that are held for collection or payment of contractual cash flows rather than for sale or settlement with a third party, information about both amortised cost and fair value is relevant to investors.
- The classification and measurement requirements should be less complex to implement than are the current requirements.
- Impairment principles should be consistent for all instruments held for collection of their contractual cash flows.

We also developed a plan with the FASB to ensure that the remaining phases of our financial instruments project and the equivalent FASB project will be considered by the boards together.

With the exception of the classification and measurement of financial assets, the boards will align the comment periods for all components of the financial instruments exposure drafts. By doing so, the boards will provide the IFRS and US GAAP communities with the opportunity to comment on the proposals of both boards.

The boards also agreed to consider together comments received on the IASB and FASB proposals with the objective of agreeing on a model that will enhance the international comparability of financial reporting.

The IASB has already given an undertaking to conduct a post-implementation review of each of our major projects. In line with this undertaking, the IASB intends to undertake a preliminary post-implementation review, which it will discuss with the FASB, on the application of its classification and measurement of financial assets by those entities adopting the requirements.

# Improvements to the accounting for financial assets

IAS 39	Improvements in IFRS 9
<p><b>Classification and measurement</b></p> <p>IAS 39 requires the classification of financial assets into one of four classes, each having its own eligibility criteria and different measurement requirements. The eligibility criteria are a combination of the nature of the instrument, its manner of use and management choice. IAS 39 has ‘tainting rules’ that force an entity to reclassify to fair value through profit or loss all financial assets classified as held to maturity if more than an insignificant amount of the financial assets in this class are sold before their maturity date.</p>	<p>Financial assets are classified in one of two measurement categories. The classification is based on an assessment of the way in which the instrument is managed (the entity’s business model) and of its contractual cash flow terms.</p> <p>The category into which the asset is classified determines whether it is measured on an ongoing basis at amortised cost or fair value.</p>
<p><b>Impairment</b></p> <p>IAS 39 requires an impairment assessment for financial assets measured at fair value through other comprehensive income (OCI) as well as both classes of financial assets measured at amortised cost. There are several different models. Some financial asset impairments cannot be reversed.</p>	<p>As a result of the new classification model, the only financial assets subject to impairment will be instruments measured at amortised cost. All impairments are eligible for reversal.</p>
<p><b>Embedded derivatives</b></p> <p>The requirements for a hybrid contract (a non-derivative host contract with an embedded derivative) are mixed. Some hybrid contracts are measured at fair value through profit or loss in their entirety. Others are split, with one component (the embedded derivative) being measured at fair value through profit or loss and the other component (the non-derivative host contract) being measured at amortised cost or as an executory contract using accrual accounting. A third category of hybrid contract is accounted for either as a single contract or on a split basis, according to management’s choice.</p>	<p>A hybrid contract (a non-derivative host contract with an embedded derivative) with a host that is a financial asset is not separated. Such contracts are classified in accordance with the classification criteria in their entirety. There is no change to the accounting for hybrid contracts if the host contract is a financial liability or a non-financial item.</p>
<p><b>Fair value through other comprehensive income</b></p> <p>IAS 39 does not have a presentation option for strategic equity investments.</p>	<p>A presentation option is available for investments in equity investments that are strategic investments. If they meet the criteria, an entity may elect, at initial recognition, to record all fair value changes for such equity instruments in OCI. Dividends received from such investments are presented in profit or loss. No recycling of gains and losses between p&amp;l and OCI will be permitted for these investments.</p>
<p><b>The cost exception for unquoted equity investments</b></p> <p>IAS 39 has an exception to the measurement rules for unquoted equity instruments (and derivatives linked to such equity instruments that must be settled by delivery of such equity instruments) for which fair value cannot be measured reliably. Such financial assets are measured at cost.</p>	<p>All equity investments must be measured at fair value. To alleviate concerns about the ability to measure some such investments at fair value, the fair value measurement project will provide application guidance to help entities identify the circumstances in which the cost of equity instruments might be representative of fair value.</p>
<p><b>Disclosure</b></p>	<p>Additional disclosures are required, reflecting the revised classification and measurement guidance.</p>

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# Our consultation process

We conducted extensive outreach activities as part of the development and follow-up of the exposure draft.

We conducted more than 100 one-on-one and small group discussions with financial and non-financial entities, auditors, regulators, investors and others. We also held roundtable meetings, jointly with the FASB, in Japan, the UK and the US to discuss the proposals on classification and measurement.

We have been working together with supervisors in key areas and held several meetings with the Basel Committee on Banking Supervision. In addition, supported by the Financial Stability Board (FSB), we held a meeting with senior officials and technical experts of prudential authorities, market regulators and their international organisations to discuss financial institution reporting issues in August 2009. This meeting included senior representatives from a number of emerging market economies that are FSB members.

Additionally, we drew on the expertise of, and met with, our Financial Instruments Working Group to discuss the exposure draft. Our project team staff and some Board members also held numerous webcasts about the exposure draft attracting many thousands of participants.

We received 244 comment letters on our proposals for classification and measurement. We analysed these comment letters and used these comments along with the feedback from our outreach activities as the basis for reconsidering the exposure draft. We reconsidered the proposals during September and October 2009 at a series of regular and additional public meetings of the Board.

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# Feedback Statement

We received broad support for our efforts to improve the accounting for financial instruments.

Most respondents also supported the principles underpinning the two classification categories that were proposed. There was less agreement with the words we used to implement those principles.

We have reflected many of the suggestions made to us in IFRS 9. We think that the requirements are expressed more clearly and will be easier to implement.

In the pages that follow we outline the more significant matters raised with us and how we responded.

# Two-measurement-category approach

One of the most common criticisms of IAS 39 is that it is complex because it has too many classification categories for financial instruments—each with its own rules for determining which instruments must, or can be, included and how the assets are tested for impairment.

In the light of what we learned from responses to our discussion paper and our extensive consultations, we concluded that financial statements that differentiated between:

- financial instruments that have highly variable cash flows or are part of a trading operation; and
- financial instruments with principal amounts that are held for collection or payment of contractual cash flows rather than for sale or settlement with a third party

would provide users of financial statements with more useful information than they were receiving from the application of IAS 39.

We therefore proposed classification and measurement on the basis of how an entity manages its financial instruments (its business model) and the contractual cash flow characteristics of the financial instruments. Our objective was to measure, on the basis of this classification, at fair value those instruments for which current values are more informative and at amortised cost those instruments for which contractual flows are more informative.

## Respondents' comments

Almost all respondents, including many users of financial statements, supported the proposed mixed attribute approach.

A small number preferred an approach that would measure all financial instruments at fair value. A few supported an approach whereby fair value measurement is the 'default' and amortised cost is used only when fair value is unreliable or impracticable—or where the costs to determine fair value outweigh the benefits.

## Our response

We retained the proposed model for financial assets and the two conditions that must be met to classify a financial asset as measured at amortised cost. However, we modified the two conditions to address concerns raised by respondents (as described in *Conditions for amortised cost*).

We decided to consider the classification and measurement of financial liabilities separately. IFRS 9 therefore prescribes the classification and measurement of financial assets only.

# More or less fair value?

The proposals had two measurement bases, amortised cost and fair value.

## Respondents' comments

Some respondents criticised the proposals because they believe that the proposals would lead to more financial assets being measured at fair value than would be required by the current requirements in IAS 39. Other respondents were equally critical, but on the basis that fewer instruments would be measured at fair value.

## Our response

It was not our objective to increase or decrease the application of fair value measurement, but rather ensure that financial assets are measured in a way that provides useful information to investors to help predict likely actual cash flows.

Whether an entity will have more or fewer financial assets measured at fair value as a result of applying IFRS 9 will depend on the nature of their business and the nature of the instruments they hold. The more risky financial assets an entity holds the more likely it is that those financial assets will be measured at fair value.

However, by removing the available-for-sale and held-to-maturity categories we have also removed the restrictions that exist in IAS 39 that prevent many financial assets being measured at amortised cost.

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# Conditions for amortised cost

We proposed that a financial instrument should be measured at amortised cost only if it has basic loan features and is managed on a contractual yield basis. When these conditions are satisfied, amortised cost provides users of financial statements with information that is useful because it reflects the anticipated cash flows arising from the financial instruments.

For more complex financial instruments, or when a financial instrument is held with the objective of collecting cash flows through its sale, cost based measurement is less useful to users of financial statements.

## Respondents' comments

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Most respondents generally agreed with the conditions. They supported an approach that determines classification on the basis of contractual terms of the instrument and how the entity manages the instrument. However, most commented that we did not describe the conditions clearly enough. Some questioned the interaction between the two conditions and whether one should have primacy over the other. A few argued that the classification approach should require only the business model condition.

Respondents also commented that the way in which we described the business model condition in the Basis for Conclusions was clearer than the description included in the exposure draft.

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## Our response

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In line with the views of most respondents, we decided that both conditions must be satisfied in order for a financial asset to be measured at amortised cost. The contractual cash flow characteristics of an instrument are important in determining whether amortised cost provides information that is useful in predicting likely future cash flows. Some types of instruments have no initial cost. Other types of instruments, such as equity investments, have a wide range of possible cash flow outcomes and do not have contractual cash flows. In such situations an amortised cost measurement approach is not feasible.

However, we have decided that the IFRS should set out as the first criterion the way in which the assets are managed (the business model condition). We decided to do so because the business model must be assessed at a higher level than on a contract-by-contract basis—for example on the basis of a portfolio of financial assets. In contrast, it is necessary to assess the terms of an asset on a contract-by-contract basis. Therefore, we think it is more efficient to assess the business model first. The entity would then need only to review the contractual terms of the subset of financial assets that are managed on a contractual cash flow basis.

We have amended the way we describe the business model condition necessary for amortised cost measurement. We now describe the model as one in which the entity's objective is to hold assets to collect contractual cash flows rather than to sell instruments before their contractual maturity in order to realise fair value changes. This change also brings our wording very close to the wording currently being considered by the FASB for the equivalent classification condition.

We have also decided to amend the way in which the IFRS describes contractual cash flow characteristics for an asset measured at amortised cost. The IFRS has a clearer explanation of the principle that an asset must yield both principal and interest, and that interest must reflect consideration for the time value of money and credit risk of the instrument. We have also added examples in the application guidance setting out how that principle is to be applied to various fact patterns.

# Accounting for hybrid contracts

A hybrid contract is a contract that contains a non-derivative host contract and an embedded derivative. IAS 39 applies to hybrid contracts in which the host contract is a financial instrument (such as a contract to pay cash) or a non-financial host (such as a contract to deliver a commodity). IFRS 9 applies to hybrid contracts in which the host contract is a financial asset within its scope.

IAS 39 often requires components of a hybrid contract to be separated. IAS 39 has different accounting requirements for the host contract and the embedded derivative. Many preparers, auditors and users consider those requirements complex and rule-based.

We proposed improving the accounting for hybrid contracts with financial hosts by requiring them to be classified as a whole using the same classification approach as described above. This approach ensures that the classification approach is consistent for hybrid and all other financial instruments. It would also simplify the accounting and removes what many perceive to be arbitrary rules for determining whether separating the host from the embedded derivative is necessary. Hybrid instruments would therefore be accounted for in their entirety either at fair value through profit or loss or at amortised cost, according to the classification criteria.

## Respondents' comments

Most respondents agreed that the current requirements for hybrid instruments are complex, but they expressed concern about the proposals, including the following:

- The use of fair value through profit or loss to measure hybrid liability instruments would lead to the recognition in profit or loss of changes in the issuer's own credit risk.
- Some financial hosts have basic loan features that are managed separately from the embedded derivatives. Classifying them as a single instrument would fail to reflect this. Respondents argued that a requirement to separate the components should be retained in these circumstances because it is consistent with the business model-based classification approach.
- Some respondents were concerned that, as they understood the proposals, an embedded derivative could affect the classification of the whole instrument even if that derivative is immaterial.
- The proposals could result in different accounting depending on whether the instrument is issued as a hybrid contract or as two separate contracts.

## Our response

The concern about reflecting an entity's own credit risk applies to all financial liabilities, not just hybrid liability instruments. We are sympathetic to this concern and have decided to exclude financial liabilities from the scope of this phase of the project to replace IAS 39. Therefore, the requirements for financial liabilities are unchanged.

We acknowledge that separating an embedded derivative from its host contract can provide additional useful information for users of the financial statements, which is one of the main objectives for this project. However, the other important objective is to simplify the accounting for financial instruments.

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Our assessment is that the additional information gained from separating the components of the contract do not justify the significant additional costs and complexity that separation entails. We also observe that if an embedded derivative is not a material component of the contract it is likely that the contract as a whole will be classified in the same way as the host contract would have been classified without an embedded derivative.

We therefore decided to retain the proposal that hybrid instruments with financial hosts that are financial assets should be classified in their entirety in accordance with the classification criteria used for all other financial assets. This will ensure that, unlike today, a single classification approach will be used to determine how financial assets are accounted for after initial recognition.

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# Reclassification after initial recognition

We proposed that entities would not be permitted, after initial recognition, to reclassify financial assets between the amortised cost and fair value categories.

## Respondents' comments

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Almost all respondents disagreed with this proposal. They said that it was inconsistent with how financial assets were required to be classified on initial recognition. They pointed out that changes in an entity's business model can and do occur, though only infrequently. If the business model is an important criterion, reclassification should be required if the business model changes to ensure that information continues to be useful for economic decisions.

## Our response

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We were persuaded by the views expressed by these respondents. The classification model is based on an entity's business model and the contractual terms of the asset. Therefore, IFRS 9 requires an entity to reclassify financial assets between the fair value and amortised cost categories if there is a change in its business model. In all other circumstances reclassification remains prohibited.

A business model is not the same as management's intentions. We expect changes to a business model to be rare and, accordingly, reclassifications should also be rare.

Financial assets must be reclassified on the first day of the reporting period following the change in business model. This requirement reduces the risk of an entity choosing a particular reclassification date in the reporting period that provides an advantageous accounting outcome. An entity that does reclassify financial assets must provide users of its financial statements with information about the effects of the change. Those disclosure requirements ensure that the changes in the business model and the associated reclassifications are transparent and the comparability of the related information is enhanced.

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# Fair value option

We proposed that an entity could elect, at initial recognition, to designate an instrument as measured at fair value through profit or loss, even though application of the classification criteria would have required the instrument to be measured at amortised cost. This option would be available only when it would eliminate or significantly reduce an accounting mismatch.

## Respondents' comments

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Almost all respondents supported a fair value option to address an accounting mismatch. Some asked that there be no restrictions on the ability of an entity to use the fair value option.

## Our response

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We have retained the option for an entity to elect, on initial recognition, to measure a financial asset at fair value through profit or loss if that designation eliminates or significantly reduces an accounting mismatch. We also retained the limitation on the use of the fair value option—ie only allowing the election when it eliminates or significantly reduces an accounting mismatch—because removing it would allow classification choice. Such choice would be inconsistent with the objectives of IFRS 9 and reduce comparability.

# Elimination of the cost exception for unquoted equities

IAS 39 requires investments in equity instruments that do not have a quoted market price in an active market to be measured at cost if their fair value cannot be measured reliably. The exception also applies to derivatives on such equity instruments, if the derivatives are settled by delivery of those equity instruments.

We proposed removing the exception, thus requiring all equity investments and derivatives on them to be measured at fair value. We think that removing this exception will lead to users of the financial statements having more useful information about those equity instruments..

## Respondents' comments

Most respondents agreed that measuring equity investments (and derivatives on those equity investments) at fair value provides more useful information than the initial cost of the instruments. Nevertheless, many did not support our proposal to eliminate this exception. They argued that for some equity investments it can be very difficult, or even impossible, to obtain sufficient information to measure their fair value without making judgements that result in a measure that is so subjective that it is not decision-useful. Moreover, for some equity investments they think the cost of gathering information and estimating fair value could exceed the benefits.

## Our response

We understand the concerns some respondents have about the difficulties and costs associated with obtaining information for some unquoted equity investments that is necessary to measure their fair value. To alleviate those concerns, we will be providing additional application guidance on how to measure the fair value of such instruments as part of the fair value measurement project. We also think that in some circumstances the cost of equity instruments might be representative of fair value, and the application guidance is designed to help entities identify those circumstances.

In the light of the additional guidance we have provided, which we think will address the cost-benefit concerns raised by respondents, we retained the proposal to eliminate the cost exception and to measure all equity investments at fair value.

# Fair value through other comprehensive income (the presentation exception)

During our consultations we were advised that entities sometimes buy equity investments for strategic purposes, rather than for the primary purpose of generating returns from dividends and changes in the value of the investment. We therefore proposed that an entity could, on initial recognition of such an investment, elect to present the changes in the fair value of the investment in other comprehensive income (OCI).

The proposal also required dividends received on such investments to be recognised in OCI. Entities would not be permitted to recycle any amounts from OCI to profit or loss, for example on disposal of the investment. If recycling was permitted it would be necessary to introduce an impairment test to ensure that impairments were presented on a consistent basis. Adding such a test for financial assets measured at fair value would make the proposals more complex.

## Respondents' comments

Most respondents agreed that we should permit entities to present changes in the fair value of particular equity investments in OCI. However, almost all of those respondents had disagreed with two aspects of the proposal:

- Dividend presentation. Respondents told us that they think of dividends as income that should be presented in profit or loss. They also pointed out that many of these investments are funded by debt, with interest on that debt being recognised in profit or loss. Recognising dividends in OCI would therefore introduce an accounting mismatch within the profit and loss section of the statement of comprehensive income.
- Recycling. Respondents said that recycling should be required when the instrument is derecognised; they attached importance to this because they see the sale of an investment as the realisation of the changes in its value.

Insurers were particularly concerned that the restrictions around the OCI alternative would not enable them to reflect their performance properly. (We comment in the next section on the adoption of IFRS 9 by insurers.)

## Our response

We have retained the proposal to permit an entity to elect, on an investment-by-investment basis, to recognise in OCI changes in the fair value of equity investments that are not held for trading.

We have retained our proposal not to permit recycling of fair value gains and losses from OCI to profit or loss. Such recycling would have made it necessary to introduce an impairment test, which would have made the requirements more complex. Additionally, determining the point at which impairment should be recognised for equity investments has proved to be problematic in practice. Our assessment was that prohibiting the recycling of such gains and losses reduced the complexity, and therefore the costs of compliance, without reducing the usefulness of the information provided to users.

However, we accepted the arguments made by respondents for recognising dividends in profit or loss. Accordingly IFRS 9 requires dividends received to be recognised in profit or loss, to the extent that they are a return on, rather than a return of, the investment.

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# Other matters

## Transition arrangements

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We will not require entities to apply the new IFRS for financial instruments until 2013. Given that we expect to complete our work on replacing IAS 39 in 2010, this will allow entities three years to prepare for its implementation.

However, we will permit entities to adopt earlier than is required the chapters of IFRS 9 that deal with the classification and measurement of financial assets—ie the subject of this phase of the project. We have provided transition relief for entities that choose to adopt the new requirements early, including relief from having to restate comparative information if an entity adopts the new requirements for financial periods beginning before 1 January 2012.

Entities that adopt early the requirements for the classification and measurement of financial assets will not be bound also to adopt early the guidance in the later phases. However, we will require entities that want to adopt early any of the later phases to adopt at the same time the requirements of any earlier phases.

Additional disclosures are required by all entities when they adopt the new guidance, to explain the effects of adoption on the entity's financial statements.

## Adoption by insurers

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We recognise that insurers may face particular problems if they apply IFRS 9 before they apply the requirements of a new IFRS on insurance contracts, which we expect to issue in 2011.

One of the concerns they have expressed to us is that they do not want to create a future accounting mismatch that IFRS 9 prevents them from remedying. For example, an insurer might classify some financial assets at amortised cost before it adopts the new IFRS on insurance contracts. However, when the new insurance IFRS is adopted it may wish to use the fair value option for such assets to remove a newly created accounting mismatch.

We will consider whether our exposure draft on insurance contracts should propose allowing an insurer to reclassify some or all financial assets as measured at fair value through profit or loss when it first adopts the new requirements for insurance contracts.

## Concentrations of credit risk (tranches)

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Our exposure draft included proposals for the accounting for transactions where concentrations of credit risk are affected by using multiple contractually linked instruments, commonly referred to as 'tranches'. We had proposed in the exposure draft that only the most senior tranche would qualify for amortised cost accounting.

Many respondents disagreed with this proposal because it was an exception to the overall classification approach, which focused on the form and legal structure of the arrangement. They also pointed out that economically similar instruments would be accounted for in different ways. In addition, they were concerned that the proposal would not be effective because it would be easy to structure an instrument to achieve a particular accounting outcome.

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We agree with those comments and we have amended the requirements in the IFRS. We concluded that holders of investments in such tranches should look through to the underlying pool of instruments to identify the assets generating the cash flows. Any tranches that are not more leveraged than the underlying pool (not just the most senior tranche) will be eligible for amortised cost accounting, provided the underlying instruments meet the conditions set out in the standard. If an entity cannot make this assessment it must measure the tranche at fair value.

### Fair values with significant measurement uncertainty

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Some respondents to the exposure draft and some participants in our outreach programme opposed measuring financial instruments at fair value through profit or loss if those fair value measurements included significant measurement uncertainty. Examples given by respondents of such circumstances are when the financial assets are not actively traded, have insufficient market depth or rely on valuation models that use unobservable inputs.

Our classification approach in the IFRS determines classification not on the basis of the reliability of the measurement, but on the business model used and the nature of the instrument. Any requirement that prevents the use of fair value if it is estimated using a valuation model would lead to many derivatives being measured at cost – and of course many types of derivatives have no initial cost. Our comment letters and outreach confirmed that there is almost universal agreement among investors and many others that derivatives should always be measured at fair value, with changes in fair value recognised in profit or loss.

We have considered presentation solutions to highlight the measurement uncertainties, including presenting information about such measures in the statement of comprehensive income.

In this phase of the project we have not included requirements for such presentation solutions, but we are committed to considering this issue further when discussing the project jointly with the FASB.

# Financial Crisis Advisory Group

The Financial Crisis Advisory Group (FCAG) was asked to consider how improvements in financial reporting could help enhance investor confidence in financial markets. The FCAG report, published in July 2009, included several recommendations relevant to this project. The table below lists the FCAG recommendations and how we are responding to them.

Recommendation	Response
The IASB and the FASB should give the highest priority to simplifying and improving their standards on financial instruments, moving forward as a matter of urgency but with wide consultation.	Our project to replace IAS 39 addresses this recommendation. We have proceeded with our work on this project quickly and with an unprecedented level of outreach and consultation, as described in more detail in the introductory sections of this document.
The IASB and the FASB should achieve converged solutions.	<p>The project to develop improved requirements for accounting for financial instruments is a joint project with the FASB.</p> <p>We are committed to achieving by the end of 2010 a comprehensive and improved solution that provides comparability internationally in the accounting for financial instruments. However, our efforts have been complicated by the differing project timetables established to respond to our respective stakeholder groups.</p> <p>We have developed with the FASB strategies and plans to achieve a comprehensive and improved solution that provides comparability internationally. As part of those plans, we reached agreement with the FASB at our joint meeting in October 2009 on a set of core principles designed to achieve comparability and transparency in reporting, consistency in accounting for credit impairments, and reduced complexity of financial instrument accounting.</p>

Recommendation	Response
<p>The IASB and the FASB should explore alternatives to the incurred loss model for loan loss provisioning that use more forward-looking information.</p>	<p>We published on 5 November 2009 an exposure draft of a proposed impairment model for those financial assets measured at amortised cost, <i>Financial Instruments: Amortised Cost and Impairment</i>. The model uses expected cash flows.</p> <p>The FASB is developing a model for accounting for credit losses for financial assets that the FASB has tentatively decided should be measured at fair value through other comprehensive income. That model will, once it is fully developed, be included in the exposure draft the FASB expects to publish in the first quarter of 2010.</p> <p>We will publish a request for views on the FASB’s model at the same time that the FASB publishes its proposals. The boards will consider the comments received on the FASB model and the IASB model together.</p> <p>The boards agreed that the FASB’s model and the IASB’s expected cash flow approach should be discussed with the expert advisory panel that is being established to advise the boards on operational issues on the application of their credit impairment models and how those issues might be resolved.</p>
<p>The IASB and the FASB should reconsider the appropriateness of an entity’s recognition of gains or losses as a result of fair value changes in the entity’s own debt because of decreases or increases, respectively, in the entity’s creditworthiness.</p>	<p>In July 2009 we published a request for information. The feedback on that document confirmed that the issue of own credit in the measurement of liabilities needs to be addressed.</p> <p>We decided to delay issuing new requirements for financial liabilities as part of IFRS 9 to allow us more time to obtain feedback on how best to deal with the effects of changes in an issuer’s own credit. We intend to address this expeditiously as part of the project to replace IAS 39 to be completed during 2010.</p>

Recommendation	Response
<p>The IASB and the FASB should continue their consultation with prudential regulators.</p>	<p>We have been working together with supervisors in key areas, including provisions and valuation. We have held several meetings with the Basel Committee on Banking Supervision.</p> <p>In addition, supported by the Financial Stability Board (FSB), we held a meeting on 27 August 2009 with senior officials and technical experts of prudential authorities, market regulators and their international organisations to discuss financial institution reporting issues. This meeting included senior representatives from a number of emerging market economies that are FSB members.</p> <p>Our next meeting with those participants is scheduled to take place in the first quarter of 2010.</p>
<p>If the IASB and the FASB develop an alternative to the incurred loss model that uses more forward-looking information, they should develop a method of transparently depicting any additional provisions or reserves that may be required by regulators.</p>	<p>We are working closely with regulators on our impairment proposals and with ways to present regulatory adjustments to reserve requirements within the context of IFRS financial reports.</p>
<p>When making improvements to financial instruments reporting, the IASB and the FASB should aim to make improvements that provide a better, more transparent depiction of the risks involved, especially in relation to complex financial instruments.</p>	<p>The accounting model that we have adopted in phase 1 requires complex financial assets to be measured at fair value through profit or loss. Requiring more complex financial instruments to be accounted for in this way provides greater transparency.</p> <p>We have also developed, as part of the derecognition and consolidation proposals, enhanced disclosure requirements about risk.</p>
<p>The IASB's joint financial instruments project with the FASB should be its focus and chief priority for the balance of 2009.</p>	<p>Our work on financial instruments has had the highest priority throughout 2009, and will continue to do so to the end of the year and beyond. We have held numerous additional Board meetings to discuss the issues and reach decisions in order to meet the timetable we set out to replace IAS 39.</p> <p>Having reached agreement with the FASB on how to bring our projects together we expect to give the completion of the financial instruments project our highest priority until they are completed in 2010.</p>

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# Notes

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