6 October 2009

IASB Update

From the International Accounting Standards Board

This IASB *Update* is a staff summary of the tentative decisions reached by the Board at a public meeting. As a project progresses, the Board can, and sometimes does, modify its earlier tentative decisions. Tentative decisions do not change existing requirements until those decisions are incorporated in a new or amended standard.

The International Accounting Standards Board met in London on 6 October 2009 for an additional Board meeting to continue work on the project Financial Instruments: Replacement of IAS 39, when it discussed:

- Classification and measurement - phase 1
  - Interaction between the two classification conditions
  - Amortised cost
  - Fair value option (FVO)
  - Reflecting changes in own credit risk for financial liabilities not measured at amortised cost
  - Accounting for embedded derivatives
  - Unquoted equity instruments: elimination of cost exception
- Impairment - phase 2
  - Guidance for variable interest rates
  - Presentation and Disclosures
  - Impairment - interaction with other IFRSs (IAS 28 and IFRS 4)
- Hedge Accounting - phase 3
  - Applying cash flow hedge accounting mechanics to a fair value

Other information

- Future Board meetings
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Financial instruments: replacement of IAS 39

Classification and measurement - phase 1

The Board continued to discuss responses received to its exposure draft *Financial Instruments: Classification and Measurement* (the ED), published in July 2009.

Interaction between the two classification conditions

On 29 September 2009, the Board tentatively confirmed the proposal in the ED that classification should be based on:

- the entity's business model for managing its financial instruments; and
- the contractual cash flow characteristics of the instrument.

At this meeting the Board tentatively:

- confirmed that an instrument must meet both of these conditions to be measured at amortised cost.
- decided that the IFRS should address the business model condition first. For those instruments that meet the business model condition, the IFRS would then address the condition related to the

contractual cash flow characteristics of the instrument. The Board emphasised that the two conditions are equally important.

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Amortised cost

The ED proposed a two-measurement-category approach, which would measure financial instruments at either fair value or amortised cost. At this meeting, the Board tentatively confirmed, as it proposed in the ED, that amortised cost provides relevant and decision-useful information if both of the classification conditions are met.

The Board tentatively decided not to require fair value information on the face of the statement of financial position. In reaching this decision, the Board noted that it may explore this issue further at a later date, possibly as part of its convergence process with the US Financial Accounting Standards Board (FASB).

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Fair value option (FVO)

Following the Board's confirmation that particular instruments would be measured at amortised cost in particular circumstances, the Board also confirmed the proposal in the ED that an entity be permitted to designate an instrument at fair value through profit or loss by electing to use the fair value option, if that designation eliminates or significantly reduces a measurement or recognition inconsistency.

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Reflecting changes in own credit risk for financial liabilities not measured at amortised cost

On 29 September 2009, the Board tentatively decided that the scope of this phase of the project should continue to include financial liabilities. At this meeting the Board considered issues such as accounting for hybrid liability contracts. The Board also considered whether the re-measurement of particular financial liabilities should reflect changes in the issuer's own credit risk, in light of the responses received both to the ED and to the IASB discussion paper *Credit Risk in Liability Measurement*.

At this meeting the Board discussed specific issues relating to own credit risk for financial liabilities not measured at amortised cost. The Board tentatively decided:

- to require a frozen credit spread measurement method for all financial liabilities that are
    a. not eligible for amortised cost, but
    b. are managed as part of a contractual cash flow business model (it follows that this measurement would not apply to financial liabilities held for trading, including derivatives, and financial liabilities for which the entity uses the fair value option)
- to provide a default method to isolate the initial credit spread for relatively simple financial liabilities, but not prescribe a method.
- to require disclosures about the methods and inputs used to isolate the initial credit spread.
- to continue to require fair value disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures* for financial liabilities measured using a frozen credit spread method.

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Accounting for embedded derivatives

Following its decision to address own credit risk for financial liabilities not measured at amortised cost, the Board tentatively decided to eliminate embedded derivative accounting for hybrid contracts, if the host is within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. The entire hybrid contract would be classified under the proposed classification model.

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Unquoted equity instruments: elimination of cost exception

IAS 39 contains a cost exception for equity instruments (and related derivatives) that do not have a quoted market price, and for which fair value cannot be reliably determined. The exception requires an entity to measure these investments on a cost basis. The ED proposed to eliminate this exception.

The Board continued its discussion on the cost exception following on from discussions on 22 and 29 September 2009 and will continue these discussions at an extra meeting at a date in October 2009 to be determined.

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Financial Instruments: impairment - phase 2

Guidance for variable interest rates

The Board discussed the application of the expected cash flow (ECF) approach to variable interest rate financial assets. The Board tentatively decided to include application guidance that requires using 'catch-up' adjustments to ensure that the carrying amount of variable rate financial assets unwinds to the remaining expected cash flows. Using 'catch-up' adjustments means that when a change in estimates results in a difference between (i) the present value of the future cash flows (discounted using the effective interest rate) and (ii) the carrying amount, that difference is recognised in profit or loss.

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Presentation and Disclosures

The Board discussed presentation and disclosure requirements to accompany the proposed ECF approach in the exposure draft on impairment of financial assets.

The Board tentatively decided to propose the following presentation on the face of the statement of comprehensive income:

- interest revenue before taking expected losses into account;
- the reduction in interest revenue resulting from the allocation of initial expected losses; and
- interest revenue based on the ECF approach (the subtotal of the first two items).

The Board tentatively decided to propose presenting the gain or loss resulting from changes in expectations as a separate line item on the face of the statement of comprehensive income.

The Board tentatively decided to propose the following disclosures in the notes to the financial statements:

- provision account for credit losses (mandating the use of a provision account and prohibiting direct write-offs);
- reconciliation of the movements in the provision account;
- vintage information and loss triangle disclosures;
- details on changes in expectations (distinguishing those changes that are credit-related from those that are not credit-related);
- management's assumptions and methodology on the ECF approach; and
- explanation of the sensitivity of key assumptions and stress testing information (if an entity performs stress testing).

The Board noted that many of those disclosures would be relevant even if the Board decided ultimately to retain the existing incurred loss model.

The Board also considered ways to enhance decision-usefulness for users of financial statements regarding the credit quality of financial assets. The Board tentatively decided:

- to propose a definition for non-performing financial assets (90 days overdue);
- to propose disclosing a reconciliation in the movement of non-performing financial assets held at amortised cost.

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Interaction with other IFRSs (IAS 28 and IFRS 4)

The Board discussed the consequences of replacing the incurred loss model with the ECF approach for the requirements in IAS 28 *Investment in Associates* and IFRS 4 *Insurance Contracts*.

IAS 28 requires that after the application of the equity method, investors apply the impairment triggers under the incurred loss model in IAS 39 to determine whether it is necessary to recognise any additional impairment loss. However, no impairment triggers will exist under the ECF approach. The Board tentatively decided to use the impairment indicators in IAS 36 *Impairment of Assets* to determine whether additional impairment losses have to be recognised for investments in associates.

IFRS 4 refers to objective evidence of a loss event in its impairment testing for reinsurance assets but provides no further guidance. The Board tentatively decided that the ED on impairment of financial assets will not propose amendments to that requirement. In accordance with IAS 8 *Accounting Polices, Change in Accounting Estimates and Errors* entities consider IAS 39 for guidance on loss events because it addresses a similar issue. The Board did not believe that eliminating the impairment guidance in IAS 39 would affect entities' impairment accounting policy for reinsurance assets. The Board will discuss in its project on insurance contracts whether to amend the requirement in IFRS 4.

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Hedge Accounting - phase 3

Applying cash flow hedge accounting mechanics to a fair value hedges

In September 2009 the Board tentatively decided to replace fair value hedge accounting. This would be done by permitting recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (an approach similar to cash flow hedge accounting).

At this meeting, the Board tentatively decided to retain the existing 'lower of' test as required in IAS 39.96(a) for cash flow hedge accounting and not to extend that test to fair value hedges.

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Next steps

The Board will continue its discussions on the Financial Instruments: Replacement of IAS 39 project at an extra meeting on Friday 16 October 2009, (11am-3pm London time). However, the Board has also reserved Monday 12 October 2009 (6am-8am London time) and Thursday 15 October 2009 (11am-3pm London time) for additional sessions if required. The IASB website and IASB email alerts will provide updated information on meeting dates.

The Board tentatively expects to publish:

- a final IFRS on classification and measurement in November 2009; and
- an exposure draft on impairment in the second half of October 2009.

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Future Board meetings

The Board will meet in public session on the following dates in 2009. Meetings take place in London, UK, unless otherwise noted.

16 October

19-23 October

26-27 October *(IASB and FASB joint meeting, Norwalk USA)*

16-20 November

14-18 December

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ISSN 1474-2675