IASB Meeting Agenda reference **4**

Staff Paper Date **1 June 2009**

Project **Financial Instruments: Recognition and Measurement**

Topic **Transitional provisions**

Background

Introduction and purpose of paper

1. This paper sets out possible transition approaches to be proposed in a classification and measurement exposure draft (the 'ED'). Until the details of the classification and measurement model have been finalized, some aspects of transition cannot be decided.

2. However, this paper asks for the Board's initial views on the overall transition approach to take. This will allow the staff to focus on that approach, propose solutions to issues that arise under that approach and bring a paper back to the Board at the main June meeting that asks for decisions from the board.

3. As was discussed at the May 2009 meeting, the ED is intended to be finalised in time for use for December 2009 year-end financial statements by early adopters. This paper does not address any proposal of an effective date, but the staff would expect that the effective date and any possibility to early adopt the standard would reflect this point and the aim of the Board to complete the entire replacement of IAS 39 by 2010.

4. **The paper contains a staff recommendation set out in paragraphs 40-48.**

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Transitional provisions

5. The impact of any final standard as a result of the ED will vary according to an entity's use of financial instruments. **Experience also shows us that transition requirements should be kept as straight-forward as possible.**

6. The staff believes there are at least two alternatives in terms of transition:

   (a) retrospective application

   (b) prospective application

7. The two alternatives are discussed below. Appendix A contains a table describing how the alternatives work mechanically, and the issues that arise as a result. The Board discussion will be structured using that table.

Retrospective application

8. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires any change in an accounting policy that is required by a new IFRS to be treated retrospectively unless that new IFRS provides specific transitional provisions. Likewise, the principle in IFRS 1 *First-time Adoption of International Financial Reporting Standards* is retrospective application, although there are exceptions and exemptions made in particular situations.

9. Retrospective application means that the financial statements are prepared as if the new requirements have always been applied. This includes any comparative information. IAS 8 contains further guidance when retrospective application is deemed not appropriate or not practicable.

10. All differences between the previous amount reported and the amount determined according to the new guidance would have to be recognised in the opening balance of retained earnings (or other component of equity as appropriate) for the earliest period presented.

11. Retrospective application would result in the most relevant information to users. It provides comparable information about the entity for both current and

comparative periods and helps address (to some extent) challenges that users may have regarding historical trend information following a significant change to new accounting requirements.

12. However, retrospective application can prove to be difficult and costly to implement for preparers. In some cases, it may be impossible for entities to generate the information necessary to apply the standard retrospectively.

13. The Board could consider providing transitional relief for some of the more difficult issues. Furthermore, the Board could consider providing relief by waiving the requirement to restate comparative information (although see earlier comments regarding the value of comparative information to users). A future Board paper will address any potential transition relief that staff considers appropriate once the Board agreed to the classification and measurement model.

14. Appendix B summarises the issues described in the following sections that arise as a result of retrospective application. **In summary, the staff believes that the most significant transition issues will be created by transition from the existing, and to any new, fair value option (FVO).**

Classification and measurement

15. An entity would have to classify all financial instruments according to the new measurement categories at the date of transition. Under a retrospective application regime, this assessment would have to be done based on the circumstances that existed when the financial instrument first qualified for recognition. Depending on the classification criteria the Board decides on this will be a difficult exercise, particularly for financial instruments that were initially recognised a long time ago. Some may not like the 'backdating' effect; however, that is the consequence of retrospective application.

16. All information about financial instruments would have to be (re-)generated to comply with the new accounting requirements. This not an issue for instruments where measurement basis and presentation of gains and loss does not change. However, if the classification of items changes, an entity would be required to

recalculate any effects (including impact on opening retained earnings and comprehensive income for every period presented). This also includes any necessary disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures* and any presentation requirements in accordance with IAS 1 *Presentation of Financial Statements*.

17. If the measurement basis changes *from amortised cost to fair value* then retrospective application is feasible (although not necessarily easy), as determination of fair values for all financial instruments is already required by IFRS 7.25[1] with very limited exceptions.

18. However, a switch *from fair value to amortised cost* would require an entity to recalculate the carrying amount. This exercise includes:

    (a) retrospective determination of the EIR[2], including initial assessment of expected cash flows and identification of transaction costs

    (b) retrospective application of the impairment requirements, including identifying prior loss events for instruments, estimating incurred losses and any subsequent reversals

    (c) retrospective assessment of any changes in expected cash flows in accordance with IAS 39.AG8

19. Further, if the Board decides to remove the cost exemption for some unquoted equity instruments and related derivatives, entities would be required to retrospectively determine fair values and changes for all periods presented. Many entities will not have fair value information as such instruments are exempted from the fair value disclosures in IFRS 7.

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[1] However, anecdotal evidence shows that there are issues around the quality of fair values disclosed.
[2] EIR information would be available for AFS debt instruments. This is unlikely to be the case for debt instruments previously classified as fair value through profit or loss.

Fair value option (FVO)

20. Under the FVO in IAS 39 designation is permitted only at initial recognition of a financial asset or financial liability (with some very complicated exceptions made at the transition to the IAS 39 FVO).

21. As discussed previously, retrospective application requires an entity to classify all financial instruments according to the new measurement categories at the date of transition. Under a retrospective application regime, this assessment would have to be done based on the circumstances that existed when the instrument first qualified for recognition.

22. This means that:

    (a) financial instruments previously designated in the FVO could be required or allowed to be classified some other way, including being measured at amortized cost;

    (b) financial instruments that had not been designated under the FVO previously could now be designated under any new or amended FVO (subject to meeting the eligibility criteria, if any);

23. An important transition issue the Board will have to decide, if they choose retrospective application, is whether any exceptions should be made to retrospective application for the FVO. For example:

    (a) would entities be prohibited from reclassifying financial instruments previously designated as at fair value through profit or loss (ie, reverse the original FVO decision)?

    (b) would entities be permitted to designate any financial instruments initially recognised prior to the date of transition to the new guidance as at fair value through profit or loss (ie, use the new FVO for items already recognised)?

24. The staff reminds the Board about the significant transition problems that arose as a result of the changes to the FVO in 2005.

Hedge accounting

25. If a financial instrument that is currently measured at fair value through profit or loss (FVTPL) is measured either at amortised cost or fair value through OCI, the Board will have to decide how an entity is permitted to apply hedge accounting.

26. A hedge relationship is regarded as designated only from the date the designation criteria are met *and* documentation is in place to support this assertion.

27. For hedged items that have been carried previously at FVTPL such documentation will not be in place prior to transition as hedge accounting was not required to present the offsetting effects in profit or loss.

28. Without transition relief, hedge relationships will only qualify for hedge accounting from the date the appropriate documentation is in place. Hence any fair value changes in the hedging instrument that arose before designation will unwind over the life of the instrument and create hedge ineffectiveness.

29. If a hedge relationship no longer qualifies for hedge accounting as the hedged item under the new guidance is measured at FVTPL, guidance would have to be provided whether this is a discontinuation of a hedging relationship (similar to the approach taken in IFRS 1) or whether the entity is required to unwind the hedge accounting effects fully retrospective.

Embedded derivatives

30. The transition issues obviously depend upon Board's decisions regarding the accounting for embedded derivatives.

31. Let us assume that the requirements to assess and separate embedded derivatives remain. If an entity was to classify a hybrid contract that previously has been measured at FVTPL in its entirety as one measured at amortised cost, it would have to make an assessment whether to separate the embedded derivative. This

assessment has to be done based on the circumstances that existed at the inception of the contract (unless transitional relief would be provided[3]).

32. If an entity changes classification from an amortised cost basis or available-for-sale to a FVTPL basis, the separation would have to be reversed and the instrument would be accounted for as if it had never been separated. This will also have consequences for hedge accounting if the separated embedded derivative has been designated as a hedging instrument.

Prospective application

33. This approach would apply the new guidance to all financial instruments from the date of adopting the revisions to the financial instruments standard.

34. This would not change the accounting for any financial instrument if the measurement basis and mechanism of presenting gains and losses does not change.

35. If the measurement basis changes *from fair value to amortised cost* this switch could be implemented by requiring a reset of the measurement basis to the fair value at the date of transition (similar to the approach taken by the reclassification amendment to IAS 39 in October 2008).[4]

36. An entity would be required to determine the effective interest rate (EIR) based on the circumstances at the date of transition (compared to retrospective application, when an entity would be required to go back to initial recognition of the instrument). However, interest revenue recognition then would not be based on the contractual effective interest anymore. Market-related changes in fair value would become part of the initial EIR determined on the transition date and will unwind until maturity of the instrument. That is, revenue recognition is some mix of amortised cost and fair value.

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[3] However, providing such relief would be inconsistent with the Board's view when it issued *Embedded Derivatives (Amendments to IFRIC 9 and IAS 39)*.

[4] Alternatively, the Board could require a retrospective determination of amortised cost. However, this would, for some instruments, lead to the same difficulties as described in the previous section.

37. This blended interest rate is of less, if any, relevance for users in predicting the future cash flows of the entity, because the predictive value of amortised cost information relies on the contractual (effective) interest rate.

38. The same issues relating to hedge accounting, embedded derivatives and the fair value option will arise as is the case for retrospective application.

39. If the measurement basis switches *from amortised cost to fair value* this raises issues in particular with the discontinuation of hedge accounting and embedded derivatives. The difference between amortised cost and fair value would be recognised in profit or loss.

Staff recommendation

40. The staff recommends retrospective application of the proposed changes in accordance with IAS 8.

41. Appendix B sets out the consequences of retrospective application based on the decisions on classification and measurement to date assuming the Board agrees with the staff recommendations at this meeting.

42. The staff acknowledges that there could be significant cost involved in generating the necessary information where transition causes a change in the measurement basis for a large number of financial instruments.

43. If the accounting for embedded derivatives changes this also results in increased cost. The staff cannot provide an assessment until the Board makes a decision in this complex area.

44. However, this issue is more relevant if the measurement basis changes from fair value to amortised cost. For changes from amortised cost to fair value this should be of less importance as fair value information already has to be generated for nearly all financial instruments in accordance with IFRS 7.

45. Further, an initial assessment of the impact on financial statements based on the Board's tentative decisions for today's IAS 39 measurement categories is as follows:

(a) few, if any, held for trading instruments, loans and receivables or held-to-maturity investments will change their measurement or presentation basis

(b) some AFS debt instrument potentially will be carried at amortised cost, but amortised cost (EIR) information should already be available (for interest revenue recognition purposes); some AFS equity instruments will be carried at fair value through OCI – the impact on profit or loss from subsequent measurement is low

(c) depending on the decision the Board makes on dedesignation of any financial instruments accounted for using the FVO or designation of any existing financial instrument into a new or amended FVO the impact on financial statements can be significant

46. If an entity is unable to determine the amortised cost as required by the new standard, the entity might be able to invoke the fair value option (if one is provided) to avoid determination of amortised cost. Alternatively, the Board could require measuring the item at fair value if an entity cannot determine amortised cost (similar to the approach taken for some hybrid contracts where the entity is unable to measure separately the embedded derivative).

47. If the Board agrees with the staff recommendation, the staff will develop a paper of detailed issues that the Board may wish to consider based upon the tentative decisions made about the accounting model. These issues will include the determination of amortised cost (including impairment), the FVO, hedge accounting and embedded derivatives.

48. The staff will also propose any additional disclosures that the board might consider on transition, especially to counter the 'backdating' effect that is a consequence of retrospective application.

Questions to the Board
Does the Board agree with the approach recommended by the staff? **If not, what does the Board wish to do, and why?**

Appendix A – Impact of transition approach on specific FI topics

Issue \ Transition	Retrospective	Prospective all contracts
Classification	• Assess eligibility for classification based on the circumstances that existed when the instrument first qualified for recognition	• Assess eligibility for classification based on the circumstances that existed at the date of transition
Measurement	• Carry forward basis if measurement basis does not change • If change in measurement basis changes determine carrying amount retrospectively • EIR to be determined based on expectations at the date of inception • Information in some cases difficult to generate	• Carry forward basis if measurement basis does not change • If measurement basis changes from FV to amortised cost, FV at the date of initial application will be new cost basis • If measurement basis changes from amortised cost to FV, difference to be recognised in profit or loss
Prior year comparatives	• Restated	• Not restated (impairs comparability)
AFS instruments	• Transfer of AFS reserve to opening retained earnings, unless item qualifies for OCI treatment, restate comparative periods to include any impact on profit or loss (or OCI)	• If carried at FVTPL all changes to P+L; any amount in OCI remains until instrument is sold; alternatively, require recycling on transition • If carried at amortised cost, release any amounts using EIR
FVO	• Date of inception of contract (+interaction with original transition to FVO) • Differences between carrying amount and FV to be recognised in retained earnings	• FVO can be invoked at the date of transition (subject to eligibility criteria, if any) • All amounts from that point are recognised in P+L • Difference between carrying amount and FV to be recognised in P+L
Instruments measured at cost less impairment (IAS 39.46(c))	• Determine FV retrospectively for the periods presented • Information can be difficult to generate	• Determine FV on the date of transition • Difference recognised in P+L
Impairment and reversals	• Impairments and reversals that arose in prior periods would have to be determined to adjust the carrying amount	• Only from the date of transition

Issue \ Transition	Retrospective	Prospective all contracts
Hedge accounting	• Any changes in measurement bases might create a demand for hedge accounting • Prospective designation only, unless exception made • Ineffectiveness arises if derivative has a fair value different from zero at designation	• Any changes in measurement bases might create a demand for hedge accounting • Prospective designation only, unless exception made • Ineffectiveness arises if derivative has a fair value different from zero at designation
Embedded derivatives	• To be assessed, if necessary • Based on circumstances that existed on the date of inception of the contract • Reverse separation of embedded derivatives if new measurement basis for the hybrid contract is at fair value through profit or loss and restate any impact	• To be assessed, if necessary • Based on the circumstances that existed on inception of the contract • Reverse separation of embedded derivatives if new measurement basis for the hybrid contract is at fair value through profit or loss

Appendix B – Impact of requiring retrospective application on date of transition

= area of significant impact

New category / Current IAS 39	Fair value		Amortised cost
	Profit or loss	**Other comprehensive income**	
Held to maturity (HTM)/ Loans and receivables	• Difference between carrying amount and fair value to be recognised in retained earnings • Any hedge accounting to be terminated • Reverse split of any embedded derivatives	• N/A (only equity instruments qualify for OCI treatment and they cannot be HTM)	• No change
Available for sale (AFS)	• AFS reserve to be transferred to retained earnings • Any hedge accounting to be terminated • Reverse split of any embedded derivatives	• Equity instruments only • Amount in AFS reserve to be transferred to new reserve	• Debt instruments only • Amortised cost have to be determined (including prior periods impairments, reversals and changes in cash flow expectations • Difference between carrying amount and amortised cost to be recognised in retained earnings
Held for trading (HFT)	• No change	• Equity instruments only • Amounts recognised in retained earnings to be transferred to new reserve	• Debt instruments only • Assessment for embedded derivatives to be separated • Amortised cost have to be determined (including prior periods impairments, reversals and changes in cash flow expectations) • Difference between FV and amortised cost to be recognised in retained earnings • Possible demand for hedge accounting to be assessed

New category / Current IAS 39	Fair value		Amortised cost
	Profit or loss	**Other comprehensive income**	
Designated (fair value option, FVO)	• No change	• Equity instrument only • Amounts recognised in retained earnings to be transferred to new reserve	• Debt instruments only • Assessment for embedded derivatives to be separated • Amortised cost have to be determined (including prior periods impairments, reversals and changes in cash flow expectations) • Difference between FV and amortised cost to be recognised in retained earnings • Possible demand for hedge accounting to be assessed
Instruments measured at cost less impairment (IAS 39.46(c))	• Difference between carrying amount and fair value to be recognised in retained earnings	• Difference between carrying amount and fair value to be recognised in OCI	• N/A