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| Project | <b>Financial Instruments: Recognition and Measurement</b> |
| Topic   | <b>Consequential amendments to IFRS 1</b>                 |

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## Introduction

1. This paper discusses the required consequential amendments to IFRS 1 arising from the project to replace the classification and measurement requirements of IAS 39.
2. The recommendations in this paper take into account the Board's discussions up to and including the 5 June 2009 additional meeting. These recommendations may change, depending on decisions made by the Board during the June meeting prior to the presentation of this paper.

## IFRS 1 overview

### *Objective and core principle of IFRS 1*

3. IFRS 1 applies to entities that adopt IFRSs for the first time. The objective of this standard is to ensure that the first IFRS financial statements prepared by a first-time adopter contain high quality information that is transparent and comparable, that provides a suitable starting point for accounting in accordance with IFRSs, and that can be generated at a cost that does not exceed the benefits.
4. The core principle of IFRS 1 is full retrospective application of the version of each IFRS that is effective at the end of the reporting entity's first IFRS reporting period. If an IFRS is not yet mandatory, the entity may apply that IFRS if it permits early adoption.

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

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

Decisions made by the Board are reported in IASB *Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

*Reasons for overriding IFRS 1's core principle*

5. IFRS 1 contains a number of departures from its core principle, in the form of (compulsory) exceptions and (voluntary) exemptions. There are two main justifications for nearly all of the exceptions and exemptions that exist in IFRS 1:
  - (a) when retrospective application may be excessively difficult or may involve costs exceeding the likely benefits
  - (b) when retrospective application could involve the unacceptable use of hindsight
6. There are two departures from the core principle in IFRS 1 (one exception and one exemption) that are justified for reasons different from those listed in the previous paragraph. These relate to specific circumstances that are not relevant as a precedent for the issues discussed in this paper.
7. The argument that IFRS 1 should contain the same transitional provisions as all other IFRSs has previously been rejected by the Board because application of the transitional provisions of IFRSs would conflict with one of the primary objectives of a first-time adopter's first IFRS financial statements (achieving comparability over time). Also, transitional provisions in individual IFRSs are designed to deal with entities that are moving from an older IASB standard to a newer IASB standard. They are not intended to take into account the financial reporting needs of an entity that moves from national or other non-IASB GAAP to IFRSs.
8. The Board has also previously rejected the argument that overrides to IFRS 1's core principle are justified because they would alleviate unforeseen consequences in cases where financial statements are used to monitor compliance with a contract. In the Board's view, it is up to the contracting parties to renegotiate, or to ensure from the start that the contract is insulated from the effects of changes to accounting standards.

## Relevant parts of IFRS 1

9. There are two parts of IFRS 1 that are relevant to the proposed replacement of the classification and measurement requirements of IAS 39:

(a) *designation date option* (paragraphs 29 and D19)

The designation date option is an exemption in IFRS1 that permits the designation of financial instruments to be carried out either at the date of initial recognition, or at the date of transition to IFRSs. This designation may be into the fair value through profit or loss category (which is called the fair value option), or into the available for sale category.

(b) *various implementation guidance issues* (paragraphs IG55, IG56, IG58A, IG59 and Example 11).

These include guidance on embedded derivatives, classification and measurement of the existing categories of financial instruments, tainting and transition adjustments. Example 11 deals with the reconciliations of equity and total comprehensive income required by IFRS 1.

10. IFRS 1 also contains two other exceptions related to financial instruments. However, these deal with derecognition and hedging. The staff have examined these and are satisfied that they are not relevant to the current phase of the IAS 39 project.

11. IFRS 1's basis for conclusions contains various references to issues that are affected by the proposals to replace the classification and measurement requirements of IAS 39. However, it is not IASB practice to address consequential amendments to BC-paragraphs in its exposure drafts.

## Staff recommendations on amendments to IFRS 1

12. Appendix A contains marked up extracts from IFRS 1 which indicate the staff's detailed proposals for consequential amendments to IFRS 1.

*Designation date option*

13. IFRS 1 indicates that the Board included the designation date option because it decided that the same considerations should apply to first-time adopters as to entities that already apply IFRSs. On the face of it, this assertion contradicts the Board's previously stated rejection of the argument that IFRS 1 should contain the same transitional provisions as other IFRSs (see paragraph 7 of this paper).
14. However, if the "same considerations" referred to in IFRS 1 are *cost-benefit* considerations, there would be no contradiction, because this would be in accordance with one of the two main justifications given in IFRS 1 for departing from its core principle. Unfortunately, there is no information in either IFRS 1 or IAS 39 as to the nature of these considerations.
15. The staff propose the following course of action in response to this situation. The designation date option (with wording suitably modified) should be retained in IFRS 1 only if the Board decides that cost-benefit considerations require it. If the same option is retained in the replaced parts of IAS 39 for cost-benefit reasons, this will be persuasive in indicating that it should also be retained in IFRS 1. If the option is removed from IAS 39, it may still be retained in IFRS 1, but only if a cost-benefit analysis with first-time adopters specifically in mind indicates that this would be appropriate.
16. The marked up copy in Appendix A assumes that the option will be retained in IFRS 1.

*Implementation guidance issues*

17. The marked up copy in Appendix A deals with the relevant implementation guidance issues on the assumption that the staff's proposals on the classification and measurement of financial instruments are accepted by the Board.

*Are additional amendments necessary?*

18. In reaction to the current phase of the IAS 39 amendments project, the staff do not recommend the addition of any further departures from the core principle to IFRS 1. It is the staff's analysis that the cost-benefit and unacceptable use of

## IASB Staff paper

hindsight considerations do not support the inclusion of further departures from IFRS 1's core principle. This recommendation is also in line with the complexity-reducing objective of the IAS 39 project .

### Staff recommendations and questions to the Board

The staff recommends that the Board include the proposed consequential amendments to IFRS 1 in the financial instruments classification and measurement exposure draft.

1. Does the Board agree with the staff's recommendation? If not, what does the Board wish to do, and why?
2. Has the Board identified other possible consequential amendments to IFRS 1 that result from the changes in the classification and measurement of financial instruments? If so, what are those additional consequential amendments?

## Appendix A

- 29 An entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss ~~or a financial asset as available for sale~~ in accordance with paragraph D19. The entity shall disclose the fair value of financial assets or financial liabilities designated into ~~each~~ this category at the date of designation and their classification and carrying amount in the previous financial statements.
- D19 ~~IAS 39 IFRS X~~ permits a financial asset instrument to be designated on initial recognition as ~~available for sale or a financial instrument (provided it meets certain criteria) to be designated as a financial asset or financial liability at fair value through profit or loss (provided it meets a specific criterion)~~. Despite this requirement ~~exceptions apply in the following circumstances:~~
- ~~(a) an entity is permitted to make an available for sale designation at the date of transition to IFRSs.~~
  - ~~(b) an entity is permitted to designate, at the date of transition to IFRSs, any financial asset or financial liability as at fair value through profit or loss provided the asset or liability meets the criteria criterion in paragraph 9(b)(i), 9(b)(ii) or 11A xx of IAS 39 IFRS X at that date.~~
- IG55 When IAS 39 requires an entity to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in IAS 39 reflect circumstances at that date (IAS 39 paragraph 11). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it treats the entire combined contract as a financial instrument held for trading at fair value through profit or loss (IAS 39 paragraph 12). ~~This results in fair value measurement (except when the entity cannot determine a reliable fair value, see IAS 39 paragraph 46(e)), with changes in fair value recognised in profit or loss.~~
- IG56 In preparing its opening IFRS statement of financial position, an entity applies the criteria in ~~IAS 39 IFRS X~~ to identify those financial assets and financial liabilities that are measured at fair value and those that are measured at amortised cost based on the circumstances when the financial asset or financial liability first satisfied the recognition criteria in IAS 39. ~~In particular:~~
- ~~(a) to comply with IAS 39 paragraph 51, classification of financial assets as held to maturity investments relies on a designation made by the entity in applying IAS 39 reflecting the entity's intention and ability at the date of transition to IFRSs. It follows that sales or transfers of held-to-maturity investments before the date of transition to IFRSs do not trigger the 'tainting' rules in IAS 39 paragraph 9.~~
  - ~~(b) to comply with IAS 39 paragraph 9, the category of 'loans and receivables' refers to the circumstances when the financial asset first satisfied the recognition criteria in IAS 39.~~

- ~~(c) in accordance with IAS 39 paragraph 9, derivative financial assets and derivative financial liabilities are always deemed held for trading (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument). The result is that an entity measures at fair value all derivative financial assets and derivative financial liabilities that are not financial guarantee contracts.~~
- ~~(d) to comply with IAS 39 paragraph 50, an entity classifies a non-derivative financial asset or non-derivative financial liability in its opening IFRS statement of financial position as at fair value through profit or loss only if the asset or liability was:~~
- ~~(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;~~
  - ~~(ii) at the date of transition to IFRSs, part of a portfolio of identified financial instruments that were managed together and for which there was evidence of a recent actual pattern of short term profit taking; or~~
  - ~~(iii) designated as at fair value through profit or loss at the date of transition to IFRSs, for an entity that presents its first IFRS financial statements for an annual period beginning on or after 1 January 2006.~~
  - ~~(iv) designated as at fair value through profit or loss at the start of its first IFRS reporting period, for an entity that presents its first IFRS financial statements for an annual period beginning before 1 January 2006 and applies paragraphs 11A, 48A, AG4B-AG4K, AG33A and AG33B and the 2005 amendments in paragraphs 9, 12 and 13 of IAS 39. If the entity restates comparative information for IAS 39 it shall restate the comparative information only if the financial assets or financial liabilities designated at the start of its first IFRS reporting period would have met the criteria for such designation in paragraph 9(b)(i), 9(b)(ii) or 11A of IAS 39 at the date of transition to IFRSs or, if acquired after the date of transition to IFRSs, would have met the criteria in paragraph 9(b)(i), 9(b)(ii) or 11A at the date of initial recognition. For groups of financial assets, financial liabilities or both that are designated in accordance with paragraph 9(b)(ii) of IAS 39 at the start of the first IFRS reporting period, the comparative financial statements should be restated for all the financial assets and financial liabilities within the groups at the date of transition to IFRSs even if individual financial assets or liabilities within a group were derecognised during the comparative period.~~
- ~~(e) to comply with IAS 39 paragraph 9, available for sale financial assets are those non-derivative financial assets that are designated as available for sale and those non-derivative financial assets that are not in any of the previous categories.~~

IG58A An entity shall treat an adjustment to the carrying amount of a financial asset or financial liability as a transition adjustment to be recognised in the opening balance of retained earnings at the date of transition to IFRSs only to the

extent that it results from adopting ~~IAS 39~~ IFRS X. Because all derivatives, other than those that are financial guarantee contracts or are designated and effective hedging instruments, are classified as ~~held for trading at fair value through profit or loss~~, the differences between the previous carrying amount (which may have been zero) and the fair value of the derivatives are recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which ~~IAS 39~~ IFRS X is initially applied (other than for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

IG59 An entity may, in accordance with its previous GAAP, have measured investments at fair value and recognised the revaluation gain outside profit or loss. If an investment is classified as at fair value through profit or loss, the ~~pre-IAS 39 IFRS X revaluation gain that had been recognised outside profit or loss is reclassified into retained earnings on initial application of IAS 39 IFRS X~~. If, on initial application of ~~IAS 39~~ IFRS X, an investment in an equity instrument is classified as ~~available for sale at fair value with changes recognised in other comprehensive income~~, then the ~~pre-IAS 39 IFRS X revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses and dividends on the available for sale financial asset in other comprehensive income and accumulates the cumulative gains, and losses, and dividends in that separate component of equity until the investment is impaired, sold, collected or otherwise disposed of. On subsequent derecognition or impairment of the available for sale financial asset, the entity reclassifies to profit or loss the cumulative gain or loss remaining in equity (IAS 39 paragraph 55(b)). derecognised. When the financial asset is derecognised, the amounts previously recognised in that separate component of equity are reclassified directly to retained earnings.~~

IG63 Example 11 following this paragraph: mark up to be confirmed, after taking into account Board decisions made at the June meeting.