Project **Financial Instruments – Recognition and Measurement**

Topic **Classification – cover paper**

Introduction

Background

1. At the May 2009 IASB meeting the Board discussed the classification of financial instruments.[1] At that meeting the Board also adopted the following working premises:

   (a) **Measurement categories**. Financial instruments would be measured at either:

      (i) fair value; or

      (ii) amortised cost.

   (b) **Recognition of fair value changes**. For financial instruments measured at fair value changes in fair value should be recognised in:

      (i) profit or loss; or

      (ii) other comprehensive income (OCI) without transfers to profit or loss (ie neither impairment nor recycling of amounts on derecognition).

[1] Agenda paper 5E of the May 2009 IASB meeting.

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.

(c) **Classification**:

(i) financial instruments should be classified into the two measurement categories:

- using as the starting point the approach of the forthcoming *IFRS for Private Entities* (IFRS for SMEs)[2]; and
- amending that classification approach to reflect that it would apply to entities other than small and medium-sized entities (SMEs) with the corresponding increase in complexity of instruments, transactions and other aspects that need to be considered;

(ii) a fair value option should be available.

(d) **Reclassification**: No reclassification permitted.

Purpose of this paper

2. This paper provides the background for, and an overview of, the agenda papers regarding the classification approach for financial instruments.

3. Because the issues addressed in those papers are inextricably linked all of the staff recommendations and questions to the Board regarding classification are included in a separate paper (agenda paper 2E). This should allow board members to understand and consider all the aspects of classification, before taking decisions on any aspect of classification.

[2] See Appendix C of agenda paper 5E of the May 2009 IASB meeting (Approach 2)

Need for classification

4. Classification of financial instruments is required because of the Board's working premise of using more than one measurement category for financial instruments (ie fair value and amortised cost).

5. Classification can relate to different aspects:

   (a) type of requirement:

      (i) mandatory classifications; and

      (ii) optional classifications (designations);

   (b) point in time:

      (i) initial classifications (ie on initial recognition); and

      (ii) reclassifications (ie after initial recognition).

   This paper addresses only mandatory initial classification. The fair value option will be addressed in a separate agenda paper for a later meeting. Because of the Board's working premises there is no paper on reclassification.

Objective of classification and deriving classification criteria

6. The objective of classification was discussed in the previous paper on classification.[3] In summary, the objective of classification is to ensure that financial instruments are allocated to measurement categories in such a way that the resulting information is useful to users. That means information should assist in assessing the amounts, timing and uncertainty of future cash flows.

[3] See paragraphs 9–11 of agenda paper 5E of the May 2009 IASB meeting.

7. In order to make that objective operational classification criteria are required. At its May 2009 meeting the Board considered the following potential classification criteria:[4]

   (a) the characteristics of the financial instrument; and

   (b) the business model.

Overview of the classification approach

8. The agenda papers addressing the classification approach for financial instruments are about:

   (a) the implications of embedded derivatives for classification (agenda paper 2A);

   (b) a principles-based classification approach regarding the *characteristics* of a financial instrument (agenda paper 2B);

   (c) a discussion of details and examples that illustrate classification outcomes of the approach under item (b) above (agenda paper 2C);

   (d) the business model overlay (agenda paper 2D); and

   (e) the staff recommendations and questions to the Board regarding *all* the papers on classification covered by this paper (ie one combined recommendation and decision paper–agenda paper 2E).[5]

9. On the basis of the Board's discussion in its May 2009 meeting the classification approach will comprise two steps:

   (a) **Step 1** is an assessment of the characteristics of the financial instrument. This step determines whether a financial instrument would qualify for the amortised cost category pending the assessment of the

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[4] See also agenda paper 5E of the May 2009 IASB meeting, which includes a high level discussion of the first two criteria.

[5] See paragraph 3 above.

business model in Step 2. Financial instruments that would not qualify for the amortised cost category on the basis of their characteristics would be mandatorily classified into the fair value category (ie Step 2 would not apply). Agenda papers 2B and 2C address Step 1.

(b) **Step 2** is the business model overlay. It determines whether a financial instrument that would qualify for the amortised cost category on the basis of its characteristics (Step 1) would still have to be classified into the fair value category. Agenda paper 2D sets out the business model overlay and complements the approach used for Step 1.