



Project **Financial Instruments – Recognition and Measurement**

Topic **Classification of financial instruments – a possible approach**

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## Introduction

### **Background**

1. At the March 2009 joint board meeting the boards discussed potential characteristics for categorising financial instruments.
2. At that meeting the boards discussed the following possible classification criteria:
  - (a) characteristics of the instrument, such as cash flow variability;
  - (b) business model of the entity; and
  - (c) intent and/or ability to trade the instrument.

### **Purpose of this paper**

3. This paper starts exploring a possible approach for establishing how different types of financial instruments (both financial assets and financial liabilities) might be measured by looking at the first two potential classification criteria above. To facilitate the discussion we have included an overview of the approaches in Appendix B which will also be distributed separately at the meeting.
4. This paper largely considers, on a high level, approaches that might be used to differentiate between instruments that are remeasured in some way, and instruments that are not. However, some of the issues discussed could also form the basis for differentiating between different remeasurement methods.
5. This paper is exploratory and is intended to help the Board make decisions about measurement methods. We do not ask the Board to make any decisions on the

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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.

paper and we do not intend to prejudice any decisions the Board ultimately may make. The Board's response to this paper will also be helpful to the staff in developing recommendations for a classification approach.

6. At the next meeting the Board will discuss papers that will describe in detail possible classification approaches. Those papers will also consider whether an approach using a single criterion could be used – for example, contractual cash flow variability. The answer to that question may partly depend on the measurement methods chosen. However, from the analysis contained in this paper, it seems likely that at least two criteria will have to be considered. If that is the case, the question of which criterion should have primacy will have to be addressed. These issues are not discussed further in this paper, but will be next month. Likewise, next month we will also include application of any described approach to particular types of financial instruments.
7. This paper does not address any measurement options either at inception (fair value or cost option) or subsequently (reclassifications). These issues will be discussed at a later stage in the project.
8. Appendix A contains approaches to the classification of financial instruments identified by constituents as part of their responses to the DP *Reducing Complexity in Reporting Financial Instruments*.

### **Objective of any approach**

9. The objective of any approach that might be used to differentiate between instruments that are remeasured and instruments that are not has to be to ensure that the information presented is useful to users. Information is useful to users if it enables them to assess amounts, timing, and uncertainty of (i.e., predict) the future cash flows of the reporting entity and use the information within their valuation process to make economic decisions.<sup>1</sup>

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<sup>1</sup> This is largely consistent with the conclusions on decision-useful information in the Conceptual Framework project. If information is determined to have predictive value it usually is considered to also have confirmatory value.

10. The information provided should also be designed to avoid significant gaps between likely future (or predicted) and actual cash flows. That is, any approach should seek to avoid significant surprises.
11. In valuing entities many users attempt to predict the future cash flows of an entity (e.g., in order to apply an earnings or cash flow multiple, or a discounted cash flow valuation). Whilst there are many detailed variations of such an approach, broadly speaking any such valuation approach typically depends upon how much reliance a user believes can be placed upon a reported number to use that number as a base for projecting future cash flows. The extent of that reliance will also often determine the period over which a user will project future likely cash flows. In addition, any multiples applied to a projection of a future cash flow are typically a function of, amongst other things, the recurring nature (or predictability) of cash flows beyond those periods for which specific cash flows are projected.

### **Contractual cash flows**

12. The following discussion might be helpful in determining which instruments are not remeasured, and which instruments are remeasured in some way.
13. Many types of financial instruments have contractually specified cash flows. In fact, the existence of such cash flows is fundamental to the definition of a financial instrument. This section discusses contractual cash flows only, leaving to one side for the moment the issue of likely actual cash flows of an entity.
14. As noted previously, an important factor is that the information provided must have strong predictive value in order to be useful. By that, we mean that the accounting measure used must help a user to predict future cash flows in such a way that the predicted future cash flows are very likely to turn out to be the same or similar to the actual cash flows that eventually occur.
15. The contractual terms and conditions of some types of financial instruments lead to more than one possible estimate of the future contractual cash flows. Indeed, some types of financial instruments have a very broad range of possible contractual outcomes (e.g. many derivatives).

16. In arriving at a single number for financial reporting purposes, it is useful to consider the difference between simply measuring the contractual cash flows, and valuing that measurement of cash flows (for example, using fair value). Or, put another way, fair value and similar approaches provide a valuation overlay to approaches that simply estimate future cash flows, but do nothing else.
17. For some types of financial instruments, measurement of contractual cash flows based on initial contractual cash flows provides a useful base to users to predict the future contractual cash flows. That is, while there may be some added value to users in also valuing that measure of cash flows and including it in the single number reported in the financial statements, that value may be limited.
18. Of course, a method that measures contractual cash flows based on initial contractual cash flows means that there has to be a meaningful initial cash flow. If no such initial cash flow exists (for example, this is true for many derivatives), then such a method is not possible since the initial contractual cash flow has no or limited predictive value.
19. Furthermore, the broader the range of possible future contractual cash flows (once again, this is true many derivatives), the lower the correlation between initial contractual cash flows (if any) and future contractual cash flows. Put differently, the higher the variability of future contractual cash flows the lower is the predictive value of initial contractual cash flow information, and hence the less useful is that information to users.
20. In the situations discussed in the preceding two paragraphs, it becomes more important to start valuing the measurement of the likely contractual cash flows to arrive at the single number in the financial statements. (Of course, some users have argued for a long time that every reported number should include that valuation overlay.)
21. In summary, for instruments with a broad range of possible future contractual cash flows, it seems essential to provide a valuation of estimated future cash flows, because not doing so would result in information with no or very limited predictive value for users.

22. Of course, the question under such an approach is how much contractual variability results in information having no or limited predictive value for users. This paper does not consider that difficult issue in detail (if required, subsequent papers will), but if the Board wishes to pursue an approach based on contractual variability then such guidance will have to be developed. Some factors that could be considered when developing such guidance are:
- (a) types of financial instrument;
  - (b) extent and/or direction of variability of future contractual cash flows;
  - (c) existence or otherwise of contractual maturity (settlement) date
  - (d) nature or type of underlying variables that create variability in future contractual cash flow outcomes; and
  - (e) extent of initial investment relative to estimated future contractual cash flows ('leverage')

#### **Actual cash flows of the reporting entity**

23. The previous section discussed how and when contractual cash flows might be used as a basis for predicting future cash flows. However, in some situations, such an approach might not provide users with useful information on the actual cash flows that are likely to the entity, even for financial instruments that have a meaningful initial cash flow and only one possible future contractual cash flow outcome.
24. What are some of these non-contractual factors that might determine future actual cash flows to an entity?

#### *Credit risk*

25. Many financial instruments are exposed to the risk that the counterparty will not perform under the terms and conditions of the financial instrument, and so the contractual cash flows do not provide strong predictive value as to the actual cash flows. This is commonly referred to as credit risk.
26. If that risk is significant, then the single number that is included in the financial statements cannot simply result from an approach that only measures contractual cash flows based on initial contractual cash flows.
27. Either:

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- (a) a method that measures contractual cash flows based on an initial cash flows needs to be amended to incorporate the effects of this non-contractual risk. For example, impairment provisions for financial assets; or
- (b) a method that includes both estimated future cash flows and a valuation overlay needs to be used. For example, fair value or a remeasurement method using a discounted cash flow approach.

### *How an entity uses financial instruments*

- 28. To reiterate the theme of this paper, accounting information is useful if it enables users to estimate the future cash flow prospects of an entity in such a way that the actual cash flows to the entity are the same or similar to those predicted.
- 29. The way that an entity uses financial instruments may result in the actual cash flows to an entity being significantly different than contractually stated cash flows. Put simply, the business purpose can drive actual cash flows to an entity.
- 30. If realisation of the value of a financial instrument is expected to occur by transferring it prior to contractual maturity, contractual cash flows may have weak predictive value for a user. In fact, generally the further from contractual maturity that realisation is, the weaker that predictive value is likely to be. In such situations, some valuation of that measurement of contractual cash flows becomes important in order for a single accounting number reported in the financial statements to be of use to a user.
- 31. However, if the business purpose is to realise the financial instrument's value by way of receipt of the future contractual cash flows, then the greater the predictive value of contractual cash flows is likely to be.
- 32. This raises the question how it can be established in a non-arbitrary way that a financial instrument is held for a particular purpose. This paper does not consider this issue in detail. However, the Board will have to develop guidance on this issue if it wishes to include the business purpose of the financial instrument in a classification approach. In developing this guidance the boards should consider how the factors set out below provides users with accounting

information that helps them estimate the future cash flow prospects of an entity.

The factors could include:

- (a) business model of the entity (which could include past behaviour); or
  - (b) ability to trade a financial instrument.
33. How an entity uses financial instruments might also be considered as a possible distinction between different remeasurement methods. For example, if an entity trades financial instruments, measuring a financial instrument using fair value as defined by the Board seems to provide the most predictive information to users about the likely future cash flows to an entity. However, if an entity does not trade financial instruments, then maybe a remeasurement method other than fair value may provides better and more predictive information to users about the future likely cash flows.

### **Summary**

34. Information is useful to users if it enables them to estimate the future cash flows from a reporting entity in order to make economic decisions.
35. For some types of instruments, measurement of contractual cash flows based on initial contractual cash flows provides a useful base to users to predict the future contractual cash flows. However, if there is no meaningful initial cash flow or there is a broad range of possible future contractual cash flows, such an approach does not provide a useful base for users to predict the future contractual cash flows. In such situations, in order to have any predictive value to users, some valuation overlay to the estimation of contractual cash flows is necessary.
36. Furthermore, some non-contractual factors mean that actual cash flows to an entity may differ significantly from the contractually specified cash flows. For example, the existence of significant non-performance risk or transfer of financial instruments before contractual maturity. In such situations, in order to have any predictive value to users, some adjustment to the measurement of contractual cash flows or some valuation overlay to the estimation of contractual cash flows is necessary.

## Questions to the Board

### Questions

One possible approach discussed in this paper is contractual variability of future cash flows.

- What views do you have regarding the extent of variability of such cash flows that would determine that a remeasurement method is required in order to ensure that useful information is provided to users to allow them to predict future cash flows?
- How would you operationalise your views in any future ED?

This paper discusses some non-contractual factors that may be important in providing accounting information to users to help them determine likely actual cash flows to an entity.

- What other factors do board members consider to be important in determining likely future actual cash flows to an entity, and why?
- How would you operationalise those factors in any future ED?

The papers for next month will describe in detail possible classification approaches. Those papers will also address the issues described in paragraph 6 of this paper. In light of that work plan, what additional information or analysis do you require in order to be able to make a decision on classification approach at the July Board meeting?



## Appendix A – Constituents' proposals on classification

- A1. The discussion paper *Reducing Complexity in Reporting Financial Instruments* (DP) published in March 2008 proposed an approach to replace the existing requirements with a fair value measurement principle with some optional exceptions (approach 2). The DP asked what restrictions respondents would suggest on the instruments eligible to be measured at something other than fair value<sup>2</sup> (Question 4(a)).
- A2. The staff noted a variety of views among respondents in determining the measurement basis of a financial instrument. These included criteria that were specific to:
- (a) the reporting entity.
  - (b) the business model (purpose of the financial instrument to the entity).
  - (c) management's views (purpose of the financial instrument to the entity through the eyes of management).
  - (d) the characteristics of the financial instrument.
  - (e) the fair value of the financial instrument.

### ***The reporting entity***

- A3. A small number of respondents think that the purpose of an entity should be used to determine the measurement basis of the financial instruments it holds. These respondents believe that a cost-based measurement should be restricted to small and medium size entities (SMEs) or private entities with limited financial instruments. These respondents argued that the cost of valuing a limited number of financial instruments could exceed the benefits for small entities. One respondent also argued that measurement should be viewed as an accounting policy issue. This respondent suggested that a small entity should be allowed to elect its measurement basis for financial instruments as an accounting policy.

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<sup>2</sup> Question 4(b) of the DP further asks how instruments that are not measured at fair value should be measured. Most respondents think that the alternative measurement basis should be amortised cost. Hence, the alternative measurement basis described in this appendix is generally amortised cost.

However, the entity must justify why its selected measurement basis is appropriate and provide adequate disclosures.

***The business model***

- A4. Many respondents think that the business model of an entity must be considered in determining the measurement basis of financial instruments it holds. These respondents believe that a distinction should be made between financial instruments that are held to be traded and those that are held for operating purposes ie borrowings or hedging. Financial instruments that are held for trading should be measured at fair value while those held for operating purposes (generally to maturity) should be measured at cost. For example, a cost based measurement is appropriate under a business model that *relies* on cash flows that relate to the instrument until their maturity and a fair value measurement basis is appropriate under a business model that *relies* on the value of the instruments either as a primary or secondary factor considered in whether to hold the instrument.

***Management's views***

- A5. Closely associated with the business model view is the view that management's views should be considered in determining the measurement basis of a financial instrument. Several respondents believe that the notion of management *intent* ie how management intends to realise the cash flows of a financial instrument (eg by trading it or holding it to maturity) or how the financial instrument is managed (eg on a fair value basis) should determine a financial instrument's measurement basis. Some respondents suggested the notion of management *expectations* ie what cash flows management expects to realise.

***The characteristics of the financial instrument***

- A6. The DP discusses eligibility for cost-based measurement might depend on the variability of a financial instrument's cash flows. Financial instruments with highly variable future cash flows might be required to be measured at fair value whereas instruments with fixed or slightly variable cash flows might be eligible

for cost-based measurement (paragraph 2.19 of DP). Some respondents were supportive of this approach commenting that it is an objective approach that prevents management biases. However, other respondents questioned whether the approach is operational. These respondents argued that it is difficult to distinguish between highly variable, variable, slightly variable and so on. These respondents believe that extended guidance would be required. Moreover, some respondents suggested a more restrictive approach where eligibility for cost-based measurement is only applicable for financial instruments with fixed cash flows eg debt with fixed interest rates.

- A7. Some respondents think that a financial instrument's measurement basis should be dependent on its definition. For example, some respondents believe that all debt instruments or loans and receivable should be measured at amortised cost and all derivatives measured at fair value.
- A8. Some respondents think the 'tradability' of an instrument should determine its measurement basis. Unlike respondents that support the notion of management intent ie whether management intends to trade the instrument, these respondents focus on the entity's ability to trade the instrument. The tradability of an instrument would depend on whether or not there is an active market for the instrument (this relates to the following discussion about the fair value of the instrument). However, tradability also depends on other factors such as legal or other external restrictions eg compliance with liquidity requirements.

***The fair value of the financial instrument***

- A9. Several respondents think that if fair value were the measurement principle, exceptions should only be permitted when:
- (a) it is not feasible or difficult to obtain the fair value for the financial instrument, for example when:
    - (i) a market for the financial instrument ceases to or does not exist

- (ii) a market for the financial instrument ceases to be active ie there is not quoted market price for the financial instrument
  - (iii) there is little (if any) market activity ie valuation is based on Level 3 inputs
- (b) the fair value does not provide more better information than cost, for example when:
  - (i) fair value is not a faithful representation of the assets/liabilities underlying cash flows of the financial instrument
  - (ii) fair value does not help predict future cash flows
  - (iii) no appropriate fair value can be identified for the financial instrument ie where fair values cannot be reliably measured or calculated

A10. One respondent suggested a combination of both the above notions ie when fair value does not differ substantially from cost and when obtaining fair value would be complicated eg for high volumes of transactions for accounts receivables that have a short term cash flow that is not expected to fluctuate.

A11. In addition, some respondents suggested a combination of several different criteria. For example, fair value should be required only for financial instruments that (i) cannot have another outcome than being traded or (ii) where management expects to settle them through trading, or (iii) whose outcome depends on market changes alone.

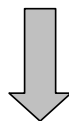
A12. Moreover, several respondents expressed particular concerns about financial liabilities. These respondents think that optional exceptions need to include financial liabilities that are neither managed nor evaluated on a fair value basis ie financial liabilities such as borrowings entered into for the purpose of providing capital and not for trading. Some respondents also highlighted issues in fair valuing financial liabilities.

***Users' views***

A13. Several users were supportive of approach 2 proposed in the DP as an intermediate solution. Most user respondents did not proposal specific restrictions for instruments to be measured on a basis other than fair value. Instead, these respondents highlighted some of the issues relating to fair value ie market liquidity issues. Some user respondents were concerned about management biases and were opposed to the notion of management intent and reclassification. Moreover, users believe that disclosures are important to understanding a financial instrument's measurement basis.

Appendix B – Predictive quality of contractual cash flows

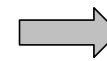
| Contractual cash flows (CCF)  |  |
|---|--|
| One possible or a narrow range of possible contractual CF outcomes<br>• Initial CF highly correlated with actual CF | Broad range of possible contractual outcomes<br>• Initial CF weakly or not correlated with future cash flows<br>• Low predictive value of CCF given broad range of possible outcomes |

 Factors that may affect predictive value

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|--|
| Realisation other than through receipt of contractual cash flows         |
| Significant non-performance risk of contractual cash flows (credit risk) |



- Business purpose, including ability to trade an instrument



- Adjust expected cash flows, or
- Use other current value measurement methods



Contractual cash flows have low or no predictive value

## Appendix C – Possible approaches to classification for financial assets, as a starting point

- A1. This paper considers, at a high level, approaches that might be used to differentiate between instruments with contractual cash flows that are remeasured in some way, and instruments that are not. The paper considers contractual cash flow variability, and the factors that may affect the predictive quality of such contractual cash flows.
- A2. Essentially, there is a spectrum of cash flow variability ranging from very straightforward instruments with little or no cash flow variability and little risk of non-performance (for example, US Treasury bonds) through to instruments that include features that create significant possible contractual cash flow variability (and possibly also include significant risk of non-performance).
- A3. It is important to understand the difference between cash flow variability and fair value volatility. This paper is about cash flow variability. For example, caps, floors and collars reduce the variability of cash flows but they result in increased fair value volatility for the hybrid contract. To illustrate: a variable benchmark<sup>3</sup> rate loan with frequent rate resets is subject to only insignificant fair value interest rate risk. However, if that loan included an interest rate cap it would be subject to potentially significant fair value interest rate risk because if the benchmark interest rate moved above the cap's strike rate then the loan would bear below market interest, similar to a fixed rate loan.
- A4. Because of the various degrees and aspects of cash flow variability, any decision about where to draw the line for classification is judgemental. Consequently, determining and describing the extent of cash flow variability that is the cut-off between different measurement categories is challenging. A similar issue exists already today regarding the definitions of categories that are subject to amortised cost accounting (ie loans and receivables, and held-to-maturity).
- A5. Three possible classification models have been suggested by board members as **a possible starting point** to determine a classification approach between fair

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<sup>3</sup> For the sake of simplicity the example only looks at the interest rate variability and the fair value interest rate risk in relation to the *benchmark* interest rate.

value and amortised cost for financial assets. Each approach would have to be refined and developed further, should the boards wish to pursue any of the approaches.

- A6. These approaches are set out below. Each approach is inconsistent, to a lesser or greater extent, with the principal focus of this paper, namely cash flow variability.

**Approach 1 – approach used in IAS 39, as a starting point**

- A7. Amongst other criteria, IAS 39 uses a ‘fixed and determinable payments’ and ‘fixed maturity’ to define the amortised cost categories today (held-to-maturity and/or loans and receivables’ categories). In addition, loans and receivables includes a notion that the holder should recover substantially all its initial investment, other than because of credit deterioration.
- A8. This cut-off could be implemented quickly by drawing on existing practice. However, the assessment of what is ‘determinable’ requires significant judgement, with some resulting diversity in practice.
- A9. It is also important to note the interaction with existing requirements with the accounting for embedded derivatives – as embedded derivative features in hosts are required to be separately accounted for if the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (assuming that the combined contract is not measured at fair value). That is, the IAS 39 criteria for separation of embedded derivatives does not use a ‘fixed and determinable’ approach. Similarly, the ‘fixed and determinable’ criteria does not have to address the classification of any separated derivatives.

**Approach 2 – approach used in IFRS for Small and Medium-sized Entities, as a starting point**

- A10. Section 11 will require a historic cost model for all basic financial investments.
- A11. Basic financial instruments will be defined in paragraph 11.8 and 11.9 of the final documents (extract below).



- 11.8 An entity shall account for the following financial instruments as basic financial instruments in accordance with Section 11:
- (a) cash.
  - (b) a debt instrument (such as an account, note, or loan receivable or payable) that meets the conditions in paragraph 11.9.
  - (c) a commitment to receive a loan:
    - (i) that cannot be settled net in cash, and
    - (ii) when the commitment executed, the loan is expected to meet the conditions in paragraph 11.9.
  - (d) an investment in non-convertible preference shares and non-puttable ordinary shares or preference shares.
- 11.9 A debt instrument that satisfies all of the conditions in (a)–(d) below shall be accounted for in accordance with Section 11:
- (a) Returns to the holder are
    - (i) a fixed amount;
    - (ii) a fixed rate of return over the life of the instrument;
    - (iii) a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR); or
    - (iv) some combination of such fixed rate and variable rates (such as LIBOR plus 200 basis points), provided that both the fixed and variable rates are positive (eg an interest rate swap with a positive fixed rate and negative variable rate would not meet this criterion). For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal amount outstanding during the period.
  - (b) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.
  - (c) Contractual provisions that permit the issuer (the debtor) to prepay a debt instrument or permit the holder (the creditor) to put it back to the issuer before maturity are not contingent on future events.
  - (d) There are no conditional returns or repayment provisions except for the variable rate return described in (a) and prepayment provisions described in (c).

### **Approach 3 – Asset origination-focused approach, as a starting point**

- A12. The presumption of this approach is that fair value through profit or loss is the conceptually correct approach for all financial instruments. However, to the extent that any financial assets are not permitted or required to be measured at fair value, the criteria for such assets should be focused on whether or not the

entity originated the assets, and hence in all likelihood has a comprehensive understanding of the risk of non-performance at initial recognition.

- A13. Under such an approach, trade receivables and originated loans would be permitted or required to be measured using amortised cost. The term ‘originated’ would include such assets acquired as a result of a business combination.
- A14. All other types of financial assets would be measured using fair value through profit or loss. A fair value option would also allow items eligible for amortised cost measurement to be measured at fair value.