Project: **Financial instruments – Replacement of IAS 39**

Topic: **Classification and measurement: summary of decisions to date**

Introduction

1. At meetings in September and October the Board re-deliberated the topics in the exposure draft *Financial Instruments: Classification and Measurement*.
2. **The purpose of this paper is to summarize the decisions that the Board has made to date. In other words, this paper provides an overview of the Board's new classification and measurement approach for financial instruments.**
3. This paper does not summarize the Board's decisions on the associated presentation and disclosure requirements.
4. We are **not** attempting to draft the IFRS in this paper.

The approach

Two classification conditions

5. At initial recognition, all financial assets and financial liabilities (**including hybrid contracts with financial hosts**) are measured at fair value and are classified on the basis of:

   (a) the entity's business model for managing its instruments; and

   (b) the contractual cash flow characteristics of the instrument.
6. A financial asset or liability is subsequently measured at amortized cost only if the objective of the entity's business model is to hold the instruments to collect

(or pay) the contractual cash flows **and** the instrument's contractual cash flows represent payments of principal and interest.

7. All other instruments are subsequently measured at fair value, except particular financial liabilities, which are measured at adjusted fair value as discussed below.

Financial liabilities

8. Financial liabilities must be subsequently measured at adjusted fair value if they:

   (a) are not eligible for amortized cost (on the basis of their contractual cash flow characteristics); but

   (b) the objective of the entity's business model is to hold them to pay the contractual cash flows.

9. That adjusted fair value amount is a current measurement that excludes changes in the entity's own credit risk. It is computed by determining the credit spread at initial recognition and "freezing" it. Subsequent measurement reflects changes in all **other** market risks.

10. Based on the eligibility conditions, this measurement attribute does not apply to financial liabilities that are held for trading (including derivatives) or financial liabilities that are designated under the fair value option.

Application of the two classification conditions to particular instruments

Contractually linked instruments (tranches)

11. The issuer and holder of contractually linked instruments **separately** assess the classification criteria. They do not have the same unit of account; thus, they do not necessarily have symmetrical accounting.

12. The issuer performs an assessment on the basis of its **overall obligation.**

13. In contrast, the investor's unit of account is the **individual instrument** in a particular tranche. To classify that individual instrument, the investor must use a "look through" approach to assess the characteristics of the underlying instruments and the individual instrument's exposure to credit risk relative to the pool of underlying instruments. To measure an individual instrument at amortized cost, the underlying pool must only contain instruments that:

(a) have basic loan features;

(b) change the cash flow variability of the instruments with basic loan features in accordance with the "basic loan features criterion"; and/or

(c) align the cash flows of the issued instruments with the instruments with basic loan features in the underlying pool.

14. If it is impracticable to look through, fair value measurement is required.

Investments in equity instruments

15. All investments in equity instruments, including unquoted equity investments, will be subsequently measured at fair value.

Financial assets acquired at a discount that reflects incurred credit losses

16. The fact that an asset is acquired at a discount that reflects incurred credit losses does not in itself disqualify it from being measured at amortized cost. Such instruments can meet the conditions discussed in paragraph 6.

Reclassification

17. Reclassification is required between the fair value category and the other categories if the entity's business model for managing its instruments changes. Such a change is expected to be very infrequent, if ever.

18. Reclassification is prohibited in all other circumstances.

Fair value option

19. An entity may make an irrevocable election on initial recognition to measure a financial asset or financial liability at fair value through profit or loss if that designation eliminates or significantly reduces an accounting mismatch.

Presentation exception for particular equity investments

20. At initial recognition of particular equity investments, an entity may make an irrevocable election to present changes in the fair value of those investments in other comprehensive income (OCI). This exception is available to any equity

investment (on an instrument-by-instrument basis) that the entity does not hold for trading purposes.

21. There is no subsequent “recycling” of the amounts presented in OCI to profit or loss. Dividends on these investments are recognized in profit or loss.