IASB Meeting Agenda reference **12E**

Staff Paper Date **21-22 Oct 2009**

Project **Financial Instruments: Replacement of IAS 39**

Topic **Exposure draft *Financial Instruments: Classification and Measurement* – Transition**

Purpose of this paper

1. **This paper discusses the proposals on transition and related disclosures in the exposure draft ('the ED') *Financial Instruments: Classification and Measurement*.**
2. To meet this objective the paper provides:
   (a) an overview of the proposals in the ED
   (b) comments received from respondents to the ED and from participants in our outreach programme
   (c) effect of decisions made during redeliberations on the ED
   (d) staff proposals on transition.
3. **We will ask separate questions on each transition proposal.**

Overview of the proposals in the ED

4. The ED, in general, proposed retrospective application of the new IFRS in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. (For your convenience, the transition proposals are replicated in the appendix).

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.

5. However, the ED proposed some exceptions for situations in which full retrospective application was considered burdensome, impractical or only possible using hindsight.

6. In summary, the exceptions to full retrospective application were as follows:

   (a) the criterion of 'managed on a contractual yield basis' is to be assessed based on the facts and circumstances that existed on the date of initial application (the accounting consequences would, however, have to be applied retrospectively)

   (b) hybrid contracts that are required to be measured at fair value. If fair value for the entire contract had not been determined in comparative periods, the sum of the fair values of the separated components is to be used to restate comparative periods. At the date of initial application fair value of the entire hybrid is to be determined. If the date of initial application is a beginning of a reporting period the difference between the sum of the fair values of the components (as determined at the date of initial application) and the entire fair value is to be recognised in the opening retained earnings. If the date of initial application is not the beginning of a reporting period any difference is recognised in profit or loss

   (c) the qualifying criteria for the fair value option are to be assessed based on the facts and circumstances that existed at the date of initial application (the accounting consequences would, however, have to be applied retrospectively)

   (d) an entity may designate or has to revoke an equity instrument not held for trading at fair value through other comprehensive income (OCI) based on the facts and circumstances that existed at the date of initial application (the accounting consequences would, however, have to be applied retrospectively)

   (e) if determination of either effective interest rate or impairment is impracticable for items classified at fair value prior to transition, the

new carrying amount and any restated amount are to be based on fair value

(f) for an investment in an unquoted equity instrument (or related derivative) measured at cost (less impairment) prior to transition any difference between carrying amount and fair value at the date of initial application is to be recognised in the opening retained earnings of the period of initial application

(g) any hedge accounting relationship that no longer qualifies under the new classification model is to be accounted for as a discontinuation of hedge accounting in accordance with IAS 39

(h) prior period interim financial reports do not have to be restated if impracticable.

Comments received from respondents

7. The ED asked the following two questions:

   (a) **Question 12:** Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

   (b) **Question 13:** Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

8. Most respondents agreed, **in principle**, with requiring retrospective application.

9. However, many questioned the practicability of such an approach.

10. In addition, many noted that the extensive exceptions to retrospective application that would be required to make such transition practicable significantly reduced (and possibly eliminated) any benefit that users might obtain from requiring comparative information to be restated.

11. A few respondents favoured prospective application. Many other respondents proposed an approach similar to that used when entities adopted the current version of IAS 39 in 2005 (see below).

12. The specific reasons for disagreeing with the ED transition proposals included:

    (a) retrospective application, especially the restatement of comparatives, would be a significant undertaking and is overly burdensome for any benefits gained (see further comments below) for investors

    (b) in many cases retrospective application will be impracticable (or even impossible). In addition, hindsight will have to be used in many circumstances. This would result in retrospective application not being applied in practice.

    (c) due to the multiple exceptions necessary for retrospective application to be practically feasible, the usefulness of restated information will be significantly reduced and such restated information might even mislead investors

    (d) the guidance is unclear whether items that are already derecognised at the date of initial application have to be restated

    (e) hedge accounting cannot be retrospectively applied, but the classification consequences have to be which might lead to an accounting mismatch that can only be prospectively resolved.

13. Further, many commentators were unclear about the meaning of 'date of initial application'. Some believed that this could be an arbitrary date between the date of issue (or even earlier) of the final guidance and the mandatory effective date, resulting in a loss of comparability over a long period of time. Such commentators suggested that the date of initial application should always be the beginning of a reporting period, with some relief for those entities early adopting in 2009.

14. Others asked for the opportunity to grandfather the IAS 39 accounting for hybrid contracts with financial hosts if the Board were to finalise its proposals on accounting for embedded derivatives.

15. Respondents also had comments on the proposed disclosures.

16. Further, some were concerned over the possible implications of a multi-step transition to a comprehensive replace of IAS 39. In particular, whether early adoption of one phase leads to mandatory adoption of any subsequent phase and whether any decisions made when adopting earlier phases can be revisited when later phases are finalised.

17. **Overall, the area that most respondents expressed concerns was the restatement of comparatives. Some of the issues raised by constituents like restatement of derecognised items or overall comparability are linked to this concern.**

Effect of decisions made during redeliberations on the ED

18. The main decision that may have a possible effect on transition requirements is the decision to measure some financial liabilities at fair value but adjusted for changes in credit risk.

19. The subsequent questions that arise for transition are:

    (a) when to determine the credit spread to be frozen; and

    (b) the impact of the extension of the transition provision for the ‘managed to collect (pay) contractual cash flows’ criterion to identify instruments qualifying for this measurement (see paragraph 6(a))

20. This issue is discussed further in paragraph 40.

Staff proposals on transition

21. The staff continues to believe that retrospective application is the most useful approach for transition to any new guidance. However, the Board should consider the cost and timing implications, as well as the comparability concerns.

22. We do not intend to fully discuss all aspects of transition. Many of these can be found in previous agenda papers discussed during the deliberations of the ED[1].

23. Instead the following paragraphs address specific concerns raised in the comment letters and during the outreach programme. We will ask a question to the Board at the end of each section.

Date of initial application

24. We agree with the comments received that the date of initial application should be clarified. This is particularly important because of the extended transition period being considered (see agenda paper 12D of this meeting).

25. The date of initial application is the date at which an entity applies the classification and measurement criteria of the new IFRS to its financial instruments. We recommend clarifying this.

26. We agree with respondents that the date of initial application should be the beginning of the reporting period in which an entity first applies the new requirements. However, we think also that this date has to address the Board's objective that the new requirements are available for those entities that wish to apply the new guidance in 2009 financial statements. In addition, entities that want to adopt the new guidance on classification and measurement should also be enabled to make the transition for their 2010 financial statements – the time between issue of the final guidance and the beginning of a 2010 annual period might not be sufficient to determine the classification or entities want to see the

[1] In particular agenda paper 4 of the 1 June 2009 meeting and agenda paper 3C of the June 2009 main meeting.

proposals on other phases of the project to replace IAS 39. So it would facilitate transition if for reporting periods starting 2009 and 2010 an entity can use a date that is different from the beginning of a reporting period.

27. **The staff recommends in the date of initial application is clarified as follows:**

"The date of initial application is the date when an entity first applies the requirements of this IFRS. If an entity adopts this IFRS for reporting periods beginning on or after 1 January 2011 the date of initial application shall be the beginning of the reporting period. If an entity adopts this IFRS for reporting periods beginning before 1 January 2011 the date of initial application can be any date between the issue of this IFRS and 31 December 2010. If an entity applied the guidance in this IFRS at a date of initial application that is not the beginning of a reporting period it shall disclose this fact and the reasons for using that date of initial application."

Date of initial application
Does the Board agree with the recommended definition of the date of initial application? If not, why and what does the Board wish to do, and why?

Retrospective application and comparative information

28. Many noted that, while full retrospective application theoretically renders the most useful information, this will be difficult to apply. Many, including users, were also concerned that due to the inevitable exceptions to full retrospective application any restated information is incomplete and may actually not help in informing users about performance in comparative periods and trend analysis.

29. One approach favoured by many was to waive the requirement to provide comparative information. Under this approach all effects from adopting the new guidance would be reflected in the opening retained earnings of the period of transition. Clearly, disclosures would be required to supplement this.

30. Many respondents noted this approach had been used on the first time adoption of IFRS. They stated that entities had put significant effort into explaining the effects of the changes by explaining the adjustments, and the effects of the adjustments, to opening retained earnings. It was stated that as a result of this approach users had understood the changes well.

31. Some also believe that such an approach would address the concerns that, while IAS 1 *Presentation of Financial Statements* only requires at a minimum one year of comparative information, the legal and regulatory frameworks in many jurisdictions require more comparative periods to be presented. For example, five years in some cases. In these situations, the restatement of comparatives would essentially be impossible for an entity wishing to early adopt.

32. The staff agrees that the inevitable exceptions to full retrospective application significantly degrade the value of comparative information to users.

33. The staff believes that waiving the requirement to restate comparatives strikes the right balance between the conceptually appropriate concept of full retrospective application (as stated in IAS 8) and the practicability of adopting the new classification model within a short timeframe (ie 2009/10). This also is reflective of concerns expressed by many about cost/benefits. However, the Board should also permit entities to fully restate their comparatives.

34. We believe such an approach, in combination with the approach to the date of initial application, would also address the issue raised by many respondents with regard to derecognised items. This is a significant issue for many entities – particularly if they are having to restate 5 years of comparatives – and the Board would specifically have to address this issue if it requires comparative restatements.

35. An approach of not requiring comparatives on adoption would address this issue as information has to be restated only in the period of adoption.

Retrospective application and comparative information
Does the Board agree with the staff recommendation not to require, but to permit, restatement of comparative periods? If not, why and what does the Board wish to do, and why?

Impracticability of retrospective application

36. Some asked the Board to consider whether entities should be permitted, but not required, to deem fair value at the date of initial application as the new amortised cost.
37. The staff thinks that these commentators believe that 'impracticable' is a very high threshold that can virtually never be met.
38. We think while this would undoubtedly ease the pain of transition, it would also impair comparability and require significant guidance about when such an option should be permitted.
39. **Hence, we recommend finalising the guidance on impracticability of retrospective application as proposed.**

Impracticability of retrospective application
Does the Board agree with the staff recommendation to finalise the guidance on impracticability of retrospective application as proposed in the ED? If not, why and what does the Board wish to do, and why?

Frozen credit spread measurement

40. The Board has decided to require an adjustment to fair value for some financial liabilities.
41. This raises the question how this frozen credit spread measurement should be reflected on transition.
42. We think it is difficult to retrospectively determine the credit spread on issue, in particular for financial liabilities that an entity has had in issue for an extended period.
43. **Hence, we recommend requiring identification of the credit spread on the date of initial application and keeping it constant from that point onwards for financial liabilities that would be measured using a frozen credit spread measurement.**
44. If the date of initial application is different from the beginning of an accounting period, an entity should use the spread determined at that date to determine the adjustment necessary to restate the opening retained earnings of the period of transition.

Liabilities measured using an adjusted fair value
Does the Board agree with the staff recommendation to require determination of the credit spread at the date of initial application for items measured using a frozen credit spread measurement and use that spread to restate the opening retained earnings of the period of transition? If not, why and what does the Board wish to do, and why?

Grandfathering of bifurcation accounting

45. Some asked that the accounting for hybrid contracts for which the embedded derivative was accounted for separately under existing IAS 39 be allowed to be grandfathered. Under the new IFRS, such contracts in their entirety might be required to be measured at fair value or an adjusted fair value.

46. **We recommend providing an option to grandfather hybrid contracts with financial hosts that were bifurcated under existing IAS 39. This would be an accounting policy choice and would have to be applied consistently for all hybrid contracts.**

47. An entity should disclose the fact that it used the grandfathering option and disclose, per class of financial instruments affected (both for the host contract and the embedded derivative(s))**:**

    (a) the impact of these contracts on profit or loss (including in which line items gains and losses have been included)

    (b) carrying amounts

    (c) fair values

    (d) disposals.

48. In the view of the staff, this would enable users to assess the impact of that accounting policy choice.

Grandfathering of bifurcation accounting
Does the Board agree with the staff recommendation to permit grandfathering the accounting for hybrid contracts with financial hosts, including the proposed disclosures? If not, why and what does the Board wish to do, and why?

Hedge accounting provisions

49. Some noted that the provisions for discontinuance of hedge accounting relationships that do not qualify under the new classification model would be effectively a nullset.

50. They noted that a cash flow hedge would generally not be impacted by the measurement attribute of the hedged item. (One commentator noted that only a hedge of the forecasted sale of an equity instrument measured at fair value through other comprehensive income (that today was an available-for-sale investment) could potentially be affected[2]).

51. For fair value hedges the measurement of the hedged item might or might not change. Going forward there will be measurement either at the old measurement basis or at fair value through profit or loss. In the first scenario, hedging relationships are still valid. In the latter case, both the hedged item and the hedging instrument will be measured at fair value through profit or loss and will offset in the income statement. Hedge accounting is not required.

52. **Hence, the staff recommends removing the provision in paragraph 31 of the ED.**

Hedge accounting provisions
Does the Board agree with the staff recommendation to remove the provision in paragraph 31 of the ED? If not, why and what does the Board wish to do, and why?

[2] The staff thinks in this case the cash flow hedge reserve should be restated as if the hedge never existed, ie not as a discontinuation of the hedge.

Transition disclosures

53. Some highlighted the usefulness of the disclosures required for early adopters and asked whether this requirement should be expanded to all entities adopting the new guidance (see agenda paper 12D).

54. Other asked the Board to instead require disclosures based on those required in IFRS 1 *First-time Adoption of IFRSs* to explain the transition. IFRS 1.24 requires the following reconciliations that would be relevant to the new guidance[3]:

"

(a) reconciliations of its equity reported in accordance with previous GAAP to its equity in accordance with IFRSs for both of the following dates:

 (i) the date of transition to IFRSs; and

 (ii) the end of the latest period presented in the entity's most recent annual financial statements in accordance with previous GAAP.

(b) a reconciliation to its total comprehensive income in accordance with IFRSs for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income in accordance with previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.

(c) if the entity recognised or reversed any impairment losses for the first-time in preparing its opening IFRS statement of financial position, the disclosures that IAS 36 Impairment of Assets would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRSs."

55. The proposed disclosures in the ED were:

"If an entity applies [draft] IFRS X for an earlier period, it shall apply the

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[3] Of course, the terminology would have to be amended.

amendments for that earlier period and disclose for each class of financial assets and financial liabilities at the date of initial application:

(a) the original measurement category and carrying amount determined in accordance with IAS 39;

(b) the new measurement category and carrying amount determined in accordance with [draft] IFRS X;

(c) the amount of any financial assets or financial liabilities designated as at fair value through profit or loss that have been reclassified in accordance with paragraph 9 of [draft] IFRS X, and their original measurement basis and presentation method;

(d) the amount of any financial assets or financial liabilities that were previously designated as at fair value through profit or loss that are no longer so designated, distinguishing between those that [draft] IFRS X requires to reclassify and those that an entity elects to reclassify."

56. We think that both sets of disclosures are useful in their own right. The disclosures proposed in the ED focused on the movements between the categories and their effects on the carrying amounts.

57. IFRS 1 makes clear that it is concerned with first-time adoption, not with changes in accounting policies – this is the scope of IAS 8. The staff agrees and emphasises that IAS 8.28 requires disclosures to describe the effects on the primary financial statements anyway.

58. Comments received that noted requiring disclosures in addition to the disclosures required by IAS 8 would be burdensome and an impediment to early adoption are, in the view of the staff, ill-founded. In fact, the information necessary to generate the disclosures must be readily available to the entity to generate the necessary journal entries on transition and account for the instruments going forward.

59. **The staff recommends finalising the disclosures as proposed in the ED (subject to drafting changes).**

Transition disclosures
Does the Board agree with the staff recommendation to finalise the proposed transition disclosures? If not, why and what does the Board wish to do, and why?

Transition to other parts of the IAS 39 replacement project

60. Some respondents asked whether the Board intended to require early adopters of the classification and measurement IFRS to also early adopt some or all final guidance from the subsequent phases of the project to replace IAS 39. They noted that not doing so could result in a number of permutations of adoption (eg an entity could early adopt the classification and measurement guidance, but not any new impairment provisions).

61. However, due to the phased approach agreed by the Board some parts will not be issued as final guidance or EDs when other final guidance is issued and available for early adoption. Requiring early adoption of other phases if an entity early adopts the classification and measurement guidance in the view of the staff is unjustified and a potential impediment to early adoption.

62. **Hence, we recommend to not requiring early adoption of any finalised guidance subsequently if an entity wishes to early adopt any of the phases.**

63. However, we think if an entity wishes to early adopt any of the subsequent guidance of the project to replace IAS 39 (eg impairment) early it should be required to early adopt any preceding final guidance. This does reduce the permutations of adoption available.

Transition to other parts of the IAS 39 replacement project
Does the Board agree with the staff recommendation not to require early adoption of subsequent guidance if an entity early adopted any previous guidance? If not, why and what does the Board wish to do, and why? Does the Board agree with the staff recommendation to require early adoption of any preceding final guidance if any subsequent guidance is early adopted? If not, why and what does the Board wish to do, and why?

Transition relief for future phases

64. Some commentators noted that once the other phases of the project to replace IAS 39 are issued they would prefer to have the ability to reconsider any decisions made for any preceding guidance they have early adopted. Those commentators generally preferred the final IFRS to state that an entity can reconsider it classification and measurement decisions in light of the subsequent guidance.

65. The staff notes that this issue should be addressed by any subsequent guidance in the light of the decisions made by the Board at that point in time. We think it is not appropriate for this standard to provide a blanket relief – in particular as early adoption is voluntary. An entity can adopt the comprehensive replacement of IAS 39 in one package.

66. **Hence, we recommend that the final guidance on classification and measurement remains silent on the point of potential transition relief.**

Transition relief for future phases
Does the Board agree with the staff recommendation that the final IFRS remains silent on potential transition relief for future phases of the project to replace IAS 39? If not, why and what does the Board wish to do, and why?

Confirmation of other decisions on transition

67. **The staff recommends finalising all other transition provisions and disclosures as proposed in the ED subject to drafting changes.**

Confirmation of other decisions on transition
Does the Board agree with the staff recommendation to finalise all other transition provisions and disclosures as proposed in the ED? If not, why and what does the Board wish to do, and why?

Appendix A – Transition provisions from the ED

24 An entity shall apply this IFRS retrospectively, subject to the transitional provisions in paragraphs 25–33, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. For the purposes of the transitional provisions in paragraphs 25–33, the date of initial application is the date when an entity first applies the requirements in this IFRS.

25 An entity shall assess whether a financial asset or financial liability meets the condition in paragraph 4(b) on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively.

26 If a hybrid contract is required to be measured at fair value in accordance with paragraph 5 but the fair value of the hybrid contract had not been determined in comparative periods, the entity shall measure the hybrid contract in the comparative periods using the sum of the fair value of the components (ie the host and the embedded derivative) at the end of each comparative period presented. At the date of initial application, the entity shall measure the hybrid contract in its entirety at fair value. Any difference between that measurement at the date of initial application and the sum of the fair values of the components at the date of initial application shall be recognised in the opening retained earnings of the reporting period of initial application if this IFRS is applied initially at the beginning of a reporting period and in profit or loss if this IFRS is applied initially during a reporting period.

27 An entity may designate a financial asset or financial liability as at fair value through profit or loss in accordance with paragraph 9. Such designation shall be made on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively.

28 An entity may designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 21. Such designation shall be made on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively.

29 An entity may revoke its previous designation of a financial asset or financial liability as at fair value through profit or loss in accordance with paragraph 9 on the basis of the facts and circumstances that existed at the date of initial application (and shall revoke its designation if the eligibility criterion in paragraph 9 is not met). That classification shall be applied retrospectively.

30 If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58–65 and AG84–AG93 of IAS 39, the entity shall determine the amortised cost of the financial instrument or any impairment on a financial asset in each period presented on the basis of the fair value of the financial instrument at the end of each comparative period. If an impairment loss is recognised using that approach or if it is impracticable for the entity to apply the effective interest method, the fair value of the financial instrument at the date of initial application shall be the new amortised cost of that instrument at the date of initial application of this IFRS.

31 If an entity previously accounted for an investment in an unquoted equity instrument (or a derivative that is linked to and must be settled by delivery of such unquoted equity instruments) in accordance with paragraphs 46(c), 47(a) and 66 of IAS 39, that instrument shall be measured at fair value at the date of initial application. Any difference shall be recognised in the opening retained earnings of the reporting period of initial application.

32 Any hedge relationship accounted for in accordance with paragraphs 85–101 of IAS 39 that is de-designated as a consequence of the classification approach in this IFRS shall be accounted for as a discontinuation of hedge accounting in accordance with paragraphs 91 and 101 of IAS 39 from the date of initial application.

33 An entity that prepares interim financial reports in accordance with IAS 34 *Interim Financial Reporting* need not apply the requirements in this IFRS to prior interim periods if it is impracticable (as defined in IAS 8).