



Project	Financial Instruments: Replacement of IAS 39
Topic	Classification and measurement: scope

Background

1. In July 2009 the Board published the exposure draft *Financial Instruments: Classification and Measurement* (ED). That ED proposed a two measurement category approach for financial assets and financial liabilities—fair value and amortized cost. A financial asset or financial liability would be measured at amortized cost if two conditions are met:
 - (a) the instrument has only basic loan features; and
 - (b) the instrument is managed on a contractual yield basis.
2. A financial asset or financial liability that does not meet both conditions would be measured at fair value.
3. Those requirements are applied to all financial instruments, including hybrid contracts if the host is within the scope of IAS 39. That is, the proposals would eliminate the requirements in IAS 39 that require an entity to identify embedded derivatives and assess whether those derivatives need to be separated from the host and accounted for separately.

Feedback received in the comment letters and outreach meetings

4. Some respondents, primarily preparers and auditors, did not think the proposed approach should apply to financial liabilities—at least not immediately. They suggested that the Board further split its phase on classification and

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.

measurement into two sub-phases—one for financial assets and another for financial liabilities. Those respondents stated that the Board should focus on developing an IFRS on the classification and measurement of financial **assets** to be available for early adoption in time for 2009 year-end financial statements. The existing guidance for financial liabilities (including the requirements for embedded derivatives and the fair value option (FVO)) would be retained until the Board more fully considers and debates the issues related to liabilities.

5. Respondents made that suggestion for the following reasons:
- (a) **speed at which the project is moving**—Respondents noted that the Board’s project on financial instruments has been accelerated significantly by the global financial crisis. However, the focus of the criticism of financial instrument accounting has been mainly on financial assets (ie the number of categories and the related impairment methodologies), with less emphasis on financial liabilities. Respondents stated that the requirements in IAS 39 for financial liabilities are working well in practice.
 - (b) **symmetry between assets and liabilities**—Respondents said that creating symmetrical categories for financial assets and financial liabilities may be “superficially” attractive. There currently is no symmetry in IAS 39 and the respondents noted that they are not convinced that such symmetry is necessary or preferable.
 - (c) **interaction with the Board’s project on own credit risk**— Respondents noted that many hybrid and structured liability contracts will be measured at fair value through profit or loss under the proposals in the ED. As a result, changes in an entity’s own credit would affect profit or loss. Respondents stated that the Board should consider this issue more fully.
 - (d) **interaction with the Board’s project on financial instruments with characteristics of equity (FICE)**—Respondents noted that the FICE project will undoubtedly change the “line” between equity and liabilities; therefore, the proposals in this project would apply to

instruments that are currently classified as equity. Those respondents recommended that the Board finalize the FICE proposals before discussing how to measure liabilities.

6. However, many respondents (including some of those who suggested addressing financial assets and financial liabilities separately) criticized the Board's decision to address financial instrument in three phases. Those respondents said that it was difficult to analyze and comment on the proposals in the ED in isolation—ie without knowing what the Board subsequently would propose on impairment or hedging. We think that at least some of those respondents would oppose an approach that would split the project into **more** phases.
7. Moreover, some respondents applauded the Board for comprehensively addressing the accounting for financial instruments, rather than making piecemeal changes. Those respondents may view addressing only assets as a piecemeal change to IAS 39.

Alternatives

8. We think there are two alternatives that the Board could consider:
 - (a) exclude financial liabilities from the scope of this phase and address them at a later date (ie only address financial assets at this point)
 - (b) include financial liabilities in the scope of this phase (ie proceed with symmetrical approach proposed in the ED)

Alternative (a)

9. The Board could decide to exclude financial liabilities from the scope of this phase. Under that alternative, we would still consider all of the issues outlined in agenda paper 7A for the September board meeting—however, we would only analyze those topics in the context of **financial assets**. The requirements in IAS 39 would be retained for financial liabilities; in particular:
 - (a) **the subsequent measurement requirements** (paragraph 47)—In general, a financial liability is subsequently measured at amortized cost

unless it meets the definition of held for trading or is designated under the FVO.

- (b) **the requirements for embedded derivatives** (paragraphs 10–13)—Hybrid liability contracts would continue to be analyzed for bifurcation.
- (c) **conditions for the fair value option** (paragraph 9 and 11A) —The existing three conditions for the FVO would be retained for financial liabilities.

10. As a result, the classification and measurement requirements for financial liabilities would be very different from the new requirements for financial assets. The extent of those differences would depend on the Board’s re-deliberations on financial assets. For example, the issuer of structured debt (ie debt with contractual terms that are not “basic loan features” but are not considered to be embedded derivatives) might account for that debt at amortized cost under the requirements in IAS 39. However, the holder would account for its investment at fair value (ie because the instrument does not have basic loan features) under the proposals in the ED.

Alternative (b)

11. The Board could decide to proceed with the approach proposed in the ED and address both financial assets and financial liabilities. We would consider all of the issues outlined in agenda paper 7A in the context of both.
12. We think there would be at least two “hot topics” if the Board decides to pursue this alternative:
- (a) **embedded derivatives**—Many of the respondents to the ED did not support the Board’s proposals on hybrid contracts, especially related to hybrid liability contracts. Some of those respondents recommended that the Board retain bifurcation.
 - (b) **own credit risk**—If the Board retains the proposals in the ED to eliminate bifurcation for financial hybrid contracts and such hybrid contracts are classified in their entirety, many respondents stated that

the Board must consider whether the re-measurement of hybrid liability contracts reflects changes in the issuer's own credit risk.

13. We think that some of the respondents who recommended that the Board only address financial assets may be satisfied if the Board decides to pursue alternative (b) **and** also decides to either
 - (a) retain bifurcation or
 - (b) require that subsequent measurement of financial liabilities does not reflect own credit risk
14. In other words, some of the respondents who supported alternative (a) may think alternative (b) is acceptable depending on what the Board decides on the topics discussed above.

Staff recommendation

15. We recommend alternative (b). We think that this phase should address both financial assets and financial liabilities—and the topics above in paragraph 12, as necessary.
16. We think that having different requirements for assets and liabilities will be complex and confusing. Consider, for example, the existing requirements for embedded derivatives, which have been widely criticized for their complexity. Those requirements would remain—but would only apply to liabilities. So in addition to retaining **complex** requirements for hybrid liability contracts, we would be developing requirements for hybrid asset contracts that most likely would be **inconsistent** with the requirements for liabilities.
17. We think that additional inconsistencies are inevitable if the Board addresses assets and liabilities separately. Also addressing only assets might result in an IFRS that looks more like a piecemeal change to IAS 39, rather than a comprehensive re-consideration of the accounting for financial instruments.
18. Furthermore, many respondents criticized the Board for dividing this project into three phases and said that it was difficult to analyze and comment on the

proposals in the ED in isolation. We think that further dividing the classification and measurement phase will exacerbate that concern.

19. Finally, we do not think it is necessary (or prudent) to delay this project until the completion of the FICE project. The FICE project won't be finalized until 2011 (with an ED in the first half of 2010) and the Board has committed to addressing the accounting for (non-equity) financial instruments expeditiously. Also, as noted in paragraph BC18 of the ED, the classification approach that is being developed in this project should be robust enough to address all financial liabilities—instruments that formally were classified as equity should be no more problematic than new, innovative products that were not contemplated during this project.

Scope of this phase: financial liabilities

Does the Board agree with the staff recommendation to address the classification and measurement of financial assets **and** financial liabilities?

If not, why and what does the Board wish to do instead, and why?