



Project	Financial Instruments: Replacement of IAS 39; <i>Financial Instruments: Recognition and Measurement</i>
Topic	Financial Instruments: Classification and Measurement ED – Comment letter analysis

Introduction

1. In July 2009 the Board published the exposure draft *Financial Instruments: Classification and Measurement* (ED). The comment period ended on 14 September 2009 and, by that date, the IASB had received 189 comment letters.
2. We have also conducted extensive outreach activities (involving over 70 one-on-one and small group discussion with different financial and non-financial entities, auditors, regulators, investors and others). The discussions held often involved numerous follow-on discussions with the same party. The outreach activities covered different geographical areas and are on-going. Moreover, the IASB and FASB held round-table meetings (in Tokyo, London, and Norwalk, CT) to discuss their respective proposals on classification and measurement. In addition, the IASB held a meeting of the Financial Instruments Working Group (FIWG) to discuss the ED. Furthermore, the staff and some board members have held numerous webcasts about the ED to which many thousands of participants have listened. The feedback from all of these outreach activities is consistent with the feedback received in the comment letters.

Purpose of this paper

3. This paper provides a summary analysis of the comment letters that were received by 14 September.

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.

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4. We continue to receive responses. In total, 210 responses have been received as of the date of the posting of this paper. If we identify additional issues in the letters received after the comment deadline, we will provide an update to the Board at a later meeting.
5. Moreover, during re-deliberations we will include a more detailed analysis of each issue in the relevant agenda paper. Agenda paper 7A sets out our general strategy for re-deliberations.
6. This paper does not provide a quantitative review of responses or attribute comments to individual respondents. Moreover, this paper does not address drafting suggestions received from respondents.

Overview of comments received

7. Nearly all respondents agreed that IAS 39 is complex and has been difficult to understand and apply. Respondents supported the Board's effort to comprehensively consider the reporting of financial instruments and agreed with the objective of the proposals—to establish principles for the classification and measurement of financial instruments that will present relevant and decision-useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of future cash flows.
8. However, nearly all respondents raised concerns. In addition to responding to the questions in the ED, most respondents provided general comments about the project. First we will summarize those general comments and then we will address the responses to the questions in the ED.

Summary of general comments

9. Many respondents expressed broad concerns about the project:
 - (a) the speed at which the project is moving (including the Board's decision to divide the project into three phases);

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- (b) the interaction between this project and other ongoing projects on the Board's agenda; and
- (c) convergence between the IASB and FASB.

The Board's rapid pace

10. Many respondents were concerned about the Board's rapid pace. Respondents acknowledged that the accounting for financial instruments needs to be addressed expeditiously and that the Board is operating under significant political pressure. However, many respondents noted that the accounting for financial instruments is a complex area and both the Board and constituents need adequate time to comprehensively consider the issues. Those respondents were concerned that the quality of the resulting standard would be suboptimal or flawed if the Board moves too quickly. Therefore, they encouraged the Board to slow down. Also, a few respondents noted that it is very difficult to handle the volume of documents that are being published (and that are expected to be published) by the IASB.
11. Some respondents suggested narrowing the scope of this phase and only addressing urgent issues on an accelerated basis. For example, a few respondents suggested that the Board only address financial **assets** in this phase. They noted that the existing requirements for financial liabilities are working well in practice and do not have to be addressed this year. However, some respondents noted that the Board has resisted requests for "piecemeal" amendments to IAS 39 in the past and encouraged the Board to continue to do so.
12. Some respondents questioned whether there has been appropriate due process. For example, some respondents suggested that the Board should have carried out field tests and others noted that the comment period should have been longer. A few respondents stated that the Board is too focused on the banking sector and has not adequately considered other industries (ie insurance, corporates, and

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pension funds). However, some respondents applauded the Board's extensive outreach efforts.

13. Moreover, some respondents expressed concerns about the Board's decision to divide the project into three phases. These respondents said that it was difficult to analyze and comment on the proposals in the ED in isolation—ie without knowing what the Board would subsequently propose on hedging or impairment. They would have preferred that the Board publish one exposure draft that contained classification and measurement, impairment, hedge accounting. However, other respondents acknowledged that the Board's phased approach was inevitable given the urgency of this project.

Interaction with other projects

14. Many respondents raised concerns about the interaction between this project and other projects on the Board's agenda. Specifically, respondents noted:
 - (a) **insurance–phase II**—It is difficult for insurance companies to analyze this project for their financial assets without knowing what the final measurement requirements will be for their insurance liabilities.
 - (b) **financial statement presentation (FSP)**—The proposed approach in this project uses “other comprehensive income” but the FSP project has not yet addressed OCI comprehensively (ie how OCI should be used and when/if recycling from OCI to profit or loss should be permitted/required).
 - (c) **financial instruments with characteristics of equity (FICE)**—The FICE project will undoubtedly change the “line” between equity and liabilities; therefore, the proposals in the project may apply to instruments that are currently classified as equity.
 - (d) **fair value measurement**—The proposals in this project may require some entities to measure more (or different) instruments at fair value. The fair value project will provide helpful guidance “how to” guidance but will be finalized after this project.

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Convergence with US GAAP

15. Many respondents were disappointed that the IASB and FASB are moving at a different pace and have proposed different approaches. However, some of those respondents acknowledged that the boards have different pressures and demands being placed on them.
16. Some respondents **encouraged** the boards to work together with an aim to ultimately agree on a single converged standard for financial instruments accounting. Other respondents stressed that it is **critical** that the accounting standards for financial instruments are globally converged. They believe that any other outcome will perpetuate demands for “a level playing field” and will be inconsistent with the mandate of the G20.
17. Although many respondents noted the importance of a converged standard, those respondents generally did **not** support the FASB’s proposals and discouraged the IASB from adopting those proposals for the sake of convergence. As discussed below, almost all respondents supported a mixed attribute approach, which would include fair value and amortized cost.

Summary of the responses to the questions in the ED

18. This section provides a high level summary of the responses to the questions in the ED. As previously noted, we will provide more detailed analyses of comments relating to these issues in topic-specific agenda papers.

A two measurement category approach

19. Almost all respondents supported the proposed mixed attribute approach and stated that amortized cost provides useful information for particular instruments in particular circumstances.
20. A small number of respondents preferred an approach that would measure all financial instruments at fair value. Some of those supported an approach where fair value measurement is the “default” and amortized cost is used only when

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fair value is unreliable or impractical—or where the costs to determine fair value outweigh the benefits.

Conditions for amortised cost measurement

21. The ED proposes that a financial instrument must be (unless the fair value option is elected) measured at amortized cost only if it has basic loan features **and** is managed on a contractual yield basis. Most respondents generally agreed with the conditions—that is, they supported an approach that determines classification on the basis of the contractual terms of the instrument and how an entity manages the instrument. However, most respondents said that the ED did not articulate the conditions clearly enough and did not provide sufficient operational guidance.
22. Moreover, some respondents questioned the interaction between the two conditions and posited whether one has (or should have) primacy over the other. Some respondents thought that the ED implied that the “basic loan features” condition was primary (ie that it is **more important** to classification than the “managed on a contractual yield basis” condition)—perhaps because it was listed first in paragraph 4 of the ED. Other respondents acknowledged that the conditions are cumulative (ie both are required and thus equally important) but said that it would be more **efficient** to analyze the “managed on a contractual yield basis” condition first because that condition is not done on an instrument-by-instrument basis (whereas the other condition is).

Basic loan features

23. Most respondents agreed that classification should consider the contractual terms of the instrument. Although some respondents thought that this condition is less important than how the entity manages the instruments. A small number of respondents thought this condition is unnecessary and that classification should depend solely on how the instruments are managed.

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24. Respondents generally noted that the condition should be more clearly articulated. Many respondents focused on the list of examples in the ED—rather than on the underlying principle. For that reason, some suggested moving the principle (ie the first two sentences of paragraph B1 in the ED) into the standard—and having the examples in the application guidance.
25. Focusing on the examples, some respondents were concerned that particular contractual terms that they considered to be “basic” were not included in the list of examples. Also some respondents said that the straightforward examples in the ED are not helpful and suggested using more complex examples and explaining how to apply the underlying principle to such examples.
26. Some respondents said that the notion of “leverage” should be discussed in the standard or application guidance (not just in the basis for conclusions, as it is in the exposure draft). Paragraph BC21 of the exposure draft states that leverage is not a basic loan feature because it amplifies the variability of cash flows such that those cash flows do not have the economic characteristics of interest. These respondents noted that including the discussion of leverage in the standard would add clarity to the condition.

Managed on a contractual yield basis

27. Almost all respondents agreed that classification should reflect how an entity manages its financial instruments. In fact, many respondents stated that an entity’s business model for managing instruments is **more** important than the instruments’ contractual terms.
28. However, most respondents said that the condition should be more clearly articulated and expressed concerns about whether the condition was operational as written in the ED.
29. Specifically, many respondents suggested that the Board eliminate the phrase “managed on a contractual yield basis” and suggested alternative wording that they believe more clearly communicates the principle. That suggested wording generally focused on whether the entity’s business model was to hold the

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instruments for collection (or payment) of contractual cash flows. (For example, some respondents preferred the FASB proposed wording, with some changes).

30. Most respondents acknowledged that this condition would require an entity to use judgement and would not be straight-forward in some cases. For example, many respondents asked for clarification on how many sales would be “allowable” if an entity asserts that it manages instruments on a contractual yield basis (or similarly, whether an entity must hold instruments for a particular percentage of the instruments’ contractual lives)—although many respondents want to avoid creating a “bright line” test such as today’s “tainting” rule for held to maturity investments. Other respondents asked how much attention could be paid to fair value information and still assert that the instruments are managed on a contractual yield basis. Respondents asked for more examples to help them analyze the instruments that are not straight-forward. They noted that the straight-forward examples in the ED are not helpful.
31. Some respondents noted that the ED explicitly states that the proposed condition is **not** assessed on an instrument-by-instrument basis but said that more guidance is needed about the level at which the condition should be assessed (eg portfolio level, reporting entity level, etc). Most respondents felt it appropriate that the entity determine the appropriate level at which the determination should be made, but agreed that it should not at an instrument-by-instrument level.
32. Finally, almost all respondents disagreed with ED’s conclusion that a financial asset that is acquired at a discount that reflects incurred credit losses is not managed on a contractual yield basis, especially when acquired as part of an otherwise performing portfolio. Those respondents stated that the proposal in the ED simply was not operational in a portfolio context. Those respondents said that such assets can indeed be managed on a contractual yield basis (for example, some respondents purchase asset portfolios to extract the contractual cash flows) and asked the Board to reconsider its proposal on such instruments. Respondents also argued that the ED’s conclusion on this issue was an exception to the proposed approach.

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Accounting for hybrid contracts

33. The exposure draft proposes that a hybrid contract with a host contract within the scope of IAS 39 is classified in its entirety in accordance with the proposed classification approach (ie hybrid financial contracts would **not** be separated).
34. While they agreed that the current requirements for hybrid instruments are complex, most respondents expressed concerns about the proposals. Those concerns related primarily to the following factors:
- (a) Many hybrid **liability** contracts would be measured at fair value through profit and loss. As a result, changes in an entity's own credit would affect profit or loss.
 - (b) Some financial hosts have basic loan features and are managed separately from the embedded derivatives, which are also managed separately. Classification should reflect that fact; therefore bifurcation is appropriate.
 - (c) "Immaterial" embedded derivatives should not affect classification.
 - (d) The proposals would result in different accounting on the basis of whether the instrument is issued as a hybrid contract or two separate contracts
35. Respondents proposed alternatives, including:
- (a) retain bifurcation — some respondents supported retaining the **existing** requirements while others suggested **new** bifurcation requirements (for example, using the "basic loan features" condition)
 - (b) retain bifurcation — but only for financial liabilities
 - (c) eliminate bifurcation but address "own credit"—some respondents stated that they would support the proposals if the re-measurement of the instrument did not reflect changes in own credit.

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36. A few respondents supported the proposals in the ED to eliminate the bifurcation requirements and stated that the proposals reduce complexity and result in a single classification approach.

Investments in contractually subordinated interests (tranches)

37. Most respondents expressed concerns about the proposed accounting for investments in contractually subordinated interests (ie tranches). Many respondents disagreed that only the senior tranche has basic loan features and believe this is an over-simplification of a complex issue. Moreover, respondents noted that the proposal is prone to structuring.
38. Some respondents suggested alternative approaches. One approach that was proposed by many would require an entity to:
- (a) look into the underlying assets of structured investment vehicles to determine whether those instruments have basic loan features; and
 - (b) determine whether the holder of the issued instrument is exposed to cash flows that are more or less variable than the holder would be exposed to if it were to hold the underlying assets.
39. Some respondents also questioned whether “symmetrical accounting” is necessary for the holders and issuers of these instruments.

Fair value through other comprehensive income

40. The ED permits an entity, on initial recognition of investments in equity instrument that are not held for trading, to make an irrevocable election to present changes in the fair value of those investments in OCI.
41. Most respondents agreed that changes in the fair value of particular equity investments should be permitted to be presented in OCI. However, almost all of those respondents had concerns about the proposals. Those concerns related primarily to the following two items:

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- (a) Dividends should be recognized in profit or loss—Many respondents intuitively regard dividends as income to be recorded in profit or loss. Moreover, in many cases, these investments will be funded by debt instrument whose interest expense will be recorded in profit or loss. Therefore, respondents noted that recognizing dividends in OCI will create a mismatch. Some respondents, notably listed investment funds, also argued that without requiring dividends to be recognized in profit or loss, their financial statements would become meaningless for their investors.
 - (b) Recycling should be required when the instrument is derecognized—Many respondents noted that realized gains or losses should be recognized in profit or loss.
42. Some respondents supported the option, noting that they agreed with the Board’s conclusion that it would be very difficult to develop a principle to identify “strategic” investments, but that dividends that represented a return **on** the investment (rather than a return **of** the investment) should be required to be recognized in profit or loss.
43. Some respondents did not support this **option** but rather believed that the Board should develop a principle to identify a particular type of “strategic” instruments. Those strategic instruments would be required to be measured at fair value through OCI. Moreover, some of these respondents stated that such investments should be reclassified to fair value through profit or loss if they no longer meet the principle.
44. Given the concerns with the proposals and the interaction with the FSP project, other respondents suggested retaining the existing requirements for available-for-sale **equity** instruments. Those respondents suggested addressing impairment, either by requiring reversals or by developing an alternative impairment approach (the approach suggested most often was a “lower of cost or market” approach).

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Reclassifications

45. The ED proposes to prohibit reclassification between the fair value and amortized cost categories. Almost all respondents disagreed with that proposal. Those respondents think that such a prohibition is inconsistent with a classification approach based on an entity's business model for managing instruments.
46. Those respondents stated that reclassification should be required when an entity's business models changes. These respondents note that changes in business models are infrequent—but not impossible. Those who commented on how such reclassifications requirements would be applied indicated that reclassifications would be applied **prospectively** so that reported financial information would always reflect the business model at the reporting date.
47. Other respondents seemed to indicate that such reclassifications would be **permitted** but not required. Those respondents did not indicate why reclassifications should be optional.
48. A few respondents stated that an instrument should be reclassified if a non-basic loan feature expired and the entity manages the instrument on a contractual yield basis (eg, a loan pays a leveraged interest rate in the first two years [1.5 x LIBOR] but pays an unleveraged interest rate after that [LIBOR]).
49. Many respondents who supported requiring reclassifications suggested robust disclosures that would provide users with information about the amount and reasons for the reclassification.

Fair value option

50. Almost all respondents supported the proposal to retain the fair value option if such designation eliminates or significantly reduces a measurement or recognition inconsistency ("an accounting mismatch").
51. Some respondents preferred an unrestricted fair value option (similar to US GAAP). Also, the respondents who preferred retaining the existing

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requirements for hybrid contracts generally supported retaining the fair value option in cases where the hybrid contracts must be separated. A few respondents requested that non-financial items be included in the scope of the fair value option.

52. A few respondents noted that instruments designated under the fair value option should be reclassified if the circumstances surrounding that designation no longer exist (ie there is no longer an accounting mismatch). However, most respondents argued that irrevocable designation is essential to the existence of a fair value option.

Elimination of cost exception for unquoted equities

53. The ED proposes that all investments in equity instruments are measured at fair value.
54. Most respondents agreed that more decision-useful information about investments in equity instruments (and derivatives on those equity investments) results if all such investments are measured at fair value.
55. However, many respondents did not agree with the proposal to eliminate the cost exception for investments in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured. In general, those respondents believe that the exception should be retained for the following reasons:
- (a) It is very difficult, and perhaps impossible, to measure such investments at fair value. The resulting measure is judgmental and unreliable—and thus not decision-useful.
 - (b) the cost of measuring such investments exceeds the benefits.
56. A handful of respondents suggested developing a current measurement method other than fair value, although none suggested an approach that had a clear measurement objective. Some other respondents recommending eliminating the exemption for derivatives on equity investments, but maintaining the exemption

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for some unquoted investments. Others recommended maintaining the exception, but revising the wording to emphasize that in almost all cases the fair value is reliably determinable.

Effective date

57. The ED notes that the Board expects to permit early adoption but does not expect the requirements to be mandatorily effective before January 2012. Additional disclosures are proposed if an entity decides to adopt the requirements before the mandated effective date.
58. A small number of respondents were opposed to early adoption because it reduces comparability.
59. Most respondents supported the proposed additional disclosure requirements for early adopters. In fact, some respondents said that the disclosures are sufficiently useful that they should be applicable to **all** adopters—not just those that early adopt. However, other respondents did not support the additional disclosures and said they were “penalizing” early adopters.

Transition

60. The ED proposes that the requirements are applied retrospectively, subject to some transition “relief”.
61. Some respondents broadly supported the principle of retrospective application because it enhances comparability. However, many respondents raised practicality concerns—for example, whether it is practicable to retrospectively calculate amortized cost. Other respondents raised cost-benefit concerns and questioned whether using hindsight could be avoided. Also, respondents were concerned whether retrospective application was possible for early adopters, given the volume of work necessary. Many respondents also questioned how useful restating comparatives actually is to investors, given the numerous exceptions to retrospective application that were necessary to address the practical implementation problems and the requirement to avoid hindsight.

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62. Many respondents proposed a transition approach similar to that required when entities adopted IAS 39 in 2005. That approach would require a reconciliation between the closing balance sheet using IAS 39 and the opening (re-stated) balance sheet with explanations for the main changes in classification and measurement in the year that the new standard was applied for the first time. Adjustments would be recognized in equity in the opening balance sheet.

Alternative approaches

63. Almost all respondents did not support the alternative approach or the variants. Those respondents did not believe that any of those approaches provide more decision-useful information than the proposed approach.
64. Those respondents stated that the alternative approach (and the first variant) does not have an underlying principle because it is based on the proposed conditions **and** the definition in *loans and receivables* in IAS 39. Moreover, the respondents noted that splitting gains and losses between OCI and profit or loss would increase complexity and reduce understandability.
65. Furthermore, respondents did not support the second variant because they did not support a full fair value approach.