Project **Financial Instruments—Classification and Measurement**

Topic **World Standard Setters' conference**

Background

Many users of financial statements and other interested parties have told the boards that the requirements for financial instruments are difficult to understand apply and interpret. They have asked the boards to develop a new standard that is principle-based and less complex.

The many ways of measuring financial instruments is a primary reason why today's requirements are complex. Those requirements result in many accounting rules, for example, on how different types of financial instruments can or should be categorized and measured, and when and how financial assets in a particular category should be impaired.

Objective of this project

In March 2009, the boards agreed that the objective of this project is to significantly improve the usefulness of financial instrument reporting for users of financial statements. The boards believe that simplification of the accounting requirements for financial instruments should be an outcome of this improvement.

Overall approach to this project

The boards plan to deliberate the issues relevant to this project separately with an objective to subsequently reconcile any differences in their technical decisions.

The IASB decided to divide its deliberations into three phases:

1. **Classification and measurement** – The IASB published an exposure draft *Financial Instruments: Classification and Measurement* in July 2009.
2. **Impairment methodology** – In June the IASB posted on its website a request for information on the feasibility of an expected cash flow approach to

impairment. The IASB plans to publish an exposure draft on impairment methodology in October 2009.

3. **Hedge accounting –** The IASB plans to publish an exposure draft in December 2009.

The FASB expects to publish one exposure draft that addresses the measurement, classification, and impairment of financial instruments, as well as hedge accounting, by the end of this year or early 2010.

The FASB has posted on its website a detailed description of its tentative approach to classification and measurement of financial instruments as a way of informing interested constituents and obtaining early input from them. The FASB will continuously update that description as it makes additional decisions. As it develops its exposure draft, the FASB will consider input received on its tentative model as well as feedback received on the IASB's exposure draft.

Proposed approaches to classification and measurement

The purpose of this session is to discuss the boards' respective proposed approaches to the classification and measurement of financial instruments. Those approaches are described below.

The boards believe that their respective proposed approaches would meet the project's objective. Both approaches would reduce the complexity that results from the numerous categories and related impairment models in IAS 39 and US GAAP and provide a clear rationale for the proposed measurement categories.

IASB's proposed approach

As noted above, the IASB published the exposure draft *Financial Instruments: Classification and Measurement* in July (see Agenda paper 6A). The exposure draft proposes two primary measurement categories for financial instruments:

1. fair value with changes in profit or loss, and
2. amortized cost.

A financial asset or financial liability must (unless the instrument is designated under the fair value option) be measured at amortized cost if two conditions are met:

1. the instrument has **basic loan features**, and
2. the instrument is **managed on a contractual yield basis**.

Instruments that do not meet those conditions must be measured at fair value through profit or loss (subject to the exemption discussed below).

If an entity measures a financial asset at amortized cost, the entity must assess at the end of each reporting period whether the asset (or group of assets) is impaired on the basis of the incurred loss impairment approach in IAS 39. Incurred impairment losses are recognized in profit or loss.

Exemption in the IASB approach

Under the IASB's proposed approach, all equity investments would be measured at fair value through profit or loss. However, at initial recognition an entity may make an irrevocable election to present in other comprehensive income (OCI) subsequent changes in the fair value of investments in equity instruments that are not held for trading. Dividends would be presented in OCI. There would be no recycling of these amounts from OCI to profit or loss and hence no impairment requirements.

This exemption was designed with strategic equity investments in mind.

FASB's proposed approach

In August the FASB posted on its website a detailed description of its tentative approach to classification and measurement of financial instruments. That approach proposes two primary measurement categories–fair value with changes in profit or loss and fair value with changes in OCI (see Agenda paper 6B).

All financial instruments would be measured at fair value with all changes in fair value recognized in net income unless the following criterion is met:

If an entity's business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party, particular changes in fair value for those instruments may be recognized in OCI.

In complying with this guidance for recognizing fair value change in OCI an entity's business strategy for a financial instrument would be evaluated on the basis of how the entity manages its financial instruments and would not be based on the entity's intent for an individual financial instrument. The entity also would need to demonstrate that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms.

For financial instruments measured at fair value through OCI, an entity also would be required to display their amortized cost, cumulative credit losses (based on the FASB's future decision on impairment), and the remaining fair value adjustment to arrive at fair value on the statement of financial position.

The amount of the change in fair value that is permitted to be recognized in OCI equals the entire change in fair value, excluding current period interest accruals, minus the current portion of the change in fair value attributable to credit losses (based on the FASB's future decision on impairment). In addition, for changes in fair value that have been recognized in other comprehensive income, realized gains or losses from sales or settlements would be recognized in net income.

Exemption in the FASB approach

The FASB's approach provides a measurement exemption for an entity's own debt if:

1. the criterion discussed above to measure an instrument at fair value through OCI is met and
2. measuring the debt at fair value would create a measurement attribute mismatch.

Instruments that meet those conditions <u>may be</u> measured at amortized cost.

Topics for today's discussion

There are three primary discussion topics:

1. the conditions for identifying financial assets and financial liabilities that must be measured at fair value through profit or loss;
2. the measurement category that should be used if an instrument is **not** measured at fair value through profit or loss (the "other" measurement category); and
3. possible exemptions, if any, to the classification approach

There are several more detailed issues, which are set out at the end of this paper. Those will be discussed if time permits.

For the convenience of participants and to facilitate the discussion, the appendix to this paper compares, at a summary level, the boards' respective proposals with IFRS and US GAAP requirements.

Topic 1: Identifying items that must be measured at fair value through profit of loss

The following questions focus on the whether the proposed conditions appropriately identify those financial assets and financial liabilities that should be measured at fair value through profit or loss.

In other words, these questions focus on the "line" that the proposed approaches draw between (a) those instruments that are measured at fair value through profit or loss and (b) those instruments that are not.

Question 1a: Do you think the IASB's classification conditions appropriately identify financial assets and financial liabilities that should be measured at fair value through profit or loss? If not, why?

Question 1b: Do you think the FASB's classification criterion appropriately identifies financial assets and financial liabilities that should be measured at fair value through profit or loss? If not, why?

Topic 2: The "other" measurement category

These questions address how an instrument should be measured if it is **not** measured at fair value through profit or loss. In other words, these questions focus on what the other measurement category should be.

Under the IASB's approach, the other measurement category is amortized cost. Under the FASB's approach, the other category is fair value through OCI.

Question 2a: If an instrument does not meet the conditions discussed in Topic 1 (and thus is not measured at fair value through profit or loss) should that instrument be measured at amortized cost or fair value through OCI? Why?

Question 2b: If an instrument is measured at fair value through OCI, are there any items that should be **presented directly** in profit or loss rather than in OCI (eg, interest accruals per the FASB's approach)? If so, why?

Question 2c: If an instrument is measured at fair value through OCI, are there any items that should be **recycled** from OCI to profit or loss (eg, realized gains or losses per the FASB approach)? If so, why?

Question 2d: Should fair value for all financial instruments be presented on the face of the statement of financial position? If so, why?

Question 2e: Should amortized cost for particular financial instruments be presented on the face of the statement of financial position in addition to fair value (eg, those financial instruments that meet the criterion discussed in Topic 1 under the FASB's approach)?

Topic 3: Possible exemptions to the approaches

As discussed above, both the IASB and FASB approaches contain exemptions.

Under the IASB's approach, an entity may elect to measure particular investments in equity instruments at fair value through OCI. Under the FASB's approach, an entity may elect to measure its own debt at amortized cost in particular circumstances.

Question 3a: Do you think the presentation exemption that the IASB proposes should be available? If so, does the IASB's approach appropriately identify the instruments that should be eligible?

Question 3b: Questions 2b and 2c address whether particular items should be recognized directly in or recycled to profit or loss when an instrument is measured at fair value through OCI. Would you reach a different conclusion if you answered those questions in the context of the instruments that you have identified in Question 3a? Please explain.

Question 3c: Do you think this measurement exemption that the FASB proposes should be available? If so, does the FASB's approach appropriately identify the instruments that should be eligible?

Question 3d: Are the conditions for the FASB's exemption operational (eg, that fair value would create a measurement attribute mismatch)?

Topic 4: Other issues

These issues will be discussed if time permits.

Embedded derivatives

Both approaches would measure hybrid contracts with financial hosts in their entirety.

Under the IASB's approach, hybrid contracts with financial hosts would be classified based on the classification conditions discussed above (ie, there are no separate classification requirements for hybrid instruments).

Under the FASB's approach, for hybrid financial instruments containing embedded derivatives that do not meet the clearly-and-closely related criterion and require separate accounting under Topic 815 of the FASB Accounting Standards Codification, all changes in fair value for the entire hybrid financial instrument would be recognized in net income. For hybrid financial instruments containing embedded derivatives that meet the clearly-and-closely-related criterion under Topic 815 and the entity's business strategy is to hold the instruments for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party, particular changes in fair value for the entire hybrid financial instrument may be recognized in other comprehensive income.

Question 4a: Should hybrid contracts have different classification conditions than non-hybrid contracts? For example, should particular hybrid contracts continue to be bifurcated? If so, what would those requirements be and why?

The IASB approach addresses the classification and measurement of contractually subordinated interests (tranches). The basis for conclusions discusses other ways of applying the classification principle to concentration of credit risk.

Question 4b: Do you agree with the IASB's application of the proposed approach to contractually subordinated interests? If not, why and how would you improve the classification and measurement of these instruments?

Credit risk in liability measurement

In June 2009 the IASB published a discussion paper on the role of credit risk in liability measurement (commonly referred to as 'own credit risk'), together with a staff paper that described the most common arguments for and against including credit risk in measuring liabilities.

The discussion paper asks whether current measurements of liabilities (including fair value) should incorporate the probability that an entity will fail to perform as required and, if not, what the alternatives are. The discussion paper seeks comment on three possible approaches to liability measurement set out in the staff paper.

Question 4c: Should the subsequent measurement of a financial liability include changes in own credit risk? If not, how should the liability be measured and why? If so, how should measurement changes due to own credit be presented in the financial statements?

Option to measure any financial instrument at fair value through profit or loss

Under the IASB's approach, a financial asset or financial liability must be measured at amortized cost if the two conditions discussed above are met unless the instrument is designated as at fair value through profit and loss ("the fair value option"). An entity is permitted to use the fair value option only if such designation eliminates or significantly reduces a measurement or recognition inconsistency.

Under the FASB's approach, the default classification is fair value with changes in profit or loss; therefore, any financial asset or financial liability may be so measured.

Question 4d: Should an entity always be permitted to measure an instrument at fair value through profit or loss (even if the instrument meets the conditions to be otherwise measured)? Why?

Elimination of the cost exception

Neither approach has a "cost exception" for investments in equity investments whose fair value cannot be reliably measured (or derivatives on those equity investments). As previously mentioned, all equity investments must be measured at fair value.

Question 4e: Are there circumstances in which an investment in an equity instrument should be measured at something other than fair value? If so, what would that measurement attribute be and why would it provide useful information?

Single statement of comprehensive income

Both boards are considering requiring a single statement of comprehensive income.

The boards also are considering whether OCI items should be grouped on that statement into those items that are recycled and those that are not recycled.

Question 4f: Should the boards require a single statement of comprehensive income? If so, should OCI items be grouped into those items that are recycled and those that are not? Why?

APPENDIX

Comparison between IAS 39 and the proposals set out in ED *Financial Instruments: Classification and Measurement*		
	IAS 39	**IASB proposals in ED**
At fair value through profit or loss		
• Based on terms	• Derivatives including separated embedded derivatives	• Instruments that do <u>not</u> have *basic loan features*, except for equity instruments designated at fair value through OCI (see below)
• Based on business model	• Instruments that are held for trading	• Instruments that are <u>not</u> *managed on a contractual yield basis*, except for equity instruments designated at fair value through OCI (see below)
• Based on designation	• *Fair value option* if one of three criteria is met (paragraphs 9 and 11A of IAS 39)	• *Fair value option* to eliminate or significantly reduce an accounting mismatch
At amortised cost	• Instrument must have fixed or determinable payments and not be traded in an active market (*loans and receivables*) • If traded in active market, entity must have intent and ability to hold to maturity (*held to maturity*)	• Instrument must have *basic loan features* <u>and</u> must be *managed on a contractual yield basis*

Comparison between IAS 39 and the proposals set out in ED *Financial Instruments: Classification and Measurement*		
	IAS 39	**IASB proposals in ED**
At fair value through OCI – recycling of realised gains and losses, recognition of interest and impairment to profit or loss	• Instruments classified as *available for sale* (default category if none of the other categories applies)	N/A
At fair value through OCI – No recycling and dividends to OCI	N/A	Equity instruments by designation (described in Topic 3)

Comparison between IAS 39 and the proposals set out in ED *Financial Instruments: Classification and Measurement*		
	IAS 39	**IASB proposals in ED**
Measurement exemptions	• Unquoted equity instruments where fair value cannot be determined reliably (and physically settled derivatives thereon) are measured at cost less impairment	N/A
Impairment	• Incurred loss model: o Held to maturity/loans and receivables: ▪ impairment loss based on estimated future cash flows ▪ reversals required o Available for sale (debt instruments): ▪ impairment loss based on fair value ▪ reversals required o Available for sale (equity instruments): ▪ impairment loss based on fair value ▪ reversals prohibited	• Single incurred loss model[1] o Impairment loss based on estimated future cash flows o Reversals required applies to all financial assets measured at amortized cost (and <u>only</u> to those financial assets).
Other		
"Tainting" provision	• Yes (held to maturity investments)	• No[2]
Reclassifications	• Permitted or required under rare circumstances	• Not permitted

[1] The Board intends to deliberate an expected cash flow approach to impairment– an exposure draft is expected to be published in Q4 2009.
[2] Separate presentation is required of gains or losses on derecognition of items measured at amortized cost.

Comparison between current US GAAP and the FASB's tentative approach		
	Current US GAAP	**Proposed US GAAP**
At fair value through profit or loss		
• Based on terms	• Derivative instruments including bifurcated embedded derivatives	• Equity instruments • Derivatives • Hybrid financial instruments containing embedded derivatives that do not meet the clearly-and-closely related criterion and require separate accounting
• Based on business model	• Instruments classified as trading securities (FAS 115)	• Required for instruments that do not meet the fair value through OCI criterion (and optional for those that do)
• Based on designation	• Fair value option under various literature	N/A
At amortised cost	• Instruments classified as held-to-maturity securities (FAS 115) • Loans and other receivables	• Own debt by designation, meets the criteria for fair value through OCI, and creates a measurement attribute mismatch

Comparison between current US GAAP and the FASB's tentative approach		
	Current US GAAP	**Proposed US GAAP**
At fair value through OCI – recycling of realised gains and losses, recognition of interest and impairment to profit or loss	• Instruments classified as available-for-sale (FAS 115)	• If an entity's business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party, certain changes in fair value for those instruments may be recognized in OCI
At fair value through OCI – No recycling	N/A	N/A
Measurement exemptions	• Loans held for sale are measured at the lower of cost or fair value	• Exemption for own debt (see above)

Comparison between current US GAAP and the FASB's tentative approach		
	Current US GAAP	**Proposed US GAAP**
Impairment	• Different models for different instruments: o Loans (FAS 114) - 3 options: ▪ Present value of expected future cash flows discounted at the loan's effective interest rate ▪ Compare to observable market price ▪ Fair value of collateral if loan is collateral dependent o Held-to-maturity or available-for-sale securities: ▪ Difference between fair value and cost ▪ Credit losses presented in profit and loss and non-credit losses presented in other comprehensive income for other-than-temporarily impaired debt instruments an entity does not intend to sell or more likely than not will not be required to sell before recovery of its amortized cost basis	• The Board is considering selecting a single model for applicable financial assets
Other		
"Tainting" provision	• Yes (held-to-maturity securities)	• No

Comparison between current US GAAP and the FASB’s tentative approach		
	Current US GAAP	**Proposed US GAAP**
Reclassifications	• Permitted or required under specified circumstances	• Not permitted