IASB Meeting | Agenda reference **14B**

Staff Paper | Date **Week beginning 15 March 2010**

Project: **Financial instruments: classification and measurement of financial liabilities**

Topic: **Cost exception for some derivative contracts over unquoted equity instruments**

Introduction

Background

1. During the deliberations leading to the issuance of IFRS 9 *Financial Instruments* the IASB decided the following:

   (a) to eliminate the cost exception in IAS 39 *Financial Instruments: Recognition and Measurement* for unquoted equity instruments for which fair value cannot be determined reliably, and for derivative contracts over such instruments if the contract is settled by physically delivering the underlying (ie the unquoted instruments)

   (b) to exclude financial liabilities from the scope of IFRS 9.

2. Therefore the cost exception remains in IAS 39 for derivative contracts[1] that are financial liabilities and where the contract is settled by physically delivering the underlying unquoted equity instruments whose fair value cannot be determined reliably.

3. The FASB's tentative decisions to date are consistent with the requirements in IFRS 9. That is, under the FASB's proposed approach, all investments in equity

[1] For financial liabilities this is the only type of instruments the cost exception can be applied to.

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.

instruments and all derivatives would be measured at fair value through profit or loss.

Purpose of the paper

4. The purpose of this paper is to confirm that there should not be a cost exception for any derivative liabilities.

Current guidance in IFRSs

5. IFRS 9 requires **all** derivatives that are not designated and effective hedging instruments to be measured at fair value through profit or loss. That IFRS also provides specific guidance about when cost might be the best estimate of fair value for investments in unquoted equity instruments (IFRS 9.B5.5-B5.8).
6. IAS 39 **requires** a derivative financial liability to be measured at cost if the derivative is linked to and must be settled by delivery of an unquoted equity instruments whose fair value cannot be reliably measured. IAS 39.AG80-81 provide guidance as to when the fair value of an unquoted equity instrument (the underlying to the derivative) cannot be determined reliably.

Staff analysis and recommendation

7. The staff thinks that it has always been the Board’s intention to remove the cost exception for both financial assets and financial liabilities within the scope of the new financial instrument standard. That was the proposal in the exposure draft *Financial Instruments: Classification and Measurement* and the Board confirmed that position during redeliberations. However, due to the Board’s decision to exclude financial liabilities from the scope of IFRS 9, the cost exception still exists in IAS 39 for derivative financial liabilities.
8. If such a derivative after initial recognition flips from being an asset to being a liability (eg a forward contract) it would have to be measured at cost. In

addition, IFRS 7 (paragraph 30) requires specific disclosures for items measured at cost. An entity would have to ensure that it can provide these disclosures in case the derivative is a liability at the end of the reporting period.

9. Further, if a reliable measurement becomes available for a derivative liability measured at cost that results in a positive fair value the instrument would be accounted for under IFRS 9 (ie at fair value).

10. The staff thinks this accounting is burdensome for reporting entities. Further, the staff thinks that having potentially two measurement bases does not result in decision-useful information, in particular if a derivative subsequently has to be accounted for at cost.

11. Hence the staff recommends that the Board confirm its previous tentative decision that there should not be a cost exception for any derivatives.

12. As a result, under IFRS 9, all derivative financial liabilities would be initially and subsequently accounted for at fair value and the guidance in IFRS 9.B5.5-B5.8 on when cost might be the best estimate of fair value (and when it is not) would be extended to such derivative liabilities.

Question 1 – No cost exception for derivatives
Does the Board agree with the staff recommendation to confirm its previous tentative decision that there should not be a cost exception for any derivatives? If not, what do you propose and why?