Project **Fair value option for financial liabilities**

Topic **Treatment of the implementation guidance in IAS 39**

Background

1. IAS 39 *Financial Instruments: Recognition and Measurement* contains a significant amount of implementation guidance (IGs). The Board's objective in the financial instruments project was to replace IAS 39 in its entirety—including eliminating the IGs. Accordingly, IFRS 9 *Financial Instruments* (IFRS 9) deleted some IGs[1] and the exposure draft *Financial Instruments: Amortised Cost and Impairment* (amortised cost ED) proposed to delete more. We expect that the hedge accounting phase of the project will do the same.

2. However, the Board decided to maintain some of the requirements in IAS 39—subsequent measurement of financial liabilities and derecognition of financial assets and financial liabilities—and relocate those requirements unchanged to IFRS 9. That relocation will take place when the Board finalizes the amendments to IFRS 9 for the changes to the fair value option (FVO) for financial liabilities. [For more information on the logistics of this relocation, please refer to agenda paper 1 for the board meeting on 3 August 2010.[2]]

[1] The exposure draft *Financial Instruments: Classification and Measurement* included those (and other) deletions.

[2] Although this agenda paper discusses the relocation of the requirements for subsequent measurement of financial liabilities, the process described in the paper is equally applicable to the relocation of the requirements for derecognition of financial assets and financial liabilities.

3. That raises the question of what to do with the IGs related to the relocated requirements. [As a reminder, IGs are non-mandatory. They accompany, but do not form part of, IFRSs.]

4. The exposure draft *Fair Value Option for Financial Liabilities* did **not** propose to delete any of the IGs in IAS 39. That is because the ED only asked for feedback on the proposed changes to the FVO—ie it did not ask for feedback on the Board's decision to retain some of the requirements in IAS 39 and relocate them to IFRS 9. There are no IGs in IAS 39 related to the FVO.

5. The following table sets out the IGs in IAS 39 and identifies those that are related to the requirements that are being relocated unchanged from IAS 39 to IFRS 9. For completeness, the table includes those IGs that the amortised cost ED **proposed** to delete (but excludes those that were deleted when IFRS 9 was finalized in November 2009).

SECTION	TOPIC	ADDITIONAL INFORMATION	PROPOSED ACTION
A	**SCOPE**	There are two IGs in this section. Both relate to whether a contract is within the scope of IAS 39.	**Not related to the relocated guidance**. We suggest that the Board address these IGs when it considers the scope of IFRS 9.
B	**DEFINITIONS**	There are twenty IGs in this section. They relate to the definitions of (1) financial instrument, (2) derivative, (3) held for trading, (4) amortized cost and (5) regular way contracts.	**Some of these are related to the relocated guidance.** The amortized cost ED proposed to delete the IGs related to amortized cost (4 IGs). The other IGs relate to the relocated guidance (16 IGs).
C	**EMBEDDED DERIVATIVES**	There are eight IGs in this section. They primarily relate to (1) whether an embedded derivative is closely related to the host and (2) determining the terms of the host contract and the embedded derivative.	**Related to the relocated guidance.**

SECTION	TOPIC	ADDITIONAL INFORMATION	PROPOSED ACTION
D	**RECOGNITION AND DERECOGNITION**		
D.1	Initial recognition	There is one IG in this section and it relates to cash collateral.	**<u>Related</u> to the relocated guidance.**
D.2	Regular way purchase or sale of a financial asset	There are three IGs in this section	**<u>Related</u> to the relocated guidance.**
E	**MEASUREMENT**		
E.1	Initial measurement of financial assets and financial liabilities	There is one IG in this section and it relates to transaction costs and initial measurement.	**<u>Related</u> to the relocated guidance.**

SECTION	TOPIC	ADDITIONAL INFORMATION	PROPOSED ACTION
E.2	Fair value measurement considerations	There are two IGs in this section.	Related to the relocated guidance but also related to the fair value measurement (FVM) project. The FVM exposure draft (May 2009) proposed to delete one of the IG in this section. We suggest that the Board address these IGs in the FVM project.
E.3	Gains or losses	There are two IGs in this section and they relate to the interaction between IFRS 9/IAS 39 and IAS 21 *The Effects of Changes in Foreign Exchange Rates*.	**<u>Related</u> to the relocated guidance.**

SECTION	TOPIC	ADDITIONAL INFORMATION	PROPOSED ACTION
E.4	Impairment and uncollectibility of financial assets	There are eight IGs in this section	**<u>Not</u> related to the relocated guidance**. The amortized cost ED proposed to delete seven of the IGs in this section. The other IG is related to impairment and hedge accounting. We suggest that the Board address these IGs during the impairment/hedge accounting phase of the project.
F F.1—F.6	**HEDGING**		**<u>Not</u> related to the relocated guidance**. We suggest that the Board address these IGs during the hedge accounting phase of the project.

SECTION	TOPIC	ADDITIONAL INFORMATION	PROPOSED ACTION
G	**OTHER**	There are two IGs in this section—one is on fair value disclosures and the other is on how cash flows arising from hedging instruments should be classified in the statement of cash flows.	**Not related to the relocated guidance**. These two IGs are not really related to IAS 39 but rather relate more directly to IFRS 7 *Financial Instruments: Disclosures* and IAS 7: *Statement of Cash Flows*.

Alternatives

6. The rest of this paper discusses only those IGs that are related to the relocated requirements (approximately 30 IGs)—ie the rows shaded in gray in the table.

7. There are two alternatives:

   (a) **Delete the IGs** as a consequential amendment to IAS 39 or

   (b) **Relocate the IGs** to IFRS 9.

Alternative (a)—delete the IGs

8. Because the IGs are non-mandatory and are not part of IFRSs, they could be deleted when the Board issues the forthcoming amendments to IFRS 9 (ie as a consequential amendment to IAS 39) even though such deletions were not set out in an exposure draft. There is no due process required for IGs.

9. However, we do **not** recommend this alternative. We think it would be inappropriate to delete the IGs without asking for feedback from constituents—especially because the underlying requirements have only been relocated (ie not changed or clarified). If constituents currently are using the IGs to understand and implement the requirements in IAS 39, the related IGs will be no less important for constituents to understand and implement those requirements once they have been relocated to IFRS 9.

10. Moreover, based on some informal discussions with constituents, we understand that some IGs are critical to entities that apply IAS 39. For example, IG B.6 discusses when two offsetting loans should be aggregated and treated as a single instrument. Given that IAS 39 does not contain authoritative guidance on 'linkage' (of non-derivatives or otherwise), constituents use the guidance in the IG to better understand the Board's thinking on that topic.

11. Finally, it has been the Board's custom and practice in this project to include deletions of IGs in an exposure draft – as discussed in paragraph 1—to provide an opportunity for constituents to voice their opinions and concerns. We are concerned that there may be unintended consequences of deleting IGs without the benefit of that input.

Alternative (b)—Relocate the IGs

12. Currently IFRS 9 does not contain any non-mandatory material (other than the basis for conclusions). However, the Board has tentatively decided to relocate the requirements related to determining the effects of changes in own credit risk from IFRS 7 *Financial Instruments: Disclosures* to IFRS 9 when it finalizes the proposed changes to the FVO. That relocated guidance includes the non-mandatory example in paragraphs IG7-IG11 of IFRS 7. That proposed relocation was set out in the draft consequential amendments that accompanied the exposure draft *Fair Value Option for Financial Liabilities* (also refer to paragraph 12 in the introduction of the ED).

13. Therefore, alternative (b) would add the IGs related to the relocated requirements to that non-mandatory section of IFRS 9.

14. If the Board decides to relocate the IGs, there are two options on timing:

    - **Alternative (b)(i)**—Relocate the IGs unchanged to IFRS 9 when the Board issues the forthcoming amendments to IFRS 9; or
    - **Alternative (b)(ii)—**Ask for feedback from constituents on which IGs could be deleted and, at future date, only relocate the necessary (remaining) IGs. In the interim, the IGs would remain (unchanged) in IAS 39.

15. The differences between (b)(i) and (b)(ii) are:

    (a) **Population**—Presumably fewer IGs would be relocated under (b)(ii) than (b)(i)—ie IFRS 9 would be less 'cluttered' with unnecessary guidance.

    (b) **Timing—**Under (b)(ii)**,** the IGs would remain in IAS 39 until further work could be done to determine which should be deleted and which should be relocated. Under (b)(i) the IGs would be relocated immediately and IFRS 9 would include all of the guidance (mandatory and non-mandatory) related to classification, measurement, and derecognition.

16. We believe that some of the IGs could be deleted, and thus, the number of IGs relocated to IFRS 9 could be reduced. However, we are concerned about

leaving the IGs in IAS 39 pending further work. We think there is a risk that such work will be delayed and the IGs will remain in IAS 39 indefinitely. Moreover, we think that alternative (b)(i) [relocating the IGs unchanged] is consistent with the Board's decision to relocate the mandatory requirements unchanged to IFRS 9. For example, some constituents asked the Board to reconsider some of the guidance in IAS 39 before relocating it—eg some urged the Board to 'tinker with' some of the application guidance related to determining whether an embedded derivative is closely related to the host. The Board decided against that suggestion and said such changes were a 'slippery slope' and inconsistent with its decision to retain the existing requirements. The same case could be made for the related IGs—ie they should not be 'tinkered' with but rather should be relocated unchanged.

17. Therefore, we recommend that the Board move all IGs related to the relocated guidance as part of the forthcoming amendments to IFRS 9. As mentioned above, that will complete Phase 1 of the financial instruments project—and all guidance (mandatory and non-mandatory) will be part of IFRS 9. IAS 39 will only contain guidance relevant to the remaining phases.

Question 1
Does the Board agree that the IGs related to the relocated requirements should also be relocated as part of the forthcoming amendments to IFRS 9? If not, what does the Board want to do instead and why?