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Basis for Conclusions
Exposure Draft ED/2009/7

Financial Instruments: Classification and Measurement

Comments to be received by 14 September 2009

International Accounting Standards Board®

Basis for Conclusions on
Exposure Draft

FINANCIAL INSTRUMENTS: CLASSIFICATION AND MEASUREMENT

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This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Financial Instruments: Classification and Measurement* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **14 September 2009.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

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Basis for Conclusions on the exposure draft *Financial Instruments: Classification and Measurement*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in developing the proposals in the exposure draft *Financial Instruments: Classification and Measurement*. Individual Board members gave greater weight to some factors than to others.

BC2 The Board has long acknowledged the need to improve the accounting requirements for financial instruments. In the light of the financial crisis and the urgent need to improve the accounting for financial instruments and to make it easier for users of financial statements to understand the financial reporting information, the Board proposes to replace IAS 39 *Financial Instruments: Recognition and Measurement* in several phases. In pursuing such an approach, the Board acknowledged the difficulties that might be created by differences in timing between this project and other projects, in particular phase II of the project on insurance contracts.

BC3 The exposure draft proposes requirements for the classification and measurement of financial instruments and related items. In the Board's view, classification and measurement requirements are the foundation for any financial reporting standard, and associated requirements (for example, impairment and hedging) have to reflect those classification and measurement requirements. In addition, the Board has noted that many of the application issues that have arisen in the financial crisis are related to the classification and measurement requirements of IAS 39.

BC4 The Board plans to develop an IFRS from the proposals in this exposure draft in time to permit (but not require) its application for 2009 year-end financial statements. This is consistent with the recommendation from the G20 leaders that the Board should take action to improve and simplify the accounting requirements for financial instruments by the end of 2009.

BC5 The Board plans to publish exposure drafts later in 2009 on the impairment of financial assets measured at amortised cost, and on improving and simplifying hedge accounting. The proposals contained in those exposure drafts will build on the classification and measurement proposals in this exposure draft and, to the extent possible, the effects of any redeliberations by the Board of the proposals in this exposure draft in light of the responses.

BC6 The Board is also committed to the convergence of IFRSs and US GAAP requirements for financial instruments. There are many detailed differences between them, making it impossible to achieve convergence on the basis of existing requirements. The Board will consider publishing for comment any proposals that the US Financial Accounting Standards Board (FASB) may publish, to the extent that they are different from the proposals contained in the exposure draft. The Board also believes that the proposals contained in the exposure draft form a common foundation with the approaches currently being considered by the FASB and, to the extent that any FASB proposals differ, will facilitate convergence in the accounting requirements for financial instruments.

Proposals

Scope

BC7 The Board has not yet reconsidered the scope of IAS 39. The scope of IAS 39 and its interaction with other standards have resulted in some application and interpretation issues. However, the Board believes that the issue of scope should be addressed comprehensively rather than only in the context of classification and measurement. Moreover, the scope of IAS 39 has not been raised as a matter of concern during the financial crisis and, hence, the Board believes that the scope of IAS 39 should be considered during a later phase of the project to replace IAS 39.

Classification approach

BC8 Many have told the Board that the number of categories of financial instruments in IAS 39, including the various impairment models associated with those categories, creates much complexity in financial reporting. The Board decided that proposing two measurement

categories and providing a better rationale for those categories would make it easier for users of financial statements to understand the financial reporting for financial instruments and improve the decision-usefulness of the reported information.

BC9 The objective of the proposed classification approach is to present information that is useful to users for their assessment of the amounts, timing and uncertainty of future cash flows.

A single measurement category for all financial assets and financial liabilities

BC10 Many users of financial statements support a single measurement category for all financial assets and financial liabilities. They note that fair value is more relevant than other measurements in helping them to assess the effect of current economic events on an entity. They assert that one measurement attribute for all financial instruments promotes consistency in valuation, presentation and disclosure and the usefulness of financial statements.

BC11 However, many others, including many preparers and auditors of financial statements and regulators and some users, do not support requiring fair value for all financial assets and financial liabilities, although some agree that reducing the number of measurement categories would reduce complexity. They generally reason that it is not appropriate to measure financial instruments at fair value if the instrument is not held for trading or not managed on a fair value basis. They also note that it is difficult to value financial instruments that are not actively traded. In addition, they believe that moving to a full fair value method would add volatility to profit or loss.

BC12 Some, including some of those who generally support the broad application of fair value for financial instruments, raise concerns about the use of fair value when fair value cannot be reliably determined. Many also agree that other issues, including financial statement presentation, need to be addressed before a comprehensive fair value measurement requirement would be feasible.

BC13 In response to those views, as well as the general concerns raised during the financial crisis and acknowledging that there are issues to be resolved before a comprehensive fair value measurement requirement for most financial instruments is feasible, the Board decided that measuring all financial assets and financial liabilities at fair value is not the most appropriate approach to improving the financial reporting for financial instruments.

BC14 Some suggested a discounted cash flow remeasurement method as a possible method to complement, but not replace, fair value. The method would use current estimates of cash flows (including expectations about possible variations in the amount and timing of those cash flows) and current interest rates (including risk margins reflecting the price for bearing the uncertainty inherent in the instrument) but would not reflect other factors such as illiquidity risk and market imperfections. However, the Board decided that the method did not have a well-specified measurement objective, and would require significant further work before the Board was able to assess whether such an approach represented an improvement to financial reporting.

BC15 The Board therefore decided to propose a classification approach that requires financial instruments to be measured at fair value or amortised cost. The Board believes that both of these measurement methods can provide useful information to users of financial statements for particular types of financial instruments in particular circumstances. In proposing such an approach, the Board acknowledged that it would not eliminate some of the complexity associated with the existing financial reporting requirements for financial instruments. However, the Board believes that the classification approach proposed should make it easier for users to understand the information about financial instruments that is presented in the financial statements compared with existing requirements, and hence, represents an improvement in financial reporting for financial instruments. Existing requirements include many categories of financial instruments that, when combined with impairment requirements, result in many different ways of determining the carrying amount of a financial instrument. Existing requirements do not have a clear rationale for why a particular instrument is classified in a particular category. Additionally, any particular category can include instruments with different characteristics, eg the loans and receivables category can include originated loans, purchased loans, some investments in first loss tranches issued by structured investment vehicles and investment securities. The Board decided that reducing the number of categories and providing a better rationale for those categories would improve the decision-usefulness of the reported information.

BC16 In developing an approach to distinguish between financial assets measured at fair value and amortised cost the Board considered a model in which only loans originated by the entity would qualify for amortised cost measurement. The Board acknowledged that for originated instruments the entity potentially has better information about the future contractual cash flows and credit risk than for purchased loans. However, the Board decided not to pursue that approach, mainly because

some entities manage originated and purchased loans in the same portfolio. Distinguishing between originated and purchased loans, which would be done mainly for accounting purposes, would involve systems challenges. In addition, the Board notes that 'originated loans' might easily be created by way of placing purchased loans into an investment vehicle.

The proposed approach

BC17 The proposed approach has two primary measurement categories—fair value and amortised cost. The Board believes that amortised cost can provide useful information only when the instrument produces predictable returns based on its contractual terms and is managed on the basis of the contractual cash flows generated if it is held rather than sold or transferred. Accordingly, a financial asset or financial liability would be measured at amortised 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.

BC18 Under the proposed approach, a financial asset or financial liability that does not meet both conditions would be measured at fair value. The Board also considered developing conditions that specified when an instrument must be measured at fair value, with the requirement that all other instruments would be measured at amortised cost. The Board rejected that approach because it believes that new conditions would have to be developed in the future to address innovative financial products.

Basic loan features

BC19 The Board used as a starting point the requirements for 'basic financial instruments' in Section 11 of the *IFRS for Small and Medium-sized Entities* (SMEs). Those requirements identify particular debt instruments that have basic lending characteristics and should be measured at amortised cost. However, the Board proposes to expand those requirements to address particular contractual features that are common in instruments held or issued by entities that are typically outside the scope of the *IFRS for SMEs*.

BC20 The Board noted that an instrument has basic loan features only if the contractual cash flows are principal and interest on the principal outstanding, which is consistent with the objective of amortised cost accounting and the effective interest method. The objective of the effective

interest method is to allocate interest revenue or expense to the relevant period. Cash flows that are interest always have a close relation to the amount advanced to the debtor (the 'funded' amount) because interest is compensation for the time value of money and the credit risk associated with the issuer of the instrument and the instrument. The Board noted that the effective interest method is not an appropriate method to allocate cash flows that are not principal or interest on the principal outstanding. The Board concluded that if a financial instrument contains contractual cash flows that are not principal or interest on the principal outstanding then a valuation overlay to contractual cash flows (such as fair value) is required to ensure that the reported financial information provides useful information.

BC21 The Board noted that leverage is not a basic loan feature. Indeed, leverage (a common characteristic of many financial options, forward contracts and swap contracts) amplifies the variability of cash flows, with the result that those cash flows do not have the economic characteristics of interest.

BC22 Sometimes an instrument has a feature that combines a fixed interest return and a variable interest return, and both of those returns would be a basic loan feature on a stand-alone basis. The Board proposes that an instrument with such features should qualify for amortised cost measurement because those features are basic loan features. An example is an investment in a debt instrument with embedded interest rate caps, collars and floors.

BC23 A debt instrument may have pre-specified resets of its interest rate in response to changes in the credit quality of the instrument. The Board believes this is a basic loan feature because its purpose is to reflect the credit quality of the financial instrument over its term, which is consistent with the notion of interest.

BC24 Many financial instruments allow the debtor to repay a debt instrument early, sometimes in exchange for compensation to the creditor. The Board decided that provisions that require the debtor to compensate the creditor for that prepayment are basic loan features as long as the compensation substantially reflects the change in the creditor's economic position (because of the change in the timing of cash flows) rather than other factors.

BC25 The Board also considered different types of credit risk associated with financial assets and the effects of subordination. The Board noted that subordination can arise in different ways.

BC26 The ranking of an entity's creditors is a common form of subordination that affects almost all lending transactions. The Board noted that commercial law (including bankruptcy law) typically sets out a basic ranking for creditors. This is required because not all creditors' claims are contractual (eg claims regarding damages for unlawful behaviour but also for tax liabilities or social insurance contributions). Although it is often difficult to determine exactly the degree of leverage resulting from this subordination the Board believes that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for general creditors such as trade creditors. Thus, the Board believes that the credit risk associated with general creditors is consistent with the notion of a basic loan feature. Consequently, the credit risk associated with any secured or senior liabilities ranking above general creditors would also be consistent with the notion of a basic loan feature.

BC27 Alternatively, a structured investment vehicle may issue different tranches to create a 'waterfall' structure that prioritises the payments by the issuer to the holders of the different tranches and, thus, specifies the order in which any losses that the issuer incurs are allocated to the different tranches. The Board noted that some tranches receive a higher return because they provide credit protection to other tranches. A tranche that provides credit protection to other tranches in any situation is leveraged and, therefore, does not have basic loan features. The Board also noted that in many structures, only the most senior tranche will receive credit protection in any situation. As a result, only that tranche will have basic loan features and be eligible for amortised cost measurement. The Board believed that the classification principle should be applied on the basis of the possible outcomes rather than the probability-weighted outcomes because it provides a clear application. Determining the probability-weighted outcomes is often difficult and highly judgemental (if not arbitrary). The Board also noted that writing credit protection reflects risk taking (albeit on a contingent basis) in addition to a proportionate tranche even if the probability of the credit protection being called on is low.

BC28 In reaching this decision the Board also considered other ways of applying the classification principle to concentration of credit risk. One possible alternative considered was to look through to the underlying assets of a structured investment vehicle. However, that approach would not work for debtors other than structured investment vehicles with a narrow investment scope. It would also give rise to the issue of how far to look through the investments held by a series of investment vehicles that invest into each other. This makes it difficult, if not impossible, to identify the 'underlying assets' in a non-arbitrary way

and would no longer reflect the characteristics of the instrument to be classified. Another possible alternative considered was to determine the credit risk at initial recognition. However, that requires setting a threshold for the investment risk at that point in time, which is difficult to implement. For example, it would require some rating or other credit grading process that is consistent for all entities. For many instruments such information may not be readily available (in particular for non-financial institutions) and it also could result in trade receivables of the same debtor incurred at the same time being determined to be an instrument with only basic loan features by one creditor but not by another creditor owing to different rating or grading results.

BC29 If a financial asset is acquired at a discount that reflects incurred credit losses, it does not have basic loan features. An investor acquiring an instrument at such a discount believes that the actual losses will be less than the losses that are reflected in the purchase price. Thus, that instrument creates exposure to significant variability in actual cash flows and such variability is not interest.

BC30 The Board noted that the proposed approach will require an entity to use judgement to determine whether a contractual feature of an instrument is a basic loan feature. The Board noted that many IFRSs require the use of such judgement.

Managed on a contractual yield basis

BC31 The Board decided that the contractual characteristics of a financial asset or financial liability by themselves do not provide sufficient information about the instrument's expected cash flows. The Board noted that the objective of the proposed classification approach is to classify financial assets and financial liabilities in such a way that the measurement reflects the predictive quality of the contractual cash flows and hence provides decision-useful information to users of financial statements in predicting future likely cash flows. The Board concluded that an entity's business model affects the predictive quality of contractual cash flows—ie whether actual cash flows will result from the collection or payment of cash flows arising from the instrument's contractual terms or from transferring the instrument before maturity to realise fair value changes.

BC32 The Board notes that an entity's business model does not relate to a choice (ie it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way that an entity is managed, and information is provided to the management of the entity.

BC33 For example, if an investment bank uses a trading business model, it could not easily become a savings bank that uses an 'originate and hold' business model. Therefore, a business model is very different from 'management intentions', which can relate to a single instrument and may change with circumstances. Consistently with this observation, the Board also determined that sales or transfers of financial instruments with basic loan features before maturity would not change the business model of an entity, as long as such transactions were consistent with managing the collection or payment of contractual cash flows rather than realising changes in fair values.

BC34 The notion of looking to an entity's business model for classification purposes is used in IAS 39. An entity is allowed to designate a financial asset or financial liability as at fair value through profit or loss if:

> ... a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management ...

BC35 However, the guidance in IAS 39 would need to be modified in order to be used as a condition for mandatory classification (rather than for voluntary designation). Therefore, the Board proposes a classification requirement that a financial instrument is managed on a contractual yield basis. The Board also proposes not to refer to a 'documented risk management or investment strategy' because an entity should not be able to circumvent the classification requirements simply by failing the documentation requirement.

BC36 The Board considered whether all financial assets and financial liabilities that are not held for trading purposes should be eligible for measurement at amortised cost. The Board rejected that alternative because the notion of 'held for trading' is too narrow and cannot appropriately reflect all situations in which amortised cost does not provide useful information. Being held for trading reflects only one type of financial instrument management that should require fair value measurement.

An alternative approach

BC37 In its deliberations leading to the exposure draft, the Board discussed alternative approaches to classification and measurement.

BC38 One alternative approach considered was that financial assets that meet the two conditions specified in this exposure draft (ie they have basic loan features and are managed on a contractual yield basis) and meet the definition of loans and receivables in IAS 39 would be measured at amortised cost in the statement of financial position. All other financial assets would be measured at fair value in the statement of financial position, including assets that meet the conditions specified in this exposure draft to be measured at amortised cost. The fair values changes for each period of such financial assets would be disaggregated and presented as follows:

(a) changes in recognised value determined on an amortised cost basis (including impairments determined using the incurred loss impairment requirements in IAS 39) would be presented in profit or loss; and

(b) any difference between the amortised cost measure in (a) and the fair value change for the period would be presented in other comprehensive income.

BC39 Some Board members think that this approach might provide decision-useful information to users of financial statements because fair value information is provided in the statement of financial position and changes in fair values are disaggregated (in profit or loss and other comprehensive income).

BC40 Possible variants of this alternative approach were also discussed.

BC41 The Board decided to ask respondents for comments on the alternative approach and variants of the alternative approach (Questions 14 and 15).

Embedded derivatives

BC42 An embedded derivative is a component of a hybrid (combined) contract that also includes a non-derivative host, with the effect that some of the cash flows of the combined contract vary in a way similar to the cash flows of a stand-alone derivative contract. IAS 39 requires an entity to assess all contracts to determine whether they contain one or more embedded derivatives that are required to be separated from the host and accounted for as stand-alone derivatives.

BC43 Many respondents to the discussion paper *Reducing Complexity in Reporting Financial Instruments* noted that the requirements and guidance of IAS 39 are complex, rule-based and internally inconsistent. Respondents, and others, have also noted the many application problems that arise from requirements to assess all contracts for embedded derivatives and, if required, to account for and measure those embedded derivative features separately as stand-alone derivatives.

BC44 The Board discussed three approaches for embedded derivatives. The approaches were

(a) to maintain the requirements in IAS 39;

(b) to propose using 'closely related' (used in IAS 39 to determine whether an embedded derivative is required to be separated from the host) as the classification criterion for the contract in its entirety; and

(c) to propose the same classification approach for all financial assets and financial liabilities (including hybrid contracts).

BC45 The Board rejected the first two approaches. The Board noted that both approaches would rely on the assessment of whether an embedded derivative is 'closely related' to the host. The 'closely related' assessment in IAS 39 is based on a list of examples that are inconsistent and unclear. That assessment is also a significant source of complexity. Both approaches would result in hybrid contracts being classified using conditions different from those that would be applied to all non-hybrid financial instruments. Consequently, some hybrid contracts that do not have only basic loan features might be measured at amortised cost. The Board also believes that neither approach would make it easier for users of financial statements to understand the information that financial statements present about financial instruments.

BC46 Therefore, the Board proposes to use the same classification approach for all financial instruments, including hybrid contracts with hosts that are within the scope of the proposed IFRS ('financial hosts'). The Board concluded that a single classification approach for all financial instruments and hybrid contracts with financial hosts is the only approach that responds adequately to the criticisms described above. The Board noted that using a single classification approach improves comparability by ensuring consistency in classification, and hence makes it easier for users to understand the information that financial statements present about financial instruments.

BC47 The Board decided not to consider proposing changes to the requirements in IAS 39 for embedded derivatives in hybrid contracts with non-financial hosts. The Board noted that those requirements are also complex and have resulted in some application problems, including the question of whether particular types of non-financial contracts are within the scope of the financial instruments standard. The Board noted the importance of ensuring that any proposals for hybrid contracts with non-financial hosts also address which non-financial contracts should be within the scope of the financial instruments standard. The Board also noted the importance for many non-financial entities of hedge accounting for non-financial items, and the relationship to both scope and embedded derivative requirements. Therefore, the Board concluded that the requirements for hybrid contracts with non-financial hosts should be addressed in a later phase of the project to replace IAS 39.

Option to designate a financial asset or financial liability at fair value

BC48 IAS 39 permits entities the option to designate on initial recognition any financial asset or financial liability as measured at fair value through profit or loss if one (or more) of the following three conditions is met:

(a) It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

(b) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.

(c) The financial asset or financial liability contains one or more embedded derivatives (and particular other conditions described in paragraph 11A of IAS 39 are met) and the entity elects to account for the hybrid (combined) contract in its entirety.

BC49 However, the Board noted:

(a) the proposals in the exposure draft would require any financial asset or financial liability that is managed on a fair value basis to be measured at fair value; and

(b) the exposure draft proposes that hybrid contracts with financial hosts should be classified in their entirety, hence eliminating the requirement to identify and account for embedded derivatives separately.

Accordingly, the Board concluded that under the proposed classification approach the conditions in paragraph BC48(b) and (c) are unnecessary.

BC50 The Board agreed that the eligibility condition in paragraph BC48(a) should be retained in the exposure draft. The Board acknowledges that the condition mitigates some anomalies that result from the different measurement attributes used for financial instruments. In particular, it eliminates the need for fair value hedge accounting of fair value exposures when there are natural offsets and problems arising from a mixed measurement model when some financial assets are measured at fair value and related financial liabilities are measured at amortised cost. The Board also noted that particular sectors believe it is important to be able to mitigate such anomalies until other current IASB projects are completed (eg insurance). Therefore, the Board decided not to consider proposing in the exposure draft changes to the eligibility condition set out in paragraph BC48(a), but to consider whether to propose any changes as part of the future exposure draft on hedge accounting.

Elimination of the 'tainting' provision

BC51 IAS 39 generally prohibits an entity from classifying any financial asset as held to maturity if the entity had, during the current financial year or during the two preceding financial years, sold or reclassified more than an insignificant amount of held-to-maturity investments before maturity.

BC52 Many respondents to the discussion paper *Reducing Complexity in Reporting Financial Instruments* criticised that provision as being an anti-abuse rule. Such respondents also noted that the held-to-maturity category in IAS 39 is not widely used because of the risk of having to recategorise all instruments out of the category if more than an insignificant amount of held-to-maturity investments are sold before maturity.

BC53 The exposure draft proposes to eliminate the held-to-maturity category and the tainting provision. The Board considered whether it should retain a notion of tainting for financial instruments measured at amortised cost. However, the Board believes that the proposed classification approach based on basic loan features and management on a contractual yield basis provides a clear rationale for measurement and that a tainting provision increases the complexity of application and is unduly prohibitive in the context of the proposed classification approach.

As noted previously, the Board also determined that sales or transfers of financial instruments with basic loan features before maturity would not change how an entity manages its financial instruments, as long as such transactions were consistent with managing the collection or payment of contractual cash flows rather than realising changes in fair values.

BC54 Instead, the Board proposes to amend IAS 1 *Presentation of Financial Statements* to require an entity to present separately in the statement of comprehensive income all gains and losses on derecognition of financial assets and financial liabilities measured at amortised cost. The Board concluded that such a presentation requirement will allow users of financial statements to understand the effects of the derecognition before maturity of instruments measured at amortised cost.

Reclassification between fair value and amortised cost categories

BC55 In October 2008 the Board amended IAS 39 to permit an entity to reclassify non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the fair value through profit or loss category in particular circumstances. The amendment also required significant disclosures if an entity decided to reclassify any financial assets. (IAS 39 had always required reclassifications between the held-to-maturity and available-for-sale categories in particular circumstances.)

BC56 The purpose of that amendment to IAS 39 was to provide short-term relief for some entities in the financial crisis and was a short-term response to requests for such relief. The amendment also aimed to align the accounting requirements for reclassifications in IAS 39 with US GAAP.

BC57 Following the amendment to IAS 39, the Board received comments from many users of financial statements that the amendment reduced their ability to understand the information about financial instruments in the financial statements and that the required disclosures have not been widely or consistently applied. Those users believe that the amendment impaired comparability among different entities as well as for financial instruments held by the same entity. Some users have also stated that allowing reclassifications has enabled some entities to manage profit or loss by managing the timing of when future fair value gains and losses will affect profit or loss.

BC58 The Board considered whether the exposure draft should require or allow reclassifications between the fair value and amortised cost categories. The Board noted that the elimination of the held-to-maturity category and the associated tainting provision would render the associated reclassification requirements unnecessary.

BC59 The Board also noted that allowing or requiring reclassifications would not make it easier for users of financial statements to understand the information that financial statements provide about financial instruments, which is a desired outcome of the proposals in the exposure draft. The Board noted that requiring or permitting reclassifications would also increase complexity because detailed guidance would be required to specify when reclassifications would be permitted (or required), and the subsequent accounting for any reclassified financial instruments.

BC60 IFRS 4 *Insurance Contracts* permits an insurer to reclassify financial assets to prevent an accounting mismatch arising when it introduces a new accounting policy for its insurance contracts. In phase II of its project on insurance contracts, the Board will consider whether to provide a similar option for use on transition to the phase II standard.

Measurement

Exemption in IAS 39 for investments in equity instruments whose fair value cannot be reliably measured (and some derivatives on those investments)

BC61 IAS 39 contains an exemption from fair value measurement for investments in equity instruments that do not have a quoted price in an active market and whose fair value cannot be reliably measured. Those equity investments are required to be measured at cost less impairment, measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. The exemption is extended to derivatives that are linked to and must be settled by delivery of such unquoted equity instruments.

BC62 The exposure draft proposes that all investments in equity instruments should be measured at fair value. Measurement at amortised cost is not applicable to equity investments because such instruments have no contractual cash flows.

BC63 The Board proposes to eliminate the exemption because measuring investments in equity instruments (and derivatives linked to those investments) at fair value provides the most relevant information to users. Measurement at initial cost provides no predictive value for users of financial statements, because cost information will reflect only the maximum loss exposure from the investment, not possible appreciation in value. In many cases fair value will be significantly different from the cost information reported.

BC64 In addition, IAS 39 requires the holder to monitor the investments for impairment and recognise a loss if one has been incurred. That requirement has been criticised because it is based on a calculation that is similar to a fair value determination and is no more reliable than measuring the equity investment at fair value.

BC65 Removing this exemption would also reduce complexity. Although there might be increased complexity in determining the fair value of the equity investment, that complexity would be offset by eliminating the requirement to monitor it for impairment.

BC66 The Board considered the costs of requiring such equity investments to be measured at fair value from the perspectives of valuation methodology and expertise, as well as the ability to obtain the information required for a fair value measurement. The Board noted that valuation methodologies for equity investments are well-developed and are often far less complex than those required for other financial instruments that are required to be measured at fair value, including many complex derivative products. However, some expressed concerns that smaller entities applying IFRSs may not have internal systems or expertise to determine easily the fair value of equity investments held, and so could face considerable costs. The Board also discussed the ability to obtain the information required to make a fair value measurement and noted that basic shareholder rights generally enable an entity to obtain the necessary information to perform a valuation.

Gains and losses

Investments in equity instruments

BC67 The proposed approach distinguishes basic lending instruments from all other financial instruments. Therefore, as discussed previously, all equity investments would be measured at fair value because those instruments do not have basic loan features. The Board believes that fair value provides the most useful information to users for investments in equity instruments.

BC68 However, reporting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity. For example, an entity may make what it views as a 'strategic investment' in equity instruments issued by another entity with the intention of establishing or maintaining a long-term operating relationship with the entity. Such investments are held not primarily to generate dividends and increases in the value of the investment, but because of the non-contractual benefits associated with holding such an investment. For example, by holding such an investment an entity may be permitted to sell its products in a particular country.

BC69 The Board also noted that when valuing an entity users of financial statements often differentiate between fair value changes arising from equity investments held for purposes other than generating investment returns and equity investments held for trading. For those reasons, the Board proposes to permit entities to irrevocably elect at initial recognition to present fair value changes of some equity instruments in other comprehensive income.

BC70 The Board considered developing a principle to identify other equity investments whose fair value changes should be presented in profit or loss (or other comprehensive income). If such a principle was used to identify such investments, the investment would be reclassified into or out of the presentation requirement according to whether it met or ceased to meet the identification principle. However, the Board decided that it would be difficult, and perhaps impossible, to develop a clear and robust principle that would identify investments that are different enough in nature to justify a different presentation requirement. The Board considered whether a list of indicators could be used to support the principle but decided that such a list would inevitably be

rule-based and could not be comprehensive enough to address all possible situations and factors. Moreover, the Board noted that such an approach would create complexity in application without necessarily increasing the usefulness of information to users of financial statements.

BC71 Accordingly, the Board proposes to permit an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading purposes. As discussed previously, the Board believes that separate presentation in other comprehensive income of gains and losses for some investments could provide useful information to users of financial statements because it would allow them to identify easily, and value accordingly, the associated fair value changes.

BC72 For investments in equity instruments that are measured at fair value through other comprehensive income, the Board decided to propose that fair value changes should not be subsequently transferred ('recycled') to profit or loss (on derecognition of the financial asset or otherwise). The Board noted that a gain or loss associated with these investments should be recognised once; therefore, recognising a gain or loss in other comprehensive income and subsequently transferring it to profit or loss is inappropriate. The Board also noted that this proposal eliminates the need for impairment requirements, which have created application problems for equity investments classified as available for sale in accordance with IAS 39.

BC73 An entity may transfer the cumulative gain or loss (including any dividends recognised) within equity. In the light of jurisdiction-specific restrictions on components of equity, the Board proposes not to provide specific requirements related to that transfer.

BC74 The Board proposes to require additional disclosures about investments in equity instruments that are measured at fair value through other comprehensive income. The Board believes those disclosures will provide useful information to users of financial statements about which instruments have been presented in that manner and the effect of that presentation.

BC75 This presentation option will add complexity to the proposed approach. Moreover, all options result in decreased comparability. However, the Board believes that the proposals that accompany this option—that the election is irrevocable and additional disclosures are required—address some of those concerns.

Effective date and transition

Effective date

BC76 The Board will set the effective date for the proposed requirements when it approves the IFRS. The Board recognises that many countries require time for translation and that the introduction of mandatory requirements of IFRSs is legally binding. In addition, entities will require time to implement new standards. The Board normally sets an effective date of between six and eighteen months after issuing an IFRS.

BC77 The Board considered the implications for transition of the phased approach being taken to replace IAS 39. In the light of the financial crisis, the Board considered that some improvements to current requirements are required as soon as possible and that the phased approach allows the Board to be responsive to such requests for improvement. However, the Board also noted the interaction between the different phases of the project to replace IAS 39 (notably, the proposals in this exposure draft and the future exposure draft on hedging). The Board accepted that some entities or jurisdictions may wish to apply all of the new requirements for financial instruments at the same time. These are expected to be completed during 2010. Accordingly, the Board expects that the new requirements will not be mandatorily effective before January 2012.

BC78 The exposure draft proposes permitting earlier application of the IFRS to allow an entity to apply the enhanced guidance on classification and measurement of financial instruments. However, although the Board believes that the proposals in this exposure draft will result in more decision-useful information, the Board acknowledges that the effect of transition will be significant for some entities. As a result, there will be less comparability between entities that apply the IFRS early and those that do not. Accordingly, the Board proposes additional disclosures for an entity that elects to apply the IFRS early.

Transition

BC79 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users because the information presented for all periods is comparable. However, the Board considered the difficulties and associated costs of full retrospective application of the proposals in the exposure draft. The Board considered whether to require prospective application, but noted that such an approach does not provide comparable information for users of financial statements. In addition, the Board noted that any transition

approach (such as prospective application) that requires resetting the effective interest rate for financial instruments measured at amortised cost reduces the usefulness of information about interest that is presented in profit or loss.

BC80 Therefore, the Board proposes retrospective application and transition relief to address particular difficulties that might arise from retrospective application. The Board also noted that IAS 8 sets out transition requirements if retrospective application is impracticable and prohibits the use of hindsight when applying a new accounting policy to a prior period.

BC81 The Board proposes requiring an entity to assess whether a financial asset or financial liability is managed on a contractual yield basis in the light of circumstances at the date of initial application. The Board believes it would be difficult, and perhaps impossible, to assess that condition on the basis of circumstances when the instrument first satisfied the recognition criterion in IAS 39.

BC82 The Board also decided to propose that the assessment of whether a financial asset or financial liability meets the eligibility criterion for designation under the fair value option should be based on the circumstances at the date of initial application. The proposed approach would change the classification of some financial instruments, including eliminating two of the three eligibility criteria in IAS 39 for the fair value option. Therefore, the Board believes that an entity should reconsider at transition its original assessment of whether to designate a financial asset or financial liability as at fair value through profit or loss.

BC83 The Board acknowledged that it may be impracticable for an entity to apply the impairment requirements in IAS 39 retrospectively in some situations. The process would be cumbersome, in particular for an entity with a large number of financial assets that were previously measured at fair value but are measured at amortised cost in accordance with the proposed approach. Several loss events and reversals might have occurred between the date that the asset was initially recognised and the date of initial application of the proposed IFRS. The Board proposes that if applying the impairment requirements is impracticable or requires the use of hindsight, an entity should use previously determined fair value information to determine whether a financial asset is impaired in comparative periods. If such an approach is used, the Board also decided to propose that the fair value at the date of initial application of the new requirements should be deemed to be the new amortised cost of that financial asset.

BC84 An entity would not have previously determined the fair value of an investment in an unquoted equity instrument (or a derivative on such an investment) that was previously accounted for in accordance with paragraphs 46(c), 47(a) and 66 of IAS 39. Moreover, an entity will not have the necessary information to determine fair value retrospectively without using hindsight. Accordingly, the Board proposes to require such instruments to be measured at fair value at the date of initial application.

BC85 An entity may not have previously determined the fair value of a hybrid contract in its entirety. Moreover, an entity will not have the necessary information to determine fair value retrospectively without using hindsight. However, an entity would have been required to measure both the embedded derivative and host separately at fair value to apply the disclosure requirements in IFRS 7. Therefore, in comparative periods, the Board proposes that the sum of the fair value of the embedded derivative and the host should be used as an approximation of the fair value of the entire hybrid contract.

BC86 The Board proposes that any hedge relationship that has to be de-designated under the new classification approach should be accounted for as a discontinuation of hedge accounting. The Board believes that the benefits of full retrospective application do not justify the costs that preparers would incur to generate the necessary information.

Alternative view on exposure draft

Alternative view of James J Leisenring

AV1 Mr Leisenring voted against publication of the exposure draft *Financial Instruments: Classification and Measurement*, for the reasons set out below.

AV2 Mr Leisenring supports efforts to reduce the complexity of accounting for financial instruments. The exposure draft minimally does this, but much more could be done. In that regard, he supports requiring that all financial instruments be measured at fair value with the result of that measurement being recognised in profit or loss. He finds no compelling reason related to improving financial reporting to reject this approach. Mr Leisenring's approach maximises comparability and absolutely minimises complexity.

AV3 It maximises comparability because all financial instruments would be at one attribute within any entity and across entities. No measurement or presentation would change based on either arbitrary distinctions or management behaviour or intentions. The exposure draft emphasises management intentions and behaviour, which substantially undermines comparability.

AV4 Complexity of accounting would be dramatically reduced with all financial instruments measured at fair value. The approach favoured by Mr Leisenring provides at least the following simplifications:

(a) no impairment model is necessary.

(b) criteria for when a given instrument must or can be measured with a given attribute are unnecessary.

(c) there is no need to bifurcate embedded derivatives or to identify financial derivatives.

(d) it eliminates the need for fair value hedge accounting for financial instruments.

(e) it eliminates the disparity in the measure of derivatives in and outside the scope of IAS 39.

(f) it minimises the incentives for structuring transactions to achieve a particular accounting outcome.

(g) no fair value option would be needed to eliminate accounting mismatches.

(h) it provides a superior foundation for developing a comprehensive standard for the derecognition of financial instruments that is not present in a mixed-attribute model.

AV5 Mr Leisenring accepts that measuring more instruments at fair value increases measurement complexity, but that increase is minimal compared with the reductions in complexity that would be otherwise achieved. There is no disagreement that derivatives must be measured at fair value. Those instruments raise the most difficult measurement issues, as cash instruments have much fewer problems. Indeed, some suggestions for an impairment model would measure at fair value the credit loss component of cash instruments. If that were to be the conclusion on impairment (an expected loss approach), it would minimise the incremental fair value measurement complexity of recording at fair value instruments now at amortised cost.

AV6 Mr Leisenring recognises that measuring all instruments at fair value through profit and loss raises presentation issues about disaggregation of fair value changes. He does not believe, however, that these issues are insurmountable.

AV7 Investors have consistently told both the IASB and the FASB that fair value of financial instruments recorded in profit or loss provides the most decision-useful information for their purposes. There is a worldwide demand for an improved and converged solution to accounting for financial instruments. Mr Leisenring is disappointed the Board will not take this opportunity to make, with other standard-setters, truly substantive changes rather than these minimal changes that perpetuate all the legitimate concerns that have been expressed about the mixed-attribute model.

AV8 Fundamental to the exposure draft is the distinction between financial instruments measured at amortised cost and at fair value. Mr Leisenring is concerned that neither of the two conditions necessary for that determination is operational. What constitutes basic loan features will produce significant implementation issues. The conclusion of paragraph BC29 illustrates this potential for confusion. This paragraph suggests variability of cash flows precludes an instrument from having basic loan features even when the variance is exclusively from credit. Variability of cash flows is certainly not prohibited by paragraphs B1–B8 if the variability is the result of credit. Mr Leisenring also questions how many sales can be observed and still conclude the instrument is managed on a contractual yield basis.

AV9 Mr Leisenring questions why, given the conclusion in paragraph B9, there is any need for a fair value option. To measure at fair value all one must do is assert they do not manage on a contractual yield basis and the conditions in paragraphs B14 and B15 would not have to be met.

AV10 He is also concerned that, in the current crisis, instruments that have provided some of the most significant losses when measured at fair value would be eligible for amortised cost. That conclusion is not responsive to the present environment. The approach also allows actively traded debt instruments, including treasury securities, be at amortised cost. These results are unacceptable to him and reduce the usefulness of reported information for investors.

AV11 The Board is required by its framework to be neutral in its decision making and to strive to produce neutral information to maximise the usefulness of financial information. The exposure draft fails in that regard as it produces information based on free choice, management intention, and management behaviour. Reporting that will result from this approach will not produce neutral information and diminishes the usefulness of financial reporting.

AV12 The Board is insistent in paragraph BC32 that accounting based on a business model is not free choice but never explains why selection of a business model is not a management choice. The existence of a trading account, a fair value option and the management of interest rate risk on a contractual yield basis are all free choices in the exposure draft.

AV13 The classification of selected equity instruments at fair value with the result of the remeasurement reported outside of profit or loss is also a free choice allowed in the exposure draft. The Board concludes that reporting fair value changes in profit and loss may not reflect the operating performance of an entity when an entity views their investments in equity securities as 'strategic'. Mr Leisenring questions why an investment that results in significant influence and requires IAS 28 accounting cannot also be 'strategic'. He also wonders how many sales of strategic investments can occur before the entity is seen to be trading.

AV14 Mr Leisenring could accept accounting for changes in fair value of some instruments outside profit or loss in other comprehensive income. That accounting, however, should not be a free choice and why that presentation is superior in defined circumstances should be developed. In addition, conditions for accepting such a presentation should be to require a single statement of comprehensive income and require comprehensive income per share.

AV15 The document is also inherently contradictory because it is based on choices by management but those classifications may not be changed. The business model of the entity may well change. When that occurs instruments will not be accounted for consistently with the objectives of the proposal. If accounting is to be based on intentions or on actual behaviour, reclassifications seem to be a natural consequence to avoid internal inconsistency within the model. It is also curious that the Board has prohibited reclassifications when even the irrevocable election of accounting for an instrument at fair value through profit and loss may result in reclassification at transition based on changed circumstances.

AV16 The credit crisis has provided confirmation that a dramatic change in accounting for financial instruments is desirable. However, many have said that while they agree that the approach suggested by Mr Leisenring would be superior, and a significant improvement, the world is not ready to embrace such change. It is unclear to Mr Leisenring what factors need to be present for the optimal solution to be acceptable. He has concluded that it is hard to envisage circumstances that would make the case any more compelling for fundamental change and improvement than the present circumstances. Therefore, this exposure draft approach will inevitably preserve a mixed-attribute model and the resulting complexity for a significant period of time.

AV17 Mr Leisenring would accept that if, for reasons other than the desire to provide useful information to investors, his approach is politically unattainable, an alternative could be developed that would be operational. That approach would require that all financial assets and financial liabilities be recorded at fair value through profit or loss except originated loans retained by the originator, trade receivables and accounts payable. This approach reduces the improvements that could be made, but it is far more operational than the approach in the exposure draft and minimises the items at amortised cost. While suboptimal, this approach would much better meet the needs of investors and improve the usefulness of reported financial information than what has been proposed.

