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IAS Plus Update.

Exposure draft proposes new classification and measurement guidance for financial instruments

Background

On 14 July 2009, the International Accounting Standards Board (IASB) issued an exposure draft (ED), ED/2009/7, *Financial Instruments: Classification and Measurement*. The ED is part of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement.* The ED proposes a new classification and measurement model for financial assets and financial liabilities.

This ED is part of the wider project to replace IAS 39 with an entirely new financial instrument standard that is expected to be mandatory no earlier than January 2012. The replacement to IAS 39 is intended to be achieved in stages. The other parts of the replacement include an ED on derecognition that was issued in March 2009 and exposure drafts on impairment and hedge accounting that are expected to be issued in the fourth quarter of 2009. The IASB expects to finalise the new classification and measurement model in time to allow entities to voluntarily adopt the new model for 2009 year-end financial statements. The finalisation of the remaining parts of the new standard is expected in 2010.

Summary of proposals

All recognised financial assets and financial liabilities that are currently in the scope of IAS 39 will be measured at either amortised cost or fair value[1]. A financial instrument that has only basic loan features and is managed on a contractual yield basis is measured at amortised cost, unless designated as at fair value through profit or loss (FVTPL). Those financial instruments measured at fair value will either be classified as at FVTPL or in the case of investments in equity instruments that are not held for trading, designated irrevocably as at fair value through other comprehensive income (FVTOCI). All investments in equity instruments and derivatives linked to equity instruments in the scope of IAS 39 must be measured at fair value, i.e. an unquoted equity investment cannot be measured at cost less impairment when fair value cannot be reliably measured as currently required by IAS 39.

The ED does not permit reclassifications out of or into amortised cost, FVTPL or FVTOCI after initial recognition.

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The headlines

- New criteria for amortised cost measurement.
- New measurement category – fair value through other comprehensive income.
- Impairment assessment only for amortised cost assets.
- No more available-for-sale assets.
- No more held-to-maturity assets and tainting rules.
- No more reclassifications between categories.
- No more embedded derivatives in financial instruments.
- No more unquoted equity investments measured at cost less impairment.

IFRS global office
Global IFRS leader
Ken Wild
kwild@deloitte.co.uk

IFRS centres of excellence

Americas		
New York	Robert Uhl	iasplusamericas@deloitte.com
Montreal	Robert Lefrancois	iasplus@deloitte.ca
Asia-Pacific		
Hong Kong	Stephen Taylor	iasplus@deloitte.com.hk
Melbourne	Bruce Porter	iasplus@deloitte.com.au
Europe-Africa		
Copenhagen	Jan Peter Larsen	dk_iasplus@deloitte.dk
Frankfurt	Andreas Barckow	iasplus@deloitte.de
Johannesburg	Graeme Berry	iasplus@deloitte.co.za
London	Veronica Poole	iasplus@deloitte.co.uk
Paris	Laurence Rivat	iasplus@deloitte.fr

1 The proposals do not change the requirement in IAS 32 to separate a financial liability and equity component of a compound instrument. The measurement of certain financial guarantee contracts, loan commitments, and liabilities arising from failed derecognition are unaffected by the proposals.

Debt instruments

A debt instrument will be measured at amortised cost or FVTPL. The available-for-sale and held-to-maturity classification categories (including the associated tainting rules) that are currently in IAS 39 will be removed.

A debt instrument can be measured at amortised cost only if both of the following criteria are met:

- it has only basic loan features, and
- it is managed on a contractual yield basis.

A debt instrument that meets both of the above criteria can still be designated as at FVTPL on initial recognition if the fair value designation would eliminate or significantly reduce an accounting mismatch that would exist had the instrument been measured at amortised cost (equivalent to the current IAS 39 fair value option for an accounting mismatch).

If a debt instrument measured at amortised cost is derecognised, IAS 1 *Presentation of Financial Statements* is amended to require the gain/loss on disposal to be separately disclosed in the statement of comprehensive income, and IFRS 7 *Financial Instruments: Disclosures* is amended to require a reconciliation of that gain/loss.

Where a debt instrument does not meet the criteria for amortised cost measurement it must be measured at FVTPL.

Basic loan features

The ED introduces the concept of basic loan features that has been adapted from a similar approach applied in the *IFRS for Small and Medium-sized Entities* recently issued by the IASB. The ED includes application guidance on what are considered to be basic loan features. In summary, a debt instrument is deemed to have basic loan features if the return to the holder is a fixed amount, fixed over the life, variable over the life due to changes in a single referenced quoted or observable interest rate or a combination of a fixed and variable return (e.g. LIBOR plus a fixed spread). Terms that limit the variability, e.g. caps and floors, or permit the issuer to prepay or holder to put the instrument are deemed basic loan features if the option to prepay or put is not contingent on future events[2] and the amount that is prepaid substantially represents unpaid interest and principal.

If the contractual cash flows of an instrument vary due to changes in credit quality of the financial instrument this term is regarded as a basic loan feature. When a debt instrument's claim against the entity is more subordinate than other claims care needs to be taken in assessing whether the instrument has basic loan features.

If the issuer's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest even in the event of the issuer's bankruptcy the instrument may have basic loan features. However, where the holder has an interest in an entity that is one of multiple contractually subordinated interests (i.e. tranches) then any tranche that provides credit protection to other tranches in any situation does not have basic loan features. In practice, this will mean only the most senior tranche of an entity that issues multiple tranches can potentially be measured at amortised cost.

The criterion for basic loan features will result in debt instruments that under IAS 39 were required to be partly measured at FVTPL as a separate embedded derivative, with the debt host contract measured at amortised cost, now either being measured at amortised cost or FVTPL in the instrument's entirety. This approach has the effect of removing the concept of embedded derivatives and debt host contracts for financial instruments that are in the scope of IAS 39.

Managed on a contractual yield basis

The ED introduces a new concept of managing on a contractual yield basis. The concept is derived from the entity's business model and therefore is most likely to be determined at a business unit, not individual financial instrument, level. The concept is based on whether key management personnel's focus is on the cash flows generated from (or payable on) the instrument, rather than the cash flows that may be realised from sale of the asset (or used to repurchase the liability).

The ED acknowledges that an entity may have different business units that are managed differently. For example, an entity may have a retail banking business managed on a contractual yield basis and an investment banking business managed on another basis. In this case, financial instruments with basic loan features in the retail banking business would qualify for amortised cost measurement even if similar financial instruments in the investment banking business do not.

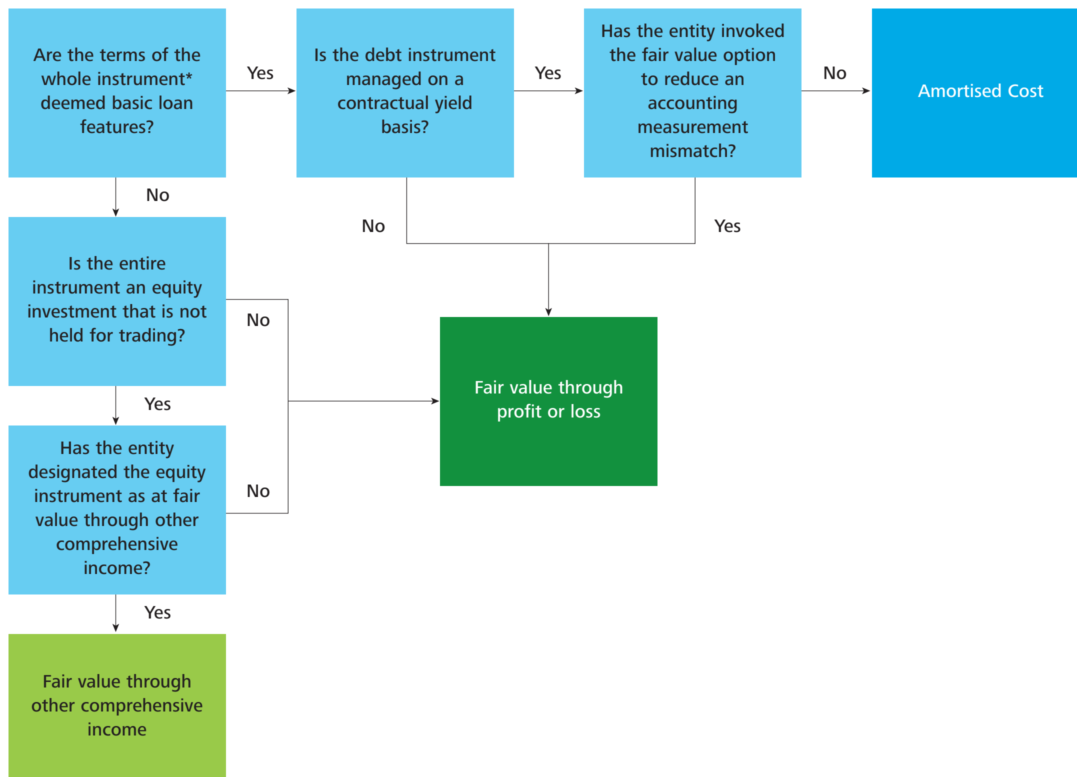
All instruments that would meet the existing held for trading definition will continue to be measured at FVTPL as they are not managed on a contractual yield basis. The ED also notes that a financial asset acquired at a discount that reflects incurred credit losses cannot be deemed to be managed on a contractual yield basis.

Equity investments

All equity investments held must be measured at fair value. The ED removes the current exemption in IAS 39 that requires unquoted equity investments to be measured at cost less impairment where fair valuation is not sufficiently reliable.

Equity investments are measured at FVTPL unless the entity irrevocably designates at initial recognition the equity investment as at FVTOCI. Designation at FVTOCI is not permitted if the equity instrument is held for trading.

2 Terms that protect the lender from credit deterioration of the borrower in cases of defaults, credit downgrades and loan covenant violations, and terms relating to possible future changes in taxation, law and similar factors that protect the lender are not considered to be contingent on future events.



* The whole instrument for this purpose includes the non-derivative liability component of an issued compound instrument where the equity component is recognised in Equity under IAS 32.

If the equity instrument is designated as at FVTOCI then all gains/losses, including fair value gains/losses and dividends, as well as transaction costs, are recognised directly in equity without any reclassifications to profit or loss. FVTOCI removes the current requirement in IAS 39 to perform an assessment of impairment and to reclassify the cumulative fair value gain/loss on disposal as all fair value movements remain permanently in other comprehensive income.

IFRS 7 is amended to require extensive disclosure of investments in equity instruments designated as at FVTOCI, including why an entity has chosen to designate as at FVTOCI.

Derivatives

All derivatives must be measured at fair value and therefore similar to the changes to equity instruments described above, the ED removes the requirement to measure at cost derivatives that are linked to and will result in the delivery of an unquoted equity investment where fair value is not sufficiently reliable.

The ED eliminates the existing separation requirements for embedded derivatives in circumstances where the hybrid contract is a financial instrument within the scope of IAS 39. Instead the entire hybrid financial instrument is evaluated under the classification criteria to determine whether it should be measured in its entirety at fair value or amortised cost. The separation requirements for non-closely related embedded derivatives continue to apply for contracts outside the scope of IAS 39 (e.g., insurance contracts, lease contracts, and purchase and sale contracts).

Impact of change

In some cases the ED will result in more fair value, in some cases less. The impact will depend on what financial instruments an entity has, how it has classified them previously, and what choices it makes under the revised classification model.

One of the greatest changes will be the ability to measure investments in government and corporate bonds with basic loan features at amortised cost which under IAS 39 would have been in many cases measured at fair value if quoted in an active market. Other instruments, such as asset-backed securities (e.g. some cash-collateralised debt obligations), service concession receivables, that may have been measured entirely at amortised cost or as available-for-sale will more likely be measured at FVTPL. Hybrid instruments with separated embedded derivatives at FVTPL (e.g. synthetic-collateralised debt obligations) will more likely be measured at FVTPL in their entirety.

Assets that are currently classified as held-to-maturity are likely to continue to be measured at amortised cost as often they contain only basic loan features and are managed on a contractual yield basis. However, the current tainting rules and hedge accounting restrictions that apply to held-to-maturity assets will be removed. Bank borrowings, issued debt, trade receivables and payables, will likely remain measured at amortised cost, however, their classification could change depending on the terms of the instruments and whether the entity manages them on a contractual yield basis.

The elimination of the available-for-sale category and the requirement for all investments in equity instruments to be measured at fair value removes the multiple impairment methodologies that currently exist in IAS 39. The ED would only require impairment assessment for financial assets measured at amortised cost. The rules on impairing amortised cost assets remain unchanged, but will be reconsidered in the ED on impairment expected to be issued in the fourth quarter of 2009.

On adoption of this ED an instrument that qualifies for amortised cost measurement may be classified as such. This would allow instruments that were designated at FVTPL under the fair value option of IAS 39 to be reclassified to an amortised cost measure on adoption of the new standard.

Effective date and transition

The effective date is not yet determined. However, the IASB's objective is to have the new classification and measurement standard issued in the fourth quarter of 2009 to allow entities with a December 2009 year end to early adopt. The standard will not be mandatory until at least January 2012.

If an entity chooses to early adopt the new classification and measurement standard consequential amendments to IFRS 7 will require disclosure of a comparison of the classification and carrying amounts of financial instruments by class under the old and new standard.

The ED requires retrospective application. However, assessment of whether instruments are managed on a contractual yield basis shall be made at the date of initial application. Also, designation as at FVTPL or FVTOCI, or dedesignation of financial instruments that were previously designated as at FVTPL, is made on the basis of the facts and circumstances that existed at the date of initial application.

In cases where retrospective application is not practical or requires hindsight other practical expedients other than full retrospective application are required.

Alternative approach

The ED also refers to an alternative approach where only those debt instruments that have basic loan features and are managed on a contractual yield basis *and* meet the current definition of loans and receivables can be measured at amortised cost. Those that do not meet the definition of loans and receivables will be measured at fair value with changes in value determined on an amortised cost basis presented in profit or loss and any difference between this amount and the fair value movement in the period recognised in other comprehensive income.

A further variant identified in the ED would be to measure all financial instruments at fair value with changes in fair value recorded in profit or loss, except for financial instruments with basic loan features that are managed on a contractual yield basis. Those instruments will be measured at fair value with changes in value determined on an amortised cost basis presented in profit or loss and any difference between this amount and the fair value movement in the period recognised in other comprehensive income. This variant is somewhat similar to an approach being explored by the US Financial Accounting Standards Board (FASB), although the FASB's classification criteria are slightly different. The FASB is expected to issue a parallel, although not fully consistent, ED addressing the classification and measurement of financial instruments in the near future.

The IASB requests views on the alternative approach as well as the classification model proposed in the ED.

Comment deadline

The IASB request comments on the ED by 14 September 2009.

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