



First Impressions: ED/2009/7 Financial Instruments: Classification and Measurement

International Financial Reporting Standards
July 2009

Foreword

Perhaps never before has financial reporting been the subject of such wide, prolonged and impassioned public debate as it has over the last 18 months. We have quickly become accustomed to discussion of what might have once been considered the preserve of specialists occupying the front pages and opinion columns of the international press and the agenda of political leaders. Put under the spotlight by the recent global financial crisis, the beam has been focused intensely on accounting for financial instruments. Although many would agree that accounting for financial instruments was not the cause of the crisis, there is an understanding that improvements to financial reporting will be part of the packages of international reforms that will come in its wake.

In April 2009 the Group of Twenty leaders (G20) called on accounting standard setters, including the International Accounting Standards Board (IASB), to improve accounting standards on valuation and impairment, and to reduce the complexity of accounting for financial instruments. The IASB's response to the call has been a plan for a short-term comprehensive review of all aspects of accounting for financial instruments and for replacement of the current IAS 39 *Financial Instruments: Recognition and Measurement*. The exposure draft (ED) *Financial Instruments: Classification and Measurement*, issued on 14 July 2009, is one of the key steps in the process.

The proposals contained in the ED would represent a significant change to the current requirements on how financial instruments are measured under International Financial Reporting Standards (IFRSs). All entities reporting under IFRSs are likely to be affected, but the impact is likely to be greatest for financial institutions – both in terms of the implementation efforts required and the effects on reported profits and capital.

The ED will cause us to consider important issues as to what information is both most relevant and most understandable to users of financial statements. As well as assessing the wider policy and conceptual objectives, we also must consider whether devils may be lurking in the detail of the ED. We will all need some time to digest the proposals, including the alternative models presented, and assess their likely impacts and costs and benefits. However, that time is limited as the ED has a comment period of 60 days. In view of the importance of the issues, we encourage all interested parties, including users and preparers of financial statements, to evaluate carefully the proposals and join in the debate – before proposals become new standards. We hope that you will find this publication of assistance in contributing to that debate.

Chris Spall
KPMG International Standards Group
20 July 2009

About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

We would like to acknowledge the efforts of the principal authors of this publication. Those authors include Chris Spall, Ewa Bialkowska and Markus Fuchs of the KPMG International Standards Group.

Content

Our First Impressions publications are prepared upon the release of a new IFRS, interpretation or other significant actual or proposed amendment to the requirements of IFRSs. They include a discussion of the key elements of the new requirements or proposals and highlight areas that may result in a change of practice.

This edition of First Impressions considers the proposed requirements of ED/2009/7 *Financial Instruments: Classification and Measurement* (the ED; or, the classification and measurement ED).

The text of this publication is referenced to the ED and to selected other current IFRSs in issue at 30 June 2009. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this ED in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

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1. Executive summary

- The ED is part of the IASB's wider project to replace IAS 39 *Financial Instruments: Recognition and Measurement* over the next year.
- The ED proposes two primary measurement categories for financial assets and financial liabilities: amortised cost and fair value.
- A financial instrument would be measured at amortised cost if it has only basic loan features and is managed on a contractual yield basis. All other financial instruments would be measured at fair value.
- The ED contains an option to classify financial instruments that meet the amortised cost criteria as at fair value through profit or loss if doing so reduces accounting mismatches.
- If a financial instrument is measured at fair value, all changes in fair value would be recognised in profit or loss, with one exception.
- For equity investments which are not held for trading an entity can choose to recognise gains and losses in other comprehensive income with no recycling of gains and losses into profit or loss. If an equity instrument is so designated, then dividend income also would be recognised in other comprehensive income.
- The existing tainting provisions for disposals before maturity of a financial asset would be eliminated
- The classification of an instrument would be determined on initial recognition. No subsequent reclassifications would be permitted or required.
- The ED would eliminate the exemption allowing some unquoted equity instruments and related derivatives to be measured at cost.
- No change is proposed to accounting for embedded derivatives with non-financial host contracts. Embedded derivatives with financial host contracts would not be bifurcated; instead the hybrid financial instrument would be assessed as a whole.
- No mandatory effective date is specified but the IASB does not expect it to be before 1 January 2012. The IASB plans to have a final standard available for early voluntary adoption in 2009 year-end financial statements.
- While reclassifications would not be permitted on an ongoing basis, at adoption of the proposed standard an entity would reconsider all classifications and designations including the fair value option.
- The deadline for comments is 14 September 2009.

2. Introduction and background

The IASB currently is revising the accounting requirements for financial instruments. The objectives of the project include improving the decision-usefulness of financial statements for users by simplifying the classification and measurement requirements for financial instruments. This project aims to replace the existing standard IAS 39.

The replacement project has three main phases:

- classification and measurement of financial instruments (ED/2009/7 issued on 14 July 2009, the subject of this publication)
- impairment of financial assets (an ED is scheduled to be published in October 2009)
- hedge accounting (an ED is scheduled to be published in December 2009).

A phased approach has been adopted in order to accelerate the replacement of IAS 39 and address the consequences of the financial crisis as speedily as possible, while giving interested parties an opportunity to comment on the proposals in accordance with the IASB's commitment to due process. The classification and measurement proposals will form a basis for making subsequent proposals on impairments and hedge accounting.

The IASB has not specified a mandatory effective date for the proposals in the ED but has stated that it does not expect it to be before 1 January 2012. Also, it plans to enact a final standard on classification and measurement in time for preparers to early adopt it voluntarily in 2009 year-end financial statements. Final standards on impairment and hedge accounting are scheduled for 2010.

At the time of publication, the IASB has issued a number of other exposure documents that form part of, or are relevant to, the IAS 39 replacement project.

In June 2009, the Board published a discussion paper (DP) *Credit Risk in Liability Measurement*. The comment period for this DP ends on 1 September 2009 so that the IASB can take comments received on this DP into account in its deliberations on classification and measurement of financial instruments. The DP discusses whether and how an entity's own credit risk should be included in current measurements of the entity's liabilities.

As a precursor to the expected exposure draft on impairment of financial assets, the IASB also issued in June 2009 a Request for Information on the feasibility of an expected loss model for the impairment of financial assets. The request states that the Board is discussing an expected cash flow approach to impairment as a possible replacement of the incurred loss model currently required by IAS 39, and outlines criticism of the incurred loss approach. The paper does not request input on the relative merits of these or other approaches but instead seeks information as to whether the expected loss approach is described clearly and would be operational. The comment period closes on 1 September 2009.

In March 2009, the IASB published Exposure Draft ED/2009/3 *Derecognition*. The ED proposes new guidance on when a financial asset should be removed from an entity's statement of financial position, and increased disclosures about transfers of assets. Comments are requested by 31 July 2009.

In May 2009 the IASB published Exposure Draft ED/2009/5 *Fair Value Measurement* (the fair value measurement ED) which proposes new guidance on the principles to be applied in determining fair values. The proposed guidance in the fair value measurement ED would apply to any measurements of the fair values of financial instruments that would be required under the

classification and measurement ED. The comment period for the fair value measurement ED ends on 28 September 2009.

The IAS 39 replacement project, and in particular its accelerated timeline, is driven in part by requests for reform from the Group of Twenty (G20). Following the G20 summit in April 2009, the Leaders' Statement called on accounting standard setters, including the IASB and the U.S. Financial Accounting Standards Board (FASB), to work urgently with supervisors and regulators to improve standards on valuation guidance and loan loss provisioning and achieve a single set of high-quality global accounting standards.

The IASB has stated that it remains committed to working together with the FASB to develop a comprehensive standard to improve the reporting of financial instruments. At the time of publication, the FASB is still developing its own proposals (see section 4). The IASB has indicated that it will consider publishing for comment any proposals that the FASB issues, particularly if they are materially different from the IASB's proposals.

The IAS 39 replacement project, like current IAS 39, addresses only financial instruments that are financial assets or financial liabilities. It does not address the accounting for an issuer's own equity instruments or the question of whether a financial instrument is appropriately classified as equity or as a financial asset or liability. These matters continue to be governed by IAS 32 Financial Instruments: Presentation and are not affected by the ED. However, the Board does have another project, Financial Instruments with Characteristics of Equity, aimed at developing a better distinction between equity and non-equity instruments. The project is being carried out jointly with the FASB and is intended to converge IFRS and U.S. GAAP in this regard. The IASB currently expects to publish an ED on this project in the fourth quarter of 2009 leading to a new final standard in 2011.

The purpose of this publication is to summarise the key features of the proposals in ED/2009/7 and highlight potential impacts and conceptual and application issues identified to date so as to facilitate informed debate and comment on the proposals.

Observations

The phased approach to replacing IAS 39 may present challenges for interested parties in commenting on the desirability of the changes proposed in this ED as there is an inter-relationship between the different phases. For example, a user might support amortised cost measurement for certain financial assets only if the impairment model applied is amended to capture expected as well as incurred losses. Therefore, commentators should consider whether their views on particular aspects of the ED are conditional on their expectations as to other aspects of the final comprehensive replacement standard and articulate any conditions that they have assumed. Similarly, the merits and pitfalls of requiring or allowing some or all financial instruments at fair value can be assessed only with an understanding of what "fair value" means and how it is measured. The guidance in IFRSs on the measurement of fair value is subject to change as a result of the IASB's separate project on fair value measurement and the ED that has been issued on this subject.

The DP on the role of credit risk in liability measurement was prompted in part by controversy regarding the inclusion of gains and losses in profit or loss related to changes in own credit risk on financial liabilities classified as at fair value through profit or loss. The classification and measurement ED mentions this DP and says that the IASB will consider responses to the DP when finalising the classification and measurement standard. However, the ED does not propose any change compared to current IAS 39 in the presentation of such gains and losses.

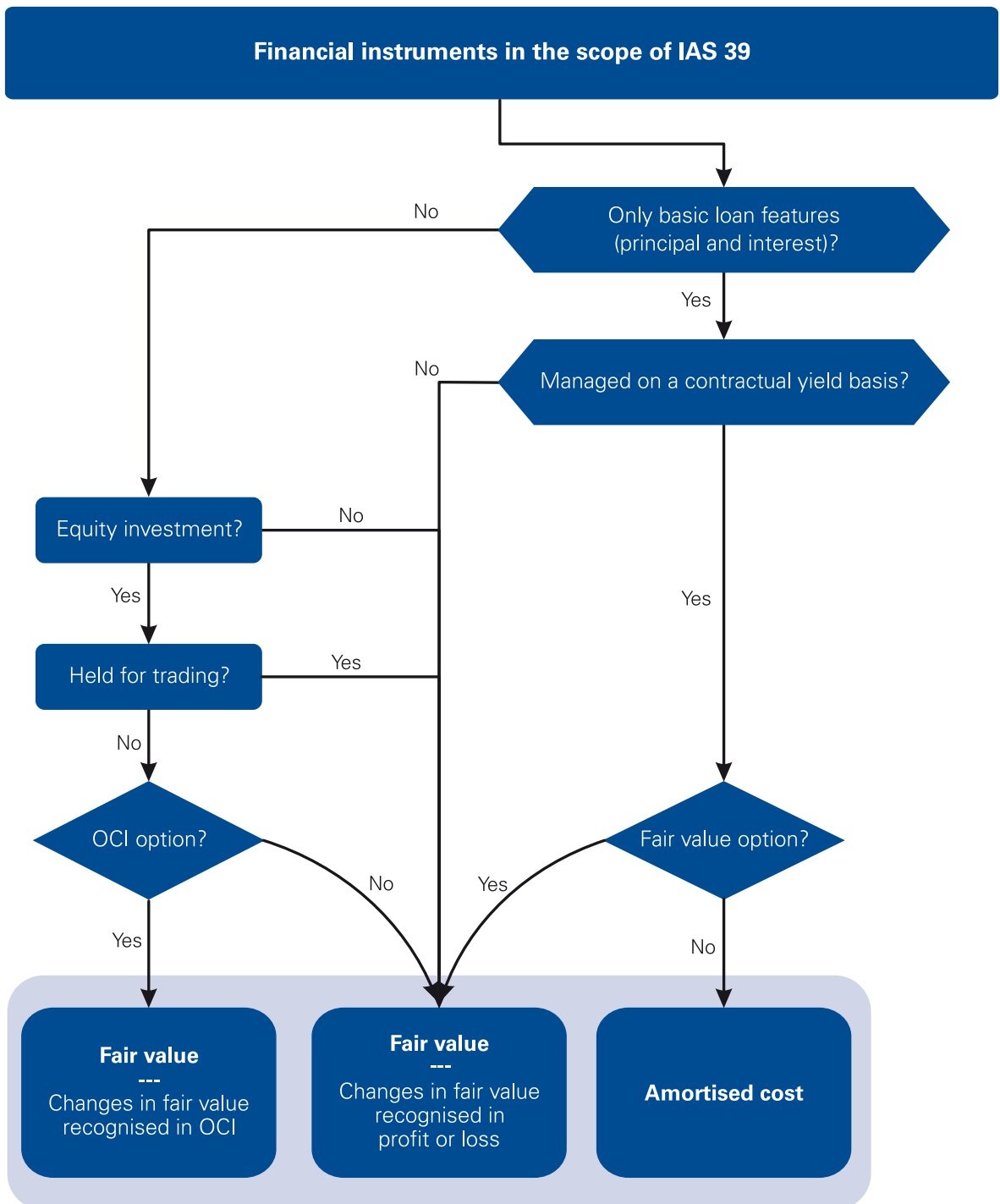
Respondents may wish to consider the arguments advanced in the DP on whether credit risk should be included in current measurements of liabilities in forming their views on this ED.

The ED reiterates the IASB's commitment to working jointly with the FASB to develop a comprehensive standard on financial instruments, consistent with requests from the G20. As noted, the FASB has yet to publish its own proposals for simplifying the accounting for financial instruments but its decisions to date differ from the IASB's proposals in the ED (see section 4). The ED does not specify how or when convergence will be achieved. It refers to the possibility that the FASB's ultimate proposals may be different from the IASB's and that the IASB would then expose those proposals to its constituents for comment. At present, it is possible that there might be continuing differences between the accounting for financial instruments under IFRSs and U.S. GAAP and that the proposals in the ED or the requirements in any final standard might be subject to further re-deliberation and possible change in order to progress convergence at a later date.

3. The proposed classification and measurement principles

3.1 Overview

The flowchart below provides an overview of the classification and measurement model in the ED. Each element of the model is explained further in the succeeding paragraphs.



ED/2009/7.3 3.2 Measurement categories

The ED proposes two primary measurement categories. On initial recognition an entity would be required to classify a financial asset or financial liability in the scope of the ED as subsequently measured at either:

- amortised cost; or
- fair value.

ED/2009/7.11 All instruments would be measured initially at fair value plus, in the case of an instrument not at fair value through profit or loss (FVTPL), transaction costs directly attributable to its acquisition or issuance.

ED/2009/7.19 If fair value measurement applies subsequently, then generally all changes in fair value would be recognised as gains or losses in profit or loss. The only exception is certain equity instruments for which there would be the option to recognise fair value changes and dividends in other comprehensive income (OCI).

ED/2009/7.C12 Any gains and losses on sales or other derecognition of financial instruments measured at amortised cost would be presented separately in profit or loss. The existing tainting provisions for disposals before maturity of a financial asset would be eliminated.

Observations

The existing categories under IAS 39 of “held-to-maturity”, “loans and receivables” and “available-for-sale” would be eliminated. Additionally, the current exemption from fair value measurement for unquoted equity investments and related derivatives whose fair value cannot be determined reliably would be removed.

3.3 Classification principles

Financial instruments would be classified into one of the two categories based on the instrument’s features and the way the instrument is managed by the entity. Certain classification choices would be available – this is further discussed in section 3.4.

ED/2009/7.4 An instrument would qualify for amortised cost measurement only if it satisfies both of the following conditions:

- it has only “basic loan features”
- it is “managed on a contractual yield basis.”

ED/2009/7BC17 The Board believes that for these instruments, and these instruments only, amortised cost measurement would be appropriate because the instrument produces predictable cash flows and the entity’s business model involves paying or receiving those returns rather than selling or transferring the instrument.

ED/2009/7.5 All other financial instruments would be measured at fair value.

3.3.1 Basic loan features

ED/2009/7.B1, B5 The key characteristic of a financial instrument with only basic loan features is that it would give rights to cash flows that are only *principal and interest*. Terms that change the amount or timing of payments are not basic loan features unless they protect the creditor or debtor. Features that result in cash flows other than principal and interest are not basic loan features.

ED/2009/7.B1 The ED describes interest as being “consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time”.

ED/2009/7.B3 The ED gives the following examples of basic loan features:*

- Returns to the holder that are:
 - a fixed amount;
 - a fixed return over the life of the instrument;
 - a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR); or
 - some combination of such fixed and variable returns (such as LIBOR plus 200 basis points), provided that both the fixed and variable rates are positive.For variable interest returns, interest would be calculated by multiplying the variable rate by the principal amount outstanding. Changes in returns attributable to changes in the timing of cash flows and pre-set changes to interest rates in response to changes in credit quality would not violate this condition.
- A combination of a fixed interest and a variable interest return, such as a variable coupon subject to a cap, floor or collar.
- Contractual terms that permit the issuer (the debtor) to prepay a debt instrument or permit the holder (the creditor) to put it back to the issuer before maturity that are not contingent on future events, but only if the prepayment amount substantially represents unpaid principal and interest. Terms that protect the lender from credit deterioration or changes in taxation or other law are not considered contingent on future events for this purpose. Such prepayment terms may require the issuer to compensate the holder for early termination.

ED/2009/7.B5, .BC62 A derivative does not have basic loan features because its cash flows do not represent returns of principal and interest, since a defining characteristic of a derivative is that there is no or little initial net investment relative to its exposure to risk. An investment in an equity instrument also does not have basic loan features.

Observations

A key issue with respect to the operability of the ED is whether the “basic loan features” concept is sufficiently clearly articulated and robust enough to produce consistent and meaningful results in practice. The Board notes that the approach would require an entity to use judgement, but are the concepts of principal, interest and protecting the position of debtor or creditor a suitably solid foundation for that judgement?

Application of the basic loan features requirements would require careful consideration and may require considerable effort to implement. It is not uncommon for loan agreements to run to tens or hundreds of pages and contain many complex terms and conditions. In deliberating the proposals, the Board discussed whether the basic loan features test should include an explicit exemption for immaterial features but decided not to include an explicit relief. Issues may arise as to whether contingent payment features that are expected to be insignificant in practice would disqualify an instrument in its entirety from amortised cost measurement.

*ED/2009/
7.BC21, B3*

The Basis for Conclusions indicates that “leverage” would not be a basic loan feature as it amplifies the variability of cash flows. This principle is not reproduced in the proposed standard but it does state that a variable interest return should be based on multiplying the principal outstanding by the relevant rate. For example, a bank makes a loan with a nominal amount of CU100, net of an arrangement fee of CU2, such that the borrower receives a net advance of CU98. Interest is charged based on LIBOR and the nominal amount of CU100. Is the principal outstanding for the purpose of the test CU98 or CU100? If it is CU98, then does the loan fail the basic loan features test because variable interest is calculated on the nominal amount of CU100?

* These examples are primarily sourced from ED/2009/7.

Under the current IAS 39, complex non-basic features in a loan generally can impact the accounting for the loan in either of two ways. If they are embedded derivatives requiring separation, then they can be accounted for separately at fair value through profit or loss while the loan, excluding the separated features, is accounted for at amortised cost. If the features are not separately accounted for in this way, then the loan is accounted for at amortised cost and the feature is included in calculating that amortised cost and the related interest income or expense. However, under the ED, a non-basic feature could cause the entire loan instrument to be measured at fair value through profit or loss.

ED/2009/7.B3

The ED states that variable interest that, throughout the life of an instrument, is referenced to a single quoted or observable rate (e.g., LIBOR) would be a basic loan feature. Also, interest that is a combination of such a variable rate and a fixed return would be a basic loan feature. It is unclear whether interest that is referenced to two or more quoted or observable rates would be a basic loan feature. For example, some loans may provide the borrower with a choice between LIBOR and the lender's quoted base or standard variable rate. Additionally, LIBOR itself is not a single rate but is quoted for different time periods. A borrower may have a choice each period between for example, one-month, three-month or six-month LIBOR. The ED does not discuss whether this would be a basic loan feature.

ED/2009/7.B6,
.B7

The ED states that a subordinated financial instrument still may have basic loan features if non-payment is a breach of contract and the creditor retains the contractual right to unpaid principal and interest even in the case of debtor's bankruptcy. However, in some types of transactions, an entity may use a "waterfall" structure that prioritises payments using multiple contractually subordinated interests or tranches. Losses incurred by the issuer are allocated to the different tranches according to their ranking. The senior tranche is paid in full before any subordinated tranche is paid.

Waterfall structures are common in securitisations. A special-purpose entity (SPE) may issue various classes of notes. Cash flows from the assets of the SPE are used to pay holders of each tranche of notes in their order of seniority. If cash flows are insufficient to pay fully the claims of all tranches, then the claims of junior tranches are reduced as holders of notes of junior tranches provide credit protection to holders of notes of senior tranches.

ED/2009/7.B8

The ED states that any tranche that provides credit protection to other tranches in any situation would not have only basic loan features as the cash flows of the tranche are not merely principal or interest because the holder also is being compensated for providing that credit protection.

Observations

The proposed guidance on subordination seems to require that no tranches, except the most senior tranche, in a waterfall structure, may qualify as an instrument containing only basic loan features. Waterfall structures may include numerous tranches, including a number of senior or intermediate tranches that both receive credit protection from more junior tranches and provide credit protection to more senior tranches. Under the proposals a senior (but not the most senior) tranche would appear not to qualify as having only basic loan features even though it is relatively senior and economically is less exposed to credit losses than a proportionate interest in the securitised pool of assets.

The ED does not state definitively that subordinated debt instruments or preferred shares classified as liabilities that rank behind general creditors of the issuer could qualify as having only basic loan features. The ED also does not discuss non-recourse finance outside of the context of waterfall structures, e.g., loans that are secured only against cash flows generated from a

specified asset or assets of an entity. If the cash flows generated by the asset are insufficient to service the loan, or if the asset is surrendered to the lender, then the lender may have no further contractual right to recover principal and interest. It is unclear whether such features are basic loan features. On the one hand, it might be argued that the lender is not providing credit protection to a third party but merely faces more risk of non-payment than would be the case for a full recourse loan. On the other hand, it might be argued that the lender is bearing not (just) credit risk but the risk that the specific asset declines in value and that part of the contractual cash flows of the loan represent compensation for this risk. However, if this logic were applied to waterfall structures, then not even the very most senior tranche would qualify as having basic loan features since the most senior tranche still bears the risk that the assets that feed the waterfall produce no or very little cash flows. We do not believe that it is the Board's intent that the most senior tranche of a waterfall structure would fail the basic loan features test.

Also, in a securitisation structure, the servicer often is entitled to receive payment in priority to any note holders. It is unclear whether this priority would preclude all the notes issued by an SPE from qualifying as having basic loan features in cases in which the servicer's return exceeds an arm's length fee.

Some commentators also may be concerned as to the robustness of a requirement based on contractual seniority and how it would be implemented in the face of evolving securitisation structures. For example, an SPE may acquire assets and issue senior and junior tranches of notes. The junior notes would fail the basic loan features test. However, if the first SPE issued the junior notes to a second SPE that in turn issued a single tranche of senior notes to investors, then those senior notes might satisfy the basic loan features test. In the Basis for Conclusions, the Board indicates that it rejected the proposition that it is necessary to look through the instruments to the underlying assets that secure them because of the operational difficulties involved. The unwillingness to extend the assessment in this way may open up the possibility of deliberate structuring around the requirement and raise questions as to its effectiveness.

ED/2009/7.BC28

The guidance on waterfall structures appears to apply to liabilities as well as to assets. Accordingly, accounting mismatches might arise as a result of applying the waterfall guidance. For example, a group may hold investments in a consolidated SPE that issues to investors notes that are secured against cash flows from the assets it holds. Assuming that the transaction does not represent a transfer of the SPE's assets within the meaning of IAS 39, the assets held by the SPE and consolidated by the group might be measured at amortised cost as might the most senior tranche of notes issued. However, other tranches might have to be measured at fair value through profit or loss. Alternatively, if the issuance of the notes satisfied the "pass-through test" as defined in IAS 39 but still did not lead to the derecognition of the assets under IAS 39, the matter would be further complicated, since the ED would retain the special guidance in IAS 39 on the measurement of liabilities that result from a transfer that does not qualify for derecognition (see section 5).

3.3.2 Managed on a contractual yield basis

In order to qualify for the amortised cost category, an instrument also should be "managed on a contractual yield basis."

ED/2009/7.B9 "Financial instruments are managed on a contractual yield basis only if they are managed, and their performance is evaluated by the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*), on the basis of the contractual cash flows that are generated" by holding or issuing the instruments.

ED/2009/7B10, BC31 This assessment would not be based on management's intentions with respect to an individual instrument. The requirement instead refers to the nature of the business model and how management manages the instruments, which is unlikely to differ for an individual asset or liability in isolation. The ED notes that a reporting entity may have several units, each with different business models and approaches to managing their own financial instruments, for example, a banking group with separate retail banking and investment banking businesses.

ED/2009/7BC32 The Board believes that whether instruments are managed on a contractual yield basis is a matter of fact that can be observed by the way that an entity is managed and information that is provided to the management of the entity.

ED/2009/7B13, BC33 The ED states that instruments held for trading would not be managed on a contractual yield basis. However, sales or transfers of instruments before maturity would not change the business model as long as the model was to manage the collection or payment of cash flows rather than to realise changes in fair value.

ED/2009/7B13 The ED states that a financial asset acquired at a discount that reflects incurred credit losses would not be managed on a contractual yield basis.

Instruments quoted in an active market would not be precluded from being considered as managed on a contractual yield basis.

Observations

Similar to our observation on the basic loan features test, an important factor in assessing the operability of the proposals is whether the "managed on a contractual yield basis" criterion is sufficiently clearly explained and robust enough to allow for consistent and meaningful application. In particular, an entity's management may hold a portfolio of instruments for more than one purpose, or a purpose that potentially involves holding or selling instruments in response to changing circumstances. In addition, an entity's management may evaluate the instruments' performance in a number of ways. Although the Board believes that the criterion is a matter of fact, in these circumstances it would appear that considerable judgment would be necessary to make the assessment.

Examples might include:

- a bank that holds a stock (or "reserve") of highly liquid investments that it generally would hold for yield but which it would sell to provide cash to forestall funding difficulties
- an insurer that holds investments that may be held for yield but which may be sold to provide funds to settle policyholder claims
- an income-driven investment portfolio that is invested in debt securities for the purpose of generating contractual interest income but may sell investments in order to reinvest funds in replacement securities that provide a more attractive contractual yield.

Some entities may monitor the performance of investments by considering both the contractual income earned on those investments and the fair values of those instruments. Companies, in particular in the financial sector, may have risk management systems that measure risk based on fair value exposures and sensitivities. Although it is not discussed in the ED, we understand that the Board does not intend that management of risk based on fair values be considered equivalent to evaluation of performance, and therefore it would not in itself preclude instruments from being considered managed on a contractual yield basis.

ED/2009/
7BC29

The ED does not explain why a financial asset that is acquired at a discount that reflects incurred credit losses would not be managed on a contractual yield basis. The Basis for Conclusions states that the exposure to variability that arises from the investor's expectation that actual losses will be less than the losses reflected in the purchase price is not interest. The ED does not discuss why this should be regarded differently from the variability that arises when an entity originates or purchases loans with a credit spread that equals or exceeds the credit losses that the entity expects to incur or how the incurrence of credit losses changes the nature of an instrument's features. Application of this requirement may be challenging when an entity acquires a portfolio of assets, some of which have incurred credit losses that have not been specifically identified, e.g., in a business combination.

3.4 Classification choices

3.4.1 The fair value option

ED/2009/7.9

An entity would continue to be able to choose to designate as measured at FVTPL an instrument that otherwise would be required to be measured at amortised cost. This optional designation would be permitted only if it eliminates or significantly reduces a measurement or recognition inconsistency (an "accounting mismatch") that otherwise would arise. The election would be available only on initial recognition of the instrument and would be irrevocable.

Observations

This option to measure at fair value is carried over from current IAS 39.

ED/2009/
7BC49

The Board considers that the two other fair value designation conditions available currently for financial instruments in IAS 39 would be rendered redundant by the other proposals in the ED and would be eliminated. These two conditions that would be eliminated relate to:

- Instruments that are managed on a fair value basis. Under the ED, instruments may qualify for amortised cost measurement only if they are managed on a contractual yield basis. Instruments managed on a fair value basis therefore would be required under the ED to be measured at fair value.
- Hybrid financial instruments containing an embedded derivative that otherwise might require separation. Under the ED, embedded derivatives would not be separated from financial host contracts (see section 3.5).

3.4.2 Designation of equity investments

ED/2009/7.21

The ED allows an entity, at initial recognition only, to elect to present fair value changes for investments in equity instruments that are not held for trading in OCI. The election would be irrevocable.

ED/2009/
7B24, 22

The amounts recognised in OCI would not be recycled to profit or loss on disposal of the investment or in any other circumstances. Accordingly, there would be no impairment testing for these assets. Dividend income on investments classified as at fair value through OCI also would be recognised in OCI and not in profit or loss.

Observations

The IASB originally discussed proposing a requirement that "strategic investments" would qualify for fair value through OCI treatment. However, the difficulties associated with defining and implementing such a concept led the Board instead to propose a free choice on initial recognition for all non-trading equity investments. If implemented, preparers would have to

think carefully about whether to make this election. Although they would be relieved from the requirement to assess and, if appropriate, recognise impairment losses under current IAS 39 as well as from the potentially increased income statement volatility that would result from FVTPL treatment under the ED, the *quid pro quo* would be to forego forever the inclusion in profit or loss of any dividend income or disposal gains on the investment. Preparers ultimately might consider this undesirable, particularly if the investment is funded by debt financing on which the related interest expense would be charged against profit or loss.

The proposals in the ED refer to the election as relating to “investments” in the plural. This might be read as meaning that the election could be made only in relation to all equity investments not held for trading or not at all. Although it is not discussed in the ED, we believe that the Board’s intention is that the election would be available on an individual instrument-by-instrument basis. If an instrument-by-instrument basis is permitted, then, for example, an entity might hold 200 shares in an investee, 100 of which are designated as at fair value through OCI and 100 of which would be classified as at FVTPL.

To the extent that an entity elects fair value through OCI treatment, gains and losses would be reported permanently in OCI with no recycling to profit or loss. This might suggest a more significant role for other comprehensive income in terms of reporting financial performance. It is interesting to note, however, that under IAS 33 Earnings per Share, an entity is required to report only earnings per share based on the profit or loss attributable to ordinary equity holders and is not required to report other comprehensive income per share or total comprehensive income per share.

IFRS 4 *Insurance Contracts* permits insurance companies to apply “shadow accounting” under which changes in the measurement of insurance contract liabilities that are driven directly by recognised but unrealised gains and losses on assets it holds may be recognised in other comprehensive income if, and only if, those unrealised gains and losses are recognised in other comprehensive income. Under current IAS 39, shadow accounting has been applied in respect of available-for-sale financial assets and, consistent with the implementation guidance to IFRS 4, the effects of remeasurement of the insurance contract liabilities are reclassified to profit or loss on realisation of the gain or loss on the related assets. The ED does not discuss how “shadow accounting” would be applied to disposals of fair value through OCI assets. There is no proposed change to the implementation guidance to IFRS 4; however, it would seem inconsistent if shadow accounting effects were reclassified to profit or loss on disposal of an investment while the cumulative gains or losses on the related investment were not. Relatedly, dividend income on fair value through OCI assets would be recognised in OCI while any direct effect of that income on the measurement of an insurance contract would be reflected in profit or loss. An insurance company might be forced to classify equity investments as measured at fair value through profit or loss to avoid these mismatches.

3.5 Embedded derivatives

ED/2009/7.8 The ED proposes to remove the existing accounting requirements for embedded derivatives, when the host contract is a financial instrument within the scope of IAS 39. This change is proposed in recognition of the criticism of the existing requirements as being complex, rules-based and internally inconsistent.

ED/2009/7.8 Features embedded in hybrid financial instruments for which the host is within the scope of IAS 39 would no longer be subject to an assessment to determine whether they should be accounted for separately as derivatives. Instead, the entire hybrid financial instrument, including all embedded features, would be assessed for classification. The presence of certain derivative-type features in a hybrid instrument would not preclude amortised cost classification, e.g., prepayment options,

or interest caps, floor and collars, even if they are in-the-money at the time of initial recognition, provided that they are basic loan features (e.g., they do not result in a leverage).

However, many embedded derivative-type features would cause the hybrid instrument to fail the “basic loan features” test, and result in the whole instrument being classified as at FVTPL. This represents a change from current IAS 39 whereby an embedded derivative might be accounted for separately at FVTPL while the host instrument is measured at amortised cost.

For example, an entity might have an investment in a conventional convertible bond. Under the terms of the bond, the holder has the option to convert it into a fixed number of equity shares of the issuer. Under current IAS 39, the bond is bifurcated into the conversion option (an embedded derivative) and the host debt instrument. Since the economic characteristics and risks of the conversion option, primarily equity price risk, are not closely related to those of the host debt instrument, the conversion option is separately accounted for at FVTPL while the host debt instrument may be classified as a loan and receivable or as available-for-sale, depending on the circumstances. However, under the ED, the convertible bond would be analysed for classification in its entirety. The presence of the conversion option would cause the instrument to fail the “basic loan features” test, so under the ED the convertible bond in its entirety would be accounted for at FVTPL.

ED/2009/7.C25 The ED proposes to remove the existing guidance in IAS 39 on when a derivative should be regarded as closely related to a host contract that is a financial instrument.

ED/2009/7.7
.BC47 The proposals are not intended to change accounting for embedded derivatives with host contracts that are not financial instruments or with host contracts that are financial instruments that are not within the scope of IAS 39, e.g., rights and obligations under leases or insurance contracts. The requirements for hybrid contracts with non-financial hosts would be addressed in a later phase of the project to replace IAS 39.

Observations

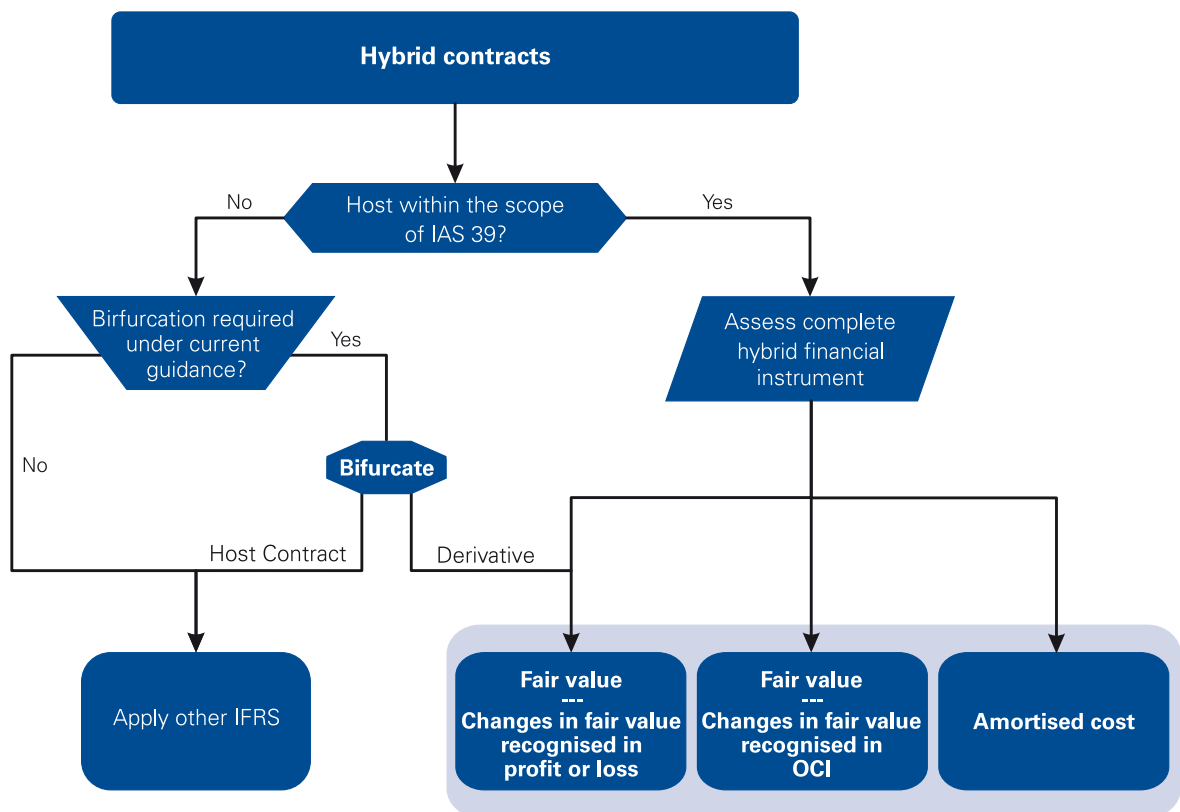
In general, the proposed approach may simplify the accounting for, and valuation of, hybrid financial instruments as it would no longer be necessary to split a single financial instrument into components and to apply valuation techniques to the separated components, which can be complex. Instead often it would be simpler to fair value the whole hybrid instrument, should it fail the “basic loan features” test.

However, entities that use freestanding derivatives to hedge risks in previously separated embedded derivatives may find that accounting for the whole hybrid instrument at FVTPL creates an accounting mismatch.

Application of the requirements in the ED might mean that there will be less opportunity for measuring financial instruments at amortised cost as, unless an embedded derivative feature meets the “basic loan features” test, the whole hybrid instrument, rather than just the derivative feature, would be measured at FVTPL. This might be the case even if the embedded derivative is expected to have a fair value close to zero throughout the life of the instrument.

The ED does not discuss the accounting for compound instruments, e.g., certain convertible debt, by the issuer. Under IAS 32, such convertible debt is split into a debt component which is accounted for as a financial liability and the conversion option which is accounted for as an equity instrument. The ED does not appear to change this analysis; however it does not state whether the issuer may regard the debt component as having only basic loan features or as being managed on a contractual yield basis even though exercise of the conversion option by the holder would extinguish the contractual cash flows.

The flowchart below illustrates a decision tree for classification of hybrid contracts under the ED.



3.6 Reclassification

ED/2009/7.10 Classification of financial instruments would be determined on initial recognition only. Subsequent reclassification between categories would be prohibited.

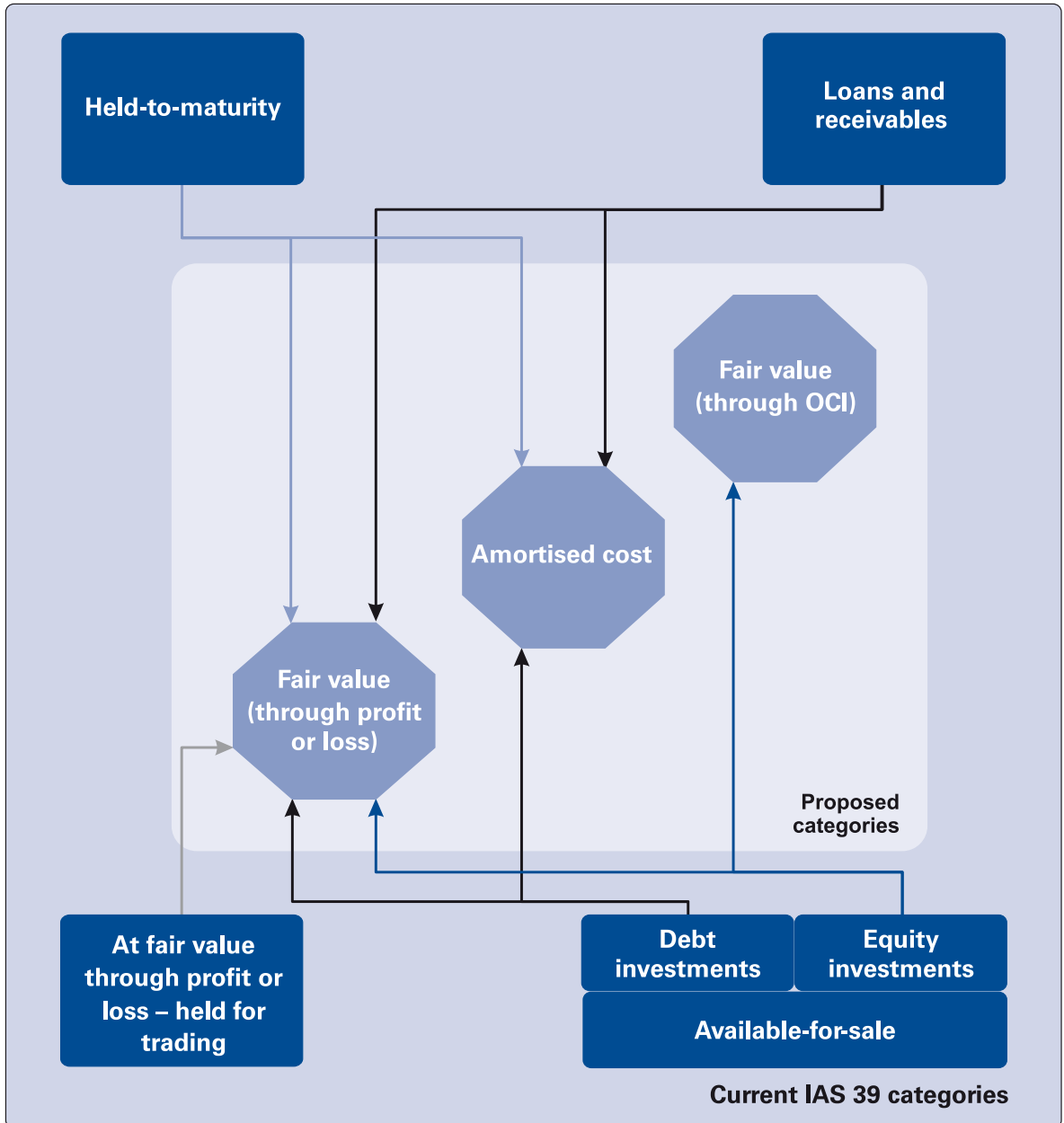
Observations

The ED prohibits any form of subsequent reclassification. This may be of concern to some preparers, who took the opportunity to reclassify assets from fair value to amortised cost measurement following the issuance in October 2008 of the *Reclassification of Financial Assets* amendments to IAS 39. The Board noted that to continue to allow or require reclassification would not make it easier for users to understand financial statements. It also would increase complexity because detailed guidance would be required to specify when reclassification would be permitted or required and the subsequent accounting for any reclassified financial instruments.

Notwithstanding this reasoning, some may argue that, to the extent the initial classification of an instrument is based on circumstances that are subject to change, for example an entity's management of an instrument on a contractual yield basis or the existence of an accounting mismatch, an entity should be either required or permitted to change the instrument's classification if those circumstances change.

3.7 Mapping of old and proposed categories

The following diagram gives an overview of how the initial classification of financial assets under IAS 39 and the classification under the ED would differ. This overview does not take into account the fair value option (under the existing IAS 39 or the ED).



Observations:

One of the most frequent questions asked about the ED is whether it will lead to more or less instruments being measured at fair value. The answer seems to be that it depends on the circumstances of each entity – in terms of the nature of the instruments it holds, the way in which it manages those instruments and the classification elections it chooses to make. However, some major directional changes can be highlighted:

- Many available-for-sale (AFS) debt investments that currently are measured at fair value may qualify for amortised cost accounting, for example simple debt instruments that are quoted in an active market. However, those that would not qualify would be measured at fair value through profit or loss rather than through OCI.
- We expect that many loans and receivables and held-to-maturity (HTM) assets would continue to qualify for amortised cost accounting. However, some would not and would be measured instead at fair value through profit or loss.

- Some instruments currently may be disaggregated into financial host instruments that are not at fair value through profit or loss and separated embedded derivatives that are measured at fair value through profit or loss. Although the proposed “basic loan features” test is different from the current requirements for separation of embedded derivatives, in many cases the presence of an embedded derivative feature that previously required separation because it was “not closely related” to its host instrument is likely to cause the entire hybrid financial instrument, rather than just the embedded feature, to be accounted for at fair value through profit or loss. However, in some cases, a previously separated embedded derivative feature may not cause an instrument to fail the basic loan features test.
- The proposed guidance on subordination may mean that many asset-backed securities, including collateralised debt obligations, that may have qualified previously for amortised cost or AFS treatment would be required to be accounted for at fair value through profit or loss. This also could apply to subordinated liabilities in a waterfall structure.
- Equity investments and related derivatives previously measured at cost would be required to be accounted for either at FVTPL or at fair value through OCI.

Although the ED does not address accounting for impairment directly, the changes in classification and measurement requirements would impact whether and how impairment is measured for many assets. In particular, impairment of AFS assets is measured currently by reference to the fair value of the investment. Some commentators have expressed dissatisfaction with two aspects of the current requirements. Firstly, they believe that, especially in illiquid markets, measuring impairment losses on debt securities based on fair value may lead to reporting an impairment loss that exceeds the expected credit loss that management expects to bear. Secondly, IAS 39 does not allow impairment losses recognised on AFS equity investments to be reversed if the fair value of the investment subsequently increases. As the ED proposes to eliminate the AFS category, it effectively eliminates the AFS impairment rules. Under the proposals, impairment of AFS debt investments that qualify for amortised cost accounting would be measured instead under the amortised cost model while no impairments would be recognised on AFS equity investments for which fair value through OCI treatment was elected. If an AFS equity investment was measured instead at fair value through profit or loss, although declines in fair value would be recognised as losses in profit or loss as they occurred, these losses also would be reversed through profit or loss if the fair value of the equity investment subsequently increased.

4. Alternative models and FASB proposals

The alternative approaches are set out in the “Summary of the proposals and invitation to comment” section of ED/2009/7.

4.1 Alternative models

The ED presents three alternative models on which comment is sought.

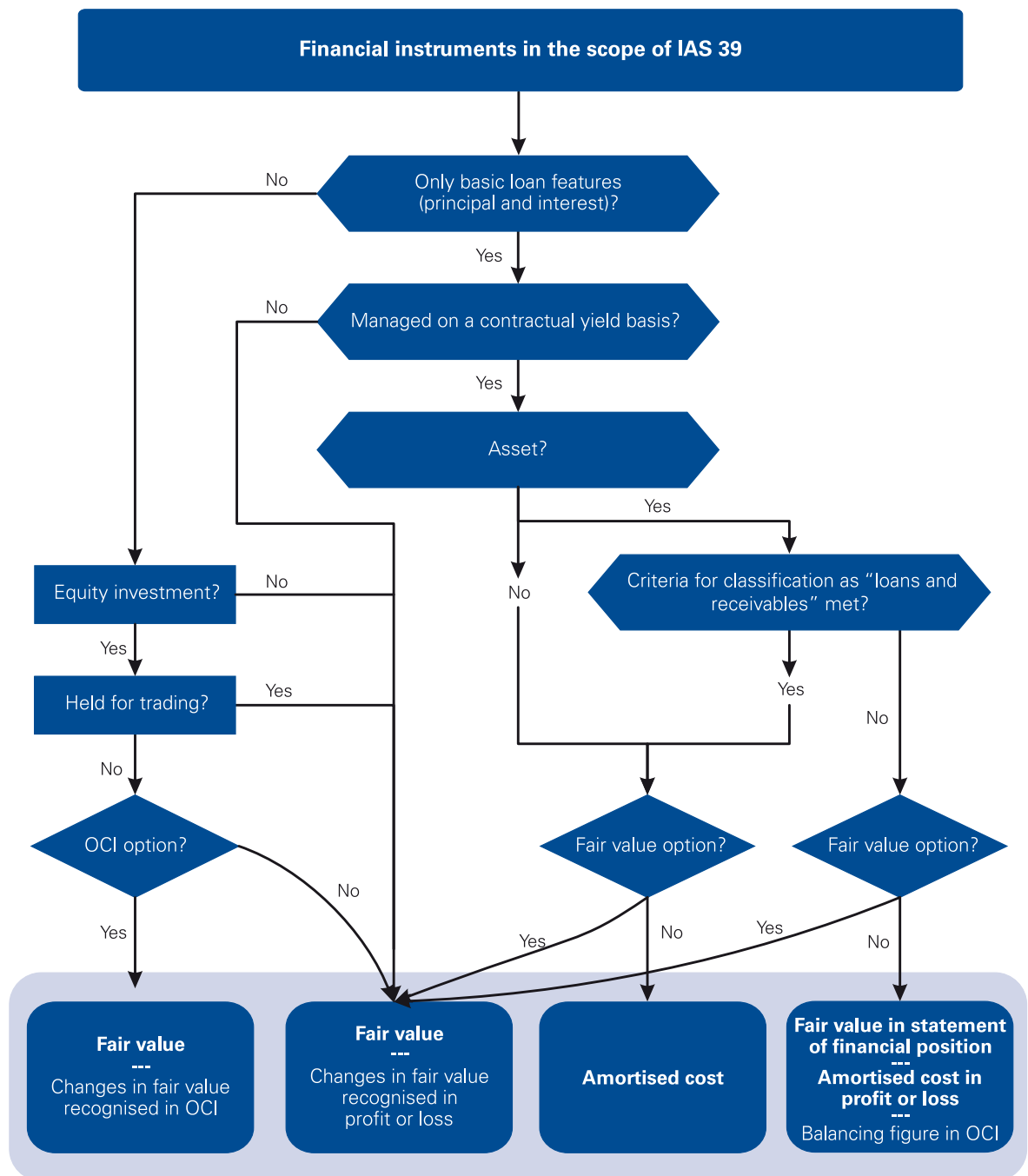
Alternative model 1

This model builds on the proposals in the ED described above, but requires financial assets to meet a further test before they would be accounted for at amortised cost. The further test is whether a financial asset meets the existing definition of “loans and receivables” in IAS 39. If it does, then it would be measured at amortised cost. If it does not, then it would be measured at fair value with gains and losses recognised as follows:

- gains and losses, including any impairments, determined on an amortised cost basis would be recognised in profit or loss; and
- the difference between the amortised cost of the financial asset and its fair value would be recognised in OCI.

“Recycling” of amounts recognised in OCI to profit or loss would be prohibited.

The flowchart below illustrates a decision tree for alternative model 1.



Observations

Alternative model 1 introduces a new measurement category for which some gains and losses would be recognised in profit or loss and some in OCI. Some might consider this akin to re-introducing the AFS category for certain debt instruments; others may consider that it would add complexity to the proposed model.

Although this new category may appear similar to AFS accounting, there would be an important difference in that impairment would be measured based on the amortised cost model rather than based on fair value. The practical impact of this might be similar to the impact under U.S.

GAAP of FSP FAS 115-2 *Recognition and Presentation of Other-Than-Temporary Impairments* which was issued in April 2009. FSP FAS 115-2 requires that, in many cases, the total amount of the other-than-temporary impairment loss on an investment in a debt security be analysed between the amount related to credit losses, which is recognised in profit or loss, and the remaining portion, which is recognised in other comprehensive income.

The ED does not explain why this alternative model might be considered preferable or why it might be worthwhile to consider both whether an asset meets the proposed “basic loan features” and “managed on a contractual yield basis” tests and also satisfies all the elements of the current loans and receivables definition, before concluding that it should be measured at amortised cost, especially given the large degree of overlap between these requirements. Perhaps the most relevant incremental element of the “loans and receivables” definition is that an asset cannot qualify as such if it is “quoted in an active market.” Some may believe that it is inappropriate not to measure an instrument at fair value if that fair value is both readily determinable and the asset is easily convertible to cash.

Alternative model 2

The only difference between alternative model 2 and alternative model 1 above is that the amount that would be recognised in other comprehensive income under model 1 is recognised instead in profit or loss and presented separately from the amounts calculated on an amortised cost basis (i.e., interest income / expense and impairment losses).

Alternative model 3

Under this model all financial instruments, both assets and liabilities, would be measured at fair value in the statement of financial position. Gains and losses on instruments that meet the amortised cost requirements under the ED would be split between profit or loss and other comprehensive income in the same way as alternative model 1.

Observations

Application of an alternative model would result in progressively more financial instruments being recognised at fair value. Under alternative model 3 all financial instruments would be measured at fair value.

4.2 FASB proposals

The FASB also is developing its proposals to improve reporting for financial instruments under U.S. GAAP. These proposals are not complete and have not been published yet. However, at a meeting on 15 July 2009, the FASB decided to propose a model with the following features:

- All financial instruments would be measured at fair value, subject to an optional exemption to measure own debt at amortised cost in some circumstances.
- Fair value changes would be recognised in profit or loss or OCI.
- Recognition of fair value changes in OCI would be dependent on meeting qualifying criteria related to management’s intent / business model and the cash flow variability of the instrument. For qualifying instruments, interest and credit-related impairments would continue to be recognised in profit or loss while their amortised cost, and the adjustment to arrive at fair value, would be displayed separately in the statement of financial position.
- Changes in the fair values of derivatives, hybrid financial instruments containing embedded derivatives requiring separation under current requirements, and investments in equity instruments would be recognised in profit or loss.

- The classification of investments would be determined at initial recognition of the investment and no reclassifications would be permitted.

Source: *Summary of Board decisions on www.fasb.org (17.07.2009)*

Observations

The FASB's proposals effectively would provide another alternative model for respondents to the ED to consider. As can be seen, the FASB currently shows a stronger preference for measuring at fair value in the statement of financial position.

5. Other issues

*ED/2009/
7.15-17*

The ED does not propose changes to the special measurement requirements for financial guarantee contracts and loan commitments. Also the ED would retain the requirements in IAS 39 for the measurement of liabilities that result from transfers of assets that do not qualify for derecognition or which result in application of the “continuing involvement” approach.

Since the ED does not address hedge accounting, financial instruments measured at amortised cost that are subject to a fair value hedging relationship would continue to be measured at amortised cost, adjusted for changes in their fair value attributable to the risk being hedged. Also, the effective portion of gains and losses on derivatives designated as cash flow hedges would continue to be recognised in OCI.

Observations

The guidance retained from IAS 39 includes the requirement that, if a transfer does not result in derecognition, the transferring entity recognises a financial liability for the consideration received and, in subsequent periods, any expense incurred on that liability. It also notes that the transferee may account for an agreement to resell the asset to the transferee for a fixed amount as a “loan and receivable” – although the ED would eliminate this category. Further analysis as to how this guidance would operate in the context of the ED may be required. Of course, this guidance may be superseded when a new standard on derecognition is approved (see section 2).

As with the existing IAS 39, the ED does not prescribe the accounting for financial guarantees in the financial statements of the holder.

6. Disclosures

ED/2009/7.C8 The ED proposes consequential amendments to IFRS 7 *Financial Instruments: Disclosures*. These include disclosure of:

- information on equity instruments designated as at fair value through OCI, including which investments have been so designated, reasons for using this election, the fair value of each investment at the end of the reporting period, and details of investments sold during the reporting period
- reconciliation of the gain or loss recognised in the statement of comprehensive income arising from derecognition of financial instruments measured at amortised cost.

7. Effective date and transition

ED/2009/7.23, .IN10 The Board intends to review the effective date of the standard but expects that the new requirements would not be mandatory before 1 January 2012. Early application would be permitted. The intention of the IASB is that the standard will be available for voluntary adoption for annual periods ending 31 December 2009.

ED/2009/7.24-33 It is proposed that the new standard would be applied retrospectively, for all periods presented, with certain exemptions, as follows:

Classification

- The assessment whether an instrument is “managed on a contractual yield basis” would be based on circumstances at the date of initial application.
- The fair value option is “reopened” at the date of initial application and so, at that date, it would be possible to:
 - designate any financial instrument that would otherwise be measured at amortised cost into the fair value option if the eligibility criterion would be met at the date of initial application
 - remove any existing designation.
- Any financial instrument not satisfying the eligibility criterion for the fair value option at the date of initial application would have to be removed from the fair value option category.
- An entity could designate an equity investment as at fair value through OCI based on circumstances at the date of initial application.
- Although the above classification decisions would be made based on circumstances as of the date of initial application, the classifications would be applied retrospectively.

Hybrid instruments

- If a hybrid instrument is measured at fair value in its entirety, but the fair value of the hybrid instrument has not been determined in previous periods, then the sum of the fair values of the components would be deemed to be the fair value for the purpose of comparative periods.

Impairment

- If retrospective application of the effective interest method and impairment requirements in IAS 39 is impracticable, then the amortised cost and impairment, for each period presented and as at the date of initial application, would be determined on the basis of the fair value of the instrument at the end of each comparative period and the date of initial application respectively.

Unquoted equity instruments measured at cost

- If unquoted equity instruments or related derivatives previously were measured at cost, those instruments would be measured at fair value at the date of initial application with any differences between the carrying amount and fair value recognised in the opening retained earnings of the reporting period of initial application.

Hedge accounting

- Any hedge relationship that is de-designated as a consequence of the classification approach would be accounted for as a discontinuation of hedge accounting from the date of initial application.

Interim reporting

- For interim reporting, the ED would not need to be applied to prior interim periods, if impracticable.

Observations

One of the stated goals of the Board is to have a final standard on classification and measurement that would be available for adoption by preparers in financial statements for years ending 31 December 2009. The comment period for the ED closes on 14 September 2009. It is difficult to be certain how long it will take the Board to consider comments received and what might be the content of a final standard. However, it is unlikely that a final standard would appear prior to November 2009. The impact of the proposals of the ED would be far ranging with a requirement to re-evaluate the classification of all instruments within the scope of IAS 39 and, in many cases, restate comparative information on a consistent basis. Given the short time available and the considerable effort required, it may be very challenging for many entities, particular financial institutions with large volumes and multiple portfolios of financial instruments, many of them complex, to adopt a final standard for 2009. Also, many entities may not wish to adopt new classification and measurement requirements before knowing what the other elements of the final replaced standard would be, particularly new rules on hedge accounting. It is unclear whether entities would be able to revise classification decisions made on early adoption of this proposed standard in light of subsequent changes to IAS 39. The uncertainty is increased by the FASB's potentially different proposals and the impact of possible convergence with U.S. GAAP requirements (see sections 1 and 4.2).

Further challenges to early adoption include:

- For the purposes of filing with the U.S. Securities and Exchange Commission (SEC), registrants are required to present two years of comparative statements of comprehensive income, in addition to the current year, whereas IFRSs requires only one year of comparative information. SEC registrants also are required to provide a five-year history of summary financial data. Similar requirements for summary financial data may apply to entities listed in other jurisdictions. For some entities, therefore, early adoption may involve having to provide up to an additional three years of full or summary information on a consistent restated basis.
- In many jurisdictions (e.g., the European Union), entities are required to apply IFRSs as adopted into local law. These entities would not be able to apply a new standard, at least not in their statutory financial reporting, until it has been enacted into local law.

The ED is likely to have a major impact on insurers. The IASB currently is working on a project, *Insurance Contracts*, to provide a new basis for accounting for insurance contracts and a final standard is planned for 2011. Many insurers will be concerned about the consistency of gain and loss recognition on their financial instruments and insurance contract liabilities.

Although the ED would preclude reclassification of assets or liabilities after initial recognition, the transitional provisions would provide a one-time opportunity for reclassifying items at the date of initial application provided the relevant criteria are met. This opportunity goes beyond the reclassifications permitted by the October 2008 Reclassification of Financial Assets amendments to IAS 39. For example, the transitional provisions would potentially allow reclassifications of instruments that were previously designated as at FVTPL and of liabilities.

As the test of whether an instrument would be managed on a contractual yield basis is carried out at the date of initial application, but the classification would be applied retrospectively, it is not clear how instruments disposed of before that date should be accounted for in the comparative periods presented. A similar issue arises as to whether an equity investment that is sold before initial application could be designated as measured at fair value through OCI.

The ED defines the "date of initial application" as the date when an entity first applies the requirements of this IFRS. It is not clear if this date can be any date of an entity's choosing during the accounting period in which the new standard is adopted.

Further, it is not clear how some of the exemptions from full retrospective application would apply in practice. For example, if fair value would be used as a proxy for the effective yield calculations and assessment of impairment, then how should movements in fair value during each comparative period be analysed between interest and impairment line items in the statement of comprehensive income, bearing in mind that both interest margin and impairment losses are key performance indicators for financial institutions?

The table below illustrates potential reclassifications from the existing to the proposed measurement categories that would arise on initial application of the ED. The table does not address specifically embedded derivatives that are accounted for separately under current IAS 39. If those instruments are embedded in a financial instrument within the scope of IAS 39, then the classification of the hybrid instrument, including the embedded derivative, would follow the principles below.

Transfer from existing measurement categories	Transfer to measurement categories in the ED		
	Amortised cost	FVTPL	Fair value through OCI with no recycling
FVTPL – Trading (excluding derivatives)	Instruments with basic loan features that are managed on a contractual yield basis at the date of initial application and for which no fair value option is chosen at that date	Instruments that are held for trading at the date of initial application would remain in this category	Option for equity investments if no longer held for trading at the date of initial application
Derivatives	n/a	Derivatives would remain in this category	n/a
FVTPL – Designated under fair value option	Instruments with basic loan features that are managed on a contractual yield basis at the date of initial application and for which the fair value option is not chosen or available at that date	Other instruments would remain in this category	Option for equity investments if not held for trading at the date of initial application

Transfer from existing measurement categories	Transfer to measurement categories in the ED		
	Amortised cost	FVTPL	Fair value through OCI with no recycling
Held-to-maturity	<p>Instruments with basic loan features for which the fair value option is not chosen at the date of initial application</p> <p>Note: In order for the asset to remain designated as held-to-maturity at the date of adoption, the entity would have to have the positive intent and ability to hold the asset to maturity. Therefore, it is assumed that the instrument would qualify as managed on a contractual yield basis.</p>	<p>Instruments that do not meet amortised cost requirements</p> <p>Instruments meeting amortised cost requirements designated into this category at the date of initial application to avoid an accounting mismatch</p>	n/a
Loans and receivables	<p>Instruments with basic loan features that are managed on a contractual yield basis and for which the fair value option is not chosen at the date of initial application</p>	<p>Instruments that do not meet amortised cost requirements</p> <p>Instruments meeting amortised cost requirements designated into this category at the date of initial application to avoid an accounting mismatch</p>	n/a
Available-for-sale – debt investments	<p>Instruments with basic loan features that are managed on a contractual yield basis at the date of initial application and for which the fair value option is not chosen at that date</p>	<p>Instruments that do not meet the amortised cost requirements</p> <p>Instruments meeting amortised cost requirements designated into this category at the date of initial application to avoid an accounting mismatch</p>	n/a
Available-for-sale – equity investments	n/a	All equity instruments other than those for which the fair value through OCI option is selected	Option for equity investments if not held for trading at the date of initial application

Transfer from existing measurement categories	Transfer to measurement categories in the ED		
	Amortised cost	FVTPL	Fair value through OCI with no recycling
Cost (certain unquoted equity instruments and related derivatives)	n/a	All equity instruments other than those for which the fair value through OCI option is selected All related derivatives	Option for equity investments if not held for trading at the date of initial application
Amortised cost liabilities	Instruments with basic loan features that are managed on a contractual yield basis at the date of initial application and for which the fair value option is not chosen at that date	Instruments that do not meet the amortised cost requirements Instruments meeting amortised cost requirements designated into this category at the date of initial application to avoid an accounting mismatch	

IAS 8.28 In the period of initial application, an entity would be required to provide the disclosures specified in paragraph 28 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, including the effect of adoption on each financial statement line item and on basic and diluted earnings per share for the current and each prior period presented.

ED/2009/7.C8 For early adopters the ED proposes to amend IFRS 7 to require the following disclosure at the date of initial application:

- the original measurement category and carrying amount determined in accordance with IAS 39
- the new measurement category and carrying amount
- the amount of financial instruments designated as at FVTPL and their original measurement basis and presentation method
- the amount of financial instruments no longer so designated, distinguishing between those that no longer meet the conditions for such classification and those that the entity chooses not to so designate
- qualitative information to enable users to understand:
 - the reasons for how the entity applied the classification requirements for those financial instruments whose classification has changed
 - the reason for any designation as at FVTPL and revocation of such designation.

First-time adopters

ED/2009/7.C2

IFRS 1 *First-time Adoption of International Financial Reporting Standards* would be amended to include the following additional mandatory exceptions from retrospective application, as follows:

- an assessment of whether a financial instrument is managed on an contractual yield basis would be carried out as at the date of transition to IFRSs
- designation as at FVTPL would be based on the circumstances existing at the date of transition to IFRSs.

However the classification itself would be applied retrospectively.

Observations:

Unlike existing users of IFRSs, first-time adopters would be required to assess classification of their financial instruments retrospectively when the date of transition already has passed. For example, an entity presenting its first IFRS financial statements for the year ending 31 December 2009 which decided to early adopt the new standard, and which presents only one comparative period, would make the assessment as at 1 January 2008.

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