

## STAFF PAPER

Week beginning 24 September 2012

REG IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Cover paper		
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## Purpose of this paper

1. This paper provides an overview of the agenda papers that will be discussed at this meeting. The staff expect that this meeting will conclude the IASB's deliberations on the limited amendments to IFRS 9 and the staff will ask the IASB's permission to begin the balloting process for an Exposure Draft.

## Background

2. In November 2011, the IASB decided to consider making limited amendments to IFRS 9 to address specific application questions raised by constituents; to consider the interaction of the classification and measurement model for financial assets with the insurance project and also to consider the differences with the FASB's tentative classification and measurement model.
3. In making this decision, the IASB noted that IFRS 9 has generally been found to be conceptually sound and operational. The IASB also noted that many constituents have either already adopted IFRS 9 early or dedicated significant resources in preparation for adoption. The IASB therefore agreed to be mindful of the extent of change to IFRS 9 and to complete the project expeditiously, seeking to minimise the cost and disruption to constituents.
4. In January 2012, the IASB and the FASB decided to jointly redeliberate selected aspects of their classification and measurement models for financial

instruments to seek to reduce key differences. The boards tentatively decided to discuss the following key differences:

- (a) the contractual cash flow characteristics of financial assets;
- (b) the need for bifurcation of financial assets and if pursued, the basis for bifurcation;
- (c) the basis for and the scope of a possible third classification category (debt instruments measured at fair value through other comprehensive income (FVOCI)); and
- (d) any interrelated issues from the topics above (for example, disclosures or the model for financial liabilities).

## Decisions to date

- 5. The boards decided to discuss each issue jointly and concluded the joint deliberations in July 2012. The boards are now considering what changes, if any, they would like to propose to their respective models and to incorporate in their respective Exposure Drafts.
- 6. A summary of tentative decisions to date is provided in **Appendix A** to this agenda paper.

## Overview of agenda papers for this meeting

- 7. The staff have brought the following papers for discussion at this meeting:
  - (a) **Agenda Paper 6B: Relief to accelerate application of own credit requirements** – In this paper, the staff provide analysis of whether the ‘own credit’ requirements for financial liabilities in IFRS 9 should be accelerated so that they may be applied sooner than the requirements for the classification and measurement (C&M) of financial assets. These ‘own credit’ requirements have received strong support from constituents; however, in the absence of an amendment, they would generally not be applied before IFRS 9 is finalised.
  - (b) **Agenda Paper 6C: Additional issues for transition to IFRS 9 as a whole** – In this paper, the staff ask the IASB to consider two additional

transition issues related to the limited amendments to IFRS 9, and one related issue for impairment.

- (c) **Agenda Paper 6D: Due process considerations for proposing limited amendments to IFRS 9** – In this paper, the staff describe the required and optional due process steps that have been undertaken in developing the proposed limited amendments to IFRS 9, and ask the IASB whether the IASB is satisfied that it has complied with the due process steps that are necessary in order to issue an Exposure Draft.
- (d) **Agenda Paper 6E: An exposure draft proposing limited amendments to IFRS 9** – In this paper, the staff request permission to ballot an Exposure Draft proposing limited amendments to IFRS 9, and recommend the comment period.

## Appendix A: An overview of tentative decisions to date

**A1. Contractual cash flow characteristics** – In February 2012, the boards discussed the assessment of the contractual cash flow characteristics of financial assets. The boards tentatively decided that financial assets with contractual terms that give rise on specified dates to cash flows that are solely P&I (eligible debt instruments) could qualify for a measurement category other than FVPL in their entirety depending on the objective of the business model within which they are held. The February 2012 decisions provide a minor adjustment to the contractual cash flow characteristics assessment in IFRS 9 to address the feedback received by the IASB on the application of the assessment to particular financial assets and would be incorporated into the FASB's tentative classification and measurement model.

**A2. Bifurcation of embedded derivatives in financial instruments** – In April 2012, the IASB and the FASB tentatively decided that financial assets with cash flows that are not solely P&I would not be eligible for bifurcation. Instead, those financial assets would be classified and measured in their entirety at fair value through profit or loss (FVPL). The IASB and the FASB also tentatively decided that financial liabilities would be bifurcated using the existing bifurcation requirements in IFRS 9 and US GAAP. The IASB also confirmed that the 'own credit' requirements in IFRS 9 for financial liabilities designated under the fair value option (FVO) would be retained<sup>1</sup>.

**A3. Business model assessment for amortised cost classification** – In April 2012, the IASB and the FASB tentatively decided that financial assets would qualify for amortised cost if the objective of the business model is to hold those assets to collect contractual cash flows. The boards tentatively decided

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<sup>1</sup> At a subsequent meeting, the FASB decided that changes in fair value that result from a change in a reporting entity's own credit risk for financial liabilities that are designated under the fair value option and, thus, measured at FVPL would be presented separately in other comprehensive income (OCI). This would be consistent with the existing presentation requirement in IFRS 9.

Cumulative gains and losses recognized in OCI associated with changes in own credit will be recognised in net income upon the settlement of the liability. The entire risk in excess of a base market risk, such as a risk-free interest rate, would be considered as the change in own credit or an alternative method that an entity deems as a more faithful measurement of such a risk.

to clarify the primary objective of ‘hold to collect’ by providing additional implementation guidance on both the types of business activities and the frequency and nature of sales that would prohibit financial assets from qualifying for amortised cost measurement.

**A4. Introduction of and business model assessment for the FVOCI**

**measurement category** – In May 2012, the IASB tentatively decided to introduce a FVOCI measurement category in IFRS 9 for debt investments (the FASB’s tentative model already included a FVOCI measurement category). The IASB also tentatively decided that:

- (a) Interest income on financial assets measured at FVOCI would be recognised in P&L using the effective interest method that is applied to financial assets measured at amortised cost.
- (b) Credit impairment losses/reversals on financial assets measured at FVOCI would be recognised in P&L using the same credit impairment methodology as for financial assets measured at amortised cost.
- (c) The cumulative fair value gain or loss recognised in OCI would be recycled from OCI to P&L when a financial asset is derecognised.

A5. The IASB and the FASB tentatively decided that financial assets would be measured at FVOCI if they are managed within a business model whose objective is both to hold the financial assets to collect contractual cash flows and to sell the financial assets. The FVPL category would be the residual. The boards also tentatively decided to provide additional application guidance on the types of business activities that would qualify for the FVOCI business model.

A6. In June 2012, the IASB and the FASB re-affirmed that a debt instrument will be measured at FVOCI only if the debt instrument passes the contractual cash flow characteristics assessment (as discussed by the boards at the February 2012 joint board meeting) and the debt instrument is managed within the relevant business model (as discussed by the boards at the joint board meeting in May 2012).

**A7. Fair value option**– In June 2012, the boards considered the FVO for financial assets in the context of the three-category classification model and any interrelated issues for the FVO for financial liabilities. The IASB tentatively decided to extend the current eligibility condition in IFRS 9 for designating financial assets under the ‘accounting mismatch’ fair value option to debt investments that would otherwise be measured at FVOCI. The FASB decided that an entity may, at initial recognition, irrevocably elect the FVO for the following financial instruments:

- (a) A hybrid financial liability may be designated at FVPL, unless
  - (i) the embedded derivative or derivatives do not significantly modify the cash flows that otherwise would be required by the contract; or
  - (ii) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative or derivatives is prohibited.
- (b) A group of financial assets and financial liabilities may be designated at FVPL if both of the following conditions are met:
  - (i) the entity manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis; and
  - (ii) the entity provides information on that basis to the reporting entity's management.

**A8. Reclassification of financial assets** – In May 2012, the boards discussed reclassification of financial assets. The IASB tentatively decided to extend the existing reclassification requirements in IFRS 9 to the FVOCI category, that is to require prospective reclassification of financial assets when the business model changes. The FASB tentatively decided to prospectively require reclassification of financial assets in its tentative model when (and only when) the business model changes. Changes in the business model that require reclassifications are expected to be very infrequent and must be (i) determined by the entity's senior management as a result of external or

internal changes, (ii) significant to the entity's operations and (iii) demonstrable to external parties.

- (a) **Reclassification mechanics** – In July 2012, the boards discussed accounting for the reclassification of financial assets between measurement categories. For reclassification of financial assets as a result of a change in the business model, the boards tentatively decided that when financial assets are reclassified from:
- (i) *FVOCI to FVPL* - the financial assets should continue to be measured at fair value and any accumulated OCI balances should be derecognised from OCI and recognised in profit or loss (P&L) on the date of reclassification.
  - (ii) *FVPL to FVOCI* - the financial assets should continue to be measured at fair value and particular changes in fair value subsequent to the reclassification date should be recognised in OCI.
  - (iii) *Amortised cost to FVOCI* - the financial assets should be measured at fair value on the reclassification date with any difference between the previous carrying amounts and the fair values recognised in OCI.
  - (iv) *FVOCI to amortised cost* - the financial assets should be measured at fair value on the reclassification date and the accumulated OCI balance at the reclassification date should be derecognised through OCI with an offsetting entry against the financial asset balance. As a result, the financial assets will be measured at the reclassification date at amortised cost as if they had always been so classified.
- (b) For reclassification of financial assets as a result of a change in the entity's business model, the FASB tentatively decided that when financial assets are reclassified from:

- (i) fair value through profit or loss (FVPL) to amortised cost, the financial assets' fair values on the reclassification date should become their new carrying amounts for amortised cost purposes.
  - (ii) amortised cost to FVPL, the financial assets' fair values on the reclassification date should become their new carrying amounts, with the difference between the previous carrying amounts and fair values recognised in P&L.<sup>2</sup>
- (c) **Reclassification disclosures (IASB-only)** - In July 2012, the IASB discussed disclosures related to reclassifying eligible debt investments into and out of the FVOCI measurement category. The IASB tentatively decided that the reclassification disclosures in:
- (i) paragraph 12B of IFRS 7 should be extended to all reclassifications into and out of FVOCI.
  - (ii) paragraph 12C of IFRS 7 should be extended to reclassifications from FVPL to FVOCI.
  - (iii) paragraph 12D of IFRS 7 should be extended to apply to reclassifications from FVPL to FVOCI and from FVOCI to amortised cost.
- (d) **Reclassification date (FASB-only)** - The FASB tentatively decided that the reclassification date should be the last day of the reporting period in which there is a change in the business model.

**A9. Transition** - In July 2012, the IASB discussed how the classification and measurement (C&M) requirements in IFRS 9 should be applied in light of the limited amendments to IFRS 9, as well as when the limited amendments should be applied. The IASB also discussed the transition to IFRS 9 as a whole considering the interaction between its phases.

- (a) **Limited amendments to C&M** – The IASB tentatively decided that on transition to the amended C&M requirements, an entity should be required to:

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<sup>2</sup> This is consistent with the existing requirements in IFRS 9.



- (i) retrospectively apply the contractual cash flow characteristics assessment as set out in IFRS 9 (2010) where it is impracticable to apply the amended contractual cash flow characteristics assessment retrospectively; and
  - (ii) disclose the carrying values of the financial assets whose contractual cash flows have been assessed under IFRS 9 (2010) rather than the amended C&M requirements due to impracticability until the affected financial assets are derecognised.
- (b) The IASB also tentatively agreed that no amendments to the existing IFRS 9 transition requirements are required in the light of either:
- (iii) the proposed amendments to the business model assessment, or
  - (iv) the proposed extension of the FVO for accounting mismatches to debt instruments that would otherwise be measured at FVOCI.
- (c) **IFRS 9 as a whole** - The IASB tentatively decided to require entities that have already applied IFRS 9 (2009) and/or IFRS 9 (2010) before they apply the limited amendments to IFRS 9 (i) to revoke previous FVO elections if an accounting mismatch no longer exists at initial application of the amended C&M requirements; and (ii) to permit them to apply the FVO to new accounting mismatches created by the initial application of the amended C&M requirements.
- (d) The IASB tentatively decided that once IFRS 9 is finalised, entities should no longer be permitted to early apply previous versions of IFRS 9. Those entities that—prior to the publication of the complete version of IFRS 9—already early applied a previous version of IFRS 9 should be able to

continue applying that version and not be required to apply the final requirements until the mandatory effective date.

- (e) The IASB also tentatively decided that early application of the entire IFRS 9 should be permitted once all of the requirements are issued.
- (f) The IASB tentatively decided to re-affirm that comparative C&M information should be permitted, but not required, to be restated, if the information is available without the use of hindsight<sup>3</sup>.

**A10. Presentation and disclosure** – In July 2012 the IASB discussed additional presentation and disclosure requirements in the light of proposed limited amendments to IFRS 9, as well as the interaction with the disclosures proposed in the impairment project.

- (a) **Contractual cash flow characteristics** – The IASB tentatively decided the following related to the amended contractual cash flow characteristics assessment:
  - (i) That the judgement involved in the assessment of contractual cash flow characteristics should be added to IAS 1 as an example of a judgement that could have a significant effect on the amounts recognised in the financial statements.
  - (ii) Not to require quantitative disclosures when the assessment of contractual cash flow characteristics could have a significant effect on the amounts recognised in the financial statements.
- (b) **Business model and the FVOCI measurement category** - The IASB tentatively decided the following related to the proposed addition of a FVOCI category for eligible debt instruments:

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<sup>3</sup> This tentative decision is consistent with the July 2012 tentative decision on impairment.

- (i) No new requirements should be added related to the presentation of gains or losses arising from the derecognition of debt instruments measured at FVOCI.
- (ii) The impairment disclosures for debt instruments measured at FVOCI should be consistent with those for assets measured at amortised cost, including disclosure of an accumulated impairment amount.
- (iii) Presentation of an allowance balance on the face of the statement of financial position should be prohibited for debt instruments measured at FVOCI.