IFRS

STAFF PAPER

November 2016

IFRS Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	IFRS 9 *Financial instruments*/IFRS5 *Non-current Assets Held for Sale and Discontinued Operations*—discontinuation of hedge accounting and business model assessment when a subsidiary is held for sale		
CONTACT(S)	Uni Choi	uchoi@ifrs.org	+44 (0) 20 7246 6410
	Markus Hahn	mhahn@ifrs.org	+44 (0) 20 7246 6964

Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a request to clarify how a reporting entity[1] applies some requirements in IFRS 9 *Financial Instruments* in its consolidated financial statements when a subsidiary is classified as held for sale applying IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*. Specifically, the submitter asks two questions:

   (a) whether a reporting entity discontinues cash flow hedge accounting applied by a subsidiary when the subsidiary is classified as held for sale; and

   (b) in applying the classification requirements in IFRS 9, whether a reporting entity considers the financial assets of a subsidiary to be within a 'hold-to-collect' business model or a 'hold-to-sell' business model, if the subsidiary holds the financial assets to collect contractual cash flows and is also classified as held for sale applying IFRS 5.

[1] 'Reporting entity' is used in this paper to refer to an entity that has subsidiaries and prepares consolidated financial statements.

2. The objective of this paper is to provide the Interpretations Committee with a summary of the submission and the staff analysis of the questions asked. At this meeting, we are requesting feedback from the Interpretations Committee about the clarity of the relevant new requirements. The International Accounting Standards Board (the Board) will then discuss the questions asked, together with feedback from the Interpretations Committee, at a future Board meeting. We will ask the Board how it would like to proceed.

Structure of the paper

3. This paper is structured as follows:

   (a) Summary of the submission – Issue 1 (paragraphs 4-11);

   (b) Staff analysis – Issue 1 (paragraphs 12-17);

   (c) Summary of the submission – Issue 2 (paragraphs 18-25);

   (d) Staff analysis – Issue 2 (paragraphs 26-32);

   (e) Previous discussion of IFRS 5-related issues (paragraph 33);

   (f) Conclusion and question for the Interpretations Committee (paragraphs 34-35); and

   (g) Appendix A – Submission received

Issue 1—Discontinuation of cash flow hedge accounting

Summary of the submission

4. In the scenario described by the submitter, a subsidiary applies cash flow hedge accounting for forecast transactions that are anticipated in the subsidiary. The forecast transactions are expected to occur after the expected date of disposal of the subsidiary. In the reporting entity's consolidated financial statements, the submitter asks at which date the reporting entity discontinues hedge accounting if the subsidiary is classified as held for sale applying IFRS 5. Paragraph 6.3.3 of IFRS 9[2] states:

> If a hedged item is a forecast transaction (or a component thereof), that transaction must be highly probable.

5. In addition, paragraph 6.5.12 (b) of IFRS 9[3] states that:

> If the hedged future cash flows are no longer expected to occur, that amount shall be immediately reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment (see IAS 1). A hedged future cash flow that is no longer highly probable to occur may still be expected to occur.

6. To illustrate the issue, the submitter used the following example:

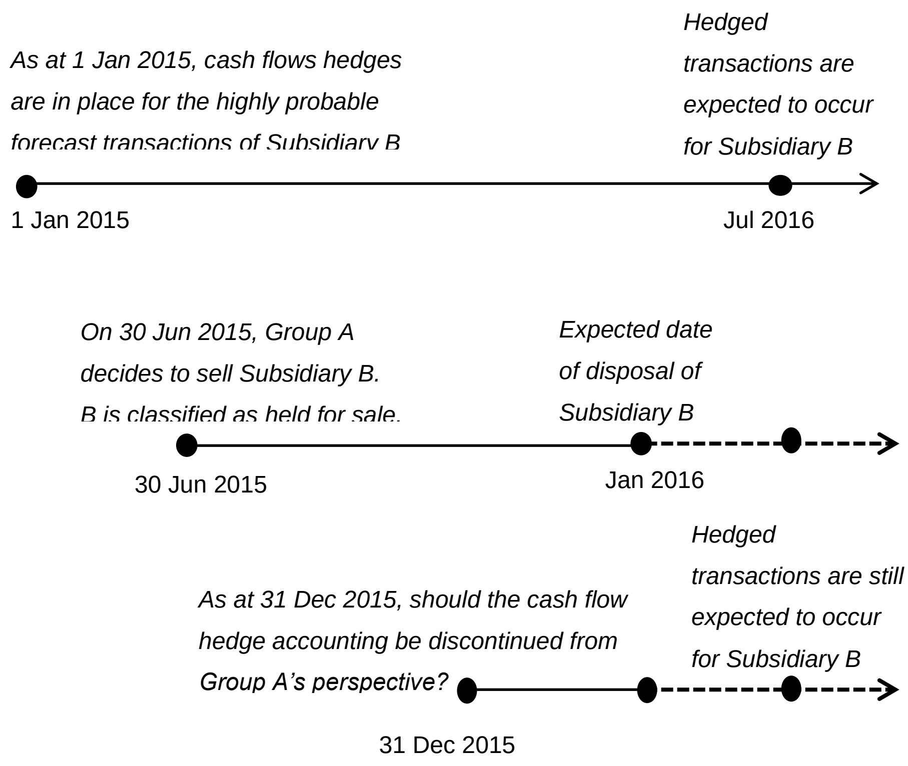
> Group A has a number of subsidiaries, including Subsidiary B. The group has cash flow hedges in its consolidated financial statements at 1 January 2015, some of which include items from Subsidiary B that are hedged with derivatives entered into by Subsidiary B. The forecast transactions will occur in July 2016.
>
> At 30 June 2015, A decides to sell Subsidiary B. Subsidiary B meets the criteria for held for sale classification applying IFRS 5 on that date, including an assessment that disposal within the next 12 months is highly probable. A classified B's assets and liabilities as a disposal group.
>
> The sale of Subsidiary B is completed on 31 January 2016.

[2] Paragraph 88(c) of IAS 39 *Financial Instruments*

[3] Paragraph 101 of IAS 39

Subsidiary B still expects the hedged transactions to occur.

Group A prepares consolidated financial statements for the period ended 31 December 2015.



View 1—discontinue hedge accounting on the date the subsidiary is classified as held for sale

7. Proponents of View 1 note that Appendix A to IFRS 10 *Consolidated Financial Statements* defines consolidated financial statements as:

> the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

8. In addition, they note that paragraph 30 of IFRS 5 requires that:

> An entity shall present […] information that enables users of financial statements to evaluate the financial effects of […] disposals of non-current assets (or disposal groups).

9. As soon as Subsidiary B is classified as held for sale applying IFRS 5, the forecast transactions are no longer expected to occur from the perspective of Group A. Although Subsidiary B may still complete the transactions, Group A expects that it will no longer be part of the group when the transactions occur. Proponents of View 1 say that it would therefore be appropriate to discontinue hedge accounting as soon as it is determined that, from the Group's perspective, the hedged transactions will no longer occur.

View 2—discontinue hedge accounting on the date the subsidiary is disposed of

10. Proponents of this view contend that Group A does not discontinue the cash flow hedge accounting of Subsidiary B until Subsidiary B is sold. Subsidiary B designates the hedges at a transaction level as per paragraph 6.3.1 of IFRS 9[4] and these are still expected to occur, even if they are not expected to affect Group A's consolidated financial statements after 31 January 2016.

11. In addition, although IFRS 10 contains various requirements in respect of consolidation adjustments to eliminate intragroup transactions and reflect uniform accounting policies, it does not suggest that any adjustments are required to reflect changes in forecast transactions from a group perspective for hedge accounting. Similarly, IFRS 5 does not contain any specific requirements to revisit hedge accounting. Supporters of this view think that Group A can therefore continue to apply hedge accounting for the period during which it continues to consolidate Subsidiary B.

Staff analysis

12. Paragraph 6.5.2 of IFRS 9 describes a cash flow hedge as (*emphasis added)*:

> a hedge of the exposure to variability in cash flow that is attributable to a particular risk associated with […] *a highly*

[4] Paragraph 6.3.1 of IFRS 9 and Paragraph 78 of IAS 39 state:"A hedged item can be…a forecast transaction…The hedge item can be a single item or a group of items…"

> *probable forecast transaction*, and *could affect profit or loss*.

13. The relevant question is whether, in its consolidated financial statements, a reporting entity performs an assessment of the eligibility of hedging accounting from a group perspective or a subsidiary perspective—ie for whom should the forecast transactions be highly probable and whose profit or loss would the transactions need to affect?

14. As noted in the submission, IFRS 10 states that, in the consolidated financial statement of a group, the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity. Because the group is *a single economic entity,* a reporting entity reflects its decision to sell a subsidiary and the consequences on the forecast transactions of the subsidiary in determining whether the forecast transactions are still eligible hedged items at the group level. This principle of IFRS 10, and how it applies to hedge accounting, can be seen in IFRS 9, for example, where it states that an intragroup transaction cannot be a qualifying hedging instrument in the consolidated financial statements of the group, noting that a reporting entity considers *the group's perspective*.

15. The Basis for Conclusions—paragraph BC6.145 of IFRS 9—explains the rationale by using an example of cash flow hedge accounting. It states that, from the group's perspective, the risk still remained unhedged. Consequently, in its consolidated financial statements, a reporting entity does not apply hedge accounting, even though it may be applied in the individual financial statements of a subsidiary.

> For example, a subsidiary might transfer cash flow interest rate risk from variable-rate funding to the group's central treasury using an interest rate swap. The central treasury might decide to retain that exposure (instead of hedging it out to a party external to the group). In that case, the cash flow interest rate risk of the stand-alone subsidiary has been transferred (the swap is an external derivative from the subsidiary's perspective). However, from the group's

consolidated perspective, the cash flow interest rate risk has not changed but merely been reallocated between different parts of the group (the swap is an internal derivative from the group's perspective).

16. A reporting entity, therefore, performs the assessment of a qualifying hedging relationship from the group's perspective on the basis of whether the transaction is highly probable and could affect the reporting entity's profit or loss. Similarly, a reporting entity discontinues hedge accounting when the hedging relationship ceases to meet the qualifying criteria from the group's perspective. In the consolidated financial statements, it is the group perspective that matters.

17. In the example provided in the submission, the forecast transactions are expected to occur after the estimated date of disposal of Subsidiary B. From Group A's perspective, the forecast transactions are no longer highly probable and thus are no longer eligible hedged items. Consequently, in its consolidated financial statements for the period ended 31 December 2015, Group A discontinues cash flow hedge accounting applying paragraph 6.5.12(b) of IFRS 9[5].

Issue 2—Financial assets held within a hold-to-collect business model within the subsidiary

Summary of the submission

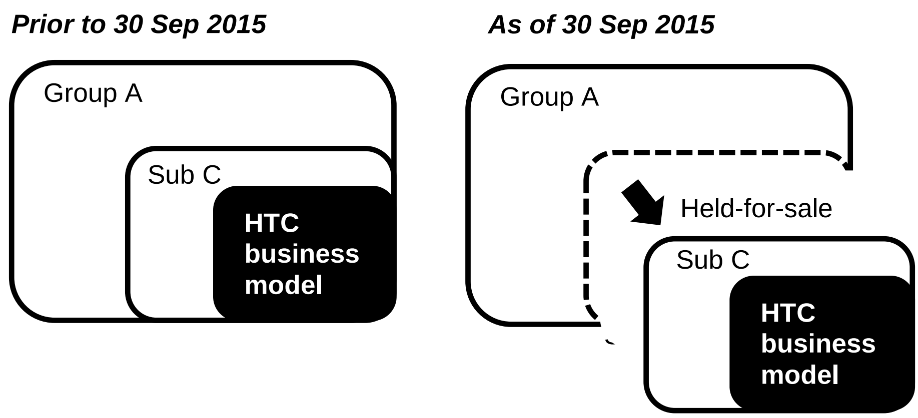
18. The submitter describes a situation in which a subsidiary holds financial assets with the objective of collecting contractual cash flows, and the subsidiary is also classified as held for sale applying IFRS 5. The submitter asks whether, in applying the classification requirements in IFRS 9 in its consolidated financial statements, the reporting entity considers the financial assets of the subsidiary to be within a 'hold-to-sell' (i.e. 'other') business model or to continue to be within a 'hold-to-collect' business model. The submitter highlights that this could also be a question as to whether the reporting entity is required to reclassify financial

[5] Paragraph 6.5.12(b) of IFRS 9 states that if the hedged future cash flows are no longer expected to occur, that amount shall be immediately reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment.

assets applying paragraph 4.4.1 of IFRS 9 when a subsidiary is classified as held for sale.

19. To illustrate the issue, the submitter provided the following example:

> Group A has a subsidiary, Subsidiary C. Subsidiary C's business model is to hold to collect (HTC) the contractual cash flows of its financial assets, of which contractual cash flows are solely payments of principal and interest as described in IFRS 9.
>
> At 30 September 2015, Group A decides to sell Subsidiary C—Subsidiary C is classified as held for sale applying IFRS 5 on that date. Subsidiary C is sold in March 2016.
>
> Group A prepares consolidated financial statements for the period ended 31 December 2015.



20. The submitter notes that IFRS 5 excludes from the scope of its measurement requirements financial assets within the scope of IFRS 9. Accordingly, a reporting entity determines the classification of financial assets, and whether to measure them at amortised cost or fair value, applying IFRS 9. The submitter identified two alternative views on the classification of Subsidiary C's financial assets in the consolidated financial statements of Group A.

View 1—The business model for the financial assets in a subsidiary is no longer 'hold-to-collect' in the consolidated financial statements

21. Proponents of View 1 say that, in the consolidated financial statements, a reporting entity performs the assessment of the business model from the group's

perspective. They note that paragraph B4.1.4 of IFRS 9 clarifies that the business model of a group and subsidiary may differ by making reference to Example 3 in that paragraph.

22. Example 3 describes a business model of originating loans and subsequently selling them to a securitisation vehicle, which the originating group consolidates. The example concludes that the objective of the business model of the consolidated group (i.e. hold to collect contractual cash flows) differs from the objective of the originating entity when it is considered as a standalone entity, separate from the securitisation vehicle (for example, if the originating entity were to prepare separate financial statements).

23. From the perspective of Group A, proponents of View 1 note that Group A has made a strategic decision to sell Subsidiary C, and Group A therefore considers the business model for the financial assets held by Subsidiary C to be held to sell. Measurement at fair value through profit or loss would also reflect Group A's intended disposal of the subsidiary.

View 2—The business model for the financial assets in a subsidiary continues to be 'hold-to-collect' in the consolidated financial statements

24. According to paragraph B4.1.2 of IFRS 9,

> An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective […] a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level […]

25. Accordingly, supporters of View 2 suggest that it would be appropriate to assess the financial assets held by Subsidiary C from a subsidiary perspective rather than from a group perspective.

Staff analysis

26. Similarly to Issue 1, the question is whether, in its consolidated financial statements, a reporting entity performs the business model assessment from a group perspective or a subsidiary perspective.

27. As noted by the Submitter, Example 3 in paragraph B4.1.4 of IFRS 9 clarifies that a business model assessment from a group perspective could lead to a different conclusion to that from a subsidiary perspective. A reporting entity performs business model assessments from a group perspective in its consolidated financial statements. The same applies to assessing whether there is a change in business model.

28. In describing a change of business model that requires reclassification of financial assets, paragraph B4.4.1 of IFRS 9 states:

> […] Such changes are expected to be very infrequent. Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line […]

29. For a subsidiary to be classified as held for sale applying IFRS 5, the reporting entity's senior management would have taken the decisions, and it would be demonstrable to external parties. From a group perspective, the reporting entity would have begun an activity that is relevant to the 'new' business model, eg an active programme to locate a buyer and complete the planned disposal as described by paragraph 8 of IFRS 5. Consequently, there is a change in business model from the group's perspective. Similarly to the analysis of Issue 1, a reporting entity performs the assessments required by IFRS 9 from a group perspective.

30. However, we do not necessarily think that the two dates must always be the same. In some cases, a change in business model could occur before the held-for-sale classification. In others, it may be possible for a change in business model to occur after the held-for-sale classification.

31. With respect to the date of reclassification, paragraph B4.4.2A of IFRS 9 states that reclassification of financial assets is effected from the first day of the entity's next reporting period. In the example provided in the submission, the reclassification date would be 1 January 2016 , assuming a change in business model occurred when the subsidiary is classified as held-for-sale if Group A's reporting period runs from 1 January to 31 December (with no interim reporting). If Group A prepares an interim financial statement as at 30 September 2016, the reclassification date would be 1 October 2016.

32. As a final observation, the intention of paragraph 4.1.2 of IFRS 9, which the submitter quotes to support View 2, is to acknowledge that an entity may have more than one business model. The assessment of business models still should be performed based on how *the reporting entity* manages the assets in those business models.

Previous discussion of IFRS 5-related issues

33. We are aware that there have been a number of IFRS 5-related discussions held by the Interpretations Committee and the Board, including those relating to its applicability to financial instruments (link to the previous Agenda Papers). We have not referred to these previous discussions when analysing the issues discussed in this paper because the previous discussions did not directly relate to the questions asked in this submission.

Conclusion

34. Based on the analysis set out in this paper, the staff is of the view that, in its consolidated financial statements, a reporting entity performs the assessments required by IFRS 9 from a group perspective.

35. On the grounds that IFRS 9 is a recently-issued Standard that is not yet effective, we would like feedback from the Interpretations Committee about the clarity of the relevant requirements in IFRS 9. We will present the feedback from the Interpretations Committee to the Board when the questions raised are discussed by the Board at a future Board meeting.

Question for the Interpretations Committee
Does the Interpretation Committee have any comments or observations in relation to the clarity of the requirements of IFRS 9 that are relevant to the questions raised in the submission?

Appendix A – Submission received

We have a request for the IFRS Interpretations Committee to consider. We believe diversity in practice in a number of related areas can he reduced through a project at the Interpretations Committee.

We have identified a number of IFRS 9/IAS 39 issues which relate to a general principle — whether transactions entered into by a subsidiary should be assessed from a group or subsidiary perspective when the subsidiary is classified as held for sale.

We think that the question as to what principle to apply could arise in a range of circumstances. Within the submission, we have detailed two specific areas:

- The application of cash flow hedge accounting in the consolidated financial statements of a parent (Issue 1).
- The business model assessment under IFRS 9 Financial instatements (Issue 2).

We believe similar issues may also arise in other areas. One such area is the application of the own use exemption (IFRS 9 paras 2.5 and 2.6, IAS 39 paras 5 and 6). A subsidiary which has been classified as held for sale may still intend to take physical delivery of a non-financial underlying, however, from the group perspective the timing of this would be post disposal and therefore the group will receive cash settlement from an acquirer.

Impairment and expected lives of assets are other areas we think might be affected.

We believe that clarification of the appropriate level at which to perform the various assessments would help address diversity in accounting in these areas.

Issue 1

Where the subsidiary of a parent meets the criteria for classification as held for sale under IFRS 5, at which date should cash flow hedge accounting be discontinued?

IFRS 9 para 6.3.3 and IAS 39 para 88(c) require forecast transactions that are the subject of hedge accounting to be highly probable.

IFRS 9 6.5.12b and IAS 39 para 101 require that hedge accounting be discontinued when forecast transactions are no longer expected to occur.

A question arises as to how the assessment of whether a transaction is expected to occur should be performed from a group or subsidiary perspective, as the conclusion might 1w different when a subsidiary is classified as held for sale. To illustrate:

- Group A has a number of subsidiary companies, including subsidiary B. The group has cash flow hedges in its consolidated financial statements at 1 January 2015, some of which include items from subsidiary B that are hedged with derivatives entered into by Subsidiary B. The forecast transactions will occur in July 2016.

- At 30 June 2015, A decides to sell subsidiary B, and the criteria for held for sale classification in IFRS s paras 6 to S are met, including an assessment that disposal within 12 months is highly probable. A classified B's assets and liabilities as a disposal group.
- The sale of the subsidiary is completed on 31 January 2016.
- Subsidiary B still expects the hedged transactions to occur.
- Group A prepares consolidated financial statements to 31 December 2015.

At which date should Group A discontinue hedge accounting for the cash flow hedges relating to subsidiary B?

We have identified two alternative views in practice:

View 1-The cash flow hedges in Group A's financial statements should be discontinued on 30 June 2015.

IFRS 10 Appendix A defines consolidated financial statements as "The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity."

IFRS 5 papa 30 further requires that "An entity shall P1csent...infoIn1ati0n that enables users of financial statements to evaluate the financial effects of…disposals of non-current assets (or disposal groups)."

When subsidiary B is considered to meet held for sale classification, from the perspective of Group A the forecast transactions are no longer expected to occur. Although subsidiary B may still complete the transactions, it is expected that they will no longer be part of Group A when that is performed.

Therefore, it would be appropriate to discontinue hedge accounting as soon as it is determined that, from the Group's perspective, the hedged transactions will no longer occur.

View 2-The cash flow hedges in Group A's financial statements should only he discontinued on 31 January 2016.

The cash flow hedge accounting relating to Subsidiary B need not be discontinued until it is sold.

The hedges are designated at a transaction level (per IFRS 9 para 6.3.; and IAS 39 para 78) and these are still expected to occur, even if they are not expected to impact Group A's consolidated financial statements beyond 31 January 2016.

In addition, although IFRS 10 contains various requirements in respect of consolidation adjustments to eliminate intragroup transactions and reflect uniform accounting policies and periods, it does not suggest any adjustments are required to reflect changes in forecast transactions from a group perspective for hedge accounting. Similarly, IFRS 5 does not contain any specific requirement to revisit hedge accounting. Although IFRS 5 para 18 requires that immediately before classification as held for sale the carrying amount of assets and liabilities shall be measured in accordance with applicable IFRSs, it does not specify that this should be from a group rather than subsidiary or transaction perspective.

Therefore, Group A can continue to apply hedge accounting for the period it continues to consolidate subsidiary B.

Current practice

We believe that current accounting standards are unclear and diversity in practice exists with both views being applied.

<u>Issue 2</u>

A similar issue exists for the business model test.

Where a subsidiary of a parent holds financial assets with the objective of holding to collect contractual cash flows, hut the subsidiary also meets the criteria for classification as held for sale under IFRS 5, should the financial assets be considered held to collect or held to sell? (We note that this could also be a question of whether reclassification as per IFRS 9 para 4.4.1 is required when a subsidiary meets the IFRS criteria for held for sale.)

IFRS 9 para 4.1.2 requires an entity to measure a financial asset at amortised cost if the business model is to hold financial assets in order to collect contractual cash flows that are solely payments of principal and interest.

IFRS 9 para 4.1.2A requires an entity to measure a financial asset at fair value through other comprehensive income if the business model is to hold financial assets in order to collect contractual cash flows and sell financial assets, with the contractual terms of the assets giving rise to cash flows that are solely payments of principal and interest.

IFRS 9 para 4.1.2A requires an entity to measure other financial assets at fair value through profit or loss.

As with issue 1, a question arises as to how the assessment of the business model assessment should be performed from a group or subsidiary perspective. To illustrate:

- Group A has subsidiary C. Subsidiary C’s business model is to hold to collect the contractual cash flows of its financial assets that meet SPPI criteria.

- At 30 September 2015, Group A decides to sell subsidiary C and the criteria for held for sale in IFRS are met. Subsidiary C is sold in March 2016. Group A prepares consolidated financial statements to 31 December 2015.

IFRS 5 para 5 excludes financial assets within the scope of IFRS 9 and IAS 39 from its measurement provisions. Instead, the decision as to whether the assets are measured at amortised cost or fair value is determined in line with those standards.

Should the consolidated financial statements of Group A reflect the financial assets held by subsidiary C as held to collect or held to sell?

We have again identified two alternative views in practice:

View 1 —Example 3 in IFRS 9 para B4.1.4 clarifies that the business model of a group and subsidiary may differ, and that for the consolidated financial statements, the business model of the group should be used.

From the perspective of Group A, a strategic decision to sell the subsidiary has been made, and the business model for the financial assets should therefore be considered to be held to sell. Measurement at fair value through profit or loss would also reflect the group's intended disposal of the subsidiary and assets.

View 2 — Subsidiary C's financial assets are held in a business model to collect contractual cash flows for the purposes of the group's consolidated financial statements.

IFRS 9 para 4.1.2 requires an entity's business model be determined "at a level that reflects how groups of financial assets are managed together to achieve a particular business objective...a single entity may have more than one business model for managing its financial instruments. Consequently, classification need not be determined at the reporting entity level."

Accordingly, it would be appropriate to assess the financial assets held by subsidiary C at that level rather than a consolidated group perspective.

Current practice

We believe that current accounting standards are unclear and diversity in practice exists with both views being applied.