30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**21 June 2007, London**
Project:	**Annual Improvements**
Subject:	**IAS 39 – Reclassifying derivatives on cessation or commencement of hedge accounting and reclassifying portfolio financial instruments (Agenda paper 12E)**

---

1. The staff have identified that the following issues would be most appropriately resolved via the annual improvements process.

   Issue 1: Should IAS 39, *Financial Instruments: Recognition and Measurement*, be clarified to explain when derivatives that cease to qualify as a hedging instrument or vice versa can be reclassified into or out of the category of financial asset or financial liability at fair value through profit or loss?

   Issue 2: Should IAS 39, *Financial Instruments: Recognition and Measurement*, be clarified to explain when a financial instrument that is part of a portfolio can be reclassified into or out of the category of financial asset or financial liability at fair value through profit or loss?

Staff recommendation

2. The staff recommends that the Board:

- should add these issues to the annual improvements project; and

- should amend IAS 39 as proposed in paragraph 11 of this paper.

Background

3. The staff has been notified of an apparent ambiguity in the guidance in IAS 39. It relates to the reclassification of certain financial instruments into or out of the category of financial asset or financial liability at fair value through profit or loss in certain circumstances. These are:
1) Reclassification of a derivative that no longer qualifies as a hedging instrument in accordance with IAS 39 or vice versa; and
2) Reclassification of financial instruments that, after initial recognition, become, or cease to be, part of a portfolio of identified instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. This issue also relates to the reclassification of financial instruments that are part of a portfolio and for which, after initial recognition, there is evidence for the first time of a recent pattern of short-term profit-taking or, there is evidence for the first time of the absence of a recent pattern of short-term profit-taking.

IAS 39 guidance: definitions

4. Paragraph 9 of IAS 39 provides a definition of the category ‘a *financial asset or financial liability at fair value through profit or loss*’ (AFVTPL). This definition is reproduced below:

A *financial asset or financial liability at fair value through profit or loss* is a financial asset or financial liability that meets either of the following conditions.

(a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is:

(i) acquired or incurred principally for the purpose of selling or repurchasing it in the near term;

(ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or

(iii) a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only when permitted by paragraph 11A, or when doing so results in more relevant information, because either

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

(ii) a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures* (as revised in 2003)), for example the entity's board of directors and chief executive officer.

5. Classification of a financial instrument as AFVTPL in accordance with either part (a)(i) or part (b) of the definition is restricted to initial recognition of the instrument. However classification of a financial instrument as AFVTPL in accordance with part (a)(ii) and part (a)(iii) is not restricted to initial recognition. Furthermore, classification of a financial instrument as AFVTPL in accordance with part (a)(ii) or part (a)(iii) is mandatory and not a choice.

6. It follows from the definition above that:

1) A derivative that was classified as an effective hedging instrument but no longer meets that classification, for example because the effectiveness test has failed, must be reclassified as AFVTPL in accordance with part (a)(iii) of the definition above; and

2) A financial instrument that, after initial recognition, becomes part of a portfolio of identified instruments that are managed together and for which there is evidence of a recent actual short-term profit-taking must be reclassified as AFVTPL in accordance with part (a)(ii) of the definition above. This might arise for example when an available for sale (AFS) financial asset is transferred into an existing portfolio that is managed together and for which

there is evidence of a recent short-term profit-taking. Alternatively this might arise, for example, when there is an existing portfolio for which there was not previously evidence of a recent actual pattern of short-term profit-taking but for which such a pattern develops.

IAS 39 guidance: Reclassification

7. Paragraph 50 of IAS 39 states 'An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category whilst it is held'. This requirement appears to contradict the requirements of parts (a)(ii) and (a)(iii) of the definition of the AFVTPL category as described above.

8. The staff believes that applying the classification of AFVTPL as set out in the definition in paragraph 9 of IAS 39 should not be restricted. The staff understands the restriction set out in paragraph 50 of IAS 39 is designed to prevent selective reclassification by management to achieve a preferred accounting result when there has been no change in the substance of the entity's financial instruments or management of them. The staff notes, however, that the classification as AFVTPL set out in parts (a)(ii) and (a)(iii) of the definition is not a choice and is triggered by a change in circumstances.

Staff recommendation

9. The staff recommends that IAS 39 be amended as proposed in paragraph 11 to remove the apparent inconsistency between paragraph 50 and paragraph 9 of IAS 39.

10. **Does the Board agree?**

Drafting

11. The staff recommends that IAS 39 should be amended as follows:

Reclassifications

50 **An entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued except when**

(a) a derivative that was previously a designated and effective hedging instrument no longer qualifies as such or vice versa; or

(b) the financial instrument becomes, or ceases to be, part of a portfolio of identified instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking; or

(c) the financial instrument is part of a portfolio of identified instruments that are managed together and for which, in the period, there is evidence for the first time of a recent actual pattern of short-term profit-taking or there is evidence for the first time of the absence of a recent pattern of short-term profit-taking.

Basis for Conclusions on Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement

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

Reclassification

BC1 The Board has identified an apparent inconsistency in the guidance in IAS 39. It relates to the reclassification of certain financial instruments into or out of the category of financial asset or financial liability at fair value through profit or loss in certain circumstances. These are:

1) Reclassification of a derivative that no longer qualifies as a hedging instrument in accordance with IAS 39 or vice versa; and

2) Reclassification of financial instruments that, after initial recognition, become, or cease to be, part of a portfolio of identified instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking. This issue also relates to the reclassification of financial instruments that are part of a portfolio and for which, after initial recognition, there is evidence for the first time of a recent pattern of short-term profit-taking or, there is evidence for the first time of the absence of a recent pattern of short-term profit-taking.

BC2 The Board has decided to address this inconsistency by clarifying the circumstances under which a financial instrument may be reclassified into or out of the category of financial asset or financial liability at fair value through profit or loss. This will allow for the circumstances when a financial instrument meets the requirements for classification as a financial asset or financial liability at fair value through profit or loss in accordance with parts (a)(ii) and (a)(iii) of the definition in paragraph 9 of IAS 39.