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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**19 September 2007, London**
Project:	**Annual Improvements**
Subject:	**Annual Improvements process – sweep issues (Agenda paper 8)** **- Reclassification of financial instruments into and out of at fair value through profit or loss** **- Replacement of term 'fall due' with 'expected to be settled'** **- Miscellaneous wording revisions arising from the ballot process**

1. The staff has been alerted to three issues during the ballot process for the 2007 annual improvements exposure draft. Each is presented in this paper as a sweep issue.

Reclassification of financial instruments into and out of the at fair value through profit or loss category

2. One Board member and the financial instruments staff have noted that, in their view, the proposed annual improvement in respect of this issue is inconsistent with the fair value option. They believe that the proposed annual improvement

introduces freedom to choose to account for a non-derivative financial instrument at fair value after initial recognition.

3. The Board placed restrictions on the use of the fair value option in order to impose discipline over how this option is used. For example, the Board decided that financial instruments should not be reclassified into or out of the category of fair value through profit or loss (see paragraph BC73 of IAS 39). That is, the fair value option is only available on initial recognition, and that designation is irrevocable. An extract of the current text of IAS 39 is included in Appendix A.

4. The proposed 2007 annual improvements amendment addresses the application of part (a) of the definition of a financial asset or financial liability at fair value though profit or loss. It does not propose any amendments to the definition itself but proposes to clarify how part (a) of the definition is applied.

5. Part (a) of the definition is as follows:

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) …

6. Parts (a)(ii) and (a)(iii) of the definition are read by some as always operative, ie they do not become operative only on initial recognition. Those that take this view believe that a non-derivative financial instrument must therefore be classified as trading in accordance with part (a)(ii) of the definition after initial recognition if, after initial recognition:

- It is transferred into 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

- It is part of a portfolio of identified financial instruments that are managed together and, at a later date, there arises evidence for the first time of a recent actual pattern of short-term profit taking.

7. The objective of the annual improvement proposal was to clarify how parts (a)(ii) and (a)(iii) operate after initial recognition of the financial instrument/derivative in light of the prohibition in paragraph 50 from reclassifying a financial instrument into or out of the at fair value through profit or loss category.

8. The Board discussed and agreed at the June meeting to clarify how paragraph 50 should be applied by inserting paragraph 50A:

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.

<u>50A The following changes in circumstances are not reclassifications for the purposes of paragraph 50:</u>

(a) <u>a derivative that was previously a designated and effective hedging instrument no longer qualifies as such;</u>

(b) <u>a derivative becomes a designated and effective hedging instrument;</u>

(c) <u>a 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; and</u>

(d) <u>a financial instrument is transferred, during the period, into a portfolio of identified instruments that are managed together and</u>

for which there is evidence of a recent actual pattern of short-term profit-taking.

9. The concern that has been raised by the Board member and financial instruments staff relates to the proposed guidance in paragraph 50A(c) and 50A(d). The concern is that the proposed amendment permits the reclassification of non-derivative financial instruments into the 'at fair value through profit or loss' category at any time after initial recognition. That is, a fair value option that an entity can use *at any time* is created because (for example) an entity can move any financial instrument into a trading portfolio. This is therefore inconsistent with the restrictions surrounding the fair value option in IAS 39 that were imposed to create discipline over use of the option. The Board member and financial instruments staff have requested that these concerns be discussed at the September Board meeting before the exposure draft is published.

10. **The staff proposes that the following question is considered:**

Should an entity be able to transfer a non-derivative financial asset or financial liability into the 'at fair value through profit or loss' category after initial recognition by changing the way in which it manages the financial instrument?

11. The staff has considered two views in response to this question:

View A:

A change in the way in which an entity manages a non-derivative financial instrument is important. Non-derivative financial instruments that are managed in a portfolio and for which there is a recent pattern of short term profit taking should be required to be classified as trading assets and liabilities and accounted for at fair value through profit or loss. This classification should be made even if this represents a change in the way in which the financial instruments has been accounted for since initial recognition. A consequence of this view is that an entity has an ability to change the basis of accounting for such an instrument after initial recognition by transferring the instrument into a trading portfolio or through such a portfolio meeting the trading conditions for the first time at a later date. The staff notes that the Board decided at the June meeting that such instruments cannot be transferred out of the 'at fair value through profit or loss' category at a later date.

If the Board supports view A, the staff propose that the amendment included in the ballot draft be retained.

View B:

No changes to the basis of accounting for non-derivative financial instruments should be permitted after initial recognition (other than those required in paragraphs 50 – 54 of IAS 39) if an entity changes the way in which it manages the instrument. This view is consistent with the restrictions placed on the use of the fair value option in 2003 (and reaffirmed in the amendment to the fair value option in 2005).

If the board supports view B, the staff proposes that paragraphs 50A(c) and 50A(d) are deleted from the proposed amendment and the definition of financial assets and financial liabilities at fair value through profit or loss is amended as follows:

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)** **it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;**
- **(ii)** **on initial recognition it is 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)** **it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).**

(b) **…**

12. The staff's attention has also been drawn to an associated issue relating to View A. The issue is that there is no specific guidance included in IAS 39 of how to account for the change in the measurement basis of financial instruments that are reclassified into the 'at fair value through profit or loss' category in accordance with 50A(c) and 50A(d). The measurement basis of such instruments would change from amortised cost to fair value. The staff believes that the change in carrying amount caused by the change in the measurement basis should be recognised in profit or loss by analogy to the guidance in paragraphs 53 and 55 of IAS 39. These paragraphs are reproduced for ease of reference in appendix A. The guidance in paragraphs 53 and 55 is given for the remeasurement of a financial asset or financial liability from cost to fair value when a reliable fair value becomes available for the first time.

13. The staff believes that the analogy to paragraphs 53 and 55 is a reasonable one however, the Board, if it supports view A, may want to take this opportunity to include specific guidance for the remeasurement by inserting paragraph 54A:

> 54A If, as a result of a change in circumstances in accordance with paragraphs 50A(c) or 50A(d), a non-derivative financial instrument is required to be reclassified as held for trading, the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55.

Staff recommendation

14. The annual improvements project staff continues to believe that the inconsistency between the definition in paragraph 9 and the restriction on reclassification in paragraph 50 needs to be addressed. The annual improvements project staff recognises that both views A and B have merit. View A reflects the way in which the non-derivative financial instruments are used by the entity, whereas view B prevents a cherry picking use of the fair value option. On balance the annual improvements project staff recommends view A, including the additional insertion of paragraph 54A as set out in paragraph 13 of this paper.

15. **Does the Board agree?**

Replacement of the term 'fall due' with 'expected to be settled'

16. One Board member has expressed concern over the proposed amendment to IAS 19 *Employee Benefits* that relate to the replacement of the term 'expected to be settled' with the term 'fall due'. The proposed amendment is to the definitions of short-term employee benefits and other long-term employee benefits. The proposed amendments to the definitions are as follows:

Short-term employee benefits **are employee benefits (other than termination benefits) ~~which~~that ~~fall due~~are expected to be settled wholly within twelve months after the end of the period in which the employees render the related service.**

Other long-term employee benefits **are employee benefits (other than post-employment benefits and termination benefits) ~~which~~that ~~do~~are not ~~fall due~~expected to be settled wholly within twelve months after the end of the period in which the employees render the related service.**

17. The intention of the proposed amendment is to introduce consistency between the terms used in the definitions and the terms used in paragraph 8 of the standard which provides examples of short-term employee benefits. The concern relates to how the revised wording might be interpreted. For example, if a payment is required in 6 months but it is known that the obligation cannot be met for at least 12 months, does that result in a classification as a long-term employee benefit because the liability is now **expected to be settled** later than its due date?

18. The staff notes that the use of the term 'expected to occur' in paragraph 8 is in the context of the expected timing of the **use of the benefit** (the paid absence). However, the term 'fall due' in the definition in paragraph 7 was used in the context of the timing of the **entitlement to benefits** (eg paid absence). The staff also notes that the classification of employee benefits between the short-term and long-term categories in IAS 19 is for the purpose of determining the measurement basis. Short-term employee benefits are calculated without discounting whereas other long-term employee benefits are accounted for at the present value of the defined benefit obligation. The classification of the

obligation as current or non-current in the statement of financial position continues to be made in accordance with the guidance in IAS 1 *Presentation of Financial Statements*.

19. The staff recommends that the proposed amendment be revised to address the concern raised. The staff recommends amending both paragraphs 7 and 8 to address the inconsistency and that this is done by focusing on the timing of the entitlement of the employee rather than the expected timing of the use of the benefit by the employee.

Staff recommendation

20. The staff recommends amending paragraphs 7 and 8 as set out in paragraph 22 of this paper.

21. **Does the Board agree?**

Drafting

22. The staff recommends that IAS 19 be amended as follows:

Definitions

7 The following terms are used in this Standard with the meanings specified:

Short-term employee benefits **are employee benefits (other than termination benefits) to which the employee becomes wholly entitled ~~fall due wholly~~ within twelve months after the end of the period in which the employees render the related service.**

Other long-term employee benefits **are employee benefits (other than post-employment benefits and termination benefits) to which the employee does not become wholly entitled ~~do not fall due wholly~~ within twelve months after the end of the period in which the employees render the related service.**

Short-term employee benefits

8 Short-term employee benefits include items such as:

(a) wages, salaries and social security contributions;

(b) short-term compensated absences (such as paid annual leave and paid sick leave) where employees are entitled to be absent ~~the absences are expected to occur~~ within twelve months after the end of the period in which the employees render the related employee service;

(c) profit-sharing and bonuses payable within twelve months after the end of the period in which the employees render the related service; and

(d) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees.

Wording revisions arising from the ballot process

23. During the preparation of the exposure draft additional wording amendments were identified that improve the clarity of one of the paragraphs in IAS 41 *Agriculture*.

Staff recommendation

24. The staff recommends that paragraph 36 of IAS 41 is amended as set out in paragraph 26 of this paper.

25. **Does the Board agree?**

Drafting

26. The staff recommends that IAS 41 should be amended as follows:

> 36 Terms and conditions of government grants vary. For example, a ~~government~~ grant may require an entity to farm in a particular location for five years and require the entity to return all of the ~~government~~ grant if it farms for ~~less~~ fewer than five years. In this case, the government grant is not recognised in profit or loss ~~as income~~ until the five years have passed. However, if the terms of the ~~government~~ grant allow~~s~~ part of ~~the government grant~~ it to be retained ~~based on the passage of time~~ according to the passage of time, the entity recognises ~~the government grant~~ that part in profit or loss ~~as income on a time proportion basis~~.

Appendix A

Extracts from IAS 39

Extracts from paragraph 9

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.**

In IFRS 7, paragraphs 9-11 and B4 require the entity to provide disclosures about financial assets and financial liabilities it has designated as at fair value through profit or loss, including how it has satisfied these conditions. For instruments qualifying in accordance with (ii) above, that disclosure includes a narrative description of how designation as at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured (see paragraph 46(c) and Appendix A paragraphs AG80 and AG81), shall not be designated as at fair value through profit or loss.

It should be noted that paragraphs 48, 48A, 49 and Appendix A paragraphs AG69-AG82, which set out requirements for determining a reliable measure of the fair value of a financial asset or financial liability, apply equally to all items that are measured at fair value, whether by designation or otherwise, or whose fair value is disclosed.

Paragraphs 53 and 55

53 If a reliable measure becomes available for a financial asset or financial liability for which such a measure was previously not available, and the asset or liability is required to be measured at fair value if a reliable measure is available (see paragraphs 46(c) and 47), the asset or liability shall be remeasured at fair value, and the difference between its carrying amount and fair value shall be accounted for in accordance with paragraph 55.

…

Gains and losses

55 A gain or loss arising from a change in the fair value of a financial asset or financial liability that is not part of a hedging relationship (see paragraphs 89-102), shall be recognised, as follows.

- **a. A gain or loss on a financial asset or financial liability classified as at fair value through profit or loss shall be recognised in profit or loss.**
- **b. A gain or loss on an available-for-sale financial asset shall be recognised directly in equity, through the statement of changes in equity (see IAS 1 *Presentation of Financial Statements*), except for impairment losses (see paragraphs 67-70) and foreign exchange gains and losses (see Appendix A paragraph AG83), until the financial asset is derecognised, at which time the cumulative gain or loss previously recognised in equity shall be recognised in profit or loss. However, interest calculated using the effective interest method (see paragraph 9) is recognised in profit or loss (see IAS 18 *Revenue*). Dividends on an available-for-sale equity instrument are recognised in profit or loss when the entity's right to receive payment is established (see IAS 18).**