



**30 Cannon Street, London EC4M 6XH, United Kingdom**  
**Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411**  
**E-mail: [iasb@iasb.org](mailto:iasb@iasb.org) Website: [www.iasb.org](http://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:**        **October 2008, London**  
**Project:**            **IAS 39 *Financial Instruments: Recognition and Measurement***  
**Subject:**            **Reclassifications out of the held for trading part of the Fair Value through Profit or Loss (FVTPL) Category (Agenda Paper 12)**

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### **Background**

1. A number of banks and others have asked the IASB to reconsider (and possibly eliminate) the prohibition reclassifying a financial asset from the 'held-for-trading' part of the FVTPL category to another category. Based on staff discussions with some banks, it appears that the types of assets in the held for trading part of the FVTPL category that some banks would like to reclassify include asset-backed securities and possibly some leveraged loans.
2. Some have made this request in the context of converging with practice under US GAAP (and ensuring that US GAAP practice confers no competitive advantage). For example, at the recent Paris meeting of some EU leaders, this issue was included in the 19-point document issued at the end of those discussions:
  9. We will ensure that European financial institutions are not disadvantaged vis-à-vis their international competitors in

terms of accounting rules and of their interpretation. In this regard, European financial institutions should be given the same rules to reclassify financial instruments from the trading book to the banking book including those already held or issued. We urge the IASB and the FASB to work quickly together on this issue in accordance with their recent announcement. We also welcome the readiness of the Commission to bring forward appropriate measures as soon as possible. This issue must be resolved by the end of the month

3. Others believe that reclassifications of financial instruments should be permitted regardless of US GAAP convergence related issues. Many comment letters from preparers to the IASB discussion paper *Reducing Complexity in Reporting Financial Instruments* stated that in situations that there has been a clear change of management intent, an entity should be allowed to make a reclassification from the 'held-for-trading' category to another category (such as loans and receivables). Such respondents stated that any such transfer should be made at the fair value on the transfer date, with the amortised cost basis being that fair value. Respondents also recommended extensive disclosure requirements to explain why the reclassification has taken place, its impact and scope.
4. The staff would like to highlight that in discussions with users of financial statements, users have always stated that reclassifications out of the FVTPL category (which includes the held for trading category) should not be permitted. Reasons advanced include concern over entities 'gaming' the rules, avoiding future fair value losses and that such a change to IFRS would *increase* uncertainty and *decrease* transparency.

### **Reclassifications between categories of financial instruments**

5. Paragraphs 50 – 54 of IAS 39 set out the reclassification requirements. For the purpose of this paper, only paragraph 50 is relevant.
6. That paragraph prohibits transfers into or out of the FVTPL category. The Board re-deliberated an issue related to paragraph 50 of IAS 39 in June 2007 as part of the last Annual Improvements process. The IASB Update for that meeting stated that:

**Reclassification of derivatives into or out of the classification as at fair value through profit or loss**

Paragraph 50 of IAS 39 prohibits the reclassification of financial instruments into or out of the ‘fair value through profit or loss’ (FVTPL) category after initial recognition. However, some financial instruments meet the criteria for classification as at FVTPL after initial recognition and vice versa. This specifically relates to derivatives that become or cease to be designated and effective hedging instruments. It also relates to financial instruments that are held within a portfolio for which evidence arises for the first time of a recent actual pattern of short-term profit-taking, or for which there is evidence of cessation of such activity.

The Board supported the view that meeting or ceasing to meet the criteria included in the definition of FVTPL as set out in paragraph 9 of IAS 39 is not a reclassification for the purposes of paragraph 50. The Board expressed concern that any amendment to the standard should not permit an entity to choose to move a financial instrument out of the category of FVTPL. It therefore asked the staff to prepare wording for an amendment to reflect this view.

7. As a result, paragraph 50A was added to IAS 39:

The following changes in circumstances are not reclassifications for the purposes of paragraph 50:

- (a) a derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;
- (b) a derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge;
- (c) financial assets are reclassified when an insurance company changes its accounting policies in accordance with paragraph 45 of IFRS 4.

**Summary of US GAAP**

8. The following paragraphs summarise the staff’s understanding of US GAAP requirements in this area, and how practice applies those requirements. That understanding reflects numerous informal discussions with FASB staff, some US regulators and US accounting firms.

9. Relevant US GAAP includes:

- a. *SFAS 159 The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*
- b. *SFAS 115 Accounting for Certain Investments in Debt and Equity Instruments*

- c. *SFAS 65 Accounting for Certain Mortgage Banking Activities and AICPA SOP 01-6 Accounting by Certain Entities that lend to or finance the activities of others*

***SFAS 159 The Fair Value Option for Financial Assets and Financial Liabilities***

10. Like IAS 39, SFAS 159 does not permit reclassification of any item designated using the fair value option (FVO). Paragraph 4 of SFAS 159 states that the decision to elect the FVO is irrevocable (unless a new election date occurs, as discussed in paragraph 9 of that Statement). (Note: the scope of SFAS 159 is wider than IAS 39, and SFAS 159 has no eligibility criteria. However, those issues are beyond the limited scope of this paper).

***SFAS 115 Accounting for Certain Investments in Debt and Equity Instruments***

11. The scope of SFAS 115 is set out in paragraphs 3 and 4 of that Statement. To summarise, SFAS 115 applies to investments in equity securities that have readily determinable fair values and to all investments in debt securities. SFAS 115 does not apply to other types of financial assets (and so is much narrower in scope than IAS 39).
12. A ‘security’ is defined in the Glossary (Appendix C) to SFAS 115.
13. Paragraph 15 of SFAS 115 addresses transfers between categories. That paragraph permits transfers into or from the trading category but states that such transfers should be “rare”. Any such transfers are accounted at the fair value on the date of transfer.
14. Based on discussions with US accounting firms, some US regulators and FASB staff, it is the staff’s understanding that ‘rare’, in practice, means never.
15. In remarks before the 2004 AICPA National Conference on Current SEC and PCAOB Developments, a SEC staff person commented on the meaning of “rare”. In that speech, it was stated, “transfers might be

appropriate if a significant business combination or other event greatly alters the company's liquidity position or investing strategy”.

16. However, following extensive discussions the IASB staff is not aware of any particular situation in which a transfer out of the trading category has occurred. That is, no situation has arisen that meets the hurdle of ‘rare’. The IASB staff will continue to research this issue.

**SFAS 65 *Accounting for Certain Mortgage Banking Activities* and AICPA SOP 01-6 *Accounting by Certain Entities that lend to or finance the activities of others***

17. The scope of SFAS 65 is set out in paragraph 3 of that Statement. To summarise, the Statement applies primarily to mortgage loans.
18. SFAS 65 sets out two categories – Held for Sale (HFS) and Held for Investment (HFI).
19. HFS assets are measured at the lower of cost or market value, with any changes below cost being recognised in earnings in the period they occur. HFI assets are measured using amortised cost.
20. Transfers from HFS to HFI are permitted if the entity has the ability and intent to hold the loan for the *foreseeable future* or until maturity (paragraph 6 of SFAS 65). Any transfer is made at the lower of cost or market value at the transfer date.
21. SOP 01-6 sets out similar accounting to non-mortgage loans.
22. The staff understands that such transfers do occur in practice because of a change in intent by the reporting entity.

**Other relevant considerations**

23. If the IFRS requirements for reclassifications are changed to converge with US practice, then other related important areas of accounting for financial instruments should arguably be considered to ensure that the classification and measurement requirements are conformed.

24. One obvious area is the accounting for impairment. If an entity is permitted to reclassify assets out of FVTPL under IFRS, more assets will be assessed for impairment than today.
25. IFRS and US GAAP practice on impairment are different in some respects.
26. One important difference relates to the 'other than temporary' test in US GAAP (that test does not exist in IFRS).
27. Temporary declines in the value of held-to-maturity debt securities are not recognized in earnings under SFAS115. However, a decline in fair value below amortized cost that is other than temporary is accounted for as a realized loss. Paragraph 16 of SFAS 115 specifies that "...[i]f the decline in fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value... and the amount of the write down shall be included in earnings." That write down results in a new cost basis for the security, which cannot be recovered if the fair value subsequently increases.
28. The determination of whether a decline is other than temporary are made using all evidence that is available to the investor - not just evidence that is related to the registrant such as its financial condition and near-term prospects. The investor also must consider the severity and duration of the decline in fair value and the investor's intent and ability to hold the investment for a period sufficient for a forecasted recovery.
29. This means that if interest rates have risen (and thus the fair value of an investment in a debt security has declined), in assessing whether that decline in fair value is other than temporary the investor must consider its intent and ability to hold the investment for the period of time it will take for it to recover. (See SEC Staff Accounting Bulletin: Codification: Topic 5M *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*).
30. Compare that guidance to the impairment requirements in IAS 39. Paragraph 60 of IAS 39 states that "[a] decline in the fair value of a

financial asset below its cost or amortised cost is not necessarily evidence of impairment (for example, a decline in the fair value of an investment in a debt instrument that results from an increase in the risk-free rate).”

31. Hence, an increase in (risk-free) rates does not determine whether a debt instrument is impaired in IAS 39. However, an increase in interest rates that results in the fair value of a debt security declining would result in impairment under US GAAP (if that decline were judged to be other than temporary).
32. Other differences may also need to be considered that are not addressed in this paper; for example, reclassifications between other categories of financial instruments.

### **Possible approaches**

33. If the Board decides to address reclassifications out of the FVTPL category there are two broad (and overlapping) approaches that might be taken:
  - a. to converge IFRS requirements with US GAAP practice as much as possible; or
  - b. to permit reclassifications based on a change in management intent in particular situations.

### **To converge IFRS requirements with US GAAP practice**

#### *The Fair Value Option*

34. No difference exists for financial instruments designated under the FVO.

#### *SFAS 115 Securities*

35. As noted previously, classifications are permitted in ‘rare’ situations.
36. As noted previously, following extensive discussions this staff person is not aware of any particular situation in which a transfer out has occurred. The staff will continue to research this issue to determine

whether a transfer has occurred and in what situation any such transfer has occurred.

37. The staff considers the term ‘rare’ to be vague and, given the number of jurisdictions that apply IFRS believe that is such a term was used, significant additional guidance would be required or the situations in which such a transfer could occur should be made explicit. For example, any proposed amendment could state that a transfer could only occur if:
- a. a significant business combination or other event greatly alters the acquirer’s liquidity position or investing strategy and so the acquirer is permitted to change the classification of instruments of its existing financial instruments. (Note that Paragraph 16 (a) of IFRS 3 *Business Combinations* and US GAAP already permit an acquirer to change the financial instrument classifications acquired financial instruments based on conditions that exist at the acquisition date); or
  - b. as a result of a change in statutory or regulatory requirements.
38. If the Board decided to do this, then the issue would also be whether to permit this for only financial instruments in the held for trading part of the FVTPL category that meet the US GAAP definition of a ‘security’, or for all types of financial instruments in the held for trading part of the FVTPL category.
39. However, the approach of setting out the situations in which a transfer can occur may result in *greater* flexibility for entities under IFRS than is the case for entities applying US GAAP; specifying situations that reclassifications *can* occur does not reflect US practice that such transfers never appear to occur.
40. A different approach would be to ask the FASB to consider changing US literature and either to:
- a. state the situations that a transfer can be made; or
  - b. to eliminate ‘rare’ except for business combinations.



## SFAS 65

41. As noted previously, SFAS 65 and SOP 01-6 allow loans to be transferred from HFS to HFI in some situations. Such transfers do happen in practice. IFRS has no equivalent categories.
42. It is difficult to replicate US GAAP practice in this area, short of importing SFAS 65 (or something similar) into IFRS. Some also note that SFAS 65 is an old standard that probably needs to be replaced.
43. One possibility might be to create a 'held for sale' category for loans and receivables and allow transfers in particular situations. The accounting for all loans thus transferred would be at the lower of the transferred value or cost. (The staff notes that creating such a category would not be consistent with the discussions in *Reducing Complexity in Reporting Financial Instruments*.) Other parts of SFAS 65 might need to be incorporated into IAS 39 as well.

### **To permit reclassifications based on a change in management intent in particular situations**

44. As noted in paragraph 3 of this paper, some believe that reclassifications of financial instruments should be permitted regardless of US GAAP convergence related issues.
45. Many comment letters to the IASB discussion paper *Reducing Complexity in Reporting Financial Instruments* stated that in situations that there has been a clear change of management intent, an entity should be allowed to make a reclassification from the 'held-for-trading' category to another category (such as loans and receivables).
46. Such respondents stated that any such transfer should be made at the fair value on the transfer date, with the amortised cost basis being that fair value. Respondents also recommended extensive disclosure requirements to explain why the reclassification has taken place, its impact and scope.
47. The reclassifications in SFAS 65 are based on a change in management intent.

48. One possible approach is to permit reclassification if a class of assets was initially recognised as part of an ‘originate-to-distribute’ business model (a bank originated assets with the purpose of selling them in the near term), but that business model no longer exists. Such assets are classified as held for trading in IAS 39 (assuming that they would have been derecognised on transfer).
49. Such an approach would address the concerns of some banks. It would not distinguish between securities and loans, but might go some way to converging with SFAS 65. It would also not result in the same rules as advocated by the EU leaders at their recent meeting (see extract in paragraph 3 of this paper).
50. Any approach based on management intent would require extensive disclosures.

**Question for the Board:**

**How would you like to proceed?**