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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 Follow up)**

Background

1. This paper summarises the key issues the Board will need to consider should the Board wish to amend IAS 39. A draft of possible amendments to IAS 39 and IFRS 7 *Financial Instruments: Presentation* that will be discussed at the meeting are also attached. That draft is based on a staff assessment of US practice. We continue to discuss with relevant US GAAP experts and will table any issues that emerge subsequent to issuance of this paper.

2. The three key issues the Board needs to consider to ensure a level playing field between IFRS and US GAAP practice in this area is achieved through any amendment are:

    a. Transfers of loans and receivables

    b. Impairment requirements for any transferred asset

    c. Effective date of any amendment.

Loans and Receivables

3. The attached draft attempts to replicate US GAAP in terms of the ability to transfer loans (SFAS 65 *Accounting for Certain Mortgage Banking Activities* and other literature) and securities (SFAS 115 *Accounting for Certain Investments in Debt and Equity Securities*), to the extent possible.

4. Paragraph 50B applies the 'rare' test for transfers out of trading to another category for eligible financial assets, except those that would have met the definition of loans and receivables at initial recognition apart from the requirement to classify them as held for trading.

5. Paragraph 50E applies the test in SFAS 65 to eligible financial assets that would have met the definition of loans and receivables at initial recognition apart from the requirement to classify them as held for trading. That test is that an entity has the intent and ability to hold the asset for the foreseeable future or until maturity.

6. This creates a level playing field for loans and other financial assets, short of importing US GAAP wholesale into IAS 39.

Impairment

7. For assets in paragraph 50B (eligible financial assets, except those that would have met the definition of loans and receivables at initial recognition apart from the requirement to classify them as held for trading), paragraph 50D attempts to replicate the SFAS 115 and US GAAP impairment guidance to the extent possible. You should recognise that that US GAAP impairment guidance consists of multiple interpretations and other pieces of literature. In essence, paragraph 50D contains:

    a. the trigger for when to <u>assess</u> for impairment (fair value below amortised cost);

    b. the trigger for when to <u>recognise</u> an impairment (if the impairment is deemed to be not recoverable);

    c. <u>measurement</u> of impairment once the impairment trigger has been met (write down to fair value); and

    d. any <u>reversal</u> of an impairment loss upon the subsequent recovery of the financial asset (specifically prohibited).

8. Items a, c and d in paragraph 50D are substantially consistent with US GAAP. However, US GAAP provides lots (and the staff mean lots!) of implementation guidance about when to recognise an impairment (item b) – the other than temporary concept.

9. The proposed amendment as currently drafted does not achieve full convergence with US GAAP in this area. The only way to do that would be to import all the US GAAP literature into IFRS.

10. The Board has at least three alternatives:

    a. **Alternative A** – *Maintain the existing IAS 39 impairment requirements for reclassified assets in paragraph 50B.* That would be straight-forward, but would not reflect the fact that SFAS 115 impairment requirements play an important role in determining US GAAP practice regarding how many financial assets are transferred. The SFAS 115 impairment model is fair value based (in terms of measurement – see c. above) whereas IFRS impairment requirements for any asset in held-to-maturity are not. Also, the impairment triggers (see point a. and b. above) often result in impairments being recognised quicker in SFAS 115 than IAS 39.

    b. **Alternative B** – *Import US GAAP on impairment of securities into IFRS wholesale* (eg, SAB 59, FASB FSP 114/115-1, EITF 99-20, SOP 03-3).

    c. **Alternative C** – Attempt to replicate only some aspects of the US GAAP impairment trigger guidance (specifically, bring in the three factors in SAB 59: (a) the length of the time and the extent to which the fair value has been less than cost, (b) the financial condition and near-term prospects of the issuer; and (c) the intent and ability to hold the impaired asset until forecasted recovery).

11. The draft attached follows Alternative C.

Effective Date

12. The attached draft includes an effective date of 1 July 2008. This would allow application for the 3Q results (with appropriate disclosures to highlight the effect of any reclassifications to users of financial statements). Given that US GAAP preparers have always been permitted to (although rarely do) reclassify securities out of the trading category in SFAS 115 and loans out of the Held for Sale category in SFAS 65 (which do

occur), it has been suggested that the Board should consider moving the effective date back to January 1, 2008.

Important questions for the Board

13. Assuming that the Board wishes to consider amending IAS 39, the staff needs the following important questions answered:

Question 1: Impairment

Question 2: Effective date

Question 3: Form and timing of any amendment

RECLASSIFICATION OF FINANCIAL ASSETS

(AMENDMENTS TO IAS 39 AND IFRS 7)

STAFF DRAFT V 10OCTOBER

NOT APPROVED BY THE IASB

THIS IS A DRAFT BASED ON THE STAFF'S CURRENT ASSESSMENT OF US GAAP. THAT ASSESSMENT MAY CHANGE SUBJECT TO ONGOING DISCUSSIONS.

CONTENTS

Reclassification of financial assets

Amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*

Amendments to IAS 39

In the Introduction, a heading and paragraph IN8A are added.

Introduction

Reclassifications

IN8A An amendment to the Standard, issued in October 2008, permits an entity to reclassify non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the fair value through profit or loss category in particular circumstances.

Paragraph 50 is amended (new text is underlined and deleted text is struck through) and paragraphs 50B–50G and 103G are added.

Measurement

Reclassifications

50 An entity<u>:</u>

- **<u>(a)</u> shall not reclassify a <u>derivative</u> ~~financial instrument into or~~ out of the fair value through profit or loss category while it is held or issued~~.~~<u>;</u>**
- **<u>(b) shall not reclassify any financial instrument out of the fair value through profit or loss category if upon initial recognition it was designated by the entity as at fair value through profit or loss; and</u>**
- **<u>(c) notwithstanding the definition of held for trading, an entity may reclassify any other financial asset out of the fair value through profit or loss category if the requirements in paragraph 50B or 50E are met.</u>**

<u>An entity shall not reclassify any financial instrument into the fair value through profit or loss category after initial recognition.</u>

50B A financial asset to which paragraph 50(c) applies (except financial assets described in paragraph 50E) can be reclassified out of the fair value through profit or loss category only in rare circumstances.

50C If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50B, the financial asset shall be reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in profit or loss shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.

50D For any financial asset (except an equity instrument) reclassified in accordance with paragraph 50B, an entity shall assess at the end of each subsequent reporting period whether there has been an impairment in accordance with the following requirements (and not in accordance with paragraphs 58–70):

(a) an entity shall determine whether a decline in fair value below the cost or amortised cost will be recovered. Factors to be included in that assessment are:

   (i) the length of time and the extent to which the fair value is below cost or amortised cost;

   (ii) the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the financial asset or the discontinuance of a segment of the business that may affect the future earnings potential; and

   (iii)the intent and ability of the entity to retain its financial asset for a period of time sufficient to allow for any anticipated recovery in fair value.

(b) if the entity determines that a decline in fair value will not be recovered, the financial asset shall be written down to fair value (for a financial asset not classified as available-for-sale) and the amount of the loss shall be recognised in profit or loss. For a financial asset classified as available-for-sale, the cumulative loss (the difference between the cost net of any principal repayment and amortisation and the current fair value) that has been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment even though the financial asset has not been derecognised;

(c) any such impairment loss recognised in profit or loss shall not be reversed through profit or loss; and

(d) the fair value to which the financial asset is written down shall be the new cost basis against which any subsequent impairments shall be assessed.

For any equity instrument reclassified in accordance with paragraph 50B, an entity shall assess at the end of each subsequent reporting period whether there has been an impairment of a financial asset or group of financial assets in accordance with paragraphs 58-70.

50E A financial asset to which paragraph 50(c) applies that would have met the definition of loans and receivables at initial recognition (if they had not been required to be classified as held for trading at initial recognition) can be reclassified out of the fair value through profit or loss category if the entity has the intent and ability to hold the financial asset for the foreseeable future or until maturity.

50F If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50E, the financial asset shall be reclassified at its fair value on the date of reclassification. Any gain or loss already recognised in profit or loss shall not be reversed. The fair value of the financial asset on the date of reclassification becomes its new cost or amortised cost, as applicable.

50G If an entity reclassifies a financial asset out of the fair value through profit or loss category in accordance with paragraph 50E, the entity shall assess at the end of each reporting period whether there is any objective evidence that the financial asset or group of financial assets is impaired, in accordance with paragraphs 58 – 70.

Effective date and transition

103G *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7), issued in October 2008, amended paragraph 50, paragraph AG8, and added paragraphs 50B–50G. An entity shall apply those amendments from 1 July 2008. An entity shall not reclassify a financial asset in accordance with paragraph 50B or 50E before 1 July 2008. Any reclassification of a financial asset made in periods beginning on or after 1 November 2008 shall only be effective from the date that the reclassification is made. Any reclassification of a financial asset in accordance with paragraph 50B or 50E shall not be applied retrospectively to reporting periods prior to the effective date set out in this paragraph.

In appendix A *Application Guidance*, paragraph AG8 is amended (new text is underlined and deleted text is struck through).

Effective interest rate

AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate. The adjustment is recognised as income or expense in profit or loss. If a financial asset is reclassified in accordance with paragraph 50B and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognised as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate. If a financial asset is reclassified in accordance with paragraph 50B and an impairment loss is subsequently recognised in accordance with paragraph 50D , the revised estimated cash flows shall exclude any cash flows relating to recovery of the previously recognised impairment loss.

Amendments to IFRS 7

Paragraph 12 is amended (new text is underlined and deleted text is struck through) and paragraphs 12A and 44E are added.

Significance of financial instruments for financial position and performance

Statement of financial position

Reclassification

12 If the entity has reclassified a financial asset <u>(in accordance with paragraphs 51–54 of IAS 39)</u> as one measured:

(a) at cost or amortised cost, rather than fair value; or

(b) at fair value, rather than at cost or amortised cost,

it shall disclose the amount reclassified into and out of each category and the reason for that reclassification ~~(see paragraphs 51–54 of IAS 39)~~.

12A If the entity has reclassified a financial asset or class of financial assets out of the fair value through profit or loss category in accordance with paragraph 50B or 50E of IAS 39, it shall disclose:

(a) the amount reclassified into and out of each category;

(b) if an asset or class of financial assets was reclassified in accordance with paragraph 50B, the rare situation, and the facts and circumstances indicating that the situation was rare;

(c) in the reporting period the reclassification occurs, the gain or loss recognised in profit or loss in that reporting period and in the prior reporting period; and

(d) in each reporting period ending subsequent to reclassification (until derecognition of the financial asset), the fair value gain or loss that would have been recognised in profit or loss if that reclassification had not occurred and the gain, loss, income and expense actually recognised in profit or loss.

Effective date and transition

44E *Reclassification of Financial Assets* (Amendments to IAS 39 and IFRS 7), issued in October 2008, amended paragraph 12 and added paragraph 12A. An entity shall apply those amendments from 1 July 2008.