Project **Financial Instruments – Recognition and Measurement**

Topic **Classification – principles that govern characteristics of financial instruments**

Introduction

Background

1. As set out in the classification cover paper (agenda paper 2), at its May 2009 meeting the IASB requested that the staff develop a classification approach in more detail.

Purpose of this paper

2. This paper develops a principles-based classification approach regarding the *characteristics* of financial instruments. It also discusses how the principles could be made operational drawing on guidance included in for forthcoming *IFRS for Private Entities* (IFRS for SMEs). Agenda paper 2C includes further details and examples that illustrate classification outcomes.

3. This paper does not ask the boards for any decisions. The staff recommendation and the questions to the Board regarding the classification approach are included in agenda paper 2E.

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Characteristics of the financial instrument

4. As set out in the classification cover paper, the objective of classification is to ensure that financial instruments are allocated to measurement categories in such a way that the resulting information is useful to users. That means information should assist in assessing the amounts, timing and uncertainty of future cash flows. This paper is about making that objective operational by developing classification criteria on the basis of the characteristics of the financial instrument.

Variability of cash flows

Types of cash flow variability

5. The variability of cash flows comes from:

   (a) variability of amounts:

      (i) contractual (eg the effect of indexation, leverage, and caps, floors or collars);

      (ii) non-contractual (non-performance risk – shortfall of contractual cash flows):

   (b) variability of timing:

      (i) contractual:

         - effect of conditionality (eg change of control clauses or change in credit quality);
         - effect of optionality (eg prepayment or extension options);

      (ii) non-contractual (non-performance risk – delayed payment).

The spectrum of cash flow variability and implications for measurement

6. This overall variability of cash flows is a spectrum that ranges from stable and simple scenarios on the one end to highly variable and complex scenarios on the

other end. The further you move away from the simple end of the spectrum the more important a valuation overlay[1] becomes to capture the variability of the financial instrument's cash flows.

7. This corresponds to the measurement methods for financial instruments (that the Board adopted as a working premise) as follows:

   (a) Amortised cost: this method does not involve a valuation overlay, but permits a user to perform their won valuation overlay incorporating whatever factors they consider important. Thus, amortised cost can provide useful information if used for financial instruments located in the rather simple part of the spectrum, but not for those at the other end.

   (b) Fair value: this method involves a complete valuation overlay. In other words, the overlay includes all aspects of the financial instrument (ie provides a market price for the contractual cash flows). Thus, fair value can provide useful information up to the most complex end of the spectrum.

Implications of amortised cost measurement

8. In this context, the purpose of classification is to screen financial instruments for their eligibility for accounting at amortised cost. That measurement basis uses the effective interest method for interest revenue or expense allocation over the relevant period. In the staff's view, the contractual cash flows of any financial instrument that qualifies for amortised cost category must represent interest (or principal payments). In the context of revenue IAS 18.5(a) defines interest as 'charges for the use of cash or cash equivalents or amounts due to the entity'. This applies correspondingly to interest expense (ie charges for the use of cash or cash equivalents or amounts due *from* the entity).

[1] A valuation overlay is referred to in this paper as it was discussed in agenda paper 5E of the May 2009 IASB meeting (see paragraphs 16–21 of that paper). In short, a valuation overlay provides a valuation of the estimate of future cash flows. Fair value is an example of an approach that uses a valuation overlay.

9. This notion of interest has the following implications:

   (a) cash flows that in economic substance represent interest are always associated with a 'funded'[2] financial instrument; and

   (b) the return associated with the financial instrument must have a close relation to the funding volume[3] that reflects the essential economic characteristics of interest:

      (i) consideration for the time value of money; and

      (ii) consideration for the credit risk associated with the financial instrument.

Principles that classify degrees of cash flow variability

Primary principle: cash flows that represent principal and interest

10. The *starting point* for classification is determined by the purpose of amortised cost accounting: allocating interest revenue or expense over the relevant period.[4] The implication for the nature of the cash flows of a financial instrument that should be eligible for amortised cost measurement is that the cash flows are limited to:

   (a) advances and repayments of the funding volume; and

   (b) cash flows that have the economic character of interest.

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[2] The notion of 'funding' was discussed in agenda paper 14 of the April 2009 IASB meeting (see paragraph 14 of that paper).

[3] Funding volume refers to the amount advanced (including any interest capitalised into the loan balance) less repayments. This term is used rather than principal or notional amount because it is not affected by product design features (such as discounts or premiums). For a simple loan originated and repayable at par with uniform fixed interest coupons the funding volume would be the nominal amount.

[4] See paragraphs 8–9 above.

11. In other words: the **primary principle** is that a financial instrument is eligible for amortised cost measurement only if (all) its cash flows represent *principal and interest.*

Secondary principles: 'determinable' and 'no leverage'

12. Two secondary principles concretise the primary principle. These two accompanying principles apply cumulatively. The cash flows of a financial instrument represent *principal and interest* if:

    (a) the contractual cash flows are **determinable**; and

    (b) the financial instrument has **no leverage**.

How to make the approach operational

13. The two secondary principles play the key role in making this approach operational. The following sections explain on a high level how that would be achieved (details and examples that illustrate classification outcomes are included in agenda paper 2C).

Determinable

What it means

14. This paper uses the principle 'determinable'. Fixed cash flows are a subset of determinable cash flows. In fact, 'fixed' is the highest degree of determinability. Thus, using 'fixed' in addition to 'determinable' does not add anything, which is why the principle is not 'fixed or determinable'.

15. The key aspect of 'determinable' is **specification**: for cash flows to be determinable they need to be defined in terms of being contractually stipulated. That specifies the reference basis (linkage) that determines contractual cash flows that are not fixed. That also specifies whether cash flows are:

    (i) discretionary or non-discretionary; and

(ii) contingent or non-contingent.

How to make it operational

16. This principle could be made operational for classification purposes by using criteria that reflect the gist of 'determinable'. Determinability relates to two different types of cash flow variability:

    (a) variability of *amounts*; and

    (b) variability of *timing*.

Variability of amounts

17. The variability of *amounts* is primarily about indexation (linkage). Indexation links the cash flow amounts (amounts of interest and / or principal payments) to changes in variables. There are various forms of indexation that create links between cash flows and different types of variables:

    (a) benchmark interest rates;

    (b) variables reflecting changes in the credit quality of the financial instrument; and

    (c) other variables.

18. How the various forms of indexation relate to the classification decision could be illustrated in application guidance. That could also clarify the effect of related aspects such as embedded option features.

19. In relation to the variability of *amounts* the forthcoming IFRS for SMEs includes the following criteria to describe 'basic' financial instruments (which for debt instruments would result in measurement at amortised cost):[5] A debt

[5] See paragraphs 11.8–11.11 of the forthcoming *IFRS for Private Entities* (IFRS for SMEs).

instrument (such as an account, note, or loan receivable or payable) that meets *all* of the following conditions:

(a) Returns to the holder are

  (i) a fixed amount, or

  (ii) a fixed rate of return over the life of the instrument, or

  (iii) a variable return that, throughout the life of the instrument, is equal to a single referenced quoted or observable interest rate (such as LIBOR) or

  (iv) some combination of these fixed rate and variable rates (such as LIBOR plus 200 basis points), provided that both the fixed and variable rates are positive (eg an interest rate swap with a positive fixed rate and negative variable rate would not meet this criteria). For fixed and variable rate interest returns, interest is calculated by multiplying the rate for the applicable period by the principal outstanding during the period.

(b) There is no contractual provision that could, by its terms, result in the holder losing the principal amount or any interest attributable to the current period or prior periods. The fact that a debt instrument is subordinated to other debt instruments is not an example of such a contractual provision.

(c) …[*relates to the timing of cash flows*][6]

(d) There are no conditional returns [or repayment provisions] except for the variable rate return described in (a) above [and prepayment provisions described in (c) above].

20. The forthcoming IFRS for SMEs also includes the following examples of financial instruments that would qualify for amortised cost:[7]

[6] The criteria and examples that relate to the variability in the timing of cash flows are excluded here and included in the section 'Variability of timing' below.

(a) trade accounts and notes receivable and payable, and loans from banks or other third parties.

(b) accounts payable in a foreign currency. However, any change in the account payable because of a change in the exchange rate is recognised in profit or loss as required by the section of the IFRS for SMEs that addresses foreign currency translation.

(c) …[*relates to the timing of cash flows*]

(d) …[*relates to the timing of cash flows*]

21. Conversely, in the examples included in the forthcoming IFRS for SMEs the following financial instruments would *not* qualify for amortised cost:

(a) an investment in another entity's equity instruments other than non-convertible and non-puttable ordinary shares and preference shares.

(b) an interest rate swap that returns a cash flow that is positive or negative, or a forward commitment to purchase a commodity or financial instrument that is capable of being cash-settled and that, on settlement, could have positive or negative cash flow, because such swaps and forwards do not meet the condition in paragraph 19(a) above.

(c) options and forward contracts, because returns to the holder are not fixed and the condition in paragraph 19(a) above is not met.

(d) investments in convertible debt, because the return to the holder can vary with the price of the issuer's equity shares rather than just with market interest rates.

(e) …[*relates to the timing of cash flows*]

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[7] Assuming they meet the conditions of paragraph 19 above.

22. There are some common contractual features that create a variability of cash flow amounts that under the criteria in the IFRS for SMEs would make the financial instruments *in*eligible for amortised cost. The staff believes at least the following examples warrant confirmation from the Board whether that outcome is intended:

    (a) Resets of interest rates in response to changes in the credit quality of the financial instrument. The common denominator of these features is that they are designed to track the credit quality of the financial instrument over its term. Examples are:

        (i) credit ratings; and

        (ii) default risk related measures defined in debt covenants (such as the interest coverage ratio or the gearing).[8]

    (b) Caps, floor, or collars embedded in loans. These reduce the cash flow variability by setting a limit that the variable interest rate cannot exceed or fall below.

Variability of timing

23. The variability of *timing* is primarily about contractual provisions that allow or require a change in cash flow dates:[9]

    (a) *Optionality*: allows one or both parties to the financial instrument (ie debtor and holder) to unilaterally change the timing of the cash flows under the contract. Common features are for example prepayment (or early redemption) and extension options. These features change the maturity of a financial instrument.

[8] The indexation linked to this type of variable can adjust (the initial margin on) a benchmark interest rate as well as an initial fixed rate that reflects the credit quality of the financial instrument at inception. For example, the interest on a 'fixed rate' loan changes in steps of 25 basis points (bps) by reference to a table that stratifies a range for the borrower's gearing. Or interest coupons on a variable rate loan might be reset in 20bps steps in response to a target interest coverage ratio with mark-ups and mark-downs for negative and positive deviations.

[9] See paragraph 5(b)(i) above.

(b) *Conditionality*: either requires changing the timing of the cash flows or allows one or both parties to the financial instrument (ie debtor and holder) to unilaterally do so. Common features are for example change of control clauses or a change in credit quality of the financial instrument[10]. These features change the maturity of a financial instrument but are contingent on the occurrence of an event.

24. How the different forms of contractual variability of the timing of cash flows relate to the classification decision could be illustrated in application guidance.

25. In relation to the variability of *timing* the forthcoming IFRS for SMEs includes the following criteria to describe 'basic' financial instruments (which for debt instruments would result in measurement at amortised cost):[11] A debt instrument (such as an account, note, or loan receivable or payable) that meets *all* of the following conditions:

(a) …[*relates to the amounts of cash flows*]

(b) …[*relates to the amounts of cash flows*]

(c) Contractual provisions that permit the issuer to prepay a debt instrument or permit the holder to put it back to the issuer before maturity are not contingent on future events.

(d) There are no conditional [returns or] repayment provisions except for the [variable rate return described in (a) above and] prepayment provisions described in (c) above.

[10] For example, clauses that accelerate repayment of a loan (eg make it puttable or immediately repayable) if the credit quality of the loan changes (eg by reference to a rating or debt covenant criteria) or in an event of default.
[11] See paragraphs 11.8–11.11 of the forthcoming *IFRS for Private Entities* (IFRS for SMEs).

26. The staff notes that the prepayment criterion used in forthcoming IFRS for SMEs (see paragraph 25(c) above) may not have the intended effect because of the interaction with the conditions related to the return to holders (see paragraph 19(a) above). These conditions apply *cumulatively*. To illustrate: if a fixed rate loan is issued at a premium or discount (no matter how small) and permits the issuer to repay the debt before maturity:

    (a) the returns to holders would not be a fixed amount (the interest coupon payments vary with the repayment date);

    (b) the rate of return would not be fixed but vary with the repayment date because of the amortisation of the premium or discount over a variable term;

    (c) the return is not variable because of an indexation to a quoted or observable interest rate; and

    (d) the rate of return is not a combination of a fixed rate and the type of variable rate that is discussed in item (c) above; instead the variability of return results from the combination of a fixed amount and a fixed rate in conjunction with a variable maturity.

    If mandatory fair value measurement is not the intended consequence of the above scenario then the guidance from the forthcoming IFRS for SMEs would have to be modified. The modification could be to the effect that a variability in return that results solely from the prepayment that meets the condition of paragraph 25(c) above would still be eligible for amortised cost.[12] It should also be clarified whether references to 'returns' include the effect of transactions costs on the yield of an instrument or not.

27. The forthcoming IFRS for SMEs also includes the following examples of financial instruments that would qualify for amortised cost: [13]

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[12] This could for example be added as a criterion (v) to the requirement in paragraph 19(a) above.
[13] Assuming they meet the conditions of paragraphs 19 and 25 above.

(a) …[*relates to the amount of cash flows*]

(b) …[*relates to the amount of cash flows*]

(c) loans to or from subsidiaries or associates that are due on demand.

(d) a debt instrument that would become immediately receivable if the issuer defaults on an interest or principal payment (such a provision does not violate the conditions in paragraph 25 above).

28. Conversely, in the examples included in the forthcoming IFRS for SMEs the following financial instruments would *not* qualify for amortised cost:

(a) …[*relates to the amount of cash flows*]

(b) …[*relates to the amount of cash flows*]

(c) …[*relates to the amount of cash flows*]

(d) …[*relates to the amount of cash flows*]

(e) a loan receivable from a third party that gives the third party the right or obligation to prepay if the applicable taxation or accounting requirements change, because such a loan does not meet the condition in paragraph 25(c) above.

29. There are some common contractual features that create variability in the timing of cash flows that under the criteria in the IFRS for SMEs would make the financial instruments *in*eligible for amortised cost. The staff believes at least the following examples warrant confirmation from the Board whether that outcome is intended:

(a) Many financial instruments require compensation payments (eg prepayment penalties) or have strike prices that make whole the other party to the contract. For example, if the debtor repays a loan early that

might trigger a payment that makes whole the holder regarding a switch to an alternative investment that replaces the prepaid investment.[14]

(b) Prepayment or put features that are contingent on events that reflect a change in the financial instrument's credit risk:

(i) a credit rating change;

(ii) an event of (credit) default other than a default on an interest or principal payment; for example a violation of debt covenant criteria that reflect credit quality (such as gearing or interest coverage ratios); such clauses are common in order to protect the holder from changes in credit risk before the instrument becomes non-performing.

(c) Prepayment or put features that are contingent on a change in control. These clauses are common in order to protect the holder against the knock-on effect that the new controlling party might have on the credit risk of the debtor.

(d) Prepayment or put features that are contingent on changes in law that affect the taxation of or levies on the financial instrument. These clauses protect the issuer and / or the holder against a change in the net return on the financial instrument.

No leverage

What it means

30. Leverage amplifies the variability of cash flows. It can be achieved in different ways and in relation to different aspects.

[14] The annual improvements to IFRSs issued in April 2009 changed the requirements for the assessment of embedded prepayment options with prepayment penalties. That resulted in more hybrid contracts with prepayment options qualifying for amortised cost in their entirety.

How to make it operational

31. This principle could be made operational for classification purposes by illustrating the most common types of leverage, which then form the basis for further analogies for IFRS users. Examples of common types of leverage are:

    (a) Interest formulas that use multiples of notional amounts or reference interest rates. (Derivatives are an example of the leverage created by using a notional amount that does not reflect a funding volume; this is in substance the same as using a multiple of a financial instrument's notional amount).

    (b) Concentration of credit risk through subordination (for example the concentration of credit risk that results from a CDO structure commonly referred to as a 'waterfall').[15]

    (c) Leverage related to investments commonly referred to as a 'deep discount bond' (this aspect could be made operational by using a reference to investments acquired at a discount that reflects incurred credit losses similar to IAS 39.AG5).

32. The different types of leverage could be illustrated in application guidance.

33. The forthcoming IFRS for SMEs does not include any specific criteria for or examples of leverage. While some of the examples (eg regarding interest rate swaps, options and forward contracts–see paragraphs 21(b) and 21(c) above) relate to leverage the rationale for not considering them as 'basic' instruments in the forthcoming IFRS for SMEs includes is the variability of their return.

[15] The IASB discussed the waterfall feature in the context of CDO structures in its November 2008 meeting (see agenda paper 11B).

Summary

34. This paper sets out a classification approach that is based on:

    (a) a **primary principle**: cash flows that represent principal and interest; and

    (b) two accompanying **secondary principles** that apply cumulatively:

        (i) the contractual cash flows must be **determinable**; and

        (ii) the financial instrument has **no leverage**.

35. This paper also explains on a high level what these secondary principles mean and how they could be made operational. It also includes related criteria and examples used in the forthcoming IFRS for SMEs.

36. Agenda paper 2C includes discussions of details and examples that illustrate classification outcomes.

37. The staff recommendation and the questions to the Board regarding the classification approach are included in agenda paper 2E.