



Project	Financial Instruments – Recognition and Measurement
Topic	Classification – staff recommendations and questions to the Board

Introduction

Background

1. As set out in the classification cover paper (see agenda paper 2)—because the issues addressed in the papers on classification are inextricably linked—all of the staff recommendations and questions to the Board regarding classification are included in this paper. This should allow board members to understand and consider all the aspects of classification, before taking decisions on any aspect of classification.

Purpose of this paper

2. This agenda paper provides staff recommendations and questions to the Board regarding:
 - (a) the accounting for embedded derivatives;
 - (b) the classification approach regarding the characteristics of a financial instrument and how to make it operational; and
 - (c) the classification approach regarding the business model overlay and how to make it operational.

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.

Accounting for embedded derivatives

Staff recommendations

3. The implications of accounting for embedded derivatives for classification are addressed in agenda paper 2A.

4. The staff recommendations are:
 - (a) Maintain the existing requirements for embedded derivative accounting (ie **Alternative 1** – see paragraph 9 of agenda paper 2A). This is because:
 - (i) the staff believes that the notion of embedded derivative accounting must be retained since it will continue to be required for hybrid contracts with *non-financial* host contracts in any case;
 - (ii) this alternative would avoid the repercussions that otherwise result from recognising some fair value changes in other comprehensive income rather than profit or loss; and
 - (iii) retaining embedded derivative accounting provides a first screening for highly complex financial instruments that provides a better starting point for the classification approach.
 - (b) If the Board does not want to maintain the existing requirements for embedded derivative accounting the staff recommends eliminating the concept of embedded derivative accounting *but only for* hybrid contracts with *financial* host contracts (ie abandon bifurcation of hybrid contracts in those cases–ie **Alternative 2**). This is because the staff does not believe that changing the bifurcation criteria for embedded derivatives (ie **Alternative 3**) is feasible as part of this classification related part of the financial instruments project.

Questions to the Board

Questions related to embedded derivatives

1. Does the Board agree with the staff recommendation to maintain the existing requirements for embedded derivative accounting (ie **Alternative 1**)? If not, why not?
2. If the Board does not agree with the staff recommendation to choose Alternative 1, does the Board agree with Alternative 2? If not, why not? What does the Board prefer, and why?

Classification approach—characteristics of financial instruments

Staff recommendations

5. The classification approach regarding the characteristics of financial instruments is addressed in agenda papers 2B and 2C. The staff recommendations are set out in the following paragraphs.
6. **Staff recommendation 1:** The staff recommends using a *principles-based* classification approach¹ 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**.
7. The staff believes that only a principles-based approach can provide a basis for classification that is able to deal with the infinite variety of financial instruments that will have to be classified into the measurement categories and that an

¹ See paragraphs 12–14 of agenda paper 2B.

approach using an exhaustive catalogue of detailed criteria with examples bears a high risk of having unintended consequences.

8. **Staff recommendation 2:** this principles-based classification approach (see staff recommendation 1) should be made operational as follows:

- (a) for ‘determinable’ using the notions of:
 - (i) variability of cash flow *amounts*; and
 - (ii) variability in the *timing* of cash flows.
- (b) for ‘no leverage’ using examples of different types of leverage.

9. **Staff recommendation 3:** the financial instruments that are eligible² for amortised cost should *not* be restricted to those that would qualify under the approach used in the forthcoming *IFRS for Private Entities* (IFRS for SMEs). Instead, the financial instruments in the following examples should also be eligible for amortised cost accounting (see paragraphs 22, 26 and 29 of agenda paper 2B):

- (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).
- (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.

² See the explanation of the two-step classification approach in paragraph 9 of agenda paper 2.

- (c) Fixed rate loans issued at a premium or discount that permits the issuer to repay the debt before maturity thus creating some variability in return that results solely from the combination of a fixed amount and a fixed rate in conjunction with a variable maturity.
 - (d) 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.
 - (e) 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.
 - (f) 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.
 - (g) 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.
10. The staff believes that on the basis of the approach used in the forthcoming IFRS for SMEs many financial instruments with very common features would not qualify for amortised cost even though they reflect a 'lending-type arrangement'. In the staff's view there is a risk that the set of financial

instruments that qualifies for amortised cost would be so narrow that the amortised cost measurement category is marginalised.

Questions to the Board

Questions related to the classification approach regarding characteristics of financial instruments

1. Does the Board agree with **staff recommendation 1** to use a principles-based approach as set out in that recommendation? If not, why not? What approach would the Board prefer instead, and why?
2. Does the Board agree with **staff recommendation 2** on how to make the approach operational? If not, why not? How would the Board prefer to make the approach operational instead, and why?
3. Does the Board agree with **staff recommendation 3** on the examples that should be eligible for amortised cost?
 - (a) If not, which of the examples should not be eligible for amortised cost and why?
 - (b) Are there any additional examples the Board would like to be included as eligible for amortised cost? If so, what examples and why?

Classification approach–business model overlay

Staff recommendations

11. The classification approach regarding the business model overlay is addressed in agenda paper 2D. The staff recommendations are set out in the following paragraphs.
12. **Staff recommendation 1:** making the business model classification criterion operational using the fair value option precondition regarding management and performance evaluation on a fair value basis as a starting point.

13. **Staff recommendation 2:** adapting this starting point by:
- (a) eliminating references to documentation;³ and
 - (b) clarifying that performance evaluation is more than simply monitoring fair value information (using a reference to the operating result that is regularly reviewed by the decision maker of the business (unit) to make investment decisions—this is a similar notion to that used for segment reporting purposes).⁴
14. **Staff recommendation 3:** adding more examples:
- (a) illustrate that financial instruments held for the purpose of a liquidity reserve would qualify for amortised cost classification;⁵ and
 - (b) illustrate in what circumstances a liquid government bond would qualify for amortised cost classification using an example where the purpose of investing in a government bond is to minimise credit risk exposure.⁶
15. The rationale for the staff recommendations is set out in agenda paper 2D (see section ‘How to make a business model overlay operational’).

³ See paragraph 22 of agenda paper 2D.

⁴ See paragraph 24 of agenda paper 2D.

⁵ See paragraph 25(a) of agenda paper 2D.

⁶ See paragraph 25(b) of agenda paper 2D.

Questions to the Board

Questions related to the classification approach regarding the business model

1. Does the Board agree with **staff recommendation 1** to use the fair value option precondition regarding management and performance evaluation on a fair value basis as a starting point for making the approach operational? If not, why not? What approach would the Board prefer instead, and why?
2. Does the Board agree with **staff recommendation 2** on how to adapt that starting point?
 - (a) If not, which of the adaptations do you object to and why?
 - (b) Are there any additional adaptations the Board would like to make? If so, what adaptations and why?
3. Does the Board agree with **staff recommendation 3** on the examples that should be added?
 - (a) If not, which of the examples should not be added and why?
 - (b) Are there any additional examples the Board would like to be added? If so, what examples and why?