Project **Financial Instruments – Replacement of IAS 39**

Topic **Classification and measurement: reclassification between fair value through P&L and other measurement categories**

Purpose of this paper

1. The exposure draft *Financial Instruments: Classification and Measurement* (ED) proposes two primary measurement categories for financial instruments. Financial assets and liabilities would be measured at either amortized cost or fair value through profit or loss (FVTPL). The ED proposes to **prohibit reclassification** of financial assets and financial liabilities between the amortized cost and FVTPL categories.

2. At the meeting on 6 October the Board confirmed the mixed measurement attribute approach proposed in the ED but also tentatively decided to require a frozen credit spread measurement (FCSM) for particular financial liabilities.

3. **The purpose of this paper is to ask the Board:**

   (a) **whether the proposed prohibition on reclassification should be carried forward to the IFRS; and**

   (b) **if the prohibition is <u>not</u> carried forward, under what circumstances should reclassifications be required (or permitted) and how should such reclassifications be accounted for.**

4. **This paper only addresses reclassifications between the FVTPL category and either the amortized cost or the FCSM category (collectively, "the other categories").**

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.

Proposals in the ED

5. Paragraph 10 of the ED states that an entity **shall not reclassify** a financial asset or a financial liability between the fair value and amortized cost categories.

6. Paragraphs BC55–BC60 explain the Board's rationale for that proposal, including:

   (a) requiring (or permitting) reclassifications would **not** make it easier for users of financial statements to understand the information that financial statements provide about financial instruments, which is the desired outcome of the proposals in the ED—the Board noted that users provided this feedback subsequent to the amendment to IAS 39 in October 2008, which permitted an entity to reclassify particular instruments in particular circumstances; and

   (b) requiring (or permitting) reclassifications would increase complexity because detailed guidance would be required to specify when reclassifications would be required (or permitted) and the subsequent accounting for reclassified financial instruments.

Relevant question in the ED

7. Question 7 in the ED asked:

   Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

Feedback received

Do you agree that reclassification should be prohibited?

8. Almost all respondents **disagreed** with the proposal that reclassification should be prohibited.

9. Most respondents stated that reclassification should be **required** in particular circumstances. Others said that reclassifications should be **permitted** but did not indicate why reclassifications should be optional.

10. A few respondents supported the proposal to prohibit reclassifications. In general, those respondents agreed with the Board's rationale set out in the ED's basis for conclusions.

User feedback

11. Most users agreed with the other respondents that conceptually reclassifications should **not** be prohibited when the classification no longer reflects how the instruments would be classified if the items were newly acquired.

12. However, users were concerned about the robustness of any reclassification requirements and the consistency and rigor with which those requirements would be applied—and thus questioned the usefulness of the resulting information. Some of those users would support reclassification as long as it was **required**. However, a few users were concerned that opportunistic reclassifications would be possible and therefore believe that the need to prevent such abuse via a prohibition on reclassification outweighs the conceptual justification of reclassification. An alternative suggestion was that quantitative and qualitative **disclosure** (instead of reclassification) could be used to address when the classification no longer reflects how the instruments would be classified if they were newly acquired.

If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements?

Entity's business model for managing its financial instruments

13. Almost all respondents argued that prohibiting reclassification is inconsistent with a classification approach based on how an entity manages its instruments. They said such a classification approach should require reclassification when an entity's business model changes. Those respondents noted that such changes

would be infrequent (or rare), significant and demonstrable—and determined by the entity's senior management as a result of external or internal changes.

14. Respondents noted that reclassifications would provide decision-useful, relevant, and comparable information to users because it would ensure that financial statements faithfully represent how financial instruments are actually managed at the reporting date. They noted that prohibiting reclassification would result in irrelevant information being provided to users because the reported information would not reflect the likely amounts, timing or uncertainty of future cash flows. They also noted that the time from when a business model changes until derecognition of a financial instrument could be quite lengthy.

15. Some respondents provided examples of when an entity's business model would change—for example, a diversified financial services firm decides to shut down its retail mortgage business. That retail mortgage business is no longer accepting new business and is actively marketing its loan portfolio for sale. Those respondents suggested that the IFRS include such examples.

Cash flow characteristics of the instrument

16. Some respondents stated that reclassification should be required (or permitted) on the basis of the contractual cash flow characteristics of the instrument—eg a loan pays a leveraged interest rate in the first two years [1.5 x LIBOR] but pays an unleveraged interest rate after that [LIBOR]. Assuming the entity's business model is to hold the loan to collect its contractual cash flows, these respondents said that the instrument should be reclassified from FVTPL to amortized cost after the first two years when the interest rate becomes unleveraged.

October 2008 amendment to IAS 39

17. Some respondents noted that the Board amended IAS 39 in October 2009 to permit an entity to reclassify particular non-derivative financial assets in particular circumstances. Those respondents pointed to that amendment as an example of why reclassifications are necessary—that is, they said that accounting standards need to accommodate a changing marketplace. Although

the objective of that amendment was to provide short-term relief for some entities in the financial crisis, some respondents said that the ED's proposal to prohibit reclassifications is inappropriate because it is not consistent with that amendment.

How would you account for such reclassifications, and why?

18. Almost all respondents stated that reclassifications should be accounted for **prospectively.** They also noted that robust disclosures should be required.

19. A few respondents proposed that the Board only require reclassifications **to** FVTPL—eg reclassification **from** FVTPL would be **prohibited**. The primary reason for that asymmetry seemed to be that such an approach might minimize abuse of reclassification requirements and result in more instruments being measured at fair value. However, almost all of the respondents that supported reclassification said that reclassifications should be symmetrical—ie required both if the instrument was reclassified to FVTPL **and** if the instrument was reclassified to amortized cost.

20. Many respondents did not comment on how they would account for reclassifications, other than saying that it should be prospective. Respondents who did provide detailed comments generally proposed that if an instrument was:

    (a) **reclassified from FVTPL to amortized cost** – the fair value of the instrument at the date of reclassification would become its new amortized cost. Based on that new amortized cost, an effective interest rate (EIR) would be calculated on the date of reclassification.

    Respondents noted that this methodology is consistent with the amendment to IAS 39 in October 2008 (paragraph 50C of IAS 39).

    (b) **reclassified from amortized cost to FVTPL** – the instrument would be remeasured at fair value at the reclassification date and any difference between the previous carrying amount (the amortized cost at

the reclassification date) and fair value would be recognized in profit or loss.

FASB approach

21. The FASB's proposed approach prohibits reclassification.

Staff analysis and recommendations

22. Consistent with the majority of respondents, we think that reclassifications should be **required** in particular circumstances.

23. We see no benefit in **permitting** (rather than requiring) reclassifications. Such optionality would decrease comparability (both among different entities and for instruments held by a single entity) and would enable an entity to manage its profit or loss by selecting the timing of when future gains or losses are recognized.

24. However, we think that the concerns expressed by the Board in BC55-BC59 of the ED as well as the concerns raised by users (see paragraph 12) are valid. We acknowledge that developing robust requirements for reclassifications that will be consistently applied will be difficult. We further acknowledge that those requirements will inevitably increase the complexity of the Board's classification approach. If the Board decides to retain the proposal in the ED and prohibit reclassification, we recommend requiring quantitative and qualitative **disclosure** to address circumstances when the classification no longer best reflects how the instruments would be classified if they were newly acquired.

Circumstances under which reclassifications should be applied

25. Under the Board's approach, classification is based on two conditions:

    (a) the entity's business model for managing its instruments; and

(b) the contractual cash flow characteristics of the instrument.

26. We considered whether reclassification should be required if one of those conditions change.

Entity's business model for managing its financial instruments

27. Consistent with the majority of respondents, we think reclassification should be required when an entity's business model changes—and begins or ceases to have the objective of holding the instruments to collect (or pay) contractual cash flows. If such a change occurs, an entity would be required to reclassify all affected instruments.

28. We think that such reclassifications would result in decision-useful and relevant information to users because it would ensure that financial statements faithfully represent how financial instruments are actually managed at the reporting date. Moreover, prohibiting reclassification decreases comparability for like instruments managed in the same way (both among different entities and for instruments held by a single entity) because classification would not reflect the entity's actual business model.

29. Classification is based on the entity's **business model** rather than **management intent** so we agree with respondents that such changes would be very infrequent (but not impossible), significant, and demonstrable—and determined by the entity's senior management as a result of external or internal changes. Such changes normally would be visible to the market. Examples of a change of business model include:

    (a) An entity has a portfolio of commercial loans that it intends to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and are all are held to collect the contractual cash flows.

(b) A financial services firm decides to shut down its retail mortgage business. That retail mortgage business is no longer accepting new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

30. A change in intent related to specific financial instruments (even in circumstances of significant changes in market conditions) is **not** a change in business model. Moreover, a temporary disappearance of a particular market for a financial instrument does not, in isolation, mean that an entity's business model has changed.

Contractual cash flow characteristics of the instrument

31. Consistent with the majority of respondents, we do **not** think that reclassification should be permitted based on the contractual cash flow characteristics of the instrument.

32. Unlike a change in business model, the contractual terms of a financial instrument are known at initial recognition. At initial recognition, the entity must classify the instruments on the basis of those contractual terms. Moreover, requiring reclassification on this basis would require an entity to reassess each instrument at the end of each reporting period. We do not think that is operational.

33. **In summary, we recommend requiring reclassifications when there is a change in the entity's business model. If an entity's business model changes, it must reclassify all affected instruments. Reclassifications should be prohibited in all other circumstances.**

Question 1 – Reclassification
Does the Board agree with the staff recommendation that reclassifications should be required if, and only if, an entity changes its business model? If not, what would you propose instead and why?

Accounting for reclassifications

34. We agree with the majority of respondents and recommend that reclassification is applied **prospectively**—that is, prior periods would not be re-stated. Our recommendation is consistent with an approach that classifies (and reclassifies) instruments based on the business model within which they are managed—classification should always reflect the business model within which the instrument was managed at the reporting date. To apply the reclassification retrospectively would **not** reflect how the instruments were managed at the prior reporting dates.

An instrument is reclassified from another category to FVTPL

35. If an instrument is reclassified **to FVTPL**, we think the instrument should be remeasured at fair value at the reclassification date and any difference between the previous carrying amount and fair value would be recognized in retained earnings. That difference should not be recognized in profit or loss because it does not reflect a fair value change (or amortization) related to the current period.

An instrument is reclassified from FVTPL to another category

36. If an instrument is reclassified **from FVTPL to another category**, we think there are two possible alternatives:

    (a) **Alternative 1**: the fair value of the instrument on the date of reclassification becomes its new carrying amount; or

    (b) **Alternative 2**: on the date of reclassification, the amortized cost or FCSM of the instrument is calculated as if the instrument had always been so classified—For instruments reclassified to amortized cost, the **original** effective interest rate (EIR) is determined and used to calculate the amortized cost of the instrument at the date of reclassification. For instruments reclassified to FCSM, the **original** credit spread is determined and used to calculate the FSCM at the date of reclassification.

37. Alternative 1 is consistent with the requirements in IAS 39 if an instrument is reclassified from fair value to amortized cost. Most respondents suggested this alternative. It is very straightforward and seems consistent with a prospective approach to reclassification (that is, it reflects information about the instrument as if it were acquired at the reclassification date).

38. The primary drawback of Alternative 1 is that the resulting EIR for instruments reclassified to amortized cost does not reflect the contractual terms of the instrument. Feedback received from some users subsequent to the amendment to IAS 39 in October 2008 indicated that the reported interest income (resulting from the new EIR) is not decision-useful or relevant.

39. Alternative 2 is more complex. It would require an entity to retrospectively calculate the instrument's EIR or credit spread (although previous periods would **not** be re-stated). As a result of using the original EIR for instruments measured at amortized cost, interest income or expense would reflect the contractual terms of the instrument. However, consistent with the proposed transition requirements (and transition relief) described in paragraph 30 of the ED, we think that it may be impracticable for an entity to apply Alternative 2 in some cases. In those cases, Alternative 1 would be used instead.

40. Also, some would argue that if an entity is not required to **apply** the new classification retrospectively, it should not be required to **compute** the new classification method retrospectively.

41. Under Alternative 2, there would be a difference between the "old" carrying amount (ie the fair value) and the "new" carrying amount on the date of reclassification. We think the difference should be recognized in retained earnings. The difference should not be recognized in profit or loss because it does not reflect fair value changes (or amortization) in the current period. This is consistent with our recommendation in paragraph 35.

42. On balance, we recommend Alternative 1— that is, the fair value of the instrument on the date of reclassification becomes its new carrying amount. This alternative is less complex and consistent with existing guidance in IAS 39.

43. Moreover, because Alternative 2 would be impracticable in some (or perhaps many) cases, Alternative 1 would have to be applied instead. That means that some reclassifications would be accounted for under Alternative 1 and others would be accounted for under Alternative 2. That would result in decreased comparability (both among different entities and for instruments held by a single entity) because entities (or a single entity) would be using two different reclassification methodologies.

Question 2 – Reclassification: prospective application
Does the Board agree with the staff recommendation that reclassifications should be accounted for **prospectively**? If not, what would you propose instead and why?

Question 3 – Reclassification from another category to FVTPL
Does the Board agree with the staff recommendation that if an instrument is reclassified from **another category to FVTPL**: (a) the instrument should be remeasured at fair value at the reclassification date; and (b) any difference between the previous carrying amount and fair value would be recognized in retained earnings. If not, what would you propose instead and why?

Question 4 – Reclassification from FVTPL to another category
Does the Board agree with the staff recommendation that if an instrument is reclassified from **FVTPL to another category**, the fair value of the instrument on the date of reclassification becomes its new carrying amount? If not, what would you propose instead and why?

Disclosures

44. We agree with respondents that robust disclosures relating to reclassifications are necessary to ensure transparency and provide decision-useful information to users.

45. We recommend that IFRS 7 is amended to include the following disclosures for all reclassifications between the measurement categories. For the purposes of IAS 34 *Interim Financial Reporting* a reclassification would be an event that is material to an understanding of the current interim period; therefore these disclosures would be required if the next reporting date is an interim reporting date.

    (a) the date of reclassification;

    (b) a detailed explanation of the change in business model and a qualitative description of its effects on the entity's financial statements;

    (c) the amount reclassified into each category;

    (d) for instruments reclassified from fair value to another category, at each interim reporting period following the reclassification date until and including the next annual reporting date:

        (i) the fair value of the instrument; and

        (ii) the fair value gain or loss that would have been recognized in profit or loss if the instrument had not been reclassified; and

    (e) for instruments reclassified from another category to fair value in the current reporting period, the amount recognized in retained earnings; and

    (f) for instruments reclassified from fair value to amortized cost:

        (i) the effective interest rate determined on the date of reclassification; and

        (ii) for each reporting period until derecognition, the interest income or expense recognized

46. We recommend that (d) is required only for a limited time after an instrument is reclassified. The disclosure responds to criticisms about an entity might be able to "cherry pick" the exact date of a reclassification from FVTPL. To counter that criticism, this will provide fair value information for a limited period.

However, we do not think those disclosures are necessary for the long-term because the objective of reclassification is provide information to users about the likely amounts, timing, and uncertainty of future cash flows. Requiring on-going information about the former measurement category is inconsistent with that objective. (Furthermore, IFRS 7 requires (d)(i) for all financial instruments on a recurring basis.)

47. Consistent with the recommendation of several respondents to the ED, we have recommended (f) to address the criticisms in paragraph 38 that reported interest income or expense (resulting from the "new" EIR) is not useful. This disclosure will highlight to users the magnitude of the interest amounts calculated under a "new" EIR.

Question 5 – Reclassification: Disclosures
Does the Board agree with the staff recommendation that that the disclosures in paragraph 45 would be mandatory for all reclassifications between FVTPL and the other categories? If not, what would you propose instead and why?

A final note

48. The staff further considered whether if was necessary to restrict the date of reclassification to year-end. This concern primarily relates to the corresponding disclosures and the ability to "cherry pick" a reclassification date.

49. Related to the former point, some were concerned that if a reclassification occurred during the year, the entity would not be required to prepare the related disclosures until year-end. As noted above, our recommended disclosures would be required at the next reporting date, which may be an interim date.

50. Related to the latter point, we think reclassifications should be reflected in the entity's financial statements as soon as the entity's business model for the relevant instrument changes. To do otherwise would be contradictory to the objective of reclassification—that is, to reflect how the instruments are actually

managed. Given the significance of a change in business model (as discussed in paragraphs 29 and 30), we do not think that an entity will be able to cherry-pick a reclassification date.