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

Topic **Classification and measurement: interaction of the two classification conditions**

Background and objective of this agenda paper

1. At the meeting on 29 September the Board discussed how to make "the cut" between those instruments that should be measured at fair value through profit or loss (FVTPL) and those that should not.

2. At that meeting, the Board tentatively agreed that the two classification conditions proposed in the exposure draft (ED) should be carried forward—that is, that classification and measurement should reflect:

   (a) the contractual cash flow characteristics of the instrument; and

   (b) the entity's business model for managing its instruments (ie whether the objective of the entity's business model is to hold the instruments to collect (or pay) contractual cash flows or to sell (or transfer) the instruments prior to their contractual maturity to realize fair value changes).

3. **This agenda paper discusses the interaction between those two classification conditions.**

4. Given that the Board agreed that **both** classification conditions should be carried forward to the IFRS, this paper **<u>does not</u>** consider whether one condition is sufficient (ie whether one of the conditions can be eliminated).

Feedback received in the comment letters and outreach meetings

5. As discussed at the Board meeting on 29 September, most respondents agreed that classification and measurement should reflect both the contractual cash flow characteristics of the instrument and the entity's business model for managing its instruments.

6. However, some respondents questioned the interaction between the two conditions and asked whether one has (or should have) primacy over the other. Some respondents thought that the ED implied that the basic loan features condition was primary (ie, that it is more important than the business model condition)—perhaps because it is listed first in paragraph 4 of the ED.

7. Other respondents acknowledged that the conditions are cumulative (ie both are required and thus equally important) but said that it would be more **efficient** to analyze the business model condition first because it is not done on an instrument-by-instrument basis (whereas the basis loan features condition is.)

8. Others agreed that both conditions are necessary but said that the business model condition should be primary and the basic loan features condition should be secondary. One respondent characterized this view as follows:

> …we think it would be an improvement if the classification model was characterised as being based on whether instruments are managed on a contractual yield basis, with an exception so that instruments managed on a contractual yield basis that do not have certain characteristics are measured at fair value….

9. That respondent gave three reasons for that view:

   (a) We think that giving greater emphasis to the business model test in this way will help the IASB to draw the most appropriate line between amortised cost and fair value by better identifying those financial assets or financial liabilities for which amortised cost provides useful information. That is because, by identifying the types of instruments that are generally managed on amortised cost basis as a starting point, the IASB may be able to understand better whether its current characteristics of the instrument test (ie the basic loan features test) should be nuanced to move the boundary between amortised cost and fair value slightly.

(b) We think such an emphasis would make the approach easier to understand.

(c) We think that such an emphasis would also reflect how the tests will be applied in practice in most cases. First, the business model test will be applied to identify which instruments might qualify as amortised cost instruments, then the characteristics of the instrument test will be applied to those instruments to narrow down the number that are allocated to the amortised cost category. We think requirements are generally easier to understand if they reflect the way they will usually be implemented.

Staff recommendation

10. We think conditions are cumulative. That is, both are required and equally important.

11. However, we agree with the comments that it is more efficient to consider the business model condition first and, thus, in practice the conditions will be applied in the order laid out by the respondent in paragraph 9(c).

12. Therefore, we recommend that the IFRS discuss the business model condition first. The contractual cash flow characteristics of the instrument would then be discussed in the context of instruments that meet that first condition – that is, in the context of instruments that the entity holds to collect (or pay) contractual cash flows.

Question 1: Interaction between the two classification conditions
Does the Board agree with the staff recommendation that the IFRS should discuss the business model condition first (and then describe the condition related to the contractual cash flow characteristics of the instrument in the context of those instruments that already “met” that first condition)? If not, why?