IFRS Interpretations Committee Meeting

Staff Paper

Agenda reference **13**

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Project **IAS 39 *Financial Instruments: Recognition and Measurement***

Topic **Impairment of financial assets reclassified from available-for-sale to loans and receivables**

Purpose of this paper

1. The purpose of the paper is to respond to a request received by the Committee for additional guidance on how an entity should account for the impairment of financial assets with a fixed maturity **after** they have been reclassified from the available-for-sale (AFS) category to loans and receivables.

2. The request identifies that during the financial crisis, a number of reporting entities reclassified certain financial assets in accordance with an October 2008 amendment to IAS 39 *Financial Instruments: Recognition and Measurement* in October 2008 (October 2008 amendment).

3. In many cases these financial assets were not impaired at the date of the reclassification, but were determined to be impaired at a subsequent reporting date.

4. The request asks for clarification on how the;

   (a) impairment loss should be recognised and measured; and

   (b) carrying amount of the financial asset should be adjusted after an impairment is recognised.

5. This paper:

   (a) provides background information on the request received;

   (b) analyses the issues raised within the context of IFRSs;

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

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 IFRIC or 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.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

(c) makes a staff recommendation for addressing the issues; and

(d) asks the Committee whether they agree with the staff recommendation.

Background information

6. In October 2008 the IASB issued an amendment to IAS 39. This October 2008 amendment, which has since been consequentially amended following the issuance of IFRS 9 *Financial Instruments*, stated that:

> 50E *A financial asset* classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) *may be reclassified out of the available-for-sale category to the loans and receivables* category if the entity has the intention 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 50D or out of *the available-for-sale category* in accordance with paragraph 50E, *it shall reclassify the financial asset at its fair value on the date of reclassification*. For a financial asset reclassified in accordance with paragraph 50D, 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*. For a financial asset reclassified out of the available-for-sale category in accordance with paragraph 50E, *any previous gain or loss on that asset that has been recognised in other comprehensive income* in accordance with paragraph 55(b) *shall be accounted for in accordance with paragraph 54.* (emphasis added)

7. In relation to any previous gain or loss on that that has been recognised in OCI (related OCI), IAS 39.54 (a) states that:

> In the case of a financial asset with a fixed maturity, the gain or loss shall be amortised to profit or loss over the remaining life of the held-to-maturity investment *using the effective interest method*. Any difference between the new amortised cost and maturity amount shall also be amortised over the remaining life of the financial asset *using the effective interest method*, similar to the amortisation of a premium and a discount. *If the financial asset is subsequently impaired, any gain or loss that has been recognised in other comprehensive income is reclassified* from equity to profit or loss in accordance with paragraph 67. (emphasis added)

8. The staff understand that in practice constituents are applying IAS 39.54 and determining that the new amortised cost of the financial asset is its fair value at the date it is reclassified.

9. However, after reclassification, different views exist in practice in applying IAS 39.54 to determine:

   (a) how the **effective interest rate** should be calculated?

   (b) if, when recognising an impairment loss, **all** previous gains or losses recognised in OCI should be reclassified to profit and loss?

   (c) how the **carrying amount** of the financial asset should be adjusted after an impairment?

Staff analysis

10. The staff have analysed the three views identified in the request (which is included in Appendix B to this agenda paper).

11. The appendix to the request also provides a useful summary of the impacts of an impairment on the;

    (a) carrying amount of the financial asset; and

    (b) profit and loss

    when applying these three views

12. The staff recommend reviewing these numerical examples in the appendix to the request when considering the technical arguments included in the staff analysis below.

View A

13. The first view (View A) is that:

    (a) the effective rate of interest is the rate that discounts the estimated future cash flows through the remaining life of the asset to the new carrying amount of the financial asset when it is reclassified (**new effective rate of interest**).

    (b) when recognising an impairment loss, **all** related OCI is reclassified from OCI to profit and loss.

    (c) after an impairment is recognised, the carrying amount of the financial asset is adjusted to be measured at the present value of estimated future cash flows, discounted at the **new effective rate of interest**.

Effective rate of interest

14. Use of a **new** effective rate of interest is supported by the following guidance:

    (a) IAS 39.54 which clarifies that if it:

    > becomes appropriate to carry a financial asset or financial liability at cost or amortised cost rather than at fair value, *the fair value carrying amount of the financial asset or the financial liability on that date becomes its new cost or amortised cost*, as applicable. (emphasis added)

    (b) IAS 39.63 which states, under the heading of impairment and collectability of financial assets measured at amortised cost that:

    > If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) *discounted at the financial asset's original effective interest rate (ie the effective interest rate computed at initial recognition).* The carrying amount of the asset shall be reduced either directly or through use of an allowance account. The amount of the loss shall be recognised in profit or loss. (emphasis added)

15. Proponents of this view argue that in applying IAS 39.63, initial recognition is determined to be when the financial assets is first recognised at amortised cost. This is when the financial asset is reclassified.

16. As a result the effective interest rate in accordance with IAS 39.63 is calculated at the rate that discounts the estimated future cash flows to the carrying amount of the financial asset when it is reclassified.

Treatment of OCI

17. After reclassification, View A requires the related OCI to be amortised over the remaining life of the asset.

18. However, when the financial asset is impaired, **all** related OCI is reclassified to profit and loss.

19. This is supported by the following guidance for the related OCI following a subsequent impairment:

    (a) A literal read of IAS 39.54 (a) which states that;

    > if the financial asset is subsequently impaired, *any* gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss. (emphasis added)

    Proponents of this view believe that **any** should be interpreted as **all**.

    (b) Consistency with IAS 39.67 and IAS 39.68 which, when a financial asset categorised as AFS is impaired, state that the:

    > the *cumulative loss* that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss
    >
    > The *amount of the cumulative loss* that is reclassified from equity to profit or loss under paragraph 67 shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss. (emphasis added)

    Proponents of this view believe that the cumulative loss should be interpreted as all, **not** some, of the cumulative losses.

Carrying amount of the financial asset

20. After an impairment is recognised, the carrying amount of the financial asset is adjusted to the present value of its estimated future cash flows, discounted at the **new** effective rate of interest.

Financial reporting implications

21. After an impairment, application of View A results in;

    (a) the financial asset carrying amount being measured at the present value of estimated future cash flows, discounted at the **new** effective rate of interest.

    (b) **all** related OCI being reclassified to profit and loss; and

    (c) recognition of an impairment in profit and loss reflecting the sum of:

        (i) the difference between the present value of the future cash flows of the financial asset, discounted at the **new** effective rate of interest, and the carrying amount of the financial asset; and

        (ii) **all** of the related OCI.

22. Consequently, when the reclassified financial asset is impaired, application of View A can lead to some counter-intuitive outcomes. This includes recognition of:

    (a) an impairment loss in profit and loss that exceeds the decline in fair value of the financial asset (eg when the impairment loss is less than related OCI losses).

    (b) a loss in profit and loss that does not reflect the decline in fair value of, or the credit loss associated with, the financial asset.

    (c) a gain in profit and loss (eg when the impairment loss is less than the offsetting related OCI gains).

    (d) increasing, rather than stable, interest income in subsequent reporting periods relating to the accretion of the financial asset.

23. We understand that in practice, there is general support for the View A approach.

View B

24. The second view (View B) is that:

    (a) the effective rate of interest is based on the previous carrying amount of the financial asset when it was initially recognised in AFS (**previous effective rate of interest**).

    (b) when recognising an impairment loss, **all** related OCI is reclassified from OCI to profit and loss. This is consistent with View A.

    (c) after an impairment is recognised, the carrying amount of the financial asset is adjusted to be measured at the present value of estimated future cash flows, discounted at the **previous effective rate of interest.**

Effective rate of interest

25. In determining the effective rate of interest to be applied to the financial asset after it is reclassified, proponents of View B also look to the guidance in IAS 39.63.

26. However, they argue that in applying IAS 39.63, initial recognition is determined to be when the financial asset is first recognised, regardless of whether initial recognition was on a basis other than amortised cost (eg as an instrument classified as AFS).

27. As a result, the effective interest rate in accordance with IAS 39.63 is calculated at the rate that discounts the estimated future cash flows to the carrying amount of the financial asset when it is first recognised, not the carrying amount when it is reclassified to amortised cost.

28. They believe this approach is appropriate because:

    (a) an effective rate of interest has been calculated on the financial asset before it is reclassified.

(b) IAS 39.9 defines an effective interest rate in terms of the **net** carrying amount of a financial asset. The net carrying amount of the financial asset is determined as the sum of its carrying amount and the related OCI.

A calculation based on this net carrying amount leads to applying the **previous** effective rate of interest.

(c) the exceptions in IAS 39.AG8 for applying a revised, rather than original, effective rate of interest do not apply to this situation.

The October 2008 amendment did not specify that a revised effective rate of interest should be calculated when an instrument is reclassified.

Treatment of OCI

29. Similarly to View A, View B requires that, in recognising an impairment after reclassification to loans and receivables, **all** related OCI is reclassified to profit and loss.

Carrying amount of the financial asset

30. After an impairment is recognised, the carrying amount of the financial asset is **always** adjusted in accordance with the guidance in IAS 39.AG8 which states that:

> 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.

31. This adjustment results in the financial asset being recognised at the present value of its estimated future cash flows, discounted at the **previous** effective rate of interest.

Financial reporting implications

32. After an impairment, application of View B results in;

    (a) the financial asset carrying amount being measured at the present value of estimated future cash flows, discounted at the **previous** effective rate of interest.

    (b) **all** related OCI being reclassified to profit and loss; and

    (c) recognition of an impairment in profit and loss reflecting the sum of:

        (i) the difference between the present value of the future cash flows of the financial asset, discounted at the **previous** effective rate of interest, and the carrying amount of the financial asset; and

        (ii) **all** of the gains and losses previously recognised in OCI.

33. This result is consistent with how the impairment would be recognised if the financial asset was not reclassified to loans and receivables, but remained classified as AFS.

34. However, when the reclassified financial asset is impaired, application of View B can lead to an **increase** in the carrying amount of the financial asset if the impairment loss is less than the amount of related OCI losses.

View C

35. The third view (View C) is that:

    (a) the effective rate of interest is based on the previous carrying amount of the financial asset when it was initially recognised in AFS (**previous effective rate of interest**). This is consistent with View B.

    (b) when recognising an impairment loss, if the amount of the impairment to be recognised is less than the amount of related OCI losses then **only part, but not all** of the related OCI is reclassified to profit and loss.

    (c) after an impairment is recognised, the **net** carrying amount of the financial asset (i.e. the sum of the loans and receivables asset and the amount of related OCI) is adjusted to be measured at the present value of estimated future cash flows, discounted at the **previous effective rate of interest**.

Effective rate of interest

36. View C applies the guidance to determine the effective rate of interest to be used in the same way as View B, using the **previous** effective rate of interest.

Treatment of OCI

37. After the financial asset is reclassified, View C requires application of a calculated effective rate of interest to amortise the related OCI over the remaining life of the asset, consistent with the approach in View B.

38. However, when the financial asset is impaired, situations may exist where **not all** related OCI is reclassified to profit and loss.

39. This is supported by interpreting the term 'any' in IAS 39.54 (a) differently to 'all'.

40. Supporters of this view do not believe that IAS 39 provides clear guidance on the amount of related OCI to be reclassified to profit and loss. This is because IAS 39.67 and IAS 39.68 are only applicable when the financial asset is

categorised as AFS and should no longer be applied once the asset is reclassified.

Carrying amount of the financial asset

41. Supporters of View B focus on the **net** carrying amount of the financial asset (i.e. the sum of the loans and receivables asset and the amount of related OCI).

42. They believe this net carrying amount should equal the present value of expected future cash flows, discounted at the **previous** effective interest rate.

43. This net carrying amount would equal the carrying amount of an identical financial asset that was initially, and subsequently, classified as loans and receivables.

44. Consequently, the carrying amount relating to the financial asset that is reclassified as loans and receivables may remain unchanged after an impairment, if the amount of the impairment is less than the amount of related OCI.

45. In this situation, the carrying amount of the financial asset will be lower than the present value of expected future cash flows because some related OCI continues to be recognised.

Financial reporting implications

46. After an impairment, application of View C results in;
    (a) the **net** carrying amount of the financial asset (i.e. the sum of the loans and receivables asset and the amount of related OCI) measured at the present value of estimated future cash flows, discounted at the **previous** effective rate of interest.
    (b) **some**, but not necessarily all, related OCI **all** related OCI being reclassified to profit and loss; and
    (c) recognition of an impairment amount in profit and loss identical to that in View B, reflecting the difference between the;
        (i) present value of the future cash flows of the **net** carrying amount of the financial asset (i.e. the sum of the loans and

receivables asset and the amount of related OCI), discounted at the **previous** effective rate of interest; and

(ii) **net** carrying amount of the financial asset. The net carrying amount of the financial assets includes the amount of related OCI.

47. This result is consistent with how the impairment would be recognised if the financial asset was classified as loans and receivables on initial recognition, not as AFS.

48. Consequently, when the reclassified financial asset is impaired, application of View C can lead to **some**, but not all of the related OCI being recognised in profit and loss if the impairment loss is less than the amount of related OCI losses.

Staff recommendation

Intent of the October 2008 amendment

49. The staff discussed this issue with the *Financial Instruments* project team.

50. In these discussions, the staff noted that the intent of the October 2008 amendment was to require application in accordance with View A.

51. This reflects the view that it is consistent with the approach in the October 2008 amendment to:

    (a) cross reference, and not make a specific amendment, to IAS 39.54 when accounting for OCI after the financial asset is impaired.

    Consequently, in recognising an impairment, the reclassification of all of OCI to profit and loss is consistent with the treatment applied when a financial asset classified as AFS is impaired.

    (b) refer to use of an original effective rate of interest to be calculated when the financial asset is initially recognised on an amortised cost basis.

    This was considered consistent with IAS 39 and to be different to requiring that a revised effective rate of interest should be applied.

IFRS 9

52. View A is also consistent with the approach proposed in IFRS 9. IFRS 9.5.3.3 states that when an entity reclassifies a financial asset so that it is measured at amortised cost, its fair value at the reclassification date becomes its new carrying amount.

53. In supporting this approach, the staff agenda paper presented to the IASB Board in October 2009[1] states that:

[1] http://www.iasb.org/NR/rdonlyres/3F19D554-151C-4EC5-BA98-57289AD91487/0/FI151009b05obs.pdf

> 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). (emphasis added)

54. The October 2009 staff agenda paper supports this approach by noting that it is consistent with a prospective approach to classification.

55. However, it also acknowledges that this effective interest rate does not reflect the contractual terms of the financial asset and may lead to recognition of interest income that is not decision-useful or relevant because of some of the reasons noted in this May 2010 Committee agenda paper.

56. The staff support View A observing that it is consistent with the:

    (a) intent of the October 2008 amendment and IFRS 9.

    (b) guidance requiring reclassification of **all** of OCI to profit and loss when a financial asset classified as AFS is impaired.

    (c) approach generally applied and accepted in practice.

57. The staff acknowledge that application of View A may lead to certain financial reporting outcomes that some consider are not decision-useful. However, this has been recognised by the Board in decisions taken to date in the *Financial Instruments* projects.

Agenda criteria assessment for the Committee

58. The staff's preliminary assessment of the agenda criteria is as follows:

    (a) The issue is widespread and has practical relevance.

    Yes. Many reporting entities reclassified financial assets from the AFS category to loans and receivables after the October 2008 amendment.

    These financial assets often have related losses that were recognised in OCI prior to their reclassification and, given the current economic environment, may be subject to impairment in subsequent reporting periods.

    (b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.

    Yes.

    We understand that View A is widely adopted and accepted in practice.

    As a consequence, current application of the alternatives to View A may exist but is not considered to be significant in existing practice. However this diversity may start to emerge because of an awareness of these divergent interpretations.

    (c) Financial reporting would be improved through elimination of the diverse reporting methods.

    Yes.

    Financial reporting would be improved through a consistently applied approach.

    However, some argue that, because of perceived counter-intuitive results arising from View A, that requiring only application of View A would not improve financial reporting.

    Instead they believe that clarifying that an alternative approach to View A is compliant with IFRSs would provide more decision-useful information and improve financial reporting.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

No.

If the Committee believe that further clarification is required to address this issue, the staff believe that the most efficient way of resolving the issue would be through amendments to current IFRSs and not through the interpretation process.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Yes.

It is probable that the Committee would be able to reach a consensus on a timely basis.

(f) *If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The Committee will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the Committee requires to complete its due process.*

No.

The staff note this issue was specifically discussed in the context of classifications in accordance with IFRS 9 by the Board in October 2009. The approach included within IFRS 9 is consistent with View A.

59. Based on the assessment of the agenda criteria, the staff recommend that Committee do not add the issue to its interpretations agenda.

60. The staff believe that the Committee could consider an amendment to IAS 39 to clarify the wording relating to this issue.

61. The staff do not believe the issue is significant enough to require a separate amendment to IAS 39 and that the issue could be addressed as part of the Annual Improvements Process (AIP).

62. However the staff note that inclusion of the issue within the 2009-2011 AIP cycle would result in an expected effective date of 1st January, 2012. The staff question how useful this effective date would be to constituents because of the;

(a) 1st January, 2013 proposed effective date for IFRS 9; and

(b) an expectation that, based on current macro-economic conditions, entities are more likely to recognise impairments to these financial assets in current, rather than future, financial reporting periods.

63. Consequently the staff do not believe the Committee should request the Board amend IAS 39 to address this issue.

Question 1 for the Committee
1. Does the Committee agree with the staff's recommendation not to add this issue to its agenda or to propose the Board amend IFRSs to address this issue? If not, how does the Committee recommend the staff to proceed? 2. Does the Committee have any comments on the proposed wording for the tentative agenda decision in Appendix A?

Appendix A – Proposed wording for agenda decision

A1. The below tentative agenda decision is proposed if the Committee support the staff recommendation in the agenda paper.

> **IAS 39 *Financial Instruments: Recognition and Measurement*— Impairment of financial assets reclassified from available-for-sale to loans and receivables**
>
> The Committee received a request for guidance on how an entity should account for the impairment of financial assets with a fixed maturity after they have been reclassified from the available-for-sale (AFS) category to loans and receivables.
>
> The Committee noted that in October 2008 the Board issued an amendment to IAS 39 relating to the reclassification of financial assets. The amendment included references to existing guidance in paragraph 54 of IAS 39 when accounting for previous gains and losses relating to a financial asset that have been recognised in other comprehensive income. The amendment also retained the existing requirements in paragraph AG8 of IAS 39 for computing the present value of estimated future cash flows at the financial instrument's original effective interest rate.
>
> The Committee concluded that the issue could be resolved most efficiently through an amendment to current IFRSs and not through the interpretation process. However, the Committee concluded that, because of the effective date of IFRS 9 *Financial Instruments*, an amendment would not clarify the issue on a timely basis.
>
> Consequently, the Committee [decided] not to add this issue to its agenda.

Appendix B – Agenda request

B1. The staff received the following Committee agenda request. All information has been copied without modification by the staff.

IFRIC AGENDA ITEM REQUEST

Impairment of financial assets reclassified from available-for-sale to loans and receivables

XXXX would like to request the IFRIC to address the following issue with respect to impairment of assets which were reclassified from the available-for-sale category to loans and receivables during the financial crisis.

The issue:

At the depth of the financial crisis, fair values of many financial assets were significantly lower than their purchase prices due to liquidity issues. A number of financial institutions reclassified assets from the available-for-sale category to loans and receivables due to the disappearance of an active market and a change in intention during the crisis. This submission addresses cases where these assets were not regarded as impaired at the date of reclassification but have subsequently become impaired. The revisions in IAS 39 on reclassification of financial assets were released within a very short timeframe without normal due process and, therefore, did not benefit from wide consultation amongst the IASB's constituents. The discussion of the proposals by the Board may not, therefore, have considered all the potential consequences of the wording used. The revisions were not accompanied by the normal amount of background and guidance to assist entities in interpreting the new standard. As indicated below, a variety of interpretations of the new requirements on reclassification seem to have emerged. IFRIC is requested to clarify how the impairment loss to be recorded in profit or loss is measured, and how the carrying value of the asset is adjusted, when such an asset is considered impaired subsequent to the reclassification.

For an asset with a fixed maturity which is reclassified from the available-for-sale category to loans and receivables, paragraph 54 of IAS 39 states that:

- The fair value of the asset on the reclassification date becomes its new amortised cost, and
- Any previous gain or loss on that asset that has been recognised in other comprehensive income, and any difference between the new amortised cost and the maturity amount, is amortised to profit or loss over the remaining life of the asset using the effective interest method.

Typically, at the date of reclassification of assets from the available-for-sale category to loans and receivables during the financial crisis,

revaluation losses had accumulated in other comprehensive income.

According to paragraphs 50F, 54(a) and 67 of IAS 39, if the asset is subsequently impaired, any gain or loss that has been recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment.

It has come to our attention that there are divergent views on accounting for impairments of
reclassified assets. Below we identify three views which we encountered in practice, although
we accept that there may be other views or other arguments for the views described below.

View A

Carrying amount of asset after reclassification
In accordance with paragraph 54 of IAS 39 the new amortised cost is the fair value of the asset at the date of reclassification.

Effective interest rate after reclassification
Paragraph 63 of IAS 39 states that, when a loan and receivable is impaired, the amount of the loss recognised in profit or loss is measured as the difference between the asset's carrying amount and the present value of the estimated cash flows discounted at the asset's "original effective interest rate". These paragraphs imply that, for reclassified assets, the original effective interest rate in paragraph 63 is the rate that discounts the estimated future cash flows through the remaining life of the asset to the new amortised cost (here referred to as the "new effective interest rate").

The net interest income for each period is equivalent to the interest accrued on the asset at the new effective interest rate, net of the amount of loss in other comprehensive income amortised to profit or loss in the period. Effectively, the net interest income in profit or loss for each period is similar to the interest income recorded for the asset before reclassification at the effective interest rate determined at initial recognition of the asset.

AFS Other comprehensive income ("AFS reserve") after reclassification
In accordance with par. 54(a) of IAS 39 the amount recognised in AFS reserve is amortised over the remaining life of the asset using the effective interest method.

Impairment of reclassified assets
Paragraph 59 of IAS 39 includes examples of objective evidence that a financial asset is impaired, including significant financial difficulty of the issuer or obligor and a breach of contract, such as a default or delinquency in interest or principal payments.

When a reclassified asset is impaired, this view considers the relevant paragraphs to

indicate that the remaining amount of gain or loss of the asset in other comprehensive income is recycled to profit or loss *and* an additional loss is recorded in profit or loss, equivalent to the difference between the estimated future cash flows of the asset, discounted at the new effective interest rate, and the carrying amount. Consequently, a double loss is recorded in profit or loss upon impairment. This loss reflects neither the credit loss nor the fair value loss incurred on the asset and may be greater than the loss that would have been recognised without reclassification, even if there is a small credit loss. This seems to be both counterintuitive, and at variance with the underlying economics.

View B

Carrying amount of asset after reclassification
As in view A, at the date of reclassification the asset is recorded at its fair value.

Effective interest rate after reclassification
Under this view the asset remains to be amortised at its original effective interest rate. The original effective interest rate for assets reclassified from available for sale to loans and receivables is interpreted to be the effective interest rate determined at initial recognition of the asset, i.e., the rate that discounts the estimated future cash flows through the life of the asset to the original purchase price of the asset (here referred to as the "initial effective interest rate") instead of the new amortised cost of the asset at the date of reclassification.

The following arguments have been expressed to support the view that the effective interest rate following reclassification should remain the initial effective interest rate:

- An AFS debt instrument already has an effective interest rate on reclassification. Unlike for held for trading ("HFT") assets, which do not have an EIR on reclassification, the reclassification of AFS assets does not necessitate the establishment of a new EIR. Under this view a new EIR only applies to financial assets reclassified from HFT.
- Paragraph 9 of IAS 39 states that the effective interest rate is the rate that discounts estimated future cash flows to the net carrying amount of the asset. Under this view, the net carrying amount of the asset is considered to be the sum of the carrying amount of the asset and the remaining gain or loss related to the asset recorded in other comprehensive income, which is equivalent to the carrying amount of the asset as if it had always been measured at amortised cost based on the initial effective interest rate since inception. For a reclassified asset this implies that the new amortised cost is the fair value at reclassification date, but the net carrying amount remains the same as the total of the new amortised cost and the AFS reserve does not change. This is consistent with the fact that the cash flows did not change.
- IAS 39 AG 8 was amended as part of the reclassification amendments but the Board retained the reference to original effective interest rate. In AG8 it is explicitly stated that the original effective interest rate is used to recalculate/adjust the carrying amount when there is a change in estimates of future cash flows. The paragraph introduced two exceptions, none of which applies to the current issue;

- fair value hedge accounting (par. 92 of IAS 39);
- change in EIR if subsequent to the date of reclassification the entity increases its estimate of future cash receipts as a result of increased recoverability.
  This paragraph therefore determines that the EIR applicable for discounting cash flows (e.g. at impairment of cash flows) is the original effective interest rate. The IASB could have chosen here to change this and explicitly use a revised effective interest rate, but the Board did not.

AFS reserve after reclassification IAS 39.54(a) determines that any gain or loss that has been recognised in comprehensive income and any difference between the new amortised cost and maturity amount shall be amortised over the remaining life of the financial asset using the effective interest method. This means that all differences including the gains and losses previously recognised in the AFS reserve should be amortised according to the effective interest method. The definition of the effective interest rate in IAS 39.9 determines that the EIR is based on discounting cash flows. However, the AFS reserve does not have any stand-alone cash flows. Also the AFS reserve needs to amortize to an ending value of 0 and an EIR cannot be mathematically applied to end at 0 as the EIR is a multiplication factor. There is no independent EIR that brings the AFS reserve to 0.

In the absence of guidance on how to amortise the AFS reserve to zero, an accounting policy must be chosen in accordance with the hierarchy of IAS 8.10.

The effect on profit or loss must be the same before and after reclassification of the asset, but this amount now has to be attributed to the two components on the balance sheet: the asset and the AFS reserve. As there is no explicit guidance on how to do this exactly this view proposes to make use of another effective interest rate to make the attribution. This EIR is chosen for this attribution only. It does not mean that the effective interest rate on the reclassified instrument as a whole has changed.

In the first table of appendix 2 it can be seen that although an EIR of 17.7% was used to attribute the total interest income to the asset and the AFS reserve, the original effective interest rate (EIR) of the instrument has not changed and remains 5%. The 17.7% is only used to be able to implement an effective amortization of the asset and the AFS reserve in line with IAS 39.54a. As can be seen the AFS reserve can only be amortised through an effective interest method when combined with the asset.

Impairment of reclassified asset
Paragraph IAS 39.54(a) indicates that paragraph 39.67 is applicable to determine the impairment loss on the reclassified asset. In addition, IAS 39 paragraph AG8 indicates that a change in the estimated cash flows needs to lead to a change in the carrying amount of the asset. Both paragraphs have been revisited by the Board when amending IAS 39 on reclassification in October 2008 so the Board deliberately decided not to amend the wording in any other respect.

Under this view, consistent with view A, IAS 39.67 is interpreted as requiring the entire AFS reserve to be recycled to profit and loss upon the assessment of an impairment,

independent of the size of the reduction in expected cash flows.

Unlike view A, view B refers to IAS AG8 which literally says that upon a decline in estimated expected future cash flows the carrying amount is recalculated by discounting the revised estimated future cash flows at the original effective interest rate. The difference between the revised net present value and the existing carrying amount needs to be recognised in profit and loss.

The resulting accounting is identical to the accounting one would see for a non-reclassified regular loan at amortised cost with an identical impairment. The frozen AFS reserve at the moment of reclassification is no longer required since once impaired all future cash flows are taken into account to measure the level of impairment.

View C

Carrying amount of asset after reclassification
Same as view B

Effective interest rate after reclassification
Same as view B

AFS reserve after reclassification
Same as view B

Impairment of reclassified asset
Paragraph 54(a) of IAS 39 indicates that paragraph 39.67 is applicable when an asset that has been reclassified from AFS to Loan and Receivable is considered impaired. In addition, IAS 39 paragraph AG8 indicates that a change in the estimated cash flows results in an adjustment to the carrying amount of the asset which is recognised in profit and loss. Both paragraphs were revisited by the Board when amending IAS 39 on reclassification in October 2008 so the Board deliberately decided not to amend the wording in any other respect.

Under this view IAS 39.67 is read as requiring that when a reclassified asset is considered impaired an impairment loss should be taken from the AFS reserve and reclassified to profit or loss. However, it does not provide guidance on the amount itself. For regular AFS assets IAS 39.68 determines the exact amount. IAS 39.68 is however only applicable for AFS assets and IAS 39.68 is not referred to in IAS 39.54(a) either. In the absence of guidance on the amount to be recycled from the AFS reserve an accounting policy is chosen in accordance with IAS 8.10.

Under this view the amount of the impairment loss of the reclassified asset is determined by reference to IAS 39.AG8. In summary, IAS 39.AG8 determines that downward adjustments of estimated future cash flows (i.e. impairments) lead to a decrease in the carrying amount and a loss recognised in profit or loss by discounting estimated cash flows at the original effective interest rate. This reflects the economic loss on the transaction and the amortised cost principles that now apply to the instrument.

The net carrying amount of the asset (the sum of the carrying amount of the asset *and* the remaining gain or loss related to the asset recorded in other comprehensive income) is now equal to the present value of the expected future cash flows discounted at the original effective interest rate and equal to the net carrying amount of a similar Loans & Receivables transaction that was classified as such at initial recognition instead but never reclassified.

We have included in the appendices an example illustrating the impact of the different views.

Current practice:

It is our understanding that all three views are applied in practice.

The IFRIC is requested to consider whether any of the views are appropriate and whether diversity in practice is acceptable.

Reasons for the IFRIC to address the issue:

XXXX would like to request the IFRIC to add to its agenda this issue for the following reasons:

- The issue is relevant for entities, mainly financial institutions, which have reclassified assets from the available-for-sale category to loans and receivables which have subsequently been considered to be impaired.

- Divergent interpretations have emerged as illustrated above.

- A clarification from the IFRIC would improve consistency in the application of the impairment requirements related to assets reclassified from the available-for-sale category to loans and receivables.

- We believe that the issue is sufficiently narrow that it can be resolved efficiently and in a timely manner by an interpretation from the IFRIC, and that such clarification is within the scope of the IFRIC.

- We are not aware of any planned or current IASB project which would provide guidance on the impairment requirements related to assets reclassified from the available-for-sale category to loans and receivables under IAS 39. We acknowledge that the IASB has a current project to replace IAS 39 and under the current proposals the issue raised in this submission would no longer be relevant. However, that project would not provide guidance on this specific issue, and the mandatory date of adoption of IFRS 9 is not before 2013. An interpretation of IAS 39 is therefore requested since divergent interpretations exist.

Appendices – PLEASE REFER TO AGENDA PAPER 13A