STAFF PAPER

12 Dec – 16 Dec 2011

REG IASB Meeting

Project	**Limited modifications to IFRS 9**		
Paper topic	Scope		
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Introduction and Background

1. In November 2009, the Board published IFRS 9 *Financial Instruments* which provided new requirements for the classification and measurement of financial assets. In October 2010, the Board added requirements for the classification and measurement of financial liabilities and transferred the derecognition requirements from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9. The original mandatory effective date for both versions of IFRS 9 was 1 January 2013 with early adoption permitted. However, in August 2011 the Board published the exposure draft *Mandatory Effective Date of IFRS 9* proposing to move the mandatory effective date of IFRS 9 to 1 January 2015, and has tentatively confirmed the proposals in the exposure draft.

2. In the November 2011 board meeting, the Board tentatively decided to consider making limited modifications to IFRS 9. The primary drivers behind this decision were to:

    (a) address specific application issues raised by those who have early adopted IFRS 9 or who have reviewed IFRS 9 in detail in preparation for application;

(b) consider the interaction between the accounting for insurance contract liabilities and the accounting for financial assets backing insurance contracts; and

(c) consider differences with the US-based Financial Accounting Standards Board's (FASB) classification and measurement model for financial instruments.

3. At that meeting, Board members expressed a desire to address this project by limiting the changes made to IFRS 9, noting that some constituents have already adopted IFRS 9 and others have devoted significant resources preparing to transition to IFRS 9. The Board also noted that IFRS 9 is considered to be fundamentally sound and that our constituents would like the project to replace IAS 39 to be completed expeditiously to make available the entire financial instruments package.

4. The purpose of this paper is to confirm the scope of this project noting the comments the Board has previously expressed about limiting its scope.

Possible topics to consider

5. The staff believe that the topics discussed in this section could be considered as part of this project, noting that:

(a) The intended review of IFRS 9 is of a limited nature. The staff understand that the primary objectives are to consider the interaction with the insurance contracts project and to consider ways to address differences with the FASB's tentative classification and measurement model for financial instruments. In addition, consideration will be given to some potential concerns that we have been made aware of in the application of IFRS 9. However, due to the limited application of the classification and measurement requirements to date, the staff suggest that we must necessarily focus on the few specific issues that have been brought to our attention that may result in IFRS 9 not being applied as intended. Apart from issues relevant to these three areas, the staff recommend that the Board should not repeat discussions it already had when developing IFRS 9.

(b) Not all discussions should necessarily lead to changes being made to IFRS 9. For example, some issues that the staff are aware of seem to be misunderstandings of IFRS 9 that could potentially be dealt with by providing clarifications rather than actually changing the decisions underlying IFRS 9.

(c) The Board will need to be particularly mindful of whether the benefit of any changes being considered outweigh the costs of requiring those who have already adopted or prepared to adopt IFRS 9 to implement those changes.

6. **Contractual cash flow characteristics test** – The staff is of the view that the IFRS 9 classification and measurement model is based on sound conceptual principles - including the test that is used to assess cash flows that are solely payments of principal and interest on the principal amount outstanding (the contractual cash flow characteristics test) and thus eligible for amortised cost measurement. Generally there has been support for the notion of principal and interest as a basis for classification and it has been found to be operational in practice. The staff are also of the view that IFRS 9 results in information that is decision useful. However, some constituents have raised questions about the application of the contractual cash flow characteristics test to specific instruments, most notably instruments where interest rates are reset and the reset period does not match the tenor of the interest rate (for example where a 10-year instrument has a semi-annual interest rate reset mechanism but every interest reset is based on a 10-year rate). Questions have also been raised about whether the application guidance in IFRS 9, in particular some of the examples in IFRS 9, always result in appropriate conclusions.

7. **Bifurcation of financial assets** – The model the FASB is currently developing requires the bifurcation of financial assets using existing bifurcation criteria under US GAAP (which is similar to the criteria in IAS 39). In addition, some constituents have requested that bifurcation be permitted for financial assets in

IFRS 9 mainly because they believe it enables them to more accurately portray how those assets are managed. Also, although the reason for retaining bifurcation for financial liabilities was the 'own credit' issue which does not apply to financial assets, some have questioned the appropriateness of having bifurcation only for financial liabilities.

8. As a result of the FASB's decisions to date and comments we have received from some constituents, the staff believe that consideration should be given to the appropriateness of bifurcation of financial assets - however, the staff notes that bifurcation was a significant source of complexity in IAS 39 and many were supportive of its removal. Therefore the staff believe that before considering bifurcation the contractual cash flow characteristics should first be considered to see whether some of the areas that have given rise to constituent requests for bifurcation can in fact be addressed by clarifying the characteristics of the instrument test. By addressing bifurcation as a secondary issue, it would also enable us to consider whether, if bifurcation were considered appropriate, it could be based on the principles underlying the characteristics of the instrument test to provide greater internal consistency in the model.

9. **A third business model or remeasurement through other comprehensive income for some debt instruments –** Both because of the insurance contracts project and the FASB's tentative decisions, the question is raised whether a third business model should be considered and/or whether some debt instruments should be remeasured through other comprehensive income (OCI), due to their characteristics, such as being quoted in an active market, or because they back insurance contracts. The model the FASB is currently developing makes use of OCI for remeasuring the fair value change of some debt instruments depending on the business strategy (model) of the reporting entity.

10. If the Board were to consider increased use of OCI for measuring financial assets, the questions to be explored include the impairment of instruments in this classification category and whether realised gains and losses should be recycled through profit or loss.

11. **Modifications to the current OCI exemption for equity investments –** IFRS 9 currently allows reporting entities to make an irrevocable election to remeasure equity investments (other than those held for trading) through OCI. Originally the Board intended to restrict this accounting to 'strategic' equity investments, but given the difficulty of identifying such investments, in an attempt to reflect the nature of the ownership consistent with strategic holdings, IFRS 9 instead prohibits recycling for these investments while allowing dividends to be recognised in profit or loss. Some (including some insurers) have asked that the Board allow recycling of gains or losses on the derecognition of these investments in conjunction with a simplified impairment model. The staff note however that the OCI election with no recycling was designed to allow those who hold ‘strategic’ investments to properly reflect their business model while also discouraging general use of this election.

12. Since the publication of IFRS 9 the staff have received anecdotal feedback that, because IFRS 9 only excludes equity investments held for trading from the scope of the OCI option, reporting entities are using or intending to use this exemption more widely than for equities the board originally intended to capture by the notion of 'strategic investments’. In addition, under the tentative classification and measurement model developed to date by the FASB, no equity investments are remeasured through OCI. The staff note however that some preparers who have chosen to apply IFRS 9 early have made their decision largely as a result of the OCI election for equities – changing the scope of this election could have material consequences for these preparers.

13. **Cost exemption** – Some constituents have requested that the Board consider including an exemption in IFRS 9 similar to that in IAS 39 paragraph 46(c). This would mean that investments in equity instruments (and physically settled derivatives over those instruments) that do not have a quoted market price in an active market and whose fair value cannot be reliably measured would be measured at cost. In developing IFRS 9, the Board debated this issue at some length and was aware of the potential challenges of measuring such investments at fair value. For this reason IFRS 9 includes application guidance to confirm that in

limited circumstances 'cost may be an appropriate estimate of fair value'[1]. Some constituents have continued to raise concerns about the complexity and cost of undertaking this measurement however the staff note that a fair value measurement objective was intended by the Board.

14. The FASB has tentatively decided to allow a practicability exception to fair value measurement for investments in nonmarketable equity securities, but this exception is only made available to non-public entities. In all other cases equity investments would be measured at fair value through the income statement.

15. **Other issues** – It is noted that the knock-on consequences of any of the topics considered would also need to be assessed (for example, the need for disclosure and the appropriate transition arrangements, and at a more fundamental level issues such as what instruments may be subject to impairment accounting).

Staff recommendation

16. Based on the analysis set out above, the staff recommend that the Board include the following topics in this project and that while addressing all of the topics consideration should be given to the extent to which we can align our model more closely with the FASB's:

    (a) Contractual cash flow characteristics test – confirm whether and what additional guidance is required to clarify how the principle is to be applied;

    (b) Bifurcation of financial assets – following consideration of the characteristics of the instrument test, reconsider the need for bifurcation of financial assets. If bifurcation were pursued, consider the basis for bifurcation.

    (c) A third business model or remeasurement through other comprehensive income for some debt instruments – consider whether some debt

[1] IFRS 9, paragraph B5.4.14

instruments should be allowed or required to be remeasured through OCI and the basis for such measurement;

17. The staff recommend that the Board does *not* reconsider the scope or mechanics of the OCI election for equity investments. The staff note that some who have chosen to apply IFRS 9 early have made their decision largely as a result of this election.

18. The staff recommend that the Board does *not* reconsider the inclusion of a cost exemption for unquoted equity investments in IFRS 9. During the deliberations in the development of IFRS 9, this issue was extremely contentious and debated in detail and at length. It took many meetings for the Board to reach consensus. In the end, the Board decided not to include a cost exemption and instead state that 'in limited circumstances, cost may be an appropriate estimate of fair value'. The staff are not aware of any additional arguments since the publication of IFRS 9 that were not previously considered by the Board. It is also noted that reintroducing a cost exemption is not relevant to the insurance contracts project nor would it align the IFRS 9 model with the FASB's tentative decisions that only allow a very narrow cost exemption for non-public entities.

Question to the Board

Does the board agree with the staff recommendation that only the following areas should be included in the scope of the project to consider limited modifications to IFRS 9:

1) Instrument characteristics test;

2) Bifurcation of financial assets;

3) Expanded use of OCI/third business model for some debt instruments?

If the Board does not agree with the staff's recommendation, what areas would they like to include in the scope of the project and why?