STAFF PAPER

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Project	**Financial instruments: classification and measurement**
Paper topic	Cover paper

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Background

1. In January 2012, the IASB and the FASB decided to jointly redeliberate selected aspects of their classification and measurement models for financial instruments to seek to reduce key differences. The boards tentatively decided to discuss the following key differences:
   (a) the contractual cash flow characteristics of financial assets;
   (b) the need for bifurcation of financial assets and if pursued, the basis for bifurcation;
   (c) the basis for and the scope of a possible third classification category (debt instruments measured at fair value through other comprehensive income); and
   (d) any interrelated issues from the topics above (for example, disclosures or the model for financial liabilities).

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2. The boards decided to discuss each issue jointly and consider what changes, if any, they would propose to make to their separate models and incorporate in their respective exposure drafts.

Purpose of this paper

3. This paper provides an overview of the boards' tentative decisions to date and sets out the next steps. It is for informational purposes only and, thus, there is no question for the boards.

Decisions to date and next steps

4. The figure below provides an overview of the key topics related to the classification and measurement of financial assets that are within the scope of the joint discussions.

Contractual cash flow characteristics assessment

Business model assessment	***Cash flows are solely P&I***	***Cash flows are not solely P&I[1]***
	Amortised cost	**FVPL** (regardless of the business model, not eligible in entirety for a measurement category other than FVPL due to cash flow characteristics)
	FV-OCI	
	FVPL	

[1] An equity investment does not have cash flows that are solely P&I. However, under IFRS 9 an equity investment that is not held for trading can be measured at FVOCI.

5. Under IFRS 9 an entity first considers the business model within which the financial assets are held and then considers the contractual cash flow characteristics of the financial assets. In contrast, under the FASB's tentative classification and measurement model for financial assets, an entity first considers the contractual cash flow characteristics of the financial asset. This assessment is followed by the assessment of the business model. The staff believe that the order of the assessment of the business model and the contractual cash flow characteristics does not change the classification conclusion.
6. **Contractual cash flow characteristics** – In February 2012, the boards discussed the assessment of the contractual cash flow characteristics of financial assets. The boards tentatively decided that financial assets with contractual terms that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (P&I) could qualify for a measurement category other than fair value through profit or loss (FVPL) in their entirety depending on the objective of the business model within which they are held. The February 2012 decisions provide a minor adjustment to the contractual cash flow characteristics assessment in IFRS 9 to address the feedback received by the IASB on the application of the assessment to particular financial assets and would be incorporated into the FASB tentative classification and measurement model. Appendix A contains an extract from the February 2012 IASB Update that summarises the tentative decisions made by the boards on this topic.
7. **Business model and the FV-OCI measurement category**[2] – In February 2012, the business model assessment under IFRS 9 and the FASB's tentative model was discussed. That session was held for educational purposes. The objective of the education session was to ensure that each board understood the other model and its basis.
8. At this meeting, the staff will ask the boards whether and, if so, how they would like to align their respective business model assessments for the **amortised cost**

[2] The joint discussion of the FV-OCI classification on the basis of the business model only applies to debt instruments (ie those instruments that have cash flows that are solely P&I). This does not impact the FV-OCI designation that is available under IFRS 9 for equity investments on initial recognition.

category (AP 6A/FASB Memo 139). The decisions made by the boards at this meeting, in conjunction with the February 2012 decisions, will determine which financial assets would be classified and measured at amortised cost in their entirety. The staff will ask the boards whether and, if so, how they would like to align the business model assessment for FV-OCI and FVPL categories at a future meeting. The related issues of recycling and reclassification will also be considered.

9. **Bifurcation of financial assets** – At this meeting, the staff will ask the boards whether financial assets that do not qualify for a measurement category other than FVPL in their entirety due to their contractual cash flows characteristics should be considered for bifurcation and, if so, what the basis for that bifurcation should be (AP 6B-6F/FASB Memos 140-140D). This may result in a component of a debt instrument being considered for classification into the amortised cost or FV-OCI categories.
10. **Interrelated issues for financial liabilities** – At this meeting, the staff will ask the boards to consider the interrelated issues for financial liabilities (AP 6B-6F/FASB Memos 140-140D). Specifically, the staff will ask the boards to consider the interaction of the following with the classification and measurement requirements for financial liabilities:
    a. the need for and the method of bifurcation for financial assets and
    b. the February 2012 decisions on the contractual cash flow characteristics assessment for financial assets.
11. Currently both IFRS 9 and the FASB's model include bifurcation of some financial liabilities. In addition, the FASB's model includes a contractual cash flows characteristics assessment for financial liabilities that currently is not aligned with the decisions reached in February 2012 for financial assets. In contrast, IFRS 9 does not contain a contractual cash flows assessment for financial liabilities.
12. The staff will ask the boards to consider the need for symmetry in the classification and measurement of financial assets and financial liabilities. The staff will ask the boards whether and, if so, how they would like to adjust their

current accounting models for financial liabilities in light of the reconsideration of their accounting models for financial assets.

13. **Other issues** – Finally, at a future meeting, the staff will ask the boards to discuss any further interrelated issues including transition, disclosures and other sweep issues. Some of these discussions may need to be joint while others may need to be separate. The boards will also separately consider what further changes, if any, they would like to make to their respective models.

Appendix A – extract from February 2012 IASB Update

The boards discussed the cash flow characteristics assessment and held an education session on the business model assessment in their respective classification and measurement models for financial instruments.

Proposed approach to the contractual cash flows characteristics assessment

The boards tentatively decided that a financial asset could be eligible for a measurement category other than fair value through profit or loss (FVPL) (depending on the business model within which it is held) if the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (P&I). Interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. Principal is understood as the amount transferred by the holder on initial recognition.

- If the financial asset contains a component other than principal and the consideration for the time value of money and the credit risk of the instrument, the financial asset must be measured at FVPL.
- If the financial asset only contains components that are principal and the consideration for the time value of money and the credit risk of the instrument, but the relationship between them is modified (for example, the interest rate is reset and the frequency of reset does not match the tenor of the interest rate), an entity needs to consider the effect of the modification when assessing whether the cash flows on the financial asset are still consistent with the notion of solely P&I.
- If the financial asset only contains components that are principal and the consideration for the time value of money and the credit risk of the instrument, and the relationship between them is not modified, the financial asset could be eligible for a measurement category other than FVPL (depending on the business model within which it is held).

For the IASB, this is a minor amendment to the application guidance in IFRS 9. For the FASB, this is an amendment to the cash flow characteristics assessment in the tentative classification and measurement model. All IASB and FASB members voted in favour of the proposed approach.

Contingent cash flows

The boards tentatively decided that a contractual term that changes the timing or amount of payments of principal and interest would not preclude the financial asset from a measurement category other than FVPL as long as any variability only reflects changes in the time value of money and the credit risk of the instrument.

In addition, the boards tentatively decided that the probability of contingent cash flows that are not solely P&I should not be considered. Financial assets that contain contingent cash flows that are not solely P&I must be measured at FVPL. An exception however will be made for extremely rare scenarios.

For the IASB, this does not represent a change to IFRS 9. For the FASB, the guidance will be included as part of the contractual cash flow characteristics assessment. All IASB and FASB members voted in favour of the decision.

Assessment of economic relationship between P&I

The boards tentatively decided that an entity would need to compare the financial asset under assessment to a benchmark instrument that contains cash flows that are solely P&I to assess the effect of the modification in the economic relationship between P&I. An appropriate benchmark instrument would be a contract of the same credit quality and with the same terms, except for the contractual term under evaluation.

The boards tentatively decided that if the difference between the cash flows of the benchmark instrument and the instrument under assessment is more than insignificant, the instrument must be measured at FVPL because its contractual cash flows are not solely P&I.

For the IASB, this is a minor amendment to the application guidance in IFRS 9. However, the IASB believe that this change will address application issues that have

arisen in the application of IFRS 9. For the FASB, the guidance will be included as part of the contractual cash flow characteristics assessment. Thirteen IASB members and all FASB members voted in favour of the decision. One IASB member voted against.

Prepayment and extension options

The boards tentatively decided that a prepayment or extension option, including those that are contingent, do not preclude a financial asset from a measurement category other than FVPL as long as these features are consistent with the notions of solely P&I.

For the IASB, this does not represent a change to IFRS 9. For the FASB, the guidance will be included as part of the contractual cash flow characteristics assessment. All IASB and FASB members voted in favour of the decision.

Business model assessment – education session

The boards discussed the business model assessment in their respective classification and measurement models for financial instruments. No decisions were made at the education session.

At a future meeting, the boards will discuss whether and how they may be able to reduce differences between their business model assessments.