STAFF PAPER

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REG FASB | IASB Meeting

Project	**Financial Instruments: Classification and Measurement**
Paper topic	Cover paper

CONTACT(S)	Yulia Feygina	yfeygina@ifrs.org	+44 (0)20 7332 2743
	Jeff Lark	jlark@ifrs.org	+44 (0)20 7246 6932
	Katherine Cancro	kcancro@ifrs.org	+44 (0)20 7246 6928
	Trent Handy	tlhandy@fasb.org	+1 (203) 956-3466
	Shahid Shah	sshah@fasb.org	+1 (203) 956-3478

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 (FVOCI)); and
   (d) any interrelated issues from the topics above (for example, disclosures or the model for financial liabilities).

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 principal and interest (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)
	FVOCI	
	Fair value through profit or loss (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 *Financial Instruments* 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 P&I (eligible debt instruments) could qualify for a measurement category other than 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's tentative classification and measurement model.
7. **Bifurcation of financial assets –** In April 2012, the boards tentatively decided that financial assets with cash flows that are not solely P&I would not be eligible for bifurcation. Instead, those financial assets would be classified and measured in their entirety at FVPL.
8. **Interrelated issues for financial liabilities –** In April 2012 the boards also considered whether and, if so, how they would like to adjust their current accounting models for financial liabilities in the light of the discussions for financial assets. The boards tentatively decided that financial liabilities would continue to be bifurcated using the existing bifurcation requirements in IFRS 9 and US GAAP. The IASB also confirmed that the 'own credit' requirements in IFRS 9 for financial liabilities designated under the fair value option (FVO) would be retained. At a FASB-only meeting in June 2012 the FASB discussed the presentation of changes in fair value that result from a change in a reporting

entity's own credit risk for financial liabilities that are designated under the FVO. The FASB decided that an entity would present such changes separately in OCI. The FASB also decided that cumulative gains and losses recognised in OCI associated with changes in own credit will be recognised in profit or loss (P&L) upon the settlement of the liability. In addition, the entire risk in excess of a base market risk, such as a risk-free interest rate, would be considered as the change in own credit or an alternative method that an entity deems as a more faithful measurement of such a risk.

9. **Business model and the FVOCI measurement category**[2] **–** In April 2012, the boards discussed how to align their respective business model assessments for the **amortised cost** category. The boards tentatively decided that financial assets that satisfy the P&I criteria would qualify for amortised cost if the objective of the business model is to hold those assets to collect contractual cash flows. The boards also tentatively decided to clarify the primary objective of 'hold to collect' by providing additional implementation guidance on both the types of business activities and the frequency and nature of sales that would prohibit financial assets from qualifying for amortised cost measurement.
10. In May 2012, the IASB tentatively decided to **introduce a FVOCI measurement category** in IFRS 9 for debt investments (the FASB's tentative model already includes a FVOCI measurement category). The IASB also tentatively decided that:
    a. Interest income on financial assets measured at FVOCI would be recognised in P&L using the effective interest method that is applied to financial assets measured at amortised cost.
    b. Credit impairment losses/reversals on financial assets measured at FVOCI would be recognised in P&L using the same credit impairment methodology as for financial assets measured at amortised cost.

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

c. The cumulative fair value gain or loss recognised in OCI would be recycled from OCI to P&L when a financial asset is derecognised.

11. The boards then jointly discussed the **business model assessment for the FVOCI and FVPL** categories, including which category should be a residual. The boards tentatively decided that financial assets would be measured at FVOCI if they are managed within a business model whose objective is both to hold the financial assets to collect contractual cash flows and to sell the financial assets. The FVPL category would be the residual. The boards also tentatively decided to provide additional application guidance on the types of business activities that would qualify for the FVOCI business model. Only financial assets that contain cash flows that are solely P&I were in the scope of the business model discussions.
12. In June 2012, the IASB and the FASB re-affirmed that a debt instrument will be measured at FVOCI only if the debt instrument passes the contractual cash flow characteristics assessment (as discussed by the boards at the February 2012 joint board meeting) and the debt instrument is managed within the relevant business model (as discussed by the boards at the joint board meeting in May 2012).
13. **Fair value option**– In June 2012, the boards considered the FVO for financial assets in the context of the three-category classification model and any interrelated issues for the FVO for financial liabilities. The IASB tentatively decided to extend the current eligibility condition in IFRS 9 for designating financial assets under the 'accounting mismatch' fair value option to debt investments that would otherwise be measured at FVOCI. The FASB decided that an entity may, at initial recognition, irrevocably elect the FVO for the following financial instruments:
    a. A hybrid financial liability may be designated at FVPL, unless
        i. the embedded derivative or derivatives do not significantly modify the cash flows that otherwise would be required by the contract; or
        ii. it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative or derivatives is prohibited.

b. A group of financial assets and financial liabilities may be designated at FVPL if both of the following conditions are met:
    i. the entity manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis; and
    ii. the entity provides information on that basis to the reporting entity's management.

14. **Reclassification of financial assets –** In May 2012, the boards discussed reclassification of financial assets. The IASB tentatively decided to extend the existing reclassification requirements in IFRS 9 to the FVOCI category, that is to require prospective reclassification of financial assets when the business model changes. The FASB tentatively decided to prospectively require reclassification of financial assets in its tentative model when (and only when) the business model changes. Changes in the business model that require reclassifications are expected to be very infrequent and must be (i) determined by the entity's senior management as a result of external or internal changes, (ii) significant to the entity's operations and (iii) demonstrable to external parties.
15. At this meeting, the staff will ask the boards to consider the remaining issues related to the reclassification of financial assets between measurement categories:

(a) <u>Reclassification date</u>: The FASB will discuss the date on which a reclassification should take effect. (IFRS 9 already includes this guidance.)

(b) <u>Reclassification mechanics</u>: The FASB will discuss the accounting for all possible reclassification scenarios between the three measurement categories. The IASB will discuss only the accounting for the reclassification of eligible debt investments into and out of the FVOCI measurement category because IFRS 9 already includes the requirements for reclassifications between amortised cost and FVPL.

(c) <u>Reclassification disclosures</u>: The IASB will discuss disclosures related to reclassifying eligible debt investments into and out of the FVOCI measurement category. The FASB will discuss disclosures related to its classification and measurement model comprehensively at a FASB-only meeting at a future date.

16. **Other issues**: At this meeting, the staff will ask the IASB to discuss transition provisions in the light of the proposed modifications to the classification and measurement requirements in IFRS 9. The IASB will also discuss whether additional disclosure requirements are needed as a result of those proposed modifications. The FASB will discuss these topics at a FASB-only meeting at a future date.
17. **Next steps:** The staff anticipates that this will be the last joint board session to discuss the boards' respective classification and measurement models.