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STAFF PAPER

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Project	**Financial Instruments: Classification and Measurement**		
Paper topic	Initial application of modified classification and measurement requirements		
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Purpose and scope of the paper

1. This paper discusses *how* the proposed limited modifications to the classification and measurement (C&M) requirements in IFRS 9 *Financial Instruments* (the limited modifications) should be initially applied, in particular[1]:
   (a) Modifications to the contractual cash flow characteristics assessment (paragraphs 4-15),
   (b) Modifications to the business model assessment, notably the introduction of the FVOCI category (at fair value through other comprehensive income) for eligible debt instruments (paragraphs 16-20), and
   (c) The extension of the existing IFRS 9 fair value option requirements to debt instruments measured at FVOCI (paragraphs 21-23)[2].

[1] Agenda Paper 6C also presented to the Board at this meeting considers the interaction between phases of IFRS 9 and focuses of *when* the proposed limited modifications should be applied and related issues.

[2] The Board also tentatively decided to extend the existing IFRS 9 reclassification requirements to debt instruments measured at FVOCI. However, reclassifications of financial assets under IFRS 9 are not relevant to transition to IFRS 9 and are not discussed in this paper.

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2. Where applicable, this paper considers disclosures related to transition to the limited modifications (paragraphs 12-15).

3. These topics are considered in the context of the existing transition requirements in IFRS 9 and the general approach to changes in accounting policies set out in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* The paper provides staff analysis and recommendations and asks the Board for decisions.

Modifications to the contractual cash flow characteristics assessment

4. The framework for accounting for changes in accounting policies (in the absence of specific transition provisions in an IFRS) is set out in IAS 8. As a general rule, IAS 8 states that, on a change in accounting policy, retrospective application results in the most useful information to users, and that it is the preferred approach to transition unless it is impracticable to determine the period-specific effect and/or the cumulative effect of the change in policy. The definition of 'impracticability' includes situations in which an entity is required to make significant estimates and it is not possible to distinguish objectively information about those estimates that:

   (a) provides evidence of the circumstances that existed at the time those estimates were to be reflected in the financial statements; and

   (b) would have been available to the entity when the relevant financial statements were authorised for issue

   from other information. (This is commonly called 'hindsight'.)

5. In IFRS 9 currently, the contractual cash flow characteristics *assessment* (and the resulting *measurement* attribute) is applied retrospectively[3] at the date of initial application of IFRS 9[4]

[3] IFRS 9 provides relief from retrospective application of the resulting measurement attribute in particular circumstances.

[4] The date of initial application is the date when an entity first applies IFRS 9, eg 1 January 2015 for those who do not apply IFRS 9early.

(except for financial assets derecognised at the date of initial application). That is, an entity is required to assess the contractual cash flow characteristics of the financial asset as of the date it was initially recognised.

6. The staff note that this transition approach is consistent with the general application of the contractual cash flow characteristics assessment in IFRS 9. That is, the contractual cash flow characteristics are assessed when the financial asset is initially recognised and are not subsequently re-assessed.

7. In recent re-deliberations, the Board tentatively decided to modify the contractual cash flow characteristics assessment. The proposed modification re-affirms the principle of 'solely principal and interest' keep in IFRS 9 but provides a minor amendment to how the principle should be applied in particular circumstances. Specifically, the Board tentatively decided to clarify that a financial asset is eligible in its entirety for a measurement category other than at fair value through profit or loss (FVPL) if the economic relationship between the principal, the time value of money and the credit risk is modified but the degree of modification is not more than insignificant. In making this assessment, an entity would consider all available information – that is, historical experience, current conditions and future forecasts – and apply judgement. For example, if an entity evaluates a financial asset with an interest rate reset mismatch feature, an entity will consider information about forward yield curves. If forward yield curves have been volatile or the entity is evaluating a long-dated instrument that inherently involves a higher degree of uncertainty, the entity must also consider these factors and assess whether the contractual cash flows over the life of the instrument are solely principal and interest.

8. The staff note that the application of the contractual cash flow characteristics assessment under current IFRS 9 already requires judgement. However the staff acknowledge that the proposed modification to IFRS 9 discussed in paragraph 7 introduces a greater degree of judgement and presents a greater risk of hindsight when as assessment is required of whether the modification in economic relationship is more than insignificant.

9. Accordingly, in line with the principles set out in IAS 8, the staff believe that in light of the proposed modification to the contractual cash flow characteristic assessment **a modification to the retrospective application of the *assessment* of the contractual cash flows is necessary where such retrospective application is impracticable** (eg due to the risk of hindsight). In all other cases the assessment would be made retrospectively based on the contractual cash flows as at initial recognition.

10. The staff have considered the following alternatives for instruments where retrospective application is impracticable:

    (a) Retrospective application of the assessment of the contractual cash flow characteristics as per limited modifications *as of the earliest period practicable* (ie as of the earliest period which would not require the use of hindsight) as generally required by IAS 8 paragraph 24;

    (b) Prospective application of the assessment of the contractual cash flow characteristics as per limited modifications based on facts and circumstances *at the date of initial application of IFRS 9*;

    (c) Retrospective application of the assessment of the contractual cash flow characteristics as set out in IFRS 9 pre-limited modifications (ie IFRS 9 (2010)[5]).

11. The staff do not believe that the assessment of the contractual cash flow characteristics could be performed at other than the date of initial recognition of the financial asset. This is because IFRS 9 generally requires contractual cash flows to be assessed on initial recognition with no subsequent reassessment. Accordingly, the staff dismiss the alternatives that would require the application of the assessment at other than the date of initial recognition of the instrument (ie paragraph 10 (a) and (b)).

12. Retrospective application of the contractual cash flow characteristics assessment pre-limited modifications to IFRS 9 would result in reduced comparability between entities and between

[5] These requirements for financial assets are identical in IFRS 9 (2009).

reporting periods for a single entity (for example, identical financial instruments could be classified differently even if economic conditions are unchanged). However, given that the limited modifications to IFRS 9 only involve a minor change to the contractual cash flow characteristics assessment, the staff believe that the reduction in comparability will not be significant. To mitigate the reduction in comparability, the Board could require disclosure of the application of the pre-limited modifications assessment. On balance, the staff believe that this is the best alternative available to the Board.

13. Accordingly, the staff recommend that on transition to the modified C&M requirements an entity should be required to retrospectively apply the contractual cash flow characteristics assessment *as set out in IFRS 9 (2010)* where the application of the modified contractual cash flow characteristics assessment is impracticable.

14. The staff note that IAS 8 requires disclosure of when retrospective application is impracticable upon initial application of an IFRS. Specifically, IAS 8 paragraph 28(h) requires disclosure of the circumstances that led to impracticability and a description of how and from when the change in accounting policy has been applied. Entities that apply IFRS 9 (2010) rather than the modified C&M requirements to particular financial assets on initial application of IFRS 9 will be in the scope of this requirement.

15. In addition, the staff believe that disclosure of the carrying values of the financial assets whose contractual cash flows have been assessed under IFRS 9 (2010) rather than the modified C&M requirements due to impracticability would provide useful information and enhance comparability. Accordingly, the staff recommend that the Board requires such disclosure until the affected financial assets are derecognised.

Questions 1 and 2 for the Board

Question 1

Does the Board agree with the staff recommendation in paragraph 13 that on transition to the modified C&M requirements an entity should be required to retrospectively apply the contractual cash flow characteristics assessment as set out in IFRS 9 (2010) where it is impracticable to apply the modified contractual cash flow characteristics assessment retrospectively?

Question 2

Does the Board agree with the staff recommendation in paragraph 15 that an entity should be required to disclose the carrying values of the financial assets whose contractual cash flows have been assessed under IFRS 9 (2010) rather than the modified C&M requirements due to impracticability until the affected financial assets are derecognised?

Modifications to the business model assessment

16. In accordance with the existing transition provisions in IFRS 9, the *assessment* of the business model is performed on the basis of facts and circumstances that exist on the date of initial application of IFRS 9[6]. This is because it would be difficult, and perhaps impossible, to assess this condition at the time when the financial asset was initially recognised[7]. The resulting *measurement* attribute however would be applied retrospectively (except for circumstances where IFRS 9 provides specific relief from retrospective application).

17. In recent re-deliberations, the Board tentatively decided to retain the concept of a 'held to collect' business model as the condition for amortised cost measurement and to clarify some of the associated guidance. The Board re-affirmed that only financial assets with contractual

[6] Paragraph 7.2.4 of IFRS 9

[7] Basis for Conclusions on IFRS 9 paragraph 7.18

cash flows that are solely payments of P&I ('eligible debt instruments') qualify for amortised cost measurement.

18. The Board also tentatively decided to require that eligible debt instruments managed within a business model whose objective is to both collect contractual cash flows and sell financial assets are measured at FVOCI. The Board tentatively decided that financial assets measured at FVOCI will be subject to the same interest income recognition and credit impairment methodology as financial assets measured at amortised cost. The Board confirmed that eligible debt instruments that are not within one of these business models would be measured at FVPL.

19. Consequently, when assessing the business model on the date of initial application of IFRS 9, an entity would classify eligible debt instruments into one of the three business models rather than one of two business models. The staff do not believe that the introduction of the additional business model or the proposed clarification to the 'hold to collect' business model has any implications on the ability to assess the business model nor the need to make that assessment as at the date of initial application of IFRS 9. Accordingly, the staff do not propose any modifications to the existing IFRS 9 transition requirements with respect to the timing of the business model assessment.

20. Likewise, the staff have considered the implications of the retrospective application of the new measurement attribute for eligible debt instruments, ie at FVOCI, and do not believe that this creates a need for additional relief from retrospective application compared to the existing transition requirements in IFRS 9. As discussed in paragraph 18, debt instruments measured at FVOCI will be subject to the same interest income recognition (ie the effective interest method) and credit impairment methodology as those applied to financial assets measured at amortised cost. IFRS 9 already contains an exception from retrospective application of the effective interest rate method[8]. Transition to the new credit impairment methodology is discussed in Agenda Paper 5G also presented to the Board at this meeting.

[8] IFRS 9 paragraph 7.2.10

Accordingly, the staff do not propose any modifications to the existing relief from retrospective application in IFRS 9.

Question 3 for the Board
Doe s the Board agree with the staff recommendation in paragraphs 19-20 that no modifications to the existing IFRS 9 transition requirements are required in light of the proposed modifications to the business model assessment?

The extension of the existing IFRS 9 fair value option requirements to debt instruments measured at FVOCI

21. IAS 39 and IFRS 9 allow an entity, at initial recognition, to irrevocably designate a financial asset at FVPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency (an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (further referred to as fair value option (FVO)[9]). In accordance with the existing transition requirements in IFRS 9, there is a 'clean slate' for the FVO for accounting mismatches for financial assets and financial liabilities at the date of initial application of the IFRS 9 C&M requirements *for financial assets*. Not only are entities *permitted* to revisit their FVO elections made under IAS 39, they are also *required* to do so on the basis of whether an accounting mismatch exists at the date of initial application of IFRS 9 C&M requirements for financial assets. The resulting measurement attributes are then applied retrospectively except where IFRS 9 provides specific relief from retrospective application.

22. In recent re-deliberations, the Board tentatively decided to extend the existing FVO for accounting mismatches to debt investments that would otherwise be measured at FVOCI.

23. The staff believe that no new transition implications arise due to the ability to designate debt instruments that otherwise would be measured at FVOCI as at FVPL. Consequently, the staff

[9] IAS 39 had additional criteria for the FVO for financial assets that are not relevant to this analysis.

do not propose any modifications to the existing IFRS 9 transition requirements with respect to the FVO for accounting mismatches for entities that newly apply IFRS 9. However, there are implications for entities that early adopt an interim version of IFRS 9. This is addressed in Agenda Paper 6C also presented to the Board at this meeting.

Question 4 for the Board
Does the Board agree with the staff recommendation in paragraph 23 that no modifications to the existing IFRS 9 transition requirements with respect to the FVO for accounting mismatches are required in light of the proposed limited modifications to IFRS 9 for entities that newly adopt IFRS 9 when it becomes effective?