STAFF PAPER

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REG IASB Meeting

Project	**Financial instruments: classification and measurement**
Paper topic	Limited Modifications to IFRS 9: Additional disclosures

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Purpose and scope of the paper

1. This paper is an IASB-only paper that addresses whether, and if so, what additional presentation and disclosure requirements should be introduced in light of the proposed limited modifications to the classification and measurement (C&M) requirements in IFRS 9 *Financial Instruments* (the limited modifications), in particular:

   (a) Modifications to the contractual cash flow characteristics assessment (paragraphs 5-12),

   (b) Modifications to the business model assessment, notably the introduction of the FVOCI measurement category (at fair value through other comprehensive income) for eligible debt instruments (paragraphs 13-21). This section considers the interaction with the presentation and disclosure requirements proposed in the Impairment project (paragraphs 22–32)[1].

2. This paper only discusses disclosures that are not covered in other Agenda Papers also presented to the Board at this meeting, specifically:

[1] Proposed impairment disclosures are discussed in greater detail in Agenda Papers 5A and 5B from this meeting.

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(a) Agenda Paper 6A addresses disclosures related to the reclassification of financial assets, and

(b) Agenda Paper 6B addresses disclosures related to the transition to the limited modifications.

3. This paper provides staff analysis and recommendations and asks the Board for decisions.

4. For the Board's information, there is Appendix A to this paper that displays the *existing* IFRS disclosure requirements relevant to the topics discussed in this paper and provides staff observations as to how these requirements would apply in the context of modified C&M requirements. Appendix A only includes those requirements that are not specifically discussed elsewhere in the paper. Appendix B includes the full text of existing IFRS disclosure requirements that *are* specifically discussed in this paper.

Modifications to the contractual cash flow characteristics assessment

Tentative decisions in this project

5. In February 2012, the Board tentatively decided to modify the contractual cash flow characteristics assessment. The proposed modification re-affirms the principle of 'solely P&I' 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 would apply judgement.

Staff analysis and recommendation

6. The proposed modification to the contractual cash flow characteristics assessment introduces **more judgement** in the assessment of the contractual terms in the classification of financial assets because an entity may need to assess whether the modification in economic

relationship is more than insignificant. The question for the Board is whether the proposed modification to IFRS 9 gives rise to the need for additional disclosures and, if so, which financial assets should be subject to such disclosures and what information should be disclosed.

7. The staff note that the assessment of the contractual cash flow characteristics already relies on the *economic* notion of solely P&I and requires judgement. The proposed modification to the contractual cash flow characteristics assessment does not change this principle but just clarifies its application. As long as a financial asset meets the solely P&I criterion it would be eligible for amortised cost or FVOCI classification (subject to business model assessment) regardless of whether there is a modification in the economic relationship Where a modified economic relationship *is* present, the judgement required in the assessment *will vary*. Sometimes the modifications may be minor. Accordingly, the staff do not believe that the Board should introduce disclosure requirements just on the basis of whether the economic relationship is modified.

8. Rather, the staff believe that the deciding factor in whether disclosure should be provided is the degree of judgment that an entity needs to apply in making the P&I determinations. In addition, the staff think that it is relevant to consider the impact on the financial statements. The staff note that if judgements made in applying the contractual cash flow characteristics assessment are significant and have a significant effect on the amounts recognised in the financial statements, that would be captured by the existing provisions in paragraph 122 of IAS 1 *Presentation of Financial Statements* that requires that an entity shall disclose '**the judgements … that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements**'. The staff think that this test would be satisfied for example in cases where products that are issued in large volumes in particular jurisdictions have modified features—the determination of whether the payments are solely P&I could have significant effects on the financial statements.

9. The staff notes that IAS 1 paragraph 123 lists already lists examples of areas of judgement that an entity may consider describing in its disclosures.

10. Accordingly, the Board could reinforce and supplement the general requirement in paragraph 122 of IAS 1 by introducing specific disclosures or the Board could add this example to the existing list in paragraph 123 of IAS 1. The staff recommend that such an example should be added. However, paragraph 122 only requires information about the judgements made.

11. The next question is whether the Board would like to specifically require quantitative disclosures for when the judgements about modified P&I have a significant effect. In such situations, the staff believe that quantitative disclosures that enable a user to assess the impact on financial statements could provide useful information. To that end, disclosures such as the following could provide useful information:

    (a) Carrying values of financial assets (split by amortised cost and FVOCI)

    (b) For financial assets measured at amortised cost, the respective fair value

    (c) For financial assets measured at FVOCI, the respective gain or loss recognised in other comprehensive income (OCI) for the period

12. A specific quantitative disclosure requirement to this effect could be added to IFRS 7 *Financial Instruments: Disclosures*. If the Board decides to require such quantitative disclosures, the staff think that these disclosures would be most useful if provided in a single note together with the qualitative information that explains how the judgement has been made (ie the IAS 1 information).

Question 1 for the Board

Does the Board agree with the staff recommendation in paragraph 10 that the judgement involved in the assessment of contractual cash flow characteristics should be added as an example to paragraph 123 of IAS 1?

Question 2 for the Board

Does the Board want to specifically require quantitative disclosures for when the judgements about modified P&I have a significant effect as described in paragraphs 11–12?

The modifications to the business model assessment

Tentative decisions in this project

13. In May 2012, the Board tentatively decided that a FVOCI measurement category for eligible debt instruments[2] should be added to IFRS 9. The Board tentatively decided that eligible debt instruments should be measured at FVOCI if they are managed within a business model whose objective is both to hold financial assets to collect contractual cash flows and to sell financial assets.

14. For this category, the Board tentatively decided that:

    (a) Interest income should be recognised in profit or loss (P&L) using the effective interest method that is applied to financial assets measured at amortised cost,

    (b) Credit impairment losses/reversals should be recognised in P&L using the same credit impairment methodology as for financial assets measured at amortised cost, and

    (c) The cumulative fair value gain or loss recognised in OCI should be recycled from OCI to P&L when financial assets are derecognised.

15. The staff do not believe that the *mere fact* of the introduction of the additional business model has any implications on the users' information needs. Accordingly, the paper does discuss any additional disclosures[3] in this regard.

16. However, the rationale for and, accordingly, the *mechanics* of the FVOCI measurement category for debt instruments should be considered for presentation and disclosure implications. These are discussed in the following sections.

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[3] For existing IFRS disclosures related to the business model assessment, refer **Appendix A**.

Implications for presentation in the statement of profit or loss (P&L)

17. The underlying premise for the FVOCI measurement category is that for financial assets managed within the respective business model two sets of information – amortised cost and fair value – are relevant. Accordingly, the mechanics of the FVOCI category discussed in paragraph 15 result in fair value information on the balance sheet and amortised cost information in P&L[4]. However, the staff are of the view that there are slightly different *presentation* considerations for FVOCI.

18. Paragraph 82(aa) of IAS 1 requires separate presentation of gains and losses arising from the derecognition of financial assets measured at amortised cost. This requirement was added by IFRS 9 to enable users of financial statements to understand the effects of derecognising before maturity instruments measured at amortised cost. It was also added for discipline in situations where an entity that measures financial assets at amortised cost (on the basis of having an objective of managing those assets in order to collect the contractual cash flows) but regularly sells them[5].

19. Because by definition FVOCI debt instruments 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 staff does not think that it is necessary to provide separate presentation of gains or losses on such sales.

20. Further, as described in further detail in Appendix A, the staff note that IAS 1 requires the separate presentation of reclassification adjustments of components of OCI (one of which will be FVOCI debt instruments), and IFRS 7 requires separate disclosure of interest revenue and of impairment for FVOCI debt instruments. Therefore, this information is already available to users of financial statements (because total reclassification adjustments for

[4] Maintaining the same P&L profile for amortised cost assets as for FVOCI debt instruments is also reflected in the relevant drafting changes to disclosures in **Appendix A**, ie that the presentation and disclosure of amounts in profit or loss should permit comparison between amortised cost assets and FVOCI debt instruments where relevant.

[5] BC4.45 of IFRS 9 (2010)

FVOCI debt instruments – interest revenue – impairment = gains or losses from derecognition of FVOCI debt instruments).

21. Consequently, the staff recommend that no new requirements should be added related to the gains or losses arising from the derecognition of FVOCI debt instruments.

Question 3 for the Board
Does the Board agree with the staff recommendation in paragraph 21 that no new requirements should be added related to the gains or losses arising from the derecognition of FVOCI debt instruments?

Interaction with impairment disclosure proposals

Proposed impairment disclosures

22. The Board has tentatively decided that debt instruments measured at FVOCI will be subject to the same impairment requirements as financial assets measured at amortised cost. Agenda Papers 5A and 5B from this meeting address the proposed disclosures for the impairment model. As a result of the requirements of IFRS 7, relevant disclosures would be provided separately for assets classified at amortised cost and those classified as FVOCI.

23. In this paper the staff discuss the impairment disclosures associated with the proposed impairment model, distinguishing between two broad types:

    (a) Disclosures related to measurement of expected losses, amounts recognised in P&L related to impairment (impairment expense and interest revenue[6]), and the gross carrying amounts of the assets subject to impairment accounting, and

    (b) Information related to the allowance balance.

24. The reason for this distinction is that amortised cost and FVOCI assets have the same P&L profile but different (net) carrying amounts on the statement of financial position.

[6] The amount of interest revenue can be affected by the impairment model for 'credit impaired' assets. This is addressed in Agenda Paper 5C of this meeting.

Analysis of disclosures related to the measurement of expected losses, impairment related amounts in P&L and gross carrying amounts for assets subject to impairment accounting

25. For the IASB, expected losses and interest revenue are measured in the same way for both amortised cost and FVOCI assets. In fact, the Board decided to introduce a FVOCI category at least in part in order to reflect consistent profit or loss with amortised cost measurement while providing fair value information on the balance sheet. Consequently, the staff think that the same disclosures should generally be applied to these two groups of instruments in respect to P&L and in relation to the measurement of expected losses. In addition, information about the gross carrying amounts of financial assets subject to impairment accounting are equally relevant irrespective of classification. The specific impairment disclosure proposals are discussed in Agenda Papers 5A and 5B at this meeting.

Analysis of disclosures related to the allowance balances

26. While the Board has tentatively decided to align P&L for amortised cost and FVOCI assets (including applying the same impairment model), the balance sheet measurement objective for these two categories is different. The staff believe that this difference gives rise to different considerations regarding the allowance balance; based on the analysis in the following paragraphs, the staff question whether the allowance balance is as relevant for FVOCI debt instruments as it is for financial assets measured at amortised cost.

27. Based on the tentative decisions to date, FVOCI debt instruments have a different carrying amount on the statement of financial position than amortised cost assets even at initial recognition, as a consequence of the proposed impairment model. Using a simple example, on initial recognition of a debt instrument with a fair value of 100 with 12-month expected losses of 5, although in both cases an impairment expense of 5 would be recognised, if classified as FVOCI the carrying amount would be 100 whereas same instrument measured at amortised cost would have a carrying amount of 95.

28. Paragraph 16 of IFRS 7 already requires disclosure of an allowance rollforward by class of financial asset. However, the question of whether an allowance account should be presented for assets at FVOCI is a new question. In accordance with IAS 39, there are no amounts

classified as accumulated OCI related to past impairments for available-for-sale (AFS) assets. When an AFS asset is impaired, the impairment measurement is actually based on fair value changes and once the asset is impaired the previously accumulated OCI balance is recognised in P&L as impairment expense. This is different to the proposed *expected loss* model.

29. For amortised cost financial assets, the accumulated impairment amount (ie the allowance), whether presented on the face of the statement of financial position or in the notes, is a measure of expected shortfalls in contractual cash flows, and the gross carrying amount reflects the discounted amount of the (full) contractual cash flows. This combination provides information for users of financial statements about anticipated future cash flows.

30. In contrast, by definition FVOCI assets have a fair value carrying amount on the statement of financial position. The staff believe that presentation of an accumulated impairment amount for FVOCI debt instruments would be a departure from that fair value carrying amount and also that the presentation would be complicated and potentially confusing. In order to provide a full picture it would be necessary to show not only an impairment allowance but also the fair value adjustment required to re-establish a fair value carrying amount. Consequently, the staff think presentation of an allowance account on the face of the statement of financial position should be *prohibited* for FVOCI debt instruments.

31. For FVOCI assets under the proposed impairment model, the accumulated impairment amount (accumulated expected credit losses) is only a subset of the accumulated OCI amount, which also contains fair value changes since initial recognition. For example, referring back to the simple example in paragraph 27 above, on initial recognition the OCI amount for the single asset would be nil comprising the impairment amount of 5 and an offsetting fair value adjustment of 5. The staff note the different measurement objectives of impairment and fair value. In accordance with IFRS 13, fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. In the expected loss impairment model the boards are developing, impairment provides a measure of expected shortfalls in contractual cash flows. In combination, the fair value adjustment for FVOCI debt instruments is effectively adjusting both for market movements and movements in expected losses in order to establish an overall

fair value carrying amount. The staff question whether separating these two components in accumulated OCI would provide useful information or whether it would in fact be confusing. Consequently, the staff recommend that a rollforward of the accumulated impairment amount should *not be required* for FVOCI debt instruments.

Question 4 for the Board

Does the Board agree with the staff recommendation in paragraph 30 that presentation of an allowance account on the face of the statement of financial position should be prohibited for FVOCI debt instruments?

Question 5 for the Board

Does the Board agree with the staff recommendation in paragraph 31 that an allowance rollforward should not be required for FVOCI debt instruments?

Final staff note about allowance disclosures

32. Paragraph 38 of Agenda Paper 5A from this meeting proposes qualitative narrative disclosures about the allowance account[7]. Despite the staff's recommendation in this paper that an allowance rollforward should not be required for FVOCI assets, the staff note that consistent with the staff's recommendations above, the qualitative narrative disclosures related to the allowance rollforward should still be required because they would not pose the same problems as the allowance rollforward itself. Rather, they would in fact provide useful information, eg because impairment expense for the period is also affected by the factors covered by those disclosures.

[7] These qualitative disclosures are (i) A discussion of the changes in credit loss expectations and the reasons for those changes (e.g., loss severity, change in portfolio composition, change in volume of assets whether purchased or originated, significant event or conditions that are affecting the calculation of the allowance that were not expected when originally calculated); (ii) A discussion of the changes in estimation techniques used and the reasons for the change; (iii) Reasons for a significant amount of write-offs; and (iv) How assets are grouped for disclosure purposes, if necessary, including specific information on what credit characteristics are considered similar to enable grouping.

Appendix A: List of C&M disclosures and staff observations

A1. The following table displays existing IFRS disclosure requirements that are related to the scope of this paper but to which the staff does ***not*** recommend any changes, other than drafting changes. The table contains staff observations as to how these requirements would appear after drafting changes, if any, due to the limited modifications project.

Disclosure number	Topic	Element of financial statements	Existing IFRS disclosure	Staff observation/ drafting change
1	Business model assessment	Summary of significant accounting policies	*Significant accounting policies applied that are relevant to an understanding of the financial statements (IAS 1.112 and 117)*	Continue to rely on IAS 1.112 and 117 requirements
2	Business model assessment	Summary of significant accounting policies	*The judgements that management has made in the process of applying the entity's accounting policies and that have had the most significant effect on the amounts recognised in the financial statements. (IAS 1.122)*	Continue to rely on IAS 1.122 requirement
3	Addition of FVOCI category for eligible debt instruments	Statement of financial position	*Carrying amounts of financial assets in each measurement category in IFRS 9, including for financial assets measured at fair value through other comprehensive income (IFRS 7.8(h)).*	Extend IFRS 7.8(h) requirement to FVOCI debt instruments and require the carrying amounts of FVOCI equities and FVOCI debt instruments to be separately

Disclosure number	Topic	Element of financial statements	Existing IFRS disclosure	Staff observation/ drafting change
				disclosed
4	Addition of FVOCI category for eligible debt instruments	Statement of comprehensive income	*Net gains or net losses on financial assets measured at amortised cost (IFRS 7.20(a)(v)).* *Before the issue of IFRS 9 (2009), paragraph 20(a)(ii) of IFRS 7 required disclosure of the net gains or net losses on available-for-sale (AFS) financial assets, showing separately the amount of gain or loss recognised in other comprehensive income during the period and the amount reclassified from equity to profit or loss for the period (in other words, amounts related to impairment and derecognition).*	Reinstate a similar requirement for FVOCI debt instruments as the one for AFS assets that was contained in paragraph 20(a)(ii) of IFRS 7 before the issue of IFRS 9 (2009)

Disclosure number	Topic	Element of financial statements	Existing IFRS disclosure	Staff observation/ drafting change
5	Addition of FVOCI category for eligible debt instruments	Statement of profit or loss	*Total interest income and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost (IFRS 7.20(b))*	Add a similar requirement for FVOCI debt instruments
6	Addition of FVOCI category for eligible debt instruments	Statement of profit or loss	*The amount of any impairment loss for each class of financial asset (IFRS 7.20(e)). In determining its classes of financial instrument, an entity must, at a minimum distinguish instruments measured at amortised cost from those measured at fair value (IFRS 7.B2).*	Do not change requirements in IFRS 7.20(e) and B2
7	Addition of FVOCI category for eligible debt instruments	Statement of comprehensive income	*Reclassification adjustments relating to components of other comprehensive income (IAS 1.92)* *Gains and losses from FVOCI equity instruments are a component of other comprehensive income (IAS 1.7)*	Extend IAS 1.7 requirement to FVOCI debt instruments

Appendix B: IFRS disclosure requirements referenced in this paper

IAS 1

Information to be presented in the profit or loss section or the statement of profit or loss

82 In addition to items required by other IFRSs, the profit or loss section or the statement of profit or loss shall include line items that present the following amounts for the period:

…

(aa) gains and losses arising from the derecognition of financial assets measured at amortised cost;

…

Disclosure of accounting policies

…

122 An entity shall disclose, in the summary of significant accounting policies or other notes, the judgements, apart from those involving estimations (see paragraph 125), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

123 In the process of applying the entity's accounting policies, management makes various judgements, apart from those involving estimations, that can significantly affect the amounts it recognises in the financial statements. For example, management makes judgements in determining:

(a) [deleted]

(b) when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities; and

(c) whether, in substance, particular sales of goods are financing arrangements and therefore do not give rise to revenue.

IFRS 7

Allowance account for credit losses

16 When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.