STAFF PAPER

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Prepared for joint Capital Markets Advisory Committee and Global Preparers Forum meeting

Project	**Financial instruments: classification and measurement**
Paper topic	Limited modifications to IFRS 9

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Purpose

1. The purpose of this paper is to solicit CMAC and GPF members' views on tentative limited modifications to IFRS 9 *Financial Instruments* and to get their perspective on disclosures. The detailed questions are outlined in the relevant sections of this paper.

Background

2. Currently classification and measurement requirements for financial instruments are set out in IAS 39 *Financial Instruments: Recognition and Measurement*. Many users of financial statements and other interested parties told the Board that the requirements in IAS 39 are difficult to understand, apply and interpret. They urged the Board to develop a new standard for financial reporting of financial instruments that was principle-based and less complex.
3. In November 2009 the IASB issued the first chapters of IFRS 9 that addressed classification and measurement of financial assets. Consistent with the objective of replacing IAS 39, IFRS 9 is principle-based and reduces complexity in accounting for financial assets. In October 2010 the Board added to IFRS 9 the requirements for classification and measurement of financial liabilities. IFRS 9 is effective from 1 January 2015, although entities can choose to early adopt it.

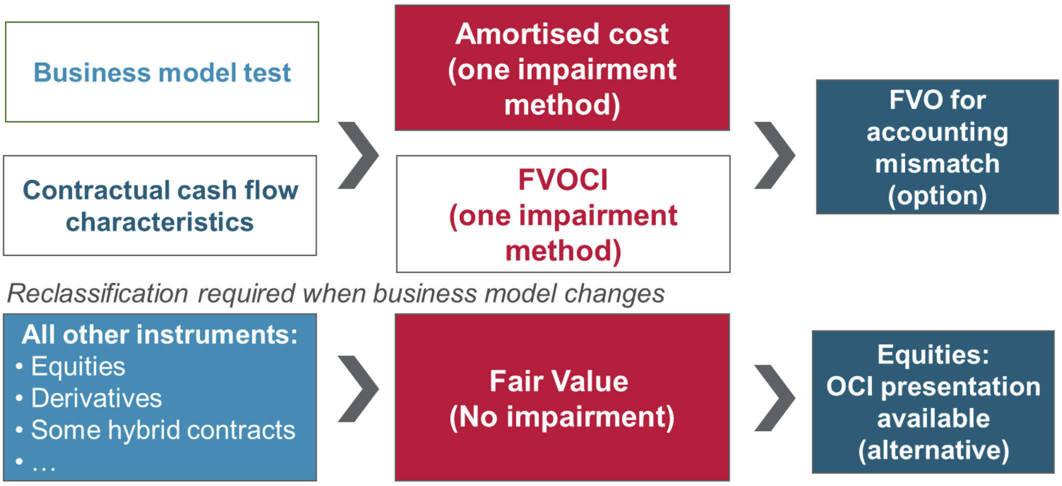
4. IFRS 9 currently requires that debt investments[1] be measured in one of the following two categories based on the *business model* and *contractual cash flow characteristics* assessments:

Amortised cost	Fair value through profit or loss (FVPL)
The asset is held within a business model whose objective is to **hold financial assets to collect contractual cash flows**. The instrument must have 'simple' cash flows. That is, contractual cash flows must be **solely payments of principal and interest** on the principal amount outstanding (P&I). Interest is defined as compensation for the time value of money and the credit risk of the instrument.	All other instruments, including derivatives, those held for trading and those managed on a fair value basis. That is, this is a residual measurement category for: for: (1) 'simple' instruments that are not held within the business model that qualifies for amortised cost; and (2) 'complex' instruments (ie those with cash flows that are not solely P&I) regardless of the business model

5. In November 2011, the Board decided to consider making limited modifications to the classification and measurement requirements in IFRS 9 to address:
   (a) Potential areas of convergence with the US FASB;
   (b) The interaction between IFRS 9 and the insurance contracts project; and
   (c) Known application issues discussed with entities that had early adopted or prepared to adopt IFRS 9.

6. The following diagram outlines the potential changes to classification and measurement of financial assets (unshaded boxes):

[1] Equity investments will be measured at fair value through profit or loss unless an entity makes an irrevocable election on initial recognition for the equity investments to be measured at FVOCI without recycling.



Modification to the business model assessment

7. The limited modifications to IFRS 9 propose introducing a third measurement category for debt investments – at fair value through other comprehensive income (FVOCI) – in the business model assessment resulting in the following classification:

<table>
<tr><th>Amortised cost</th><th>FVOCI</th><th>FVPL</th></tr>
<tr><td>The instruments are held within a business model whose objective is to hold to collect contractual cash flows</td><td>The instruments are managed within a business model whose objective is to both hold to collect contractual cash flows and to sell financial assets</td><td rowspan="2">All other instruments, including derivatives, those held for trading and those managed on a fair value basis.

That is, this is a residual measurement category for:
(2) ‘simple’ instruments that are not held within the business models that qualify for amortised cost or FVOCI; and

(2) ‘complex’ instruments (ie those with cash flows that are not solely P&I) regardless of the business model</td></tr>
<tr><td colspan="2">The instrument must have ‘simple’ cash flows. That is, contractual cash flows must be solely payments of principal and interest on the principal amount outstanding (P&I). Interest is defined as compensation for the time value of money and the credit risk of the instrument (ie there is no change to the principle underlying the contractual cash flow characteristics assessment).</td></tr>
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8. Some examples of debt investments that would be consistent with the objective of the FVOCI business model include:

(a) Example 1: A life insurer holds a portfolio of debt instruments to fund a portfolio of specified life insurance contract obligations. The objective of the business model is to match the duration of financial assets with the insurance contract obligations. The insurer also monitors the yield on the portfolio to earn a targeted yield. The insurer assesses the portfolio to determine the optimal mix to achieve the targeted duration match and yield. Hence the objective of the business model is to hold some financial assets within the portfolio for the collection of contractual cash flows and to sell others to achieve a targeted yield and duration match.

(b) Example 2: A non-financial entity expects a future cash outflow to settle an obligation and invests its excess cash in both short and long-duration debt instruments. The entity's business model is to maximise the yield by selling and acquiring higher yielding instruments on the basis of market factors until the need for the invested funds arises.

9. The Board has tentatively decided that debt investments measured at FVOCI will have interest income and impairment recognised using the same approach as for financial assets measured at amortised cost. In addition, any gain or loss on derecognition of the instrument will be reclassified (ie recycled) from other comprehensive income (OCI) to profit or loss. Thus, debt investments measured at FVOCI will have an amortised cost profile in profit or loss while being measured at fair value on the balance sheet. The Board believes this is the most useful information about these instruments because the objective of the business model is to both hold and sell financial assets.

Question 1 – FVOCI measurement category
Do you believe it is appropriate to measure some debt investments at FVOCI? If so, do you believe it is appropriate to measure debt investments at FVOCI if they are managed with the objective of both collecting contractual cash flows and selling? If you do agree, is it because you think both amortised cost and fair value information is relevant for these debt investments or for other reasons?

Question 2 – FVPL measurement category
Do you believe it is appropriate for FVPL to continue to be the residual measurement category?

Modification to the contractual cash flow characteristics assessment and related disclosures

10. IFRS 9 requires that debt investments meet the *cash flow characteristics assessment* in order to be eligible for amortised cost measurement. Given the Board's recent decisions in this project, debt investments must also satisfy this assessment to be measured at FVOCI.
11. As described above, the cash flow characteristics assessment in IFRS 9 requires an instrument to have cash flows that are solely P&I, with interest defined as compensation for the time value of money and the credit risk of the instrument. This principle has been supported by constituents. However, some have raised application issues which the Board has sought to address in the limited modifications project.
12. The main issue arises with instruments where there is a 'disconnect' between the duration of an interest rate reset period and the interest rate that is set (for example, a 1-year instrument with an interest rate that is reset every month to the current 12-month interest rate). The P&I notion in IFRS 9 has been articulated very strictly and may result in some instruments being measured at FVPL when the difference in cash flows resulting from the 'modified' interest rate reset feature would be only very slightly different from what they would have been if the interest rate reset period matched the interest rate (for example, the difference between the reset to a 12-month rate in the example above and the reset to a one month rate may in fact be insignificant).
13. To address that issue, the Board has tentatively decided to clarify that:
    (a) if a financial asset only contains components that are principal, the consideration for the time value of money and the credit risk of the instrument, but
    (b) the relationship between these components is modified compared to a 'perfect instrument' (for example, the interest rate is reset and the frequency of the reset does not match the tenor of the interest rate)

    the instrument's cash flows are solely P&I if the effect of the modification is not more than insignificant. This is a minor change to the application guidance in IFRS 9.

14. The Board tentatively plans to discuss disclosures arising from the limited modifications to IFRS 9 at a future meeting.
15. The staff suggest that the following disclosures be required for debt investments that have a modified relationship between principal, the consideration for the time value of money and the credit risk (as described in paragraphs 11 and 133) and are measured at amortised cost or FVOCI:
    (a) The carrying value; and
    (b) The terms of such instruments and how the entity assessed whether those instruments were still consistent with the notion of being solely P&I.

Question 3 – Contractual cash flow characteristics assessment and related disclosures
Do you believe that it is important to provide information about the volume and/or types of instruments that have modified cash flows but an entity has concluded can be classified at other than FVPL? Do you believe that the disclosures suggested in paragraph 15 would provide useful information? Would you suggest any other disclosures for these instruments?