STAFF PAPER

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Project	**Financial instruments: classification and measurement**
Paper topic	The scope of FVOCI for debt instruments

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What is this paper about?

1. This paper asks the boards to confirm that the FVOCI measurement category should only be available for financial assets that:
   (a) pass the contractual cash flow characteristics assessment; and
   (b) are managed within the relevant business model[1].
2. This scope has been implicit in the decisions that the boards have made in their joint discussions since January 2012.
3. The staff recommend that the FVOCI measurement category should only be available for financial assets that pass the contractual cash flow characteristics assessment.

[1] Under IFRS 9, an entity may make an irrevocable election at initial recognition to present fair value gains and losses on an investment in an equity instrument that is not held for trading in other comprehensive income (OCI). This option is outside of the scope of this paper.

Background

4. In November 2011, the IASB decided to consider making limited modifications to IFRS 9. The primary drivers behind that decision were to:
   (a) address specific application issues raised by constituents related to classification of specific instruments;
   (b) consider the interaction between classification and measurement of financial assets (C&M) and accounting for insurance contract liabilities; and
   (c) consider reducing the differences with the FASB's tentative C&M model for financial instruments (the FASB's model).
5. In making this decision, the IASB noted that IFRS 9 is conceptually sound and operational. The IASB also noted that some constituents have already early adopted IFRS 9 and others have dedicated resources in preparation for adoption. Accordingly, the IASB directed the staff to keep any proposed changes to IFRS 9 to the minimum and to complete the project expeditiously. Consistent with the above objectives, in December 2011, the IASB confirmed the limited scope of review of IFRS 9.
6. In January 2012, the IASB and the FASB decided to jointly redeliberate selected aspects of their C&M models for financial instruments to seek to reduce key differences. The tentative decisions that have been made to date are consistent with the limited scope of the review of IFRS 9 agreed by the IASB. Furthermore, consistent with this scope, the decisions to date have been made on the basis that instruments that do not meet the contractual cash flow characteristics test be required to be measured at FVPL irrespective of business model.[2]

[2] IFRS 9 allows an election for equity investments that are not held for trading to be measured at FVOCI.

7. In February 2012, the boards refined and aligned their respective contractual cash flow characteristics assessments[3]. Consistent with IFRS 9 and the FASB's model, the boards re-affirmed that financial assets that do not pass the contractual cash flow characteristics assessment would not be eligible in their entirety for a measurement category other than FVPL[4].
8. In April and May 2012, the boards discussed the business model assessment for financial assets, including the need for and the articulation of the FVOCI measurement category, and defined the FVOCI business model. Consistent with the tentative decisions of February 2012, only financial assets with contractual cash flows that are solely P&I were in the scope of those discussions and thus were confirmed to be eligible for classification as FVOCI based on business model.[5]

Staff analysis and recommendation

9. The staff believe that the FVOCI measurement category should only be available for financial assets that pass the contractual cash flow characteristics assessment. This is because such an approach is consistent with:

   (a) **IFRS 9 and the FASB's model pre joint redeliberations** – Both IFRS 9 and the FASB's tentative model require financial assets that do not pass the contractual cash flow characteristics assessment to be measured at FVPL regardless of the business model within which they are held.[6] The staff believe a measurement basis other than FVPL would not provide

[3] Those decisions represent a minor change to IFRS 9 and a change to the FASB's model.

[4] Paragraphs 3 and 23 of AP 5A/ FASB Memo 133 of February 2012.

[5] Paragraph 3 of AP 6A/ FASB Memo 139 of April 2012; paragraph 2 of AP 6B/FASB Memo 152 of May 2012.

[6] 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, the FASB's tentative classification and measurement model requires that an entity consider first the contractual cash flow characteristics of a financial asset and then the business model assessment.

useful information for financial assets with volatile and/or leveraged cash flows[7].

(b) **Amortised cost measurement** – This measurement attribute is designed simply to reflect the payment of interest on an instrument over its life and the repayment of principal, ie it is a simple measurement attribute only suited for instruments with payments that represent solely principal and interest. Both the amortised cost and FVOCI classification categories provide an amortised cost based measurement in profit or loss[8]. This means that only instruments that satisfy the contractual cash flow characteristics assessment are suited to the measurement attribute required in the amortised cost and FVOCI categories.

(c) **The objective of the joint redeliberations** – The key objective of these joint deliberations is to seek to reduce key differences between the boards' *existing* models. As discussed above, under both C&M models financial assets that do not pass the contractual cash flow characteristics assessment would be classified at FVPL.

(d) **The IASB-only objective** – This objective is to limit the change to IFRS 9 and to complete the project expeditiously.

10. The staff is of the view that expanding the use of FVOCI to financial assets that do not pass the contractual cash flow characteristics assessment would involve a major overhaul of IFRS 9 and the FASB's model. If the boards were to pursue this route, the following implications would arise:

(a) For financial assets at FVOCI, the classification would *solely* rely on the business model assessment. In other words, financial assets managed within the relevant business model would be classified *regardless* of their

[7] Under IFRS 9 pre joint deliberations there were only two measurement categories for debt instruments – amortised cost and FVPL. Under the FASB's model, there were three measurement categories for debt instruments – amortised cost, FVOCI and FVPL.

[8] As discussed in AP 6A of May 2012.

contractual cash flow characteristics. Such an approach would be inconsistent with the boards' rationale for requiring the contractual cash flow assessment.

(b) The staff do not believe that the boards intended to ignore the contractual cash flow characteristics in classifying some financial assets. Unless further criteria were introduced, as the boards have tentatively agreed that financial assets shall not be bifurcated, instruments with highly structured features and even stand-alone derivatives could be eligible for FVOCI classification. The staff question whether this would provide useful information. The staff also note that if the boards wanted to introduce new criteria to further subdivide financial assets that do not meet the contractual cash flow characteristics assessment between those that would be allowed or required to be measured at FVOCI and those that must be measured at FVPL, additional time would be required to undertake this effort and a rationale for the distinction would need to be developed. This would also introduce new criteria into the model that were present neither in IFRS 9 nor the FASB's model.

(c) Arguably if financial assets with volatile and/or leveraged cash flows would qualify for other than FVPL, the boards would need to consider whether and why a different approach is justified for financial liabilities.

(d) If the FVOCI category were extended to also include debt instruments that do not meet the contractual cash flow characteristics assessment, the IASB would have two types of instruments that do not meet the assessment in FVOCI, some of which would be recycled and subject to impairment accounting (debt instruments) and some would not (equity instruments). This may necessitate further consideration of the FVOCI option for equity instruments which has been outside the scope of the project to review IFRS 9.

11. The staff do not believe that such a major overhaul of IFRS 9 and the FASB's model was contemplated by the boards. Furthermore, under both current IFRS

and US GAAP derivatives are measured at FVPL. The staff question the appropriateness of introducing changes that could result in either standalone or embedded derivatives and instruments containing a more than insignificant leverage being remeasured through OCI. The staff believe that measuring such instruments at FVOCI would not provide decision useful information for users of the financial statements and that these areas could not be re-considered expeditiously. The staff anticipate that significant time would be added to the project timetable if these areas were to be considered.

12. Accordingly, the staff recommend that the boards re-affirm the previous decisions that the FVOCI category should only be available for financial assets that:

    (a) pass the contractual cash flow characteristics assessment; and

    (b) are managed within the relevant business model[9].

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 12 that the FVOCI category should only be available for financial assets that pass the contractual cash flow characteristics assessment and are managed within the relevant business model?

Question for the FASB
Does the FASB agree with the staff recommendation in paragraph 12 that the FVOCI category should only be available for financial assets that pass the contractual cash flow characteristics assessment and are managed within the relevant business model?

[9] IFRS 9 allows an election for equity investments that are not held for trading to be measured at FVOCI.