

**STAFF PAPER**
**21 May – 25 May 2012**

REG FASB | IASB Meeting

Project	Financial instruments: classification and measurement		
Paper topic	Cover paper		
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This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB *Action Alert* or in IASB *Update*.

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**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).

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The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit [www.ifrs.org](http://www.ifrs.org)

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit [www.fasb.org](http://www.fasb.org)

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. The topics being discussed at this meeting are shaded in grey.

		<i>Contractual cash flow characteristics assessment</i>	
		<i>Cash flows are solely principal and interest (P&amp;I)</i>	<i>Cash flows are not solely P&amp;I<sup>1</sup></i>
<i>Business model assessment</i>	<b>Amortised cost</b>		<b>FVPL</b> (regardless of the
	<b>FVOCI</b>		business model, not eligible in entirety for a measurement category
	<b>Fair value through profit or loss (FVPL)</b>		other than FVPL due to cash flow characteristics)

<sup>1</sup> 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 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 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. Appendix A contains an extract from the February 2012 IASB Update that summarises the tentative decisions made by the boards on this topic.
7. **Business model and the FVOCI measurement category<sup>2</sup>** – 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

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<sup>2</sup> 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 impact the FVOCI designation that is available under IFRS 9 for equity investments on initial recognition.

- activities and the frequency and nature of sales that would prohibit financial assets from qualifying for amortised cost measurement.
8. At this meeting, the staff will ask the boards whether and, if so, how they would like to align their respective business model assessments for the **FVOCI and FVPL** categories. The staff have illustrated the scope of this discussion by shading the relevant boxes in the figure in paragraph 4.
  9. There are three papers:
    - a. IASB AP 6A – An IASB-only paper asking the IASB if they would like to introduce a FVOCI measurement category in IFRS 9. (The FASB’s tentative model already includes a FVOCI measurement category.) This paper also discusses the mechanics of FVOCI measurement, including impairment, interest income recognition and recycling.
    - b. IASB AP 6B/FASB Memo 152 – Discusses how to determine the business model for the classification of eligible financial assets at FVOCI, including whether FVOCI or FVPL should be a ‘residual’ category.
    - c. IASB AP 6C/FASB Memo 153 – Discusses the reclassification of financial assets between measurement categories.
  10. **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.
  11. **Interrelated issues for financial liabilities** – Also in April 2012, the boards considered whether and, if so, how they would like to adjust their current accounting models for financial liabilities including reconsideration of their accounting models in light of the discussions for financial assets. The boards tentatively decided that financial liabilities would 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 would be retained. The FASB will discuss “own credit” presentation requirements at a future FASB-only meeting.
  12. **Other issues** – At a future meeting, the staff will ask the boards to discuss any further interrelated issues including transition, disclosures and other sweep issues.

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Some of these discussions may need to be joint while others may be separate.  
The boards will also separately consider what further changes, if any, they would like to make to their respective models.

## Appendix A – extract from February 2012 IASB Update

The boards discussed the cash flow characteristics assessment and held an education session on the business model assessment in their respective classification and measurement models for financial instruments.

### Proposed approach to the contractual cash flows characteristics assessment

The boards tentatively decided that a financial asset could be eligible for a measurement category other than fair value through profit or loss (FVPL) (depending on the business model within which it is held) if the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (P&I). Interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. Principal is understood as the amount transferred by the holder on initial recognition.

- If the financial asset contains a component other than principal and the consideration for the time value of money and the credit risk of the instrument, the financial asset must be measured at FVPL.
- If the financial asset only contains components that are principal and the consideration for the time value of money and the credit risk of the instrument, but the relationship between them is modified (for example, the interest rate is reset and the frequency of reset does not match the tenor of the interest rate), an entity needs to consider the effect of the modification when assessing whether the cash flows on the financial asset are still consistent with the notion of solely P&I.
- If the financial asset only contains components that are principal and the consideration for the time value of money and the credit risk of the instrument, and the relationship between them is not modified, the financial asset could be eligible for a measurement category other than FVPL (depending on the business model within which it is held).

For the IASB, this is a minor amendment to the application guidance in IFRS 9. For the FASB, this is an amendment to the cash flow characteristics assessment in the tentative

classification and measurement model. All IASB and FASB members voted in favour of the proposed approach.

#### *Contingent cash flows*

The boards tentatively decided that a contractual term that changes the timing or amount of payments of principal and interest would not preclude the financial asset from a measurement category other than FVPL as long as any variability only reflects changes in the time value of money and the credit risk of the instrument.

In addition, the boards tentatively decided that the probability of contingent cash flows that are not solely P&I should not be considered. Financial assets that contain contingent cash flows that are not solely P&I must be measured at FVPL. An exception however will be made for extremely rare scenarios.

For the IASB, this does not represent a change to IFRS 9. For the FASB, the guidance will be included as part of the contractual cash flow characteristics assessment. All IASB and FASB members voted in favour of the decision.

#### *Assessment of economic relationship between P&I*

The boards tentatively decided that an entity would need to compare the financial asset under assessment to a benchmark instrument that contains cash flows that are solely P&I to assess the effect of the modification in the economic relationship between P&I. An appropriate benchmark instrument would be a contract of the same credit quality and with the same terms, except for the contractual term under evaluation.

The boards tentatively decided that if the difference between the cash flows of the benchmark instrument and the instrument under assessment is more than insignificant, the instrument must be measured at FVPL because its contractual cash flows are not solely P&I.

For the IASB, this is a minor amendment to the application guidance in IFRS 9. However, the IASB believe that this change will address application issues that have arisen in the application of IFRS 9. For the FASB, the guidance will be included as part of the contractual cash flow characteristics assessment. Thirteen IASB members and all FASB members voted in favour of the decision. One IASB member voted against.

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*Prepayment and extension options*

The boards tentatively decided that a prepayment or extension option, including those that are contingent, do not preclude a financial asset from a measurement category other than FVPL as long as these features are consistent with the notions of solely P&I.

For the IASB, this does not represent a change to IFRS 9. For the FASB, the guidance will be included as part of the contractual cash flow characteristics assessment. All IASB and FASB members voted in favour of the decision.