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STAFF PAPER

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Project	**Financial instruments: classification and measurement**		
Paper topic	Reclassification of financial assets		
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Purpose of this paper

1. This paper discusses reclassification of financial assets between classification and measurement categories.
   (a) For the IASB, this paper is relevant only if the IASB pursues a third measurement category and decides that some debt investments should be classified and measured at fair value through other comprehensive income (FVOCI) depending on the business model within which they are managed. Specifically, the IASB would need to consider whether the existing reclassification requirements in IFRS 9 *Financial Instruments* would apply to that third measurement category. Consistent with the IASB's previous decision to consider making limited modifications to IFRS 9, this paper does not reconsider reclassification more broadly.
   (b) For the FASB, this paper provides an opportunity to reconsider its decision to prohibit reclassification of financial assets from one classification category to another. The staff analysis includes feedback recently received about whether

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reclassifications should be required or permitted between the categories resulting from the FASB's tentative business model assessment.

2. This paper provides relevant background for the boards, staff analysis and recommendation and asks the boards for decisions.

Background

Past proposals and current requirements for reclassifications – IASB

3. The IASB C&M ED[1] proposed prohibiting reclassifications of financial assets between measurement categories[2]. The IASB believed that requiring (or permitting) reclassifications would not make it easier for users to understand the information about financial instruments and would increase complexity in the accounting for financial instruments. Besides, the IASB believed that reclassification should not be necessary because classification is based on the business model for managing financial assets, which is not expected to change.

4. However, almost all respondents (including most users) argued that prohibiting reclassification is inconsistent with a classification approach that is based on how an entity manages its financial assets. They noted in an approach based on an entity's business model for managing financial assets that reclassifications would provide useful, relevant and comparable information to users because it would ensure that financial statements faithfully represent how those financial assets are managed at the reporting date. In particular, most users stated that, conceptually, reclassifications should not be prohibited when the classification no longer reflects how the instruments would be classified if the items were newly acquired. If reclassification were prohibited, the reported information would not reflect the amounts, timing and uncertainty of future cash flows.

5. The IASB was persuaded by these arguments and decided that reclassification should not be prohibited. The IASB agreed that prohibiting reclassification decreases

[1] The IASB's exposure draft ED/2009/7 *Financial Instruments: Classification and Measurement* (July 2009)

[2] Paragraph 10 of that ED

comparability for like instruments that are managed in the same way. However, the IASB noted that *permitting* reclassification (rather than *requiring* it) would decrease comparability, both between different entities and for instruments held by a single entity, and would enable an entity to manage its profit or loss by selecting the timing of when future gains or losses are recognised. Therefore, the IASB decided that reclassification should be *required* when (and only when) the business model for managing those financial assets changes[3].

6. The IASB noted that, as highlighted by many respondents, such changes in business model would be very infrequent. Accordingly, IFRS 9 requires that such changes must be determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. IFRS 9 provides the following examples of a change in the business model:

   (a) An entity has a portfolio of commercial loans that it holds to sell in the short term, and acquires an entity that holds the loans in order to collect the contractual cash flows, and/or

   (b) A financial services firm decides to shut down its retail mortgage business, stops accepting new business, and is actively marketing it for sale.

7. IFRS 9 also provides guidance on what is *not* a change in business model as follows:
   (a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);
   (b) The temporary disappearance of a particular market for financial assets;
   (c) A transfer of financial assets between parts of the entity with different business models.

8. The IASB also considered whether only *some* reclassifications should be required (eg 'one-way reclassification' whereby reclassification is required only to the fair value

[3] The IASB also considered whether reclassification should be permitted or required when contractual cash flow characteristics of a financial asset vary (or may vary) over that asset's life based on its original contractual terms. However, the IASB noted that, unlike a change in business model, the contractual terms of a financial asset are known at initial recognition. An entity classifies the financial asset at initial recognition on the basis of the contractual terms over the life of the instrument. Therefore the IASB decided that reclassification on the basis of a financial asset's contractual cash flows should not be permitted.

measurement category but is prohibited to amortised cost). Proponents of this approach argued that it might minimise abuse of the reclassification requirements and result in more instruments being measured at fair value. However, the IASB rejected this approach. This is because, in the IASB's view, there is no conceptual reason to require reclassification in one direction but not the other.

9. The IASB considered how reclassifications should be accounted for. Almost all respondents to the ED said that reclassifications should be accounted for prospectively and should be accompanied by robust disclosures. The IASB reasoned that if classification and reclassification are based on the business model within which financial assets are managed, classification should always reflect the business model within which financial assets were managed at the reporting date. In contrast, to apply the reclassification retrospectively would not reflect how the financial assets were managed at the prior reporting dates. Accordingly, the IASB required that reclassification should be accounted for *prospectively* from the reclassification date.

10. The IASB also considered the date at which reclassifications should take effect. The IASB reasoned that entities should be prevented from choosing a reclassification date to achieve a particular accounting result and therefore decided that reclassifications should take effect from the beginning of the following reporting period. The IASB also noted that an entity will most likely disclose a change in business model in its financial statements in the reporting period in which the change in business model takes place because it is a significant and demonstrable event.

11. Finally, consistent with the feedback from constituents, the IASB required robust qualitative and quantitative disclosures to provide transparency about reclassifications. These disclosure requirements are reproduced in Appendix A.

Past proposals and current tentative decisions for reclassifications – FASB

12. Similar to the IASB C&M ED, the FASB's proposed Update[4] would not have permitted reclassifications of financial instruments for changes in business model. An

[4] The FASB Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities — Financial Instruments* (Topic 825) *and Derivatives Hedging* (Topic 815) (May 2010)

entity would be required to determine the classification of financial instruments when the entity initially recognises the financial instruments and would not be allowed to subsequently change that decision. The FASB was concerned about the potential for earnings management. That is, if reclassifications were allowed, entities might reclassify financial assets that were initially classified at amortised cost or FVOCI to FVPL and thus recognise gains in P&L on appreciated financial assets for which an entity is not recognising losses. Besides, the FASB believed that presenting realised gains and losses separately in P&L would be sufficient for users to evaluate management's financial instrument activities.

13. Feedback received from respondents on the FASB's proposed Update generally differs between users of financial statements and other (non-user) respondents about whether reclassifications between categories should be prohibited. Most users of financial statements agree with the proposed Update in that they do not support reclassifications based on changes in an entity's business strategy. Those users of financial statements who do support reclassifications believe that an entity should disclose the reason for the reclassification as well as provide information that describes the effect of the reclassification on the entity's financial statements.

14. Other (non-user) respondents who support using an entity's business strategy as the primary criteria for the classification and measurement of all financial instruments generally also support allowing for reclassifications if the business model changes. Many of the constituents supporting this view, however, agree with users of financial statements that there should be increased transparency and disclosures when reclassifications occur. Nearly all who supported reclassifications encouraged the FASB to provide detailed guidance regarding portfolio turnover and the implications of sales on the (past, current, and future) classification of (current and future) financial assets within a particular business model to avoid confusion and diversity in practice. Non-user respondents who did not support reclassifications believe that allowing reclassifications will reduce comparability and consistency between reporting periods and among entities.

15. Subsequent to the FASB's redeliberations on the proposed Update, the FASB staff performed targeted outreach with preparers (including both public and nonpublic

entities) and auditors to determine the operationality and auditability of the FASB's tentative classification and measurement model[5]. Most preparers and auditors, including nonfinancial institutions and private company preparers, think the proposed classification and measurement model should include reclassifications. Similar to the requirements in IFRS 9, they support requiring reclassifications only when the business model for managing those financial assets significantly changes the entity's operations and is demonstrable to external parties. They think such changes in an entity's business model would be very infrequent but would provide useful, relevant and comparable information to users because it would allow an entity's financial statements to faithfully represent how those financial assets are managed at the reporting date. They also agree that qualitative and quantitative disclosures should be required for reclassifications.

Staff analysis and recommendation

16. The staff note that the boards have received broadly consistent feedback from their constituents. The key themes articulated by constituents are:
    (a) If financial assets are initially classified on the basis of the business model within which they are managed, assets should be reclassified if the business model changes.
    (b) Changes in business model will be very infrequent.
    (c) If the boards' C&M models require reclassification between measurement categories, it should be accompanied by robust disclosures.
17. The staff agree with this feedback and believe that the number of measurement categories does not affect the theme articulated in paragraph 16(a) or the rationale summarised in paragraphs 4 and 14. That is, if classification is based on the business model for managing financial assets, a change in the business model should lead to a change in the assets' classification. Prohibition of reclassification in these circumstances would result in financial assets being classified inconsistently with the

[5] The outreach reflects the tentative decisions reached by the Board through September 7, 2011.

business model within which they are managed and would not provide useful information about the timing, amount and uncertainty of cash flows.

18. The staff believe that there is no conceptual reason to require only *some* reclassifications. In other words, reclassification should be required when there is a change in business model, irrespective of what the prior business model was or what the current business model is. However, the staff agree that such changes will be very infrequent.

19. Accordingly, the staff believe that reclassifications should be accounted for *prospectively* such that financial assets are always classified and measured consistently with the business model within which they are managed. The prospective reclassification would take effect from the beginning of the reporting period following the change in business model.

20. The staff agree with the concerns that *permitting* reclassifications would lead to decreased comparability and the potential for earnings management. However, in the staff view, *requiring* reclassifications accompanied by robust disclosures does not give rise to similar concerns. On the contrary, the staff believe that classifying financial assets in accordance with the business model within which they are currently managed will increase comparability and consistency both between different entities and for instruments held by a single entity.

21. While the staff acknowledge that requiring reclassifications may increase complexity of the C&M model, they believe that this concern is outweighed by the usefulness of the information provided to users of financial statements.

22. Therefore, the staff recommend:
    (a) The IASB extends the current reclassification requirements in IFRS 9 to the FVOCI measurement category. The disclosures requirements in IFRS 7 will apply to all reclassifications.
    (b) The FASB includes a requirement in its tentative C&M model to prospectively reclassify financial assets when (and only when) the business model changes, which should be rare. Business model changes requiring reclassifications must be (i) determined by the entity's senior management as a result of external or internal changes, (ii) significant to the entity's operations and (iii) demonstrable to external parties. This reclassification requirement would be prospective and

would take effect from the beginning of the reporting period following the change in business model.

23. The FASB staff will bring the proposed disclosure requirements to the FASB as a follow-on topic at a future FASB only meeting.

Question for the IASB

Does the IASB agree with the staff recommendation in paragraph 22 that the current reclassification requirements in IFRS 9 should be extended to the FVOCI measurement category?

Question for the FASB

Does the FASB agree with the staff recommendation in paragraph 22 to include a requirement in its tentative C&M model to prospectively reclassify financial assets when (and only when) the business model changes?

Appendix A: IFRS 7—Disclosures for the reclassification of financial assets

12B An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with paragraph 4.4.1 of IFRS 9. For each such event, an entity shall disclose:

(a) the date of reclassification.

(b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.

(c) the amount reclassified into and out of each category.

12C For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified so that they are measured at amortised cost in accordance with paragraph 4.4.1 of IFRS 9:

(a) the effective interest rate determined on the date of reclassification; and

(b) the interest income or expense recognised.

12D If an entity has reclassified financial assets so that they are measured at amortised cost since its last annual reporting date, it shall disclose:

(a) the fair value of the financial assets at the end of the reporting period; and

(b) the fair value gain or loss that would have been recognised in profit or loss during the reporting period if the financial assets had not been reclassified.