

STAFF PAPER

11 – 12 December 2013

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 for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Purpose of paper

1. This paper provides an overview of the redeliberations of the IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) ('the IASB's Limited Amendments ED').
2. This paper provides context for the IASB's discussion at this month's meeting. It is for informational purposes only and thus does not contain any questions for the IASB.

Redeliberations to date

3. **Effective date of IFRS 9 *Financial Instruments* and the 'own credit' requirements**—At the July 2013 meeting, the IASB tentatively decided that the own credit requirements in IFRS 9 should be made available for early application before the completed version of IFRS 9 is issued and that the mandatory effective date of IFRS 9 should be left open pending the finalisation of the impairment and classification and measurement requirements. These amendments were incorporated into IFRS 9 *Financial Instruments* (Hedge Accounting and

amendments to IFRS 9, IFRS 7 and IAS 39), which was issued in November 2013¹.

4. **Contractual cash flow characteristics assessment**—At the September 2013 joint meeting the IASB and the FASB discussed the contractual cash flow characteristics assessment. The boards tentatively decided to clarify the meaning of ‘principal’ and ‘interest’, including the notion of the time value of money, and the application of the solely payments of principal and interest condition to contingent and prepayment features. Some of the tentative decisions made by the boards were the same while others were different. Further detail about the boards’ respective tentative decisions is provided in the IASB Update, which is reproduced in Appendix A to this paper.
5. **Business model assessment**—At the November 2013 joint meeting, the IASB and the FASB discussed the business model assessment. The boards tentatively decided to:
 - (a) clarify the guidance on the business model assessment generally;
 - (b) clarify the guidance on the ‘hold to collect’ business model;
 - (c) retain two fair value measurement categories; that is, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVPL);
 - (d) define the business model that results in measurement at FVOCI and to retain FVPL as the residual measurement category; and
 - (e) clarify the guidance on the FVOCI and FVPL measurement categories.
6. Some of the tentative decisions made by the boards were the same while others were different. Further detail about the boards’ respective tentative decisions is provided in the IASB Update, which is reproduced in Appendix B to this paper.

¹ At the November 2013 meeting, the IASB noted that it will only be able to determine the mandatory effective date after redeliberations on the impairment and classification and measurement requirements have been completed and the issue date of the final version of IFRS 9 is known. However, to assist entities in their planning, the IASB tentatively decided that the mandatory effective date of IFRS 9 will be no earlier than annual periods beginning on or after 1 January 2017.

Topic for this month's meeting

7. **Fair value option**—At this month's meeting, the staff will ask the IASB to consider whether entities should be permitted to designate financial assets that would otherwise be mandatorily measured at FVOCI as measured at FVPL if such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch'), as proposed by the Limited Amendments ED.
8. This is discussed in Agenda paper 6A *Fair value option*.

Next steps

9. At a subsequent meeting, the IASB will discuss the following topics:
 - (a) Interaction between the accounting for financial assets and insurance contract liabilities under the IASB's Insurance Contracts project and the various related issues and alternatives raised in comment letters and outreach activities;
 - (b) Presentation and disclosure requirements proposed in the Limited Amendments ED; and
 - (c) Transition.
10. The staff expects that those discussions will complete the IASB's redeliberations of the proposals in the Limited Amendments ED.

Appendix A

Tentative decisions made by the boards on the Contractual Cash Flow Characteristics Assessment (IASB Update September 2013)

Financial Instruments: Classification and Measurement

The IASB and the FASB discussed clarifications and improvements to the solely principal and interest (P&I) condition in the boards' recent Exposure Drafts.

Agenda Paper 6B

The staff presented the key observations on amortised cost as a measurement basis. The discussion was for educational purposes. No tentative decisions were made.

Agenda Paper 6C

The IASB and the FASB discussed the meaning of 'principal' for the purposes of the application of the solely P&I condition. The boards tentatively decided that principal should be described as the amount transferred by the holder for the financial asset on initial recognition.

Fifteen IASB members and seven FASB members agreed. One IASB member was absent.

Agenda Paper 6D

The IASB and the FASB discussed the meaning of 'interest' for the purposes of the application of the solely P&I condition, including the meaning of 'time value of money' and the application of that concept to regulated interest rates, and tentatively decided to clarify the meaning of interest.

Specifically, the boards tentatively decided:

1. to clarify that de minimis features should be disregarded for classification;
2. to emphasise the underlying conceptual basis for the solely P&I condition—that is, the notion of a basic lending-type return;
3. to confirm that time value of money and credit risk are typically the most significant components of a basic lending-type return however not the only possible components;
4. to clarify that a basic lending-type return also generally includes consideration for liquidity risk, profit margin and consideration for costs associated with holding the financial asset over time (such as servicing costs);
5. to emphasise what are not the components of a basic lending-type return and why (for example, indexation to equity prices); and
6. To clarify the meaning of the time value of money, specifically:
 - a. to clarify the objective of the consideration for the time value of money—that is, to provide consideration for *just* the passage of time, absent return for other risks and costs associated with holding the financial asset over time;
 - b. to articulate the factors relevant to providing consideration for the passage of time—notably, the tenor of the interest rate and the currency of the instrument;
 - c. to clarify that both qualitative and quantitative approaches could be used to determine whether the interest rate provides consideration for just the passage of time, if the time value of money

- component of the interest rate is modified (for example, by an interest rate tenor mismatch feature) but do not prescribe when each approach should be used; and
- d. to not allow a fair value option in lieu of the quantitative assessment.

Fifteen IASB members and seven FASB members agreed. One IASB member was absent.

The boards also tentatively decided to accept regulated interest rates as a proxy for the consideration for the time value of money if those rates provide consideration that is broadly consistent with consideration for the passage of time and do not introduce exposure to risks or volatility in cash flows that are inconsistent with the basic lending-type relationship.

Fifteen FASB members and five FASB members agreed. One IASB member was absent.

The IASB also tentatively decided to provide guidance on how the quantitative assessment of a financial asset with a modified time value of money component should be performed—that is, by considering the contractual (undiscounted) cash flows of the instrument relative to the benchmark instrument—and to replace the 'not more than insignificant' threshold in the boards' proposals by the 'not significant' threshold (that is, a financial asset with the modified time value of money component of the interest rate would meet the solely P&I condition if its contractual cash flows could not be significantly different from the benchmark instrument's cash flows).

Fifteen IASB members agreed. One IASB member was absent.

The FASB directed the staff to perform further analysis of the operational aspects of this assessment.

Agenda Paper 6E

The IASB and the FASB discussed the application of the solely P&I condition to financial assets with contingent features.

The boards tentatively decided to clarify that the nature of the contingent trigger event in itself does not determine the classification of the financial asset. In addition, the boards tentatively decided that in clarifying the guidance on contingent features no distinction should be made between contingent prepayment and extension features and other types of contingent features.

Fifteen IASB members and seven FASB members agreed. One IASB member was absent.

The IASB also tentatively decided to confirm that a contingent feature that results in contractual cash flows that are not solely P&I is inconsistent with the solely P&I condition unless the feature is non-genuine.

Fifteen IASB members agreed. One IASB member was absent.

The FASB tentatively decided that if a contingent feature results in contractual cash flows that are not solely P&I but those non-P&I cash flows have a remote probability of occurrence, it is consistent with the solely P&I condition. If the occurrence of non-P&I cash flows no longer remains remote, an entity will be required to reclassify the financial asset into the FVPL category. However, reclassifications out of the FVPL category will be prohibited.

Four FASB members agreed.

The FASB directed the staff to perform further analysis of contingent features that provide protective rights to

the holder.

Agenda Paper 6F

The IASB and the FASB discussed the application of the solely P&I condition to financial assets with prepayment and extension features.

For contingent prepayment features, the boards tentatively decided to clarify that the nature of the contingent trigger event in itself does not determine the classification of the financial asset. The boards tentatively decided that no distinction should be made between contingent prepayment and extension features and other types of contingent features.

Fifteen IASB members and seven FASB members agreed. One IASB member was absent.

With one exception (see the following tentative decision), the IASB also tentatively decided to confirm that a prepayment feature that results in contractual cash flows that are not solely P&I is inconsistent with the solely P&I condition unless the feature is non-genuine.

Eleven IASB members agreed. One IASB member was absent.

Notwithstanding the previous tentative decision, the IASB tentatively decided to provide an exception for financial assets that meet the following conditions:

1. the financial asset is acquired or originated with a significant premium or discount
2. the financial asset is prepayable at the amount that represents par accrued and unpaid interest (and may include reasonable additional compensation for the early termination of the contract), and
3. the fair value of the prepayment feature on initial recognition of the financial asset is insignificant.

Such financial assets will be eligible for classification at other than FVPL (subject to the business model assessment).

Ten IASB members agreed. One IASB member was absent.

The FASB tentatively decided that if a prepayment feature results in contractual cash flows that are not solely P&I but those non-P&I cash flows have a remote probability of occurrence, it is consistent with the solely P&I condition. If the occurrence of non-P&I cash flows no longer remains remote, an entity will be required to reclassify the financial asset into the fair value through profit or loss (FVPL) category. However, reclassifications out of the FVPL category will be prohibited.

Five FASB members agreed. The FASB's tentative decision is subject to further analysis of contingent features that provide protective rights to the holder, as discussed above.

Next steps

At a future meeting, the boards will consider additional matters related to the solely P&I condition including items raised at today's meeting. After the boards make decisions on clarifying the solely P&I condition, the staff will ask the FASB whether it would like to retain that condition for classifying financial assets or to pursue a different approach. The boards will also discuss the business model criteria at a subsequent meeting.

Appendix B

Tentative decisions made by the boards on the Business Model Assessment (IASB Update November 2013)

Financial Instruments: Classification and Measurement

The IASB and the FASB discussed clarifications to the business model assessment in the boards' recent Exposure Drafts.

Agenda Paper 6A: Overall Business Model Assessment

The boards discussed the meaning of the term *business model*, including the role of cash flow realisation, and the level on which the business model is assessed and tentatively decided to clarify that the business model assessment should:

- a. refer to the actual management of financial assets in order to generate cash flows and create value for the entity—ie whether the likely actual cash flows will result primarily from the collection of contractual cash flows, sales proceeds or both;
- b. allocate financial assets to the measurement attribute that will provide the most relevant and useful information about how activities and risks are managed to generate cash flows and create value; and
- c. be assessed at a level that reflects (groups of) financial assets managed together to achieve a particular (common) objective.

Fifteen IASB members agreed. Seven FASB members agreed.

The boards discussed clarifications of how the business model—and a change in the business model—should be assessed and tentatively decided to clarify that:

- a. The entity's business model for managing financial assets is often observable through particular activities that are undertaken to achieve the objectives of that business model.
- b. Sales do not drive the business model assessment and information about sales activity should not be considered in isolation (as further described in paragraph 76 (a)-(b) of the observer notes for Agenda Paper 6A).
- c. A change in business model will occur only when an entity has either stopped or started doing something on a level that is significant to its operations—and that would generally be the case only when the entity has acquired or disposed of a business line.

Fifteen IASB members agreed. Four FASB members agreed.

The IASB also tentatively decided to clarify that:

- a. Business activities usually reflect the way in which the performance of the business model and underlying financial assets in that business model are evaluated and reported (ie key performance indicators) as well as the risks that typically affect the performance of the business model and how those risks are managed.

- b. An entity should consider all relevant and objective information that is available at the date of the assessment but should not consider every 'what if' or worse-case scenario if the entity does not reasonably expect those scenarios to occur.
- c. If cash flows are realised in a way that is different from the entity's expectations at the date the business model assessment was made, it will neither:
 - i. result in the restatement of prior period financial statements; nor
 - ii. change the classification of the remaining financial assets in the business model

as long as the entity considered all relevant and objective information that was available at the time it made the assessment.

Fifteen IASB members agreed.

In addition, the FASB tentatively decided to converge the guidance in its tentative classification and measurement model with IFRS 9 regarding the date on which reclassification is reflected in the financial statements. Specifically, the FASB tentatively decided that the reclassification date would be the first day of the first reporting period following the change in the business model. The FASB had earlier proposed that the reclassification date should be the last day of the reporting period in which the change in business model occurs.

Four FASB members agreed.

Agenda Paper 6B: Hold to Collect Business Model

The boards discussed clarifications to the hold to collect business model and tentatively decided to clarify the application guidance for the hold to collect business model as set out in paragraphs 62 (a)-(d) of the observer notes for Agenda Paper 6B, specifically:

- a. to reinforce the current hold to collect "cash flows (value) realisation" concept;
- b. to emphasise that insignificant and/or infrequent sales may not be inconsistent with the hold to collect business model;
- c. to clarify that sales information should not be considered in isolation and is not determinative; and
- d. to clarify that credit risk management activities aimed at minimising potential credit losses due to credit deterioration are integral to the hold to collect objective.

Sixteen IASB members agreed. Seven FASB members agreed.

In addition, as part of the clarifications under point (a) above, the FASB tentatively decided that the guidance on the hold to collect business model should emphasise activities aimed at achieving the business model's objective.

Seven FASB members agreed.

The boards tentatively decided that sales made in managing concentration of credit risk should be assessed in the same way as any other sales made in the business model.

Twelve IASB members and four FASB members agreed.

Agenda Paper 6C: Fair Value Categories

The boards discussed the fair value measurement categories.

The boards tentatively decided to retain two fair value measurement categories, that is fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVPL), and to define the business model that results in measurement at FVOCI and to retain FVPL as the residual measurement category.

Twelve IASB and seven FASB members agreed.

The boards tentatively decided to clarify the application guidance for the FVPL measurement category, specifically that:

- a. financial instruments managed and evaluated on a fair value basis or held for trading purposes must be measured at FVPL; and
- b. for financial assets that are measured at FVPL, the entity makes decisions based on changes in- and with the objective of realising the assets' fair value.

Twelve IASB members agreed. Seven FASB members agreed.

In addition, the IASB tentatively decided to clarify that the activities the entity undertakes in the FVPL measurement category are primarily focused on fair value information, and key management personnel uses that fair value information to assess the assets' performance and to make decisions accordingly. In addition, another indicator is that the users of the financial statements are primarily interested in fair value information of these assets in order to assess the entity's performance.

Twelve IASB members agreed.

The boards also tentatively decided to clarify the application guidance for the FVOCI measurement category as set out in paragraph 76 (a)-(c), (d)(ii)-(d)(iv) and (e) of the observer notes for Agenda Paper 6C, specifically that:

- a. In the FVOCI business model, managing financial assets both to collect contractual cash flows and for sale is the outcome of the way in which financial assets are managed to achieve a particular objective rather than the objective itself; that is, the assets classified in FVOCI are managed to achieve the business model objectives (such as liquidity management, interest rate risk management, yield management and duration mismatch management) by both collecting contractual cash flows and selling.
- b. Both collection of contractual cash flows and realisation of cash flows through selling are integral to the performance of the FVOCI business model and that there is no threshold for the frequency or amount of sales in the FVOCI business model.
- c. Particular activities are typically aimed at achieving the FVOCI business model objectives.

Twelve IASB members agreed. Seven FASB members agreed.

The IASB also tentatively decided to clarify that for financial assets in the hold to collect and sell business model, the key performance indicators include the contractual interest yield, impairment charges and fair value changes.

Twelve IASB members agreed.

In addition, the FASB tentatively decided to remove the guidance in the FASB's Exposure Draft requiring an individual asset for which an entity has at initial recognition not yet determined whether it will hold the financial asset to collect contractual cash flows or sell to be measured at FVOCI.

Seven FASB members agreed.

Next steps

The boards will consider the other aspects of their respective proposals at future meetings.