STAFF PAPER

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Prepared for Capital Markets Advisory Committee 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 seek further views from CMAC members on the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9 (2010)*. The detailed questions for CMAC members are outlined in the relevant sections of this paper.

Background

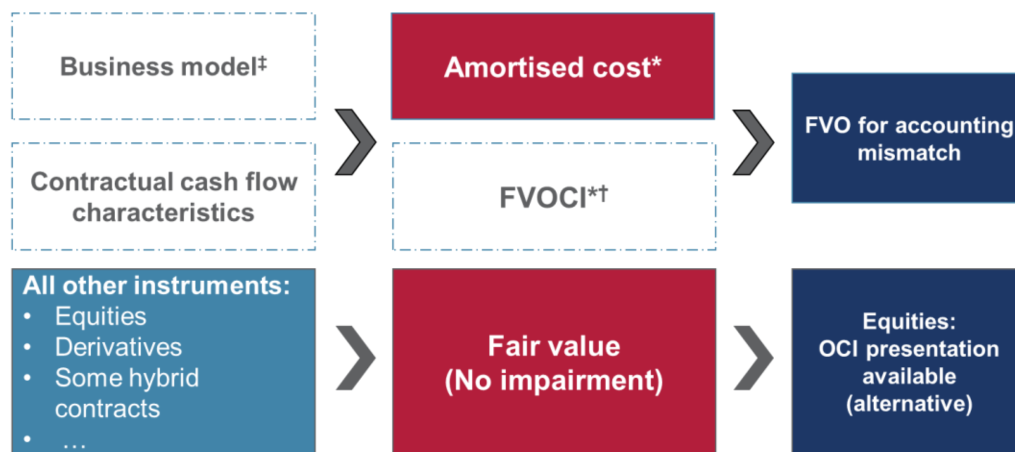
2. This Exposure Draft is a result of the Classification and Measurement phase of the overall project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. It proposes only narrow scope amendments to the requirements for classification and measurement of financial instruments in IFRS 9 *Financial Instruments* (issued October 2010).

3. The IASB believes that IFRS 9 is fundamentally sound and that when classifying financial assets, using a basis that provides information about future cash flows to the users of financial statements, is the right one. The IASB is also mindful to minimise the cost and disruption to entities that have already applied IFRS 9 or who have undertaken significant preparations to do so. Consequently, the Exposure Draft does not change the basic classification criteria that already exist in IFRS 9, that is, the assessment of the business model and the contractual cash flow characteristics. Rather, it re-affirms these principles, clarifies how these principles should be applied

and proposes the introduction of the fair value through other comprehensive income (FVOCI) measurement category that is based on those principles.

4. A preliminary discussion of these proposals was held at the joint Global Preparers Forum and Capital Markets Advisory Committee meeting in June 2012.[1]

5. The following diagram outlines the scope of the proposed amendments to the classification and measurement requirements for financial assets in IFRS 9 (unshaded boxes with dashed outlines):



6. Additional information is available in the *Investor Perspectives* article published about the Exposure Draft at http://www.ifrs.org/Investor-resources/2012-perspectives/December-perspectives/Pages/Patrick-Finnegan-IFRS-9-December-2012.aspx.

Proposed introduction of a FVOCI measurement category

7. The IASB received feedback that having only two measurement categories in IFRS 9 is sometimes too limiting. It doesn't allow entities to properly reflect their business models for managing some financial assets. In particular, some told the IASB that there is a distinct business model in which the financial assets are managed to both collect contractual cash flows and for sale.

[1] See agenda paper from that meeting on the IFRS website: http://www.ifrs.org/Meetings/Documents/CMACwithGPFJun2012/AP1FICM.pdf.

8. For example, some financial institutions manage financial assets both to collect contractual cash flows and to sell the assets to achieve a specific business objective such as liquidity management. Such portfolios could be rebalanced frequently to achieve a desired profile or to comply with regulatory requirements.

9. Currently in IFRS 9, such financial assets will fall into the FVPL measurement category because they are not held to collect contractual cash flows.

10. The FVOCI category addresses these criticisms and is therefore intended to capture the business model where both holding financial assets to collect contractual cash flows and selling financial assets are integral to the entity's objective in managing the financial assets.

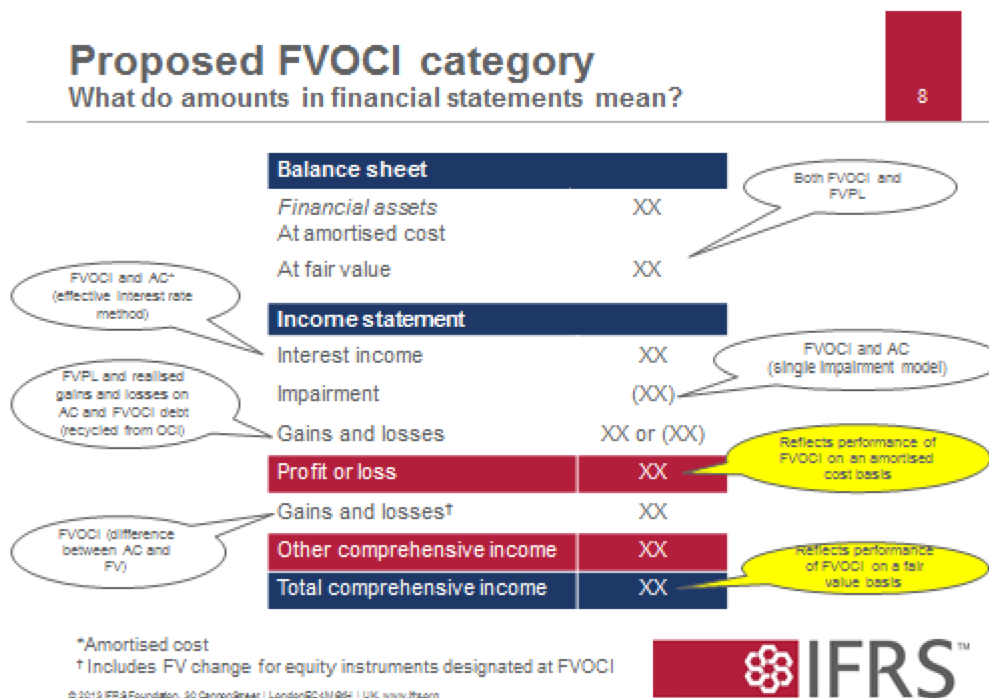
11. Some examples of debt investments that would be consistent with the objective of the FVOCI business model include:

    (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 financial institution holds financial assets to meet its everyday liquidity needs. The entity seeks to minimise the costs of managing its liquidity needs and therefore actively manages the contractual yield on the financial assets. The entity would hold some assets to collect contractual cash flows and sell other financial assets to reinvest in higher yielding financial assets or to better match the duration of liabilities.

    (c) Example 3: 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.

12. The IASB concluded that in assessing performance of financial assets managed both to collect contractual cash flows and to sell, both fair value and amortised cost information are relevant and must be provided in the primary financial statements. Under the proposals, profit or loss will reflect the performance on an amortised cost basis and total comprehensive income will reflect the performance on a fair value basis. Debt investments classified at FVOCI will be subject to the same impairment and interest revenue recognition models as financial assets measured at amortised cost. In addition, any gain or loss on derecognition of such instruments will be reclassified (ie recycled) from other comprehensive income (OCI) to profit or loss.



13. The proposed FVOCI category also takes into account the interaction between classification and measurement of financial assets and insurance contract liabilities under the IASB's tentative decisions in the Insurance Contracts project. Those decisions will require changes in the discount rate of insurance contract liabilities to be recognised in OCI rather than profit or loss.

Question 1
Do you think it is appropriate to measure simple debt instruments at FVOCI if they are managed both in other to collect contractual cash flows and for sale?

Question 2
Do you think both amortised cost and fair value information is relevant for these debt instruments and should be provided in the primary statements?

Transition

14. At present, more than one version of IFRS 9 can be applied early. An entity is permitted to early apply either the classification and measurement requirements for financial assets only (ie IFRS 9 issued in 2009) or the classification and measurement requirements for both financial liabilities and financial assets (ie IFRS 9 issued in 2010). To enhance comparability, the Exposure Draft proposes that after IFRS 9 is completed only that completed version of IFRS 9 (ie including classification and measurement, impairment and general hedge accounting chapters) can be early applied[2] (except as described below).

15. The Exposure Draft also proposes that an entity will be permitted to apply early just the own credit requirements without applying the other requirements of IFRS 9 from the same date. Those are the requirements to present changes in the fair value of an entity's financial liabilities due to changes in their credit quality in other comprehensive income rather than in profit or loss. Effectively, this will result in entities being able to continue applying the IAS 39 requirements while presenting own credit changes in OCI.

Question 3
Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (ie including all chapters)? If not, why?

[2] Entities that have already applied an earlier version of IFRS 9 by the time these proposed transition provisions become effective will be permitted to continue to apply that version until the mandatory effective date of IFRS 9 or until the entity chooses to early apply the completed version of IFRS 9.

Question 4
Do you agree that entities should be permitted to apply the own credit requirements in IFRS 9 early even if they do not yet apply the other requirements in IFRS 9?