STAFF PAPER

18-21 November 2013

REG FASB | IASB Meeting

Project	**Financial Instruments: Classification and Measurement**		
Paper topic	Cover paper		

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Purpose of the paper

1. This paper provides a brief background of the boards' respective projects on the classification and measurement of financial instruments and an overview of the joint redeliberations. In particular, this paper provides a summary of:
   (a) the agenda papers on the business model assessment for this month's joint board meeting;
   (b) the joint redeliberations to date, notably on the contractual cash flow characteristics assessment; and
   (c) the next steps.
2. This cover paper is for information purposes only.

Background

3. To increase international comparability in the accounting for financial instruments, the boards decided in January 2012 to jointly deliberate selected aspects of their classification and measurement models. With the objective of reducing key differences, the boards jointly discussed the following topics:

(a) the contractual cash flow characteristics of financial assets, including the need for bifurcation of financial assets and if pursued, the basis for bifurcation;

(b) the basis for and the scope of a possible *fair value through other comprehensive income (FVOCI) measurement category* for financial assets; and

(c) interrelated issues from the topics above (for example, disclosures and the model for financial liabilities).

4. These joint deliberations resulted in the publication 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') and the FASB's proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ('the FASB's proposed ASU').

5. In May 2013, the staff presented to the boards the summary of the feedback received on the IASB's Limited Amendments ED. In June 2013, the staff presented to the boards an update on the IASB's user outreach activities and a summary of the outreach and comment letter feedback received on the FASB's proposed ASU. In July 2013, the staff presented to the boards the plan for joint redeliberations.

6. That plan has been developed on the basis of the feedback received on both the IASB's Limited Amendments ED and the FASB's proposed ASU and reflects the fact that the boards had different starting points in the joint deliberations and therefore the scope of their respective proposals was different. That is, the IASB proposed *limited* amendments to the *existing* classification and measurement requirements in IFRS 9 for financial assets whereas the FASB proposed a *comprehensive new* classification and measurement model for financial instruments.

7. Accordingly, some of the topics will be re-deliberated jointly whereas other topics will be re-deliberated separately. For example, at the July IASB-only meeting, the

staff asked the IASB to consider transition requirements for the 'own credit' provisions in IFRS 9 and IFRS 9's mandatory effective date.

Joint redeliberations

Business model assessment

The objective and scope of the series of papers on the business model assessment

8. The business model assessment will be discussed at this month's joint board meeting. The aspects of the business model assessment for the boards' redeliberations have been identified on the basis of the feedback received from constituents and are discussed in the following three papers:

   (a) Agenda Paper 6A / FASB Memo 249R *Business Model Assessment: Overall business model assessment*

   (b) Agenda Paper 6B / FASB Memo 250R *Business Model Assessment: Hold to Collect Business Model*

   (c) Agenda Paper 6C / FASB Memo 251R *Business Model Assessment: Fair Value Categories*

9. These three papers were discussed at the boards' joint education session in October but have been updated to clarify particular points and respond to some questions raised by board members. An overview of those papers is provided below.

Agenda Paper 6A / FASB Memo 249R Business Model Assessment: Overall business model assessment

10. This paper focusses on the business model assessment generally. The topics discussed in that paper are relevant to all of the measurement categories in the boards' classification and measurement model for financial assets.

11. The staff do not recommended any fundamental changes to the business model assessment. Instead the staff propose clarifications to the application guidance in IFRS 9 (as amended by the IASB's Limited Amendments ED) and the FASB's proposed ASU on the overall business model assessment. Specifically the staff propose to clarify:

    (a) the meaning of 'business model', including the role of cash flow realisation;

    (b) the level on which the business model is assessed;

    (c) the information that should be considered when making the assessment;

    (d) the role of sales in the business model assessment; and

    (e) a change in business model.

Agenda Paper 6B / FASB Memo 250R Business Model Assessment: Hold to Collect Business Model

12. This paper focusses on the hold to collect business model assessment for financial assets classified at amortised cost. Specifically this paper proposes clarifications to the assessment of the hold to collect business model and the role of sales in that assessment.

Agenda Paper 6C / FASB Memo 251R Business Model Assessment: Fair Value Categories

13. This paper considers the business model assessment in the context of the two fair value measurement categories: FVOCI and FVPL. It does not discuss the fair value option (FVO), which the staff will bring to the boards at a later date.

14. This paper first considers whether the FVOCI category should be retained as a distinct measurement category and, if so, whether the FVOCI category should be defined, with the FVPL category being the residual category (as proposed by both boards).

15. It then proposes clarifications to the articulation and assessment of the FVOCI and FVPL categories.

Contractual cash flow characteristics assessment

16. At the September 2013 meeting, the boards considered various aspects of the solely principal and interest ('P&I') condition. Specifically, the boards discussed:

    (a) the objective and mechanics of amortised cost as a measurement category;

    (b) the meaning of 'principal';

    (c) the meaning of 'interest', including the meaning of 'time value of money';

    (d) contingent features; and

    (e) prepayment features.

17. The boards tentatively decided to clarify the meaning of 'principal' and 'interest' and the application of the solely P&I condition to contingent and prepayment features. Some of the decisions made by the boards were the same while others were different. The tentative decisions made by the boards, as summarised in the IASB Update and FASB's September 18, 2013 Joint FASB/IASB Board Meeting: Summary of Board Decisions, are included in Appendix A to this paper.

18. At a future meeting, the boards will consider additional matters relating to the solely P&I condition. In addition, the staff will ask the FASB whether it would like to retain that condition for classifying financial assets or to pursue a different approach.

Next steps

19. At a subsequent meeting, the staff will ask the boards to consider any additional interrelated issues that may arise from the joint re-deliberations. Some of these discussions may need to be joint while others may need to be separate.

20. The staff anticipate that re-deliberations on the joint topics, as well as the IASB only re-deliberations, will be substantially complete by the end of 2013. The

FASB will continue to expeditiously consider the feedback received on its proposed ASU.

Appendix A: Tentative decisions made by Boards on the Contractual Cash Flow assessment (September 2013)

Financial Instruments: Classification and Measurement[1]

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;

[1] Extracted from the IASB Update and the FASB's September 18, 2013 Joint FASB/IASB Board Meeting: Summary of Board Decisions

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.