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STAFF PAPER

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Project	**Financial Instruments: Impairment**
Paper topic	Financial assets measured at FVOCI

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Introduction

Purpose of the paper

1. In November 2012 the IASB issued the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* ('the Limited Amendments ED'). The Limited Amendments ED proposed a new mandatory measurement category for eligible[1] financial assets, namely, fair value through other comprehensive income (FVOCI).

2. The Exposure Draft *Financial Instruments: Expected Credit Losses* ('the ED') proposed to include financial assets mandatorily measured at FVOCI within its scope. Furthermore, the ED proposed that the general model[2] should apply to those financial assets.

3. Whether these proposals are included in the final version of IFRS 9 *Financial Instruments* (IFRS 9) will depend on the outcome of the redeliberations on the classification and measurement project. This paper considers the treatment of expected credit losses of financial instruments at FVOCI if this category is included in the final version of IFRS 9. This paper considers the *timing of*

[1] Financial assets that meet the contractual cash flow characteristics condition and that are managed both to collect the contractual cash flows and for sale.

[2] In applying the general model, an entity recognises (i) lifetime ECL for financial instruments whose credit risk has significantly increased; and (ii) 12-month expected credit losses for all other instruments.

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recognition of expected credit losses (ECL) on financial assets mandatorily measured at FVOCI. It does not consider the *measurement* of expected credit losses. That was discussed in Agenda Paper 5C *Measurement of expected credit losses* at the IASB meeting in October 2013.

4. For ease of reference, Appendix A includes an extract from the ED to illustrate the proposals, namely Example 10—Debt instruments mandatorily measured at FVOCI.

Background

5. One of the weaknesses identified by the Financial Crisis Advisory Group (FCAG) in its 2009 report was the complexity of having multiple impairment approaches. In particular, IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) currently measures impairment on financial assets classified as 'loans and receivables' and 'held to maturity' on the basis of shortfalls in contractual cash flows, whereas for available-for-sale (AFS) financial assets it is measured based on fair value. Consequently, identical assets can have different bases of impairment measurement that are simply due to their classification.

6. In response to this identified weakness, the IASB has aimed to achieve a single impairment model for all financial instruments. The Basis for Conclusions to the ED states the following:

> BC55 In the IASB's view, applying a single expected credit loss model to both financial assets at amortised cost and financial assets at FVOCI ensures comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics. In addition, a single expected credit loss model reduces a significant source of complexity for entities compared with applying IAS 39…
>
> BC174 The impairment of debt instruments that are classified as available-for-sale financial assets under IAS 39 is one of the requirements that is most heavily criticised by users of financial statements, as it is based on fair value fluctuations and not aligned with the impairment

> model applied to similar financial assets measured at amortised cost.

7. When the new FVOCI measurement category was proposed, the IASB noted in the Limited Amendments ED:

> BC22 The IASB therefore decided that the fair value through other comprehensive income measurement category should result in a fair value carrying amount in the statement of financial position and amortised cost information being provided in profit or loss. Accordingly…
>
> (b) impairment should be recognised in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost…

8. Accordingly, the IASB proposed that the general model in the ED should apply to financial assets measured at FVOCI in order toaddress the weakness of having multiple impairment approaches.

Summary of staff recommendations

9. We recommend that the IASB should:

    (a) not introduce a specific practical expedient for financial assets measured at FVOCI; and

    (b) clarify that expected credit losses reflect management's expectations about credit risk, including consideration of market information, rather than the market's assessment of credit risk.

Structure of the paper

10. The paper is set out as follows:

    (a) detailed feedback received (paragraphs 11-17);

    (b) staff analysis (paragraphs 19-37); and

    (c) staff recommendations and questions to the IASB (paragraphs 38-42).

Detailed feedback received

11. Respondents were almost unanimous in their support for including financial assets measured at FVOCI within the scope of the proposed impairment model. These respondents agreed that:

    (a) a single impairment model for all financial assets reduces the complexity of current IFRS; and

    (b) prevents the delayed recognition of expected credit losses (ECL) in profit or loss for financial assets measured at FVOCI, compared to the requirements in IAS 39 for AFS debt instruments.

12. A few respondents did not support including financial assets measured at FVOCI within the scope of the proposals and instead preferred the current impairment requirements for AFS debt instruments in IAS 39. To summarise the current requirements, an entity would recognise an impairment allowance on AFS debt instruments in profit or loss when there is objective evidence of impairment and the impairment amount is based on fair value.

13. The majority of respondents that supported including financial assets measured at FVOCI within the scope of the proposed impairment model agreed that the general model should apply to these financial assets.

14. However, some respondents proposed that the IASB should include a practical expedient for financial assets measured at FVOCI. Respondents suggested a number of alternatives to form the basis of such a practical expedient.

    (a) Some were variants of the FASB's proposed practical expedient (see paragraph 18), which was to not recognise 12-month ECL when:

        (i) only either one of the criteria for the FASB's proposed practical expedient is met, rather than both;

        (ii) the fair value of the financial asset exceeds its amortised cost (ie only criterion (a) of the FASB proposal); or

        (iii) the loss allowance is insignificant (ie only criterion (b) of the FASB's proposal).

    (b) Other respondents however proposed that for financial assets measured at FVOCI an entity should be allowed to:

(i) not recognise a 12-month ECL allowance at all; or

(ii) not recognise a 12-month ECL for financial assets that are of 'low credit risk'[3].

15. Respondents argued that by introducing a practical expedient:

(a) the operational burden of assessing significant increases in credit risk and measuring ECL would be reduced. They argued that these assets are already measured at fair value in the balance sheet and the expected credit losses are therefore correctly reflected being inherent in that value;

(b) the amount presented in other comprehensive income (OCI) would not be a meaningful number because it is the contra entry for the ECL recognised in profit or loss; and

(c) it would not be appropriate to recognise initial ECL in profit or loss for financial instruments purchased in an active market that prices the ECL into the instrument.

16. Others however did not believe that any specific practical expedients were necessary. Instead they argued that if a financial asset is considered to be of low credit risk, the 'low credit risk' exemption would apply and the 12-month ECL amount is likely to be insignificant. The entity may accordingly not need to recognise a loss allowance for ECL simply on the basis of materiality.

17. Lastly, based on our outreach performed and comment letters received, we also identified some areas to clarify. We discuss these in paragraphs (39-42).

FASB proposals

18. In its Proposed Accounting Standards Update *Financial Instruments – Credit Losses (Subtopic 825-15)* (proposed ASU) the FASB also included assets measured at FVOCI within the scope and generally ECL, if recognised, are measured in the same way as for other assets (ie based on shortfalls in contractual cash flows and based on a lifetime measurement). However, the FASB proposed a specific practical expedient for financial assets at FVOCI, namely:

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[3] Refer to Agenda Paper 5B *Operational Simplifications: 30dpd and low credit risk* discussed at the IASB meeting in October 2013.

> 825-15-25-2 **If both of the following conditions are met** as of the reporting date, as a practical expedient, an entity **may elect** not to recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income:
>
> a. The fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset.
>
> b. Expected credit losses on the individual financial asset are insignificant, which may be determined by considering the general expectation of the range of expected credit losses given the credit-quality indicator(s) for the asset as of the reporting date. [emphasis added]

Staff analysis

19. The IASB noted the following in paragraph BC55 of the ED:

> In the IASB's view, applying a single expected credit loss model to both financial assets at amortised cost and financial assets at FVOCI ensures comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics. In addition, a single expected credit loss model reduces a significant source of complexity for entities compared with applying IAS 39.

20. As noted in paragraph 11 above, the proposal to include financial assets measured at FVOCI within the scope received very strong support. Accordingly, we do not intend to discuss this aspect of the proposals again. Instead, we are only discussing whether the general model should apply, or whether the IASB should introduce some type of practical expedient for financial assets measured at FVOCI.

21. As noted in paragraphs 13-14, the majority of respondents agreed that the general model should apply to financial assets at FVOCI. However, a number of respondents proposed that the IASB should include a practical expedient for

financial assets measured at FVOCI, primarily because the assets are already at fair value on the balance sheet. Namely:

(a) some proposed a practical expedient similar to the FASB proposal; while

(b) others proposed not to recognise a 12-month ECL allowance but that lifetime ECL should be recognised when there have been significant increases in credit risk.

22. Regardless of their detailed views, the vast majority of respondents agreed that the recognition of lifetime ECL in profit of loss (based on shortfalls in contractual cash flows) was appropriate when there were significant increases in credit risk. We will therefore focus our analysis only on the 12-month ECL allowance for financial assets measured at FVOCI.

Approaches proposed by respondents

23. In our view, the alternatives proposed (see paragraph 14) can be grouped into two broad themes, each of which we will consider in more detail below:

(a) no 12-month loss allowance when particular conditions are met; or

(b) no 12-month loss allowance when ECL is immaterial.

No 12-month loss allowance when particular conditions are met

24. Respondents proposed that a 12-month loss allowance should not be recognised for financial assets measured at FVOCI either when:

(a) the fair value of the financial asset exceeds its amortised cost; or

(b) the financial asset is considered 'low credit risk'.

Fair value-based assessment

25. Respondents that favour this approach argued that when financial instruments are acquired in an active market at fair value, the fair value already incorporates the initial ECL. Consequently, as long as the fair value exceeds the amortised cost carrying amounts, the initial ECL have not increased and are appropriately

accounted for. To recognise 12-month ECL when there has not been a significant increase in credit risk would double-count the initial expected credit losses.

26. We acknowledge this argument. However, we reject it because is not limited to financial instruments that are acquired in an active market at fair value. This also holds true for originated financial instruments. Originated financial assets are also on 'market terms' (as reflected in their pricing). Both financial assets measured at amortised cost and those measured at FVOCI are initially recognised at fair value in IFRS. In addition, the proposed classification and measurement model is based on financial assets with similarly 'simple' cash flows being measured at amortised cost and FVOCI, with the same information being included in profit or loss. In addition, the proposed FVOCI business model applied when an aspect of the business model is to collect contractual cash flows. This means that impairment information is as relevant for this business model as it is for items measured at amortised cost. The IASB stated in paragraph BC175 of the ED:

> Similar to financial assets that are measured at amortised cost, the contractual cash flow characteristics of financial assets mandatorily measured at FVOCI would solely represent payments of principal and interest. The IASB therefore believes that an impairment approach that is based on expected future cash flows and changes in credit quality, rather than changes in fair value, more faithfully reflects the economic reality of expected credit losses that are associated with these financial assets. It is also consistent with both amortised cost and fair value information about these financial assets being provided to the users of financial statements.

27. We agree with the respondents who recommended that the recognition of a loss allowance should not depend on amortised cost exceeding fair value. These respondents argued that the mere fact that the fair value of the financial asset is less than amortised cost does not indicate that there has been an increase in credit risk. Changes in fair value could result from changes in other market risks such as interest rates. We agree with this and continue to believe that increases in credit risk are indicated by changes in the risk of default of the borrower. This is consistent with the current IAS 39, which states:

> Par 60 …A decline in fair value of a financial asset below its cost or amortised cost is not necessarily evidence of impairment…

Financial asset is considered low credit risk

28. Respondents that favour this approach or who favour not recognising ECL on low credit risk FVOCI assets argued that:

    (a) when financial instruments are acquired in an active market at fair value, the fair value already incorporates the initial ECL (similar to paragraph 25); and

    (b) the expected credit losses for instruments that are low credit risk and measured at FVOCI are immaterial (we discuss this in paragraphs 35-37)

29. We note that the ED already includes operational relief for instruments that are low credit risk from recognising lifetime ECL and assessing whether credit risk has significantly increased[4]. In the Basis for Conclusion to the ED the IASB stated:

> BC208 In order to reduce operational burden… this Exposure Draft does not require an entity to recognise lifetime expected credit losses on financial instruments with low credit risk at a reporting date (irrespective of their change in credit risk). Consequently, an entity will not need to assess the change in credit quality from initial recognition for financial instruments that have a low credit risk on a reporting date…

30. This IASB tentatively confirmed this exemption at its October 2013 meeting, at which the IASB tentatively decided:

> that an entity can assume that a financial instrument has not significantly increased in credit risk if it is low credit risk at the reporting date…

[4] Refer to Agenda paper 5B of the October 2013 IASB meeting.

> when an instrument is no longer low credit risk, an entity would assess whether there has been a significant increase in credit risk to determine whether lifetime expected credit losses should be recognised…[5]

31. If the IASB were to consider introducing an *additional* practical expedient for low credit risk FVOCI assets, it would also have to consider whether 'significant increase in credit risk' is still the appropriate point to start recognising lifetime ECL, or whether an entity may need to recognise an allowance for increases in credit risk before such point. If the IASB were to conclude that an entity would need to recognise an allowance before there is a significant increase in credit risk, it would have to consider what amount of allowance should be recognised.

32. It is also worth considering why the IASB decided that the same impairment model should apply both to financial assets measured at FVOCI and to those measured at amortised cost. In the Limited Amendments ED, the IASB stated that:

> BC19 …financial assets should be mandatorily measured at fair value through other comprehensive income if, and only if, they
>
> (a) have contractual cash flow characteristics that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (paragraph BC46); and
>
> (b) are managed within the relevant business model (described in the following paragraph).
>
> BC20 …if the entity's business model is to manage financial assets both to collect contractual cash flows and to sell, financial assets managed within that business model should be measured at fair value through other comprehensive income (depending on their contractual cash flows)…

[5] The IASB Update for October 2013 can be accessed at: http://www.ifrs.org/Updates/IASB-Updates/Pages/IASB-Updates.aspx

> BC140 …the fair value through other comprehensive income measurement category results in a fair value carrying amount in the statement of financial position **while the effect on profit or loss would be the same as if the financial assets were measured at amortised cost**. This is considered appropriate for such a business model because, by design, both holding and selling activities are taking place, making both amortised cost and fair value information relevant to the financial statements. [emphasis added]

33. Consequently, because the collection of contractual cash flows is as important for financial assets measured at FVOCI as for financial assets measured at amortised cost, the IASB believed that the information in profit or loss should be the same as for financial assets measured at amortised cost. This implies that information about the non-collectability of those contractual cash flows is equally relevant, ie ECL should be recognised in the same way for both financial assets measured at FVOCI and those that are measured at amortised cost.

Staff recommendation

34. On the basis of the arguments above, we **do not recommend** that the IASB should include relief from recognising 12-month ECL for financial assets measured at FVOCI, because:

    (a) a fair value-based practical expedient is inconsistent with the general model, which is based on an entity's assessment of the changes in the risk/probability of a default occurring;

    (b) introducing a fair value-based or low credit risk practical expedient represents a different impairment approach and would be inconsistent with the IASB's objective of having a single impairment model for all financial assets measured at amortised cost and FVOCI; and

    (c) such an approach would result in the treatment in profit or loss not being the same for financial assets measured at amortised cost and those measured at FVOCI (see paragraph 7). Accordingly the IASB would not provide the information it had sought to achieve for this business model in the Classification and Measurement project.

No loss allowance when ECL is immaterial

35. Some respondents proposed that the IASB should include a practical expedient not to recognise ECL on financial assets measured at FVOCI when the ECL are immaterial.

36. We note that IFRSs have as an overriding principle that the accounting policies in the various IFRSs need not apply if the effect is immaterial (refer to IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* paragraph 8). Some respondents also made this observation in their comment letters.

37. Accordingly, we **do not recommend** that the IASB provide an additional exemption to this effect in the impairment proposals. Furthermore, by including an explicit statement to that effect in one IFRS, we believe would risk implying that the same is not true for other IFRSs.

Staff recommendation

38. On the basis of our analysis in paragraphs 19-37 we **do not recommend** providing relief from recognising 12-month ECL as a practical expedient for financial assets measured at FVOCI.

Question 1 to the IASB
Does the IASB agree with the staff recommendation to not provide relief from recognising 12-month ECL as a practical expedient for financial assets measured at FVOCI?

Clarification of requirements—ECL do not necessarily represent the market assessment of credit risk

39. A few respondents had questioned whether an entity's estimates of ECL are the same as the fair value changes attributable to changes in credit risk for financial assets measured at FVOCI.

40. Fair value changes attributable to credit risk reflect market participants' view of credit risk and are based on information available in the market.

41. In contrast, the ECL allowances reflect management's own assessment of the collectability of contractual cash flows, which includes market inputs. However, management may have additional information at its disposal to estimate ECL; for example technical defaults. Furthermore, in our outreach, respondents have said that they believed they often have more up-to-date or timely borrower-specific information on ECL than do other market participants. This was especially the case for entities that rely on external credit rating information. Preparers noted that credit rating agency information may often be lagging more up-to-date borrower-specific information. However, they acknowledged that market prices and information are relevant to the assessment of increases in credit risk.

42. We recommend that in drafting we clarify that expected credit losses reflect management's expectation of credit risk rather than the market's assessment of credit risk and acknowledge that market information is a relevant consideration for management in making that assessment.

Question 2 to the IASB
Does the IASB agree with the staff recommendation to: - clarify that expected credit losses reflect management's expectation of credit risk rather than the market's assessment of credit risk and acknowledge that market information is a relevant consideration for management in making that assessment?

Appendix A

Extract of Example 10 from the Exposure Draft[6]

Example 10—Debt instruments mandatorily measured at FVOCI

IE63 An entity purchases a debt instrument with a fair value of CU1,000 on 1 January 20X0 and classifies the debt instrument as mandatorily measured at FVOCI. The instrument carries a market-related interest rate of 5 per cent over the contractual term of ten years, and has a 5 per cent effective interest rate. At initial recognition the entity determines that the asset is not credit-impaired. The entity recognises an impairment loss in profit or loss at an amount equal to 12-month expected credit losses of CU20. The journal entries to recognise the debt instrument and the expected credit losses on 1 January 20X0 would be as follows:

	Debit	**Credit**
Financial asset—FVOCI	CU1,000	
Cash		CU1,000
Impairment (profit or loss)	CU20	
Other comprehensive income		CU20

IE64 Disclosure would be provided about the ‘loss allowance’ amount of CU20.[7]

IE65 On 31 December 20X0 (the reporting date), the fair value of the debt instrument has decreased to CU950 as a result of changes in market interest rates and an increase in expected credit losses. The entity determines that there has not been a significant increase in credit risk since initial recognition and that it is still appropriate to measure expected credit losses at an amount equal to 12-month expected credit losses. However, the expected credit losses have increased by CU10 (ie from CU20 to CU30).[8] The journal entries to recognise the increase in expected credit losses and the changes in the fair value of the instrument would be as follows:

	Debit	**Credit**
Impairment (profit or loss)	CU10	
Other comprehensive income	CU40	
Financial asset—FVOCI		CU50

IE66 Disclosure would be provided about the accumulated impairment amount (the ‘loss allowance’) of CU30.

[6] *Some respondents were concerned that this example implied that an allowance must be recognised* at the date of acquisition*, even if that was not a reporting date. This concern will be addressed in drafting.*

[7] The presentation of a loss allowance balance in the statement of financial position is prohibited (see ED 2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*, which proposes to add paragraph 16A to IFRS 7). However, disclosure of ‘loss allowance’ information is still required.

[8] For simplicity, journal entries for the receipt of interest revenue are not provided.

IE67 On 1 January 20X1, the entity decides to sell the debt instrument for CU950, which is its fair value at that date. The journal entries to derecognise the debt instrument and reclassify the gains and losses that have accumulated in other comprehensive income would be as follows:

	Debit	**Credit**
Cash	CU950	
Financial asset—FVOCI		CU950
Loss on sale (profit or loss)	CU20	
Other comprehensive income		CU20