

STAFF PAPER

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| Project | Financial Instruments: Classification and Measurement | | |
|-------------|---|--|--------------------|
| Paper topic | Contractual Cash Flow Characteristics: The Meaning of ‘Principal’ | | |
| CONTACT(S) | Yulia Feygina | yfeygina@ifrs.org | +44(0)20 7332 2743 |
| | Rahul Gupta | rgupta@fasb.org | +1 203 956 5317 |
| | Nicholas Milone | nkmilone@fasb.org | +1 203 956 5344 |
| | Alex Debbink | amdebbink@fasb.org | +1 203 956 5296 |

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Purpose and structure of the paper

1. This is the second paper in the series of papers for the September joint board meeting on the **solely principal and interest (‘P&I’) condition** in IFRS 9 *Financial Instruments* 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’).
2. The objective of this paper is to clarify the meaning of ‘principal’ in the context of the solely P&I condition. In that regard, this paper:
 - (a) provides relevant background information, including:
 - (i) a summary of—and staff observations on—the current articulation of ‘principal’ in IFRS 9 and the FASB’s proposed ASU, and
 - (ii) a brief overview of the relevant feedback received on the IASB’s exposure draft ED/2012/4 *Classification and*

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Measurement: Limited Amendments to IFRS 9 (Proposed amendments to IFRS 9 (2010)) ('the Limited Amendments ED') and the FASB's proposed ASU;

- (b) discusses possible alternatives for how 'principal' could be described, and the implications of those alternatives; and
- (c) provides a staff recommendation on the articulation of 'principal' and a question for the boards.

Background

Current language

3. Principal is not defined in IFRS 9. However, paragraph BC4.23 of IFRS 9 states that 'cash flows that are interest always have a close relation to the amount advanced to the debtor (the 'funded amount')'. Agenda Paper 5A/FASB Memo 133 of February 2012 ('the February 2012 paper') refers to this language in IFRS 9 and describes it as 'economic principal.'
4. Consistent with the boards' discussion at their meeting in February 2012, the FASB's proposed ASU (specifically ASC 825-10-15-18) described principal as 'the amount transferred by the holder on initial recognition.'
5. While the language in IFRS 9 and the FASB's proposed ASU is different, the staff believe that the boards did not intend to have different meanings for the term 'principal'. Indeed the staff note that the amount advanced to the debtor (as described in IFRS 9) and the amount transferred by the holder (as described in the FASB's proposed ASU) would be the same on the origination of the instrument.¹
6. In the staff's view, the wording in paragraph BC4.23 of IFRS 9 and the wording in the FASB's proposed ASU are different because they were designed for

¹ The entire amount transferred by the holder *in the transaction* may also include transaction costs. However the amount transferred by the holder *to the debtor for the asset* is the same.

different purposes. Specifically, the language in paragraph BC4.23 of IFRS 9 was not intended to constitute a definition of principal. Rather, it was intended to explain the notion of a simple lending-type return and emphasise the close relationship between ‘principal’ and ‘interest’ in such basic lending transactions. The staff acknowledge that the language in paragraph BC4.23 focuses only on the origination of a financial asset.

7. In contrast, the FASB’s proposed language sought to define the term principal and thus captures *both* the origination of a financial asset and the acquisition of a financial asset in a secondary market.
8. The language in both IFRS 9 and the FASB’s proposed ASU discusses the meaning of principal only on the *initial recognition* of the instrument. In other words, the language in those documents does not reflect the fact that the amount of principal may change over the life of the instrument—for example, if principal is repaid over the instrument’s life.
9. Finally, the language in both IFRS 9 and the FASB’s proposed ASU describes principal by reference to the actual transaction in which the financial asset was originated or purchased (ie the amount advanced to the debtor or transferred by the holder). Neither document describes principal by reference to the contractual terms of the instrument (ie what is contractually defined as ‘principal’).

Feedback received

10. Some respondents to the Limited Amendments ED and the FASB’s proposed ASU asked the boards to clarify the meaning of ‘principal’ and expressed concerns about the current language in IFRS 9 and the FASB’s proposed ASU. Those who advocated convergence emphasised that it is important that the boards develop a common articulation of principal.
11. Much of the detailed feedback from the outreach and comment letter respondents was raised in the context of assessing whether a financial asset has contractual cash flows that meet the solely P&I condition if the asset has a prepayment feature

or has an interest rate that is below or above market. Many respondents offered possible views about the meaning of the term principal—for example, some suggested it is the contractually stated principal amount or the amount that the current holder paid for the asset.

12. Some respondents stated a preference for a particular meaning of principal. Others simply noted the implications for particular instruments of different articulations and asked the boards to consider those implications and to clarify what the boards intended. Yet others did not express a strong view but said that the description of principal should not preclude the following assets from being eligible for amortised cost:
- (a) financial assets that are originated or acquired at a significant premium or discount and are prepayable at par; and
 - (b) financial assets with interest rates that are either below or above market.

Alternatives for describing the meaning of principal

13. The staff agree that the meaning of principal is fundamental to the consistent and appropriate application of the solely P&I condition. Specifically, the meaning of principal is relevant to assessing:
- (a) whether the cash flows on a financial asset are indeed solely payments of principal (and interest on the principal amount outstanding), and
 - (b) whether the prepayment amount on a prepayable financial asset ‘substantially represents unpaid amounts of principal and interest’.
14. The staff are aware that divergent views already exist among interested parties and acknowledge that different meanings of principal will result in different classification outcomes for particular instruments. Accordingly, the staff believe that the boards should consider and clarify the meaning of principal for the purposes of applying the solely P&I condition.

15. The staff have identified the following three alternatives for describing the meaning of principal:
- Alternative A—the amount that is **contractually defined** as ‘principal’;
 - Alternative B—the amount that was advanced to the debtor when the debtor **originally issued** the instrument; and
 - Alternative C—the amount that was transferred by the **current holder** for the asset.
16. A simple example may help illustrate the three alternatives. Consider a bullet loan with the following contractual features:
- The contractually stated principal is CU100. Interest of 5% is computed on this amount.
 - Only interest payments are required to be paid over the life of the asset.
 - At maturity, CU100 is due.
 - The instrument is prepayable at any time before maturity. The prepayment amount is CU100.
17. The debtor originally issued the bullet loan for CU98². The current holder purchased the loan in the secondary market for CU95.
18. From the perspective of the current holder, the three alternatives set out in paragraph 16 would result in the following amounts being considered as ‘principal’:

| Alternative A | Alternative B | Alternative C |
|---|--|---|
| <i>Principal is the amount that is contractually defined as ‘principal’</i> | <i>Principal is the amount that was advanced to the debtor when the debtor originally issued the</i> | <i>Principal is the amount that was transferred by the current holder for the asset</i> |

² For example, this can happen when the interest rate demanded by investors at the time of issuance is slightly different to the contractual interest rate (in this case 5%).

| | <i>instrument</i> | |
|-------|-------------------|------|
| CU100 | CU98 | CU95 |

19. To assess whether the bullet loan meets the solely P&I condition, the holder must determine whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. To make that assessment, it is necessary to understand what principal is – so the alternatives are to compare the contractual cash flows to:
- (a) CU100 under Alternative A;
 - (b) CU98 under Alternative B; and
 - (c) CU95 under Alternative C.
20. Consistent with the discussion in paragraph 8, the example—and the analysis below—discusses the principal amount only in the context of initial recognition. This is for simplicity.

Staff analysis and recommendation

Alternative A: the amount that is contractually defined as ‘principal’

21. Alternative A considers only the financial asset’s contractual cash flows. Some would argue that this alternative is consistent with the wording in IFRS 9 and the FASB’s proposed ASU.
22. However, that staff is concerned that this alternative would seemingly prohibit some assets from being measured at amortised cost, even though such assets have simple cash flows—and amortised cost could provide useful information by allocating the effective return over the life of the instrument (assuming that the holder holds the asset to collect the contractual cash flows). For example, read literally, a zero coupon bond would not qualify to be measured at amortised cost under this alternative because that instrument **does not have** a contractually stated

principal amount upon which interest is computed. Rather, the amount that is repaid at maturity clearly is comprised of both economic principal and interest. Therefore this alternative is unworkable for particular financial instruments with simple cash flows.

23. Moreover, the staff think that Alternative A is inconsistent with the real economics of the financial asset because it does not consider the transaction in which the holder acquires the asset. As a result, under this alternative a financial asset with a contractual interest rate that is below or above market might appear to have contractual cash flows that are inconsistent with the solely P&I condition if the *stated contractual* interest rate did not reflect consideration for the time value of money and credit risk. However, *economically*, such an asset may indeed contain payments that are solely principal and interest because the holder would acquire the asset—and thus recognise it on initial recognition—at an amount other than the contractually stated principal amount. Amortised cost would allocate that premium or discount over the life of the instrument, resulting in an effective return that that is economically consistent with the notion of interest.
24. In addition, Alternative A could potentially disregard cash flows that economically are not solely P&I—and conclude that the asset could qualify for amortised cost. To illustrate, an entity may acquire a financial asset in the secondary market at a significant discount—for example, because interest rates have risen sharply since the asset was issued—and the asset is prepayable at par. If the issuer prepays, the holder will receive a significant gain that is inconsistent with an economic notion of solely principal and interest. However, Alternative A will ignore that economic ‘super return’ because it focuses only on the contractual cash flows (ie what is contractually described as principal) —and, as a result, the asset may qualify to be measured at amortised cost. While it may seem illogical for the issuer to prepay in those circumstances (based on a pure economic

analysis), there may be various reasons why the issuer nevertheless decides to do so, and amortised cost likely will not communicate that possibility.³

25. As noted in paragraph 9 of this paper, the staff thinks that neither board intended to describe principal by a reference to the contractual terms of the instrument (ie what is contractually defined as ‘principal’). For the reasons discussed in the paragraphs above, the staff think that such a literal interpretation of principal would be inappropriate.

Alternative B: the amount that was advanced to the debtor when the debtor originally issued the instrument

26. Alternative B considers only the transaction in which the financial asset was **originated**, irrespective of whether the current holder acquired the asset at origination or subsequently in the secondary market. Some would argue that this articulation is appropriate because they believe (subject to the business model assessment) that if the asset would have qualified for amortised cost at origination, then it should always qualify for amortised cost, ie even if the current holder did not acquire the asset at origination because that outcome would always be appropriate due to the *contractual terms* of the asset. Proponents of this alternative also point out that zero coupon bonds, which are problematic under Alternative A, would qualify for amortised cost under this alternative—and they believe that this is an appropriate outcome.
27. However, the staff believe that the conditions that existed at origination **are irrelevant** to subsequent holders. Indeed the staff think the solely P&I condition in IFRS 9 and the FASB’s proposed ASU requires the holder to assess the economics of the asset **that it holds**, which necessarily includes the transaction in which the holder acquired the asset. Moreover, the staff think this alternative

³ A similar logic would apply to an acquisition at a premium although the staff acknowledge that an instrument prepayable at par at any time is generally unlikely to be acquired with a significant premium over that par amount unless the prepayment option is contingent and the occurrence of the contingent event is not likely.

would be very difficult—if not impossible—to operationalise because it would require a subsequent holder to determine the amount that the original holder paid for the asset.

Alternative C: the amount that was transferred by the current holder for the asset

28. This alternative focuses on the amount that the current holder transferred for the financial asset. In other words, it reflects the economics of the financial asset from the perspective of the current holder; ie the holder would assess the solely P&I condition by comparing the contractual cash flows to the amount that it actually invested. As a result, financial assets with contractual interest rates that are significantly above or below market rates (such that the stated contractual interest rates do not reflect consideration for the time value of money and credit risk), zero-coupon bonds and similar instruments could meet the solely P&I condition, as long as they do not contain any non-P&I cash flows. This is because—consistent with the discussion of the objective and mechanics of amortised cost, which is discussed in IASB AP 6B/FASB Memo 242 for this month’s meeting—the transaction amount that is attributable to the financial asset could result in an economic return on that investment that represents solely P&I.
29. The staff think that Alternative C is consistent with the boards’ logic that underlies the current description of principal in both IFRS 9 and the FASB’s proposed ASU—and indeed is consistent with both boards’ intention that principal is the amount that **the current holder** transferred for the financial asset.
30. However, the staff acknowledge that some board members may disagree that a financial asset should be measured at fair value through profit or loss if that asset was acquired at a discount or a premium and is prepayable at par—and this would be the outcome under Alternative C (if the discount or premium was significant). These assets are analysed and discussed further in IASB AP 6G/FASB Memo 246. In that paper, the staff propose alternatives, which include permitting such assets to be measured at amortised cost in particular circumstances.

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| IASB Agenda ref | 6C |
| FASB Agenda ref | 243 |

Question for the Boards

Do the boards agree with the staff recommendation to describe principal consistently with Alternative C, as the amount transferred by the current holder for the financial asset?