

# STAFF PAPER

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## REG FASB | IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Contractual Cash Flow Characteristics: Amortised Cost as a Measurement Basis		
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### Purpose and structure of the paper

1. This paper opens 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. This paper:
  - (a) Provides a brief overview of the relevant feedback received on the IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) ('the Limited Amendments ED') and the proposed ASU (paragraphs 5-8),
  - (b) Discusses the mechanics and information content provided by amortised cost as a measurement basis (paragraphs 9-12), and

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- (c) Reviews the considerations in classifying financial assets at amortised cost and discusses contractual cash flow characteristics compatible with the amortised cost measure, and how these considerations are captured in the solely P&I condition (paragraphs 13-29).
3. The objective of this paper is to clarify and affirm the conceptual basis for the solely P&I condition and to guide the boards in their re-deliberations. The focus of this paper as well as the other papers in this series is only the proposals in the recent exposure drafts that would apply the solely P&I condition to financial assets. Accordingly, the discussion in this paper supports the staff analysis and recommendations in the subsequent papers in the P&I series for this meeting.
4. This paper does not contain questions to the boards.

### Feedback received

5. Some respondents to the Limited Amendments ED and the proposed ASU expressed the view that the application of the solely P&I condition would be clearer if it were linked closely to the objective of amortised cost measurement. They made some specific suggestions about when amortised cost would provide useful information<sup>1</sup>, which includes providing information about:
- (a) ‘the effective return on a financial asset or financial liability by allocating interest revenue...over the expected life of the financial instrument’. They noted that this is consistent with the objective for amortised cost measurement articulated in the IASB's Exposure Draft *Financial Instruments: Amortised Cost and Impairment*.
- (b) the amounts, timing and uncertainty of future cash flows. Along these lines, some respondents noted their view that amortised cost provides the most useful information for financial assets that are ‘plain vanilla’,

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<sup>1</sup> Depending on the business model assessment and other aspects of the contractual cash flow characteristics assessment.

‘normal lending’, part of the ‘banking book’, or ‘traditional, unleveraged loans and receivables’.

6. Some respondents specifically stated that clarifying the objective for amortised cost measurement would help to clarify the context of the solely P&I condition and assist in its application and thus improve classification outcomes.
7. Some respondents also raised questions about whether one or more of the following considerations are important for classifying financial assets at amortised cost:
  - (a) **‘Appropriateness’ of the asset’s return** (ie whether the return on the financial asset must be consistent with the market, and whether an entity is required to justify how it prices a financial asset in order for it to be classified at amortised cost).
  - (b) **Variability in cash flows** (ie whether variability in contractual cash flows should preclude a financial asset from being measured at amortised cost measurement and if so, why particular financial assets with variable interest rates are allowed to be so classified).
  - (c) **Variability in fair values** (ie whether susceptibility to changes in fair value should preclude a financial asset from being measured at amortised cost, and if so, why financial assets with fixed interest rates are allowed to be so classified).
  - (d) **The fair value of a particular feature** (ie whether the presence in a financial asset of particular features with a ‘meaningful’ fair value should preclude the asset from being measured at amortised cost).
8. Most respondents who requested that the boards clarify the objective for amortised cost measurement also requested various clarifications to the solely P&I condition. However they believed that any clarifications to the solely P&I condition or its application to particular instruments should be consistent with the clarified objective for amortised cost measurement.

## Amortised cost as a measurement basis<sup>2</sup>

9. Amortised cost of a financial instrument is calculated using the effective interest method. This method is essentially a **spreading mechanism** that allocates interest revenue or interest expense over a relevant period, and in doing so, amortises or accretes the carrying amount recorded on initial recognition to the ultimate contractual cash flows.<sup>3</sup> This results in the recognition *in profit or loss* over time of the **effective return** on a financial instrument as the difference between the amount recorded on initial recognition and the ultimate contractual cash flows.
10. Amortised cost is a **cost-based measure**. The carrying value of a financial asset recorded *in the statement of financial position* at any given point in time does not—nor is it intended to—provide information about the fair value of the future cash flows. This is reflected in the fact that the effective interest rate is established at initial recognition.<sup>4</sup> Rather, it is a measure of the amount invested in the financial asset at any given point in time<sup>5</sup> that provides a constant link between the amount recorded on initial recognition and future contractual cash flows. In doing so, the measure reflects the value of the expected<sup>6</sup> contractual cash flows discounted at

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<sup>2</sup> This section only discusses *contractual* cash flows. As a result of the decoupling of the measurement of impairment and the measurement of the financial asset in the boards' impairment projects, impairment considerations are outside of the scope of the analysis in this paper. It is noted however that at least for 'purchased credit impaired' financial assets there can still be an interaction between the measurement of impairment and the measurement of the financial asset but this interaction is set aside for the purposes of this analysis.

<sup>3</sup> The staff note that there are particular detailed differences between IFRS and US GAAP in the application of the effective interest method and the calculation of amortised cost. Those differences are outside the scope of this project; however, in the staff's view, they do not change the basic underlying concepts discussed in this paper.

<sup>4</sup> Although for instruments with floating interest rates part of the interest rate linked to a benchmark rate is updated.

<sup>5</sup> This amount can remain unchanged over the instrument's life if the instrument was initially recognised at par and is a bullet instrument; or it can change over the instrument's life if the instrument was initially recognised at a premium or discount or is an amortising instrument.

<sup>6</sup> Here and further in this paper, the reference to expected cash flows relates to variability of the *contractual* cash flows (eg due to prepayments) rather than expectations of shortfalls in those contractual amounts (ie credit losses).

the applicable effective interest rate (EIR). Revisions to the estimates of the timing and/or amount of contractual cash flows result in adjustments to the carrying value of the financial asset (called ‘catch up’ adjustments).

11. The information content provided by the amortised cost measure is determined – and limited – by its allocation mechanics, and therefore this measurement attribute only provides useful information for particular types of instruments<sup>7</sup>. Therefore, in classifying a financial asset at amortised cost it is important to consider:
  - (a) Whether the allocation of the effective return can be performed from a purely mechanical viewpoint, and
  - (b) When such an allocation would provide useful information about the financial asset.
12. Accordingly, the following section discusses the implications of amortised cost allocation mechanics for the determination of:
  - (a) what considerations are relevant to assessing whether a financial asset should be classified at amortised cost, and
  - (b) which features, or contractual cash flow characteristics, are compatible with the amortised cost measure.

### **Considerations in classifying financial assets at amortised cost**

13. This section discusses the relevance of the following considerations in classifying financial assets at amortised cost:
  - (a) Variability in cash flows and the asset’s return
  - (b) Fair value of the asset or a particular feature.

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<sup>7</sup> As noted above, amortised cost allocates the effective return over time. Therefore, in addition to providing useful information only for particular types of financial assets, amortised cost also provides useful information only for particular business models. That is, it is important that financial assets are held for the collection of that effective return, ie the contractual cash flows. Otherwise the allocation mechanism is not relevant to providing information about the asset’s ultimate cash flows. However the business model condition is outside the scope of this paper.

***Variability in cash flows and the asset's return***

14. As an allocation mechanism, amortised cost works best for financial assets with contractual cash flows that are **fixed** (ie those that are known at contract inception and that are not contingent<sup>8</sup>) both in timing and amount. Common examples of instruments with fixed cash flows include financial assets with fixed interest rates, zero coupon bonds and principal-only strips that are not prepayable. As long as cash flows are fixed, the allocation over time can be performed. This is true regardless of the stated amount of the cash flows or the payment pattern. That is, the allocation could be effectively performed even if:
- (a) the stated fixed rate on the instrument is above or below the market rate on initial recognition, or/and
  - (b) the payments over time are uneven or/and occur at uneven intervals.
15. It is important to also note that regardless of the stated interest rate or stated payment pattern, the effective return recognised over time on a fixed-rate instrument would always be appropriate relative to the market conditions that exist at initial recognition of the instrument. This is due to the initial measurement requirements for financial instruments. That is, financial instruments are initially recognised at fair value, which is typically the transaction price. If the transaction price includes another element, that element will be recognised separately from the financial asset. For example, if an entity provides an interest-free loan to a customer, the entity will recognise the loan at fair value and the rest of the transaction amount will be recognised as an expense or reduction of income unless it qualifies for recognition as some other type of asset.<sup>9</sup> In the extreme, the yield on a financial asset can even be negative –

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<sup>8</sup> For example, this means that cash flows on an instrument are not considered fixed if the instrument will pay interest at 5% for 5 years and then, depending on a particular event, at either 5% or 6% in year 6.

<sup>9</sup> The staff acknowledge that there are detailed differences between IFRS and US GAAP related to the initial recognition requirements for financial instruments. Those differences are outside the scope of this project; however, in the staff's view those detailed differences do not change the basic underlying concepts discussed in this paper.

amortised cost can still ‘cope’ with those conditions and reflect that negative effective return.

16. Finally, it is important to note that the effective return that is recognised over time for a financial asset with fixed contractual payments would not include consideration unrelated to a basic lending-type return because there is no variability in the contractual cash flows.
17. Mechanically, amortised cost could also allocate the effective return for financial assets with **variable** contractual cash flows as long as those cash flows are *determinable*. For financial assets with variable cash flows, it is important to consider both the *degree* and the *source* of variability in the contractual cash flows in order to determine whether the amortised cost allocation mechanism would work well and provide useful information. Some hold the view that amortised cost can work for *any* variable cash flows, via the ‘catch up’ adjustments mechanism. That is, at each reporting date an entity would be required to calculate the present value of the current expected contractual cash flows and recognise in profit or loss interest revenue for the period *plus* any required catch-up adjustment that must be made to the carrying value of the financial instrument.
18. However the staff generally believe that as the variability in contractual cash flows increases and is driven by factors unrelated to a basic lending type return, amortised cost essentially ceases to *allocate* the effective return and increasingly becomes a fair value-*like* measure. In such cases, the staff do not believe that amortised cost provides superior information compared to fair value measurement. Besides, for such instruments, amortised cost loses the benefit of being a simple measurement technique and becomes increasingly more difficult to apply.
19. The following paragraphs explore *sources* of variability in a greater detail. Variability in the asset’s contractual cash flows may arise due to factors relevant to a basic lending-type relationship including:

- (a) Compensating the asset holder for just the passage of time (this is the simplest form of interest, absent the risks and costs associated with the asset),
  - (b) Providing consideration for the basic risks associated with holding a financial asset for a particular period of time; that is, credit risk and liquidity risk, and
  - (c) Providing a profit margin and/or compensation for costs associated with the financial asset such as servicing costs.
20. For financial assets with a fixed interest rate all these elements of the effective return are fixed at initial recognition. For such assets, the amortised cost allocation mechanism provides useful information by recognising in profit or loss in each period the basic lending type return consistent with the *conditions on initial recognition*.
21. Likewise, amortised cost would also provide useful information if any variability in the contractual cash flows arises only to **maintain** the holder's return for those basic lending-type considerations as conditions change over time. In each period, amortised cost would recognise in profit or loss the basic lending-type return that is consistent with the *current conditions*. For example, a bank's published variable interest rate or a variable interest rate linked to LIBOR would be consistent with this analysis.
22. In contrast, variability in cash flows may arise due to factors unrelated to a basic lending-type relationship. For example, if the variable interest rate on a financial asset is referenced to an equity index, such variability is outside a basic lending-type relationship and is driven by a factor other than those relevant to such a relationship. In such cases, allocation of the return over time is not appropriate because the return itself is not related to compensating the asset holder for the passage of time and the basic risks and costs associated with holding the asset.
23. Accordingly, the solely P&I condition in IFRS 9 and the proposed ASU is designed to identify financial assets with fixed or variable cash flows that provide



a basic lending-type return to the holder and where any contractual variability in cash flows is intended only to maintain such a return over time consistent with the changing conditions. The solely P&I condition is also designed to screen out (and thus measure at fair value through profit or loss) those financial assets with variability in cash flows that is outside the basic lending-type relationship and driven by factors other than those relevant to such a relationship.

24. As a final observation on the *degree* of the variability of the contractual cash flows, clearly the nature of the feature in itself does not *always* determine the effect on the variability and whether the amortised cost allocation mechanism would work and provide useful information. For example, a financial asset could contain a link to a commodity index that could only impact contractual cash flows by a de minimis amount. Such an asset would be akin to an asset with a fixed interest rate because the variability in cash flows is de minimis.

### ***Fair value of the asset or a particular feature***

25. Amortised cost is not a proxy for fair value. That is, amortised cost is not designed to – and does not – provide information about changes in fair value. This is particularly true for instruments with fixed interest rates; however, amortised cost still provides useful information about these instruments' cash flows by recognising the effective return over time. Accordingly, the staff believe that a holder of such an instrument should not be precluded from classifying it at amortised cost simply because over the asset's life its amortised cost could be very different from its fair value—and the holder could therefore realise a gain or loss if the holder were to sell the instrument.<sup>10</sup>
26. Similarly, the staff also believe that the impact at initial recognition of a particular contractual feature on the instrument's fair value should not *in itself* determine how the instrument is classified. For example, a contractual provision should not

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<sup>10</sup> The staff note that the business model condition for the amortised cost category requires that the assets are held for the collection of contractual cash flows (subject to the re-deliberations of the business model condition).

be automatically considered consistent with the amortised cost measurement simply because it has a negligible impact on the fair value of the financial asset on initial recognition (eg because the provision is unlikely to impact the instrument's cash flows). It may be the case that the feature *could* have a dramatic effect on future contractual cash flows and amortised cost could provide incomplete information about that potential effect. In contrast, amortised cost can still provide useful information about the instrument's cash flows if a financial asset is originated at an interest rate that is below market and the asset's fair value at initial recognition is different from the stated contractual par amount). Regardless of whether a feature (such as an off-market interest rate) has an impact on the asset's fair value on initial recognition, amortised cost can allocate the effective return over time as long as the contractual cash flows are fixed or otherwise determinable.

27. However, the impact of the feature on the asset's fair value on initial recognition could be a helpful *indicator* of whether the feature affects (or could affect) the asset's cash flows such that the amortised cost allocation mechanism would not provide useful information. For example, if a financial instrument contains a contingent feature that requires a revision to the interest rate upon the occurrence of a specified event (eg a change in an equity index), a meaningful fair value to such feature may indicate that the return on the financial asset includes consideration that is unrelated to a basic lending type return. In other words, it is important to understand the reason for the feature's impact on the asset's fair value at initial recognition and how that feature affects the economics and the cash flows on the financial asset—and thus whether amortised cost would provide complete and useful information by allocating the effective return over time.

### **Key observations**

28. To conclude, the key observations in this paper that are relevant to the staff's analysis in the subsequent papers in this series include:

- (a) Amortised cost is a relatively simple mechanism that **allocates the effective return** on a financial asset over the relevant time period.
- (b) The allocation mechanism is easy to apply and would provide useful information (subject to business model) for financial assets with contractual cash flows that are **fixed** (ie known at initial recognition and not contingent). The allocation can also be performed for financial assets with **variable** contractual cash flows as long as those cash flows are determinable. However, for a financial instrument with a variable interest rate, consideration must be given to the degree and sources of variability in cash flows in order to establish whether the amortised cost allocation mechanism would work well and provide complete and useful information.
- (c) If the variability in cash flows relates to **basic lending-type considerations** (for example time value of money and the credit risk) and simply reflects changes in those conditions over time, amortised cost would provide useful information by allocating those cash flows over time. However, if the variability in cash flows is driven by factors outside of a basic lending-type relationship, it would not be appropriate to allocate the return over time because the return itself is not related to compensating the holder for the passage of time and the basic risks and costs associated with holding the asset for a particular period of time.
- (d) The impact of a contractual provision on the **fair value** of the financial asset or the susceptibility of the financial asset to changes in fair value over time in themselves do not determine whether amortised cost is an appropriate measurement attribute for the financial asset. However, the impact of a contractual feature on the fair value of the instrument on initial recognition could be a helpful indicator of its impact on the contractual cash flows and whether the amortised cost allocation mechanism would work well and provide complete and useful information.

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29. Subsequent P&I papers for this month's meeting provide further analysis in light of the discussion in this paper.