

STAFF PAPER

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IASB Meeting

Project	Financial Instruments: Classification and Measurement		
Paper topic	Update on the FASB's tentative classification and measurement model for financial instruments		
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Purpose of paper

1. This paper provides:
 - (a) a brief background of the IASB's and FASB's joint deliberations of the classification and measurement (C&M) of financial instruments (paragraphs 3-13), and
 - (b) an update on the FASB's recent decisions related to its tentative C&M model for financial instruments (paragraphs 14-21).
2. This paper is for informational purposes only and does not contain any questions for the IASB.

Background

3. The IASB and the FASB have had a long-term objective to improve and simplify the accounting for financial instruments and to achieve increased international comparability in this area. However the alignment of the IASB's and the FASB's respective accounting models for financial instruments has been complicated by the different timetables established by the boards in response to their respective stakeholder groups.

IASB

4. The IASB issued the chapters of IFRS 9 *Financial Instruments* relating to the C&M of financial assets in November 2009—and added the requirements related to the C&M of financial liabilities in October 2010.¹ In November 2011, the IASB decided to consider making limited amendments to IFRS 9 with the following objectives:
- (a) to address specific application questions raised by constituents since the issuance of IFRS 9;
 - (b) to take into account the interaction between the C&M model for financial assets and the tentative accounting model for insurance contracts liabilities under the IASB's Insurance Contracts project; and
 - (c) to reduce key differences with the FASB's tentative C&M model for financial instruments.
5. In making this decision, the IASB noted that IFRS 9 has generally been found to be conceptually sound and operational and therefore the IASB confirmed the narrow scope of the deliberations consistent with the objectives stated above. The IASB also noted that many interested parties have either already applied IFRS 9 early or dedicated significant resources in preparation for its initial application. The IASB has been mindful of the extent of changes to IFRS 9 and has sought to minimise the cost and disruption to interested parties.

FASB

6. In May 2010 the FASB issued a comprehensive proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)* ('2010 ASU') on accounting for financial instruments that contained proposals on C&M, impairment methodology and hedge accounting. The 2010 ASU proposed a C&M model whereby almost

¹ Most of the requirements for the C&M of financial liabilities were carried forward unchanged from IAS 39. However, the requirements related to the fair value option for financial liabilities were changed to address the issue of 'own credit risk'.

all financial assets and financial liabilities would be subsequently measured at fair value. Changes in fair value would be presented in either profit or loss or other comprehensive income on the basis of specified conditions. The FASB commenced its re-deliberations on the proposed model in December 2010 and, on the basis of feedback received, had been developing a mixed measurement C&M model. That model contained classification conditions similar to those in IFRS 9—in particular it considered the asset’s cash flow characteristics and business strategy / business activities².

Joint deliberations

7. Consistent with the long-standing objective of increasing international comparability in the accounting for financial instruments and the feedback received from their respective constituents, in January 2012 the boards decided to jointly deliberate selected aspects of their C&M models.
8. The boards were mindful of their different starting points (ie that the IASB was considering *limited* amendments to the *existing* C&M requirements in IFRS 9 whereas the FASB were considering a whole *new C&M model*) so they had an objective of reducing key differences. Accordingly, 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 measurement (FVOCI) category for financial assets; and
 - (c) interrelated issues from the topics above (for example, disclosures and the model for financial liabilities).

² While the FASB’s tentative model immediately prior to joint deliberations contained classification conditions similar to those in IFRS 9, that model would have first bifurcated embedded derivative features from financial assets and financial liabilities consistent with the current US GAAP requirements.

9. The boards decided to discuss each issue jointly and consider what changes, if any, they would propose to make to their separate models and incorporate in their respective exposure drafts.
10. The boards' 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)) ('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* ('FASB's proposed ASU'). As noted above, the IASB's Limited Amendments ED proposed *limited* amendments to the *existing* C&M requirements for financial assets in IFRS 9 while the FASB's proposed ASU proposed *a comprehensive new* C&M model for financial instruments. The key aspects of the boards' respective models were largely aligned.
11. The comment period on these proposals ended on 28 March 2013 and 15 May 2013, respectively. In May through July 2013, the staff presented summaries of all of the feedback received on the boards' respective exposure drafts—and also presented a plan for joint redeliberations. That plan was developed on the basis of the feedback received by the boards—which differed in a number of respects—and also reflected the fact that the boards had different starting points and thus had different scopes for their redeliberations.
12. Specifically, many of the FASB's stakeholders questioned whether a new comprehensive new C&M model was needed and raised concerns about the complexity of the proposals. Instead, many of the FASB's stakeholders advocated targeted improvements to US GAAP (particularly to the current clearly and closely related bifurcation requirements). In contrast, overall, the IASB's stakeholders continued to support the C&M model in IFRS 9 and supported the proposed limited amendments to that model. Accordingly, the project plan contemplated both joint and separate redeliberations.
13. At joint public meetings in September 2013 through November 2013, the boards discussed the contractual cash flow characteristics assessment and the business

model assessment for financial assets.³ Most of the decisions made about the contractual cash flow characteristics assessment were agreed jointly and there was also agreement on the key objectives of the business models. However, there were differences in the boards' decisions on some specific details such as the assessment of some contingent and prepayment features as well as the articulation of particular aspects of the business model assessment. The FASB directed its staff to perform further analysis of particular aspects of the contractual cash flow characteristics assessment—and also indicated that it would consider at a future meeting whether it would like to confirm the C&M model that boards had been jointly discussing or pursue another model. In particular the FASB indicated that it planned to consider the complexity of the C&M proposals and the cost/benefit of the tentative decisions.

Update on the FASB's recent tentative decisions

14. Consistent with the intention stated by the FASB during joint redeliberations and the project plan discussed by the boards in July 2013, the FASB continued to discuss the contractual cash flow characteristics and business model assessments subsequent to the boards' joint discussions. The FASB's objective was to ensure that the new C&M model reflected the feedback received from its stakeholders.

Contractual cash flow characteristics assessment

15. In December 2013, the FASB discussed the contractual cash flow characteristics assessment that the boards had been discussing jointly as a condition for classifying and measuring financial assets. In particular, the FASB discussed concerns raised by its stakeholders about the complexity of that assessment and whether the benefits of that new assessment outweighed the costs of applying it. The FASB also considered alternatives to that assessment if the FASB decided not to continue to pursue it.

³ The relevant portions of the IASB Update are reproduced in Appendices A-B to Agenda Paper 6 for this meeting.

16. The FASB tentatively decided that it would not continue to pursue the contractual cash flow characteristics assessment. In making that decision, the FASB expressed concern that the condition was arguably just as complex as current US GAAP requirements and in many cases would result in similar classification outcomes. The FASB observed that the application of the contractual cash flow characteristics assessment would require judgement and was therefore concerned that it could result in the need to develop an extensive body of new application guidance. The FASB also expressed concern that having different C&M models for financial assets and financial liabilities would increase complexity. Accordingly, the FASB was not convinced that the contractual cash flow characteristics assessment would satisfy its cost-benefit considerations.
17. In light of that decision, the FASB discussed the accounting for hybrid financial assets and decided to **retain the bifurcation requirements in current U.S. GAAP**. That is, financial assets that contain embedded derivatives would have those embedded derivatives assessed for bifurcation—and if bifurcation is required, the embedded derivatives would be separately classified and measured at fair value through profit or loss. (The accounting for the host contract is discussed in the next paragraph.)
18. In addition, the FASB directed the FASB staff to perform additional analysis of whether the FASB should develop a new approach for using another cash flow characteristics assessment to determine the C&M of the following items—or whether the current US GAAP requirements should be retained for them:
- (a) a host contract that remains after the bifurcation of embedded derivative(s) in hybrid financial assets,
 - (b) hybrid financial assets with an embedded derivative that does not require bifurcation, and
 - (c) all other financial assets (for example, financial assets not within the scope of Topic 815 on derivatives and hedging).

Business model assessment

19. In light of the tentative decisions made by the FASB in December 2013 on the contractual cash flow characteristics assessment, the FASB decided to consider whether it would like to continue to pursue the business model assessment that the boards had been discussing jointly as a condition for classifying and measuring financial assets. Accordingly, in January 2014, the FASB discussed that business model assessment and decided not to continue to pursue it. The FASB also decided not to pursue the approach that it had been discussing prior to the boards' joint deliberations which focused on the business activities that an entity uses in acquiring and managing the financial assets. In making those decisions, the FASB took the view that targeted improvements to current U.S. GAAP would be the most cost-beneficial way of improving the current requirements.
20. Accordingly, the FASB directed the FASB staff to conduct further analysis of targeted improvements that can be made to the current U.S. GAAP guidance for classifying and measuring loans and securities. After considering those targeted improvements to the respective models for loans and securities, the FASB will consider whether it should align those models or retain two separate models.

FASB's next steps

21. At a future meeting, the FASB staff will bring to the FASB an analysis of whether it should develop a new approach for using another cash flow characteristics assessment for classifying particular financial assets, as well as further analysis of targeted improvements that can be made to the current U.S. GAAP guidance for classifying and measuring loans and securities.