

STAFF PAPER

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IASB Meeting

Project	Financial Instruments: Classification and Measurement and Impairment		
Paper topic	Transition to IFRS 9—application of particular classification and measurement requirements and a transition issue on impairment		
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Purpose and structure of paper

1. This paper considers the transition requirements for the classification and measurement (C&M) proposals in 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').
2. Specifically, the staff will ask the IASB to consider the application of the following C&M requirements **on transition to IFRS 9**:
 - (a) Assessment of a modified time value of money component of an asset's interest rate when an entity applies the contractual cash flow characteristics condition (paragraphs 5-12);
 - (b) Assessment of a prepayment feature in a financial asset that is acquired or originated with a significant premium or discount and is prepayable at par plus accrued and unpaid interest (paragraphs 13-17);
 - (c) Fair value option (FVO) designations for entities that have already applied a previous version of IFRS 9 (paragraphs 18-24).
3. Each section contains relevant background information, staff analysis and recommendation and a question for the IASB. The first two sections capture transition to the respective C&M requirement by **all** entities; that is, both existing

IFRS preparers and first-time adopters of IFRS (FTAs). The third section is relevant only to existing IFRS preparers.

4. This paper also considers a transition issue related to the new impairment requirements—specifically, whether transition provisions that the IASB deliberated in December 2013 should be extended to FTAs (paragraphs 25-29).

Assessment on transition to IFRS 9 of a modified time value component of an asset's interest rate

Background

5. The Limited Amendments ED proposed clarifying that a financial asset with a modified economic relationship between the principal and the consideration for the time value of money and the credit risk would not meet the solely principal and interest (P&I) condition in IFRS 9 if the modification could result in cash flows that are *more than insignificantly* different from the 'benchmark cash flows' (ie cash flows on a financial asset that does not contain the modification but is otherwise identical).
6. In accordance with the existing transition requirements in IFRS 9, when IFRS 9 is initially applied, the assessment of the contractual cash flow characteristics is based on the facts and circumstances that existed at the initial recognition of the financial asset, and the resulting classification is applied retrospectively.
7. The IASB acknowledged that the proposed clarification to the contractual cash flow characteristics condition in IFRS 9 introduces a greater degree of judgement and presents a greater risk that hindsight will be used when an entity assesses whether the modification in the economic relationship is more than insignificant. Accordingly, the IASB proposed that if it is impracticable (as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) on transition to IFRS 9 for an entity to assess a modified economic relationship based on the facts and circumstances that existed at the initial recognition of the financial asset, then the entity must assess the contractual cash flow characteristics of that financial asset **without taking into account** the specific requirements related to modified economic relationships. In other words, the entity essentially would

assess the asset's contractual cash flows characteristics (as at initial recognition) using the requirements as set out in previous versions of IFRS 9.

8. In addition, the Limited Amendments ED proposed that an entity must **disclose** the carrying values of the financial assets whose contractual cash flows were assessed at transition to IFRS 9 without taking into account the specific requirements for modified economic relationships (hereafter the staff refer to these assets as 'the affected financial assets'). Such disclosure would be required until those affected financial assets are derecognised. The IASB concluded that this disclosure would enhance comparability and provide useful information to users of financial statements.
9. In re-deliberating the Limited Amendments ED in September 2013, the IASB re-affirmed the proposed clarification to the contractual cash flow characteristics condition for assets that have interest rates with a modified time value of money component but tentatively decided to replace the proposed 'not more than insignificant' threshold with a 'not significant' threshold. That is, a financial asset with a 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.

Staff analysis and recommendation

10. The Limited Amendments ED did not specifically seek input on the transition proposals and respondents did not provide comments related to those proposals.
11. In the staff's view, the tentative decision that the IASB made in re-deliberating the Limited Amendments ED—ie the decision to replace the 'not more than insignificant' threshold with a 'not significant' threshold—does not affect the rationale for the related transition and disclosure requirements that were proposed in the Limited Amendments ED (discussed in paragraphs 7 and 8 of this paper).
12. Accordingly, the staff recommend that the IASB re-affirm these transition and disclosure proposals. That is, if it is impracticable (as defined in IAS 8) on transition to IFRS 9 for an entity to assess a modified time value of money component of an asset's interest rate based on the facts and circumstances that existed at the initial recognition of the financial asset, then the entity must assess

the contractual cash flow characteristics of that financial asset **without taking into account** the specific requirements related to the modification of the asset's interest rate. In addition, in those cases, the entity will be required to disclose the carrying value of the affected financial assets until those assets are derecognised.

Question 1 for IASB

Does the IASB agree with the staff recommendation in paragraph 12?

Assessment on transition to IFRS 9 of a financial asset that is acquired or originated at a significant premium or discount and is prepayable at par plus accrued and unpaid interest

Background

13. In accordance with the existing requirements in IFRS 9, a financial asset must be classified at fair value through profit or loss (FVPL) if it has a prepayment feature that could result in contractual cash flows that are not solely P&I (unless that feature is not genuine).
14. However, in re-deliberating the Limited Amendments ED, the IASB tentatively decided to provide an exception for financial assets that meet the following conditions:
 - (a) the financial asset is acquired or originated with a significant premium or discount,
 - (b) the financial asset is prepayable at the amount that represents par plus accrued and unpaid interest (and may include reasonable additional compensation for the early termination of the contract), and
 - (c) 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).¹

¹ Absent this exception, in some cases where an asset has a significant premium or discount on initial recognition, the return that could arise if a prepayment were made at par may not have been considered to be solely P&I and thus the asset would have been required to be measured at FVPL.

Staff analysis and recommendation

15. On transition to IFRS 9, an entity would need to assess whether a financial asset meets the conditions set out above in paragraph 14 *based on the facts and circumstances that existed at the initial recognition* of the financial asset, including whether the fair value of the prepayment feature was insignificant.
16. The staff believe that in particular cases it may be impracticable (as defined in IAS 8) for an entity to determine whether the fair value of the prepayment feature was insignificant when the asset was initially recognised. For example, that may be the case if the entity did not bifurcate the embedded prepayment feature and did not account for it separately at fair value under IAS 39 *Financial Instruments: Recognition and Measurement*. Therefore the staff recommend that a **transition provision** similar to that described above in paragraph 12 for a modified time value component of an asset's interest rate is also required for assets acquired or originated with a significant premium or discount that are prepayable at par plus accrued and unpaid interest. That is, if it is impracticable (as defined by IAS 8) on transition to IFRS 9 for an entity to assess whether the fair value of the prepayment feature was insignificant on initial recognition of a financial asset, an entity shall assess the contractual cash flow characteristics of that financial asset without taking into account the exception for prepayment features discussed in paragraph 14.
17. Likewise, the staff note that the transition provision discussed in paragraph 16 could result in reduced comparability between entities and on a period-by-period basis within a single entity because the contractual cash flows of assets with prepayment features subject to the exception discussed in paragraph 14 could be assessed differently; ie based on whether it was impracticable to take into account that exception. Accordingly, the staff recommend that **disclosure** similar to that discussed in paragraph 12 is also required for such prepayable financial assets. That is, the entity would be required to disclose the carrying value of prepayable financial assets that, on transition to IFRS 9, were assessed **without taking into account** the exception discussed in paragraph 14 because it was impracticable (as defined by IAS 8) to do so. Such disclosure would be required until those prepayable financial assets are derecognised.

Question 2 for IASB

Does the IASB agree with the staff recommendations in paragraphs 16-17?

FVO designations for entities that have already applied a previous version of IFRS 9²

Background

18. In accordance with IFRS 9, entities are permitted to designate a financial asset or a financial liability as measured at FVPL under the FVO if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’).³
19. The Limited Amendments ED proposed the introduction of a third mandatory measurement category—fair value through other comprehensive income (FVOCI)—and also proposed to extend the current FVO for financial assets in IFRS 9 to financial assets that would otherwise be measured at FVOCI if doing so would eliminate or significantly reduce an accounting mismatch. The Limited Amendments ED also proposed other limited amendments to the C&M requirements in IFRS 9 that would cause the measurement attribute of some financial assets to change.
20. The Limited Amendments ED also proposed that on initial application of the completed version of IFRS 9, an entity **that has already applied a previous version of IFRS 9** (ie IFRS (2009), IFRS 9 (2010) or IFRS 9 (2013)) and has therefore already made its FVO designations under that previous version would be

² The existing transition provisions in IFRS 9 provide a ‘clean slate’ for the FVO designations for accounting mismatches for both financial assets and financial liabilities at the date of initial application of C&M requirements for *financial assets* for entities that have **not** already applied a previous version of IFRS 9. That is, when the C&M requirements for financial assets are initially applied, entities are *both*

- **Permitted to revisit their FVO elections for accounting mismatches for both financial assets and financial liabilities**, ie to elect to apply the FVO even if an accounting mismatch already existed before the date of initial application and/or revoke the FVO even if an accounting mismatch continues to exist; *and*
- **Required to revoke their FVO elections for accounting mismatches for both financial assets and financial liabilities** if an accounting mismatch no longer exists at the date of initial application.

³ There are other eligibility conditions in IFRS 9 for designating financial *liabilities* under the FVO but those conditions are not relevant to this paper and thus are not discussed.

required—and permitted—to reconsider its FVO designations only to the extent that either:

- (a) previous accounting mismatches no longer exist or
- (b) new accounting mismatches are created

as a result of applying the limited amendments to the C&M requirements that were proposed in the Limited Amendments ED.

21. During its redeliberations of the Limited Amendments ED, the IASB tentatively confirmed the proposals in the Limited Amendments ED to introduce the FVOCI mandatory measurement category and to extend the current FVO in IFRS 9 to financial assets that would otherwise be measured at FVOCI. The IASB also tentatively confirmed the other limited amendments to the C&M requirements in IFRS 9 that could cause the measurement attribute of some financial assets to change.

Staff analysis and recommendation

22. The Limited Amendments ED did not specifically seek input on the transition proposals related to the FVO and respondents did not provide comments related to them.
23. The staff believe that the tentative decisions that the IASB has made during its redeliberations of the Limited Amendments ED do not affect—and indeed confirm—the rationale for the transition proposals related to the FVO.
24. Hence, the staff recommend confirming the transition proposals in the Limited Amendments ED related to the FVO for entities that have already applied a previous version of IFRS 9 and are subsequently applying the amended C&M requirements in the completed version of IFRS 9. Specifically, those entities:
- (a) are required to revoke previous FVO elections if an accounting mismatch no longer exists at initial application of the completed version of IFRS 9 as a result of the amended C&M requirements, but are not permitted to revoke previous FVO elections if an accounting mismatch continues to exist; and

- (b) are permitted to apply the FVO to new accounting mismatches that are created by the initial application of the amended C&M requirements in the completed version of IFRS 9, but are not permitted to newly apply the FVO to accounting mismatches that already existed before the initial application of the completed version of IFRS 9.

Question 3 for the IASB

Does the IASB agree with the staff recommendation in paragraph 24?

Expected credit loss model—transition issue for FTAs

25. In December 2013, the IASB discussed the proposed transition requirements that an entity should apply on initial application of the expected credit loss model. At that meeting the IASB tentatively confirmed that:
- (a) the new requirements should be applied retrospectively in accordance with IAS 8; and
 - (b) in order to assist entities to apply the proposals retrospectively, entities may apply:
 - (i) the low credit risk exception (as proposed in paragraph C2(a) of the Exposure Draft ED/2013/3 *Financial instruments: Expected Credit Losses* (the Impairment ED), with some clarifications) to identify financial instruments for which the credit risk has not significantly increased;⁴ and
 - (ii) the rebuttable presumption for contractual payments that are more than 30 days past due if the entity identifies increases in credit risk according to days past due.⁵
26. In October 2013, the IASB tentatively decided that an entity could assess changes in credit risk using an approach that considers the credit risk of an asset at the reporting date compared with the credit criteria on initial recognition for that

⁴ Refer Agenda Paper 5B *Operational Simplifications: 30dpd and low credit risk* of the IASB October 2013 meeting and the IASB Update October 2013 available at <http://www.ifrs.org/Updates/IASB-Updates/Pages/IASB-Updates.aspx>.

⁵ Consistent with Application Guidance B5-B8 included in the Impairment ED.

financial asset type.⁶ On transition, an entity could therefore assess the change in credit risk on transition by considering the credit quality applicable for financial assets of the relevant type at the time that the financial asset was initial recognition.

27. For the remainder of instruments not identified in paragraphs 25 and 26 an entity should use the best information that is available without undue cost or effort to obtain or approximate the credit risk on initial recognition. The best available information is information that is:
- (a) reasonably available and does not require the entity to undertake an exhaustive search for information; and
 - (b) relevant in determining or approximating the credit risk at initial recognition.
28. If the entity is not able to determine or approximate the credit risk on initial recognition in accordance with paragraph 27, unless the low credit risk exception applies, the entity should measure the loss allowance at the lifetime expected credit losses until that financial instrument is derecognised.
29. In the staff's view, the transition provisions on the initial application of the expected credit loss model are as relevant for FTAs as for existing preparers. Hence the staff recommend that the same transition provisions be applied by FTAs.

Question 4 for the IASB: Expected credit loss model

Does the IASB agree with the staff recommendation in paragraph 29?

⁶ Refer Agenda Paper 5A *Assessing when to recognise lifetime expected credit losses* of the IASB October 2013 meeting and the IASB Update October 2013 available at <http://www.ifrs.org/Updates/IASB-Updates/Pages/IASB-Updates.aspx>.