IFRS

STAFF PAPER

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IFRS® Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	IFRS 9 *Financial Instruments*—Financial assets eligible for the OCI presentation election		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (the Committee). Comments on the application of IFRS Standards do not purport to set out acceptable or unacceptable application of IFRS Standards—only the Committee or the International Accounting Standards Board (the Board) can make such a determination. Decisions made by the Committee are reported in IFRIC® *Update*. The approval of a final Interpretation by the Board is reported in IASB® *Update*.

Introduction

1. The IFRS Interpretations Committee (the Committee) received a request to clarify whether particular financial instruments are eligible for the presentation election in paragraph 4.1.4 of IFRS 9 *Financial Instruments*. That election permits a holder to present in other comprehensive income, rather than profit or loss, subsequent changes in the fair value of particular investments in equity instruments. The submitter asked whether financial instruments are eligible for that presentation election if they would be classified as equity by the issuer applying paragraphs 16A-16D of IAS 32 *Financial Instruments: Presentation*.

2. The purpose of this paper is to provide the Committee with a summary of the staff's analysis and ask whether the Committee agrees with the staff recommendation not to add this matter to its standard-setting agenda.

3. This paper includes:

    (a) background information;

    (b) staff analysis and assessment against the Committee's agenda criteria; and

    (c) staff recommendation and questions for the Committee.

4. We did not conduct outreach on this matter because it relates to the classification requirements in IFRS 9, which are not yet effective.

Background information

Relevant requirements in IFRS 9

5. For particular investments in equity instruments that an entity would otherwise measure at fair value through profit or loss, paragraph 4.1.4 of IFRS 9 permits an entity to make an irrevocable election at initial recognition to present subsequent changes in fair value in other comprehensive income. The term ‘equity instruments’ in paragraph 4.1.4 is italicised, which means that it is a defined term. Appendix A of IFRS 9 refers to paragraph 11 of IAS 32 for that definition.

6. Paragraph 5.7.5 of IFRS 9 further states that an entity may apply that presentation election only to an investment in an equity instrument within the scope of IFRS 9 that is neither held for trading (as defined by IFRS 9) nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies.

Relevant requirements in IAS 32

7. Paragraph 11 of IAS 32 sets out the definitions of a financial liability and an equity instrument. An equity instrument is defined as ‘any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities’. Consequently, a financial instrument that meets the definition of a financial liability cannot meet the definition of an equity instrument.

8. Paragraph 11 of IAS 32 also notes that, as an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of that Standard. Paragraphs 16A and 16B apply to particular puttable financial instruments and paragraphs 16C and 16D apply to particular financial instruments that impose on an entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. This exception was added to IAS 32 in 2008—

it changed how an issuer classifies particular instruments in particular circumstances but it did not change the definitions of a financial liability or an equity instrument.

The request

9. The submitter asked whether the holder can use the presentation election in paragraph 4.1.4 of IFRS 9 for a financial instrument that has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32. In other words, the submitter requested clarity on whether the term 'equity instrument' used in paragraph 4.1.4 of IFRS 9 includes those instruments that would be classified as equity by the issuer applying paragraphs 16A-16D of IAS 32. The submitter outlined two alternative views on this matter.

Alternative views

View 1—The instruments are not eligible for the presentation election

10. Proponents of View 1 note that the financial instruments described in paragraphs 16A-16D of IAS 32 are financial liabilities that, as an exception, the issuer classifies as equity instruments. Those instruments do not meet the definition of equity instruments in IAS 32.

11. The presentation election in paragraph 4.1.4 of IFRS 9 applies only to equity instruments defined as such by IAS 32. Consequently, the financial instruments described in paragraphs 16A-16D of IAS 32 are not eligible for the presentation election in paragraph 4.1.4 of IFRS 9.

12. Proponents of View 1 note that this view is supported by paragraph BC5.21 in the Basis for Conclusions on IFRS 9, which says:

> IFRS 9 permits an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading. The term 'equity instrument' is defined in IAS 32 *Financial Instruments: Presentation*. The IASB noted that in particular circumstances a puttable instrument (or an instrument that

> imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) is classified as equity. However, the IASB noted that such instruments do not meet the definition of an equity instrument.

View 2—It is unclear whether the instruments are eligible for the presentation election

13. Proponents of View 2 think that there is a potential inconsistency between IFRS 9 and its Basis for Conclusions, and request that the Board or the Committee clarify this issue. They acknowledge paragraph BC5.21 in the Basis for Conclusions on IFRS 9 (reproduced above) but also note the wording in paragraph 2.1(d) of IFRS 9. Specifically, proponents of View 2 express the view that paragraph 2.1(d) seems to suggest that if an instrument has all the features and meets the conditions in paragraphs 16A-16D of IAS 32, then it is an equity instrument for the holder. Paragraph 2.1(d) says (emphasis added):

> This Standard shall be applied by all entities to all types of financial instruments except:
>
> …
>
> (d) financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32. However, ***the holder of such equity instruments*** shall apply this Standard to those instruments, unless they meet the exception in (a).

14. Proponents of View 2 think that the instruments described in paragraphs 16A-16D of IAS 32 should be treated as equity instruments in every accounting aspect because in substance those instruments represent a residual interest in the net assets of the issuer. They also say that View 1 may create an unreasonable distinction between a direct investment in an instrument and an indirect investment (ie through an investment fund).

Staff analysis and assessment against the Committee's agenda criteria

What does IFRS 9 say?

15. The presentation election in paragraph 4.1.4 of IFRS 9 applies to particular investments in equity instruments. As noted in paragraph 5 of this paper, the term 'equity instruments' in paragraph 4.1.4 is italicised, which means that it is a defined term. Appendix A of IFRS 9 refers to paragraph 11 of IAS 32 for that definition. Thus the presentation election applies only to instruments that meet the definition of an equity instrument in IAS 32.

16. As stated in paragraph 11 of IAS 32, the instruments described in paragraphs 16A-16D of that Standard meet the definition of a financial liability. In other words, those instruments do not meet the definition of an equity instrument. We therefore agree with View 1—those instruments are not eligible for the presentation election in paragraph 4.1.4 of IFRS 9.

17. The Board explained this outcome in paragraph BC5.21 of IFRS 9. This paragraph was included in the Basis for Conclusions to reflect the Board's discussion in October 2009—see paragraphs 18 and 39 of Agenda Paper 6 from the October 2009 Board meeting. At that meeting, the Board discussed the feedback on the proposals that ultimately led to the presentation election in paragraph 4.1.4 in IFRS 9. Consistent with a request from some respondents for additional clarity, the Board explained in the Basis for Conclusions on IFRS 9 that the term 'equity instrument' used in paragraph 4.1.4 is defined in IAS 32 and that the instruments described in paragraphs 16A-16D of IAS 32 do not meet that definition.

18. With regards to the view outlined in paragraph 13 of this paper, we think IFRS 9 and its Basis for Conclusions are consistent. Paragraph 2.1(d) is part of the Standard's scope. We therefore think its objective is to point out only that the holder of (a) an instrument that meets the definition of an equity instrument in IAS 32 or (b) an instrument classified by the issuer as equity applying paragraphs 16A-16D of IAS 32 must apply IFRS 9 to those instruments (unless the instruments meet paragraph 2.1(a) of IFRS 9). Chapters 4 and 5 of IFRS 9 specify the classification and measurement

requirements for all financial assets within the scope of that Standard, including those described in paragraph 2.1(d).

19. Finally, as noted in the submission, the scope of the presentation election results in a different outcome between a direct investment in an equity instrument and an indirect investment (ie through an investment fund) if that indirect investment does not meet the definition of an equity instrument in IAS 32. The Board intentionally designed the presentation election in paragraph 4.1.4 to be relevant to a narrow population of investments in equity instruments that an entity holds for reasons other than increases in the investment's value. That is, as described in paragraphs BC5.22 and BC5.23 of IFRS 9, the election was designed specifically for investments that an entity holds for non-contractual reasons or benefits such as to build or enhance a business relationship with the investee or in order to gain access to a particular market such as a direct holding of equity shares.

Conclusion having considered the Committee's agenda criteria

20. The presentation election in paragraph 4.1.4 of IFRS 9 is available only for particular investments in equity instruments, as defined in IAS 32. Accordingly, we think the holder of a financial instrument that has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32 cannot use the presentation election in paragraph 4.1.4 of IFRS 9 for that instrument. This is because such an instrument does not meet the definition of an equity instrument in IAS 32.

21. This conclusion is supported by the Board's explanation of its decision in this respect set out in paragraph BC5.21 of IFRS 9.

22. For these reasons, we think that the requirements in IFRS 9 provide an adequate basis for the holder of the particular instruments described in the submission to classify such instruments. Having considered the agenda criteria in paragraphs 5.16-5.17 of the Due Process Handbook, we think it is not necessary to add to or change IFRS Standards to improve financial reporting.

Consulting the Board

23. On a number of previous matters concerning IFRS 9, we sought the Committee's advice before discussing with the Board. In this instance, we do not propose to discuss this matter with the Board because we think the Board's intentions are outlined in paragraph BC5.21 of IFRS 9.

Staff recommendation

24. On the basis of our assessment of the Committee's agenda criteria (and in particular our assessment of whether it is necessary to add to or change IFRS Standards to improve financial reporting), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend publishing an agenda decision that outlines how an entity applies the relevant requirements in IFRS 9 to the instruments described in the submission.

25. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions for the Committee

1. Does the Committee agree with the staff recommendation not to add this matter to its standard-setting agenda?
2. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

Appendix A

Proposed wording of the tentative agenda decision

IFRS 9 *Financial Instruments*—Financial assets eligible for the election to present changes in fair value in other comprehensive income

The Committee received a request to clarify whether particular financial instruments are eligible for the presentation election in paragraph 4.1.4 of IFRS 9. That election permits the holder of particular investments in equity instruments to present subsequent changes in fair value in other comprehensive income, rather than in profit or loss. The submitter asked whether financial instruments are eligible for that presentation election if they would be classified as equity by the issuer applying paragraphs 16A-16D of IAS 32 *Financial Instruments: Presentation*.

The Committee observed that the presentation election in paragraph 4.1.4 of IFRS 9 refers to particular investments in *equity instruments*. 'Equity instrument' is a defined term, and Appendix A of IFRS 9 specifies that it is defined in paragraph 11 of IAS 32. An equity instrument is defined in IAS 32 as 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities'. Consequently, a financial instrument that meets the definition of a financial liability cannot meet the definition of an equity instrument.

The Committee also observed that paragraph 11 of IAS 32 also specifies that, as an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument by the issuer if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32.

Accordingly, the Committee concluded that a financial instrument that has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32 is not eligible for the presentation election in paragraph 4.1.4 of IFRS 9. This is because such an instrument does not meet the definition of an equity instrument in IAS 32. This conclusion is supported by the Board's explanation of its decision in this respect outlined in paragraph BC5.21 of IFRS 9.

The Committee concluded that the requirements in IFRS 9 provide an adequate basis for the holder of the particular instruments described in the submission to classify such instruments. In the light of the existing requirements in IFRS Standards, the Committee [determined] that neither an IFRIC Interpretation nor an amendment to a Standard was necessary. Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B
Submission

A1. The submission has been reproduced below. We have deleted details that would identify the submitter of this request.

IFRS IC Potential Agenda Item Request

IFRS 9 - Are financial instruments classified as equity by the issuer under paragraphs 16A-16D of IAS 32 eligible for classification as at FVOCI by the holder?

We have been informed that there are divergent views on whether an holder of a financial instrument, classified as equity by the issuer in accordance with paragraphs 16A-16D of IAS 32 *Financial Instruments: Presentation* (IAS 32), may classify such financial instrument as fair value through other comprehensive income (FVOCI) in accordance with IFRS 9 *Financial Instruments* (IFRS 9).

Under IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39), most of these financial instruments (eg interests in debt funds, private equity funds, mutual funds, etc…) are now classified by the holder as available for sale (AFS). However, it seems that under IFRS 9, the holder might be required to classify these financial instruments as at fair value through profit or loss (FVPL), ie the holder could not classify these financial instruments as FVOCI.

Background

Under IFRS 9 a financial asset may be classified at FVOCI only in the two cases:

- the financial asset meets all the conditions indicated in paragraphs 4.1.2A of IFRS 9, or
- the financial asset is an investment in an equity instrument that is not held for trading (ie apply the option provided by paragraph 4.1.4 of IFRS 9).

Paragraph 4.1.2A of IFRS 9 states that:

"*A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:*

(a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding."

Interests in investment funds usually do not give rise to cash flows that are solely payments of principal and interest (SPPI). Consequently, they cannot be classified as FVOCI, because they do not meet the SPPI criterion in paragraph 4.1.2A (b) of IFRS 9.

Paragraph 4.1.4 of IFRS 9 allows classifying equity instruments that are not held for trading at FVOCI. It states that:

"*A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income.*"

Consequently, an entity, in order to classify a financial asset at FVOCI, should first verify whether the financial asset is an investment in an equity instrument, as defined in IAS 32, by considering the perspective of the issuer.

Appendix A *Defined terms* of the IFRS 9 refers to paragraph 11 of IAS 32 for the definitions of 'financial liability' and 'equity instrument'. In particular, an equity instrument is defined as follow:

"An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities."

This means that a financial instrument that meets the definition of a financial liability cannot be an equity instrument. However, the definition of a 'financial liability' in paragraph 11 of IAS 32 includes a limited scope exception for the issuer of a financial instrument. It states that: "(…) *As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D* (...)".

Paragraphs 16A and 16B of IAS 32 set out the conditions to classify as equity instruments puttable financial instruments. Paragraphs 16C and 16D deal with instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation.

The issue

Can financial instruments held, such as interests in debt funds, private equity funds, mutual funds, that meet the conditions of paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32, be classified as at FVOCI according to IFRS 9?

Views

One of our stakeholders conducted an outreach with some European banks. The results of this outreach shows that there are the following views on this issue:

View 1 – No, the holder cannot classify these financial instruments at FVOCI

Financial instruments that meet the condition included in paragraphs 16A-16D of IAS 32 are financial liabilities that are classified as equity instruments by the issuer (ie they do not meet the definition of equity instruments of IAS 32). The option provided by IFRS 9 to present the changes in fair value in OCI refers only to equity instruments defined as such by IAS 32.

Consequently, they are not eligible for classification in the FVOCI category by the holder. This view is supported by paragraph BC5.21 of IFRS 9, which states that:

"*IFRS 9 permits an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading. The term 'equity instrument' is defined in IAS 32 Financial Instruments: Presentation. The IASB noted that in particular circumstances a puttable instrument (or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) is classified as equity. However, the IASB noted that such instruments do not meet the definition of an equity instrument.*"

Supporters of this view note that the accounting manuals of major accounting firms hold this view.

View 2 – The IASB/IFRS IC should clarify whether the holder may classify these financial instruments at FVOCI

Paragraph 2.1of IFRS 9 states that:

"This Standard shall be applied by all entities to all types of financial instruments except:

a) …

d) *financial instruments issued by the entity that meet the definition of an equity instrument in IAS 32 (including options and warrants) or that are required to be classified as an equity instrument in accordance with paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32. However,* **the holder of such equity instruments** *shall apply this Standard to those instruments* (…)" [emphasis added].

The wording used in this paragraph seems to suggest that: if a financial instrument meets the criteria of paragraphs 16A-16D of the IAS 32, then it is an equity instrument also for the holder. However, this requirement is not consistent with paragraph BC5.21 of the IFRS 9, which states: "*such instruments do not meet the definition of an equity instrument"*.

Consequently, the IASB/IFRS IC should clarify this inconsistency between the Standard and its Basis for Conclusions.

Supporters of this view also observed that:

- IAS 32 provides an exception to the definition of a financial liability for financial instruments that meet the requirements in paragraphs 16A-16D. These financial instruments should be treated as equity instruments in every accounting aspect. They should be classified as equity instruments, both by the holder and the issuer, because in substance they represent a residual interest in the net assets of the issuer.
- View 1 may create additional volatility on banks' profit or loss and therefore it may impact the attractiveness of this type of investments (eg debt funds, private equity funds, mutual funds, etc…);
- View 1 may end up in creating an unreasonable distinction between direct investment in securities and indirect investment (ie through an investment fund) when in substance they are the same.

Reasons for the Committee to address the issue

Our assessment of the IFRS IC's agenda criteria is as follow:

The Interpretations Committee should address issues:	**Agenda criteria satisfied?**
that have widespread effect and have, or are expected to have, a material effect on those affected;	Yes. Investments through investment funds are common in practice, particularly in the financial sector. The two views presented above are expected to lead to different profit or loss results, particularly in the financial sector.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	Yes. We think that addressing this issue the IFRS IC would help entities in implementing IFRS 9 and in investment decisions.
that can be resolved efficiently within the confines of existing IFRSs and the Conceptual Framework for Financial Reporting.	Yes. We think that this issue can be resolved efficiently clarifying the requirements in IFRS 9.
In addition:	
Can the Interpretations Committee address this issue in an efficient manner?	Yes. The issue is narrow in scope.
The solution developed should be effective for a reasonable time period.	Yes. The issue is not related to an IASB project that is expected to be completed in the near future. The FICE project is not expected to be completed in the near future and IFRS 9 will be effective in 2018.