IFRS

IASB Agenda ref **6A**

STAFF PAPER

Week beginning 15 October 2012

REG IASB Meeting

Project	**Financial Instruments: Classification and Measurement**		
Paper topic	Update on Boards' individual decisions		
CONTACT(S)	Riana Wiesner	rwiesner@ifrs.org	+44 (0)20 7246 6926
	Yulia Feygina	yfeygina@ifrs.org	+44 (0)20 7332 2743
	Katherine Cancro	kcancro@ifrs.org	+44 (0)20 7246 6928

Background

1. In January 2012, the IASB and the FASB decided to jointly redeliberate selected aspects of their classification and measurement models for financial instruments to seek to reduce key differences.
2. The boards concluded their joint deliberations in July 2012 and during those joint deliberations the boards were able to more closely align their models. Since then, each board has separately considered what additional changes, if any, they would like to propose to other aspects of their respective models for inclusion in their respective Exposure Drafts.
3. In September 2012 the IASB concluded its deliberations on the limited amendments to IFRS 9 and granted the IASB staff permission to commence with the drafting of the exposure draft.

Purpose of this paper

4. This paper provides an update on the IASB and FASB's individual decisions since the conclusion of the joint deliberations in July 2012 and highlights any resulting differences between IFRS 9 *Financial Instruments* (post the proposed limited amendments) and the FASB's tentative model, to inform the

Board prior to balloting the ED. **The staff do not propose discussing this paper at the Board meeting. This paper is for information purposes only and the board will not be asked to make any decisions in respect of this paper.**

Joint decisions to date

5. The IASB and the FASB reached tentative decisions on the following matters (see Appendix A for a summary of these decisions) during the joint deliberations on classification and measurement:
   (a) contractual cash flow characteristics;
   (b) bifurcation of embedded derivatives in financial instruments;
   (c) business model for amortised cost classification;
   (d) for the IASB the introduction of, and business model for FVOCI classification;
   (e) reclassification of financial assets between measurement categories (including the mechanics); and
   (f) the fair value option.

Individual decisions to date

6. Following the conclusion of the joint deliberations in July 2012, the boards have made the following individual decisions:

IASB:

7. The IASB reached tentative decisions on the following transition and disclosure matters:
   (a) Extending existing disclosures in IFRS 7 *Financial Instruments: Disclosures* on reclassification to reclassifications into and out of fair value through other comprehensive income (FVOCI);
   (b) Transition requirements and disclosures for the initial application of the limited amendments to IFRS 9;

(c) Transition requirements for the initial application of IFRS 9 as a whole, including eliminating the option to early apply previous versions of IFRS 9 following the completion of IFRS 9;

(d) Accelerating the application of the IFRS 9 own credit requirements by modifying the transition requirements in the final version of IFRS 9 to permit an entity to early apply only the own credit requirements without otherwise changing the classification and measurement of financial instruments; and

(e) Additional presentation and disclosure requirements in the light of the proposed limited amendments to IFRS 9 as well as the interaction with the disclosures proposed in the impairment project.

8. At the September 2012 meeting the IASB granted the staff permission to begin drafting the Exposure Draft.

FASB:

Business model assessments

9. The FASB discussed the concepts to be incorporated in application guidance related to the business model assessment for measurement at amortised cost and FVOCI. The FASB have not yet drafted its application guidance however the relevant extract from their board meeting update is attached as an appendix to this paper (see Appendix B).

Acceleration of decision on presentation of changes in own credit risk

10. The FASB tentatively agreed that cumulative gains or losses recognised in other comprehensive income associated with changes in own credit risk for liabilities that are designated under the fair value option (as for IFRS 9) will be recognised in profit or loss (recycled) upon settlement of the liability.

11. While the FASB's decision for the recognition of changes in own credit in OCI is similar to that in IFRS 9, this tentative decision is not completely converged with the existing requirements of IFRS 9. IFRS 9 prohibits the cumulative own credit gains or losses previously recognised in OCI to be

recognised in profit or loss (recycled) upon derecognition of the liability. The FASB proposal would allow recycling.

12. The FASB also considered whether to accelerate its tentative decision regarding the presentation of changes in fair value attributable to changes in own credit risk for financial liabilities for which the fair value option has been elected.
13. The FASB decided not to accelerate the proposed own credit requirements in an exposure draft that is separate to the exposure draft on the overall classification and measurement proposals (see Appendix B).[1]

Foreign currency gain or loss on foreign currency denominated instruments measured at FVOCI

14. The FASB tentatively decided that foreign currency gains or losses on foreign currency denominated debt instruments measured at FVOCI should recognised in earnings and that such changes in foreign currency gains or losses should be calculated based on the fair value of the instrument. However, the tentative decisions permits an entity to use another fair value based approach that the entity deems as a more faithful measurement of the foreign currency gains and losses.
15. This tentative decision is not completely converged with the IASB's tentative decision to retain the existing requirements in paragraph AG83 of IAS 39 which requires the foreign currency translation gains or losses to be based on the amortised cost amount of the instrument. The treatment of foreign currency gains and losses on such instruments is consistent with the board's rationale that measurement at FVOCI should reflect amounts recognised in profit or loss as if the instrument is measured at amortised cost, while the fair value is recognised in the statement of financial position.

[1] IFRS 9 already includes the requirements relating to own credit and the IASB was effectively just asked if those requirements should have a different effective date to the rest of IFRS 9. In contrast the FASB will be exposing their proposals as part of the C&M model so their discussion was about whether the own credit proposals should be addressed separately to the rest of their model.

Equity investments

16. The FASB tentatively decided that equity investments (both marketable and non-marketable investments) should be measured at fair value through profit or loss (FVPL). However, as a practical expedient, an entity may elect to measure investments in non-marketable equity securities at cost adjusted for impairment and observable price changes in transactions involving identical or similar equity securities.
17. The FASB's proposed measurement requirements for equity investments are not completely converged with the existing requirements of IFRS 9. IFRS 9 requires that all equity investments are measured at FVPL but unlike the FASB model, IFRS 9 further permits an entity to irrevocably designate an equity investment at FVOCI, with all changes in fair value (except dividend income) recognised in OCI. Cumulative gains or losses recognised in OCI are prohibited from being recognised in profit or loss (recycled) upon derecognition of the investment. The IASB plans to publish educational material on measuring the fair value of unquoted equity investments before the end of the year.

Applicability of tentative C&M model to specialised industries

18. The FASB considered the applicability of the tentative decisions on the classification and measurement of financial instruments on certain specialised industries and tentatively decided to retain the existing industry guidance for some specialised industries such as broker-dealers, investment companies and mortgage banks.

19. The FASB will continue its deliberations at future meetings to discuss some remaining key topics such as contractually linked instruments, demand deposits, redemption value, scope and transition.

Appendix A: Joint tentative decisions to date

<table>
<tr><th>Area of discussion</th><th>IASB tentative decisions</th><th>FASB tentative decisions</th><th>Result</th></tr>
<tr><td>1. Contractual cash flow characteristics</td><td colspan="2">Only contractual cash flows that give rise on specified dates to cash flows that are solely payments for principal and interest (P&I) qualify for measurement category other than FVPL.
Include additional guidance that if the relationship between the principal, time value of money and credit risk is modified, the instrument should be compared to a benchmark instrument to assess the effect of the modification.</td><td>Converged</td></tr>
<tr><td>2. Bifurcation of embedded derivatives</td><td colspan="2">Financial assets with contractual cash flows that are not solely (P&I) would not be eligible for bifurcation (similar to existing IFRS 9 requirements). Those financial assets would be classified and measured in their entirety at FVPL.
Financial liabilities would be bifurcated using the existing bifurcation requirements in IFRS 9 and US GAAP.</td><td>Converged on not permitting bifurcation of financial assets.
Substantially converged on the bifurcation of financial liabilities.</td></tr>
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<tr><th>Area of discussion</th><th>IASB tentative decisions</th><th>FASB tentative decisions</th><th>Result</th></tr>
<tr><td>3. Business model test for amortised cost</td><td colspan="2">Only financial assets with contractual cash flows that consist solely of P&I that are held in a business model with the objective to collect contractual cash flow qualify for measurement at amortised cost.
Additional application guidance that demonstrate a ‘hold to collect’ business mode to be included.</td><td>Convergence on the objective of amortised cost classification. However development of FASB application guidance not completed yet so differences in application may arise.</td></tr>
<tr><td>4. Fair value through other comprehensive income (FVOCI)</td><td colspan="2">FVOCI classification to be included for eligible debt instruments.
Financial assets held within a business model with the objective to both hold assets in order to collect contractual cash flows and to sell assets will qualify if the contractual cash flow characteristics criteria are also met.
Interest on financial assets measured at FVOCI would be recognised in profit or loss using the effective interest method that is applied to financial assets measured at amortised cost.
Cumulative gains or losses recognised in OCI should be</td><td>Convergence on the objective of FVOCI classification and the recycling of cumulative gains or losses from OCI upon derecognition. However, development of FASB application guidance not completed yet so differences in application</td></tr>
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Area of discussion	IASB tentative decisions	FASB tentative decisions	Result
	recognised in profit or loss only when the instrument is derecognised.		may arise.
5. FVOCI - impairment	• Expected credit losses/reversals would be recognised in P&L using the same credit impairment methodology as for financial assets measured at amortised cost.	• Expected credit losses/reversals would be recognised using the same credit impairment methodology as for financial assets measured at amortised cost, but only when the fair value of the asset is less than the amortised cost basis and expected credit loss are not insignificant.	Impairment of financial assets measured at FVOCI is not completely converged as a result of the practical expedient.[2]

[2] The relevant extract from their board meeting update is attached as an appendix to this paper (see Appendix B)

Area of discussion	IASB tentative decisions	FASB tentative decisions	Result
6. Reclassification – reason and mechanics	• Financial assets would be reclassified when there has been a change in the business model • Agreed proposed reclassification mechanics for between measurement categories		Convergence on the requirement and the mechanics for reclassification.
7. Reclassification - date	Reclassification date defined as the first day of the reporting period following period in which the business model changed.	Reclassification date defined as last day of reporting period in which business model changed	Not converged

Appendix B: FASB Summary of Decisions Reached

August 29, 2012 FASB Board Meeting

Accounting for financial instruments: classification and measurement.

The Board discussed the application guidance related to the business model assessment for the classification and measurement of financial assets at amortized cost, fair value though other comprehensive income (FVOCI), and fair value through net income (FVNI). The Board decided that the application guidance to be included in the proposed standard should incorporate the following concepts to assist stakeholders in applying the principle associated with the business model assessment for classification and measurement of financial assets.

Amortized Cost

1. Examples of types of business activities that would be consistent with an amortized cost classification.
2. Sales of financial assets as a result of significant credit deterioration would be consistent with the objective of amortized cost classification if such sales are to maximize the collection of contractual cash flows through sales rather than through cash collection. Sales for other reasons should be very infrequent.
3. Sales of financial assets that result from managing the credit exposure due to concentration of credit risk would not be consistent with the primary objective of amortized cost classification.

FVOCI

1. Examples of types of business activities that would be consistent with a FVOCI classification.
2. Financial assets classified at FVOCI may be held for collection of contractual cash flows or sold. That is, management may hold the assets for an unspecified period of time or sell the assets to meet certain objectives.

FVNI

1. Financial assets that are held for sale at initial recognition would not be consistent with the primary objective of amortized cost or FVOCI classification.

The Board also tentatively decided to clarify that financial assets are classified at initial recognition into one of the three classification categories on the basis of an entity's business model. The classification of financial asset(s) is determined at origination or acquisition by the entity's key management personnel on the basis of how the asset(s) will be managed together with other financial assets within a distinct business model. An entity may have more than one business model for managing its financial assets.

September 5, 2012 FASB Board Meeting

Accounting for financial instruments: classification and measurement.

Request to Accelerate Decision on Presentation of Changes in Fair Value Attributable to Changes in Own Credit Risk

The Board discussed whether to accelerate the Board's tentative decision in the classification and measurement project regarding the presentation of changes in fair value attributable to changes in own credit risk for financial liabilities for which the fair value option has been elected. The Board decided not to accelerate the implementation of its tentative decision on the presentation of changes in own credit risk in other comprehensive income.

Measurement of Foreign Currency Gain or Loss on Foreign Currency Denominated Debt Instruments Classified at FVOCI

The Board discussed the measurement of foreign currency gain or loss on foreign currency denominated debt instruments classified at fair value through other comprehensive income (FVOCI). The Board decided that an entity should calculate the measurement of the foreign currency gain or loss using a method based on fair value of the instrument, for example, by measuring the instrument at fair value in the foreign currency times the difference between the end of period spot exchange rate and the beginning of the period spot exchange rate. Other fair-value-based approaches would also be appropriate, and the method would be applied consistently period over period. Investment companies would continue to apply the method in Subtopic 946-830, Financial Services—Investment Companies—Foreign Currency Matters.

September 7, 2012 FASB Board Meeting

Accounting for financial instruments: impairment.

The Board also discussed how the CECL model would apply to debt securities and financial assets measured at fair value through other comprehensive income (FV-OCI). The Board tentatively decided that the CECL model should apply to financial assets classified at amortized cost and financial assets measured at FV-OCI. However, as a practical expedient, an entity need not recognize expected credit losses for financial assets classified as FV-OCI when both of the following conditions are met:

1. The fair value of the financial asset is greater than the amortized cost basis.
2. Expected credit losses on the financial asset are insignificant.