IAASB International Auditing and Assurance Standards Board

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March 27, 2013

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Hans,

Re: Comments on IASB's Exposure Draft on Classification and Measurement: Limited Amendments to IFRS 9

I am pleased to provide comments on the IASB's November 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (ED). These comments have been developed by the International Auditing and Assurance Standards Board (IAASB)'s IASB Liaison Working Group (the Working Group), with a particular focus on auditability or verifiability, and reviewed by the IAASB Steering Committee.

Overall, the Working Group considers that the proposals in the ED represent improvements over the existing IFRS 9 *Financial Instruments.* However, the Working Group questions if the ED provides sufficient guidance to support exercising sound professional judgments in practice. The Working Group considers that it is neither necessary nor desirable for the IASB to provide exhaustive guidance for every possible situation, but it believes that it is essential for accounting standards to provide clear guidance about key principles so that preparers and auditors can exercise sound professional judgements.

The analysis of the Working Group noted several instances where the ED leaves room for discussion and confusion from an auditability perspective. In the Appendix, the Working Group points to several areas where auditors could come to different viewpoints and conclusions than preparers. Specific areas include how to determine an entity's business model for managing financial assets and how to assess contractual cash flow characteristics of financial assets. The Working Group also urges the IASB to set out clear expectations regarding how management should support and document its significant judgments.

I hope that you will find the comments helpful. If you require any clarification or would like to discuss this letter further, please do not hesitate to contact myself or Mr. Tomokazu Sekiguchi, the Chair of the Working Group (t.sekiguchi@asb.or.jp).

Yours sincerely,

Prof. Arnold Schilder
Chairman, IAASB

Cc. Mr. Prabhakar Kalavacherla, Member and Liaison Representative, IASB

Appendix

IASB EXPOSURE DRAFT-

CLASSIFICATION AND MEASUREMENT: LIMITED AMENDMENTS TO IFRS 9

Comments of the IAASB's Working Group

I. COMMENTS ON SPECIFIC QUESTIONS IN THE ED

A) QUESTION 2: ASSESSMENT OF CONTRACTUAL CASH FLOW CHARACTERISTICS

Issues Description

Paragraph 4.1.1 of the ED requires an entity to classify financial assets as subsequently measured at fair value through profit or loss (FV-PL), fair value through other comprehensive income (FV-OCI) or amortized cost on the basis of (a) the entity's business model for managing the financial assets and (b) the contractual cash flow characteristics of the financial assets. Paragraphs B4.1.7 to B4.1.26 provide guidance about how the contractual cash flow characteristics of the financial assets should be assessed.

(1) *<u>Assessment of whether a modification of an economic relationship could result in cash flows that are more than insignificantly different from the benchmark cash flows</u>*

Paragraphs B4.1.9A to B4.1.9E of the ED provide guidance about how to assess contractual cash flow characteristics where the economic relationship between principal and consideration for the time value of money and the credit risk in a financial asset are *modified* by an interest rate reset feature. Paragraph B4.1.9C requires the financial asset to be measured at FV-PL, if the modification could result in cash flows that are *more than insignificantly different* from the benchmark cash flows.

Paragraphs B4.1.9C-D of the ED provide guidance about how to assess whether a modification could result in cash flows that are *more than insignificantly different* from the benchmark cash flows. However, the Working Group is of the view that additional guidance would be helpful for preparers and auditors to help them exercise sound professional judgment in deciding on the appropriate accounting in each circumstance. For example, although paragraph B4.1.9D states that an entity shall consider *reasonably possible scenarios* rather than every scenario, the Working Group questions how many scenarios, in practice, need to be assessed. For example, the IASB tentatively decided to require at least two scenarios during the discussion about its credit impairment project, and similar guidance would be helpful regarding the matters addressed in the paragraphs B4.1.9C-D.

In addition, the Working Group finds that details on how the assessment should be made are unclear. For example, it is not clear whether the assessment should be made by interest interval period or throughout the contractual term. Further, it is not clear whether the assessment should be based on the information set that is observable at the financial reporting date or whether forward-looking information (including prospective macro-economic trends) should be incorporated. Depending on the mechanism used, the conclusions reached by management and auditors about the classification of financial instruments may differ significantly.

(2) *<u>Classification of financial assets whose contractual cash flows include payments that are unrelated to principal, the time value of money and the credit risk</u>*

Paragraph B4.1.8A of the ED states that if the contractual cash flows include payments that are unrelated to principal, the time value of money and the credit risk, the contractual cash flows do not represent solely payments of principal and interest; accordingly, such financial instruments shall be measured at FV-PL. In explaining the related guidance, paragraph BC4.25 of the existing IFRS 9 indicates that the notion of *materiality* is considered in the assessment of contractual cash flow characteristics, however it is not clear whether that paragraph will remain after the limited amendments are made.

The Working Group understands that the notion of materiality *always* applies in the preparation of financial statements, unless stated otherwise in a standard. However, the Working Group is unsure whether the IASB intends that it continue to permit some leeway to an entity in determining the classification of a financial asset whose contractual cash flows include payments that are unrelated to the three components, or whether the IASB intends that even a very immaterial feature of an instrument should affect the classification and measurement for the entire instrument. In the latter case, for example, even where 99.9% of a financial instrument's contractual cash flows are related to principal, the time value of money and credit risk, the existence of the 0.1% feature (for example, deep out of money share-indexed options) would mandate that the entire instrument be classified into the FV-PL category.

In addition, some may question how the concept of materiality should be applied when assessing the contractual characteristic of a financial asset, since the concept of materiality is usually considered in the context of the financial statements as a whole. For example, some may judge materiality on the basis of whether an unrelated portion of the financial asset is material compared to the financial asset in question (for example, some may conclude that 0.1% is not material for the financial asset). Others may judge materiality based on a measurement related to the financial statements as a whole (for example, whether the fair value of the financial asset is material, in comparison to, say, profit before tax from continuing operations.)

The Working Group is of the view that this is an area where preparers and auditors may have different viewpoints, and that clarification would be helpful to facilitate sound and consistent professional judgments by preparers and auditors.

(3) *Whether to revisit the test of contractual cash flow characteristics when contractual cash flows of a financial instrument are revised*

Paragraph 3.1.1 of the existing IFRS 9 requires an entity to classify a financial asset when it first recognises that asset, and a revision of this classification is not required or permitted unless there is a change in an entity's business model. However, the Working Group is unclear whether the IASB intends that a classification modification is not required or permitted where the contractual term of the financial asset is modified after initial recognition. This may occur, for example, when creditors give a concession regarding the term of a financial instrument to maximise their return (such contractual modifications are not rare in practice).

The ED does not appear to contain a requirement for an entity to revisit its initial classification assessment to ensure that the cash flows related to the financial instrument in question continue to support the initial classification. Without an explicit statement, preparers and auditors may arrive at different conclusions about whether a change to the previous classifications should take place.

Notwithstanding that this is not new to the ED, the Working Group is of the view that the proposed requirement to assess any modified economic relationships further highlights the importance of clarity in this respect.

(4) *Whether, and if so, when an entity should reassess the contractual cash flow characteristics*

Similar to the previous issue, the Working Group is unclear about whether or not an entity is required or permitted to reassess the test of contractual cash flow characteristics after initial assessments if there are changes in the entity's external factors. The Working Group is of the view that continuous reassessments would be almost impossible in the ever-changing economic environment. However, in certain circumstances, reassessment might be considered as necessary or appropriate. For example, there may be a significant increase or decrease in benchmark interest rates that was not considered as a "reasonably possible scenario" at the time of the initial assessment.

Whether, and if so, when to reassess the contractual cash flow characteristics is critical in understanding how the proposed standard should be applied in practice. Therefore, the Working Group is of the view that clarification on this issue would be helpful.

Actions that the IASB May Wish to Consider in Addressing the Issues:

The Working Group recommends that further consideration be given by the IASB, to clarify the following:

- How to assess whether the modification of an economic relationship could result in cash flows that are more than insignificantly different from the benchmark cash flows (including whether, and if so, how the concept of materiality should be applied to the assessment);
- Whether financial assets whose contractual cash flows include payments that are unrelated to the principle, the time value of money and the credit risk should always be classified under the FV-PL category, and also what represents the principal, the time value of money and the credit risk;
- Whether an entity is required to revisit its contractual cash flow characteristics test when changes are made to the contractual terms of a financial instrument; and
- Whether, and if so, when reassessment of the contractual cash flow characteristics test is necessary.

B) QUESTION 5: ASSESSMENT OF BUSINESS MODELS

Issues Description

Paragraphs 4.1.2 and 4.1.2A of the ED require an entity to classify a financial instrument on the basis of the contractual terms of the financial asset and the business model used to manage the asset. Paragraph B4.1.2B of the ED provides guidance about how the business model for managing the financial assets, and thereby their classification, is determined. The paragraph states that all objective evidence that is relevant to assessing the entity's business model must be considered, and provides the following examples as types of evidence to be considered:

(a) How the performance of the business is reported to the entity's key management personnel;

(b) How managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed); and

(c) The frequency, timing and volume of sales in prior periods, why such sales have occurred and expectations about the sales activity in the future.

(1) *Need for enhanced guidance about how to assess business models*

In explaining how these types of evidence should be assessed, paragraph B4.1.3 of the ED provides guidance about how the level of sales may be considered (corresponding to the example of evidence referred in paragraph B4.1.2B (c)). However, there is no explicit guidance about the assessment with regard to how the performance is reported and how the managers of the business are compensated (corresponding to the examples referred in paragraph B4.1.2B (a) and (b).)

The Working Group believes that providing enhanced guidance about what evidence should be considered in the assessment of business models is essential for preparers and auditors. The differences in business models that are applicable to FV-OCI and FV-PL (as well as the difference in business models applicable to amortized cost and FV-OCI) are often subtle and significant judgment is required to assess the evidence. For example, when financial assets are managed both to collect contractual cash flows and for sale (and thus, may fall under FV-OCI category), the performance of these assets is often reported not solely on the basis of their fair value but also on the basis of interest income and debtors' credit standings. In addition, it is often the case that managers of such businesses are typically compensated on the basis of a longer-term horizon than those of a trading business.

(2) *Other comments*

Paragraph B4.1.2A of the ED explains that the entity's business model for managing the financial assets is a *matter of fact* that can be observed by the way the business is managed and how its performance is evaluated by the entity's key management personnel. The Working Group understands that the term "matter of fact" is used to contrast with management's intention, which is inherently subjective. It is true that the use of the notion of "business model" increases objectivity for the classification of financial assets, but judgment is still necessary in determining the entity's business model in the context of the entity's circumstances. In the Working Group's view, using the words "matter of fact" may unexpectedly undermine the importance of exercising judgment in determining an entity's business model.

In addition, paragraph B4.1.2B of the ED requires an entity to consider "*all* objective evidence" that is relevant to assessing the entity's business model (emphasis added). The Working Group feels that this may be interpreted as requiring too high a bar for preparers and auditors, although that is not likely the intention of the IASB. Wording such as "an entity should consider *all reasonably available evidence"* may prevent confusion in practice.

Actions that the IASB May Wish to Consider in Addressing the Issues:

The Working Group has the view that the IASB should consider strengthening the guidance about how relevant evidence is to be assessed in determining an entity's business model.

In addition, the Working Group suggests that the following modifications be made to the wording in paragraphs B4.1.2A and B4.1.2B.

- Remove the words "a matter of fact" in the first sentence (for paragraph B4.1.2A); and
- Modify the explanations of what evidence should be considered in the assessment (paragraph B4.1.2B).

II. OTHER COMMENTS

C) DOCUMENTATION REQUIREMENTS FOR MANAGEMENT

Issue Description

As stated in our previous comment letters, the Working Group continues to believe that it is important that accounting standards specify what actions an entity's management can take to provide evidence to support and substantiate its judgments regarding significant accounting matters. Developing appropriate supporting documents can help improve the quality of the decisions made and help auditors obtain sufficient appropriate evidence regarding those decisions. The Working Group believes that the IASB should emphasize the importance of maintaining appropriate documentation to support key judgments in several aspects of the ED.

For example, it might be helpful if paragraph B4.1.2B of the ED were to be supplemented by a requirement for management to evidence factors considered when determining an entity's business model and the conclusions reached. As stated in our comments on Question 5, the Working Group believes that determining the business model requires substantive judgment, and it is necessary for management to provide sufficient evidence to support such judgments.

In addition, the Working Group finds that paragraph B4.1.3 of the ED gives the impression that the absence of a documented investment policy does not preclude an entity from providing evidence to support the argument that the sales are due to the deterioration of credit quality. In hindsight, there can be many reasons for the sales of financial assets; therefore, the Working Group questions how preparers and auditors will be able to effectively demonstrate the reason for sales without a documented investment policy that has been prepared before those sales occurred. The Working Group thinks that it is important to give further emphasis to the need for a documented investment policy, and clarify, if the IASB believes it possible, how an entity might support the reasons for sales in the absence of such a policy.

Actions that the IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that more emphasis be given to how an entity can provide evidence to support its significant judgments.

D) RECLASSIFICATION OF FINANCIAL ASSETS

Issue Description

Paragraph 4.4.1 of the existing IFRS 9 requires reclassification of financial assets when the entity changes its business model. Guidance and examples are provided in paragraphs B4.4.1 to B4.4.3 of the existing IFRS 9, and these provisions are left unchanged in the ED.

As proposed in the ED, an entity would be required to reclassify its financial assets measured at FV-OCI to amortized cost (or FV-PL) or vice versa, when there are changes in its business model. However, there is no relevant guidance or examples, both of which the Working Group believes would be helpful.

As stated in our comment on Question 5, the Working Group is also of the view that the differences in business models that are applicable to deciding whether to apply FV-OCI and FV-PL are often subtle. Additionally, whether to reclassify financial assets requires an even higher amount of judgment, when considering reclassification of financial assets measured at FV-OCI to amortized cost (or FV-PL) or vice versa, compared with the reclassification of those measured at FV-PL to amortized cost or vice versa. For example, some may question if a change in an entity's process for reporting performance to key management personnel or compensation arrangements may necessitate reclassification of financial assets, and if so, to what extent is objective evidence of this change needed.

Actions that the IASB May Wish to Consider in Addressing the Issue:

The Working Group is of the view that additional guidance or examples about reclassification of financial assets measured at FV-OCI to amortized cost (or FV-PL) or vice versa would be helpful.