IFRS News

Emerging issues and practical guidance*

Supplement – December 2008

Frequently asked questions on reclassification of financial assets

The November edition of *IFRS News* provided background information on the IASB's recent amendment to IAS 39, 'Financial instruments: Recognition and measurement', and IFRS 7, 'Financial instruments: Disclosures', permitting the reclassification of certain financial assets. The Board has since amended the standard to clarify that the cut-off date for retrospective application of the amendment was 1 November 2008. Any reclassifications after that date must use the fair value at the date of reclassification.

The ability to reclassify financial assets has proved popular with financial institutions, and a number of interpretation issues have arisen over the past few weeks. Scott Bandura of PwC's Global Accounting Consulting Services central team presents some of the frequently asked questions that have arisen in this context. We have included again the flowchart that we first published in the November edition of *IFRS News*, for convenience.

Scope of the amendment

Question 1

Can financial assets designated at fair value through profit or loss at initial recognition (that is, through the use of the fair value option) be reclassified under these amendments?

Answer 1

No. IAS 39 para 50(b) prohibits entities from reclassifying financial instruments out of the fair value through profit or loss category if they were voluntarily designated into that category on initial recognition.

Question 2

Can financial assets be reclassified into the held-for-trading category? For example, if a financial asset is reclassified out of the held-for-trading category in September 2008 due to the deterioration in the financial markets at that time, can it be reclassified back into the held-for-trading category in a later period?

Answer 2

No. IAS 39 para 50 prohibits entities from reclassifying financial instruments into the fair value through profit or loss category after initial recognition.

Question 3

In rare circumstances, can a financial asset that is no longer held for the purpose of selling it in the near term be reclassified out of the fair value through profit or loss category and into the held-to-maturity category?

Answer 3

Yes, provided at the date of reclassification the conditions for classifying the asset as held to maturity are met including having a positive intention and ability to hold to maturity.

Question 4

Can an entity reclassify financial instruments that form part of the portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit making (IAS 39 para 9a(ii))?

Answer 4

Yes. IAS 39 para 50(c) permits a financial asset classified as held for trading to be reclassified if the financial asset is no longer held for the purpose of selling it in the near term. The entity should then meet the requirements in paras 50B (rare circumstances) or 50D (the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity).

Question 5

The definition of loans and receivables refers to financial assets that are not quoted in an active market. What does 'quoted in an active market' mean?

Answer 5

IAS 39 AG71 states that a financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. What is 'regularly occurring' is a matter of judgement and depends on the facts and circumstances of each particular instrument. For example, instruments acquired on original issuance date or shortly thereafter for which there was no further occurring market transactions are not generally considered to be quoted in an active market. Further guidance on the definition of active market can be found in the IASB Expert Advisory Panel education document on the IASB website www.iasb.org.

Question 6

Can a financial asset classified as held for trading or available for sale that was previously quoted in an active market and is no longer quoted in an active market be reclassified to loans and receivables under the amendment?

Answer 6

Yes, provided that it would have met the definition of a loan or receivable before and at the date of reclassification and that it meets either the conditions in IAS 39 paras 50B (rare circumstances) or 50D (the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity).

Question 7

IAS 39 para 50F indicates that for reclassifications of available-for-sale assets to loans and receivables, the gain or loss recorded in equity should be accounted for in accordance with IAS 39 para 54. However, IAS 39 para 54 deals only with instruments reclassified from available for sale to held to maturity. Should management read IAS 39 para 54 to include available-for-sale assets reclassified as loans and receivables?

Answer 7

Yes. The amendment explicitly indicates that entities should use the guidance in IAS 39 para 54 for loans and receivables. This means that any gain or loss in equity will be amortised over the remaining life of the asset using the effective interest rate method.

Question 8

Can a loan commitment that an entity has classified at fair value through profit or loss because the entity has a past practice of selling the assets resulting from its loan commitments shortly after origination be reclassified under the proposed amendments?

Answer 8

No. Loan commitments in the scope of IAS 39 meet the definition of a derivative and are therefore prohibited from being reclassified under this amendment as per IAS 39 para 50(a).

Question 9

When an entity reclassifies a financial asset into loans and receivables under this amendment at 1 July 2008, can the entity also retrospectively apply hedge accounting at that date?

Answer 9

No. Hedge accounting is only permitted to be applied prospectively from the date the hedging relationship is designated and documented.

Subsequent measurement

Question 10

When a financial asset is reclassified into loans and receivables or held to maturity, what effective interest rate

should be used for subsequent measurement at amortised cost?

Answer 10

IAS 39 paras 50C and 50F state that the effective interest rate is calculated using the fair value at the date of reclassification rather than the original effective rate of the instrument as the fair value at the date of reclassification becomes its new amortised cost basis. The effective interest rate calculated on the date of reclassification is therefore used to recognise interest income in future periods (See also Q&A 14).

Question 11

IAS 39 para 61 states, 'A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment'. What should be considered the 'cost' for an equity investment that has been reclassified into available for sale?

Answer 12

The fair value at the date of reclassification is the 'cost' for assessing impairment.

Question 13

IAS 39 para 63 states, 'The amount of the [impairment] loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows …discounted at the financial asset's original effective interest rate (ie the effective interest rate computed at initial recognition).' What should be considered the original effective interest rate for a financial asset that has been reclassified into loans and receivables or held to maturity?

Answer 13

The effective interest rate determined at the date of reclassification should be considered the original effective interest rate for calculating impairment.

Question 14

How should a subsequent increase in the estimates of expected future cash flows of a financial asset that was reclassified in accordance with IAS 39 paras 50B, 50D or 50E be accounted for?

Answer 14

Under IAS 39 AG8, as revised in October 2008, any increase in the estimates of expected future cash flows arising from recoveries is reflected by adjusting the effective interest rate prospectively, rather than as an adjustment to the carrying amount. Consequently, any increased recoverability of cash receipts is spread over the remaining life of the debt instrument.

Question 15

An entity has reclassified a floating rate financial asset to loans under the amendment on 1 July 2008. The loan was originally purchased for C100. At the date of reclassification, the fair value of the instrument had decreased substantially as a result of a decline in the creditworthiness of the counterparty to C80, and the entity expects to get undiscounted cash receipts of C90. At 31 December, the credit rating of the counterparty has increased (for example, because of government backing); the entity now expects to get undiscounted cash receipts of C100. How should the entity account for that increase in expected cash receipts?

Answer 15

Management should recalculate its effective interest rate prospectively to reflect those new cash receipts. The amendments to IAS 39 AG8 state that the increase in expected future cash receipts must be reflected in a new effective interest rate.

Question 16

An entity reclassified a fixed rate asset to loans and receivables under the amendment on 1 July 2008. The loan was originally purchased for C100. At the date of reclassification, the fair value of the instrument at 1 July 2008 had decreased substantially as a result of a decline in the creditworthiness of the counterparty to C60 and the entity expects to get undiscounted cash receipts of C75. At 31 December 2008, the recoverability of cash receipts has decreased to C50. Should management recalculate its effective interest rate (downwards) to reflect those revised expected cash receipts?

Answer 16

No. The amendments to IAS 39 AG8 require the effective interest rate to be adjusted only where there are increases in the estimates of future cash receipts. Decreases in estimates of future cash receipts do not result in a downwards adjustment to the effective interest rate. The reduction in estimated cash receipts at 31 December 2008 will be reflected as an impairment loss measured in accordance with IAS 39 para 63.

Question 17

An entity reclassified a fixed rate debt instrument to loans and receivables under the amendment on 1 July 2008.

The loan was originally purchased for C100. At the date of reclassification, the fair value of the instrument at 1 July 2008 had decreased substantially as a result of a decline in the creditworthiness of the counterparty to C60. At 31 December 2008, the recoverability of cash receipts has decreased to C50; the entity records an impairment loss. At 31 March 2009, the recoverability of cash receipts has increased to C60. How should management account for the increase in cash receipts?

Answer 17

Management should account for the increase in expected cash receipts as a reversal of the impairment that is recorded at 31 December 2008 in accordance with IAS 39 para 65.

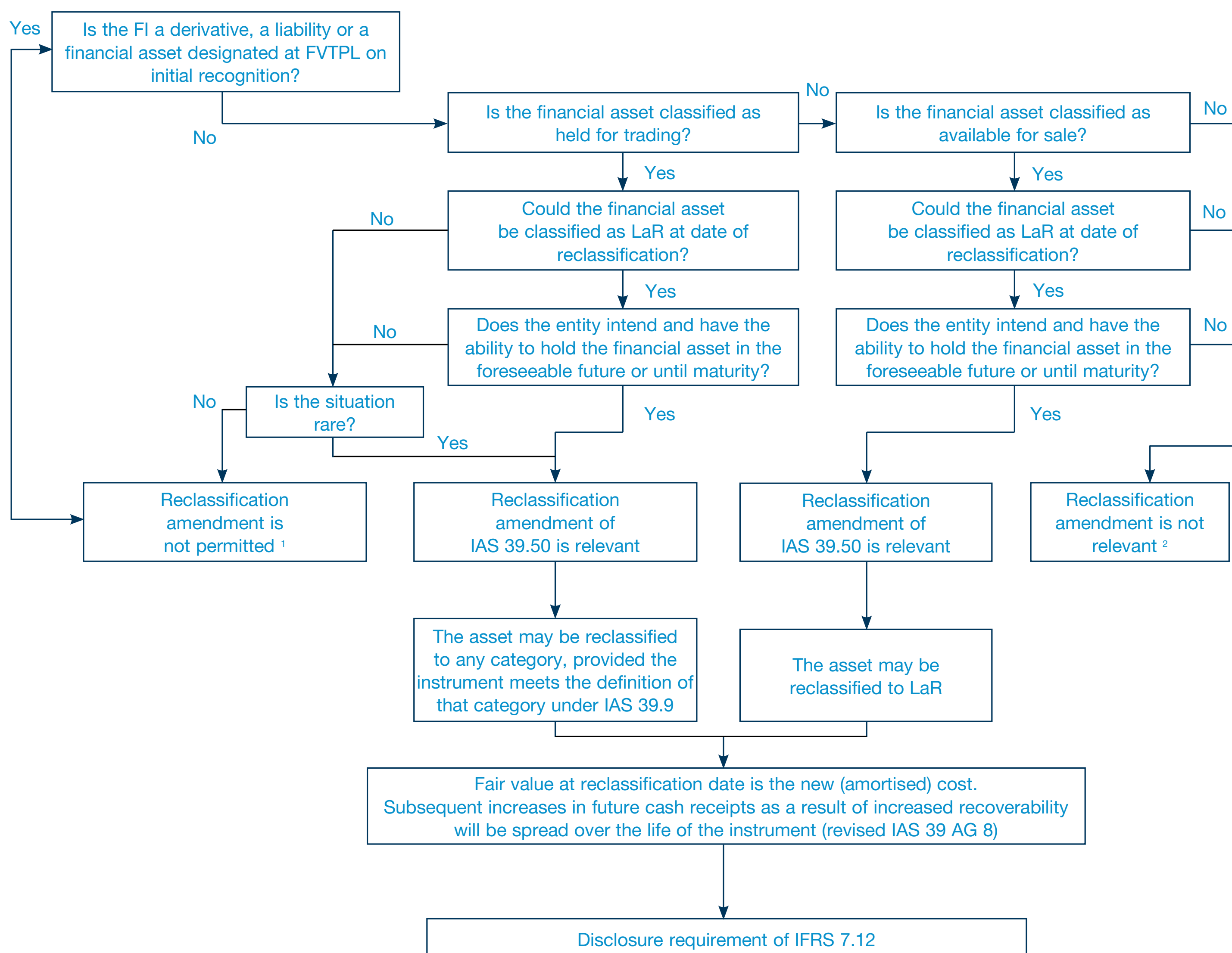
Question 18

An entity reclassifies a financial asset denominated in a foreign currency to loans and receivables. Does management calculate the 'amortised cost' of the financial asset at the date of reclassification in the foreign currency and apply the spot rate to translate that amortised cost to the functional currency at the date of reclassification?

Answer 18

Yes. In accordance with the guidance in IAS 39 IG E3.4, the measurement of the financial asset is first determined in the foreign currency and is then translated into the functional currency using the spot rate on the date of the transfer.

Amendment of IAS 39 for the reclassification of financial instruments published in October 2008



[1] See IAS 39.50

[2] See IAS 39.51-54 for guidance on reclassification