Financial instruments: Classification and measurement — joint deliberations now complete

What you need to know

- The Boards tentatively agreed on a converged approach to accounting for reclassifications between measurement categories. The only difference remaining is the ‘date of reclassification’. This is not expected to be a key difference, particularly given the anticipated infrequency of changes in business model.
- The IASB tentatively decided to extend the disclosure requirements in IFRS 7 in respect of reclassifications between the amortised cost and fair value through profit or loss measurement categories to reclassifications into and out of the proposed new fair value through other comprehensive income measurement category.
- The IASB also made some tentative decisions about transitional provisions and disclosures to accompany the proposed modifications to the IFRS 9 classification and measurement model.
- The IASB decided to propose that once the final version of IFRS 9 is published, those entities early adopting IFRS 9 must apply this version.

Highlights

At the joint meeting in July 2012, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) discussed accounting for reclassifications of financial assets and related disclosures. At a separate meeting, the IASB also discussed transitional provisions and disclosure requirements that will accompany the limited modifications to IFRS 9.

The Boards have now concluded their joint discussions on the classification and measurement of financial assets. The outcome of these discussions is a substantially converged approach to the classification and measurement of debt instruments. The Boards plan to issue their respective exposure drafts (EDs) on classification and measurement during the fourth quarter of 2012.

We consider the key decisions the IASB made at the meeting, both jointly with the FASB and separately. A summary of the key joint decisions made in previous meetings is included in the appendix to this publication. All of the decisions noted here are tentative and subject to change.

Accounting for reclassifications between measurement categories

IFRS 9 Financial Instruments requires prospective reclassification when an entity changes its business model for managing financial assets. This means that an entity would not restate any previously recognised gains, losses or interest.

In May 2012, the Boards agreed that this requirement should apply to all reclassifications of financial assets between the measurement categories, including the fair value through other comprehensive income (FVOCI) measurement category for eligible debt instruments that the IASB had previously decided to add to the IFRS 9 classification and measurement model.

IFRS 9 already deals with reclassifications between the amortised cost (AC) and the fair value through profit or loss (FVTPL) measurement categories. Accordingly, we focus below on the accounting for reclassifications of eligible debt instruments into and out of the new FVOCI measurement category.

1 In January 2012, the Boards decided to jointly re-deliberate selected aspects of their classification and measurement models for financial instruments to seek to reduce key differences.
2 Changes in the business model that require reclassifications are expected to be very infrequent and must meet certain conditions.
3 The FASB’s original proposals already included FVOCI for debt instruments.
4 Paragraphs 5.6.2 and 5.6.3.
In July 2012, the boards decided the following accounting consequences would arise at the ‘date of reclassification’ into or out of the FVOCI:

Reclassifications from FVOCI into FVTPL

The debt instruments are transferred at fair value. Any accumulated OCI balances pertaining to the reclassified debt instruments should be recycled from OCI to P&L.

Reclassifications from FVOCI into AC

The debt instruments are transferred initially at fair value. The accumulated OCI balance at the reclassification date should be derecognised by transferring it to the related financial asset balance. As a result, the debt instruments will be measured at the reclassification date at amortised cost as if it had always been so classified.

Reclassifications from FVTPL into FVOCI

The debt instruments are transferred at fair value. Changes in fair value of the debt instruments subsequent to the reclassification date should be recognised in OCI (fair value changes prior to reclassification date are not transferred to OCI). An EIR will be calculated based on the carrying amount at the reclassification date.

Reclassifications from AC into FVOCI

The reclassified debt instruments should be measured at fair value with any difference between the previous carrying amounts and the fair values recognised in OCI.

Transition provisions of the limited amendments to IFRS 9

Limited modification to the IFRS 9 contractual cash flow characteristics assessment

In February 2012, the IASB modified the contractual cash flow characteristics assessment (the ‘characteristics assessment’). Refer to the appendix of this publication for details on this minor modification.

When adopting IFRS 9, the standard requires the characteristics assessment to be made retrospectively, based on the contractual cash flows as at initial recognition. In July 2012, the IASB decided to modify the retrospective application of the characteristics assessment, where such retrospective application is impracticable, to require entities to retrospectively apply the characteristics assessment as per IFRS 9 (2010). For instance, if an entity determined that applying the judgemental assessment is not possible without the benefit of hindsight, because it is not possible to objectively distinguish information that provides evidence of circumstances that existed and would have been available to the entity at the time of initial recognition, then it should apply the version of the assessment as set out in IFRS 9 (2010). Applying the characteristics assessment of IFRS 9 (2010) means that instruments with modifying features would most likely be classified and measured at fair value.

In addition, the IASB decided to require disclosure of the carrying values of the financial assets whose cash flows have been assessed under the characteristics assessment as set out in IFRS 9 (2010) until these assets are derecognised.

Fair value option (FVO) for early appliers

The application of the revised classification and measurement requirements will cause the classification of some financial assets to change, and consequently accounting mismatches will change. Therefore, the IASB tentatively decided to:

(i) Require entities that have already applied IFRS 9 (2009) and/or IFRS 9 (2010) to revoke previous FVO elections if an accounting mismatch no longer exists at initial application of the amended classification and measurement requirements

(ii) Permit such entities to apply the FVO to new accounting mismatches created by the initial application of the amended classification and measurement requirements

Entities will neither be permitted to revoke previous FVO elections if an accounting mismatch continues to exist, nor will they be permitted to apply the FVO to accounting mismatches that already existed before the initial application of the revised classification and measurement requirements.

Phased early application of IFRS 9

The IASB decided that, once the complete version of IFRS 9 is published, (which will include the revised classification and measurement model, the expected loss impairment model and the general hedge accounting model), entities adopting IFRS 9 would no longer be permitted to take a phased approach to adopting IFRS 9.

The IASB also decided that early adoption of the complete version of IFRS 9 would be permitted.

Entities that had already adopted a previous version of IFRS 9 (prior to the publication of the complete version of IFRS 9) would be able to continue applying that version and they would not be required to apply the final requirements until the mandatory effective date. Such entities may not ‘upgrade’ to another interim version once the complete version of IFRS 9 is finalised.

How we see it

The IASB’s decision to prohibit a phased adoption once the final version of IFRS 9 is finalised is intended to deal with concerns about comparability. If the Board had not made this decision, it would have been possible to choose from as many as four versions of IFRS 9 for early adoption at a given point in time. This would have significantly undermined comparability between entities and between periods for a single entity.

5 IFRS 9 defines ‘date of reclassification’ as the first day of the first reporting period following a change in business model. In July 2012, the FASB tentatively decided that the reclassification date should be the last day of the reporting period in which there is a change in a business model.

6 Paragraph 28(h) IAS 8 requires disclosure of the circumstances that led to impracticability and a description of how and from when the change in accounting policy has been applied.
Additional presentation and disclosure requirements

Disclosure and presentation requirements related to the proposed FVOCI measurement category
The IASB decided to:

- Require the impairment disclosures for debt instruments measured at FVOCI to be consistent with those for assets measured at amortised cost, including disclosure of an accumulated impairment amount.
- Prohibit the presentation of an allowance balance on the face of the statement of financial position for debt instruments measured at FVOCI.

What’s next?
The IASB intends to issue its ED on classification and measurement during the fourth quarter of 2012. The ED is expected to include:

- Application guidance on the types of business activities that would qualify for the FVOCI business model
- Additional implementation guidance clarifying the primary objective of the amortised cost ‘hold to collect’ business model

In addition, we also believe the IASB will need to consider whether to extend its IFRS 9 hedge accounting model to financial assets recorded at FVOCI. However, such a decision would unlikely to be made before the feedback on the ED is received and a final decision to introduce the FVOCI measurement category is made.

In light of the timeline set for the ED for this project, we do not expect a final classification and measurement standard before the middle of 2013. This, in addition to the timeline of the impairment phase and insurance project, will continue to put pressure on the mandatory effective date of the final IFRS 9. Specifically, whether 2015 is a feasible date for applying the complete version of IFRS 9. The IASB is expected to request feedback on the effective date as part of its request for comment on its forthcoming ED on the new impairment model.

Example
An entity acquires a debt instrument on 1 January 2011, with a face value of CU 4,500 and classifies the instrument at FVOCI. On that date, the fair value equals the face value. Expected losses for the debt instrument on 1/1/2011 are CU 20.

On 31 December 2011, the fair value of the debt instrument has decreased to CU 4,430. Expected losses for the instrument have increased to CU 30.

The following table illustrates the journal entries the entity would make for the above debt instrument. The amounts in brackets reflect credit movements/credit balances.

<table>
<thead>
<tr>
<th>Date</th>
<th>Journal entry</th>
<th>Cash</th>
<th>FVOCI debt instrument</th>
<th>Amortised cost debt instrument</th>
<th>Allowance for credit losses</th>
<th>OCI</th>
<th>Impairment expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/2011</td>
<td>JE1</td>
<td>(4,500)</td>
<td>4,500</td>
<td></td>
<td>(20)</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>31/12/2011</td>
<td>JE3</td>
<td>(70)</td>
<td></td>
<td></td>
<td>(10)</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>31/12/2011</td>
<td>JE4</td>
<td></td>
<td></td>
<td></td>
<td>70</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(4,500)</td>
<td>4,430</td>
<td></td>
<td></td>
<td>40</td>
<td>30</td>
</tr>
<tr>
<td>1/1/2012</td>
<td>JE5</td>
<td>(4,430)</td>
<td></td>
<td></td>
<td>(30)</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>1/1/2012</td>
<td>JE6</td>
<td></td>
<td></td>
<td></td>
<td>70</td>
<td>(70)</td>
<td></td>
</tr>
<tr>
<td>1/1/2012</td>
<td>JE7</td>
<td>(4,500)</td>
<td></td>
<td></td>
<td></td>
<td>4,500</td>
<td>(30)</td>
</tr>
</tbody>
</table>

JE1: To record the purchase of the debt instrument at fair value.

JE2: To record an impairment expense based on the expected loss model (based on deliberations in the impairment project).

JE3: To record additional impairment based on the increased estimate for expected losses (based on deliberations in the impairment project).

JE4: To write down the carrying amount of the debt instrument to its new fair value.

JE5: To reclassify the debt instrument in the amortised cost measurement category.

JE6: To establish an allowance for credit losses expected at the date of reclassification (based on deliberations in the impairment project).

JE7: The accumulated OCI balance of CU 70 is derecognised by transferring it to the debt instrument balance.

Example

An entity acquires a debt instrument on 1 January 2012, the debt instrument is reclassified into the AC measurement category, based on a change in business model which took place in December 2011.

For simplicity, interest is ignored.

7 Adapted from the IASB agenda paper 6A discussed in July 2012 meeting.
Summary of key joint decisions made in previous Meetings

Contractual cash flow assessment
In February 2012, the Boards agreed to align the cash flow characteristics assessment in their respective classification and measurement models. From an IFRS 9 perspective, this decision will be in a minor modification to its application guidance. Under this proposed modification, an entity, in making an assessment as to whether the contractual cash flows of an instrument consist solely of principal and interest, would be required to evaluate whether the economic relationship between the principal, the time value of money, and the credit risk is modified by a more than insignificant degree.

Amortised cost business model assessment
In April 2012, the Boards decided that financial assets that satisfy the contractual cash flow characteristics test will qualify for amortised cost if the assets are held within a business model whose objective is to hold the assets in order to collect contractual cash flows (i.e., the approach used in IFRS 9). Additional implementation guidance is expected to address the current tension between some of the examples provided in IFRS 9.

Bifurcation of financial instruments
In April 2012, the Boards decided that financial assets that contain cash flows that are not solely principal and interest would not be eligible for bifurcation into an ‘embedded derivative’ and ‘host contract’. Rather, they would be classified and measured in their entirety at fair value through profit or loss.

The Boards also decided that financial liabilities would be bifurcated using the existing bifurcation requirements in IFRS 9 and US GAAP.

FVOCI and FVTPL business model assessment
In May 2012, the Boards decided that financial assets with contractual cash flows that are solely payments of principal and interest would qualify for FVOCI classification and measurement at initial recognition if the entity’s business model for a portfolio is both: (1) to hold to collect contractual cash flows; and (2) to sell the financial assets. The Boards agreed that financial assets that pass the contractual cash flow characteristics assessment, but fail either the business model criteria for FVOCI or amortised cost, would be classified as FVTPL, as a residual category.

Mechanics of the FVOCI measurement category
In May 2012, the IASB decided that, for assets recorded at FVOCI, entities should provide amortised cost information in profit or loss and fair value information on the balance sheet. Therefore, interest income and credit impairment losses/reversals would be recognised in profit or loss using the same methodologies as for financial assets measured at amortised cost. The net cumulative fair value gain or loss recognised in other comprehensive income (OCI) would be recycled from OCI to profit or loss when these financial assets are derecognised.

Application of the conditional fair value option (FVO) in IFRS 9 to the FVOCI measurement category
In June 2012, the IASB tentatively decided to extend the FVO in IFRS 9 to debt instruments that would otherwise be measured at FVOCI. This means that an entity may, on initial recognition, irrevocably elect to designate a debt instrument at FVTPPL, if doing so eliminates or significantly reduces an accounting mismatch.

Footnote:
8 For further details on previous tentative decisions made by the IASB, please see previous editions of IFRS Developments, available on www.ey.com/ifrs.