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IFRS Developments

IFRS 9 classification and measurement – IASB deliberations are now substantially complete

What you need to know

In September, the IASB has tentatively decided:

- To propose an amendment to IFRS 9 that would allow an entity to apply the requirements for the presentation of fair value gains or losses attributable to changes in the issuer's own credit risk, without the need to early adopt IFRS 9 in its entirety.
- In the period in which IFRS 9 is initially applied, it will not require the disclosures otherwise required by paragraph 28(f) of IAS 8.
- Once IFRS 9 is finalised, previous versions of IFRS 9 will not be available for early adoption six months after the publication of the final version of IFRS 9.

Overview

In July 2012, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) concluded their joint discussions[1] 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.

At its September meeting, the IASB substantially concluded its deliberations on its project to make limited amendments to IFRS 9. Here, we highlight the key decisions made at this meeting. A summary of the key 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.

Early adoption of 'own credit' gains and losses to be allowed

IFRS 9 (2010)[2] requires that when a financial liability is designated as at fair value through profit or loss under the fair value option, the change in the fair value of the liability attributable to changes in the issuer's own credit should be recognised in other comprehensive income (OCI).[3] IFRS 9 further requires that amounts presented in OCI will not subsequently be reclassified (recycled) to profit or loss.

Currently, entities are allowed to early adopt either IFRS 9 (2009) or IFRS 9 (2010). However, IFRS 9 (2010) includes the IFRS 9 (2009) requirements for classification and measurement of financial assets, as well as for financial liabilities. Therefore, any entity wishing to make use of the 'own credit' requirements by early adopting IFRS 9 (2010) would need to apply IFRS 9 (2010) in its entirety, including the classification and measurement requirements for financial assets.

[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] Paragraphs 5.7.7 - 5.7.9.

[3] If the presentation of changes in the liability's credit risk were to create or enlarge an accounting mismatch, IFRS 9 (2010) requires the gains or losses on that liability to be presented in profit or loss. However, the circumstance in which this would occur is expected to be rare.

As a result of the re-opening of the classification and measurement requirements in IFRS 9, entities are unlikely to consider the early adoption before these limited modifications have been finalised. Furthermore, in July 2012, the Board tentatively decided that, once the different phases of the IFRS 9 project (i.e., limited improvements to classification and measurement, impairment, general hedge accounting) are finalised, entities will no longer be permitted to early apply previous versions of IFRS 9.[4]

This would mean that entities would have to wait until IFRS 9 is finalised in its entirety before being able to apply the revised classification and measurement and 'own credit' requirements. It is currently expected that implementing the impairment requirements of IFRS 9 would require a significant lead time. As a result, an entity may not be able to make use of the 'own credit' requirements before 2015.

In response to continuing requests from constituents, the IASB decided to propose an amendment to IFRS 9 that would allow an entity to early apply only the 'own credit' requirements without the need to apply IFRS 9 in its entirety. This means that, until the mandatory effective date of IFRS 9, entities could elect only to change their accounting for own credit while continuing otherwise to account for their financial instruments in accordance with IAS 39.

Taking into consideration its current work plan to finalise all phases of IFRS 9 by the end of 2013, the IASB plans to include this relief in the final version of IFRS 9 only, rather than publishing this as a separate amendment to IFRS 9 (2010). However, if the time line for completing the project were to be extended beyond the end of 2013, the Board may potentially consider including this relief in IFRS 9 (2010).

Additional transition issues

When it amended the effective date and transition disclosures for the classification and measurement phase of IFRS 9 in December 2011, the IASB noted that it was not modifying the requirements of IAS 8. However, at the time, the IASB did not discuss in detail the interaction of IFRS 9 with IAS 8.

Paragraph 28(f) of IAS 8 requires an entity to disclose, for the current period and for each prior period presented, the amount of the adjustment for each financial statement line item affected when the initial application of an IFRS has an effect on the current period or on any prior period. Constituents have asked the Board whether IAS 8 requires disclosure of the line item amounts that would have been reported in accordance with the previous accounting policy, i.e., (a) in accordance with the new policy for prior periods if these are not required to be restated at transition; and/or (b) in accordance with the previous accounting policy for the current period.

Notwithstanding that this question is being addressed more broadly by the ongoing project on effective dates and transition methods, the IASB has decided to clearly set out the disclosures required upon initial application of the new classification and measurement requirements for financial instruments.

The IASB decided not to require in the period in which IFRS 9 is initially applied, disclosure of the line item amounts reported in prior periods in accordance with the classification and measurement model in IFRS 9. Nor will it require disclosure of the current-period line item amounts reported in accordance with IAS 39. In making this decision, the IASB considered, among other factors, whether such disclosures would provide useful information, whether the existing transition disclosure requirements are sufficient and enable users to assess the effect of transition and the cost of providing such disclosures.

Consistent with the above decision, the IASB has also revisited a tentative decision it had made in July 2012 and has decided that, in the period in which IFRS 9 is initially applied, disclosure of the current-period line item amounts that would have been reported in accordance with the impairment model in IAS 39 will not be required. Instead, the IASB decided to require, on the date of initial application of IFRS 9, a disclosure that would permit reconciliation of the ending impairment allowances under IAS 39 to the opening impairment allowances under IFRS 9 by measurement category, showing separately the effect of reclassifications on the allowance balance at that date.

Phased early application of IFRS 9

In July 2012, the IASB decided that entities should no longer be permitted to early apply previous versions of IFRS 9 when all of the phases are completed and the final version of IFRS 9 is published. Instead, entities will only be permitted to early apply IFRS 9 in its entirety.

If this proposed amendment were to take immediate effect, the right to early apply previous versions of IFRS 9 would be immediately suspended. This would create uncertainty and disadvantage entities preparing to early apply IFRS 9 before the standard is finalised.

As the IASB has always stated that it will seek to avoid disadvantaging those who early apply IFRS 9 and also to minimise the disruption caused by the project to consider limited modifications to IFRS 9, it decided that earlier versions of IFRS 9 will be withdrawn only for reporting periods beginning more than six months after the entire IFRS 9 is published.

Next steps

The IASB has instructed its staff to begin the balloting process for the exposure draft for these amendments. The exposure draft is expected to be issued in November 2012, with a comment period of 120 days.

[4] Those entities that applied a previous version of IFRS 9 prior to the publication of the complete version of IFRS 9 would be permitted to continue applying that version until the mandatory effective date of IFRS 9.

Appendix

Summary of key decisions on classification and measurement made in previous Meetings[5]:

Contractual cash flow assessment
In February 2012, the Boards agreed to align the cash flow characteristics assessment in their respective classification and measurement models.

Under this proposed amendment, an entity, in making an assessment as to whether the contractual cash flows over the life of an instrument consist solely of payments 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 measurement at 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). The Boards decided to provide additional implementation guidance factors that would prohibit financial assets from qualifying for amortised cost measurement.

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 (consistent with the approach used in IFRS 9) for bifurcation into an 'embedded derivative' and a 'host contract'.

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

The IASB also confirmed that the 'own credit' guidance in IFRS 9 would be retained for liabilities recorded at fair value using the fair value option.

Introduction of a new measurement category for debt instruments
In May 2012, the Boards decided to propose that financial assets with contractual cash flows that are solely payments of principal and interest would qualify for fair value through other comprehensive income measurement if, at initial recognition, the entity's business model for a portfolio is both: (1) to hold to collect contractual cash flows; and (2) to sell financial assets. The assessment of the business model is performed at an aggregated level (rather than the instrument level).

The Boards also decided to create application guidance on the types of business activities that would qualify for the fair value through other comprehensive income business model. The Boards agreed that financial assets that pass the contractual cash flow characteristics assessment, but fail the business model criteria for either fair value through other comprehensive income or amortised cost, would be classified as at fair value through profit or loss, as a residual category.

The IASB also decided that, for assets recorded at fair value through other comprehensive income, entities should provide amortised cost information in profit or loss and fair value information on the balance sheet. The net cumulative fair value gain or loss recognised in other comprehensive income would be recycled to profit or loss when these financial assets are derecognised.

In June 2012, the IASB decided to propose extending the fair value option in IFRS 9 to debt instruments that would otherwise be measured at fair value through other comprehensive income.

Accounting for reclassification of financial assets between measurement categories
In May 2012, the Boards agreed to require prospective reclassifications when an entity changes its business model for managing financial assets. Business model changes requiring reclassification are expected to be very infrequent.

In July 2012, the Boards tentatively agreed on a converged approach to accounting for reclassifications between measurement categories. The only difference remaining is the 'date of reclassification'. However, this is not expected to be a key difference.

The IASB also decided to propose extending 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.

Phased early application of IFRS 9
The IASB decided that, once the complete version of IFRS 9 is published, entities adopting IFRS 9 would no longer be permitted to take a phased approach to adopting IFRS 9.

Entities that had already adopted a previous version of IFRS 9 (prior to publication of the complete version) would be able to continue applying that version and they would not be required to apply the final requirements until the mandatory effective date.

[5] For further details on previous tentative decisions made by the IASB, please see previous editions of *IFRS Developments*, available on www.ey.com/ifrs.

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