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Issue 47 / November 2012

IFRS Developments

The IASB proposes limited amendments to IFRS 9 classification and measurement model

What you need to know

The ED contains the following proposals:

- An amendment to the 'contractual cash flow characteristics' assessment to allow instruments with an insignificant modified economic relationship between principal and interest to be classified at amortised cost
- The introduction of a FVOCI category for particular financial assets that pass the contractual cash flow characteristics assessment
- Clarifications to the Application Guidance on business model assessment
- An amendment to 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 in other comprehensive income, without the need to early adopt IFRS 9 in its entirety
- A requirement that six months after IFRS 9 is issued, previous versions of IFRS 9 will no longer be available for early adoption. Instead, early adopters will have to apply IFRS 9 in its entirety

Overview

The IASB[1] has released an exposure draft (ED), *Classification and Measurement Limited Amendments to IFRS 9 (proposed amendments to IFRS 9 (2010))*. Following both IASB-only and joint re-deliberations with the US FASB[2], the outcome is a substantially converged set of principles for the classification and measurement of debt instruments. The ED is available for comment for a period of 120 days.

The amendments are primarily aimed at: (a) addressing specific application issues raised by early adopters of IFRS 9; (b) addressing income statement accounting mismatches and short-term volatility issues which have been identified as a result of the insurance contracts project; and (c) reducing key differences between IFRS 9 and the FASB's tentative classification and measurement model.

This issue of *IFRS Developments* summarises the main proposals in the ED.

Contractual cash flow characteristics assessment

The ED proposes a minor amendment to the application guidance in IFRS 9 to clarify that if the contractual cash flows on a financial asset include only payments of principal and consideration for the time value of money and credit risk, but the economic relationship between these components is modified due to leverage or interest rate mismatch feature (a modified economic relationship),[3] then an entity will have to assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. In making such an assessment, an entity considers the cash flows of a comparable financial asset that is identical in all respects (including credit quality) except that it does not contain the modification to the economic relationship ('benchmark cash flows'). If the modification *could* result in contractual cash flows that are 'more than insignificantly different' from the benchmark cash flows, the contractual cash flows are not solely payments of principal and interest. As a result, the instrument under assessment would fail the contractual cash flow characteristics assessment and would have to be measured at fair value through profit or loss (FVTPL).

[1] International Accounting Standards Board.

[2] US Financial Accounting Standards Board.

[3] i.e., an interest rate that is reset where the frequency of the reset does not match the tenor of the interest rate.

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To illustrate this point, when an entity evaluates a financial asset with an interest rate reset feature such as a floating interest rate instrument which is reset monthly to a three-month interest rate, the entity assesses the financial asset against an instrument of the same credit quality and with the same contractual terms, except that the interest rate is reset to a monthly interest rate.

In assessing a modified economic relationship, the proposals require an entity to consider the variables that affect future cash flows. However, an entity is required to consider only reasonably possible scenarios rather than every possible scenario.

The ED clarifies that the reason for setting the modified cash flows in a certain way is not relevant to the assessment. Moreover, if an entity is unable to conclude that the contractual cash flows could not be more than insignificantly different from the benchmark cash flows, the financial asset must be measured at fair value through profit or loss.

How we see it

The proposed amendment to the contractual cash flow characteristics assessment will mean that more assets may qualify for amortised cost accounting. However, relatively common features of financial instruments held in some jurisdictions are still likely to create the possibility of a significant difference in cash flows. Hence, these instruments will still not qualify for amortised cost.

Introduction of a new measurement category for debt instruments

The ED proposes that debt instruments (such as loans and debt securities) held within a business model in which assets are managed both in order to collect contractual cash flows and for sale, should be measured at FVOCI[4] but only if they pass the contractual cash flow characteristics assessment. Like the amortised cost measurement category, the assessment of the business model is performed at an aggregated level (rather than the instrument level). Likewise, an entity may, on initial recognition, irrevocably elect to designate a debt instrument at fair value through profit or loss if, and only if, doing so eliminates or significantly reduces an accounting mismatch.

The proposals would require entities that have financial assets accounted for at FVOCI, to provide amortised cost information in profit or loss and fair value information on the balance sheet. Therefore, interest, revenue and impairment losses/reversals and any gain or loss on derecognition will be recognised in profit or loss and other gains or losses will be recognised in other comprehensive income. Interest revenue and impairment will be computed and recognised in the same manner as for financial assets measured at amortised cost. 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 – an approach that differs from that for equity instruments measured at FVOCI.

The ED provides the following examples of when the business model may be to both hold financial assets to collect contractual cash flows and to sell financial assets:

Example 1:

A bank holds financial assets to meet its everyday liquidity needs. The bank seeks to minimise the costs of managing its liquidity needs and therefore actively manages the contractual yield on the financial assets. The bank monitors the contractual yield and will typically hold some financial assets to collect contractual cash flows and sell other financial assets to reinvest in higher yielding financial assets or better match the duration of liabilities. This strategy has resulted in significant and recurring sales activity in the past, which is expected to continue.

Example 2:

An insurer holds financial assets in order to fund insurance contract liabilities. The insurer uses the proceeds from the contractual cash flows on the financial assets to settle insurance contract liabilities as they come due. The insurer also undertakes significant buying and selling activity to rebalance the portfolio of financial assets on a regular basis as estimates of the expected cash flows needed to fulfil the insurance contract liabilities change to ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities.

How we see it

The decision to introduce a FVOCI category for debt instruments means that financial assets held within certain business models which do not qualify for amortised cost, and would have otherwise defaulted to FVTPL,[5] could be classified and measured at FVOCI.

Unlike IAS 39, debt instruments measured at FVOCI will be subject to the same impairment model as those measured measured at amortised cost. For example, a 12-month expected loss will need to be recognised in profit or loss with an offsetting credit to OCI[6] on initial recognition (as proposed by the redeliberations on the impairment model). Changes in fair value for reasons other than credit (e.g., a liquidity discount) will not be recorded in profit or loss until derecognition. In addition, only debt instruments which pass the contractual cash flow characteristics assessment will qualify for measurement at FVOCI.

4 Fair value through other comprehensive income.

5 Fair value through profit or loss.

6 Other comprehensive income.

The IFRS 9 classification and measurement model for financial assets based on the proposed amendments

As illustrated in the flow chart below, debt instruments (such as loans and debt securities) would be classified in one of the three measurement categories, based on their contractual cash flow characteristics assessment and the business model within which they are held. These are either at amortised cost, FVOCI or FVTPL. The proposed amendments do not affect the classification and measurement model for equity instruments and derivatives.

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.

Business model assessment

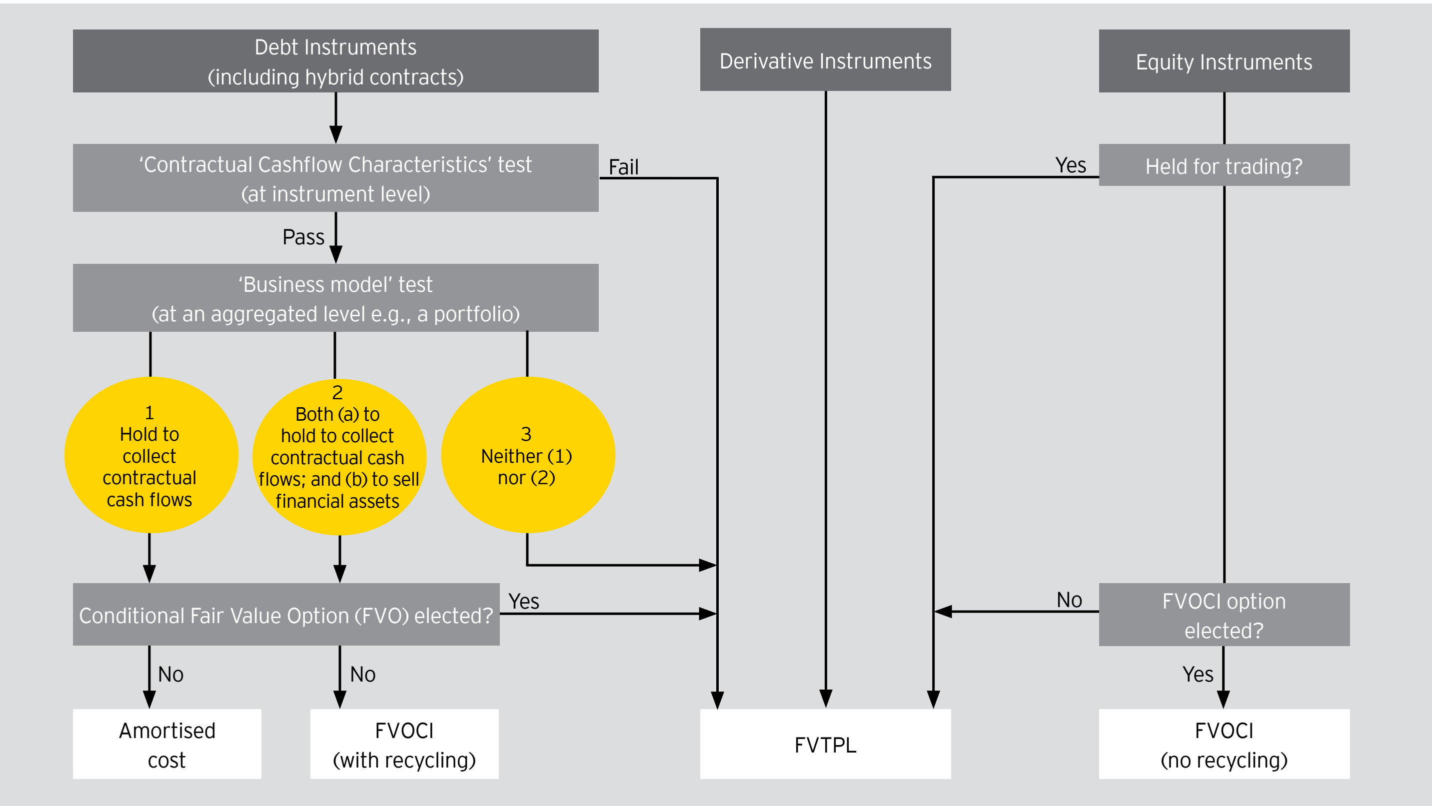
The ED amends the application guidance to clarify that:

- The business model for managing the financial assets is a matter of fact that can be observed by the way the business is managed, and also how its performance is evaluated by the entity's key management personnel.
- Determination of the business model for managing the financial assets is not driven by a single factor. Rather, all objective evidence relevant to assessing the entity's business model must be considered. Such evidence includes, but is not limited to: (a) how the performance of the business is reported to the entity's key management; (b) how managers of the business are compensated (e.g., 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, the reason for such sales and expectations about future sales activity.

Amortised cost business model assessment

The ED clarifies that sales may be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows if such sales are infrequent (even if significant), or insignificant both individually and in aggregate (even if frequent). Likewise, sales may be consistent with the objective of collecting contractual cash flows if they are made close to the maturity of the financial assets and the proceeds from them approximate the collection of the remaining contractual cash flows.

Furthermore, the fact that the requirement to sell the financial assets is imposed by a third party (e.g., a regulator), rather than being at the discretion of the entity, is not relevant to the business model assessment.



Accounting for the reclassification of financial assets between measurement categories

The proposals extend the existing reclassification requirements in IFRS 9 to the FVOCI category. Accordingly, reclassification will be required when an entity changes its business model for managing financial assets. Changes in business models are expected to be very infrequent and must meet certain conditions. Reclassifications are applied prospectively from the 'date of reclassification',[7] i.e., an entity would not restate any previously recognised gains, losses or interest.

The ED also extend the disclosure requirements in IFRS 7 of reclassifications between the amortised cost and FVTPL measurement categories to the new provisions for reclassifications into and out of the FVOCI measurement category.

Phased early application of IFRS 9

The ED proposes that entities should no longer be permitted to early adopt previous versions of IFRS 9 once all of the phases of IFRS 9 are completed and the final version is published. Instead, entities will only be permitted to early apply IFRS 9 in its entirety. To minimise the disruption caused by the limited amendments, the ED proposes that earlier versions of IFRS 9 will be withdrawn only for reporting periods beginning more than six months after IFRS 9 in its entirety is issued.

Early adoption of 'own credit' provisions

Notwithstanding the aforementioned proposal to prohibit phased early application once IFRS 9 is finalised, an entity would be permitted to early apply only the 'own credit' provisions in IFRS 9. These provisions require an entity to present in OCI the fair value gains and losses attributable to changes in the entity's own credit risk for financial liabilities designated as measured at FVTPL. This means that, until the mandatory effective date of IFRS 9, entities may elect to only change their accounting policy for own credit risk while continuing to account for their financial instruments in accordance with IAS 39.

How we see it

We welcome the proposal to allow early adoption of the 'own credit' requirements of IFRS 9. The application of the current requirements means that improving perceptions of an entity's creditworthiness reduces earnings, and worsening perceptions of creditworthiness increases earnings. Such counter-intuitive earnings volatility proved to be very large, particularly for banks. The proposals would allow entities to exclude such volatility for liabilities designated at FVTPL from their reported profits.

Looking ahead

The IASB has given constituents 120 days to provide feedback. The comment period closes on 28 March 2013.

The FASB has not yet finalised its classification and measurement model. While the general principles of the two models may seem substantially aligned, potential differences in application guidance may result in different classification and measurement outcomes for debt instruments.

How we see it

In light of the timeline for this ED, we do not expect a final classification and measurement standard before the middle of 2013. This, in addition to the timeline for the impairment phase and insurance project, will undoubtedly cause some constituents to question whether a 2015 mandatory effective date is feasible 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.

[7] 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.

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