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December 2012

iGAAP Alert
IASB issues proposals for limited amendments to IFRS 9

In a nutshell

The most significant proposed change to IFRS 9 *Financial Instruments* is the introduction of a new category for classification of financial assets. The fair value through other comprehensive income (FVTOCI) measurement category would apply to financial assets that:

- contain contractual cash flows that are solely payments of principal and interest; and
- are managed as part of a business model whose objective is both to collect contractual cash flows and for sale.

This FVTOCI category would provide the same measurement outcome as the existing available for sale category under IAS 39 as applied to debt instruments, except a difference will arise when the new impairment expected loss model is introduced, likely late 2013.

The amendments propose to permit an early adopter of IFRS 9 to early apply the requirement to recognise changes in own credit risk for certain financial liabilities in other comprehensive income without early adopting the rest of the Standard. The proposals also provide clarifications to the contractual cash flow assessment and the business model assessment when classifying debt instruments at amortised cost or FVTOCI.

Background

On 28 November 2012 the International Accounting Standards Board (IASB) issued for public comment an Exposure Draft, ED/2012/4 *Clarification and Measurement: Limited Amendments to IFRS 9*. These amendments are a response to application questions that have arisen on how to apply the contractual cash flow characteristics test for certain types of debt instruments, including those that contain an interest rate mismatch feature (i.e., the interest rate frequency does not match the tenor of the interest rate). The Board has also been considering the interaction of the classification and measurement model for financial assets with the Insurance Contracts project and the US FASB's tentative classification and measurement model for financial instruments. This has led to the ED proposing the introduction of the new FVTOCI measurement category for certain debt instrument assets. The IASB has also taken the opportunity to propose new requirements regarding the early adoption of IFRS 9.

The comment period for the ED ends on 28 March 2013.

The proposals

FVTOCI measurement category

The ED proposes that financial assets 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 fair value through other comprehensive income (unless designated at fair value through profit and loss as such designation eliminates or significantly reduces a measurement or recognition inconsistency). This is subject to the assets passing the contractual cash flow characteristics assessment (which is the same test used in determining whether financial assets are measured at amortised cost). Under the proposals, interest revenue, foreign exchange gains and losses, credit impairment would be recognised in profit or loss with other gains or losses (i.e., the difference between those items and the total change in fair value) being recognised in other comprehensive income (OCI). Any cumulative gain or loss recorded in OCI would be reclassified to profit and loss on derecognition or dealt with in accordance with specific guidance in the case of reclassifications. Interest income and credit impairment will be recognised in the same manner as for assets measured at amortised cost and would be accounted for in line with the yet to be published proposals on impairment. This would result in the same information in profit of loss as if the asset was measured at amortised cost, yet the statement of financial position will reflect the instrument's fair value.

Observation

The FVTOCI category provides the same measurement outcome as the existing available for sale category under IAS 39 *Financial Instruments: Recognition and Measurement* as applied to debt instruments with the important difference of impairment being based on the IASB's forthcoming expected loss model rather than the incurred loss model in IAS 39.

Amended application guidance on business model test

The ED proposes application guidance on how to determine whether the business model is to manage assets both to collect contractual cash flows and for sale. In addition, the ED proposes clarifications of the existing application guidance in IFRS 9 on when the objective of the business model is holding to collect contractual cash flows (i.e., part of the amortised cost criteria).

The ED proposes that sales that occur for reasons other than credit deterioration could still be consistent with the objective of holding financial assets to collect contractual cash flows if such sales are infrequent (even if significant) or insignificant both individually and in aggregate (even if frequent). Under the proposals, sales of financial assets may also 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 the sales approximate the collection of the remaining contractual cash flows. The ED also proposes to amend the current application guidance in the form of examples of scenarios where the business model may be to hold financial assets to collect contractual cash flows. Under the proposals some of the examples would be modified and one further example (involving a financial institution) would be added.

The document proposes that a business model whose objective is both to collect contractual cash flows and to sell will involve greater sales activity in terms of frequency and volume of sales, as compared to a business model whose objective is to collect contractual cash flows. This is on the basis that in the former, selling financial assets is integral to achieving the business model objective rather than just incidental to it. The proposals include three examples of scenarios of when an entity's business model may be to manage assets both to collect contractual cash flows and for sale, whilst noting that the list is not exhaustive. These examples include a non-financial entity, a financial institution and an insurer.

Observation

In the case of some entities (particularly financial institutions), careful analysis would be necessary on a portfolio by portfolio basis to determine whether the financial assets are managed to collect contractual cash flows or to collect contractual cash flows and for sale.

Reclassifications

The existing IFRS 9 requires reclassification between classification categories if the business model for managing the financial assets changes. This applies to debt instruments held at amortised cost and fair value through profit or loss (FVTPL). This concept has been extended to the new FVTOCI classification category. If an entity reclassifies a financial asset out of the amortised cost category to the FVTOCI category, its fair value is determined at the reclassification date with any difference between this and its previous carrying amount recognised in OCI and no adjustment to the effective interest rate. If an entity reclassifies a financial asset out of the FVTOCI category to the amortised cost category, the asset is reclassified at its fair value with a concurrent removal of the any previously accumulated gain or loss from OCI with this amount adjusting the fair value at the reclassification date (however this is not a reclassification adjustment in accordance with IAS 1 *Presentation of Financial Statements*). This has the effect of changing the measurement basis from fair value to amortised cost on the reclassification date. Also, the effective interest rate is not adjusted in this case. If an entity reclassifies a financial asset out of FVTPL to FVTOCI, its fair value at the reclassification date becomes its new carrying amount. This is also the case if an entity reclassifies a financial asset out of FVTOCI to FVTPL. In addition in that case the cumulative gain or loss in OCI is reclassified to profit and loss as a reclassification adjustment in accordance with IAS 1.

Contractual cash flows characteristics assessment

The ED proposes new guidance on how the contractual cash flows characteristics assessment should be made in certain cases. The proposals state that the economic relationship between principal and the consideration for the time value of money and credit risk may be modified through either insignificant leverage or the application of an interest rate reset feature (i.e., an interest rate that is reset or resettable where the frequency of the reset does not match the tenor of the interest rate). In such cases, the proposals require an entity to assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal outstanding. Unless the results of this assessment are clear with little or no analysis, the entity is required to consider the cash flows (benchmark cash flows) on a comparable financial asset that does not contain the modification (i.e., a contract of the same credit quality and with the same contractual terms including when relevant the same reset periods but without the feature under evaluation). The comparable financial asset may be an actual instrument or a hypothetical one.

The proposals provide an example of where an instrument being assessed is one that contains a variable interest rate that is resettable monthly to a three month interest rate and the comparable benchmark instrument would be an instrument with identical contractual terms and identical credit quality except for the fact that the variable interest rate is resettable monthly to a monthly interest rate. If the modification could result in cash flows that are more than insignificantly different from the benchmark cash flows then under the proposals the instrument would not have cash flows including solely payments of interest and principal and therefore could not be classified at amortised cost or FVTOCI. An entity should consider variables that affect future cash flows (such as volatility of interest rates) but needs to only consider reasonably possible scenarios that an entity is able to consider without undue cost and effort rather than every possible scenario. However, if an entity is unable to conclude that contractual cash flows could not be more than insignificantly different from the benchmark cash flows, the instrument must be measured at FVTPL.

The proposals introduce some changes to the Examples in the application guidance to IFRS 9 that illustrate how this assessment would be made. These changes would also make clear that if the contractual payments are indexed to a variable not related to time value of money or credit risk (e.g., equity index) such as an assessment is not necessary as the instrument would be measured at FVTPL.

The proposals also include two proposed clarifications in respect of contractually linked instruments. Firstly, a feature within a contractually linked instrument whereby it is prepayable contingent on a prepayment occurring in the underlying pool of instruments would not prevent the contractually linked instrument from having cash flow characteristics that are only payments of principal and interest on principal amount outstanding. Secondly, the proposals would clarify that if the underling pool of instruments includes instruments that are collateralised by assets that do not meet the contractual cash flows characteristics test, for example loans secured on property, this would also not prevent a contractually linked instrument from meeting the contractual cash flows characteristics test and therefore not prevent either amortised cost or FVTOCI accounting.

Effective date

The effective date of IFRS 9 would remain annual periods beginning on or after 1 January 2015 with earlier application permitted. However, under the proposals if an entity were to apply the amended IFRS 9 for a period beginning on or after 1 January 2015, it would also need to apply the forthcoming requirements on impairment and hedge accounting that will be included in IFRS 9 when finalised. However, the proposals would permit an entity to early apply the existing requirements of IFRS 9 for the presentation in other comprehensive income of gains or losses attributable to changes in a liability's credit risk for financial liabilities designated under the fair value option without early applying the other requirements of the Standard. Under the proposals if an entity chose to do this, it would be required to disclose this fact and apply the corresponding disclosure requirements of IFRS 7 *Financial Instruments: Disclosures*.

Transition

Consistent with the current version of the Standard, an entity would apply the amended IFRS 9 as per the proposals retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors with some limited exceptions. However, the entity need not restate prior periods and may only do so if, and only if, this is possible without the use of hindsight. Under the proposed amendment, the date of initial application (i.e., the date when the entity first applies the requirements of the revised Standard) would be the beginning of the first reporting period in which the entity adopts the Standard. If it is impracticable for an entity to retrospectively assess a modified economic relationship between the principal and consideration for time value of money and credit risk under the proposals then the entity shall retrospectively assess the contractual cash flow characteristics of the financial asset in accordance with IFRS 9 (2010) prior to the proposed amendments.

The ED also proposes that if an entity early applied IFRS 9 (2009), IFRS 9 (2010) or the IFRS 9 including the Hedge Accounting chapter (expected to be issued in the first quarter of 2013) and then applies these amendments it:

- shall revoke a previous designation of a financial asset or financial liability as measured at FVTPL if such designation no longer meets the conditions for such designation as a result of applying the amendments; and

- may designate a financial asset or financial liability as measured at FVTPL if such designation did not previously meet the conditions for such designation but now does as a result of applying the amendments.

Such designation and revocations shall be made on initial application of the amendment and be applied retrospectively.

Convergence with US GAAP

The proposals to amend the contractual cash flows characteristics assessment and the business model test (including the new FVTOCI category) are in line with the FASB's tentative decisions reached in developing their future financial instruments standard.

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Designed and produced by The Creative Studio at Deloitte, London. 23737A

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