

Patrick Finnegan: IFRS 9—Limited Amendments, Significant Improvements

14 December 2012



In November 2012 we proposed limited amendments to the classification and measurement requirements in IFRS 9 *Financial Instruments*. The proposed amendments are narrow in scope and are consistent with the existing principles in IFRS 9.

The proposals introduce a third measurement category: fair value through other comprehensive income (FVOCI). This measurement category is built on the existing classification conditions in IFRS 9 and will provide two sets of information—amortised cost in profit or loss and fair value in the balance sheet—in situations in which both sets of information are relevant to assessing the amounts, timing and uncertainty of future cash flows.

The proposals would change the requirements for the early application of IFRS 9 with an aim to improve comparability among entities that are applying IFRS 9 before its mandatory effective date while also responding to longstanding concerns about the volatility that occurs in profit or loss due to changes in an issuer's own credit risk, when non-derivative financial liabilities are measured at fair value.

Finally, the Exposure Draft clarifies a narrow range of application questions, such as how to analyse the amount or frequency of sales to determine whether they are consistent with measuring a financial asset at amortised cost, or how to assess particular contractual cash flows.

We are seeking comments on the proposals by 28 March 2013. [Click here](#) for information about how to provide your comments to us.

Why are we replacing IAS 39?

When we developed IFRS 9, our objective was to reduce complexity in accounting for financial instruments. IAS 39 *Financial Instruments: Recognition and Measurement* has many classification and measurement categories that are not based on clear or consistent rationales. It also has different impairment models that apply to financial assets depending on how those assets are classified. Moreover, IAS 39 requires bifurcation of complex instruments using a set of rules that are often unclear and

inconsistent. In addition, the hedge accounting rules are very strict and are not aligned with many entities' risk management activities.

We are undertaking the project to replace IAS 39 in three phases: Classification and Measurement, Impairment and Hedge Accounting.



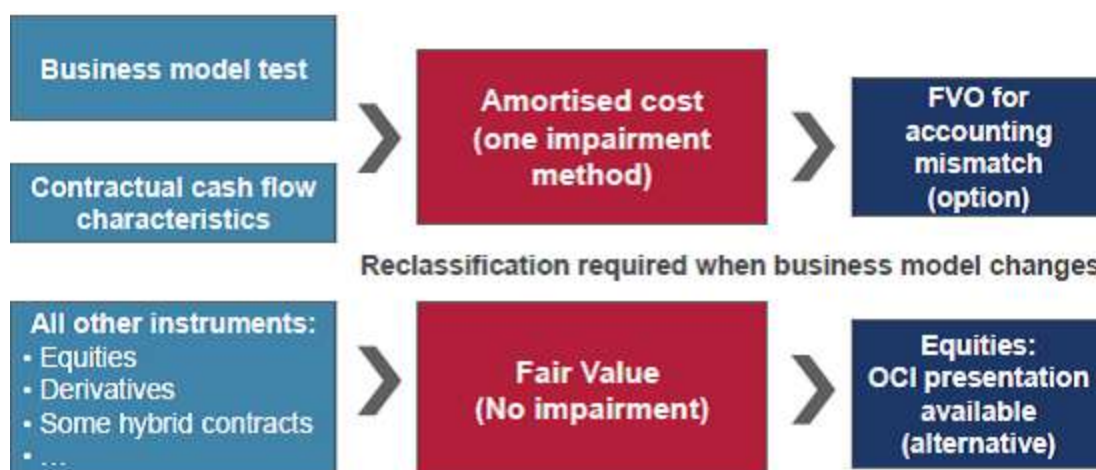
This *Investor Perspectives* article discusses the Classification and Measurement phase. Read more information about the [other phases of the Financial Instruments project](#).

What does IFRS 9 currently require?

Financial assets

IFRS 9's model has two measurement categories for financial assets. It requires assets to be measured at either fair value through profit or loss¹ or amortised cost on the basis of how an entity manages financial assets and the asset's cash flows. Although some stakeholders told us that all financial instruments should be measured at fair value through profit or loss (which would certainly minimise accounting complexity), most believe that more than one measurement category is needed to appropriately reflect the variety of financial instruments and how an entity manages them. Unlike IAS 39, IFRS 9 provides structure and logic to classification so that it is easier for investors and analysts to understand the information about the financial instruments in an entity's financial statements.

IFRS 9's classification and measurement model for financial assets—before the proposed amendments—can be illustrated as follows:



In essence, if a financial asset is a simple debt instrument and the objective of the entity's business model within which the asset is held is to hold financial assets to collect their contractual cash flows, the financial asset is measured at amortised cost. In such cases, amortised cost provides information that is useful in assessing the amounts, timing and uncertainty of the asset's future cash flows. A 'simple' debt instrument is a financial asset with contractual cash flows that are solely payments of principal and interest. For this purpose, interest is a return for the time value of money and the credit risk of the asset.

In all other circumstances, IFRS 9 requires financial assets to be measured at fair value through profit or loss. That would be the case, for example, when the objective of an entity's business model is to realise value from selling financial assets before they mature or if the financial assets contain complex cash flows (for example, payments that are linked to an equity index). In those situations, investors tell us that fair value can help them to assess changes in the entity's financial position and profitability in a more accurate and timely manner compared to amortised cost.

Financial liabilities

IFRS 9 carried forward unchanged almost all of the accounting requirements in IAS 39 for financial liabilities. We were told that those requirements are working well, but with one exception.

We received consistent and widespread feedback that changes in value attributable to changes in an issuer's own credit risk for non-derivative financial liabilities measured at fair value should not affect profit or loss because an entity generally cannot realise those amounts. Consequently,

IFRS 9 requires those own credit amounts to be presented in other comprehensive income (OCI).

Summary of IFRS 9's improvements

IFRS 9 resulted in the following key improvements over IAS 39:

- Logical structure and rationale for classification. The two measurement categories for financial assets reflect the nature of their cash flows and the way they are actually managed.
- A single classification approach for all financial assets, thus eliminating the complex requirements for bifurcating hybrid financial assets
- All equity investments are measured at fair value.
- A single impairment model for all financial assets that are not measured at fair value through profit or loss.
- Financial assets are reclassified between measurement categories when, and only when, the entity's business model for managing them changes, which is a significant event and thus uncommon.
- The effects of changes in own credit are presented in OCI if a non-derivative financial liability is measured at fair value.

Why are we proposing amendments to IFRS 9?

We believe that the basis for classifying financial instruments in IFRS 9 that focuses on providing information about the instrument's future cash flows is the right one. The proposals do not change those concepts in IFRS 9.

We had three objectives for publishing the proposals:

- To take into account the interaction between the classification and measurement of financial assets and the accounting for insurance contract liabilities. We have always said that the interaction would be considered once the insurance contract model was developed sufficiently.
- To clarify a narrow range of application questions.
- To reduce key differences between IFRS 9 and the model being considered by the US Financial Accounting Standards Board (FASB) with an aim of achieving increased comparability internationally in the accounting for financial instruments.

The proposals

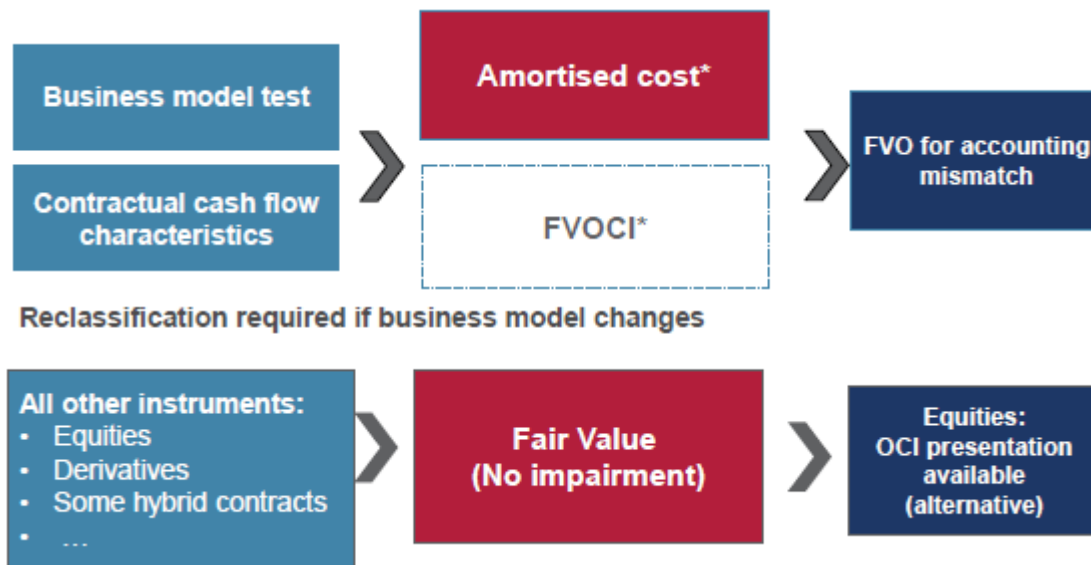
We are proposing the following limited-scope amendments to IFRS 9:

- Introduce a FVOCI measurement category for qualifying debt instruments.
- Eliminate the phased approach to the early application of IFRS 9, except for the requirements related to own credit.
- Clarify a narrow range of application questions, such as the amount/frequency of sales that would be consistent with a 'hold to collect' business model and how to assess the asset's contractual cash flows in particular circumstances.

Introduction of the FVOCI category

The most significant proposal is the introduction of a third measurement category for qualifying debt instruments. That is, simple debt instruments that are managed both in order to collect contractual cash flows and for sale would be required to be measured at FVOCI. This new category would capture, for example, those circumstances in which an entity is seeking to maximise its return from a combination of collecting contractual cash flows and realising value appreciation.

Although we acknowledge that the introduction of another measurement category would inevitably increase the complexity of IFRS 9, the FVOCI category would retain the existing classification structure in IFRS 9. As illustrated below, the classification of a financial asset would still be based on the nature of its contractual cash flows and how the entity manages its assets, but with the addition of the FVOCI category.



This proposal:

- responds to the feedback that IFRS 9 does not accommodate a known business model with an objective of both collecting contractual cash flows and selling financial assets;
- addresses a potential accounting mismatch that would arise because of the interaction between the accounting for financial assets and the accounting for insurance contracts liabilities. That is because, according to the tentative decisions in the Insurance Contracts project, particular changes in the measurement of insurance contracts liabilities will be presented in OCI; and
- reduces key differences between IFRS 9 and the FASB's tentative model because the boards have agreed on a common objective for the FVOCI measurement category.

Because the FVOCI category is designed to capture financial assets that an entity manages both to collect contractual cash flows and for sale, two sets of information are relevant for this category—amortised cost and fair value. The proposals provide that information. The balance sheet would reflect the fair value carrying amount, while the effect on profit or loss would be the same as if the financial assets were measured at amortised cost. The difference between the fair value and amortised cost information would be recognised in OCI.

Specifically, financial assets measured at FVOCI would have the same impairment and interest income recognition approach as assets measured at amortised cost. Furthermore, when the financial asset is derecognised

(when it is sold or matures), the cumulative gains or losses recognised in OCI would be recycled to profit or loss.

It is important to note that the FVOCI measurement category is different from the available-for-sale (AFS) category in IAS 39.

- There is a clear business model resulting in the measurement at FVOCI; cash flows are realised both through collection of contractual cash flows and through sale. The business model for FVOCI is a matter of fact and is evidenced by the way the assets are managed and performance is reported. In contrast, the AFS category in IAS 39 was essentially a residual classification and a free choice.
- FVOCI makes use of the two existing measurement bases in IFRS 9—amortised cost and fair value—and uses the same interest recognition and impairment approaches as for assets measured at amortised cost. In contrast, IAS 39 applied different impairment models to different measurement categories.

Early application and the 'own credit' requirements

In general, the proposals would not allow parts or phases of IFRS 9 to be applied in isolation after IFRS 9 is complete. In other words, if an entity decides to early apply IFRS 9 after it is completed, all phases of IFRS 9 must be applied from the same date. This is proposed to improve comparability for users of financial statements.

However, while we were deliberating the limited amendments to IFRS 9, many stakeholders reiterated concerns about recognising gains or losses on changes in own credit in profit or loss when markets continue to remain volatile and own credit changes are significant.

We sympathise with these concerns but at the same time we reaffirmed that we will not make changes to IAS 39, because it is being replaced by IFRS 9. Consequently, we decided to propose that, when IFRS 9 is complete, an entity could elect to early apply only the own credit requirements. In effect, an entity would be permitted to keep its IAS 39 financial instruments accounting in place and only adopt the requirements to present the effects of changes in own credit in OCI.

Clarification of a narrow range of application questions

a. Business model assessment

We have become aware of inconsistent interpretations of the meaning of 'held to collect'. As a result, the proposed amendments are not intended only to accommodate a third measurement category—they also clarify the existing requirements in IFRS 9.

In addition, in some of the outreach that we conducted in advance of publishing the proposals, we heard that some stakeholders were concerned that the proposed introduction of the FVOCI category and the clarifications to the amortised cost category would mean that the amortised cost category would effectively become a 'held to maturity' category. That is not the case!

Our proposals provide application guidance on the types of business activities and on the frequency and nature of sales that would qualify for (or prohibit) measurement at amortised cost. The frequency and significance of past sales, the reasons for those sales and the expectations for future sales need to be considered to determine whether an asset can be measured at amortised cost. Sales of assets that are due to the deterioration in their credit quality are not inconsistent with measuring assets at amortised cost. Sales that occur for other reasons are consistent with a 'held to collect' business model as long as those sales are infrequent or insignificant. Following the amendments, the amortised cost measurement category is not narrower than originally intended although it may be narrower than some have interpreted it to be.

In addition, the objective of the amortised cost measurement category has been incorporated into the FASB's tentative classification and measurement model, which reduces key differences between the boards' respective models.

b. The contractual cash flow characteristics assessment

The proposals clarify when contractual cash flows are still considered to be principal and interest in cases in which the interest rate is leveraged or is reset for a period that does not match the rate used (for example, the interest rate is reset every month to a three-month interest rate). The objective of the proposed clarification is to ensure that financial assets with contractual cash flows that economically represent solely principal and interest qualify for the amortised cost measurement category (subject to

how they are managed). Furthermore, the contractual cash flow characteristics assessment, along with the proposed clarification, has been incorporated into the FASB's tentative classification and measurement model. This represents a significant reduction in key differences² between the boards' models.

Conclusion

In summary, the classification principles in IFRS 9, which are preserved in the proposed amendments, will make the evaluation of the classification and measurement of financial assets much easier to understand, because it will be aligned with the entity's management of financial instruments and, thus, reflect the underlying economic decisions made by management.

The creation of the FVOCI category creates a richer package of information for investors. This is accomplished by providing information about fair value in the balance sheet and about contractual cash flows in profit or loss. Changes in fair value that are not recognised in profit or loss would be reported in OCI.

We believe that the clarifications being proposed will also improve the consistency of application of IFRS 9. Finally, we have achieved a positive outcome in our joint discussions with the FASB, which we expect should more closely align the accounting for financial instruments globally.

The Exposure Draft [Classification and Measurement: Limited Amendments to IFRS 9](#) is available on the IASB website.

Comments are due by 28 March 2013. You can provide your comments by either:

- submitting a [comment letter](#) through our website; or
- arranging a conference call or meeting through the [investor liaison](#).

¹ There is a presentation alternative under IFRS 9 for equity investments. An entity may choose to present fair value gains and losses on equity investments in other comprehensive income. This presentation alternative is only available on initial recognition for equity investments that are not held for trading and it is irrevocable.

2 Before the joint deliberations, the FASB's tentative model required bifurcation of hybrid financial assets.

Respond to the author

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