Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) continue to work together to reduce key differences between the classification and measurement model in IFRS 9 Financial Instruments and the model the FASB is developing.

At the meeting on 21 May 2012, the IASB tentatively decided that a fair value through other comprehensive income (FVOCI) measurement category would be added to IFRS 9 for debt instruments that pass the contractual cash flow characteristics assessment. This would further align the guidance in IFRS 9 with the FASB’s tentative model. The FVOCI category will be subject to the same impairment and income recognition models as financial assets measured at amortised cost. Cumulative fair value gains and losses recognised in OCI would be recycled to profit or loss upon derecognition.

The Boards have also tentatively agreed to align their business model assessment applicable to the FVOCI category for financial assets that meet the cash flow characteristics criteria and to align their models with respect to the requirements on reclassifications of financial assets between measurement categories.

A summary of the key joint decisions made in previous meetings is included in an appendix to this publication.

The Boards intend to issue their respective exposure drafts on classification and measurement in the second half of 2012. All of the decisions noted here are tentative and may change as the boards have not yet concluded their deliberations.

What you need to know

The IASB and the FASB continue to make progress aligning their respective classification and measurement models.

Consistent with FASB’s existing proposals, the IASB has tentatively agreed to introduce a FVOCI category for financial assets with contractual cash flows that are solely principal and interest.

The FVOCI category will be subject to the same impairment and income recognition models as financial assets measured at amortised cost. Cumulative fair value gains and losses recognised in OCI would be recycled to profit or loss upon derecognition.

Financial assets with contractual cash flows that are solely payments of principal and interest, but which do not meet the business model criteria for fair value through other comprehensive income or amortised cost classification, would be classified in the residual category of fair value through profit and loss.

The IASB tentatively decided to extend the existing reclassification requirements in IFRS 9 to the FVOCI category.
FVOCI and FVTPL business model assessment

The Boards decided that financial assets with contractual cash flows that are solely payments of principal and interest (e.g., plain vanilla bonds) 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 financial assets. The assessment of the business model is performed at an aggregated level (rather than the instrument level). This means that the category will apply to portfolios of eligible financial assets where, on initial recognition, some assets are expected to be sold and some are expected to be held to collect the contractual cash flows, but the entity is unable to determine which instruments will be sold and which will be held.

The Boards decided to create application guidance on the types of business activities that would qualify for the FVOCI business model. In general, portfolios held for trading or managed to realise cash flows through active buying and selling, rather than both sales and collection of contractual cash flows, would not meet the business objective for FVOCI classification. Therefore, the Boards agreed that financial assets that pass the contractual cash flow characteristics assessment, but fail either the business model criteria for FVOCI or the business model criteria for amortised cost would be classified as fair value through profit or loss (FVTPL), as a residual category.

Mechanics of the new FVOCI measurement category

The IASB decided that, for assets recorded at FVOCI, entities should provide amortised cost information in profit or loss and fair value information in the balance sheet. The mechanics of this category would work, as follows:

- Interest income should be recognised in profit or loss using the effective interest method that is applied to financial assets measured at amortised cost.
- Credit impairment losses/reversals should be recognised in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost.
- The net cumulative fair value gain or loss recognised in other comprehensive income (OCI) should be recycled from OCI to profit or loss when these financial assets are derecognised.

How we see it

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

For example, it is often the case that more than an infrequent number of sales are made out of liquidity portfolios held by banks. The effect is that such portfolios will not qualify for amortised cost under IFRS 9 despite the fact that many of the assets within these portfolios will be held for substantial periods of time for the collection of contractual cash flows. Under the new proposals, such portfolios will most likely meet the business model criteria for the FVOCI category.

While recording such portfolios at FVOCI will result in less volatility in profit or loss, we suspect that most banks would still prefer to record them at amortised cost. This is because under Basel III debits to OCI will be treated as deductions from regulatory capital.

Unlike the available-for-sale (AFS) category in IAS 39, financial assets measured at FVOCI will be subject to the same impairment model as financial assets measured at amortised cost. This would mean, for example, that, on initial recognition, a 12-month expected loss will need to be recorded in profit or loss with an offsetting credit to OCI. Changes in fair value for reasons other than credit (e.g. a liquidity discount) will not be recorded in profit or loss until derecognition.

Interaction with insurance project

One of the key reasons for the IASB decision to introduce a FVOCI category is to address concerns raised about the interaction between the accounting for insurance contract liabilities (as developed in the insurance project (IFRS 4 phase II)) and the accounting for financial assets backing insurance contracts.

At their meeting on 24 May 2012, the Boards tentatively decided to present changes in insurance liabilities arising from movements in interest rates in OCI. The expense recorded in profit or loss for interest accretion on the insurance liability would be based on the discount rate determined at inception. The cumulative amount recognised in OCI at the reporting date would represent the difference between the insurance liability measured at (i) the original discount rate and (ii) the discount rate at the reporting date.

We discuss the impact for insurance contracts in our upcoming Insurance Accounting Alert.
Reclassification of financial assets

The Boards agreed to require prospective reclassifications when, and only when, an entity changes its business model for managing financial assets. Business model changes requiring reclassification are expected to be very infrequent and must be:

• Determined by the entity’s senior management as a result of external or internal changes
• Significant to the entity’s operations
And
• Demonstrable to external parties

From an IFRS 9 perspective, this decision would merely extend the existing reclassification requirements in IFRS 9 to the FVOCI category.

What does the classification and measurement model look like based on the decisions made so far?

As illustrated in the chart below, debt instruments (such as loans and debt securities) would be classified, based on their contractual characteristics and the business model within which they are held, into one of the following three measurement categories: amortised cost, FVOCI or FVTPL.

The Boards have not yet addressed whether to introduce an option for financial assets that meet the business model criteria for FVOCI to be recorded at fair value through profit or loss.

These decisions do not affect the classification and measurement of equity instruments and derivatives.

What’s next?

The Boards plan to jointly address the following:

• How to account for reclassifications
• Application guidance on the types of business activities that would qualify for the FVOCI business model
• Interrelated issues including transition and disclosures

The IASB plans to re-deliberate several aspects of its classification and measurement model, including:

• Implementation guidance on the types of business activities that would qualify for the amortised cost business model
• Issues relating to the guidance on non-recourse debt and contractually-linked instruments

We also presume the IASB will need to decide whether to extend its IFRS 9 hedge accounting model to financial assets recorded at FVOCI.

How we see it

In light of the current timeline for this project, we do not expect a final classification and measurement standard before the middle of 2013.

For our analysis of the implications of the May tentative decisions on the classification and measurement model that the FASB is developing for financial instruments, please see our US publication, To the Point issue 2012-11 (May 2012): Classification and measurement – the GAAP continues to narrow, available on www.ey.com/UL/en/Accounting Link.
Appendix

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, the primary consequence of this decision will be a minor amendment to its application guidance.

Under this proposed amendment, an entity would be required to assess the effect of modifying features (such as a floating rate instrument where the frequency of the interest rate reset does not match the tenor of the instrument) when assessing whether the cash flows are still consistent with the notion of solely principal and interest. To make such an assessment, an entity would compare the cash flows of the instrument that contains a modifying feature to an appropriate benchmark instrument of the same credit quality and with the same terms except for the contractual term under evaluation.

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). The Boards decided to provide additional implementation guidance on the types of business activities, and the frequency and nature of sales, that would prohibit financial assets from qualifying for amortised cost measurement. This guidance is currently being developed by the Boards.

The additional implementation guidance is expected to address the current tension between some of the examples provided in IFRS 9. For instance, it will be made clearer that financial assets recorded at amortised cost may be sold to manage the duration of insurance assets and liabilities or to fund capital expenditures only if such sales are expected to be infrequent.

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 of an “embedded derivative” and a “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. 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.

For further details on previous tentative decisions made by the IASB, please see our publication, IFRS Developments issue 27 (April 2012) Classification and measurement of financial instruments – narrowing the GAAP, available on www.ey.com/ifrs.