

Limited improvements to the IFRS 9 classification and measurement model

What you need to know

- ▶ The IASB has confirmed its intention to consider making limited improvements to the IFRS 9 classification and measurement model.
- ▶ The scope of this project is limited to only three specific areas.

Overview

At its 13 December 2011 meeting, the International Accounting Standards Board (the IASB or the Board) confirmed its tentative decision of 15 November to consider making limited improvements to the IFRS 9 *Financial instruments* classification and measurement model.

The primary objectives for this project are:

- ▶ To consider the interaction between the accounting for insurance contract liabilities and that of financial assets backing insurance contracts
- ▶ To address specific application issues raised by early adopters of IFRS 9 and those who have reviewed IFRS 9 in detail in preparation for application

And

- ▶ To consider differences with the FASB's¹ classification and measurement model for financial instruments.

The IASB has decided to limit the scope of this project to the following three specific topics which should meet the above stated objectives:

1. **Remeasurement through other comprehensive income (OCI)² or the introduction of another business model** – whether some debt instruments should be allowed or required to be remeasured through OCI and, if so, the basis for such measurement.
2. **The contractual cash flow characteristics of the financial asset** - whether additional application guidance should be provided to clarify how the principle was intended to be applied.
3. **Bifurcation of hybrid financial assets** - whether, after considering any additional guidance provided for the contractual cash flow characteristics test, there is a need to re-introduce bifurcation and, if so, the basis for the bifurcation.

¹ US Financial Accounting Standards Board

² IFRS 9 already includes an OCI measurement option for equity instruments which are not held for trading. Under this irrevocable option, only dividends are recorded in profit or loss. No 'recycling' of gains and losses is permitted.

The IASB has also indicated that, while addressing these topics, it will take the opportunity to consider possibilities for aligning the IFRS 9 model more closely with the US FASB's tentative classification and measurement model.

The limitation of the scope should minimise potential disruption to those who have already applied IFRS 9, or who are close to applying IFRS 9. It will also allow for timely completion of the project.

The IASB has also acknowledged that any changes made will likely have knock-on consequences that will need to be considered, for example, for disclosures, transition and impairment accounting.

Further, the IASB decided not to consider, as part of this review, the inclusion of an exemption in IFRS 9 similar to that in IAS 39 which allows investments in equity instruments (and physically settled derivatives over those instruments) to be measured at cost, when they do not have a quoted market price in an active market and whose fair value cannot be reliably measured. Instead this will be included in the educational materials being prepared for IFRS 13 *Fair Value Measurement*.

In addition, this review will not include modifications to allow the recycling of realised gains or losses on the derecognition of investments in equity instruments measured at fair value through OCI. The IASB noted that the irrevocable election to measure equity instruments through OCI was designed to allow those who hold 'strategic'

investments to properly reflect their business model while also discouraging general use of this election. Furthermore, some preparers who have already chosen to apply IFRS 9 have made their decisions largely as a result of the OCI election for equities. Changing the scope of this election could have material consequences for these preparers.

The interaction with the insurance contracts project

The July 2010 Exposure Draft *Insurance Contracts* proposed that insurance liabilities should be remeasured through profit and loss. This proposal will potentially cause an accounting mismatch if the assets held to back those insurance liabilities are measured at amortised cost. Furthermore, the IASB has been exploring ways to present changes in insurance contract liabilities in a way that disaggregates the effects of changes in the discount rate from other changes, such as by presenting changes in insurance contract liabilities that arise from changes in the discount rate in OCI.

In light of the above, the IASB received requests to reconsider the possibility of remeasuring some financial assets, primarily those backing insurance contracts, through OCI rather than profit and loss.

We discuss this further in our upcoming *IFRS Developments for Insurers*.

How we see it

The IASB's decision to consider expanding the use of OCI or introducing another business model marks an important development for the insurance contracts project, as well as for the project on financial instruments. An OCI solution could lead to breaking the lingering deadlock around the volatility issue within the insurance project, which would move the project forward substantially.

This could also lead to resolving certain implementation issues faced by other industries, for example, the potential earnings volatility resulting from portfolios held by banks to manage liquidity risk. Such portfolios, commonly known as 'liquidity buffers', would, in many cases, fail the 'Business Model' test in IFRS 9, because prudential regulations often require them to be turned over frequently in order to demonstrate their liquidity. Therefore, the assets in such portfolios would often be measured at fair value through profit and loss, hence, creating earnings volatility.

Expanding the use of OCI poses a number of challenging questions that will have to be explored and addressed by the IASB. For example, would this model be optional or compulsory, available only to insurer or all entities? How should impairment be measured and recognised for financial instruments in this classification category, and should realised gains and losses be recycled through profit and loss?

We encourage affected entities to actively participate in the debate on OCI and consider providing input to the IASB.

Application issues

Certain implementation issues have been raised by entities that have already adopted, or begun preparations to adopt, IFRS 9. These include the application of the contractual cash flow characteristics test to specific instruments, and whether the application guidance (in particular, some of the examples in IFRS 9) always result in appropriate conclusions.

Some of the issues resulted from the application of the contractual cash flow characteristics test relate to the following:

Floating rate instruments where interest rates are reset but the reset period does not match the tenor of the interest rate (i.e., residual maturity).

The application guidance in IFRS 9³ states that '... For example, a constant maturity bond with a five-year term that pays a variable rate that is reset periodically but always reflects a five-year maturity does not result in contractual cash flows that are payments of principal and interest on the principal amount outstanding. That is because the interest payable in each period is disconnected from the term of the instrument (except at origination).'

This application guidance results in many common instruments (such as Japanese government ten-year constant maturity bonds which have a semi-annual interest rate reset mechanism but every interest reset is based on a 10-year rate) not being eligible for measurement at amortised cost. Some constituents raised concerns that the application guidance focuses too much on the form of the instrument rather than the underlying principles.

Constituents noted that there could be different reasons why an entity would acquire or issue an instrument whose reset period may diverge from the residual maturity. For example, it may be that: (a) an entity is anticipating certain movements in interest rates and would like to benefit from that; or (b) this is a common way to transact in a particular

market due to a market convention or a governmental regulation, that may, for example, pursue an objective of achieving stability in interest rates. Constituents have also suggested that while it seems reasonable that instruments in (a) above are reported at fair value, instruments in case (b) appear to be different. The motivation to enter these types of transactions is not to exploit arbitrage opportunities, but to follow the market convention. Therefore, in such cases, the constituents argued that the amortised cost measurement that allocates cash flows to an appropriate period is capable of providing relevant information to users.

Accordingly, the constituents requested the Board to reconsider amending this application guidance by adding an explanation as to why the fair value is the most relevant measure for some instruments of that nature, contrasting it to a case where the amortised cost measure would be more appropriate.

Hybrid contracts

IFRS 9 removed the requirement in IAS 39 *Financial Instruments: Recognition and Measurement* to bifurcate and separately account for derivatives embedded in non-derivative host financial assets.

Instead, IFRS 9 requires that a reporting entity assess the hybrid financial asset (i.e., the combined financial asset host and embedded derivative) in its entirety to determine whether the instrument's cash flows comprise principal and interest on the outstanding principal. Certain embedded derivatives affecting the cash flows arising on host debt instruments (such as prepayment options, extension options, interest rate caps and floors and reset options) are considered not to result in payments other than principal and interest. However, many other embedded derivatives result in cash flows other than payments of principal and interest and therefore render the hybrid contract ineligible for measurement at amortised cost.

Some constituents⁴ have requested that bifurcation be permitted for financial assets in IFRS 9, mainly because they believe it enables them to more accurately portray how those assets are managed. Others have questioned the appropriateness of having bifurcation only for financial liabilities.

The IASB noted that bifurcation of embedded derivatives was a significant source of complexity in IAS 39 and many were supportive of its removal. Therefore, the Board tentatively decided that before considering the appropriateness of bifurcation of financial assets, it should first consider whether these issues could be addressed by clarifying the characteristics of the instrument test.

How we see it

In our view, any decision to re-introduce bifurcation of embedded derivatives should be accompanied by revised guidance on the criteria for bifurcation and how to calculate the effective interest rate when there is no bifurcation, these being some of the major areas of operational difficulty in the application of IAS 39.

Convergence with US GAAP

The project to revise the accounting for financial instruments started as a joint project between the IASB and the US FASB (collectively, the Boards). The convergence efforts have been complicated by the different project timetables established by the Boards to respond to their respective stakeholder groups. However, the Boards remain committed to achieving increased comparability internationally in accounting for financial instruments. In fact, the IASB has previously committed to seek feedback from its constituents on the FASB's classification and measurement model and to consider what should be done to reconcile any differences.

³ Paragraph B4.13 – instrument B example.

⁴ Refer to the European Financial Reporting Advisory Group (EFRAG) study on accounting for hybrid financial instruments, paper 12.03, 12 January 2011.

While the FASB is now finalising its re-deliberation of the classification and measurement portion of its May 2010 proposals, significant differences still remain between the FASB's model and IFRS 9. In light of this, the IASB has indicated that any effort to refine and improve IFRS 9 classification and measurement model should also consider possibilities for aligning the IFRS 9 model more closely with the FASB's proposed model.

How we see it

Bringing IFRS 9 closer to the model the FASB is currently developing may be possible, but could prove to be challenging. For example:

- ▶ The FASB's tentative model requires bifurcation of the financial assets using the existing bifurcation criteria under US GAAP (which are similar to the criteria in IAS 39). If the IASB were to re-introduce bifurcation, it remains uncertain whether it would decide to use the same criteria.
- ▶ The FASB's tentative model makes use of OCI for remeasuring the fair value change of most debt securities. Even if the IASB were to expand the use of OCI, the boards may pursue somewhat different routes on whether to make this permissive or mandatory, and whether or not realised gains and losses should be recycled through profit and loss.

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