

Financial instruments: Classification and measurement - the ball continues to roll

What you need to know

- ▶ The Boards confirmed that financial assets with contractual cash flows that are not solely payments of principal and interest will not qualify for the new FVOCI category.
- ▶ The IASB decided that financial assets measured at FVOCI may be designated, on initial recognition, at fair value through profit or loss only if such a designation eliminates or significantly reduces an accounting mismatch.

Highlights

In May 2012, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) decided that financial assets with contractual cash flows that are solely payments of principal and interest (e.g., plain vanilla bonds) would be classified for fair value through other comprehensive income (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.

At their meeting on 13 June 2012, the Boards reaffirmed their previous decision that a debt instrument (such as a loan or a debt security) will be measured at FVOCI *only* if it passes the contractual cash flow characteristics assessment and the debt instrument is managed within the relevant business model (as described above).

This means that financial assets with contractual cash flows that are not solely payments of principal and interest will not qualify for the FVOCI category and must therefore be measured at fair value through profit or loss (FVTPL).

Furthermore, the IASB tentatively decided to extend the option in IFRS 9 for designating financial assets at FVTPL under the fair value option (FVO) to debt instruments that would otherwise be measured at FVOCI. This means that an entity may, on initial recognition, irrevocably elect to designate a debt instrument at FVTPL, if doing so eliminates or significantly reduces an accounting mismatch.

The FASB tentatively decided to:

- ▶ Incorporate the eligibility conditions for the application of the FVO for hybrid financial liabilities similar to what is currently in IFRS 9

And

- ▶ Retain the eligibility conditions for the application of FVO for a group of financial assets and financial liabilities, as proposed in its tentative classification and measurement model with the clarification that an entity must manage its net exposure of a group of financial assets and financial liabilities on a fair value basis

How we see it

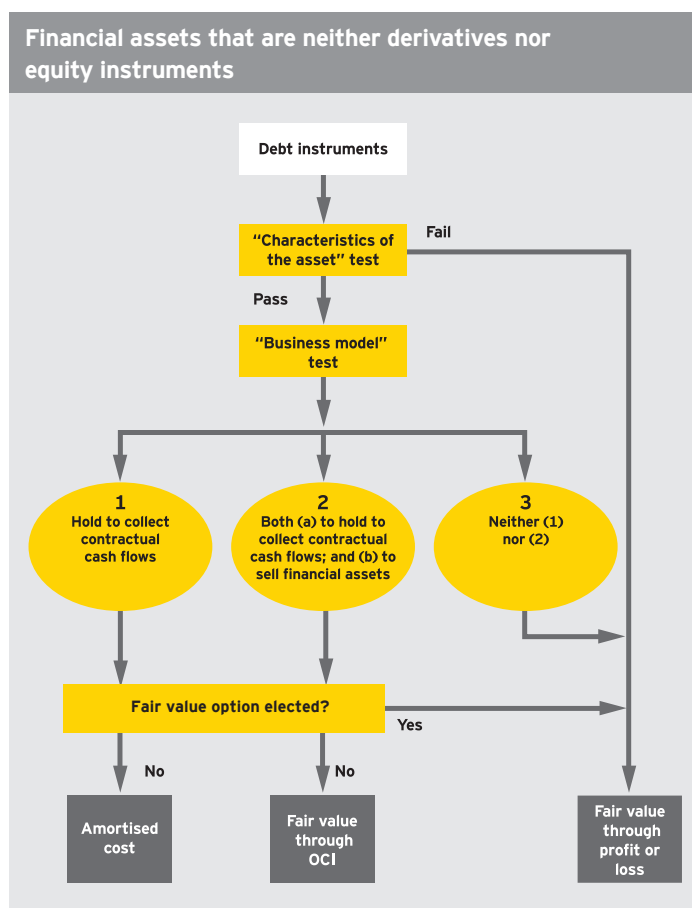
We welcome the IASB decision to extend the availability of the FVO to debt instruments measured at FVOCI, since this will provide more useful and relevant information to users.

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

Impact of decisions on the classification and measurement model

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 three measurement categories: amortised cost, FVOCI or FVTPL as illustrated in the chart below.

The Boards' redeliberations did not affect the classification and measurement model for 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 redeliberate 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 on-recourse debt and contractually-linked instruments

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

The IASB intend to issue its exposure draft on classification and measurement during the fourth quarter of 2012.

How we see it

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

Appendix

Summary of key joint decisions made in previous meetings¹

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, this decision will result in a minor amendment to its application guidance.

Under this proposed amendment, an entity would be required to assess the effect of modifying features 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. The Boards are currently developing their respective implementation guidance.

The additional implementation guidance is expected to address the current tension between some of the examples provided in IFRS 9.

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.

FVOCI and FVTPL business model assessment

In May 2012, the Boards decided that financial assets with contractual cash flows that are solely payments of principal and interest 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). The Boards decided to create application guidance on the types of business activities that would qualify for the FVOCI business model.

The Boards agreed that 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.

Mechanics of the FVOCI measurement category

In May 2012, the IASB decided that, for assets recorded at FVOCI, entities should provide amortised cost information in profit or loss and fair value information on the balance sheet. Therefore, interest income and credit impairment losses/reversals would be recognised in profit or loss using the same methodologies as for financial assets measured at amortised cost. The net cumulative fair value gain or loss recognised in other comprehensive income (OCI) would be recycled from OCI to profit or loss when these financial assets are derecognised.

Reclassification of financial assets

In May 2012, the Boards agreed to require prospective reclassifications when an entity changes its business model for managing financial assets. Business model changes requiring reclassification are expected to be very infrequent. From an IFRS 9 perspective, this decision would merely extend the existing reclassification requirements in IFRS 9 to the FVOCI category.

¹ For further details on previous tentative decisions made by the IASB, please see previous editions of *IFRS Developments*, available on www.ey.com/ifrs.

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