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IFRS Developments

IASB issues IFRS 9 *Financial Instruments* – classification and measurement

What you need to know

- The IASB has issued the final version of IFRS 9, which combines classification and measurement, the expected credit loss impairment model and hedge accounting.
- The standard will eventually replace IAS 39 and all previous versions of IFRS 9.
- Financial assets are measured at amortised cost, fair value through profit or loss, or fair value through other comprehensive income, based on both the entity's business model for managing the financial assets and the financial asset's contractual cash flow characteristics.
- Apart from the 'own credit risk' requirements, classification and measurement of financial liabilities is unchanged from existing requirements.
- Application is required for annual periods beginning on or after 1 January 2018, but early adoption is permitted.

Highlights

On 24 July 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9 *Financial Instruments* (IFRS 9, or the standard), bringing together the classification and measurement, impairment and hedge accounting phases of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and all previous versions of IFRS 9. The classification and measurement requirements address specific application issues arising in IFRS 9 (2009) that were raised by preparers, mainly from the financial services industry. The expected credit loss model addresses concerns expressed following the financial crisis that entities recorded losses too late under IAS 39.

This publication focuses on the changes for classification and measurement. For a summary of the new IFRS 9 expected credit losses requirements, read our recent publication *IFRS Developments 87: IASB issues IFRS 9 Financial Instruments – expected credit losses*. Our publications, *IFRS Developments 68: The IASB issues IFRS 9 (2013) – hedge accounting is now complete* and *Applying IFRS – Hedge accounting under IFRS 9* discuss further the IFRS 9 hedge accounting model.

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Building a better working world

FVOCI is aimed at portfolios where both interest and fair value information is relevant and useful.

Classification of financial assets

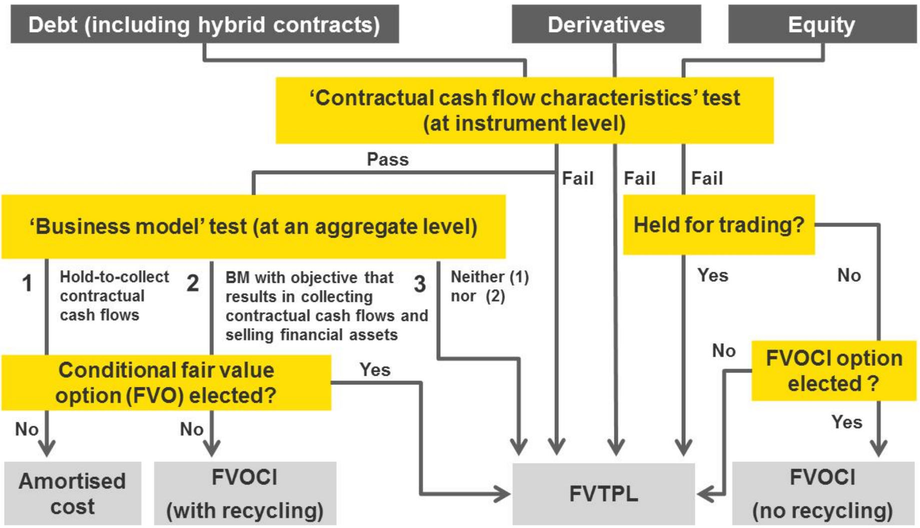
The standard introduces principles-based requirements for classification and measurement. The classification and measurement of financial assets depends on two assessments: the financial asset's contractual cash flow characteristics and the entity's business model for managing the financial asset.

The contractual cash flow characteristics test identifies financial assets for which amortised cost information would be relevant, with interest revenue or expense allocated over a relevant period, using the effective interest method. Such instruments potentially qualify for measurement at amortised cost or at fair value though other comprehensive income (FVOCI). All other financial assets are measured at fair value through profit or loss (FVPL).

The business model assessment determines whether financial assets held in a portfolio must be measured at amortised cost, FVOCI or FVPL. The first two categories, amortised cost and FVOCI, only apply to portfolios of instruments which have also passed the contractual cash flow characteristics test. The business model assessment is dependent on the particular objective of the business model under which those portfolios of assets are held.

With the exception of certain equity securities, IFRS 9 (2009) initially reduced the number of measurement categories for financial instruments to only two: FVPL, for which fair value information is relevant; and amortised cost, for which amortised cost information is relevant. In addition, IFRS 9 introduces a FVOCI measurement category for debt instruments.

Classification and measurement diagram



The new FVOCI measurement category is aimed at portfolios of debt instruments, for which amortised cost information, as well as fair value information, is relevant and useful. This will be the case if their performance is affected by both contractual cash flows and the realisation of fair values through sales. The FVOCI measurement category is mandatory when a portfolio of debt instruments:

- Consists of debt instruments that pass the contractual cash flow characteristics test, (i.e., the contractual cash flows of the instruments consist of solely payments of principal and interest)
- Is held within a business model in which assets are managed to achieve a particular objective by both collecting contractual cash flows and selling financial assets

For debt financial instruments at FVOCI, fair value changes are recognised in other comprehensive income. Interest revenue, foreign exchange revaluation and impairment losses or reversals are recognised in profit or loss. Interest revenue and expected credit losses are computed and recognised in the same manner as financial assets measured at amortised cost. Upon derecognition, the net cumulative fair value gains or losses recognised in other comprehensive income are recycled to profit or loss.

Equity securities are measured at FVPL unless the entity choses, on initial recognition, to present fair value changes in other comprehensive income (OCI). This option is irrevocable and applies only to equity instruments which are not held for trading. Unlike debt instruments, gains and losses in OCI are not recycled on sale and there is no impairment accounting. Derivatives are also measured at FVPL. In comparison to IAS 39, there is no bifurcation of embedded derivatives for financial assets recorded at amortised cost or FVOCI.

How we see it

The introduction of the FVOCI measurement category helps insurers to achieve some consistency of measurement for assets held to back insurance liabilities under the new IFRS 4 insurance contracts model. It also addresses concerns raised by preparers who expect to sell financial assets in greater volume than would be consistent with a business model whose objective is to hold financial assets to collect contractual cash flows and would, without this category, have to record such assets at FVPL.

Contractual cash flow characteristics test

Debt financial instruments may qualify for amortised cost or FVOCI (depending on the business model) only if they give rise to 'solely payments of principal and interest'.

The new terms, 'de minimis', 'non-genuine', and 'significantly different' will need to be interpreted by preparers.

Many instruments have features that are not in line with the "solely payments of principal and interest" condition. The standard makes it clear that such features are disregarded if they are 'non-genuine' (extremely rare, highly abnormal, and very unlikely) or 'de minimis' (the magnitude of the impact is too trivial or minor to merit consideration). In all other cases, such instruments would fail the contractual cash flow characteristics test and would be measured at FVPL.

The standard describes interest as the return on a basic lending arrangement to the holder, which generally includes consideration for the time value of money, credit risk, liquidity risk, a profit margin and consideration for costs associated with holding the financial asset over time (such as servicing costs). The time value of money component of interest represents just the consideration for the passage of time. The standard addresses other features that may be included in the time value of money, such as any mismatch between interest rate reset periods and tenors, or average or lagging interest rates. These will result in an instrument failing the contractual cash flow characteristics test if the resulting undiscounted contractual cash flows could be 'significantly different' from the undiscounted cash flows of a benchmark instrument that does not have such features.

In the final version of IFRS 9, interest rates established by a government or a regulatory authority (regulated interest rates) are accepted as a proxy for the consideration for the time value of money if those rates provide consideration that is 'broadly consistent with consideration for the passage of time'.

How we see it

Although the 'de minimis' and 'non-genuine' thresholds are low, allowing entities to disregard such features will results in more debt instruments qualifying for the amortised cost or FVOCI measurement categories than in IFRS 9 (2009). The terms, 'de minimis', 'non-genuine', and 'significantly different' are new to IFRS 9 and each will need to be interpreted by preparers in analysing the impact of the clarified contractual cash flow characteristics test for the debt instruments they hold.

Business model assessment

A business model is typically observable through particular activities undertaken by the entity to achieve its objective, such as how its performance is evaluated, how its managers are remunerated and how its risks are managed.

Portfolios of debt instruments that are held to collect contractual cash flows are measured at amortised cost. The FVOCI measurement category applies to portfolios of financial assets that are held within a business model whose objective is achieved by both holding to collect contractual cash flows and selling financial assets. Debt instruments that are neither measured at amortised cost nor measured at FVOCI are measured at FVPL.

There is a multitude of business model objectives in practice which qualify for measurement at FVOCI. For example, a bank may hold a portfolio of financial assets for liquidity purposes in stress scenarios, but the regulator requires the bank to demonstrate the liquidity of the assets by regularly selling significant volumes of financial assets. Alternatively, an insurance company may hold a portfolio of debt instruments to fund its portfolio of insurance contract liabilities and, as the liabilities change over time, the insurer needs to rebalance the portfolio of debt instruments, resulting in frequent and significant sales. In both these cases, holding to collect contractual cash flows and selling financial assets are an integral part of the business model. Hence, the portfolios in these examples are measured at FVOCI.

Classification of financial liabilities

Changes introduced by IFRS 9 in respect of financial liabilities are limited to the measurement of liabilities designated at FVPL using the fair value option. Fair value changes of such financial liabilities which are attributable to the change in the entity's own credit risk are presented in other comprehensive income, unless doing so would introduce an accounting mismatch, in which case, the whole fair value change is presented in profit or loss. All other IAS 39 requirements in respect of liabilities have been carried forward to IFRS 9, including the criteria for using the fair value option and the requirements related to the separation of embedded derivatives in hybrid contracts.

Fair value option

The fair value option in IFRS 9 applies to financial assets that would otherwise be mandatorily measured at amortised cost or FVOCI. An entity is permitted to measure these financial assets at FVPL if doing so would eliminate or significantly reduce a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch'). The fair value option for financial liabilities remains unchanged compared with IAS 39. The designation to measure financial assets or liabilities at FVPL is irrevocable and only permitted at initial recognition.

Effective date and transition

The standard applies to annual periods beginning on or after 1 January 2018, although early application is permitted. Retrospective application is required, however, transition reliefs are provided (including no restatement of comparative period information). Entities will only be permitted to early apply a previous version of IFRS 9 if their date of initial application is before 1 February 2015. However, if an entity has early applied a previous version of IFRS 9 before 1 February 2015, the entity is permitted to continue to apply that version until IFRS 9 becomes mandatorily effective in 1 January 2018.

Moreover, it will be possible to apply early just the new accounting treatment of fair value gains and losses arising from own credit risk on liabilities designated at fair value through profit or loss without applying the other requirements of IFRS 9, until IFRS 9 becomes mandatorily effective.

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