Overview
At their joint meeting on 17 April 2012, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) made tentative decisions to more closely align their models, including alignment of the following:

- Business model assessment for the amortised cost classification category of financial assets
- Bifurcation requirements for financial assets and financial liabilities

The Boards intend to issue their respective exposure drafts on classification and measurement in the second half of 2012.

Background
In December 2011, the IASB decided to make limited improvements to the IFRS 9 Financial Instruments classification and measurement model. In making this decision, the IASB indicated that, while addressing these topics, it will take the opportunity to consider possibilities to align the IFRS 9 model more closely with the US FASB's tentative classification and measurement model, including the use of a further classification category for debt instruments: fair value through other comprehensive income (OCI).

In February, the Boards made some tentative decisions regarding the cash flow characteristics assessment. These tentative decisions would primarily result in greater alignment between the FASB's tentative model and the IFRS 9 model.

From an IFRS 9 perspective, these decisions are expected to result only in minor clarifications and a minor amendment to its application guidance.

What you need to know
- The IASB and the FASB have made significant progress to align their respective classification and measurement models.
- The FASB has tentatively agreed to change its business model assessment for amortised cost financial assets, which would align with the IFRS 9 business model assessment.
- Implementation guidance will be developed to clarify the IFRS 9 business model assessment for the amortised cost classification category.
- Under IFRS 9, bifurcation would continue to be prohibited for financial assets. Financial liabilities would continue to be bifurcated based on existing guidance.
- The Boards have still to debate whether to introduce a further classification category for debt instruments: fair value through other comprehensive income (OCI).
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. This means, if a financial asset contains payments that are solely principal and interest and the relationship between the principal, the time value of money and the credit risk is modified (e.g., a floating rate financial asset where the interest rate is reset, but the frequency of reset does not match the tenor of the instrument), an entity would need to assess whether the instruments yield the appropriate economic return.

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. For example, for a floating interest rate instrument which is reset monthly to a rate other than a monthly interest rate, that instrument would be assessed against an instrument of the same credit quality and with the same terms except that the interest rate is reset to a monthly interest rate. If the difference between the cash flows of the benchmark instrument and the instrument with a modifying feature is more than insignificant, the instrument with a modifying feature would be measured at fair value through profit or loss because the cash flows are not considered to be solely principal and interest.

Amortised cost business model assessment

In April, the Boards tentatively decided that financial assets 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, assuming the instrument meets the cash flow characteristics test).

The Boards tentatively decided to clarify the primary objective of “hold to collect” by providing 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.

Consistent with the existing requirements under IFRS 9:

- The “hold to collect” assessment would not depend on management’s intention for an individual instrument. Instead, it would require consideration of the objective of the business model, as determined by the entity’s key management personnel, at a higher level of aggregation.
- To qualify for amortised cost classification, an entity would have a “hold to collect” objective, but would not be required to hold all of those instruments until maturity for the portfolio to qualify for amortised cost.
- For future asset acquisitions, an entity would need to consider the prior selling activity and anticipated selling activity for the assets being evaluated to determine whether they qualify for a “hold to collect” business model.
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 liabilities or to fund capital expenditures only if such sales are expected to be infrequent.

**How we see it**

The upcoming new guidance is expected to clarify that some business models will not qualify for amortised cost. These include the holding of financial assets for liquidity risk management purposes (such as liquidity portfolios that are required for regulatory purposes) if sales are more than infrequent. If the business model test is not met, then such holdings will need to be recorded at fair value through profit or loss unless the IASB decides to permit them to be recorded at fair value through other comprehensive income (OCI), as currently proposed by the FASB.

**Bifurcation of financial instruments**

The Boards tentatively decided that financial assets that contain cash flows that are not solely principal and interest would not be eligible for bifurcation (between 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 tentatively 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.

**How we see it**

The decision not to reinstate bifurcation for financial assets minimises the change to IFRS 9. However, it will not please those constituents who have been pressing the IASB to make this change.

The proposed amendment to the cash flow characteristics assessment made in January will mean that more assets may qualify for amortised cost accounting without the need for the separation of embedded derivatives. For example, a debt instrument that pays interest at LIBOR with insignificant leverage would meet the cash flow characteristics assessment, and so qualify for a measurement category other than fair value through profit or loss.

In our view, the IASB still needs to revisit the guidance on the criteria for bifurcation for liabilities. The “closely related” criteria pose a number of problems of interpretation. These include the treatment of term-extending options in fixed rate debt instruments – an issue recently submitted to the IFRS Interpretations Committee. The Board will also need to reconsider the effective interest rate guidance, including the consequences of changes in estimated future cash flows.

**What’s next**

In addition to the implementation guidance on the business model for amortised cost, both of the Boards plan to address the following issues:

- Whether to align the business model assessments in their respective models for other categories. This includes whether or not to introduce a fair value through other comprehensive income category for debt instruments, as currently exists in US GAAP.
- Whether, and to what extent, reclassification between categories would be permitted.
- Interrelated issues including transition and disclosures.

For our analysis of the implications of the April 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 2012-10 (April 2012): Classification and measurement- narrowing the GAAP*, available on www.ey.com/UL/en/Accounting Link.

For further details on previous tentative decisions made by the IASB, please see our publication, *IFRS Developments issue 23 (January 2012): Limited improvements to the IFRS 9 classification and measurement model*, available on www.ey.com/ifrs.
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