Straight away

IFRS bulletin from PwC

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IASB proposes limited modifications to IFRS 9

Background

The IASB has issued an exposure draft (ED) proposing limited modifications to IFRS 9 (2010) 'Financial instruments'. These proposals are to address three specific areas: application issues that have arisen in practice since the original IFRS 9 was issued with regards to the use of amortised cost; interaction with the Insurance project; and to reduce differences between IFRS 9 and the FASB's classification and measurement proposals (which is now largely aligned for debt instruments).

Key amendments

Clarification of amortised cost business model

In IFRS 9 financial assets qualify for amortised cost measurement if the objective of the business model is to hold those financial assets in order to collect contractual cash flows. Whilst that objective has not changed in the ED, the Board has clarified the primary objective of 'hold to collect' by providing additional application guidance on the types of business activities and the frequency, volume and nature of sales that would allow assets to qualify for amortised cost measurement. For example, the ED clarifies that sales due to deterioration in credit quality would not conflict with the objective of holding to collect cash flows. In addition, where an entity has a portfolio with assets that it would only sell in a 'stress case' scenario and where that 'stress case' is expected to be 'infrequent' then that would also be consistent with the amortised cost business model.

Introduction of a fair value through other comprehensive income (FVOCI) category for eligible debt instruments

A FVOCI measurement category for eligible debt instruments is proposed in the ED. A debt instrument would be measured at FVOCI only if it passes the solely payments of principal and interest (SPPI) test and is held in a business model that is managed both in order to collect contractual cash flows and for sale. A debt instrument measured at FVOCI will have the same impairment and interest income recognition as financial assets measured at amortised cost. Also, the cumulative fair value gain or loss recognised in OCI will be recycled from OCI to profit or loss when these financial assets are derecognised.

It is expected that debt instruments backing insurance contracts may fall into this category and will therefore have a consistent measurement with insurance liabilities under the proposals being discussed in the IASB's Insurance project.

Reclassifications and fair value option extended to FVOCI

Consistent with the reclassification and fair value option in the current IFRS 9, these provisions have equally been extended to instruments in the new FVOCI category. Therefore when an entity changes its business model, guidance has been provided on how to account for moving between each of the categories. In addition, a fair value option is permitted to be applied to debt instruments that would otherwise be classified at amortised cost or FVOCI if designating them at fair value through profit or loss (FVPL) will reduce or significantly eliminate an accounting mismatch.

'Modified' contractual cash flow characteristics test

In IFRS 9 today, a financial asset could be eligible to be measured at amortised cost (subject to the business model criterion) if the financial asset's contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. In this context, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding.

Sometimes the debt instrument's contractual terms, whilst being time value of money and credit related, are 'not perfect' (or there is a 'modified economic relationship' to use the term in the ED). For example, when the frequency of interest rate reset (say monthly) does not match the tenor of the interest rate (for example, 3 month Libor) or the interest is leveraged. The ED proposes a new requirement for an entity to consider the effect of the 'modified economic relationship' when assessing whether the cash flows on the financial asset are still consistent with the notion of being SPPI.

The ED incorporates a notion that there is some variation from the 'perfect' instrument that would still be acceptable from an SPPI perspective. In order to assess this acceptability, the ED proposes that an entity compares the financial asset under assessment to the 'perfect' (in the ED 'benchmark') instrument. If the difference between the cash flows of the benchmark instrument and cash flows of the instrument under assessment is more than insignificant, the instrument must be measured at FVPL because its contractual cash flows are not considered SPPI.

Transition

The IASB has included two key proposals with regard to transition in the ED: (1) to allow an entity to early apply only the requirements for the presentation of fair value gains or losses attributable to changes in the issuer's own credit risk, without the need to early apply IFRS 9 in its entirety and (2) that once IFRS 9 is finalised (that is, all phases), earlier versions of IFRS 9 are to be withdrawn on a date six months after the publication of the final version of IFRS 9 and hence entities will no longer be able to apply IFRS 9 in phases.

Am I affected?

Although most entities have financial instruments and therefore the provisions in IFRS 9 will apply to them, the limited modification in the ED will largely affect entities in the financial services sector.

What's next

The comment period ends on 28 March 2013. Entities should consider responding to these proposals so their views can be considered by the IASB in its re-deliberations and finalisation of the classification and measurement of financial instruments. It is also expected that the FASB will issue an exposure draft on their classification and measurement model in Q1 2013.