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HKFRS / IFRS UPDATE 2013/02

CLASSIFICATION AND MEASUREMENT: LIMITED AMENDMENTS TO IFRS 9

Summary

In late 2012, the International Accounting Standards Board (IASB) published Exposure Draft *ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9*. The ED is a result of IASB's joint deliberations with the US Financial Accounting Standards Board (FASB) on limited aspects of the classification and measurement requirements for financial assets in IFRS 9 *Financial Instruments*. In December 2012, the HKICPA issued invitation to comment on these proposed amendments. Due to the HKICPA's policy to converge HKFRS with IFRS, these proposed amendments may also affect HKFRS financial statements.

In summary the ED proposes:

- To include additional application guidance to clarify the 'contractual cash flow characteristics test' to be applied in determining whether financial assets are recorded at amortised cost after initial recognition
- To introduce a third business model for debt instruments.

The proposed effective date is for annual periods beginning on or after 1 January 2015 with retrospective application (to the extent possible).

The ED also proposes that once all chapters of IFRS 9 are completed and the completed version of IFRS 9 is issued, only that version of IFRS 9 would be available for early application. This means that entities would not be able selectively to choose to adopt earlier versions of IFRS 9 (with the exception of the 'own credit' provisions in IFRS 9 for financial liabilities that are designated as at Fair Value through Profit or Loss).

The HKICPA's comment period will end on 28 February 2013 whereas the IASB has requested comments on the Exposure Draft by 28 March 2013.

Financial institutions and insurance companies with significant holdings of portfolios of debt instruments are likely to be most affected by these proposals. These could lead to significant reclassifications of debt instruments across the different measurement categories: amortised cost, and fair value through other comprehensive income (FVTOCI) and fair value through profit or loss (FVTPL). If the proposals in the ED are finalised as proposed, entities can expect less volatility in profit or loss for their debt investment portfolios. However they might experience higher equity volatility which could have an effect on their levels of regulatory capital.

STATUS

Exposure Draft

EFFECTIVE DATE

Annual periods beginning on or after 1 January 2015

ACCOUNTING IMPACT

Significant for entities with substantial debt investment portfolios; may also affect other entities

Background

Since the publication of IFRS 9, the IASB has received questions on the application of IFRS 9 to certain types of financial instruments. In particular, questions have arisen about how to apply the 'principal and interest' notion to particular type of financial instruments, as this is fundamental to the question of whether financial assets are required to be measured at fair value or amortised cost after initial recognition. The IASB has also been asked to consider the interaction of IFRS 9 for financial assets with the insurance project which deals with the accounting for insurance liabilities. Furthermore, there has also been widespread view that there should be comparability between the IASB and FASB models for financial instrument accounting.

In light of the feedback that the IASB has received, in December 2011, the IASB made a decision to reconsider certain (limited) aspects of IFRS 9 that was previously finalised. The IASB decided to consider the following specific areas:

- Address specific application issues in IFRS 9 – the 'contractual cash flow characteristics' test, and the 'principal and interest' notion under IFRS 9
- Interaction with the IASB's insurance project
- Closer alignment with the FASB's classification and measurement model.

Proposed amendments

The contractual cash flow characteristics test under IFRS 9

Under IFRS 9 as currently issued, to qualify for amortised cost measurement a financial asset must meet both of the following tests:

- A business model test
- A contractual cash flow characteristics test.

To meet the business model test, financial assets are required to be held with the objective of collecting contractual cash flows. This does not depend on intentions for each individual instrument, and the test is therefore carried out at a higher level; this is on the basis of the business model as determined by key management personnel as defined in IAS 24 *Related Party Disclosures*. A single entity could have more than one business model (for example, an entity might have one portfolio of financial assets that it manages to collect contractual cash flows and another portfolio of investments that it manages in order to realise changes in fair value).

To meet the contractual cash flow characteristics test, the entity is required to assess whether the terms of the instrument only provides for cash flows that are solely payments of principal and interest on the principal amount outstanding. In contrast to the business model test, the contractual cash flows characteristics test is performed on an instrument by instrument basis. IFRS 9 considers interest to be limited to consideration for time value of money and credit risk.

To assist entities in applying the contractual cash flow characteristics test, the ED proposes to include additional application guidance. If there has been a modification in the relationship between principal and interest such that the interest is no longer purely compensation for the time value of money and credit risk, the ED proposes that the entity should analyse the effect of the contractual term that results in the modification and consider whether the effect is more than insignificant when compared to the benchmark financial instrument. An appropriate benchmark would be a contract of the same credit quality and with the same terms, except for the contractual term under evaluation.

For example, if an entity holds a financial asset that contains an interest rate mismatch feature (e.g. a floating interest rate that is reset monthly to a quarterly 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.

The ED does not propose to define or quantify the term 'insignificant'.

The approach to be followed is illustrated in the following diagram:

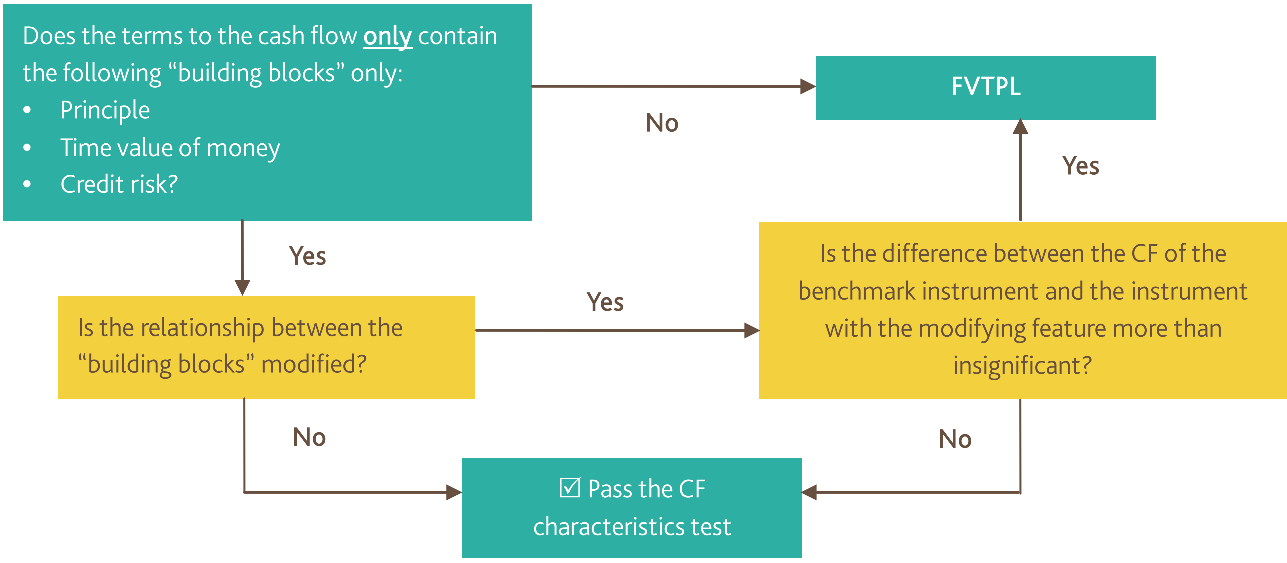

Illustration 1: IASB's proposed clarification/amendments to the contractual cash flows characteristics test

A third business model – fair value through other comprehensive income (FVTOCI)

The ED also proposes to introduce a third business model to IFRS 9 for debt investments. The proposed third business model would apply to debt instruments that meet the contractual cash flow characteristic test and where the entity's business model objective is both to hold to collect the cash flows and sell the financial assets.

Criteria for FVTOCI for debt instruments

- *Contractual cash flow characteristics test* ☑
- *Business model objective:*
  - *Hold to collect*☑
  - *Sell the financial assets* ☑

Illustration 2: Criteria for debt instruments at FVTOCI

The proposed accounting mechanics for this third category are as follows:

- Recognise interest revenue in profit or loss using the effective interest rate method (as for financial assets measured at amortised cost)
- Recognise credit impairment losses/reversals in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost
- Recognise the cumulative fair value gain or loss in OCI and recycle the gain or loss to P&L only when the debt instrument is derecognised.

The ED proposes that the option to measure financial assets at fair value through profit or loss option (the fair value option) would also be available to debt instruments that would otherwise be measured at FVTOCI. (Under the fair value option, entities can elect to designate financial assets or liabilities at fair value through profit or loss if it eliminates an accounting mismatch.)
The ED also proposes that the existing reclassification requirements in IFRS 9 would also apply to the FVOCI category for debt instruments. This means that reclassification would be required when an entity's business model for managing the debt instrument changes.

Effective date and transition

The proposed effective date is for annual periods beginning on or after 1 January 2015.

The proposals would permit early application; however this would require adoption of IFRS 9 in full. This means that entities would no longer be able selectively to choose to early adopt an earlier version of IFRS 9 (with the exception for the ‘own credit’ requirements for financial liabilities that are designated as at Fair Value through Profit or Loss). Those entities that have already early adopted a previous version of IFRS 9 would be able to continue applying that version and would not be required to apply the final requirements until the mandatory effective date.

For transition, the IASB proposes that the amendments should be applied retrospectively. This is consistent with the general requirement in IFRSs under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.* However, if it is impracticable to apply the modified contractual cash flows characteristics test without the use of hindsight, then the ED proposes that entities would apply the existing test in IFRS 9 (2010).

For entities that have already early adopted IFRS 9 (2009) or IFRS 9 (2010), the ED proposes that on application of the limited amendments, entities would:

(i) Revoke any previous fair value option elections if an accounting mismatch no longer exists at initial application of the limited amendments
(ii) Be allowed to apply the fair value option to new accounting mismatches that arise as a result of the initial application of the limited amendments.

BDO's support and assistance on HKFRS/IFRS

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