# IFRS 9
# Classification and Measurement
## Are you lost?


### Introduction

It has not been easy to keep up to date with the International Accounting Standards Board's (IASB) decisions on the project to replace IAS 39 *Financial Instruments: Recognition and Measurement.* The fact that the project is split into three phases[1] has made it particularly tricky to keep track of all the decisions reached.

The IASB has also recently discussed some amendments to IFRS 9 Financial Instruments in respect of classification and measurement of financial assets[2]. This publication provides a high-level summary of the IFRS 9 classification and measurement model for financial instruments including the recent tentative decisions.

### Recent developments

In November 2011, the IASB decided to consider limited modifications to IFRS 9 for the following reasons:

- To reduce the differences between the IASB's model and the US Financial Accounting Standards Board's (FASB) model which is near final.
- To consider the interaction between the accounting for insurance contract liabilities proposed in the ongoing IFRS 4 Insurance project and the accounting for financial assets.
- To address application issues related to the classification of specific instruments by clarifying the application guidance supporting IFRS 9.

The key areas that the IASB and the FASB jointly re-deliberated were:

- A possible additional classification category (debt instruments measured at fair value through other comprehensive income (FVTOCI)).
- The need for bifurcation of non-closely related embedded derivatives from financial assets.
- The contractual cash flow characteristics criterion for financial assets.

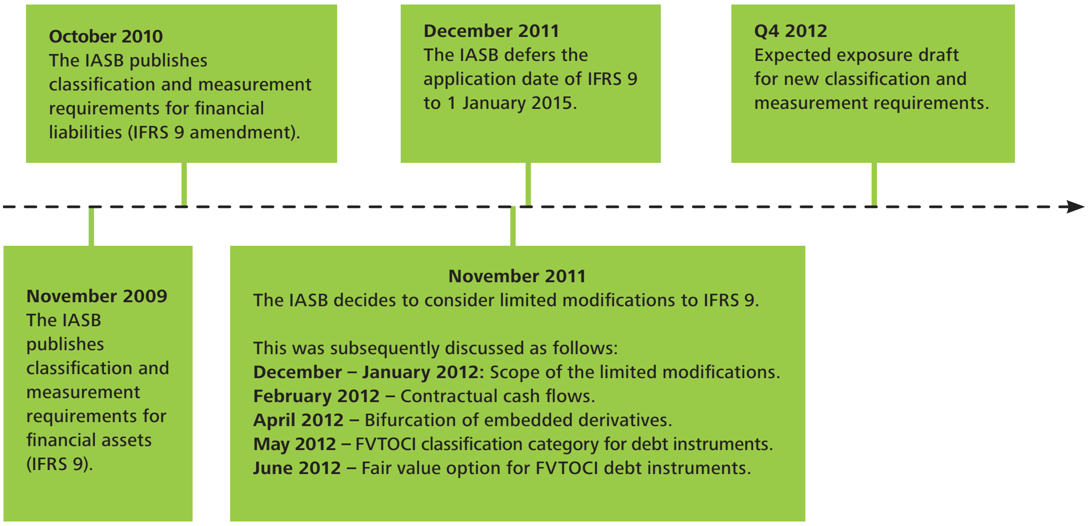
The IASB and FASB did not re-deliberate issues relating to financial liabilities. Consequently, the requirements with regard to classification and measurement of financial liabilities remain unchanged.

The application date of IFRS 9 was initially set for periods beginning on or after 1 January 2013. However, as the project has taken longer to complete than expected, the IASB decided in December 2011 to defer the application date to periods beginning on or after 1 January 2015 as well as remove the requirement to restate comparative information.

1 Phase 1: Classification and Measurement; Phase 2: Impairment, Phase 3: Hedge Accounting.

2 In November 2009, the IASB published IFRS 9 on classification and measurement for financial assets which was subsequently amended in October 2010 with a model for financial liabilities.

**Figure 1. Classification and Measurement project milestones**




## What changes are proposed to IFRS 9 Classification and Measurement?

As mentioned above, the proposed amendments relate solely to the model for financial assets.

### The measurement categories

Currently IFRS 9 primarily has two measurement categories for financial instruments on the balance sheet. They are: amortised cost and fair value.

Amortised cost is only available for assets that meet two conditions:

1. First, the assets must be held in a business model whose objective is to collect the contractual cash flows (as opposed to an objective of realising fair value through sale) – "held to collect".

2. Second, the contractual cash flow characteristics must represent repayment of principal and interest on principal, where interest is the compensation for the time value of money and credit risk (in essence this condition requires the instrument's terms to be plain vanilla).

For items measured at fair value, gains and losses are recognised in profit or loss, except for equity investments designated as FVTOCI (see below for further detail).

However, as a result of the re-deliberations with the FASB in May 2012 the IASB tentatively decided to introduce a FVTOCI category for financial assets that meet two conditions:

1. First, the assets must be held in a business model whose objective is both to collect the contractual cash flows and to sell financial assets (the latter being particularly relevant for holdings of liquidity portfolios).

2. Second, the contractual cash flow characteristics must represent repayment of principal and interest on principal (i.e. the same contractual cash flows condition as for amortised cost assets noted above).

It should be noted that the mechanics of the FVTOCI category for debt instruments is different to that which applies to equity investments (see boxed text).

Financial assets that do not meet the business model tests for amortised cost or FVTOCI would have to be measured at fair value through profit or loss (FVTPL).

Although it is too early to say what the effect will be, some believe that this new classification category would capture liquidity portfolios where assets are bought and sold more frequently (prehaps at the instigation of regulators), yet managed on a yield basis.

As well as introducing the new FVTOCI category for debt instruments, the IASB decided to add some additional guidance to clarify the objective of 'hold to collect'. Such guidance would include these types of business activities as well as the frequency and nature of sales that would prohibit financial assets from qualifying for amortised cost measurement.

To address some concerns and questions that have been raised in practice, the IASB also added guidance to clarify principles around contractual cash flow characteristics. This guidance is not intended to change the requirements currently in IFRS 9.

**Mechanics of the new FVTOCI category for debt instruments**

The FVTOCI category appears similar to Available For Sale (AFS), however they are different. Below is a summary of the similarities and differences between AFS and FVTOCI.

The following mechanics would be the same as accounting for AFS debt instruments under IAS 39:

- The financial asset would be measured at fair value on the balance sheet.
- Fair value gains or losses would be recognised in Other Comprehensive Income (OCI) over the life of the financial asset.
- Cumulative fair value changes would be reclassified to profit or loss when the financial asset is derecognised.
- Interest income would be recognised in profit or loss using the effective interest rate method that is applied to financial assets measured at amortised cost.

However, the following mechanics would differ:

- The impairment method used to recognise impairment losses/reversals in profit or loss would be the same as for financial assets carried at amortised cost. Consequently, amounts reclassified from OCI to profit or loss when the financial asset is impaired will be based on amortised cost calculations (unlike impairment recognised under IAS 39's AFS category which is based on fair value).

### Reclassification

Given the business model criteria, IFRS 9 requires reclassification between amortised cost and FVTPL if there is a change in business model (and, if reclassifying from fair value to amortised cost, the 'plain vanilla' cash flow test is fulfilled).

With the introduction of the new FVTOCI category for debt instruments, the IASB extended the reclassification requirements to this category. In other words, reclassification between amortised cost, FVTPL and FVTOCI will be required if there is a change in the business model (and, if reclassifying from fair value to amortised cost, the 'plain vanilla' cash flow test is fulfilled).

### Fair value option

IFRS 9 acknowledges that even if the conditions are met, it might not be useful to measure certain financial assets at amortised cost. This would be the case if it gave rise to a measurement mismatch against another instrument that is measured at fair value. Consequently, there is an option in IFRS 9 to designate an asset at FVTPL in such cases.

The IASB tentatively decided to extend the fair value (through profit and loss) option to financial assets that are classified as FVTOCI on the basis that categorisation into the FVTOCI category could give rise to measurement mismatches against other instruments measured at FVTPL.

## What has not changed from the IFRS 9 that we know today?

### Contractual cash flow requirements

The IASB decided to keep the requirements regarding contractual flows (i.e. that they should be solely principal and interest) unchanged. In short:

- If the financial asset contains a component other than principal, consideration for the time value of money, and for the credit risk of the instrument, the financial asset must be measured at FVTPL.
- A contractual term that changes the timing or amount of payments of principal and interest would not preclude the financial asset from being eligible for measurement at amortised cost as long as any variability only reflects changes in the time value of money and credit risk of the instrument.

# The IASB has not proposed making any amendments to IFRS 9 on classification and measurement of financial liabilities issued in October 2010.

- The probability of contingent cash flows that are not solely principal and interest should not be considered. Financial assets that contain contingent cash flows that are not solely principal and interest must be measured at FVTPL.

- The existence of prepayment and extension options, including those that are contingent, does not preclude a financial asset from being eligible for a measurement category other than FVTPL as long as these features are consistent with the notions of solely principal and interest.

**Equities and equities not held for trading**

It is clear that equity investments and derivatives cannot satisfy the 'plain vanilla' contractual cash flow test described above and hence these are always measured at fair value.

Fair value changes for such items are taken to profit or loss unless an option, available only for equity investments not held for trading, is elected at initial recognition to take the gains or losses to other comprehensive income permanently with only dividend income recognised in profit or loss (i.e. the category of 'fair value through other comprehensive income'). Unlike the proposed new FVTOCI category for debt instruments described earlier there is no recycling on derecognition and no impairment analysis needed.

**Bifurcation of embedded derivatives**

IFRS 9 does not require an assessment or separation of any embedded derivatives for financial assets. Instead, if there are exotic features, the instrument is likely to fail the contractual cash flow characteristics test and be measured at FVTPL in its entirety (by virtue of it not qualifying for amortised cost accounting or, under the new proposals failing the FVTOCI category for debt instruments).

**Classification and measurement of financial liabilities**

The IASB has not proposed making any amendments to IFRS 9 on classification and measurement of financial liabilities issued in October 2010. As a reminder the key points to note are as follows:

- Financial liabilities are measured at amortised cost or fair value.

- For financial liabilities designated at FVTPL under the fair value option, IFRS 9 requires fair value changes arising from changes in own credit risk to be permanently recorded in OCI (unless it creates a measurement mismatch).

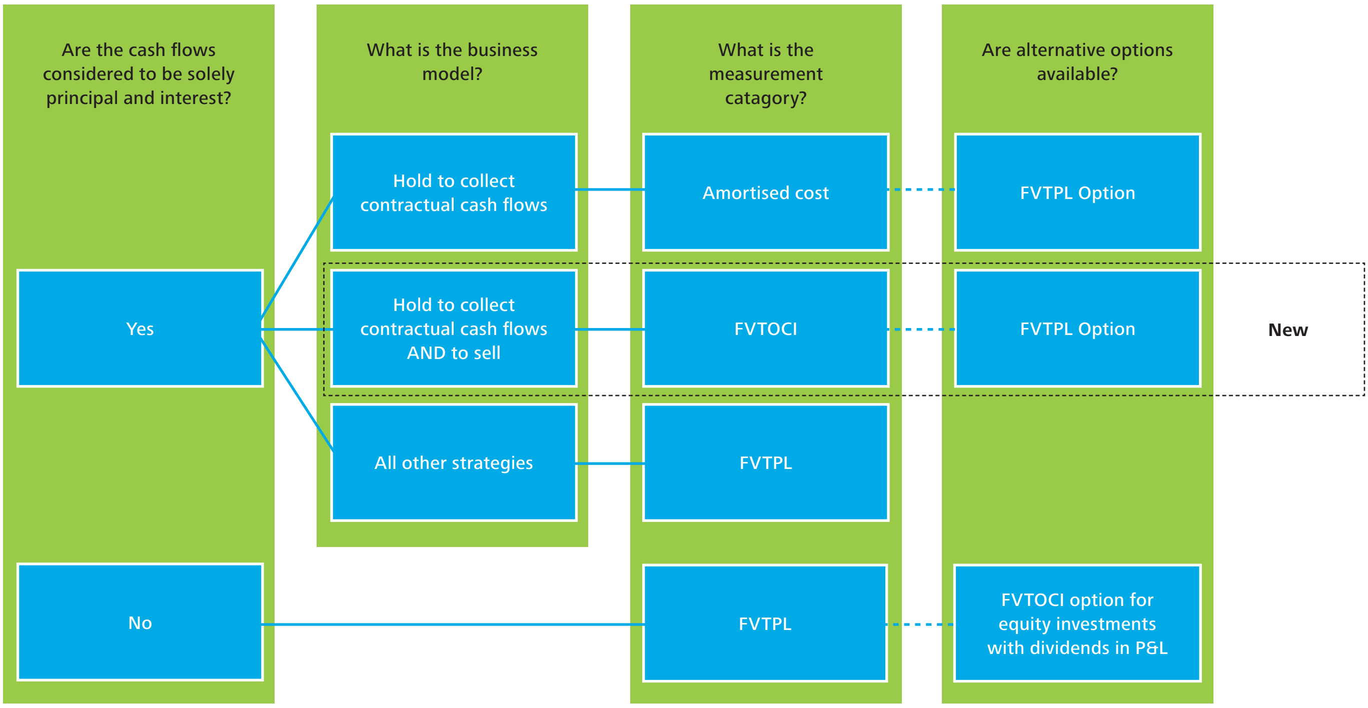
- Bifurcation of non-closely related embedded derivatives is required, if the host contract is not measured at fair value.

## What is next?

The IASB will be wrapping up its discussions on the limited modifications to the classification and measurement requirements of IFRS 9. According to the IASB's work plan, an exposure draft is to be published in the fourth quarter of 2012.

### A summary of the classification and measurement model for financial assets after taking into account the latest discussions

Most analyses for classification and measurement would start with asking the question “what is my business model?”. However, to simpfly the diagram we start with the contractual cash flow test.

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