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Proposed amendments to IFRS 9 – Classification and measurement

Preparing for a new business model

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IN THE HEADLINES

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> “Banks, insurance companies and other financial institutions are most likely to be affected by the proposed changes. Some entities will expect an overall reduction in P&L volatility, although for others volatility in equity and regulatory capital may increase.”

– Andrew Vials,
KPMG’s global IFRS Financial Instruments leader

Preparing for a new business model

On 28 November 2012, the IASB issued an exposure draft (ED) that proposes limited amendments to IFRS 9 (2010) *Financial Instruments* on the classification and measurement of financial assets and financial liabilities. The ED introduces:

- a new fair value through other comprehensive income (FVOCI) measurement category for financial assets;
- a new business model, along with new application guidance on applying the business model concept;
- a ‘modified economic relationship’ test for assets where the economic relationship between principal and interest is subject to change; and
- permission to early apply only the own credit requirements for financial liabilities measured under the fair value option, without having to early apply IFRS 9 in its entirety.

New judgements to be made

The FVOCI measurement category

IFRS 9 (2010) currently includes two primary measurement categories for financial assets: amortised cost and fair value through profit or loss (FVTPL). The introduction of a third measurement category – FVOCI – with its own business model definition may result in new judgements to ensure that financial assets are classified in the appropriate category. Rather than having to determine whether an asset is in a ‘held to collect’ business model, an entity would now have to determine whether it is in a ‘held to collect’ business model, a ‘held both to collect and to sell’ business model, or neither.

Entities may therefore need to reassess how they define their business models for acquiring and holding financial assets. This in turn may lead them to reassess how the business is managed, how performance is evaluated by the entity’s key management personnel, and how managers of the business are compensated – e.g. based on the fair value of the assets managed.

Entities may also have to ‘upgrade’ their accounting systems, to ensure that they are capable of capturing both fair value and amortised cost – e.g. impairment calculation – information for FVOCI assets.

‘Modified economic relationship’ test

Assessing whether cash flows are solely payments of principal and interest will require, in some cases, a ‘modified economic relationship’ test. This test would require more judgement, in terms of defining both: what is a ‘benchmark’ instrument; and when cash flows in a modified relationship are ‘more than insignificantly different’ from a benchmark instrument.

Entities may have to undertake a comprehensive review of their loan documentation and the terms of their investment securities to identify contractual terms that modify the economic relationship between principal and interest.

Changes in profit or loss volatility are likely – especially for financial institutions

Introduction of the FVOCI measurement category may reduce profit or loss volatility where entities:

- hold financial assets in business models that have no trading intent; but
- have greater sales activity in terms of frequency and volume of sales compared to business models whose objective is to hold financial assets solely to collect contractual cash flows.

Banks, insurance companies and other financial institutions are expected to be most affected by the limited amendments. Banks may hold financial assets to meet various liquidity needs, and insurance companies may hold financial assets to fund their insurance liabilities or to match the duration of their longer-term insurance liabilities. The limited amendments may have a significant impact on how these financial assets will be classified and measured, and may give rise to a change in profit or loss volatility; however, the direction of that change would depend on how the financial assets would be classified and measured under the current and proposed requirements.

Banks are the biggest users of the fair value option for financial liabilities. Early application of the own credit requirements would help to reduce profit or loss volatility from this source sooner than would otherwise be possible.

There may be unexpected consequences

Regulatory capital requirements

Although profit or loss volatility from some assets may be reduced, the amendments may have a significant impact on the computation of an entity's capital requirements. For example, assets that an entity may previously have expected to measure at amortised cost may need to be measured at FVOCI – with any unrealised fair value losses reducing its regulatory capital.

Entities may wish to seek adjustments to the calculation of certain regulatory capital requirements if they would be affected by the proposals. They may also wish to manage stakeholder expectations by communicating these impacts before the effective date of the limited amendments.

Other consequences

Hybrid assets with characteristics of both equity and debt instruments would be measured at FVTPL. This may lead to inconsistent accounting outcomes for similar instruments.

The IASB has not proposed any special requirements for loans with interest rates that are subject to regulation. If these fail the general 'principal and interest' test, then they would need to be measured at FVTPL. The IASB will gather further feedback on this issue.

Entities that classify assets as measured at FVOCI – rather than amortised cost or FVTPL – may find their processes for hedge accounting affected.

Transition requirements/ preparation

Entities that have already applied, or are planning to early apply, IFRS 9 (2009) and/or IFRS 9 (2010) may have to re-engineer the conversion process to take into account these proposals.

Although entities would not be required to restate comparatives, they may need to:

- develop, test and implement new processes and systems in advance of the IFRS 9 effective date of 1 January 2015; and
- run those systems and processes in parallel with existing systems.

Entities should assess current processes and systems to ensure that they are able to comply with the new classification and measurement requirements as at the date of initial application.

Amendments limited in name only

These amendments could have a wide impact on your organisation – particularly considering that different drivers of profit or loss and equity volatility could impact your share price and business valuation. You need to start proactively assessing and managing the whole process now…

> "The new 'fair value through other comprehensive income' category will be welcomed by many in the insurance industry, as it is intended to dovetail with the IASB's tentative decision that changes in insurance liabilities driven by changes in discount rates should also be excluded from P&L. However, the debate will continue as to whether the IASB has found the best overall package to try to minimise accounting mismatches."

– Chris Spall, KPMG's global IFRS Financial Instruments deputy leader

Background to the proposals

Under IFRS 9 (2010), a financial asset is measured at amortised cost if it is held within a business model whose objective is to hold assets to collect contractual cash flows and its cash flows are solely payments of principal and interest. All other financial assets are measured at fair value, with changes in fair value recognised in profit or loss – except for some equity investments for which changes in fair value are recognised in other comprehensive income (OCI).

The proposal introduces a third measurement category, under which a financial asset is required to be measured at FVOCI if:

- its cash flows are solely payments of principal and interest; and
- it is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale.

Gains and losses on such an asset would be recognised in OCI – except for interest income, credit impairment losses/reversals and foreign exchange gains and losses; these would be recognised in profit or loss in the same manner as for financial assets measured at amortised cost. When the financial asset is derecognised, the cumulative gain or loss previously recognised in OCI would be reclassified to profit or loss.

The existing option in IFRS 9 to measure an asset at FVTPL in order to reduce an accounting mismatch would be available for financial assets that would otherwise be mandatorily measured at FVOCI.

Find out more

For more information on the proposals, please go to the IASB announcement on the amendments, or speak to your usual KPMG contact.

Timeline[1]

28 November 2012:
Exposure draft published

28 March 2013:
Comment period ends

1 January 2015:
Effective date

31 December 2015:
Earliest annual financial statements in which proposals would apply

1 Assumes a 31 December annual reporting period.

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