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Summary of IFRS Exposure Draft – Classification and Measurement: Limited Amendments to IFRS 9

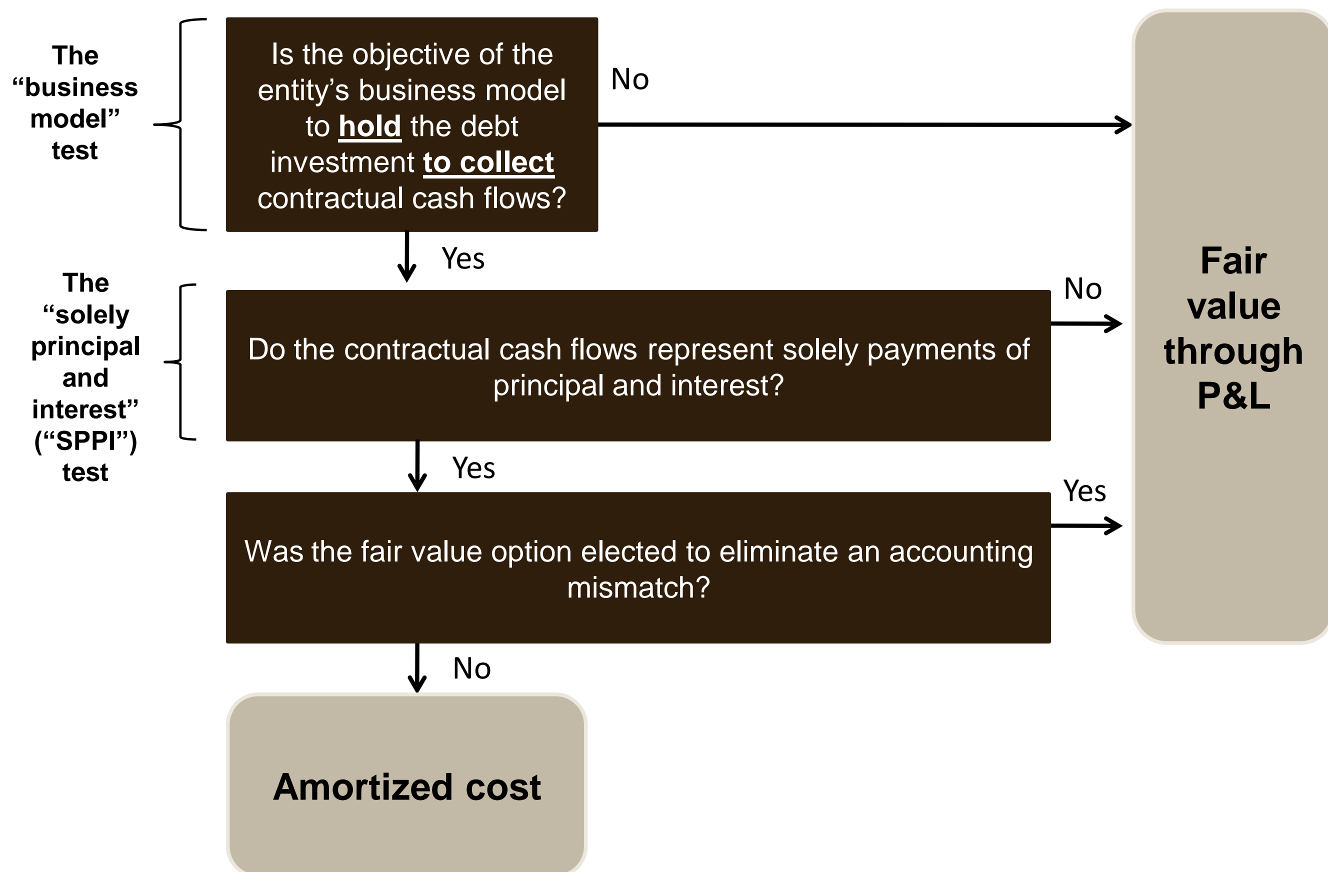
April 2014

In November 2012, the International Accounting Standards Board (IASB) issued proposed changes to IFRS 9 *Financial Instruments* which affect the classification and measurement of debt investments. If enacted, the proposals will have a significant impact on publicly accountable entities with debt investments, especially MNP Credit Union clients.

Below are two decision trees that show both the current and proposed IFRS 9 classification and measurement requirements effecting debt investments.

No amendments are proposed in respect of financial liabilities and equity investments.

Decision Tree 1: Current IFRS 9 Classification and Measurement Requirements for Debt Investments



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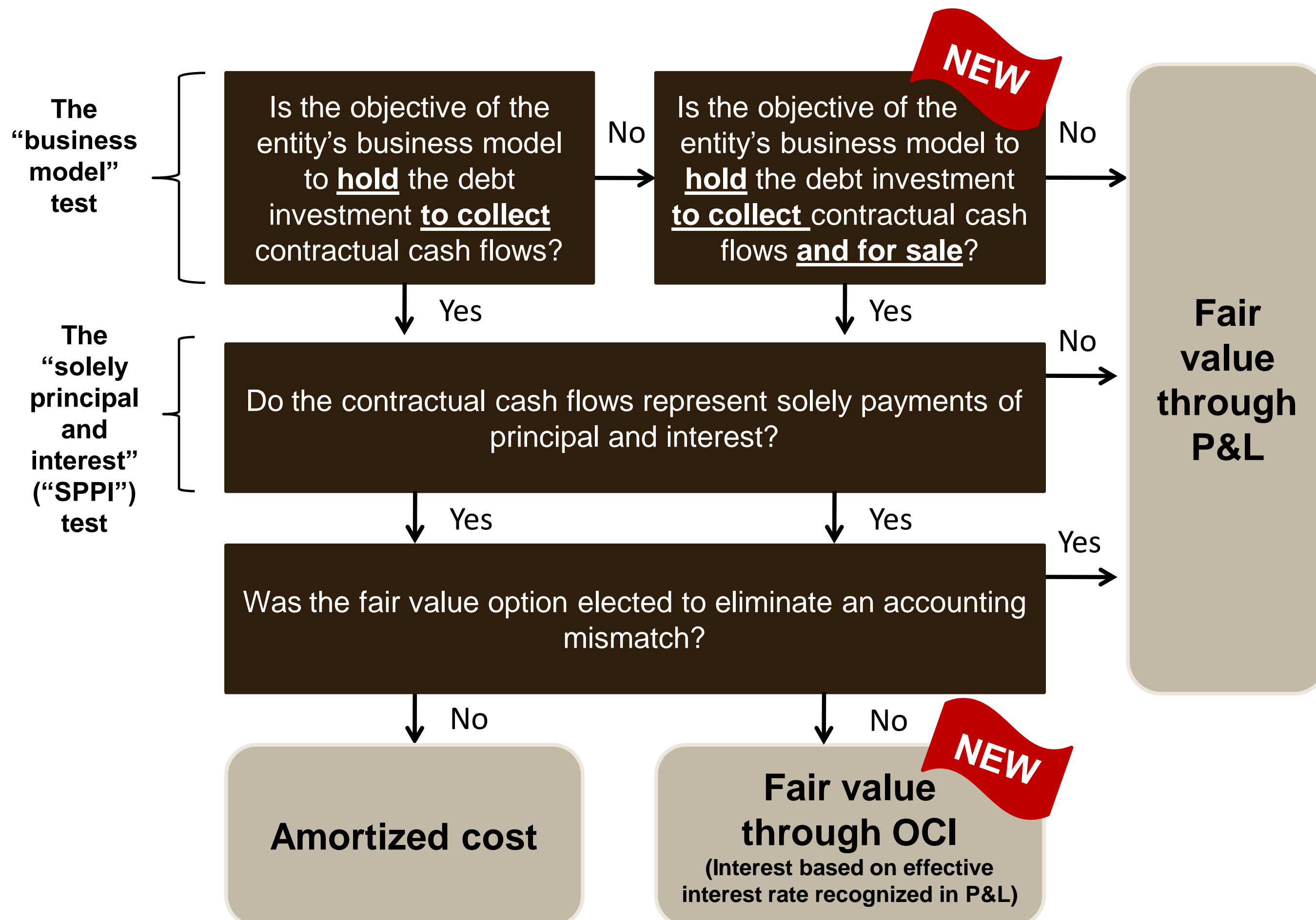
Decision Tree 2: Proposed IFRS 9 Classification and Measurement Requirements for Debt Investments



Proposal 1: New Classification and Measurement Category

As can be seen in decision tree 2 above, the Exposure Draft (ED) proposes a new classification and measurement category for financial assets, namely, fair value through other comprehensive income (FV through OCI).

Debt investments that meet both the following conditions will be classified in this FV through OCI category:

- They are held within a business model whose objective is to hold the asset in order collect contractual cash flows AND for sale.
- The contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest.

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For financial assets at FV through OCI, the measurement will be the same as the IAS 39 Available for Sale category. Interest, based on the effective interest rate method, will be recognized in profit or loss. The balance sheet will reflect fair value with unrealized gains/losses recognized in OCI. On derecognition the cumulative unrecognized gain/losses in OCI will be reclassified to profit or loss.

The purpose of the change is to:

- Reduce differences between the Financial Accounting Standards Board (FASB) and the IASB models.
- Address concerns raised by constituents from various jurisdictions.
- Consider the interaction of IFRS 9 with the ongoing insurance project.

Proposal 2: New and Clarified Guidance to Help Entities Determine the Objective of the Business Model (i.e., "Held to Collect" or "Held to Collect and for Sale" or "Neither")

The proposals include additional guidance and clarification of existing guidance on how to apply the "business model" test to debt investments.

- The objective of the business model is not determined on an instrument-by-instrument basis but rather at a higher level of aggregation by an entity's key management personnel.
- The objective of the business model is a matter of fact and can be observed by the way the business is managed and its performance is evaluated by the entity's key management personnel.
- All factors are considered, including: how the performance of the business is reported to the entity's key management personnel; how portfolio managers are compensated (e.g. whether the compensation is based on the fair value of the assets managed); and the frequency, timing and volume of sales in prior periods, why the sales have occurred, and expectations about sales activity in the future.
- Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Examples of sales that may be consistent with a business model whose objective it is to hold financial assets in order to collect contractual cash flows include:
    - Sales resulting from deterioration in the credit quality below an entity's documented risk management policy.
    - Infrequent sales (even if significant) or insignificant sales both individually and in aggregate (even if frequent).
    - Sales close to maturity so that the proceeds approximate the collection of the remaining contractual cash flows.

Examples of "Held to Collect" Business Models That May Lead to Amortized Cost Classification:

1. An entity has predictable funding needs and matches the maturity of its financial assets to its estimated funding needs. Infrequent sales occur because of unanticipated funding needs or deterioration of credit quality. Reports to key management personnel focus on the credit quality. The entity monitors fair values among other information.
2. An entity purchases loans that may or may not include credit losses. If payments are not made on time the entity attempts to extract the contractual cash flows through various means; however, the entity does not expect to recover all the contractual cash flows. In some cases, swaps are used to change the interest rate from floating to fixed.
3. A financial institution holds financial assets to meet liquidity needs in a 'stress case' scenario (e.g. a run on the bank's deposits). The entity does not anticipate selling these assets except in such scenarios; however, it monitors fair values to ensure that the cash amount that would be realized would be sufficient.

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Examples of "Held to Collect and for Sale" Business Models That May Lead to FV Through OCI Classification:

1. An entity holds debt investments to meet its everyday liquidity needs and that involves recurring and significant sales activity. The entity actively manages the contractual yield. It holds some financial assets to maturity while it sells others before maturity to reinvest in higher yielding financial assets or to better match the duration of liabilities.
2. A financial institution holds debt investments to meet liquidity needs in a 'stress case' scenario (e.g. a run on the bank's deposits). The entity's regulator routinely requires sales, to demonstrate that the assets are liquid.
3. An entity anticipates capital expenditures in a few years and therefore invests its excess cash in debt investments. To maximise the return on those financial assets, the entity will sell financial assets and re-invest the cash in debt investments with a higher yield when such an opportunity arises. The portfolio managers are compensated based on the return generated.
4. An insurer holds debt investments to fund insurance contract liabilities. It uses the proceeds from the contractual cash flows to settled insurance contract liabilities as they come due. The insurer also undertakes significant buying and selling activity to regularly rebalance the portfolio as estimates of the expected cash flows needed to settle the liabilities change.

Neither "Held to Collect" or "Held to Collect and for Sale" Business Models Leading to FV through P&L Classification:

This is treated as a residual category and the current or proposed amendments do not contain detailed examples of business models that will lead to FV through P&L classification. The following debt investments will fall within this category:

- Where collecting contractual cash flows are only incidental and the main purpose of the portfolio is to maximize cash flows through sale of the debt investment.
- Portfolios that are held for trading.
- Debt investments that fail the SPPI test (Refer to the decision trees above and proposal 3).

Proposal 3: Additional Guidance on Assessing Whether Contractual Cash Flows are Solely Payments of Principal and Interest on the Principal Amount Outstanding (i.e., the SPPI test)

IFRS 9 currently includes guidance on applying the SPPI test to many scenarios including: debt investments with equity conversion, prepayment and extension features, and contractually linked instruments that create concentrations of credit risks (e.g. securitization tranches). Refer to IFRS 9 paragraph B4.1.7 - B4.1.26 for more detail.

The additional guidance proposes that the following financial assets will fail the SPPI test:

1. Instruments where the contractual cash flows include payments that are unrelated to principal, the time value of money or credit risk.
2. Instruments with modified economic relationships which results in cash flows that are more than insignificantly different from "benchmark" cash flows. "Benchmark" cash flows refer to contractual cash flows of a comparable financial asset that does not contain the modification.

Unless it is clear with little or no analysis that contractual cash flows could not be more than insignificantly different from the benchmark cash flows, an entity would need to assess the significance of the modification using either an actual or hypothetical instrument.

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The proposed standard lists 2 examples of instruments with modified economic relationships:

- Instruments that include leverage which increase the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest.
- Instruments with an interest rate reset feature where the frequency of the reset does not match the tenor of the interest rate (e.g. debt investment with an interest rate that resets monthly to a 5-year interest rate).

Proposal 4: Transitional Requirements

The following amendments are proposed to transitional provisions:

- An entity that chooses to early adopt IFRS 9 six months after the completed version of IFRS 9 (including all chapters) have been issued, will be required to apply the completed version of IFRS (i.e., an entity will not be allowed to early adopt earlier versions of IFRS 9).
- Despite the transitional requirement above, entities will be permitted to only early apply IFRS 9 paragraph 5.7.7, without otherwise changing the classification and measurement of financial instruments. Paragraph 5.7.7 requires and entity to present the effect of changes in the credit risk of financial liabilities designated as at FV through P&L, in other comprehensive income.
- If an entity early adopted IFRS 9 (2009) or IFRS 9 (2010) before a certain date and subsequently applies the amendments resulting from this ED, it will be required to revisit financial assets which were designated at FV through P&L because of an accounting mismatch. Some financial assets may now meet the criteria while the designation may need to be revoked for others.

Other Proposals:

The ED also proposes the following minor amendments:

- Guidance on reclassifying financial assets from or to the FV through OCI category upon a change in the business model objective.
- Consequential amendments to other standards.

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