Comment Letter Analysis and Issues Paper – ED 230 *Classification and Measurement: Limited Amendments to AASB 9* (proposed amendments to AASB 9 (2010)

Introduction and background

1 The purpose of this issues paper is to outline potential issues in ED 230 and decide whether these issues, or any other issues, should be included in the AASB's submission on IASB ED/2012/4. This paper is structured to correspond to the questions asked by the IASB in ED/2012/4.

2 Comments are to be received by the IASB by 28 March 2013 and were due to the AASB on 13 February 2013. Two submissions have been received by the AASB as at the date of this Issues Paper (agenda paper 8.5). The paper incorporates feedback from those submissions and feedback received as a result of staff's initial targeted outreach. Staff expect that additional feedback may be received in due course by way of submissions to the IASB which are copied to the AASB. Due to the timing of the comment period staff recommend that the AASB's submission to the IASB is finalised through the AASB's financial instruments impairment sub-committee, which includes the Chairman.

3 The following key issues are discussed in this paper:

(a) Contractual cash flows - modified economic relationship (Questions 1 to 3)

(b) Business model for fair value through other comprehensive income (FVOCI) (Questions 4 and 5)

(c) Extension of the fair value option (Questions 6)

(d) Application of versions of IFRS 9 and considerations for first time adopters (Questions 7 and 8)

Contractual cash flows - modified economic relationship

<u>Modified economic relationships (Question 1)</u>

Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

Modified economic relationship application guidance (Question 2)

Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

Clarification of the objective of the application of the contractual cash flow characteristics assessment (Question 3)

Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

4 Staff's preliminary recommendation is to support the proposal in the ED to broaden the notion of what is 'solely principal and interest' to include contractual cash flows of financial assets which could not be more than insignificantly different from cash flows of a benchmark instrument. In the AASB's comment letter to the IASB on IASB ED/2009/7 *Financial Instruments: Classification and Measurement* the AASB had concerns that the 'basic loan features' criterion was too narrow and that it would inappropriately result in classification of some instruments that are managed on a contractual yield basis being measured at fair value.

5 Feedback from constituents indicates that there may be some financial assets (for example, certain financial assets in regulated markets) for which the contractual cash flows would not be considered to be solely principal and interest under the proposed approach. An example is Chinese mortgage bonds where interest rates are set by a regulator or government agency without regard to a market-based link between interest rates and maturities. This could preclude such assets being measured at amortised cost, which some may consider would be the most appropriately measurement category. Staff recommend that the IASB should provide additional guidance concerning what the appropriate benchmark for regulated assets should be to clarify whether it is their intention that such assets should not be measured at amortised cost.

6 Staff recommend that additional guidance is given to clarify when the assessment of whether contractual cash flows are solely principal and interest is required. Guidance similar to that concerning reassessment of embedded derivatives in IFRIC 9

Reassessment of Embedded Derivatives could be given such that (re)assessment would be required only when:

(a) the entity first becomes party to the contract; and

(b) a change in the terms of the contract significantly modifies the cash flows that would otherwise have been required under the contract

Question to the Board:

1. Do you agree with the staff recommendations? Are there any other issues which have not been identified above?

Business model for fair value through other comprehensive income (FVOCI)

Measurement of financial assets at FVOCI (Question 4)

Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that:

(i) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost; and

(ii) all other gains and losses are recognised in OCI?

If not, why? What do you propose instead and why?

Business model application guidance (Question 5)

Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

7 Staff are concerned that the IASB’s original aim of simplifying financial instrument accounting is being undermined by the proposals. We note that the proposals would involve greater need for judgement in determining the appropriate business model; dealing with reclassifications on a change in business model and staff are also concerned about the interaction of the proposals with the other phases of IFRS 9 which have not yet been completed ie. hedge accounting and impairment. Staff also have concerns that until entities undertake a comprehensive review of IFRS 9 it is not apparent whether there could be unintended consequences arising from introducing a mandatory FVOCI category.

8 However, overall, the preliminary staff recommendation is to support the proposal to introduce a mandatory FVOCI measurement category for financial assets that are held

within a business model in which assets are managed both in order to collect contractual cash flows and for sale (subject to the contractual cash flow characteristics assessment). Informal feedback from Australian constituents suggests that having only two measurement categories for debt assets is too limiting and that amortised cost in profit or loss and fair value on balance sheet would provide useful information to be provided. Introducing this category would address some of the concerns about amortised cost category being too narrow and fair value through profit or loss (FVPL) not being the most useful category for some financial assets (such as liquidity portfolios).

9 The support of staff is subject to the fair value option also being extended to these financial assets (see response to Question 6 below).

10 Staff are particularly concerned about the increase in complexity which is introduced into IFRS 9 by the proposal to recycle amounts from OCI to profit or loss. We note that the FVOCI designation in IFRS 9 for equity securities does not involve recycling.

11 Staff recommend that, should the IASB proceed with this proposal, the amendment should be made concurrently with the issuance of the impairment requirements in IFRS 9. This would limit the number of versions of IFRS 9 available for early adoption and increase comparability between entities.

Question to the Board:

2. Do you agree with the staff recommendations? Are there any other issues which have not been identified above?

Extension of the fair value option (Question 6)

Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

12 Staff agree that the fair value option should be extended to financial assets that would otherwise be mandatorily measured at FVOCI.

13 IFRS 9 requires that, in order to be eligible to apply the fair value option, the fair value designation must eliminate or significantly reduce a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') (IFRS 9 paragraph 4.1.5). IFRS 9 contains limited guidance on how an entity should determine whether an accounting mismatch exists.

14 In the context of its insurance contracts project, the IASB has tentatively decided that certain components of insurance liabilities (remeasurements due to changes in discount rates) would be recognised through OCI. The IASB intends that introducing the mandatory FVOCI category would reduce the mismatch between financial assets and insurance liabilities. However as well as a mismatch arising from changes in discount rates used in measuring insurance liabilities there is also likely to be a mismatch from changes in inflation rates. Feedback from Australian insurers and regulators is that they want the ability to measure both insurance liabilities and assets backing insurance contracts at FVPL.

15 Staff recommend that the IASB clarify whether insurers would be eligible to use the fair value option for both financial assets that would otherwise be mandatorily measured at FVOCI and insurance liabilities, ie. whether insurers would qualify for the ‘accounting mismatch’

16 Staff also recommend that the IASB clarify how the ‘accounting mismatch’ should be performed for portfolios of instruments and when there is a mismatch in the tenor of financial assets and liabilities.

Question to the Board:

3. Do you agree with the staff recommendations? Are there any other issues which have not been identified above?

Application of versions of IFRS 9 and considerations for first time adopters

Application of versions of IFRS 9 (Question 7)

Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (ie including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

Application of completed version of IFRS 9 (Question 8)

Do you agree that entities should be permitted to choose to early apply only the ‘own credit’ provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

Considerations unique to first-time adopters (Question 9)

Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

17 Staff agree that in the interest of increasing comparability between entities, an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9. The six-month withdrawal period between issuance of the completed version and the introduction of the prohibition on newly applying previous versions of IFRS 9 appears sufficient.

18 Staff agree that entities should be permitted to choose to early apply only the ‘own credit’ provisions in IFRS 9 once the completed version of IFRS 9 is issued.

19 Staff have not identified any considerations unique to first-time adopters.

Question to the Board:

4. Do you agree with the staff views? Does the Board have an alternative view?

Other matters

Question to the Board:

5. Are there any other matters which should be included in the AASB's submission to the Board?

Attachments

Australian submissions on AASB ED 230 (IASB ED/2012/4) *Classification and Measurement: Limited Amendments to AASB 9* [Agenda paper 8.5]