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ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9 - Proposed amendments to IFRS 9 (2010)

Grant Thornton International Ltd is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9 - Proposed amendments to IFRS 9 (2010)* (the ED). We have considered the ED, as well as the accompanying draft Basis for Conclusions.

Contractual cash flow test

We support the Board's efforts to provide relief for certain types of financial instruments which would be classified at fair value under the current requirements of IFRS 9 *Financial Instruments*. We are however concerned that the proposed changes may not go far enough to address legitimate concerns raised. As a result, certain types of financial instrument for which amortised cost measurement may provide more meaningful information will continue to be classified at fair value.

We suggest then that the Board may need to think somewhat more flexibly about the definition of interest to address concerns raised.

The 'fair value through other comprehensive income' measurement category

We appreciate the Board's efforts to address concerns raised over the implications of the two category model in the current version of IFRS 9, including potential accounting mismatches in the insurance industry and the resulting classification of certain bank portfolios. We also note that the introduction of an additional 'fair value through other comprehensive income' (FVTOCI) category will significantly compromise the reduction in complexity that was offered by the original version of IFRS 9. On balance, however, we support the introduction of the additional category.

We expand on these comments in our responses to the specific questions raised in the ED's Invitation to Comment section, which are set out in the Appendix.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@uk.gt.com or telephone + 44 207 391 9510).

Yours sincerely,

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Responses to Invitation to Comment questions

Contractual cash flow characteristics assessment: a modified economic relationship between principal and consideration for the time value of money and the credit risk

Question 1

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?

We support the Board's efforts to provide clarification and relief in this area. We believe that the proposals improve IFRS 9's current requirements for the solely payments of principal and interest (SPPI) assessment. From a practical point of view, however, the relief provided appears limited and could be said to amount to little more than a specific application of materiality.

Although we support the proposal as far as it goes, we have some broader concerns about the SPPI assessment and specifically its application to interest payments. These are explained in our response to Question 3 below.

Question 2

Do you believe that this exposure draft provides sufficient, operational guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

Yes, we think the guidance is probably sufficient and operational. We think it is particularly helpful that the ED clarifies that the assessment:

- considers only reasonably possible scenarios rather than all possible scenarios; and
- need not always be a detailed assessment.

In expressing this support we note that this is a new type of assessment so it will take time for practice to develop. The assessment may be more challenging for entities that have no direct exposure to 'benchmark instruments' as defined in the ED (possibly including entities in the types of regulated environment referred to in BC44). These challenges will however be mitigated by the fact that entities that hold large numbers of similar debt assets will presumably perform the assessment by category rather by individual asset.

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?

We think that the proposed amendment will indeed clarify the application of the contractual cash flow characteristics assessment to financial assets with interest rate mismatch features as described in paragraph B4.1.9A of the ED.

As noted in our response to Question 1, it seems the scope of the proposed assessment is limited to this particular situation. This leaves open the question of how to address some other types of 'modification', such as an interest rate reset for which the tenor matches the reset period but for which the rate is an average rate for the preceding period. We therefore suggest the Board should clarify whether the proposed assessment approach applies narrowly to the modification referred to, or more broadly to any features in an instrument that will or may cause its cash flows to deviate from benchmark cash flows.

We are also aware of other types of instrument for which the application of the SPPI test is not entirely clear, including:

- interest free (or other off-market) loans such as many intercompany loans
- variable rate loans with some degree of lender discretion on the interest rate reset (such as many mortgage products)
- loans acquired at a premium or discount to par
- interest rate resets in some regulated environments as referred to in BC44 of the ED.

We are not suggesting specific application guidance for each of these types of instrument or feature. However, we feel that the underlying cause of many of these issues is that IFRS 9 takes a rather narrow view of what constitutes 'interest'. The proposed guidance indicating that benchmark interest features require an exact correlation between the frequency of reset and the interest rate tenor is one manifestation of this narrow view.

We suggest that the Board should perhaps think more flexibly about this topic. This may involve reconsidering the current guidance on what does and does not constitute 'interest' and broadening the criteria to include other concepts or components.

In order to help address the regulated market issue, we suggest that the Board should consider whether the guidance on interest should include the concept that the SPPI assessment takes into account commonly accepted rate-setting practices in the entity's jurisdiction (or similar). We think it would be unfortunate (and probably inappropriate) to define SPPI in a way that results in mandatory fair value through profit or loss (FVTPL) classification of debt instruments that are considered 'basic' in their environment.

We also question whether it is appropriate that interest rate features that would not be regarded as embedded derivatives in accordance with IAS 39 should result in an instrument failing SPPI in accordance with IFRS 9 (while acknowledging that the concept of embedded derivatives does not apply to financial assets in accordance with IFRS 9).

Business model assessment: the 'fair value through other comprehensive income' measurement category for financial assets that contain contractual cash flows that are solely payments of principal and interest

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:

(a) 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

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

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

Although the resulting complexity is unfortunate (see below), on balance we agree with the proposal to introduce an additional FVTOCI category. We note that this proposal has been made following extensive outreach with constituents, and we welcome the Board's efforts to address the legitimate concerns raised. These include insurers, who are concerned that IFRS 9 as currently drafted would result in a mismatch between (some of) their financial assets and their insurance liabilities, and some banks, who are concerned that many of their non-trading portfolios would be forced into FVTPL under the existing provisions of IFRS 9.

The additional category would of course increase complexity, by for example:

- adding a second 'boundary' for the classification decision rather than one, making classification decisions more difficult
- creating the need for recycling of balances from OCI to profit or loss on impairment, potentially compromising IFRS 9's single impairment model.

We find it regrettable that, taken as a whole, IFRS 9 now seems unlikely to deliver the expected simplification benefits in comparison with IAS 39. However, the Board's experience perhaps suggests that, with hindsight, significant simplification might have been an unachievable objective.

While acknowledging that insurers have raised concerns about accounting mismatches, we also note that it is difficult to assess the extent to which this proposal would address those concerns. This is partly because the Board's insurance is not yet finalised. Accordingly, we suggest that the Board may need to consider specific adaptations to the general classification and measurement model for the insurance industry. One suggestion is to include an option which would allow entities to elect to measure eligible financial instruments at FVTOCI on initial recognition if this would mitigate accounting mismatches that may otherwise arise as a result of measuring financial assets and the related insurance liabilities on different bases. Other short-term expedients pending finalisation of a revised insurance standard might also merit consideration. We would prefer that the general model is not unduly influenced by these particular concerns at this stage.

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?

We think the extent of guidance is sufficient. The application of the business model criteria will require professional judgement based on specific facts and circumstances. We think that additional guidance could add complexity without reducing the need for judgement.

We think the definition of the 'held to collect contractual cash flows' category, the supporting guidance and the underlying principle, are sufficiently clear.

We think the definition of the 'held to collect contractual cash flows and for sale' category, and its distinction from the FVTPL category, are less clear.

The definition and guidance appear to convey mixed messages as to whether collecting cash flows and selling assets is itself a business model or objective, or is instead the outcome of the business model and its objectives (whatever they may be). We favour the latter view because collecting cash flows and selling assets is not inherently an objective. It is also perhaps inherently contradictory and confusing if characterised as an objective given that collecting cash flows and selling the assets are mutually exclusive actions.

Also, the guidance in B4.1.2A and B4.1.2B suggests that the business model assessment considers a range of factors. By contrast the supporting guidance in B4.1.3 to B4.1.5 focuses heavily on the extent, timing and circumstances of asset sales. This creates some doubt as to whether the boundaries between the three categories are primarily determined by expected sales activity, primarily by the entity's objectives, or by a combination of both.

We suggest that clarity would be improved by:

- amending the description in 4.1.2A(a) along the lines: "The asset is held in a business model whose objective is expected to result in holding assets to collect cash flows and selling assets, both to a significant extent"
- developing somewhat the guidance in B4.1.2B(a) – (c) by explaining how particular scenarios indicate particular categories. This is relevant for factors such as the provision of fair value information to management and fair value-based remuneration. Intuitively, the presence of those factors points towards the FVTPL category but we think they are also often present in business models that fit the FVTOCI category guidance. We also note that in many businesses which might be described as managing on a fair value basis, there can in practice be assets that are held, possibly for a long period.

An alternative approach would be to define the FVTPL category. A definition might be developed based upon the concept of 'managed and performance is evaluated on a fair value basis' as used in paragraph 4.2.2(b) and B4.1.6 of IFRS 9 (2010). This would leave the FVTOCI category as the default. We understand that the Board may have already considered and rejected such an approach and we fully acknowledge that it presents its own challenges. Intuitively, however, in a three category model we think it may be clearer and simpler to define the edges rather than the intermediate category.

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?

We agree that the fair value option should be extended in the proposed manner.

Early application

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?

We agree. Prohibiting entities from newly applying previous versions of IFRS 9 after the completed version of IFRS 9 is published will increase comparability between entities.

We also believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and the prohibition on newly applying previous versions of IFRS 9 becoming effective is appropriate, providing relief for those entities that have been preparing to early apply a particular phase of IFRS 9.

Presentation of 'own credit' gains or losses on financial liabilities

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?

We 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.

We also believe a similar amendment should be made to IAS 39 now, so as to allow entities to apply this change under the current standard as well.

First-time adoption

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?

We are not aware of any considerations unique to first-time adopters that the IASB should consider.