

Proposal from Erlend Kvaal in conjunction with IFRS 9 PIR to remove or amend the FVOCI model for debt instruments

Overview

This note is about the accounting for debt instruments under IFRS 9. The standard describes two business models for managing debt instruments, each with a mandatory accounting category: amortised cost (para. 4.1.2) and fair value through other comprehensive income (FVOCI, para. 4.1.2A). If neither of these models apply, debt instruments are measured at fair value through profit or loss (FVTPL, the default category of 4.1.4). However, irrespective of business model, any debt instrument can be measured at FVTPL by using the irrevocable fair value option of 4.1.5.

My recommendation is to remove para. 4.1.2A or, as a minimum, limit its use to offset clearly defined accounting mismatches.

The reasons for my proposal is that the current FVOCI model for debt instruments:

- Creates undesirable complexity for preparers and users of financial statements.
- Blurs the classification of debt instruments

Background

The original IFRS 9 (2009) had only two measurement categories for debt instruments, amortised cost and fair value (FVTPL). The amortised cost category was limited to a business model of collecting contractual cash flows (interest and principal, SPPI). Assets held for other purposes were measured at FVTPL. The requirement to use amortised cost could be overridden by the fair value option, which would be irrevocable.

The standard was amended in 2013, largely in line with the proposals in ED 2012/4 Classification and measurement: Limited amendments to IFRS 9. A second defined business model, described as holding the asset both for the purpose of collecting cash flows and for sale, was introduced in a new para. 4.1.2A. For instruments classified under the “hold to collect and sell” business model FVOCI became mandatory measurement. The introduction of para. 4.1.2A required thirteen additional paragraph amendments (not counting affective date and transition rules) to reflect the mechanics of the new category.

The reasons for the change, explained in the BC of the ED, which are largely repeated in the current BC4.124 – 215, was two-fold (BC4.138):

- FVTPL does not properly measure performance when assets are held both to collect cash flows and for sale.
- The insurance accounting project foresaw the effects of discount rate changes on insurance liabilities in OCI. FV changes on associated assets resulting from general interest rate changes could off-set those effects if taken to OCI.

Contrary to the FVOCI system for equity instruments, the accumulated OCI balances of FVOCI debt instruments were to be recycled. The defence for this paradox is in current BC4.151 – 153. (In the ED, the choice was also defended with a reference to similarity with US GAAP (BC25 of the ED), but this argument has not been upheld in the current BC.)

The amendments proposed in ED 2012/4 was approved by a majority of the Board, but opposed by (former) board members Cooper and Engström. Their dissenting opinion (reproduced in a separate DO chapter at the end of the current BC) contains most of the arguments that I forward in this note, although worded differently.

Complexity for practitioners

Increased complexity for practitioners comes from two main sources:

- The standard has become harder to read with all the exceptions and special measures that the lately introduced model required.
- FVOCI requires a split between P/L and OCI which is perceived as difficult to execute and give economically meaningless numbers.

The first argument is illustrated by the increase in standard text and paragraphs coming with the 2013 amendments. Generally, in accounting, a system with multiple options are harder to deal with for preparers and users than a system with no or fewer options.

The mechanics of the FVOCI model imply that net return from the loan is split between the P/L and OCI (paras. 5.7.10 and 11). The split should be doable for anyone who is capable of calculating amortised cost. It suffices to compute first the P/L numbers according to amortised cost (including impairment) and take any remaining change in FV to OCI. (On this point, though, the standard text is contradictory, see next section.) Nonetheless, my own classroom experience is that even clever students go astray in simple cases.

The resulting residual in the OCI is a meaningless number. In a very simple example, a fixed-rate bond is issued at par (meaning that the contractual interest rate is equal to the market rate at the date of issue). If market rates for the issuer follow the general interest rates (e.g. treasury bonds), a general rate increase will give lower bond prices, and vice versa. These FV changes do indeed have an economic meaning as the pure effect of changes in market interest

rates. As such, they could meaningfully offset the effect of changes in discount rates on, e.g., insurance liabilities.

However, bond prices are affected by two main factors: interest rate movements and changes in credit risk. (Instrument-specific changes in liquidity may also be a factor, but not developed in this argument.) Under amortised cost, credit risk is taken care of by the impairment rules of IFRS 9, and these impairment rules are therefore also followed for the P/L part of the FVOCI-measured bond. However, these impairment principles are not market-based, so most often there will be a difference between the market assessment and the accounting assessment of credit risk. An obvious example is the mandatory allowance of 12 month ECL at initial recognition. For a bond issued at the balance sheet date (so that initial recognition is at the issue date), the market assessment of credit risk is included in the pricing of the bond, so that any additional credit allowance would represent a deviation from FV.

The residual in the OCI will therefore be a composite with no clear economic meaning. Its ability to offset the effect of discount rate changes will therefore also be limited. The claim in the ED that the FVOCI model should be better suited to “appropriately reflect the performance of financial assets that are managed both in order to collect contractual cash flows and for sale” is for that reason also hard to accept.

Previous IASB board members Cooper and Engström argued that a better solution than FVOCI would be FV disclosures in the notes for financial assets not measured at fair value. I fully concur with that view.

Standard text confusion

The reasoning above is that impairment losses on a FVOCI debt instrument go to P/L. This is based on the wording in para 5.7.10: “A gain or loss on a financial asset through other comprehensive income in accordance with paragraph 4.1.2A shall be recognised in other comprehensive income, except for impairment gains and losses (see Section 5.5) ..., until the financial asset is derecognised or reclassified.” It follows that those impairment gains and losses are in P/L.

However, Section 5.5 on impairment says the following in para 5.5.2: “An entity shall apply the impairment requirements for the recognition and measurement of a loss allowance for financial assets that are measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However, the loss allowance shall be recognised in other

comprehensive income and shall not reduce the carrying amount of the financial asset in the statement of financial position.”

How the loan loss allowance (or maybe the change in the loan loss allowance?) can be at the same time in P/L and OCI is an unsolved conundrum.

After having circulated a first draft of this note to banking experts in my environment, I understand that, alongside the P/L classification assumed here, a practice of taking impairment losses on FVOCI-instruments to OCI (based on para. 5.5.2) also exists. Apart from the obvious problem with inconsistent practice, such classification would not improve the quality of reported numbers. That practice would lead to a performance measure (in the P/L) which is neither comparable with amortised cost classification nor with FVTPL classification.

Classification of debt instruments

IFRS 9 section 4 is about the classification of financial assets; however, the classification criteria (contractual cash flows, interests, principal) mostly fit to the subgroup of debt instruments. (Typically, accounting textbooks show the IFRS 9 classification in separate flow-charts for debt instruments and equity / derivative instruments.¹)

The original IFRS 9 specified the criteria for amortised cost (hold to collect SPPI, para. 4.1.2); the essential feature not included (and therefore implies a violation of the criteria) is selling the instrument. Debt instruments that do not satisfy those criteria (and other financial assets) were at FVTPL through the default rule of 4.1.4. Consequently, debt instruments were divided into two mutually exclusive categories where the opportunity to sell is the determinant.

The stated intention of the 2013 ED was to open a third category. In my view, that aim was not achieved. A holder of a debt instrument essentially has only two alternative strategies: to sell or not to sell. If he has decided not to sell whatever good opportunities may pop up, the hold to collect category is obviously appropriate, while if he opens for selling he cannot choose that category. With the current wording of para. 4.1.2A, the potential seller would have to choose FVOCI irrespective how actively he trades his debt instruments. In other words: paras. 4.1.2 and 4.1.2A are exhaustive (and mutually exclusive). Therefore, as stated, the default FVTPL in para. 4.1.4 has no role for holders of debt instruments. The fact that the

¹ E.g. Picker et al.: Applying IFRS Standards, 4th ed (Wiley) p. 168.

holder actually collect contractual cash flows while being the owner of the instrument, is not a feature that distinguishes a non-trading entity from a trading entity. Also traders do collect the cash flows that the trading portfolio give right to.

Of course, the FV option in para. 4.1.5 is still open to holders of debt instrument irrespective of how frequent they trade, but with the caveat that the policy choice is irrevocable.

Previous IASB board members Cooper and Engström argued (in DO5) that “hold to collect” could indeed be distinguished as a separate business model, but that further sub-division of the residual category was not feasible. That is also my view.

It seems that many entities (banks) group their debt instruments in three categories (in line with stated intention of the ED, but possibly in conflict with the wording) and that the third category is a trading portfolio with mandatory FVTPL (therefore not using the FV option). If the arguments in this section (and those of Cooper and Engström) are valid, we would expect to see discretion exercised in the delimitation between the “hold to collect and sell” portfolio and the trading portfolio of debt instruments. Some random observations into the reporting of European banks (taken from the Stoxx Europe 600 Banks index) seems to confirm that assumption. High degree of discretion impairs comparability and reporting quality.

Conclusion

The category FVOCI for financial assets impairs the accounting for debt instruments. Para. 4.1.2A and related paragraphs should preferably be removed.

I have not considered the need for insurers to use FVOCI on debt instruments to offset the effect of discount rate changes for insurance liabilities. If that need is real (and worthy of support), the scope of the FVOCI rule should be delimited accordingly. For “normal entities” (including banks), debt instruments that are not “held to collect” measured at amortised cost, should be measured at FVTPL.

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