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AFS versus FVTOCI: Twins or Siblings?

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ABSTRACT

AFS (available-for-sale securities) and FVTOC (fair value through other comprehensive income) have several similar characteristics that users may presume they are the same in accounting. Both require fair value measurement and recognition of changes in fair value in other comprehensive income (OCI). AFS is introduced in IAS 39, whereas FVTOCI securities have recently been finalized and published in IFRS 9. This paper identifies the similarities and differences between AFS and FVTOCI securities on classification and measurement, impairment, and hedge accounting. An empirical research on Thai banks and AFS was conducted during 2012-2015. The findings of this study indicate that some of AFS Securities may not meet the criteria for FVTOCI Securities classification. Impairment loss is an overhaul from IAS 39; expected loss is applied in IFRS 9. While both standards consider hedge accounting as optional, IFRS 9 widens the choices of hedging instruments and is more principle based.

JEL Classification: M41

Keywords: IAS 39; IFRS 9; classification and measurement of financial assets; impairment loss; hedge accounting; banks; regulatory capital management

I. INTRODUCTION

IASB has finalized and published IFRS 9 Financial Instruments which will become effective on January 1, 2018. A classification in IFRS 9 that closely resembles the available-for-sale (AFS) category in IAS 39 is fair-value-through-other comprehensive income classification (FTOCI). Both AFS and FVTOCI require fair value measurement and recognition of unrealized gains and losses in other comprehensive income (OCI). These make the two appear to be very much alike. However, the criteria for classification differ between the two standards and the accounting for impairment loss differs. Hedge accounting appears to be least affected, since the same three categories of hedges are addressed. Nevertheless, IFRS 9 simplifies hedge accounting and makes it easier to apply with much flexibility and yet more judgment exercised.

This study addresses the differences between AFS and FVTOCI on classification and measurement, impairment loss and hedge accounting. Illustrations are given for clarification of certain detailed deviations. The next section of the paper will analyze the differences between AFS and FVTOCI. This is followed by a discussion on implications on regulatory capital in the banking industry coupled with an empirical study on Thai banks in 2012-2015. Summary and concluding remarks will end the paper.

II. CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

IFRS 9 has been developed to reduce complexity in accounting for financial instruments under IAS 39. The latter has been criticized for classifying and measuring financial instruments not based on clear or consistent rationales. In addition, impairment is measured differently depending on the classification of the financial assets. Bifurcation of financial assets is required generally under a set of unclear and inconsistent rules.

A. Debt Instruments

IAS 39 has four categories of classification of debt instruments: available-for-sale, held-to-maturity and loans and receivable, and fair value through profit and loss (FVTPL). IFRS 9 has three measurement categories: fair value through profit and loss, amortized cost, and fair value through other comprehensive income. Unlike IAS 39 whose classification and measurement is based on management intent and AFS is a residual category other than trading and held-to-maturity securities, IFRS 9 provides a logical structure and rationale to classification. Classification and measurement depends on the business model and contractual cash flow characteristics of the financial assets.

Amortized cost is applied when the objective of the business model is to hold the financial assets to collect their contractual cash flow. Furthermore, the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. On the other hand, if the business model has the objective of both to collect contractual cash flows and for sale, management is now concerned about maximizing its return from a combination of collecting contractual cash flows and realizing value appreciation. The pertinent category is FVTOCI. All other circumstances, the debt instruments are measured at FVTPL.

Unlike AFS Debt Securities in IAS 39 which is a residual category after not meeting both held-to-maturity and fair value through profit or loss, the FVTOCI Debt Security category must meet the business model for managing financial assets. Evidence of facts on managing the financial asset determines the likely future cash flows from the debt instruments. Such evidence includes: "(a) How the performance of the business is reported to the entity's key management personnel; (b) How managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets manage); and (c) The frequency, timing, and volume of sales in prior periods, why such sales have occurred and expectations about the sale activity in the future" [IFRS 9, B4.1.2B]. Example 1 discusses the designation of FVTOCI.

Example 1: Entity A has excess cash of $100,000 which is earmarked for the anticipated capital expenditures 5 years from now, and invests in a debt instrument. The objective of the entity is to maximize the return on this investment. The manager responsible for investment is compensated based on the return derived from the yield of this debt instrument investment. Hence, a year later when the yield increases, he will sell this investment and reinvest in another debt security for generating higher return on this financial asset. Accordingly, this financial asset qualifies to be classified as FVTOCI since the business model reflects the objective of holding the debt instrument both to collect contractual cash flows and to sell.

Balance sheet presentation of the amortized cost classification will be at amortized cost, while the FVTPL category is at fair value with changes in fair value in P&L. FVTOCI, on the other hand, applies both amortized cost and fair value. Like the FVTPL classification, the balance sheet would reflect the fair value-carrying amount. However, the difference between the fair value and amortized cost would be recognized in OCI.

Both IAS 39 and IFRS 9 contain a fair value option (FVO). Entities are allowed to elect the FVO; when doing so the entities could eliminate or significantly reduce a measurement or recognition inconsistency in measuring assets/liabilities giving rise to gains and losses from different bases. Hence, even if the debt instrument meets both criteria to be classified as FVTOCI at initial recognition, an entity may select to classify the financial asset at FVTPL. Likewise, an AFS debt security qualified under IAS 39 could be classified as FVTPL if FVO is selected. Like IAS 39, reclassification is required if the financial asset no longer meets the criteria specified under the standard.

B. Equity Instruments

IFRS 9 requires all equity investments to be measured at fair value. However, cost is permitted in limited circumstances when more recent information is insufficient to measure fair value. Cost is also permitted when it represents the best estimate within a wide range of possible fair value measurements. There is no "cost exceptions" for unquoted equity securities. IAS 39, on the other hand, allows unquoted equity investments measured at cost. Similar to IAS 39, changes in fair value can be categorized in P&L or OCI. Under IAS 39, those booked in P&L are classified as FVTPL. AFS is the pertinent category if the securities are not held for trading and the effects of changes in fair value are measured in OCI. However, the classification under IFRS 9 for changes in OCI is related to the classification of FVTOCI. The latter is different from AFS as reclassification between FVPL and FVTOCI is not permitted since the entity irrevocably designates the equity instruments at FVTOCI. No P&L effect other than dividend income is booked under FVTOCI. All the gains and losses even on disposal remain permanently in equity. AFS in IAS 39 recognizes all gain/loss on disposal in P&L by reclassifying from OCI.

III. IMPAIRMENT LOSS

IFRS 9 adopts a single model for all financial assets to account for impairment loss. Unlike IAS 39, FVTOCI debt instruments use the same interest recognition and impairment approaches as for assets measured at amortized cost. IAS 39 does not apply one impairment model for all financial assets not measured at fair value through profit or loss. Impairment is computed differently depending on the measurement categories. While IAS 39 applies the incurred loss model to account for impairment loss of AFS securities, IFRS 9 applies a "three-bucket" (three categories) expected loss approach. Under the incurred loss model, impairment loss is recognized only when the available information indicates that it is probable the asset has been impaired and the amount of the loss can be reasonably estimated. Such available information signifies objective evidence of impairments because of one or more events that occurred after the initial recognition of the asset and that loss event (or events) that has (have) an impact on the estimated future cash flows of the financial asset (or group of assets) that can be reliably estimated.

A. Debt Security under IAS 39

When there is objective evidence that the AFS-Debt Security is impaired, reclassification is required to transfer from the cumulative other comprehensive income to profit or loss. The previous direct recognition in the other comprehensive income is reclassified to profit or loss even though the asset has not been derecognized. "The amount of cumulative loss that is recycled to profit or loss is the difference between the acquisition cost (net of any principal repayment and amortization) and current fair value, less any impairment loss on that financial asset previously recognized in P&L" [IAS 39 par. 68] (PwC, p. 9075).

Once the AFS-Debt Security has been written down because of an impairment loss, a new effective interest rate is imputed. The imputation is based on the rate used to discount the future cash flows for measuring impairment loss.

Subsequent to the impairment loss recognition, any increase in interest rate due to a decrease in fair value will give rise to a difference between amortized cost and fair value. If there is no further change in the credit status/rating of the issuer and no evidence of any further credit-related impairment, there are two acceptable treatments to account for the further reduction of fair value.

If there is no further objective evidence of impairment, the decline in fair value is recognized in other comprehensive income. This decline is attributable to an increase in the basic risk free interest rate. Likewise, an increase in fair value attributable to a decrease in interest rate is accounted for as a change in the other comprehensive income. This change is not due to an improvement in the issuer's credit standing. Hence, a reversal of impairment is not allowed.

In order to treat the increase in fair value of a previously impaired AFS-Debt Security as a reversal of previous charge, any further decline in fair value at the reporting date since acquiring the asset is attributable to the continuing presence of an objective evidence of impairment. Under this review, the entire change in fair value is perceived as having objective evidence of impairment when it initially arises even if some of the change in fair value is market related due to an increase in interest rate. To be consistent with IG E4.9 of IAS 39, any impairment of a non-monetary asset in a previous period, the subsequent losses are also recognized in profit and loss until the asset is derecognized. Similarly, any increase in fair value, because of a decrease in interest rate and the increase can be objectively related to an event occurring after the impairment loss, can be recognized in profit or loss as a reversal of the previous impairment.

B. Debt Instrument under IFRS 9

IFRS 9 applies a dual approach under expected loss model in accounting for impairment. Expected credit losses is defined "as the weighted average of credit losses with the respective risks of a default occurring as the weightings" [IFRS 9, Appendix A]. Estimation should apply reasonable and supportable information about past events, current conditions, and reasonable and supportable forecasts of future economic conditions. At inception of the debt instrument, expected credit losses are measured through a loss allowance account at an amount equal to the 12-month expected credit losses (see Example 2 below).

Example 2: Assume Bank A has a portfolio of loans for $100,000. An analysis of the history of this type of loans coupled with consideration of current events and forecasts of future economic conditions reveals that lifetime loss default rate is estimated to be 10%. On the other hand, the estimated default rate in the next 12 months is 2%. Hence, the 12-month expected loss is computed as follows: $100,000 x 2% x 10% = $200.

Journal Entry Required:

Impairment Loss on Debt Security	200	
Other Comprehensive Income		200

As the carrying amount of the FVTOCI debt instrument is at fair value, no allowance account is presented on the balance sheet under IFRS 9. Nevertheless, disclosure is required on the loss allowance of this FVTOCI debt security.

Subsequently, if the credit risk of the debt instrument has increased significantly, the loss allowance account will be adjusted to an amount equal to the lifetime expected loss of $10,000. Assume the fair value of the debt securities is now $950,000. The required journal entry is as follows:

Impairment Loss on Debt Security	9,800	
OCI	40,200	
Debt Security – FVTOCI		50,000

Debt Security – FVTOCI is adjusted to the current fair value reflecting a decline from $100,000 to $950,000. The impairment loss is adjusted for the change in expected credit loss of $9,800 since initial recognition of $200. The debit to Other Comprehensive Income shows the balancing amount which also reflects the cumulative change in fair value other than the impairment loss $40,000.

On the other hand, if the credit risk at the reporting date is low, no adjustment is made to the OCI account and no recognition of impairment loss under the assumption that credit risk on the debt instrument has not deteriorated significantly. An investment grade rating has been suggested by the Standard to indicate a low credit risk. A rebuttal presumption is provided in IFRS 9 when contractual payments are more than 30 days past due for significant increase in credit risk. In addition, the impairment can be reversed if the subsequent credit risk has decreased.

The computation of interest revenue varies contingent upon the stage of the impairment. Credit quality deteriorates since initial recognition from stage 1 (good book) to stage 2 (bad book) to state 3 (ugly book). Debt instruments under stages 1 and 2 earned interest on the carrying amount. However, interest revenue in stage 3 is computed on the net carrying amount after deducting the impairment allowance. This is consistent with the incurred loss model under IAS 39 upon satisfying criteria for impairment.

C. AFS-Equity under IAS 39

Unlike debt instruments, a reversal of the previous impairment loss is not allowed for AFS-Equity. The inability to reverse the previous loss is due to "at the subsequent reporting or balance sheet date, conditions may have changed to such an extent that a loss would not have been recognized, or a smaller loss would have been recognized, if the impairment review were first carved out at that date" (PwC p. 9071). In short, it is difficult to distinguish between reversals of impairment of equity security from other increases in fair value. Hence, reversals for AFS-Equity Security are not allowed until they are sold.

D. FVTOCI-Equity under IFRS 9

IFRS 9 disallows the reclassification of AFS-Equity from FVTOCI to FVTPL. Unlike IAS 39, the selection of FVTOCI is based on the justification that it is an irrevocable strategic investment. The reclassification is not attributed to the change of intent of management, as allowed in IAS 39. As such, only dividends is accounted for in P&L. Any gain or loss from the disposal of FVTOCI equity securities remain permanently in equity. They are not recycled to P&L as would be the case under IAS 39. Accordingly, FVTOCI Equity Securities are no longer tested for impairment.

IV. HEDGE ACCOUNTING

Hedge accounting under IAS 39 has been criticized of being rule-based, complex, and inconsistent between financial versus nonfinancial items. Moreover, it is not reflective of risk management. IFRS 9 attempts to develop a new hedge accounting model, enabling firms to better reflect their risk management activities in the financial statements.

Like IAS 39, IFRS 9 retains the current three types of hedging relationships: Fair Value Hedge, Cash Flow Hedge, and Net Investment Hedge. However, IFRS 9 takes a more principle-based approach and aligns hedge accounting more closely with risk management. It allows components of non-financial items to be hedged, as long as a risk component can be identified and measured. Furthermore, it allows aggregated exposures to be hedged items without the requirements under IAS 39 of de-designating and re-designating the first-level hedge when establishing the second-level hedge. As such, the combination of non-derivative exposure and derivative (first-level hedge) constitutes the hedged item to be hedged by a hedging instrument (second-level hedge). For example, the aggregated exposure of a 5-year variable rate debt held for sale in domestic currency which is the sum of a 5-year fixed rate debt in foreign currency and 5-year fixed to variable cross-currency interest-rate swap (CCIRS) can be hedged by a hedging instrument of a 4-year domestic variable to fixed interest-rate swap (IRS).

In addition, if the hedge ratio is adjusted for risk management purposes, a hedging relationship would be rebalanced after inception. Therefore, the hedging relationship is no longer de-designated and re-designated as required under IAS 39. Although hedge accounting is not allowed to be discontinued voluntarily, under certain circumstances it must be discontinued. These include expiration of hedging instruments, and not meeting risk management objectives or other qualifying criteria.

Nevertheless, IFRS 9 is more flexible in qualifying hedging instruments. Cash instruments as well as FVTPL non-derivative financial instruments with certain exceptions qualify as hedging instruments. The exceptions primarily refer to the application of fair value option that results in change in fair value from change in credit risk of financial liability accounted for in other comprehensive income. Additionally, the qualifying hedging instruments could be the entire items or partial designations such as only the FX risk component, the intrinsic value, spot element, or proportion of nominal amount.

A. Qualifying Hedges – AFS Investments in Equity under IAS 39

IAS 39 grants special accounting for fair value hedge on AFS equity securities by requiring changes in fair value be booked in P&L rather than OCI. Fair value hedge is pertinent in protecting the potential loss due to change in fair value. This change is accounted in P&L for AFS equity provided certain criteria are met; these include the hedge is expected to be highly effective. Change in fair value of the hedging instrument is also accounted for in P&L. When the hedge is effective, the two P&Ls will be offset.

B. Qualifying Hedges – FVTOCI Investments in Equity under IFRS 9

Equity investments at FVTOCI pertain to investments not held for trading and the entity made an irrevocable election at initial recognition to present changes in fair value of the hedged item in OCI. Fair value change could be attributed to foreign exchange risk exposure or equity price risk exposure, or both. Any changes in fair value of the hedging instrument are also accounted for in other comprehensive income. Any ineffectiveness in OCI are never reclassified from accumulated other comprehensive income to profit or loss. Example 3 will illustrate the application of fair value hedge under IAS 39 versus IFRS 9.

Example 3: On November 15, 2015, Bank X purchases an equity security for $1,000. It is appropriately classified as available-for-sale under IAS 39 and FVTOCI under IFRS 9. Gains and losses arising on it are therefore taken to equity in accordance with the standards. At the end of 2015, the current fair value of the security is $1,200. To protect this value, the bank enters into a hedge on January 2, 2016 by purchasing a forward contract. The fair value of the forward contract is $0 and $100 on January 2, and December 31, 2016 respectively. At the end of 2016 the fair value of the equity security is $1,100.

Analysis:
Hedged item: AFS/FVTOCI equity security
Hedging Instrument: Forward Contract
Underlying: Price of the security
Notional amount: $1,000
Partial Balance Sheet Presentation: FV of Hedging Instrument and Hedged Item

	11/15/15	12/31/15	1/2/16	12/31/16
Hedged Item:				
AFS/FVTOCI Equity Security	1,000	1,200	1,200	1,100
Hedging Instrument:				
Forward Contract	N/A	N/A	0	100

Journal Entries for 2015:

To record purchase of an AFS/FVTOCI investment in equity security for $1,000:

Investment in AFS/FTOCI equity security	$1,000	
Cash		$1,000

To record the increase in the fair value of the AFS/FVTOCI equity security at end of 2015 (prior to hedge):

Security F.V. Adj. – AFS/FVTOCI	$200	
OCI		$200

Journal Entries for Year 2016:

IAS 39: To record increase in the fair value of the forward contract:

Forward Contract	$100	
Gain		$100

IFRS 9: To record increase in the fair value of the forward contract:

Forward Contract	$100	
OCI		$100

IAS 39: To record the decrease in the fair value of the equity security applying special accounting:

Loss	$100	
Investment in AFS equity security		$100

IFRS 9: To record the decrease in the fair value of the equity security:

OCI	$100	
Investment in AFS equity security		$100

Assessment of hedge effectiveness at end of 2016:
Change in F.V. of Hedging Instrument/Change in F.V. of Hedged Item = $100/ ($100) = (100%)

IAS 39: Net effect on P&L: $100 - $100 = $0
IFRS 9: Net effect on Equity (Other Comprehensive Income) = $100 – ($100) = $0

C. Qualifying Hedges – AFS Investment in Debt Security under IAS 39

AFS investment in debt is accounted for at amortized cost, but reported at fair value. Changes in fair value are accounted for in OCI. A valuation account is used to bridge the cost and fair value on the asset side and OCI on the equity side to account for the temporary change in the market. Fair value hedge is the pertinent hedge to AFS Debt Securities since most of the AFS debt instruments are fixed rate. Upon application of the fair value hedge to protect against changes in value caused by fixed terms, rates, or prices, a new effective interest rate needs to be imputed each time there is a change in fair value. This is very cumbersome. It requires the recognition of a change in fair value of the hedged item, AFS debt security, in the current income statement and as an adjustment to the carrying amount in the balance sheet pertinent to the risk being hedged. In addition, the adjustment to the carrying amount is treated as an adjustment to the contractual interest rate provision and amortized as a yield adjustment of the hedged item. The necessity to tracking for updating the carrying amount and computing the interest rate with the revised annual yield is very tedious.

IAS 39 allows a practical expedient. Under this allowance, the amortization of the resulting adjustment of hedged financial instrument to be deferred until the hedge is removed. System changes are required to accommodate the capturing of the original cost, amortized cost, value of the risk to be hedged, and fair value for each individual financial instrument. By deferring amortization until the cessation of the hedge, the complexity of re-computing the interest rate and amortization of basis adjustment due to changes in the effective interest rate is alleviated (Duangploy and Pence, 2010).

D. Qualifying Hedges – FVTOCI Debt Security

Similar to fair value hedge of AFS Debt Security, IFRS 9 requires amortization of any hedge adjustment is amortized to profit and loss based on a recalculated EIR. Such amortization may begin as soon as an adjustment exists. Nevertheless, like IAS 39, IFRS 9 allows deferral of amortization and shall begin no later than when the hedged item ceases to be adjusted for hedging gains and losses" [IFRS 9 Par. 6.5.10].

E. Hedge Effectiveness

Both IAS 39 and IFRS 9 require an economic relationship between the hedged item and hedging instrument and formal documentation of the hedging relationship and the company's risk management objective and strategy of undertaking the hedge. Unlike IAS

39 which requires a ratio between 80% and 125% to represent highly effective both prospectively and retrospectively, IFRS 9, being more principle-based, does not specify a numeric threshold for representation of high effectiveness and requires only prospective assessment. However, it requires that a hedge qualify for hedge accounting if the effect of credit risk does not dominate the value changes that result from the economic relationship. In addition, the hedge ratio of the hedging relationship is the actual quantity of the hedged item and hedging instrument.

V. IMPLICATIONS ON REGULATORY CAPITAL MANAGEMENT

Banks are subject to regulatory capital requirements. They have the incentive to use AFS securities as a buffer for their stress tests. Prior research indicates banks have incentive to manage earnings and regulatory capital by strategic timing of sales of AFS securities (Barth, et al., 2014). Studies from Karaoglu (2005), Dechow and Shakespeare (2009), Dechow et al. (2010) indicate a significant association between earnings management incentives and asset securitizations.

Table 1
Correlation among variables of listed Thai banks and AFS

Variables	Size	Net Investments	AFS	G/L on Re-measurement	Net Inc.
Size	1	0.8992	0.8463	0.1831	0.91402
Net Inv.	0.8992	1	0.9631	0.2212	0.9169
AFS	0.8463	0.9631	1	0.2572	0.8987
G/L on Re-measurement	0.1831	0.2212	0.2572	1	0.1796
Net Income	0.9140	0.9169	0.8987	0.1796	1

Following prior studies, a sample of eleven banks listed in the Stock Exchange of Thailand was used to study the impact of AFS classification on the financial position and performance of the listed banks during 2012 – 2015. As shown in Table 1, the correlation coefficients of five variables are displayed. As expected, there is a high correlation of over 0.899 between size (total assets) of the banks and net investments, AFS Securities, and net income. Consistent with the findings of Barth, et al. (p. 6), AFS constitutes a high proportion of bank net investment in securities resulting in a high correlation with AFS and net investment of .9631. The net investment also correlates with net income of .9169. Besides being highly correlated with net investment, AFS is also highly associated with size and net income. This implies there is significant association between AFS securitization and earnings management in larger banks than smaller banks. The low correlation between size and the spread of the AFS portfolio between fair value and book value indicates smaller banks were more associated with portfolio spread than lager banks. Confirming the accounting of gain or loss on re-measurement in other comprehensive income, the unrealized portfolio spread has a very low correlation with net income.

Classification as FVTOCI may have an impact on the banks' liquidity buffer portfolio held to fund unexpected cash outflows arising from stressed scenarios. The removal from AFS in IAS 39 and replaced by FVTOCI in IFRS 9 may have a knock-on effect on regulatory capital. Given the required business model and contractual characteristics assessment under IFRS 9 for classification into FVTOCI, some financial assets currently classified as AFS may not qualify for FVTOCI category. Instead, it may be included in the amortized cost classification. Banks and financial institutions need to reassess whether the existing AFS be reclassified into amortized cost or FVTOCI categories.

Now that IFRS 9 does not provide special accounting for hedging FVTOCI equity securities, such a scheme may no longer be useful. Recent study by the CFA Institute on 44 banks in the U.S., Canada and Europe over an eight-year period emphasized the importance of paying attention to the other comprehensive income. It appears that Basel III framework changes the bank capitalization rules. Other comprehensive income or unrealized gains or losses on investment securities which formerly was excluded in regulatory capital is now required to be reflected in regulatory capital (Cohen, 2015). The importance of paying attention to other comprehensive income is not restricted to just the banking industry, but also non-financial companies as well. Future study will examine any new strategy in managing other comprehensive income and regulatory capital.

VI. SUMMARY AND CONCLUSIONS

A direct transfer of knowledge from AFS to FVTOCI is not warranted. They are not twins. The devil is in the details. Beginning with the classification, a wrong application of required criteria will end up in wrong designation. AFS securities and FVTOCI securities apparently look alike. However, AFS and FVTOCI have different criteria for such classification. Hence, some of the existing AFS debt instruments may have to be reclassified to amortized cost category if they failed the recognition criteria in IFRS 9 on debt instruments. IFRS 9 requires meeting the contractual characteristics of solely principal and interest, and business model of collecting cash flows rather than ability and intent as in IAS 39.

Impairment loss is an overhaul from IAS 39. IFRS 9 improves comparability of amounts of impairment loss in Income Statement among assets with similar characteristics and therefore facilitates both users and preparers of financial instruments. Previously, whenever there is a difference between acquisition cost and fair value, an impairment loss is recognized under IAS 39. Any change in fair value recognized could be attributed to interest rate change rather than credit risk. Hence, under a single impairment loss model in IFRS 9, both amortized cost and FVTOCI debt are subject to the same single impairment model. In addition, the balance sheet presentation of FVTOCI is exclusively in fair value. While the cumulative OCI in the equity reflects the change in fair value, the impairment loss is reflected in the income statement. Although an allowance for impairment is not presented in the balance sheet, it is disclosed in the notes to financial statements.

Simplification prevails in IFRS 9 for equity securities. IAS 39 has been criticized for its complexity in delivering impairment loss on AFS equity securities based on a significant or prolonged decline in their fair value below cost. Such judgmental basis results in diverse practice no longer exists in IFRS 9, since no impairment test is required for equity securities.

While hedge accounting is optional under both IAS 39 and IFRS 9, IFRS 9 widens the choices of hedging instruments which include non-derivatives at FVTPL. Both have the same categories of hedge accounting. Fair value hedge on debt securities between IAS 39 and IFRS 9 is least affected, special accounting for AFS equity security is no longer permitted in IFRS 9 for FVTOCI – Equity Security. Nevertheless, IFRS 9 being more principle based attempts to align hedge accounting model more closely with risk management accounting resulting in more useful information. It gives more flexibility in allowing rebalancing and aggregate hedge. On the other hand, this adds complexity to systems and processes in tracking rebalanced hedging relationships and qualitative hedge effectiveness assessments. Voluntary discontinuing hedge in IAS 39 is no longer allowed under IFRS 9.

The issue of regulatory capital requirement may also need to be revisited. The new requirements under BASEL III may prompt banks and financial institutions to reassess their regulatory requirements. The strategic selection of AFS securities for realized gains and losses to manage earnings and regulatory capital is no longer valid.

AFS and FVTOCI are not twins. However, they could be perceived as siblings having the same source of outcome in other comprehensive income rather than net income. Entities may want to start assessing their current portfolios and preparing for the transition for IAS 39 and IFRS 9. Training and systems change should be in the horizon since simply transferring of knowledge from AFS accounting to FVTOCI accounting is undoubtedly not warranted.

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