

IFRS News Special Edition

December 2009

“We welcome the IASB’s efforts to reduce the complexity in accounting for financial instruments, and believe that IFRS 9 represents a good start in the project to replace IAS 39.

Unfortunately, by accelerating the replacement of IAS 39 and dividing the project into various phases, there is an increased risk of application problems emerging, leading to more amendments. With this in mind companies now need to consider whether to adopt IFRS 9 early, or to stay with IAS 39’s existing requirements for the time being. We hope this special edition of IFRS News will help in that process.”

Andrew Watchman
Executive Director of International
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IFRS 9 ‘Financial Instruments’

IFRS 9 Financial Instruments (IFRS 9) addresses the classification and measurement of financial assets. It represents the completion of the first phase of the IASB’s project to replace IAS 39, its current Standard on financial instruments. IFRS 9 aims to reduce the complexity in accounting for financial instruments by having fewer categories of financial assets and a principle-based approach to their classification.

The IASB’s overhaul of its Standard on financial instruments has been the subject of much attention and scrutiny. The IASB has felt compelled to respond quickly to widespread criticism of IAS 39 and its alleged role in contributing to the financial crisis.

By publishing IFRS 9 on 12 November 2009, the IASB has made a considerable effort to make the new Standard available to companies for early adoption in their December 2009 year ends. Companies not wishing to adopt it early, however, are only required to apply it from 1 January 2013.

This special edition of IFRS News informs you about the new Standard, and the benefits and challenges that adopting it will bring.



About the new Standard

Structure

IFRS 9 is designed to eventually replace IAS 39 'Financial Instruments: Recognition and Measurement' in its entirety – a very large scale project. In order to deliver the most critical components in time for 2009 financial year-ends, the IASB decided to divide the project into three distinct phases. The publication of IFRS 9 marks the completion of Phase 1.

At this stage, IFRS 9 only contains chapters relating to the classification and measurement of financial assets. New chapters will be added as each stage of the project is completed.

The 3 phases of the IASB's project to replace IAS 39

- Phase 1: Classification and measurement
- Phase 2: Impairment methodology – the Exposure Draft 'Amortised Cost and Impairment' was published on 5 November 2009
- Phase 3: Hedge accounting

In addition to the above three phases, the IASB is considering issues related to derecognition (an Exposure Draft was issued in April 2009) and financial liabilities as part of the project. It was originally intended that financial liabilities would be dealt with in phase 1 of the project. The question of how 'own credit risk' (in relation to the measurement of financial liabilities) should be dealt with proved so controversial however that the IASB decided that it needs more time to resolve this part of the project.

Timetable for the replacement of IAS 39

	Q4 2009	Q1 2010	Q2 2010	Q3 2010	Q4 2010
Replacement of IAS 39					
Phase 1: Classification and measurement	IFRS issued				
Phase 2: Impairment	ED issued				IFRS expected
Phase 3: Hedge accounting		ED expected		IFRS expected	
Related projects					
Derecognition				IFRS expected	
Fair value measurement guidance			IFRS expected		
Consolidation			IFRS expected		

Simplifications compared to IAS 39

	IFRS 9 treatment	IAS 39 treatment
Measurement categories	Two categories: <ul style="list-style-type: none"> • fair value • amortised cost. 	Four categories: <ul style="list-style-type: none"> • fair value through profit or loss • held to maturity • amortised cost • available for sale.
Impairment	<ul style="list-style-type: none"> • One impairment method. 	Different impairment methods applied to: <ul style="list-style-type: none"> • financial assets carried at amortised cost • financial assets carried at cost • available for sale financial assets.
Embedded derivatives	<ul style="list-style-type: none"> • For host contracts within the scope of IFRS 9, IFRS 9's application requirements are applied to the combined (hybrid) instrument in its entirety. 	<ul style="list-style-type: none"> • Complex rules determine whether the embedded derivative needs to be separated from the host contract.

What is the US doing?

Following the financial reporting crisis, the US Financial Accounting Standards Board has also committed to replacing its requirements on accounting for financial instruments. Unlike the IASB, however, it has not broken the replacement project into phases. Instead it plans to publish a comprehensive exposure draft containing its proposals in the first quarter of 2010. Current indications are that the two Boards have divergent views in a number of areas. However, the Boards have also resolved to re-examine these differences and take further steps to arrive at a comparable solution in due course.



Classification and measurement

Classification

IFRS 9 requires an entity to classify financial assets at either amortised cost or fair value on the basis of:

- a) the entity's business model for managing the financial assets; and
- b) the contractual cash flow characteristics of the financial asset unless it chooses to designate the financial asset at fair value through profit or loss (see box).

Amortised cost classification

IFRS 9 requires a financial asset to be classified at amortised cost where:

- the objective of the entity's business model is to hold the financial assets to collect the contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

The entity's 'business model'

An entity's business model for managing financial assets:

- is determined by the entity's key management personnel
- does not depend on management's intentions for individual instruments (it is based on a higher level of aggregation).

An entity may have more than one business model for managing its financial instruments. Changes to an entity's business model are expected to be very infrequent.

Examples of instruments meeting the amortised cost requirements*

- an instrument with a stated maturity date where the cash flows are entirely fixed, or where interest is at a variable rate or a rate which is a combination of fixed and floating
- a bond with a stated maturity date where principal and interest are linked (on a non-leveraged basis) to an inflation index of the currency in which the instrument is issued
- a variable rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis
- a bond with a stated maturity date which pays a variable market interest rate subject to a cap
- a full recourse loan secured by collateral.

* it is assumed that the objective of the entity's business model is to hold the financial assets to collect the contractual cash flows

Examples of instruments that do not meet the amortised cost requirements

- a convertible bond
- a loan that pays an inverse floating interest rate.

Option to designate a financial asset at fair value through profit or loss

IFRS 9 contains a modified version of IAS 39's 'fair value option' – the option to designate a financial asset at fair value through profit or loss in some circumstances.

At initial recognition, an entity may designate a financial asset that would otherwise be measured subsequently at amortised cost as measured at fair value through profit or loss. Such a designation can only be made, however, if it eliminates or significantly reduces an 'accounting mismatch' that would otherwise arise.

Fair value for other financial instruments

If a financial asset does not meet the criteria for amortised cost classification, it is measured at fair value.

In other words, where the condition that the contractual cash flows are solely payments of principal and interest is failed, or the objective of the entity's business model is not to hold the financial asset to collect the contractual cash flows, the asset must be measured at fair value.



Investments in unquoted equity instruments

Unlike IAS 39, it is not possible under IFRS 9 to measure investments in equity instruments at cost where they do not have a quoted market price and their fair value cannot be reliably measured.

Although IFRS 9 requires such investments to be measured at fair value, it notes that, in limited circumstances, cost may be an appropriate estimate of fair value. IFRS 9 provides a list of indicators that cost might not be representative of fair value.

Embedded derivatives

IFRS 9 eliminates the requirement to separate embedded derivatives within hybrid contracts if the host contract is within the scope of IFRS 9. Instead, the classification requirements of IFRS 9 are applied to the combined (or hybrid) instrument in its entirety. This means that the entire instrument will be classified at fair value in many cases.

If a host instrument that contains an embedded derivative is outside the scope of IFRS 9 (such as a financial liability or most contracts to buy or sell goods or services), IAS 39's existing requirements continue to apply to determine whether the embedded derivative must be separated.

Gains and losses on assets at fair value

The default requirement under IFRS 9 is that a gain or a loss on a financial asset that is measured at fair value and is not part of a hedging relationship, is presented in profit or loss.

Election to present gains and losses on equity investments in other comprehensive income

At initial recognition an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not held for trading. Amounts recognised in other comprehensive income are not subsequently transferred to profit or loss (sometimes referred to as 'recycling'). The cumulative gain or loss may, however, be transferred within equity.

Where this election is made, dividends are still recognised in profit or loss unless they clearly represent a recovery of part of the cost of the investment.

Impairment

The reduction in the number of categories of financial instrument to two means that only one impairment method is necessary.

For financial assets held at fair value, all gains and losses are either presented in profit or loss or in other comprehensive income. It is therefore not necessary to assess these assets for impairment. Impairment requirements are therefore only applied to financial assets measured at amortised cost. This contrasts with the stand-alone requirements of IAS 39, under which the greater number of measurement categories meant that differing impairment requirements were necessary.

Reclassification

IFRS 9 requires an entity to reclassify financial assets when, and only when, it changes its business model for managing its financial assets.

IFRS 9 makes it clear that changes in an entity's business model for managing its financial instruments are expected to be very infrequent.

Not changes in business model:

- a change in intention related to particular financial assets
- a temporary disappearance of a particular market for financial assets
- a transfer of financial assets between parts of the entity with different business models.

Effect of IFRS 9 on specific financial assets

Instrument	Treatment under IAS 39	Potential treatment under IFRS 9
Debt instruments quoted in an active market	Fair value (either through profit or loss or other comprehensive income) unless the entity has the positive intention and ability to hold to maturity	May now qualify for amortised cost accounting
Debt instruments classified as 'available for sale' under IAS 39 which do not meet IFRS 9's criteria for amortised cost classification	Fair value through other comprehensive income	Fair value through profit or loss
Asset backed securities where the terms of the loan give rise to cash flows other than payments of principal and interest or limit those cash flows in a way that is inconsistent with payments representing principal and interest	Amortised cost or fair value (either through profit or loss or other comprehensive income)	Fair value through profit or loss
Investments in equity instruments which do not have a quoted market price and where fair value cannot be reliably measured	Cost	Fair value

Effective date and transition

Effective date

IFRS 9 is effective for annual periods beginning on or after 1 January 2013, with earlier application being permitted.

Partly in response to political pressure, the IASB accelerated its timetable to replace IAS 39 in order to ensure that companies could adopt IFRS 9 for their 31 December 2009 year end financial statements. As a result, IFRS 9 contains complex transition rules.

Transition

IFRS 9's transition rules are complex. In summary, the main requirements are as follows:

- IFRS 9 is required to be applied retrospectively subject to certain transitional provisions. For the purpose of applying these transitional provisions, it is necessary to determine the date of initial application (which is the date when an entity first applies the requirements of IFRS 9).
- Under the transitional rules, application of IFRS 9's classification requirements (determining whether financial assets are classified at fair value or amortised cost) is based on the facts and circumstances at the date of initial application. The resulting classification is applied retrospectively.
- The transitional rules also state that if an entity adopts IFRS 9 for reporting periods beginning before 1 January 2012, it need not restate prior periods. If this is the case, the entity adjusts the opening retained earnings of the reporting period of initial application.

EU says no to early adoption of IFRS 9 for European companies

At least for now, companies in the European Union (EU) will not be able to adopt IFRS 9 early.

The European Financial Reporting Advisory Group (EFRAG) has stated that "more time should be taken to consider the output from the IASB project to improve accounting for financial instruments" and has decided not to recommend endorsement of the Standard to the EU at this stage.

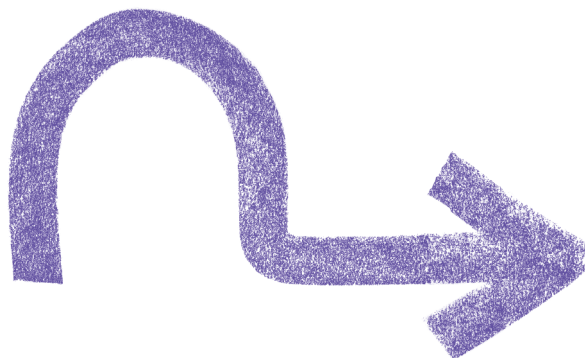
The move comes despite the EU's part in exerting pressure to make changes to IAS 39 ready for December year ends, and EFRAG's own initial recommendation that IFRS 9 should be endorsed. The final decision about the endorsement of the new Standard will now be left to the next group of European commissioners, who are not due to take office until early 2010. European companies will only be able to adopt IFRS 9 early once it has been endorsed for use in the EU.

The decision has not proved popular with some European companies, who fear that they will be put at a competitive disadvantage compared to companies outside the European Union that can adopt IFRS 9 immediately. Several large companies have even gone so far as to indicate that they may use IFRS 9's rules as 'pro forma' information in their financial statements.

The date of initial application

The determination of the date of initial application depends on whether the entity adopts IFRS 9 before or after 1 January 2011.

- IFRS 9 adopted before 1 January 2011 – the date of initial application can be any date between the issue of IFRS 9 (12 November 2009) and 31 December 2010
- IFRS 9 adopted on or after 1 January 2011 – the date of initial application is the beginning of the first reporting period in which it is adopted.



Advantages and disadvantages of early adoption

Advantages

- Reduced complexity in accounting for financial assets as a result of having only two measurement categories
- Improved ability to align accounting with the company's business model for managing financial assets
- Gives a (one-off) opportunity to reclassify financial assets on initial adoption (assuming all the criteria are met)
- Only one set of impairment rules needs to be considered, with no separate impairment assessment (or losses) for investment in equity instruments
- Simplified accounting for and valuation of financial instruments containing embedded derivatives
- Greater flexibility on date of initial application for early-adopters.



Disadvantages

- Need to re-evaluate the classification of all instruments within the scope of IAS 39, with limited time for entities to complete the assessment and implement system changes
- Restricted ability to reclassify financial instruments on an ongoing basis
- Inability to assess the overall impact of the IASB's overhaul until the remaining phases are complete
- The possibility of change to IFRS 9 as a result of convergence with US GAAP and decisions made in later phases
- The possibility of accounting mismatches where IFRS 9's requirements are incompatible with existing hedge accounting designations.

