The long trek to IFRS 9

IN THE FIRST OF A TWO-PARTER ON IFRS 9, **MATEUSZ LASIK** EXAMINES THE EVOLVING REQUIREMENTS OF FINANCIAL INSTRUMENT ACCOUNTING.

Most of the focus on accounting standards in the wake of the financial crisis concerned various aspects of financial instruments accounting. The IASB (International Accounting Standards Board) was faced with remarks from auditors, regulators, preparers of financial statements and investors which indicated that existing guidance in areas such as classification of financial instruments, measurement of liabilities, impairment and hedge accounting was in need of change.

It was against this background that the IASB decided to accelerate its project to improve financial instrument accounting and create the next generation of standards to replace IAS 39. It split the project into three phases: classification and measurement; impairment; and hedge accounting.

In the course of the project some of the three phases have been broken down into subphases. The board has also been working on projects covering debt/equity classification and derecognition of financial assets and financial liabilities. More recently it has added a workstream dealing with offset of financial assets and financial liabilities. Figure 1 shows the timelines for these various activities.

FINANCIAL ASSETS After issuing the exposure draft Financial Instruments: Classification and Measurement in July 2009, the IASB published a final standard (IFRS 9: Financial Instruments) in November 2009. The scope of the final standard was restricted to financial assets due to concerns raised about the proposals for financial liabilities (see part two of this feature, next month). Treasurers will wish to be familiar with the requirements of IFRS 9 as it captures the accounting for all financial assets.

All recognised financial assets currently in the scope of IAS 39 will be measured at either amortised cost or fair value. The available-for-sale and held-to-maturity classifications (including the associated tainting rules) currently in IAS 39 are eliminated under IFRS 9.

DEBT INSTRUMENTS An asset that is a debt instrument generally must be measured at amortised cost if both the "business model test" and the "contractual cashflow characteristics test" are satisfied. Unless the asset satisfies both of the tests, it will be accounted for at fair value through profit or loss (FVTPL).

The business model test asks whether the objective of the entity's business model is to hold the financial asset to collect the contractual cashflows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes). Treasurers managing liquidity portfolios comprising bonds and other instruments will wish to note that although the objective of an entity's business model may be to hold financial assets so it can collect contractual cashflows, the entity need not hold all of those assets until maturity.

Thus, an entity's business model can be to hold financial assets to collect contractual cashflows even when some sales of financial assets are expected to occur. For example, an entity's assessment that it holds investments to collect their contractual cashflows is still valid even if it sells the investments to fund capital expenditure. However, if more than an infrequent number of sales are made out of

a portfolio, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cashflows. This will be an area of judgement.

The contractual cashflow characteristics test requires that the contractual terms of the financial asset give rise on specified dates to cashflows that are solely payments of principal and interest on the principal amount outstanding. As a result, many financial assets that contain non-vanilla features (embedded derivatives that under IAS 39 were required to be accounted for separately) will be accounted for at FVTPL in their entirety.

Treasurers who manage portfolios including collateralised debt obligations (CDOs) should note the specific and complex guidance on the classification of contractually linked instruments (where receipts under an asset are paid by the issuer to the holder of the asset in order of priority over other multiple contractually linked instruments). An example of such instruments would be notes issued in tranches from a special purpose entity set up to collateralise debt obligations where payments on the tranches are prioritised, resulting in each tranche being relatively senior or subordinate to all other tranches. A tranche will be regarded as containing payments of principal and interest (and therefore potentially eligible for amortised cost measurement) only if all three of the following criteria are met:

- The tranche must only have cashflows whose characteristics are solely payments of principal and interest on the principal outstanding (e.g. the interest rate is not linked to, say, a commodity index).
- The underlying pool of instruments held by the entity issuing the tranche must contain one or more financial assets whose contractual cashflows are only payments of principal and interest. The underlying pool of instruments can contain other instruments, such as derivatives, but these must only reduce the cashflow variability of the pool of instruments held whose contractual cashflows are solely payments of principal and interest or align the fixed or floating nature of the interest rate, foreign currency risk, or timing differences of the cashflows of the tranches and the cashflows of the underlying pool of financial instruments.
- The exposure to credit risk in the underlying pool of financial instruments inherent in the tranche must be equal to or lower than the exposure to credit risk of the underlying pool of financial instruments.

A debt instrument that meets both the business model and contractual cashflow characteristics tests can still be designated as at FVTPL on initial recognition if that designation eliminates or significantly reduces an accounting mismatch that would exist if the instrument were measured at amortised cost (equivalent to the current fair value option for an accounting mismatch contained in IAS 39).

For debt instruments not designated at FVTPL under the fair value option, reclassification is required between FVTPL and amortised cost, or vice versa, if the entity's business model objective for its financial assets changes so that its previous model no longer applies. It is expected that reclassification will be rare.

Figure 1: Timeline for IAS 39 replacement project

<table>
<tr><th></th><th>Classification and measurement financial assets</th><th>Classification and measurement financial liabilities</th><th>Impairment</th><th>Hedge accounting</th><th>Offset</th><th>Financial instruments with characteristics of equity</th><th>Derecognition</th></tr>
<tr><td>2008 & Q1-3 2009</td><td colspan="2">Exposure draft</td><td>Request for information</td><td></td><td></td><td>Discussion paper</td><td>Exposure draft</td></tr>
<tr><td>Q4 2009</td><td>Final standard IFRS 9</td><td></td><td>Exposure draft</td><td></td><td></td><td></td><td></td></tr>
<tr><td>H1 2010</td><td></td><td>Exposure draft</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Q3 2010</td><td></td><td></td><td></td><td>Exposure draft</td><td></td><td></td><td>Final standard disclosures only</td></tr>
<tr><td>Q4 2010</td><td></td><td></td><td></td><td></td><td>Exposure draft</td><td></td><td></td></tr>
<tr><td>Q1 2011</td><td></td><td></td><td></td><td></td><td></td><td>Exposure draft</td><td></td></tr>
<tr><td>Q2 2011</td><td colspan="4">Final standard (converged)</td><td>Final standard (converged)</td><td></td><td></td></tr>
<tr><td>Q4 2011</td><td></td><td></td><td></td><td></td><td></td><td>Final standard (converged)</td><td></td></tr>
<tr><td>2012</td><td></td><td></td><td></td><td></td><td></td><td></td><td>Decision on further developments</td></tr>
<tr><td>2013/2014</td><td colspan="6">Mandatory effective date – to be determined</td><td></td></tr>
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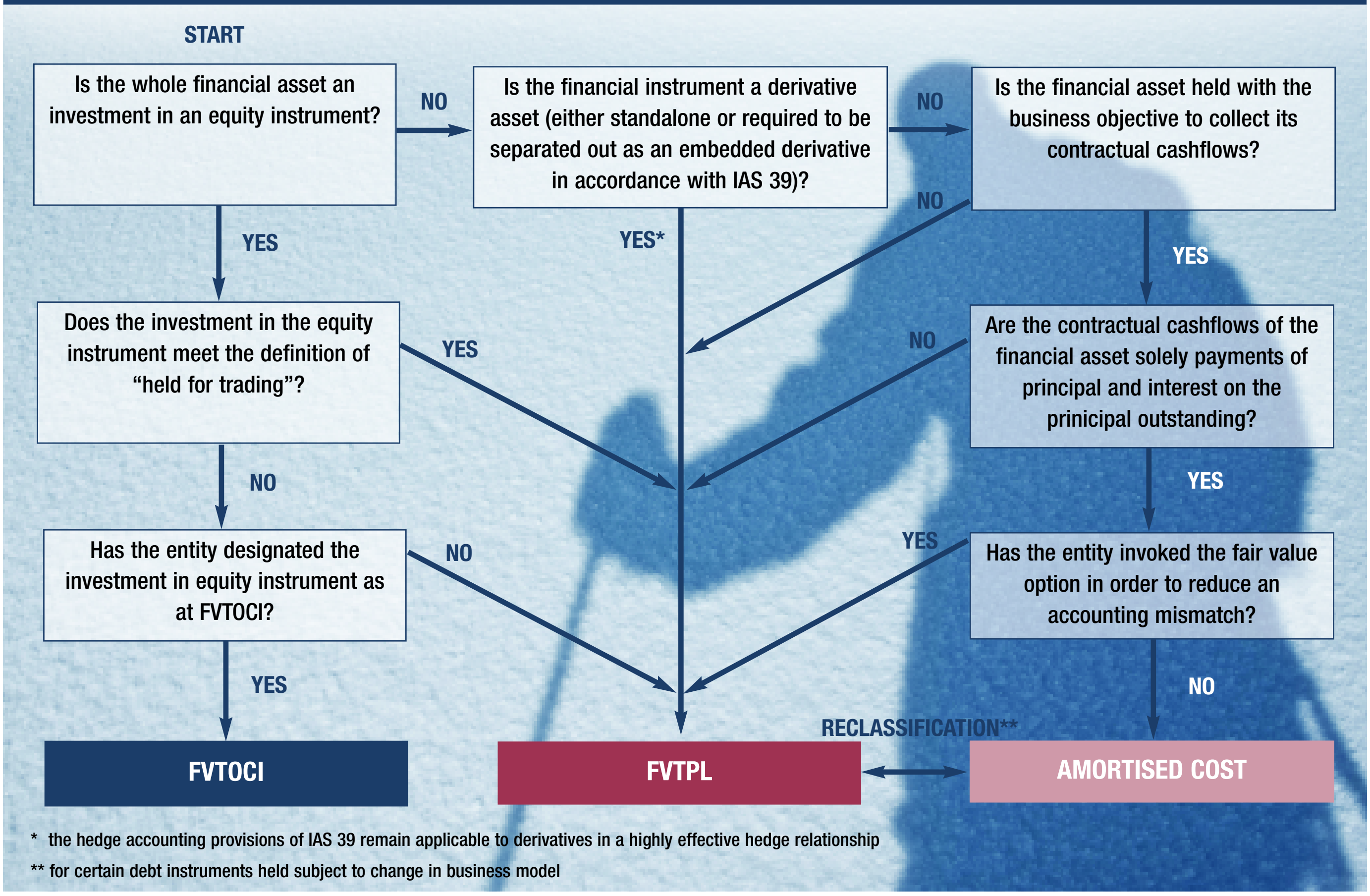
Figure 2: IFRS 9 methodology for classification of financial assets



EMBEDDED DERIVATIVES IFRS 9 does not retain IAS 39's concept of an embedded derivative for hybrid contracts if the host contract is a financial asset within the scope of IFRS 9.

Consequently, embedded derivatives that would have been separately accounted for at FVTPL under IAS 39 because they were not closely related to the financial asset host will no longer be separated. Instead, the contractual cashflows of the financial asset are assessed in their entirety and the asset as a whole is measured at FVTPL if any of its cashflows do not represent payments of principal and interest. As IFRS 9 applies only to financial assets in the scope of IAS 39, the requirement to assess contractual arrangements for non-closely related embedded derivatives still applies to all hybrid contracts with a financial liability host and non-financial host contracts that are outside the scope of IAS 39.

EQUITY INSTRUMENTS All equity investments within the scope of IFRS 9 are to be measured at fair value with the default recognition of gains and losses in profit or loss. Only if the equity investment is not held for trading can an irrevocable election be made at initial recognition to measure it at fair value through other comprehensive income (FVTOCI), with only dividend income recognised in profit or loss. All other changes in fair value are recognised in other comprehensive income (equity) with no recycling of those amounts to profit or loss and no impairment. This option would therefore be available for instance for a strategic investment made by a corporate in the equity of a supplier or competitor as long as the stake would not give rise to significant influence, joint control or control over the investee.

Also, it is worth noting that IFRS 9 does not allow the current exemption in IAS 39 that requires unquoted equity investments to be measured at cost less impairment where fair valuation is not sufficiently reliable. The exemption is also removed for derivatives that are linked to and will result in the delivery of an unquoted equity investment where fair value is not sufficiently reliable.

However, IFRS 9 does contain guidance on when cost might be the best estimate of fair value of an unquoted equity investment that is difficult to value because of little or no timely or relevant information. It also gives examples of when cost will not be representative of fair value, such as when there has been a significant change in performance of the investee compared with budgets, plans or milestones. Figure 2 illustrates the IFRS 9 methodology for classification of financial assets.

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The second part of this feature on next-generation financial instrument accounting will appear in the next issue of The Treasurer.