Grant Thornton

Technical Accounting Alert

Release of IFRS 9 Financial Instruments

Introduction

The purpose of this alert is to provide details of IFRS 9 *Financial Instruments* (IFRS 9) which addresses the classification and measurement of financial assets.

Relevant standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 39 Financial Instruments: Recognition and Measurement	AASB 139 Financial Instruments: Recognition and Measurement
IFRS 9 Financial Instruments	AASB 9 Financial Instruments
IAS 34 Interim Financial Reporting	AASB 134 Interim Financial Reporting

Background

In April 2009 the IASB announced an accelerated timetable for replacing IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). The move was in response to the financial crisis, and followed the conclusions of the G20 leaders and the recommendations of international bodies such as the Financial Stability Board.

The IASB have divided their project to replace IAS 39 into three main stages: Phase 1: Classification and Measurement; Phase 2: Impairment Methodology; and Phase 3: Hedge Accounting. The publication of IFRS 9 represents the completion of Phase 1 of the project. However, at this stage IFRS 9 addresses only financial assets (financial liabilities having been removed from the scope pending further consideration of various issues). Financial liabilities therefore continue to be accounted for in accordance with IAS 39.

A separate project is also underway to replace IAS 39's requirements on derecognition. The output from this project will form part of IFRS 9 in due course.

Main features of IFRS 9	
Scope and structure	• will eventually replace IAS 39 in its entirety • broken down into chapters. At this stage, only chapters on classification and measurement of **financial assets** are included • chapters relating to Phases 2 and 3 of the project, as well as requirements for financial liabilities and derecognition, will be added in due course.
Fewer measurement categories	• reduces the number of categories of financial assets; all financial assets must be measured at either amortised cost or fair value • IAS 39's measurement category terminology (held to maturity, loans and receivables, available for sale) is largely eliminated.
Conditions for amortised cost measurement	• the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows; <u>and</u> • 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.
Fair value for other financial assets	• financial assets that do not meet the conditions for amortised cost are measured at fair value • at initial recognition, entities may also designate a financial asset to be measured at fair value through profit or loss if the designation eliminates or significantly reduces an 'accounting mismatch' • gains and losses on financial assets measured at fair value (excluding hedging relationships) are presented in profit or loss with one exception (see box below).
Election to present gains and losses on equity investments in other comprehensive income	• irrevocable election on initial recognition to present gains and losses on an investment in an equity instrument in other comprehensive income • dividends receivable are however recognised in profit or loss • not available for equity instruments held for trading.
Impairment	• only one impairment method (in contrast to numerous methods required in IAS 39) • the surviving impairment method is that currently required for assets measured at amortised cost in accordance with IAS 39 • for the time being, impairment requirements continue to be part of IAS 39. These requirements have been amended to remove those aspects that are no longer applicable (primarily the requirements on impairment of available for sale assets and those held at cost).
Reclassification	• financial assets are reclassified if, and only if, the entity changes its business model for managing its financial assets • Application Guidance makes it clear such changes are expected to be very infrequent.
Effective date and transition	• effective for annual periods beginning on or after 1 January 2013 • earlier application permitted • mainly retrospective application. However, comparatives do not need to be restated if adopted for a reporting period beginning before 1 January 2012 (see below for more detail).

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 a financial asset at fair value through profit or loss (see below).

Business model

The entity's business model for managing financial assets is determined by the entity's key management personnel. It does not depend on management's intentions for individual instruments. It is instead based on a higher level of aggregation.

The application guidance to IFRS 9 makes it clear that changes to an entity's business model are expected to be very infrequent. IFRS 9 does however note that an entity may have more than one business model for managing its financial instruments. As an example, the Standard mentions an entity which holds a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio that it manages in order to trade to realise fair value changes.

An objective of holding financial assets in order to collect contractual cash flows does not mean that the entity has to hold all of the relevant instruments until maturity. Sales can occur in particular circumstances without compromising that objective. Where the performance of a portfolio of assets is evaluated on a fair value basis, or the portfolio is held for trading, the assets are not held to collect contractual cash flows and must be measured at fair value through profit or loss. Moreover, if more than an infrequent number of sales are made out of a portfolio, the entity must assess whether and how this is consistent with an objective of collecting contractual cash flows.

Contractual cash flows that are solely payments of principal and interest on the principal outstanding

IFRS 9 requires entities to assess whether the contractual cash flows are solely payments of principal and interest on the principal outstanding for the currency in which the financial asset is denominated. If this is the case, and the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows, the financial asset is measured at amortised cost (unless the entity opts to designate it at fair value through profit or loss, see below).

IFRS 9 notes a number of cases where the condition that the contractual cash flows are solely payments of principal and interest is either not met, or may not be met:

- The existence of leverage means the condition is <u>not</u> met.

- A provision that permits the issuer (ie the debtor) to prepay a debt instrument or that permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity will meet the condition only if:

a) the provision is not contingent on future events (other than terms that protect the holder against the credit deterioration of the issuer, or a change in control of the issuer; or the holder or issuer against changes in relevant taxation or law); and
b) the prepayment amount substantially represents unpaid amounts of principal and interest, which may include reasonable additional compensation for the early termination of the contract.

- Extension options will meet the condition only if:

  a) the provision is not contingent on future events (other than terms that protect the holder against the credit deterioration of the issuer, a change in control of the issuer; or the holder or issuer against a change in relevant taxation or law); and
  b) the terms of the extension option can solely result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal outstanding.

- A contractual term that changes the timing or amount of payments of principal or interest does not meet the condition unless it:

  a) is a variable interest rate;
  b) meets the conditions above relating to a provision that permits the issuer to prepay a debt instrument or that permits the holder to put a debt instrument back to the issuer before maturity; or
  c) meets the conditions above relating to extension options.

- An instrument that is subordinated to other instruments can meet the condition if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest even in the event of the debtor's bankruptcy.

- Where a financial asset is subordinated as the result of an entity using multiple contractually linked instruments to create concentrations of credit risk* (tranches) however, a tranche will only meet the condition if:

  a) the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) have cash flow characteristics that are solely payments of principal and interest on the principal outstanding
  b) the cash flow characteristics of the underlying pool of financial instruments meet certain conditions specified in IFRS 9; and
  c) the exposure to credit risk in the underlying pool of instruments that is inherent in the tranche is equal to or lower than the exposure to credit risk in the underlying pool.

* each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the different tranches.

Various examples are included in the Application Guidance to provide non-exhaustive illustrations of when the contractual cash flows condition is or is not met. The examples include common situations such as variable interest rates, variable rates with a cap, inflation-linking features and embedded options.

Fair value for other financial instruments

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.

Embedded derivatives

Where a contract contains an embedded derivative (meaning the cash flows relating to that part of the instrument vary like those of a stand-alone derivative), the required accounting depends on whether the host instrument is within the scope of IFRS 9. IFRS 9 eliminates the requirement to separate embedded derivatives within hybrid contracts if the host contract is within the scope of IFRS 9 (broadly, when the host is a financial asset).

The host contract is within the scope of IFRS 9 if it is:

- within the scope of IAS 39 (which is incorporated into IFRS 9 by cross-reference); and
- a financial asset.

Host contract in scope of IFRS 9
If the host instrument is within the scope of IFRS 9, 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. However, a number of embedded derivatives commonly found in debt instruments (such as some prepayment and extension options - see above) may not preclude amortised cost classification. In other cases, the embedded derivative will introduce an element of leverage into the contractual cash flows such that the condition that the contractual cash flows are only payments of principal and interest is failed (see above).

Host contract outside scope of IFRS 9
If the host instrument is outside the scope of IFRS 9 (ie it is a financial liability or a non-financial contract), IAS 39's existing requirements continue to apply to determine whether the embedded derivative must be separated. If separated, the embedded derivative will be accounted for at fair value and the host contract will be accounted for in accordance with other appropriate IFRSs.

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

IFRS 9 contains a modified version of the option to designate a financial asset at fair value through profit or loss that was in IAS 39.

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 a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

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.

Investments in unquoted equity instruments

Although IFRS 9 requires that all investments in equity instruments and contracts on those instruments must be measured at fair value, it notes that, in limited circumstances, cost may be an appropriate estimate of fair value.

IFRS 9 notes that this may be the case if insufficient more recent information is available to determine fair value. It also notes that cost might be appropriate as an estimate of fair value if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. IFRS 9 provides a list of indicators that cost might not be representative of fair value.

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 (depending on whether the election to present gains and losses on equity investments in other comprehensive income is taken or not). It is therefore not necessary to assess these assets for impairment. Under IFRS 9, the impairment requirements in IAS 39.58-65 and IAS 39.AG84-AG93 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 (different impairment requirements were applied to financial assets carried at amortised cost, financial assets carried at cost, and available-for-sale financial assets).

Measurement

At initial recognition, IFRS 9 requires entities to measure a financial asset at its fair value plus, in the case of a financial asset not at fair value through profit or loss, directly attributable transaction costs.

After initial recognition, financial assets are either measured at fair value or amortised cost as described above.

Reclassification

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

Where reclassification occurs, all affected financial assets are reclassified in accordance with IFRS 9's general classification requirements. The change is made prospectively from the first day of the reporting period following the change in business model. Where a financial asset is reclassified as measured at fair value, or measured at amortised cost, IFRS 9 sets out rules for determining the fair value or amortised cost as at the date of reclassification.

IFRS 9 makes it clear that changes in an entity's business model for managing its financial instruments are expected to be very infrequent. It notes that a change in intention related to particular financial assets, a temporary disappearance of a particular market for financial assets, or a transfer of financial assets between parts of the entity with different business models, are not changes in business model.

Effective date and transition

Effective date

Entities are required to apply IFRS 9 for annual periods beginning on or after 1 January 2013. Earlier application is permitted.

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).

- The determination of the date of initial application depends on whether the entity adopts IFRS 9 before or after 1 January 2011. If it adopts IFRS 9 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. If the entity adopts IFRS 9 on or after 1 January 2011, the date of initial application is the beginning of the first reporting period in which it is adopted.

- 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 this IFRS 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.

The following table illustrates the application of these rules:

Annual period	Beginning before 1 January 2011	Beginning on or after 1 January 2011	Beginning on or after 1 January 2012	Beginning on or after 1 January 2013
Standard mandatorily effective?	No	No	No	Yes
Date of initial application (DIA)	Any date between the issue of IFRS 9 and 31 Dec. 2010 (see above)	Beginning of the reporting period	Beginning of the reporting period	Beginning of the reporting period
Classification and measurement of financial assets in accordance with IFRS 9	Classification assessed at DIA*. Measurement retrospective with simplifications#.	Classification assessed at DIA*. Measurement retrospective with simplifications#.	Classification assessed at DIA*. Measurement retrospective with simplifications#.	Classification assessed at DIA*. Measurement retrospective with simplifications#.
Comparative periods restated?	No - opening retained earnings for period of initial application adjusted	No - opening retained earnings for period of initial application adjusted	Yes	Yes

* matters assessed at the DIA include:

- assessment of the entity's business model (IFRS 9.8.2.4);
- measurement of a hybrid contract where the contract is measured at fair value in its entirety but the fair value of the hybrid contract had not been determined in comparative periods (IFRS 9.8.2.5);
- designation of an investment in an equity instrument as at fair value through other comprehensive income (IFRS 9.8.2.7);
- designation of financial assets (and financial liabilities) as measured at fair value through profit or loss and revocation of previous designations where permitted or required (IFRS 9.8.2.7-8.2.9);

restatement simplifications include:

- IFRS 9 is not applied to financial assets that have already been derecognised at the date of initial application (IFRS 9.8.2.1);
- measurement of hybrid contracts in comparative periods where the fair value of the hybrid contract is required to be measured at fair value in its entirety but the fair value of the hybrid contract had not been determined in comparative periods (IFRS 9.8.2.5);
- determination of the amortised cost of a financial asset or any impairment on a financial asset where it is impracticable for an entity to apply retrospectively the effective interest method or the impairment requirements (IFRS 9.8.2.10);
- investments in unquoted equity instruments (or derivatives that are linked to and must be settled by delivery of such instruments) that were accounted for at cost under IAS 39 (IFRS 9.8.2.11)

Interim periods

Entities preparing interim financial reports under IAS 34, do not need to apply the requirements of IFRS 9 to interim periods prior to the date of initial application if it is impracticable to do so.

Grant Thornton comment

We believe the IASB has made a good start in its project to replace IAS 39. We welcome its efforts to reduce complexity, in particular by: (i) reducing the number of categories of financial instruments; (ii) introducing a principle-based approach to classification; (iii) eliminating the complex and rule-based requirements for embedded derivatives within financial assets; and (iv) having a single impairment method.

Unfortunately, by accelerating its replacement of IAS 39 and dividing the project into various phases, the IASB has increased the risk that application problems will emerge, leading to more amendments. Also, the IASB and FASB are working to different timetables in this area. Their future convergence efforts may result in more changes. In fairness, however, the IASB had little choice but to respond to political pressures to publish a new Standard in time for 2009 year-ends. Entities should now give careful consideration as to whether to adopt IFRS 9, or stay with IAS 39 for the time being. In making this decision, entities should factor in the possibility of further changes to classification and measurement requirements. It can be expected that many will prefer to wait until the 'final package' is complete.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au