

Straight away

IFRS bulletin from PricewaterhouseCoopers

IFRS 9 'Financial instruments' introduces new requirements for financial assets

What is the issue?

IFRS 9 'Financial instruments' addresses classification and measurement of financial assets and is available for early adoption immediately. The major changes to existing guidance in IAS 39 are outlined below.

- IFRS 9 replaces the multiple classification and measurement models in IAS 39 with a single model that has only two classification categories: amortised cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual characteristics of the financial assets. A financial asset is measured at amortised cost if two criteria are met: a) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows, and b) the contractual cash flows under the instrument solely represent payments of principal and interest.
- The new standard removes the requirement to separate embedded derivatives from financial asset hosts. It requires a hybrid contract to be classified in its entirety at either amortised cost or fair value. Most embedded derivatives introduce variability to cash flows. This is not consistent with the notion that the instrument's contractual cash flows solely represent the payment of principal and interest. Most hybrid contracts with financial asset hosts will therefore be measured at fair value in their entirety.
- Two of the existing three fair value option criteria become obsolete under IFRS 9, as a fair value driven business model requires fair value accounting, and hybrid contracts are classified in their entirety. The remaining fair value option condition in IAS 39 is carried forward to the new standard – that is, management may still designate a financial asset as at fair value through profit or loss on initial recognition if this significantly reduces an accounting mismatch. The designation at fair value through profit or loss will continue to be irrevocable.
- IFRS 9 prohibits reclassifications except in rare circumstances when the entity's business model changes; in this case, the entity is required to reclassify affected financial assets prospectively.
- There is specific guidance for contractually linked instruments that create concentrations of credit risk, which is often the case with investment tranches in a securitisation. In addition to assessing the instrument itself against the IFRS 9 classification criteria, management should also 'look through' to the underlying pool of instruments that generate cash flows to assess their characteristics. To qualify for amortised cost, the investment must have equal or lower credit risk than the weighted-average credit risk in the underlying pool of instruments, and those instruments must meet certain criteria. If 'a look through' is impracticable, the tranche must be classified at fair value through profit or loss.
- IFRS 9 classification principles indicate that all equity investments should be measured at fair value. However, management has an option to present in other comprehensive income unrealised and realised fair value gains and losses on equity investments that are not held for trading. Such designation is available on initial recognition on an instrument-by-instrument basis and is irrevocable. There is no subsequent recycling of fair value gains and losses to profit or loss; however, dividends from such investments will continue to be recognised in profit or loss.
- IFRS 9 removes the cost exemption for unquoted equities and derivatives on unquoted equities but provides guidance on when cost may be an appropriate estimate of fair value.

IFRS 9 represents the first milestone in the IASB's planned replacement of IAS 39. The next steps involve re-consideration and re-exposure of the classification and measurement requirements for financial liabilities, further exploration and field testing of the proposed impairment approach for financial assets, and development of enhanced guidance on hedge accounting. The IASB is also likely to publish a request for views on the FASB comprehensive exposure draft on financial instruments, which is expected to be issued in the first quarter 2010. The IASB aims to fully replace IAS 39 by the end of 2010.

Am I affected?

Banks and insurance companies will be most significantly impacted by the new standard, but all entities that hold financial assets will be affected. The degree of the impact will depend on the type and significance of financial assets held by the entity and the entity's business model(s) for managing financial assets.

The effective date of the new classification and measurement guidance is 1 January 2013; early application is permitted. IFRS 9 should be applied retrospectively; however, if adopted before 1 January 2012, comparative periods do not need to be restated. In addition, entities adopting before 1 January 2011 are allowed to designate any date between then and the date of issuance of IFRS 9, as the date of initial application that will be the date upon which the classification of financial assets will be determined.

What do I need to do?

Management should familiarise themselves with the detailed requirements of IFRS 9 and evaluate the effects of the new standard on the classification and measurement of financial assets held by the entity. Management should consider the potential benefits of early adoption of the new guidance in light of the provided relief from restatement of comparative information and the relaxed requirements for the determination of the date of initial application for early adopters.

However, management should bear in mind that the financial instruments project is evolving. The IASB has indicated that the effective date of IFRS 9 may be pushed back to align the mandatory adoption of the standard with the effective dates for IAS 39 replacement stage II – 'Amortised cost and impairment' and 'Insurance' projects. In addition, there may be changes in the financial statements presentation for financial assets to enable investors to more easily reconcile the IASB and FASB models.

Management and other interested parties should monitor the IAS 39 replacement project and consider the impact of further decisions in the context of requirements already established by IFRS 9.

European companies will want to follow the endorsement process by the European Commission. We understand that EFRAG has decided that more time should be taken to consider the output from the IASB project to improve accounting for financial instruments. Therefore, at this stage, EFRAG will not finalise its endorsement advice to the European Commission on IFRS 9.

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