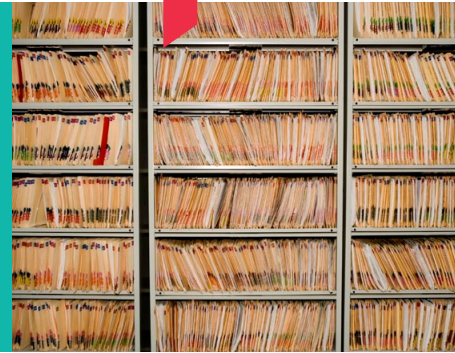


# INTERNATIONAL FINANCIAL REPORTING BULLETIN 2010/02

## IFRS 9 FINANCIAL INSTRUMENTS



### Background

In July 2009, the International Accounting Standards Board issued for comment an Exposure Draft (ED) of proposed changes to the accounting for financial instruments. The exposure draft set out proposals to simplify the approach for the classification and measurement of financial instruments in comparison to the current requirements set out in IAS 39. The IASB's project to replace the existing financial instruments standards was accelerated in response to calls from the G-20, the Financial Stability Board and other constituents.

The ED was the first of three exposure drafts that the IASB will issue as proposals to replace IAS 39. The second exposure draft, *Financial Instruments: Amortised Cost and Impairment* was issued by the IASB on 5 November 2009 and is open for comment until 30 June 2010. The final ED will deal with hedge accounting and is expected to be published in the first quarter of 2010.

On 12 November 2009, the IASB issued IFRS 9 *Financial Instruments* (IFRS 9) as the first part of Phase I to replace IAS 39. The scope of IFRS 9 is currently limited to the classification and measurement of financial assets. The IASB will continue its work on financial liabilities, in particular measurement issues related to the effects of changes in an entity's own credit risk on fair value measurement, and will include the requirements for those instruments in IFRS 9 in due course.

### Scope

IFRS 9 applies to all assets within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

### Classification and measurement

IFRS 9 requires that on initial recognition, all financial assets are classified into one of two measurement categories:

- Amortised cost; or
- Fair value.

IFRS 9 eliminates the Held to Maturity (HTM), Available for Sale (AFS) and Loans and Receivables categories. In addition, the exception that requires equity instruments and related derivatives to be measured at cost rather than fair value, where the fair value cannot be reliably determined, has been eliminated with fair value measurement being required for all of these instruments.

A financial asset is measured at amortised cost only if it meets the following two conditions:

- The objective of an entity's business model is to hold the financial asset in order to collect 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 amount outstanding.

All other instruments are required to be measured at fair value. IFRS 9 retains the current requirement for financial instruments that are held for trading to be recognised and measured at fair value through profit or loss, including all derivatives that are not designated in a hedging relationship.

### STATUS

Final

### EFFECTIVE DATE

Annual periods beginning on or after 1 January 2013, with earlier application permitted. Extensive transitional provisions.

### ACCOUNTING IMPACT

Significant changes to the classification and measurement of financial assets.

### The entity's business model for managing financial assets

The first test is whether the financial assets are being held in order to collect contractual cash flows. Financial assets are considered to be held in order to collect contractual cash flows on the basis of the objectives of the entity's business model as determined by key management personnel (as defined in IAS 24 *Related Party Disclosures*).

Financial assets are not assessed on an individual instrument basis; instead classification is assessed at a higher level of aggregation on the basis of the entity's overall business model. IFRS 9 acknowledges that an entity may have separate business models for portfolios of investments that are managed in different ways (for example, an entity may hold one portfolio of investments which are managed in order to collect cash flows and hold another portfolio of investments which are managed in order to trade to realise fair value changes).

An entity's business model could be to hold financial assets to collect contractual cash flows even when sales of those assets occur (i.e. an entity need not hold all instruments in a portfolio to maturity). For example, an entity may sell an investment which no longer meets its investment policy or when the entity needs to fund some capital expenditure. Judgement is needed in these situations as, if more than infrequent sales are made, an entity will need to assess whether such sales are consistent with an objective of collecting the contractual cash flows.

Financial assets that meet the definition in IAS 39 of held for trading or whose performance is managed on a fair value basis, are not held to collect contractual cash flows and are required to be measured at fair value through profit or loss.

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

Having established which financial assets are held for the collection of contractual cash flows, an entity is then required to assess whether the contractual cash flows of each of those financial assets are solely payments of principal and interest on the principal outstanding. In contrast to the initial business model test, this second test is applied on an individual asset basis, and not on a portfolio basis.

Contractual terms that include leverage (such as a stand-alone option, or a forward or swap contract) result in economic characteristics that are not interest. Leverage is a feature that amplifies the variability of contractual cash flows (for example, one which changes an interest rate by a multiple of a benchmark rate). As such, contracts which include leverage do not meet the condition of being solely payments of principal and interest on the principal outstanding and are required to be measured at fair value through profit or loss.

The terms of a debt instrument may include terms which permit repayment before maturity, or the extension of the contractual term. These terms do not preclude the financial asset from being regarded as having contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. However, restrictions are included to limit the circumstances in which this would be the case.

The first restriction is that the prepayment or extension provision must not be contingent on future events, other than to protect:

- the holder of the debt instrument against credit deterioration of the issuer (this includes defaults, credit downgrades or loan covenant violations); or
- the holder or the issuer against changes in relevant tax legislation or in the law.

Where the terms permit early repayment, the amount payable must substantially represent unpaid principal and interest, and may also include compensation for the early repayment (this might apply in the event of the early repayment of a fixed rate loan, where the lender might incur swap breakage costs). Where the terms contain an extension option, the contractual cash flows during the extension period must represent only payments of principal and interest on the principal amount outstanding.

Contractual terms that change the timing of payments of principal and interest are not solely payments of principal and interest on the amount outstanding unless:

- the variable interest rate is for the time value of money and the credit risk (the guidance notes that for some instruments this may be determined at initial recognition only, and so may be fixed) associated with the principal amount outstanding; and
- if the contractual term is a prepayment option, it meets the conditions for a prepayment option (see above); or
- if the contractual term is an extension option, it meets the conditions for an extension option (see above).

Financial assets could have contractual cash flows that are described as principal and interest but do not actually represent the payment of principal and interest on the principal amount outstanding as set out in IFRS 9, because other factors are included. This could be the case when a creditor's claim is limited to specific assets or to the cash flows from specified assets of the debtor. In such situations, the creditor is required to 'look through' to the particular underlying assets (which can be financial assets or non-financial assets) or cash flows, to assess whether the contractual cash flows on the financial asset being classified are payments of principal and interest on the principal amount outstanding. If a financial asset contains terms which give rise to other cash flows or limit the cash flows in a manner which is inconsistent with the payment of principal and interest, the financial asset fails to meet the conditions for measurement at amortised cost and must instead be measured at fair value.

However, the classification of a financial asset is not affected by what IFRS 9 refers to as non-genuine cash flow characteristics. It is clarified that a cash flow is not genuine if it will affect contractual cash flows only on the occurrence of an event which is extremely rare, highly abnormal and very unlikely to occur. It is recognised that in many lending arrangements, financial liabilities are ranked relative to the debtor's other creditors. From the lender's perspective, financial assets that are subordinated relative to other financial assets may still have contractual cash flows that are payments of principal and interest on the principal outstanding as long as the subordination does not affect the contractual rights to the holders of the subordinated assets to unpaid principal and other amounts due. For this to be the case, the debtor's non payment would have to be breach of contract, and the lender (or holder of the financial asset) would need to retain the contractual rights to cash flows even in the event of the debtor's bankruptcy.

Certain financial assets include arrangements where payments to holders of financial assets are prioritised through multiple subordinated interests (ie tranches) in a 'waterfall' structure where payments to senior debt holders are prioritised over those to other tranches. As an example of this type of arrangement, an SPE might be set up to purchase a portfolio of mortgage receivables. In order to generate the required funding, the SPE issues bonds of various credit grades (from AAA to B) to external investors. When cash is received from the mortgage portfolio, these are used first to pay amounts due to the AAA bond holders. When the cash received exceeds the amount due to these bond holders, it 'overflows' down to the next level (the AA bond holders) – hence the term 'waterfall' structure. This means that the holders of a tranche have the right to payments of principal and interest on the principal outstanding only if the issuer generates sufficient cash flows to satisfy the higher-ranking tranches.

A tranche has cash flow characteristics that are payments of principal and interest only if:

- the contractual terms of the tranche being assessed (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal outstanding,
- the underlying pool of financial instruments has certain cash flow characteristics (described below); and
- the credit risk exposure of the underlying pool of financial instruments inherent in the tranche (and therefore the tranche itself) is equal to or lower than the credit risk exposure of the underlying pool of financial instruments.

The 'underlying pool' of financial instruments is the pool of instruments that are ultimately creating the cash flows. A holder of a tranche is required to 'look through' a structure until the 'underlying pool' has been identified. This might require the tracing of transactions through a number of linked entities.

If the holder cannot meet all of the conditions set out above at initial recognition, the tranche must be measured at fair value.

The cash flow characteristics on the underlying pool of financial instruments include the requirement for the pool to contain at least one or more instruments which have contractual cash flows that are solely payments of principal and interest. The underlying pool may also include instruments that reduce the cash flow variability of other instruments (such as an interest rate cap or floor) as long as, when combined with the other instruments, the resulting cash flows are solely for payments of principal and interest outstanding on the principal outstanding. Similarly, instruments may be included that align the cash flows of tranches with the cash flows of the pool of underlying instruments to address differences in (and only in) fixed or floating interest rates, the currency in which the cash flows are denominated or the timing of the cash flows.

If any instrument in the pool fails to meet either of the conditions set out in the paragraph above, or if the underlying pool of instruments can change after initial recognition in such a way that either of these conditions may not be met, the tranche must be measured at fair value.

### Contracts which contain embedded features

The terms of a financial asset may include cash flow characteristic which contain certain embedded features, such as interest rate floors and caps, early repayment features and extension provision. Provided the host contract is within the scope of IFRS 9 and all of the conditions in IFRS 9 are met, these financial assets are measured at amortised cost and the embedded features are not bifurcated and accounted for separately.

Other financial assets contain more complex embedded features which cause some or all of the cash flows that would otherwise be required by the contract to be modified in such a way that they are not solely the payments of principal and interest on the principal amount outstanding. IAS 39 would typically require these embedded features to be accounted for separately at fair value through profit or loss, with the host contract remaining either at amortised cost or at fair value with changes in value, other than impairment and certain foreign currency movements, being recorded in equity. For those contracts where the host contract is a financial instrument within the scope of IFRS 9, the embedded derivatives are not accounted for separately and the entire contract is recorded at fair value.

Where the host contract is not within the scope of IFRS 9, either not being a financial instrument, a financial liability, or a financial asset which is scoped out of the standard, the current guidance in IAS 39 continues to apply to the analysis and accounting treatment of embedded derivatives.

### Fair value option

IFRS 9 includes an election, similar to that of IAS 39, which permits an entity, on an optional basis, to classify a financial instrument at fair value through profit or loss where that financial instrument would otherwise be measured at amortised cost. This election, which can be applied on an individual financial instrument basis or to a group of financial instruments, is made at initial recognition and is irrevocable.

In a change from IAS 39, this option is only available if the designation results in the elimination of, or significant reduction in, a measurement or recognition inconsistency. IAS 39 also permits the fair value option to be applied to financial instruments that are managed on a fair value basis, and to those instruments that contain an embedded derivative that would be required to be accounted for separately but the entity elects to measure the entire contract at fair value. Both of these latter criteria are eliminated in IFRS 9, because financial instruments managed on a fair value basis are required to be measured on that basis and the separation of embedded derivatives is eliminated, with contracts containing such embedded features being required to be measured at fair value in their entirety unless the instrument as a whole qualifies to be measured at amortised cost.

### Reclassification

The classification of financial assets is made on initial recognition. Reclassification after initial recognition is prohibited, unless an entity fundamentally changes its business model for managing its financial assets in which case reclassification is required. The circumstances in which reclassification is required are extremely restrictive, with fundamental changes in the business model being expected to be very infrequent. The following examples are given of circumstances which are not changes in business model:

- a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);
- a temporary disappearance of a particular market for financial assets; and
- a transfer of financial assets between parts of an entity with different business models.

### Investments in equity instruments

Investments in equity instruments do not meet the conditions to be measured at amortised cost because they do not contain contractual terms that give rise to cash flows on specified dates that are solely payments of principal and interest on the principal outstanding. Consequently investments in equity instruments are measured at fair value.

For investments in equity instruments which are not held for trading (for example, those held for strategic purposes), IFRS 9 allows an entity, on initial recognition, to make an irrevocable election to recognise all changes in fair value in Other Comprehensive Income (OCI). There are no transfers from OCI to profit or loss (that is, no recycling) and hence no impairment requirements. Dividends from such designated equity instruments are recognised in profit or loss when the right to receive payment of the dividend has been established, in accordance with IAS 18 *Revenue*.

In a change from IAS 39, IFRS 9 has no exemption from fair value measurement for those instruments for which fair value cannot be reliably measured. The IASB notes in its Basis for Conclusions that IAS 39 requires investments measured at cost to be monitored for impairment, and that this approach effectively requires fair value measurement to be adopted for the purposes of impairment.

However, it is also noted that in certain extremely limited circumstances, cost might be representative of fair value and additional guidance has been included in IFRS 9 in comparison with the exposure draft. However, it is also noted that those circumstances will never apply to equity investments held by entities such as financial institutions and investment funds.

### Disclosure and consequential amendments to other accounting standards

IFRS 9 is accompanied by consequential amendments to a wide range of other accounting standards and interpretations. These include significant changes to IFRS 7 *Financial Instruments: Disclosures*, including substantial new disclosures for any equity instruments where changes in their value are recorded in OCI, and to IAS 1 *Presentation of Financial Statements* which would require separate disclosure on the face of the income statement of gains or losses arising on the sale of financial assets measured at amortised cost.

### Effective date and transition

IFRS 9 applies to annual accounting periods commencing on or after 1 January 2013, with earlier application permitted. If it is applied for a period beginning before 1 January 2013, disclosure is required of that early adoption and the extensive consequential amendments to other IFRSs also need to be applied.

The new standard is required to be applied on a fully retrospective basis in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, subject to extensive transitional provisions. However IFRS 9 is prohibited from being applied to financial assets in comparative periods where those financial assets have already been derecognised at the date of initial application.

A summary of the transitional provisions are as follows:

- For the purpose of the transitional provisions, the date of initial application is the date when an entity first applies the requirements of IFRS 9. This date can be any date between the issue of IFRS 9 (12 November 2009) and 31 December 2010 if an entity adopts the new standard before 1 January 2011. If IFRS 9 is adopted on or after 1 January 2011, the date of initial application is the beginning of the first reporting period in which the standard is adopted.
- If an entity adopts IFRS 9 during a reporting period, additional disclosures are required, including the reasons why the particular date of adoption has been used.
- The assessment of whether a financial asset is held for the collection of contractual cash flows is made as at the date of initial application of IFRS 9. The resulting classification is then applied on a fully retrospective basis.
- If a hybrid contract (ie one containing an embedded derivative as defined in IAS 39) is required by IFRS 9 to be measured at fair value, but that fair value has not been determined in previous accounting periods, the hybrid contract is measured in comparative periods using the sum of the fair value of the components (ie the host contract and embedded derivative(s)). At the date of initial application of IFRS 9, the entire (combined) contract is measured at fair value, with any difference between that fair value and the combined fair value of the component parts being recognised either in opening retained earnings of the reporting period of initial application (if the date of initial application of IFRS 9 is the beginning of a reporting period) or in profit or loss (if the date of initial application of IFRS 9 is during a reporting period).
- At the date of initial application an entity may designate a financial asset as measured at fair value through profit or loss in order to eliminate or significantly reduce an accounting mismatch or an investment in an equity instrument as at fair value through other comprehensive income based on the facts and circumstances that exist at that date. These classifications are then applied on a fully retrospective basis.
- The previous optional designation of a financial asset as at fair value through profit or loss in accordance with IAS 39 may be revoked on the basis of facts and circumstances as at the date of initial application and is required to be revoked if the eligibility criterion for such designation is not met. The applicable measurement basis is then applied on a fully retrospective basis.


- Although the scope of IFRS 9 covers only financial assets, as part of the transitional guidance, financial liabilities that were designated as at fair value through profit or loss on the basis that this designation eliminated or significantly reduced a measurement mismatch are also revisited. Financial liabilities may be so designated as at the date of initial application of IFRS 9, and the designation may (or may be required) to be revoked, based on the facts and circumstances at the date of initial application of the standard.
- If an instrument previously measured at fair value is reclassified to be measured at amortised cost and it is impracticable (as defined in IAS 8) for the effective interest rate and impairment requirements of IAS 39 to be applied on a retrospective basis, then the amortised cost of the financial instrument, or any impairment of the financial asset, is determined on the basis of the fair value of the financial instrument at the end of each comparative period. The fair value of the instrument as at the date of initial application then becomes its new deemed amortised cost.
- Investments in unquoted equity investments (or derivatives linked to, and required to be settled by delivery of, such instruments) that were measured at cost under IAS 39, are remeasured to fair value as at the date of initial application. Any difference between that fair value and the previous carrying amount is recognised in opening retained earnings of the reporting period of initial application.
- Notwithstanding the requirement to apply IFRS 9 retrospectively in accordance with IAS 8, entities that adopt IFRS 9 for reporting periods beginning before 1 January 2012 need not restate prior periods. If prior periods are not restated, any difference between previous carrying amounts and the carrying amount at the start of the reporting period that includes the date of initial application of IFRS 9 is recognised in opening retained earnings of the reporting period that includes the date of initial application.
- Entities which prepare interim financial reports in accordance with IAS 34 Interim Financial Reporting are not required to restate comparative information if such restatement is impracticable (as defined in IAS 8).

On initial application of IFRS 9, the disclosures required by IAS 8 will be required. These include, to the extent practicable (as set out in IAS 8) the effect on each financial statement line item and on basic and diluted earnings per share for the current and prior period(s) presented.

In addition, when IFRS 9 is applied for the first time, the following disclosures are required for each class of financial assets at the date of initial application:

- The original measurement category and carrying amount, determined in accordance with IAS 39;
- The new measurement category and carrying amount, determined in accordance with IFRS 9; and
- The amount of any financial assets that were previously designated as at fair value through profit or loss that are no longer so designated, with separate disclosures being required for those that IFRS 9 requires to be redesignated and those which have been redesignated on an optional basis.

This information is required to be presented in tabular format, together with a narrative explanation of how the classification requirements in IFRS 9 have been applied, and the reasons for any designation or revocation of the designation of financial assets at fair value through profit or loss.



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