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**Status:** Final**Effective date:**  
Immediate**Accounting impact:**

Permits certain financial assets previously required to be on balance sheet at fair value to be measured at amortised cost



# International Financial Reporting Bulletin

Amendments to IAS 39 and IFRS 7 *Reclassification of Financial Assets*

**Introduction**

The International Accounting Standards Board (IASB) has amended IAS 39 *Financial Instruments: Recognition and Measurement* to enable, in certain circumstances, financial assets to be reclassified out of the “held to trading” and “available for sale” categories.

The amendments were issued as an urgent response to the current financial crisis, without due process, with the agreement of the IASCF Trustees.

The effect of the amendment is that certain financial assets are now permitted to be transferred to either the Loans and Receivables or Held To Maturity categories, resulting in them being carried at amortised cost rather than fair value with an associated anticipated reduction in earnings and equity volatility. Where a financial asset is reclassified from the Held For Trading to Available For Sale category, although the asset will continue to be measured at fair value, certain changes in fair value may be eligible to be recorded in reserves rather than in the income statement.

It is anticipated that the amendments to IAS 39 will primarily be applicable in to entities in the financial sector (in particular banks and insurance companies) although other entities may also have financial assets that are covered by the amendments.

**Background**

The recent credit crunch has seen turmoil in markets recently with some commentators, rightly or wrongly, blaming the requirements in accounting standards to measure financial assets at fair value. In particular, concerns have been raised that the requirement to measure many financial assets at fair value in current economic conditions, where markets for certain assets had effectively dried up, was resulting in a vicious cycle of asset devaluations that only exacerbated the lack of confidence in markets and the global economy. This lack of confidence was then leading to further reductions in fair value, further undermining confidence.

In addition, the IASB received requests to address differences between the reclassification requirements of IAS 39 and US GAAP requirements so as to create a level playing field, as, unlike US GAAP, IFRS previously did not permit any reclassifications for assets classified as held for trading.

**Effect** The amendments permit the following reclassifications of financial assets:

1. A non-derivative financial asset which was originally required to be designated as held for trading may be reclassified out of the fair value through profit and loss category in “rare circumstances”. Although the amendment does not elaborate on what might constitute a rare circumstance, the press release issued by the IASB and accompanying comments made by its Chairman, Sir David Tweedie, have indicated that the recent credit crunch falls to be treated as such.
2. A financial asset which was required to be classified as held for trading because of an intention to sell in the short-term may be reclassified as loans and receivables if they would have otherwise have met the definition of a loan and receivable (essentially the assets have fixed and determinable payments, are not quoted in an active market and recoverability is subject only to credit deterioration of the debtor). This will principally affect mortgage assets that were intended to be sold, perhaps through a securitisation transaction, shortly after origination (and so designated as held for trading), but because of the freezing up of the markets could not be sold.
3. A financial asset that was voluntarily designated on initial recognition as available for sale may be reclassified as a loan and receivable, provided the asset would otherwise still meet the definition of a loan and receivable (i.e. the assets have fixed and determinable payments, are not quoted in an active market and recoverability is subject only to credit deterioration of the debtor).

The following are additional relevant observations of the revisions:

- If a financial asset is to be reclassified, it must meet the definitions of the category into which it is to be classified at the date of reclassification.
- Reclassification is only permitted in accordance with 1 above for assets which are no longer held for the purpose of selling or repurchasing in the near term, notwithstanding that they may originally been held for these purposes.
- Financial assets may only be reclassified in accordance with 2 or 3 above if the entity has both the intention and ability to hold the asset for the foreseeable future, or until its maturity.
- Reclassification is **not** permitted for any financial asset that upon initial recognition was designated (i.e. voluntarily chosen) by the entity to be at fair value through profit and loss.
- The need for a “rare circumstance” does not apply to assets reclassified in accordance with 2 and 3 above, rather is ‘intention based’. This aligns, as far as possible, IFRS requirements with US GAAP in respect of this point. However, if an asset to be reclassified remains quoted on a market, it will not

meet the definition of Loans and Receivables. In consequence, amortised cost measurement for such assets can only be achieved through reclassification as held-to-maturity (HTM). In order to be reclassified as HTM the asset(s) must have fixed and determinable payments and a specified maturity date (so that, for example, an equity instrument cannot be classified as HTM as it has no specified maturity date). In addition, the holder must have the intention and ability to hold the asset to its maturity. After reclassification to HTM, the asset(s) would be subject to the strict tainting provisions of IAS 39 which, if breached, would lead to the entire HTM portfolio being reclassified to the Available For Sale category. This in turn would mean having to be on balance sheet at fair value albeit with certain changes in fair value being taken to equity – although any future impairment would still be charged to the income statement.

- On reclassification to HTM or loans and receivables the fair value of the asset at the date of reclassification becomes its cost or amortised cost as appropriate. A worked example is set out below. Where the estimated future cash flows of reclassified assets are increased due to an increase in the estimated recovery of cash flows (i.e. recovery of previously recorded impairment losses), the effect of that increase is recognised as an adjustment to the effective interest rate from the date of change in estimate rather than as an immediate adjustment to the carrying amount of the asset. This means that any improvement in the recovery of a financial asset after reclassification to a category measured at amortised cost is spread over the remaining term of the financial asset, and is not recognised as an immediate credit to the income statement.
- Although the changes have been driven by the impact of the recent credit crisis on financial institutions, the standard as amended applies to all entities. Therefore, to the extent other entities have invested in held for trading financial assets they can be reclassified to other categories of financial asset in IAS 39 provided they meet the requirements as set out above.
- Following reclassification, the assets would still be subject to the impairment testing provisions of IAS 39.

*Example: subsequent measurement  
at amortised cost*

Entity A originated a portfolio of unquoted fixed rate loan assets with a face value of £1,000 some time ago which it intended to trade (via a securitisation) in the short term. Entity A was unable to securitise the loan assets due to the effect of the credit crisis. The fair value of these loans assets has now fallen to £503. The entity decides to reclassify the assets as loans and receivables in accordance with the revised IAS 39. The loans currently pay interest of 5% per annum, with the principal due for repayment 5 years following reclassification. An effective interest rate of 22.6% should therefore be applied to the book value on reclassification if measured at amortised cost to determine the correct finance income to recognise in the income statement. The resulting carrying value of the asset may need to be assessed for impairment.

Time	Carrying value b/f	Finance income	Cash inflow	Carrying value c/f
Year 1	503	114	(50)	567
Year 2	567	128	(50)	645
Year 3	645	145	(50)	740
Year 4	740	167	(50)	857
Year 5	857	193	(1050)	0

**Disclosures**

IFRS 7 *Financial Instruments: Disclosure* has also been amended to require extensive and detailed disclosures where an entity reclassifies any asset out of the fair value through profit or loss or available for sale categories under the provisions of the amended IAS 39. The disclosures required are:

- The amount reclassified into and out of each category;
- For each reporting period until derecognition, the carrying amounts and fair values of all financial assets that have been reclassified in the current and previous reporting periods;
- For assets reclassified on the grounds of a “rare situation”, the facts and circumstances indicating that the situation was rare;
- For the reporting period when the financial asset was reclassified, the fair value gain or loss in that period and the previous reporting period;
- For each reporting period following the reclassification (including the reporting period in which the asset was reclassified) until derecognition of the financial asset, the fair value gain or loss that would have been recognised if the financial asset had not been reclassified, and the gain, loss, income and expense recognised in profit or loss; and
- The effective interest rate and estimated amounts of cash flows the entity expects to recover, as at the date of the reclassification of the financial asset.

**Effective date and transitional rules**

The amendment to IAS 39 is effective from 1 July 2008 (**not** periods beginning on or after this date) and shall not be applied retrospectively, i.e. reclassification cannot be made as of a date prior to 1 July 2008. Any reclassification of a financial asset made in periods beginning on or after 1 November 2008 shall take effect only from the date the classification is made. Consequently, any reclassification made in earlier accounting periods can be deemed to have taken place at any date between 1 July 2008 (or the date the asset is first recognised if later) and the end of the accounting period in question.

Entities applying IFRS as endorsed for use by the European Union (EU) can apply the amendment as, in the same way as the IASB, the European Commission endorsed the amendments to IAS 39 without its normal due process.



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