



# On the Horizon for IFRS

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## **IASB issues IFRS 9 on classification and measurement of financial assets**

Introduction

Background

Main features of IFRS 9

Classification

Business model

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

Fair value for other financial instruments

Impairment

Measurement

Reclassification

Effective date and transition

## **GTI IFRS Team issues new guide on deferred tax**

## **GTI IFRS Team issues Example Consolidated Financial Statements 2009**

## **IASB issues IFRS 9 on classification and measurement of financial assets**

### **Introduction**

On November 12, 2009, the IASB issued IFRS 9, *Financial Instruments* (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets.

### **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 has divided the project to replace IAS 39 into three main phases:

- Phase 1: Classification and Measurement
- Phase 2: Impairment Methodology
- Phase 3: Hedge Accounting

The issuance of IFRS 9 represents the completion of Phase 1 of the project. However, at this stage IFRS 9 addresses only financial assets (financial

liabilities were removed from the scope pending further consideration of various issues). For now financial liabilities will continue to be accounted for in accordance with IAS 39.

A separate project is also underway to replace IAS 39's requirements on derecognition. As with the planned later phases and financial liabilities, the output from the derecognition project will be incorporated into IFRS 9 in due course.

#### Main features of IFRS 9

<b>Scope and structure</b>	Will eventually replace IAS 39 in its entirety Broken down into chapters. The initial chapters issued in November 2009 cover classification and measurement of financial assets. Future chapters relating to impairment (Phase 2), hedging (Phase 3) financial liabilities, and derecognition will be added in due course
<b>Fewer measurement categories</b>	Reduces the number of categories of financial assets; all financial assets must be measured at either amortized cost or fair value IAS 39's measurement category terminology (held to maturity, loans and receivables, available for sale) is largely eliminated
<b>Conditions for amortized cost measurement</b>	The objective of the entity's business model is to hold the financial asset to collect the 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 outstanding
<b>Fair value for other financial assets</b>	Financial assets that do not meet the conditions for amortized cost are measured at fair value At initial recognition, an entity may elect to designate any financial instrument at fair value through profit and 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 recognized in profit or loss unless there is an irrevocable election to recognize gains and losses on equity investments in other comprehensive income (see below)

<b>Election to recognize gains and losses on equity investments in other comprehensive income</b>	Irrevocable election on initial recognition to recognize gains and losses on an investment in an equity instrument in other comprehensive income Dividends are recognized in profit or loss, unless clearly a return of investment Not available for equity instruments held for trading
<b>Impairment</b>	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 amortized 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).
<b>Reclassification</b>	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
<b>Effective date and transition</b>	Effective for annual periods beginning on or after January 1, 2013 Earlier application permitted Mainly retrospective application. However, comparative financial statements do not need to be restated if adopted for a reporting period beginning before January 1, 2012 (see below for more detail).

#### Classification

Unless an entity chooses to designate a financial asset at fair value through profit or loss (see below), IFRS 9 requires an entity to classify financial assets at either amortized cost or fair value on the basis of

- The entity's business model for managing the financial assets; and
- The contractual cash flow characteristics of the financial asset

### **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 based on a higher level of aggregation, such as a portfolio.

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 realize 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. When 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 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 amortized cost unless the entity elects 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 not met
- A provision that permits the issuer (i.e. the debtor) to prepay a debt instrument or that permits the holder (i.e. the creditor) to put a debt instrument back to the issuer before maturity will meet the condition only if:
  - 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 protects the holder or issuer against changes in relevant taxation or law); and
  - 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:
  - 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 protects the holder or issuer against a change in relevant taxation or law); and
  - 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:
  - Is a variable interest rate; and
  - 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
  - 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
- When a financial asset is subordinated as the result of an entity using multiple contractually linked instruments to create concentrations of credit risk (tranches) where 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, a tranche will only meet the condition if:
  - 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
  - The cash flow characteristics of the underlying pool of financial instruments meet certain conditions specified in IFRS 9; and
  - 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

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**

When the condition that the contractual cash flows are solely payments of principal and interest is not met, or the objective of the entity's business model is other than to hold the financial asset to collect the contractual cash flows, the asset must be measured at fair value.

#### **Embedded derivatives**

When 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 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 amortized cost classification. However, if the

Various examples are included in the Application Guidance to provide illustrations of when the contractual cash flows condition is or is not met. The

embedded derivative introduces an element of leverage into the contractual cash flows, the condition that the contractual cash flows are only payments of principal and interest would not be met (see above).

#### **Host contract outside scope of IFRS 9**

If the host instrument is outside the scope of IFRS 9 (i.e. 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 standards as applicable.

#### **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 amortized 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*).

#### **Gains and losses on assets measured at fair value**

The default recognition requirement under IFRS 9, for a gain or a loss on a financial asset measured at fair value, is through profit or loss unless the financial asset is part of a hedging relationship.

#### **Election to recognize gains and losses on equity investments in other comprehensive income**

At initial recognition, an entity may make an irrevocable election to recognize subsequent changes in the fair value of an investment in an equity instrument that is not held for trading in other comprehensive income. Amounts recognized in other comprehensive income will not subsequently be reclassified

to profit or loss on realization (sometimes referred to as *recycling*). The cumulative gain or loss may, however, be reclassified within equity.

When an entity elects recognition in other comprehensive income, dividends would continue to be recognized in profit or loss unless the dividends 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 for evaluating whether cost might not be representative of fair value.

#### **Impairment**

The reduction in the number of categories of financial instruments to two means that only one impairment method is necessary.

For financial assets held at fair value, all gains and losses are either recognized in profit or loss or in other comprehensive income if the entity elects to recognize gains and losses on equity investments in other comprehensive income. 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 therefore only apply to financial assets measured at amortized cost.

### **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 amortized cost.

### **Reclassification**

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

When 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. When a financial asset is reclassified, IFRS 9 sets out rules for determining the fair value or amortized cost as of 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 changes in intent related to particular financial assets, a temporary disappearance of a particular market for financial assets, and transfers 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 January 1, 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 January 1, 2011. If it adopts IFRS 9 before January 1, 2011, the date of initial application can be any date between the issue of IFRS 9 (November 12, 2009) and December 31, 2010. If the entity adopts IFRS 9 on or after January 1, 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 amortized 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 January 1, 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 and restatement rules:

Adoption period	Beginning before January 1, 2011	Beginning on or after January 1, 2011	Beginning on or after January 1, 2012	Beginning on or after January 1, 2013
Standard mandatorily effective?	No	No	No	Yes
Date of initial application (DIA)	Any date between the issue of IFRS 9 and Dec. 31, 2010 (see above)	Beginning of the reporting period	Beginning of the reporting period	Beginning of the reporting period
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 derecognized at the date of initial application (IFRS 9.8.2.1)

- If an entity measures a hybrid contract at fair value but the fair value of the hybrid contract had not been determined in comparative reporting periods, the fair value of the hybrid contract in the comparative reporting periods is measured as the sum of the fair values of the components at the end of each comparative reporting period (IFRS 9.8.2.5)
- If it is impracticable for an entity to apply the effective interest method or the impairment requirements retrospectively the entity shall measure the fair value of the financial asset at the end of each comparative period as its amortized cost, and similarly fair value at initial application as amortized cost (IFRS 9.8.2.10)
- If an entity previously accounted for an investment in an unquoted equity instrument (or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument) at cost, it shall measure that instrument at fair value at initial application. Any difference between the previous carrying amount and fair value is recognised in the opening retained earnings of that reporting period (IFRS 9.8.2.11)

#### Interim periods

Entities preparing interim financial reports under IAS 34, *Interim Financial Reporting*, 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.

#### GTI IFRS Team issues new guide on deferred tax

On November 30, 2009, the GTI IFRS team issued a new guide, [\*Deferred tax – A Chief Financial Officer's guide to avoiding the pitfalls \(Understanding deferred tax under IAS 12 Income Taxes\)\*](#). Preparation of financial statements under IFRS requires the application of IAS 12, *Income Taxes* (IAS 12). The new

guide summarizes IAS 12's approach to calculating the deferred tax provision in order to help CFOs prioritize and identify key issues. It also includes interpretational guidance in certain problematic areas of deferred tax calculation.

### **GTI IFRS Team issues Example Consolidated Financial Statements 2009**

On November 27, 2009, the GTI IFRS Team issued [\*Example Consolidated Financial Statements 2009\*](#), which illustrate the application of the presentation and disclosure requirements of IFRS by an entity that is not a first-time adopter of IFRS.

The publication reflects changes in IFRS that are effective for the year ending December 31, 2009 and illustrates the adoption of the various newer requirements including:

- IAS 23, *Borrowing Costs* (as revised in 2007)
- IFRS 7, *Financial Instruments: Disclosures* – improving disclosures about financial instruments
- IFRIC 13, *Customer Loyalty Programmes*

IAS 1, *Presentation of Financial Statements* (as revised in 2007) and IFRS 8, *Operating Segments*, which are effective in 2009, were adopted early (in 2008) for the purposes of this publication. The effects of initial application of these changes are therefore shown in GTI's publication *Example Consolidated Financial Statements 2008*. Because many entities will adopt these requirements for the first time in 2009, GTI has for convenience also included sample initial application disclosures in the Appendices to *Example Consolidated Financial Statements 2009*.