

Know your standards

IFRS 9, Financial Instruments

The issue of IFRS 9, *Financial Instruments* is part of the project to replace IAS 39, *Financial Instruments – Recognition and Measurement*. IFRS 9 represents the outcome of work to date undertaken by the International Accounting Standards Board (IASB) in conjunction with the Financial Accounting Standards Board (FASB) in the US to improve and converge financial reporting standards. It was issued in November 2009 and initially dealt with classification and measurement of financial assets. IFRS 9 was subsequently updated in October 2010 to include accounting for financial liabilities.

IFRS 9 is effective for accounting periods commencing on or after 1 January 2013, with earlier application possible. Note that further developments are in progress dealing with impairment, derivatives and hedging. To the extent that IFRS 9 does not yet deal with a particular issue, the requirements of IAS 39 continue to apply.

This article focuses on the accounting requirements relating to financial assets and financial liabilities only. Other aspects of accounting for financial instruments, such as hedging arrangements, will be considered in a separate article.

For 2011 exams, IFRS 9 is examinable in relation to accounting for financial assets only. Other elements of accounting for financial instruments, such as accounting for financial liabilities and hedging arrangements, continue to be accounted for in accordance with IAS 39. You are not required to know the transitional arrangements within IFRS 9 dealing with first-time application of that reporting standard, and nor are you expected to know both sets of accounting requirements relating to financial assets contained within IFRS 9 and IAS 39.

For 2012 exams, IFRS 9 will be examinable in relation to accounting for both financial assets and financial liabilities. If any further amendments are made to IFRS 9 by 30 September 2011 – for example, in relation to accounting for hedging transactions or impairment – they will also be examinable in 2012 exams.

Arguably, IFRS 9 has simplified and improved accounting for financial assets in comparison with its predecessor, IAS 39. The number of classifications has been reduced from four to three, as the available-for-sale classification has not been retained within IFRS 9. This has consequently resulted in elimination of the requirement to recycle gains and losses previously taken to equity upon derecognition of the financial asset, bringing the benefit of reduced complexity of financial reporting information.

IFRS 9, FINANCIAL INSTRUMENTS

AUGUST 2011

There is increased emphasis on fair value accounting and reporting, which is regarded as both relevant and reliable information to those interested in financial reports. IFRS 9 has also reduced the degree of discretion for classification and accounting treatment of financial assets, which should support consistent reporting of financial information relating to financial assets and enhance understanding and comparability of that information.

If we begin with the classification of financial assets, IFRS 9 now classifies financial assets under three headings as follows:

CLASSIFICATION OF FINANCIAL ASSETS

1 Financial assets at fair value through profit or loss (FVTPL)

This is the normal default classification for financial assets and will apply to all financial assets unless they are designated to be measured and accounted for in any other way. This classification includes any financial assets held for trading purposes and also derivatives, unless they are part of a properly designated hedging arrangement. Debt instruments will be classified to be measured and accounted for at FVTPL unless they have been correctly designated to be measured at amortised cost (see later). Initial recognition at fair value is normally cost incurred and this will exclude transactions costs, which are charged to profit or loss as incurred. Remeasurement to fair value takes place at each reporting date, with any movement in fair value taken to profit or loss for the year, which effectively incorporates an annual impairment review.

2 Financial assets at fair value through other comprehensive income (FVTOCI)

This classification applies to equity instruments only and must be designated upon initial recognition. It will typically be applicable for equity interests that an entity intends to retain ownership of on a continuing basis. Initial recognition at fair value would normally include the associated transaction costs of purchase. The accounting treatment automatically incorporates an impairment review, with any change in fair value taken to other comprehensive income in the year.

Upon derecognition, any gain or loss is based upon the carrying value at the date of disposal. One important point is that there is no recycling of any amounts previously taken to equity in earlier accounting periods. Instead, at derecognition, an entity may choose to make an equity transfer from other components of equity to retained earnings as any amounts previously taken to equity can now be regarded as having been realised.

IFRS 9, FINANCIAL INSTRUMENTS

AUGUST 2011

3 Financial assets measured at amortised cost

This classification can apply only to debt instruments and must be designated upon initial recognition. For the designation to be effective, the financial asset must pass two tests as follows:

- The business model test – to pass this test, the entity must be holding the financial asset to collect in the contractual cash flows associated with that financial asset. If this is not the case, such as the financial asset being held and then traded to take advantage of changes in fair value, then the test is failed and the financial asset reverts to the default classification to be measured at FVTPL.
- The cash flow characteristics test – to pass this test, the contractual cash flows collected must consist solely of payment of interest and capital. If this is not the case, the test is failed and the financial asset reverts to the default classification to be measured at FVTPL.

One example of a financial asset that would fail this test is a convertible bond. While there is receipt of the nominal rate of interest payable by the bond issuer, and the bond will be converted into shares or cash at a later date, the cash flows are affected by the fact that the bond holder has a choice to make at some later date – either to receive shares or cash at the time the bond is redeemed. The nominal rate of interest received will be lower than for an equivalent financial asset without conversion rights to reflect the right of choice the bondholder will make at some later date.

This classification of financial asset requires annual review for evidence of possible impairment and, if there is evidence, there must be an impairment review. Any impairment identified must be charged to profit or loss in full immediately.

One problem that may arise in relation to financial assets measured at fair value is whether a reliable fair value can be determined at the reporting date. For exchange-traded financial assets, such as equity shares in a listed entity, this may be a relatively straightforward process. If, however, the financial assets in question are not traded on an exchange, there may be no definitive method to determine fair value at a particular date. This could result in the exercise of judgment or discretion, which could undermine the reliability or relevance of any amounts accounted for as a fair value.

Illustration 1 – classification and measurement of financial assets

An entity, Suarez, purchased a five-year bond on 1 January 2010 at a cost of \$5m with annual interest of 5%, which is also the effective rate, payable on 31 December annually. At the reporting date of 31 December 2010 interest has been received as expected and the market rate of interest is now 6%.

IFRS 9, FINANCIAL INSTRUMENTS

AUGUST 2011

Required:

Account for the financial asset at 31 December 2010 on the basis that:

- (i) it is classified as FVTPL, and
- (ii) it is classified to be measured at amortised cost, on the assumption it passes the necessary tests and has been properly designated at initial recognition.

Answer:

(i) If classified as FVTPL

This requires that the fair value of the bond is measured based upon expected future cash flows discounted at the current market rate of interest of 6% as follows:

Year	Expected cash flows	6% discount factor	Present value \$m
31 December 2011	\$5m x 5% = \$0.25m	0.9434	0.2358
31 December 2012	\$0.25m	0.8900	0.2225
31 December 2013	\$0.25m	0.8396	0.2099
31 December 2014	\$0.25m + \$5m	0.7921	<u>4.1585</u>
			4.8267

Therefore, at the reporting date of 31 December 2010, the financial asset will be stated at a fair value of \$4.8267m, with the fall in fair value amounting to \$0.1733m taken to profit or loss in the year. Interest received will be taken to profit or loss for the year amounting to \$0.25m.

(ii) If classified to be measured at amortised cost

This requires that the fair value of the bond is measured based upon expected future cash flows discounted at the original effective rate of 5%. This will continue to be at \$5m as the following calculation confirms:

Year	Expected cash flows	5% discount factor	Present value \$m
31 December 2011	\$5m x 5% = \$0.25m	0.9524	0.2381
31 December 2012	\$0.25m	0.9070	0.2267
31 December 2013	\$0.25m	0.8638	0.2160
31 December 2014	\$0.25m + \$5m	0.8227	<u>4.3192</u>
			5.0000

In addition, interest received during the year of \$0.25m will be taken to profit or loss for the year.

IFRS 9, FINANCIAL INSTRUMENTS

AUGUST 2011

IMPAIRMENT OF FINANCIAL ASSETS

IFRS 9 effectively incorporates an impairment review for financial assets that are measured at fair value, as any fall in fair value is taken to profit or loss or other comprehensive income for the year, depending upon the classification of the financial asset (see earlier).

For financial assets designated to be measured at amortised cost, an entity must make an assessment at each reporting date whether there is evidence of possible impairment; if there is, then an impairment review should be performed. If impairment is identified, it is charged to profit or loss immediately. Quantification of the recoverable amount would normally be based upon the present value of the expected future cash flows estimated at the date of the impairment review and discounted to their present value based on the original effective rate of return at the date the financial asset was issued.

Illustration 2 – impairment of financial assets measured at amortised cost

Using the information contained within Illustration 1, where the carrying value of the financial asset at 31 December 2010 was \$5m. If, in early 2011, it was identified the bond issuer was beginning to experience financial difficulties, and there was doubt regarding full recovery of the amounts due to Suarez, an impairment review would be required. The expected future cash flows now expected by Suarez from the bond issuer are as follows:

Year	Expected cash flows
31 December 2011	\$0.20m
31 December 2012	\$0.20m
31 December 2013	\$0.20m
31 December 2014	\$0.20m + \$4.4m

Required:

Calculate the extent of impairment of the financial asset to be included in the financial statements of Suarez for the year ending 31 December 2011.

IFRS 9, FINANCIAL INSTRUMENTS

AUGUST 2011

Answer:

The future cash flows now expected are discounted to present value based on the original effective rate associated with the financial asset of 5% as follows:

Year	Expected cash flows	5% discount factor	Present value \$m
31 December 2011	\$0.20m	0.9524	0.1905
31 December 2012	\$0.20m	0.9070	0.1814
31 December 2013	\$0.20m	0.8638	0.1727
31 December 2014	\$0.20m + \$4.4m	0.8227	<u>3.7844</u>
			4.3290

Therefore, impairment amounting to the change in carrying value of (\$5.0m – \$4.329m) \$0.671m will be recognised as an impairment charge in the year to 31 December 2011. Additionally, there will also be recognition of interest receivable in the statement of comprehensive income for the year amounting to (4.329m x 5%) \$0.2165m.

Both the IASB and FASB in the US continue their work on accounting for impairment of financial assets, with a reporting standard expected before the end of 2011.

CLASSIFICATION OF FINANCIAL LIABILITIES

IFRS 9 was updated in October 2010 to include recognition and measurement of financial liabilities. Essentially, the requirements of IAS 39 in relation to financial liabilities are now contained in IFRS 9 and require that financial liabilities should be accounted for as follows:

1 Financial liabilities at fair value through profit or loss (FVTPL)

Like the equivalent classification for financial assets, this will include financial liabilities incurred for trading purposes and also derivatives that are not part of a hedging arrangement.

2 Other financial liabilities measured at amortised cost

If financial liabilities are not measured at FVTPL, they are measured at amortised cost.

IFRS 9 also retains the option for some liabilities, which would normally be measured at amortised cost to be measured at FVTPL if, in doing so, it eliminates or reduces an accounting mismatch, sometimes referred to as 'the fair value option'. Where this is the case, to the extent that part of the change in fair value of the financial liability is due to a change in the entity's own credit risk, this should be taken to other comprehensive income in the year, with the balance of any change in fair value taken to profit or loss. If this accounting

IFRS 9, FINANCIAL INSTRUMENTS

AUGUST 2011

treatment for the credit risk creates or enlarges an accounting mismatch in profit or loss then the gain or loss relating to credit risk should also be taken to profit or loss.

SUMMARY

The overall impact of IFRS 9 is that there is likely to be increased emphasis on fair value accounting for financial assets, rather than the use of other forms of measurement such as amortised cost or historical cost. In addition, accounting for impairment of financial assets has become less complex.

There have been no significant changes to accounting for financial liabilities.

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