



CHARTERED CERTIFIED ACCOUNTANTS

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IFRS 9 'Financial Instruments'

IFRS 9 '*Financial Instruments*' was released in November 2009 and is intended to completely replace IAS 39 '*Financial Instruments: Recognition and Measurement*' by the end of 2010.

Anybody who has knowledge of IAS 39 will agree that this standard was by far one of the most complex standards currently in issue. The new standard is designed to simplify the way entities account for financial instruments and will apply to accounting periods beginning on or after 1 January 2013; but earlier adoption is permitted.

Initial recognition of financial assets

All financial assets are initially measured at fair value plus, in the case of a financial asset not at fair value, through profit or loss transaction costs.

Preparers of financial statements who use IFRS should note that IFRS 9 only deals with the classification and measurement of financial assets. A consistent theme of IFRS 9 is that it requires financial assets to be classified on initial recognition at amortised cost or fair value.

Financial assets are measured at amortised cost dependant on how the entity manages its financial instruments in its business model (see below). If the entity's business model is to hold financial assets in order to collect contractual cash flows, then the financial asset can be measured at amortised cost.

However, the contractual terms must give rise (on specified dates), to cash flows that are solely payments of capital and interest (also referred to as 'principal' and 'interest') on the capital amount (principal amount) outstanding. The financial asset concerned cannot be recognised at amortised

cost if the entity intends to sell it to realise its fair value changes. IFRS 9 does contain several examples to illustrate this condition.

Any other financial asset that does not meet this criteria is measured at fair value.

The business model for recognition of financial assets

Management and key personnel are responsible for their entity's business model in relation to how it manages its financial instruments. (Management and key personnel are dealt with and defined in IAS 24 '*Related Party Disclosures*'). This approach was considered appropriate by the IASB because it aligns the accounting for financial assets with the way the entity deploys the assets in the business.

Withdrawal of other types of financial asset

IAS 39 has the following categories of financial assets:

- Held-to-maturity assets.
- Available-for-sale assets.

In IFRS 9 the above categories are eliminated in an attempt to simplify the process of accounting for such financial instruments.

Embedded derivatives

Under IAS 39, an embedded derivative is a feature within a contract. It acts as a component part of a 'hybrid' financial instrument which also includes a non-derivative host contract. This means that some of the cash flows of the hybrid instrument vary in a similar way to a stand-alone derivative. A 'hybrid' instrument is a combination of both the host contract and the embedded derivative.

A common embedded derivative is where a company raises finance by issuing convertible debt. The host contract is the loan, but this loan contains an 'option' to convert the debt into shares. The 'option' is the embedded derivative because it is deriving its value from fluctuations in the share price. IAS 39 requires the use of 'split accounting' where the host contract (in this case, the loan) is split from the derivative (the option).

Under IFRS 9, embedded derivatives are no longer separated from hybrid contracts that have a financial asset host. Instead, the entire hybrid contract is assessed for classification using the principles above.

Option to recognise at fair value

IFRS 9 allows entities to designate a financial instrument on initial recognition at fair value through profit or loss, even if it meets the criteria for recognition at amortised cost. However, care must be taken here to apply the option when appropriate because the option to measure at fair value should only be exercised where it eliminates, or significantly reduces a measurement or recognition inconsistency, often referred to as an 'accounting mismatch'.

Reclassification

Where an entity changes its business model and the change is significant to the entity's operations and demonstrable to third parties, then reclassification of the financial asset from fair value through profit or loss to amortised cost or vice versa should take place. Such situations are considered very rare but if it is done, it should be done prospectively from the date of reclassification. Any gains, losses or interest are not restated.

Investments in equity instruments

Under IFRS, an entity will prepare the statement of comprehensive income which comprises the usual income statement (UK GAAP currently terms this statement the 'profit and loss account'), but with an added statement being the statement of 'other comprehensive income'. Other comprehensive income contains any gains and losses which have been taken in the statement of financial position (balance sheet) which would traditionally be reported in the statement of recognised income and expenses (SoRIE) such as gains on property revaluations and actuarial gains and losses on defined benefit pension schemes.

Where an entity has shares in other entities (investments in equity instruments), then these should be measured at fair value. Where investments in equity instruments are subsequently remeasured, any gains or losses on remeasurement are recognised in profit or loss. However, under IFRS 9, dividends on investments in equity instruments that are not held for trading are recognised in profit or loss as opposed to other comprehensive income. This is consistent with the requirements laid down in IAS 18 'Revenue', provided that none of the 'dividend' represents recovery of the investment.

For an investment in an equity instrument that is not held for trading, IFRS 9 has an option to allow an entity, on initial recognition, to irrevocably elect to measure it at fair value through other comprehensive income, with only dividend income being recognised in profit or loss.

Users of IFRS 9 should note that no amount recognised in other comprehensive income is ever reclassified to profit or loss at a later date.

Measurement

Under IAS 39, investments in unquoted equity instruments can be measured at cost where fair value cannot be reliably determined. IFRS 9 eliminates this exception and stipulates that all such instruments are measured at fair value. IFRS 9 does, however, contain comprehensive guidance on when cost may be the best estimate of fair value and when cost is not representative of fair value.

Impairment

On the subject of impairment of financial assets, the guidance contained in IAS 39 still applies. In designing this standard, the IASB wanted to simplify the process of accounting for financial assets. For this reason, the numerous impairment methods detailed in IAS 39 have been reduced to one single method of impairment in IFRS 9. The intention here is to improve comparability.

Changes in value of financial assets

Any changes in the fair value of financial assets that are measured at fair value are recognised in profit or loss. However, equity investments which exercise the option to recognise such changes in other comprehensive income should not be measured in profit or loss. This also applies to any gains or losses relating to financial assets that are also part of a hedge relationship.

Financial liabilities

IFRS 9 only deals with financial assets and does not consider financial liabilities. The IASB is in the process of dealing with the issues relating to financial liabilities and is expected to issue final requirements at the end of 2010.

Steve Collings FMAAT FCCA DipIFRS is audit and technical manager at LWA Ltd and a partner in AccountancyStudents.co.uk. He also lectures on financial reporting and auditing issues.

