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November 2009

iGAAP Alert.

IFRS 9 Financial Instruments

In a nutshell

The International Accounting Standards Board (IASB) has issued a standard introducing a new classification and measurement model for financial assets.

The standard introduces the following key changes:

- New classification and measurement requirements for financial assets.
- New criteria for amortised cost measurement.
- New measurement category – fair value through other comprehensive income.
- Impairment assessment only for amortised cost assets.
- No more available-for-sale assets.
- No more held-to-maturity assets and tainting rules.
- No more embedded derivatives in financial assets.
- No more unquoted equity investments measured at cost less impairment.

IFRS 9 has yet to be considered by the ASB.

Background

On 12 November 2009, the International Accounting Standards Board (IASB) issued IFRS 9 *Financial Instruments*. This Standard introduces new requirements for the classification and measurement of financial assets and is effective from 1 January 2013 with early adoption permitted.

The exposure draft for this Standard included both financial assets and financial liabilities within its scope, however, due to concerns raised with the proposals for financial liabilities the scope was restricted to only financial assets.

New requirements for classification and measurement of financial liabilities, derecognition of financial instruments, impairment and hedge accounting are expected to be added to IFRS 9 in 2010 as illustrated in the timetable (see page 2). As a result, IFRS 9 will eventually be a complete replacement for IAS 39 *Financial Instruments: Recognition and Measurement*.

An early adopter of IFRS 9 continues to apply IAS 39 for other accounting requirements for financial instruments within its scope that are not covered by IFRS 9 (e.g. classification and measurement of financial liabilities, recognition and derecognition of financial assets and financial liabilities, impairment of financial assets, hedge accounting, etc.).

Summary of IFRS 9

Under IFRS 9 recognised financial assets that are currently in the scope of IAS 39 will be measured at either amortised cost or fair value.

A debt instrument (e.g. loan receivable) that (1) is held within a business model whose objective is to collect the contractual cash flows and (2) has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding generally must be measured at amortised cost. All other debt instruments must be measured at fair value through profit or loss (FVTPL).

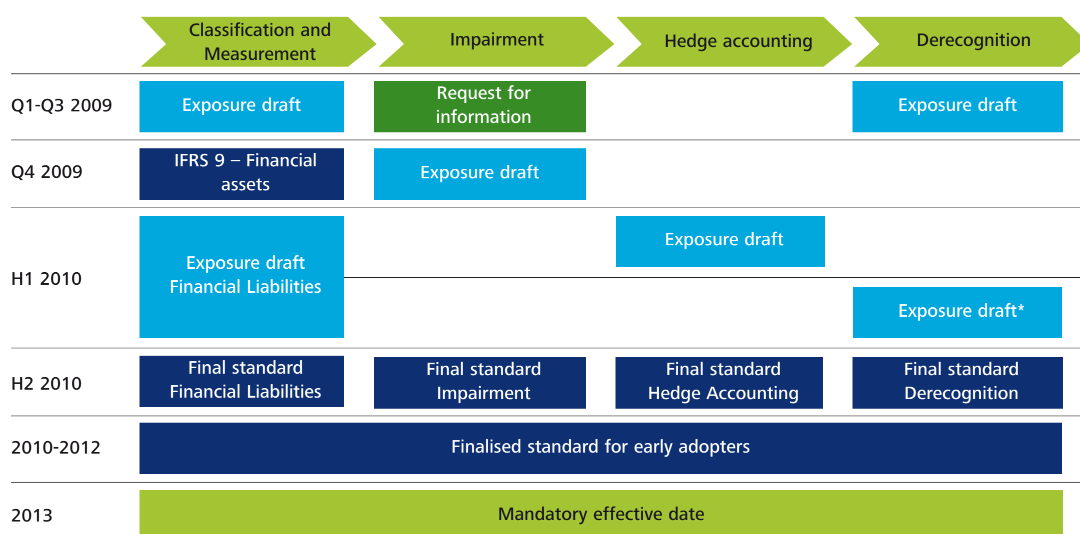
A fair value option is available (provided that certain specified conditions are met) as an alternative to amortised cost measurement.

All equity investments within the scope of IFRS 9 are to be measured at fair value with the default recognition of gains and losses in profit or loss. Only if the equity investment is not held for trading can an irrevocable election be made at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) with only dividend income recognised in profit or loss.

Despite the fair value requirement for all equity investments, IFRS 9 contains guidance on when cost may be the best estimate of fair value and also when it might not be representative of fair value.

All derivatives within the scope of IFRS 9 are required to be measured at fair value. This includes derivatives that are settled by the delivery of unquoted equity instruments, however, in limited circumstances cost may be an appropriate estimate of fair value.

Timeline for replacing IAS 39



*Due to significant changes from the original exposure draft, a revised exposure draft of the proposals for derecognition is expected to be issued.

Debt instruments

A debt instrument will be measured at amortised cost or FVTPL. The available-for-sale and held-to-maturity classifications (including the associated tainting rules) that are currently in IAS 39 are eliminated under IFRS 9. A debt instrument generally must be measured at amortised cost if both the 'business model test' and the 'contractual cash flow characteristics test' are satisfied.

Business model test: The objective of the entity's business model is to hold the financial asset to collect the contractual cash flows (rather than have the business model objective to sell the instrument prior to its contractual maturity to realise its fair value changes).

Contractual cash flow characteristics test: 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. A debt instrument that meets both of the above criteria can still be designated as FVTPL on initial recognition if the fair value designation would eliminate or significantly reduce an accounting mismatch that would exist had the instrument been measured at amortised cost (equivalent to the current IAS 39 fair value option for an accounting mismatch).

Where a debt instrument does not meet the criteria for amortised cost measurement it must be measured at FVTPL.

Business model test

The business model test described above is determined at a higher level than the individual financial instrument level (e.g. portfolio or business unit level). This is not based on management's intent for individual instruments. The Standard also acknowledges that an entity may have different business units that are managed differently. As a result, similar assets may be subject to different business models within the same entity.

Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those assets until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur. For example, an entity's assessment that it holds investments to collect their contractual cash flows is still valid even if they would sell the investments to fund capital expenditure. However, if more than an infrequent number of sales are made out of a portfolio, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

The original proposals in the exposure draft would have prevented an asset acquired at a discount reflecting incurred credit losses ('distressed debt') from being measured at amortised cost because it did not pass the business model test. The Standard takes a different approach, potentially allowing distressed debt to pass the business model test if the business model for the holder is to collect the contractual cash flows on the debt.

Reclassifications

For debt instruments not designated at FVTPL under the fair value option, reclassification is required between FVTPL and amortised cost, or vice versa, if the entity's business model objective for its financial assets changes so that its previous model no longer applies. For example, reclassification from amortised cost to fair value might be required when a financial services firm decides to shut down its retail mortgage business and it no longer accepts new business and is actively marketing its mortgage loan portfolio for sale.

When a reclassification is required it is applied from the first day of the first reporting period following the change in business model. The Standard expects reclassifications to occur very infrequently.

Contractual cash flow characteristics test

The requirement in IFRS 9 to assess the contractual cash flow characteristics of a financial asset has been adapted from a similar approach applied in the *IFRS for Small and Medium-sized Entities* recently issued by the IASB. The concept is that only instruments with contractual cash flows of principal and interest on principal (hereafter referred to as "principal and interest") may qualify for amortised cost measurement. The Standard describes interest as consideration for the time value of money and the credit risk associated with the principal outstanding during a particular period of time. Therefore, an investment in a convertible loan note would not qualify because of the inclusion of the conversion option which is not deemed to represent payments of principal and interest.

This criterion will permit amortised cost measurement when the cash flows on a loan are entirely fixed (e.g. a fixed interest rate loan or zero coupon bond), or where interest is floating (e.g. a GBP loan where interest is contractually linked to GBP LIBOR), or combination of fixed and floating (e.g. where interest is LIBOR plus a fixed spread). Other examples provided in the Standard of instruments that satisfy this criterion include:

- a variable rate instrument with a stated maturity date that permits the borrower to choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term;

- a fixed term variable market interest rate bond where the variable interest rate is capped; and

- a fixed term bond where the payments of principal and interest are linked to an unleveraged inflation index of the currency in which the instrument is issued.

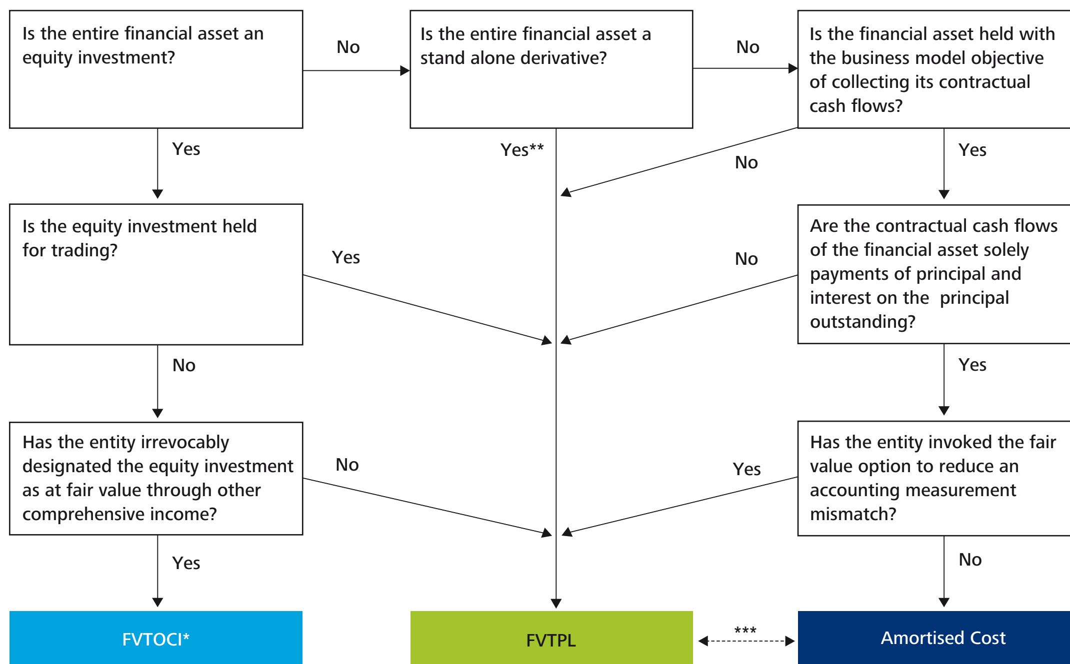
Examples of instruments that do not satisfy this criterion include:

- a bond that is convertible into equity instruments of the issuer; and

- a loan that pays an inverse floating interest rate (e.g. 8% minus LIBOR).

IFRS 9 contains application guidance and further examples illustrating the application of this criterion.

Classification model for financial assets within the scope of IFRS 9



* Dividend income that represents a return on investment is presented in profit or loss.
** The hedge accounting provisions of IAS 39 remain applicable to derivatives designated in effective hedge relationships.
*** Reclassification required when and only when an entity changes its business model for managing its financial assets.

Embedded derivatives

IFRS 9 does not retain IAS 39's concept of an embedded derivative for hybrid contracts if the host contract is a financial asset within the scope of IFRS 9. Consequently, embedded derivatives that would have been separately accounted for at FVTPL under IAS 39 because they were not closely related to the financial asset host will no longer be separated. Instead, the contractual cash flows of the financial asset are assessed in their entirety and the asset as a whole is measured at FVTPL if any of its cash flows do not represent payments of principal and interest as described by the Standard.

As IFRS 9 only applies to financial assets in the scope of IAS 39, the requirement to assess contractual arrangements for non-closely related embedded derivatives still applies to all hybrid contracts with a financial liability host and non-financial host contracts that are outside the scope of IAS 39.

Non-recourse lending

When debt instruments are non-recourse, i.e. the lender's claim is limited to specific assets of the borrower, it will be necessary to consider whether the loan only represents contractual cash flows that are payments of principal and interest. The Standard requires an entity to look through to the underlying assets or cash flows to make this determination. If the terms of the loan give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest the loan cannot be measured at amortised cost.

For example, an entity that is developing an investment property may issue a fixed rate bond whose terms state that the principal and interest on the bond are repayable solely from the sale proceeds of the development property and without recourse to the issuing entity. Such a bond would fail the 'contractual cash flow characteristics test' because the underlying asset to which the bond is contractually linked does not have cash flow characteristics of principal and interest.

Contractually linked instruments

Where the receipts under an asset are paid by the issuer in order of priority over other multiple contractually linked instruments the Standard has specific conditions for the cash flows of such instruments to be regarded as payments of principal and interest. An example would be tranched notes issued from a special purpose entity set up to collateralise debt obligations where payments on the tranches are prioritised resulting in each tranche being relatively more senior or more subordinate to other tranches.

A tranche will only be regarded as containing payments of principal and interest (and therefore potentially eligible for amortised cost measurement) if all the following criteria are met:

- Firstly, the tranche must only have cash flows characteristics that are solely payments of principal and interest on the principal outstanding (e.g. the interest rate is not linked to, say, a commodity index).

- Secondly, the underlying pool of instruments held by the entity issuing the tranche must contain one or more financial assets whose contractual cash flows are only payments of principal and interest. The underlying pool of instruments can contain other instruments, such as derivatives, but these must only reduce the cash flow variability of the pool of instruments held whose contractual cash flows are solely payments of principal and interest or align the fixed or floating nature of the interest rate, foreign currency risk, or timing differences of the cash flows of the tranches and the cash flows of the underlying pool of financial instruments. Where derivatives are used to reduce the cash flow variability of instruments in the pool, the combined cash flows must give rise to payments of principal and interest for this condition to be satisfied.

- Thirdly, the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments.

To make this assessment the entity has to look through until it can identify the pool of instruments that are creating, rather than passing through, the cash flows.

In cases where the underlying pool of instruments can change, all possible permitted instruments must be considered as part of this assessment. For example, if the pool of instruments at initial recognition of the tranche does not include written credit derivatives, but the pool of instruments could include these in the future, then the tranche is not eligible for amortised cost measurement.

When it is impracticable to assess the underlying pool of instruments the test is deemed to fail and the tranche must be measured at FVTPL.

Fair value option

An entity may irrevocably elect on initial recognition to measure a financial asset at FVTPL if that designation eliminates or significantly reduces an accounting mismatch had the financial asset been measured at amortised cost.

For example, an entity may hold a fixed rate loan receivable that it commercially hedges with an interest rate swap, with matching terms, that swaps the fixed rate to a floating rate. Assuming the conditions for amortised cost measurement are met, measuring the loan asset at amortised cost would create a measurement mismatch with the interest rate swap held at FVTPL. In this case the loan receivable could be designated at FVTPL under the fair value option to reduce the measurement mismatch that arises from measuring the loan at amortised cost.

Equity investments

Under IFRS 9 all equity investments held must be measured at fair value. The current exemption in IAS 39 that requires unquoted equity investments to be measured at cost less impairment where fair valuation is not sufficiently reliable is not available under the new Standard. However, IFRS 9 does contain guidance on when cost might be the best estimate of fair value of an unquoted equity investment that is difficult to value because of little or no timely or relevant information. It also gives examples of when cost will not be representative of fair value such as when there has been a significant change in the performance of the investee compared with budgets, plans or milestones.

Gains and losses arising on equity investments are recognised in profit or loss (i.e. they are measured at FVTPL) unless the entity irrevocably designates at initial recognition that they should be recognised in other comprehensive income (i.e. designating them as at FVTOCI). Designation at FVTOCI is not permitted if the equity investment is held for trading.

If the equity investment is designated as at FVTOCI then all gains or losses (except dividend income) are recognised in other comprehensive income without any subsequent reclassification to profit or loss (although a transfer of the cumulative gain within equity is permitted). Dividend income is recognised in profit or loss in accordance with IAS 18 *Revenue*.

Designation as at FVTOCI means that the current requirements in IAS 39 to perform an assessment of impairment and to reclassify cumulative fair value gains or losses on disposal no longer apply because all fair value movements other than dividend income remain permanently in equity.

As a consequential amendment, IFRS 7 is amended to require extensive disclosures regarding investments in equity instruments designated as at FVTOCI, including why an entity has chosen to designate as at FVTOCI.

Derivatives

Under IFRS 9, all derivatives within its scope must be measured at fair value; therefore similar to the changes regarding equity investments described above, the new Standard removes the requirement to measure at cost derivatives that are linked to and will result in the delivery of an unquoted equity investment where fair value is not sufficiently reliable. However, IFRS 9 describes in certain limited cases where cost maybe acceptable as a best estimate of fair value.

Impact of IFRS 9

In some cases IFRS 9 will result in more financial assets at fair value, in others less. The impact will depend on what types of financial asset an entity holds, how it has classified them previously, and what choices it makes under the new classification model.

One of the most significant changes will be the ability to measure some debt instruments (e.g. investments in government and corporate bonds) at amortised cost which under IAS 39 would in many cases have been measured at fair value if quoted in an active market. Other instruments, such as asset-backed securities (e.g. some cash-collateralised debt obligations) and service concession receivables, that may under IAS 39 have been measured entirely at amortised cost or as available-for-sale will more likely be measured at FVTPL.

Hybrid financial assets with separated embedded derivatives at FVTPL (e.g. synthetic-collateralised debt obligations) will instead by measured at FVTPL in their entirety.

Assets that are currently classified as held-to-maturity are likely to continue to be measured at amortised cost as they are held to collect the contractual cash flows and often give rise to only payments of principal and interest. However, the current tainting rules and restrictions from applying hedge accounting for interest rate risk or prepayment risk that apply to held-to-maturity assets will be removed.

Changes in the requirement to test financial assets for impairment

Financial asset	IAS 39 classification	Impairment testing required?	IFRS 9 classification	Impairment testing required?
Debt instruments	Available-for-sale	Yes	Amortised cost	Yes
	Loan and receivable	Yes	FVTPL	No
	Held-to-maturity	Yes		
	FVTPL	No		
Equity investments	Available-for-sale	Yes	FVTOCI	No
	Cost less impairment	Yes	FVTPL	No
	FVTPL	No		

The elimination of the available-for-sale category and the requirement for all equity investments to be measured at fair value removes the multiple impairment methodologies that currently exist in IAS 39 (as illustrated in the table above). IFRS 9 only requires impairment assessment for financial assets measured at amortised cost. The rules on impairing amortised cost assets remain unchanged at this stage, but they are potentially subject to change under the proposals in the IASB's exposure draft *Financial Instruments: Amortised Cost and Impairment*, issued in November 2009, which proposes an 'expected loss' approach to impairment measurement.

Effective date, comparative information and transition

The effective date of IFRS 9 is for annual periods beginning on or after 1 January 2013, with early adoption permitted. However, reporters complying with endorsed IFRS should note that endorsement of IFRS 9 has been postponed to allow additional time to evaluate it.

When the Standard is applied it is required to be applied retrospectively. However, the business model assessment is to be made at the date of initial application (which is the date when an entity first applies IFRS 9). Also, designation as at FVTPL or FVTOCI, or de-designation of financial instruments that were previously designated as at FVTPL, is to be made on the basis of the facts and circumstances that existed at the date of initial application.

A financial asset or financial liability designated as at FVTPL under existing IAS 39 on the basis of an accounting mismatch can only be retained if the accounting mismatch continues to exist at the date of initial application. If the accounting mismatch does not exist at the date of initial application then the previously designated fair value option must be revoked. An entity may also choose to revoke its previous designation of a financial asset or financial liability as at FVTPL if it had previously been designated due to an accounting mismatch.

In cases where retrospective application is not practical or requires hindsight, other practical expedients other than full retrospective application are required.

Entities adopting the new Standard with an initial application date before 1 January 2012 will be exempt from the requirement to restate prior periods.

Financial liabilities

The scope of the original exposure draft for this Standard included both financial assets and financial liabilities. Comments received from respondents to the exposure draft raised concerns about the requirement for financial liabilities with cash flow characteristics that do not represent payments solely of principal and interest to be measured at FVTPL in their entirety due to the resulting fair value movements due to own credit risk being recognised in profit or loss.

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Designed and produced by The Creative Studio at Deloitte, London. 1271A

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