FROM IAS 39 TO IFRS 9: MORE THAN JUST A NAME CHANGE

Stephen Chan, Partner and Head of Technical & Training, BDO Hong Kong, explains the background to a new IFRS and the key changes.

BACKGROUND

IAS 39 *Financial Instruments: Recognition and Measurement* establishes the principles for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. It also deals with the classification of financial instruments, their ongoing measurement (including when impairment is required), when financial instruments should be recognised and derecognised, and hedge accounting requirements. At the G20 summits in 2009, world leaders declared that improvements were needed to financial reporting. As IAS 39 is widely considered to be one of the most 'unfriendly' IFRSs due to its complexities and internal inconsistencies, the IASB has significantly accelerated its project to replace the standard.

However, replacing IAS 39 is no easy task. The IASB therefore divided the project into various chunks. IFRS 9 *Financial Instruments* (issued 12 November 2009) is the first milestone but is also only part of the 'solution', because it covers only the classification and measurement of financial assets. The IASB has an ambitious target of completing this replacement project during 2010 as set out below:

PLANNED PUBLICATIONS

- Improved derecognition requirements of financial assets (and liabilities), covered by the exposure draft (ED) issued by the IASB in April 2009.
- Revised impairment methodology, covered by the IASB's November 2009 ED, which was out for consultation until 30 June 2010.
- Enhanced guidance on hedge accounting; an ED was expected to be published in the first quarter of 2010 (unfortunately delayed).
- New requirements for classification and measurement of financial liabilities, covered by the IASB's July 2009 ED, but not yet finalised pending re-consideration.

IFRS 9 applies to annual accounting periods commencing on or after 1 January 2013, with earlier application permitted (subject to local laws and regulations). If it is applied for a period beginning before 1 January 2013, disclosure is required of that early adoption and the extensive consequential amendments to other IFRSs also need to be applied.

The new standard is required to be applied on a fully retrospective basis, subject to extensive transitional provisions. However application of IFRS 9 to financial assets in comparative periods where those financial assets have already been derecognised at the date of initial application is prohibited.

A number of jurisdictions including Hong Kong have adopted IFRS 9 with the same effective date. However, the European Union (EU) has announced its decision to delay its adoption in the EU pending further consideration.

KEY CHANGES

The following is a very brief outline for some of the more important changes introduced by IFRS 9.

NEW SINGLE MODEL FOR CLASSIFICATION OF FINANCIAL ASSETS

IFRS 9 eliminates 'the held to maturity' category and the related 'tainting' rules, and also the 'available for sale' and 'loans and receivables' categories by requiring that on initial recognition, all financial assets are classified into one of just two measurement categories – amortised cost or fair value (FV).

NEW CRITERIA FOR AMORTISED COST MEASUREMENT

A financial asset is measured at amortised cost only if it meets two conditions: the objective of an entity's business model is to hold the financial asset in order to collect 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 amount outstanding.

NO EXEMPTION FROM FV MEASUREMENT FOR UNQUOTED EQUITY INVESTMENTS

Investments in equity instruments do not meet the conditions to be measured at amortised cost because they do not contain contractual terms that give rise to cash flows on specified dates that are solely payments of principal and interest on the principal amount outstanding. Consequently investments in equity instruments are measured at FV. IFRS 9 has no exemption from FV measurement for those instruments for which FV cannot be reliably measured.

NEW FV MEASUREMENT CATEGORY: THROUGH OCI

For investments in equity instruments which are not held for trading (eg, those held for strategic purposes), IFRS 9 allows an entity, on initial recognition, to make an irrevocable election (on an instrument-by-instrument basis) to recognise all changes in FV in other comprehensive income (OCI). There are no transfers from OCI to profit or loss (that is, no recycling) and hence no impairment requirements. Dividends from such designated equity instruments are recognised in profit or loss when the right to receive payment of the dividend has been established.

STRICTER RESTRICTION ON APPLYING FV OPTION

IFRS 9 includes an election, similar to that of IAS 39, which permits an entity, on an optional basis, to classify a financial instrument or group of instruments at FV where that financial instrument would otherwise be measured at amortised cost.

In a change from IAS 39, this option is only available if the designation results in the elimination of, or significant reduction in, a measurement or recognition inconsistency.

STRICTER RESTRICTION ON RECLASSIFICATION

The classification of financial assets is made on initial recognition. Reclassification after initial recognition is prohibited, unless an entity fundamentally changes its business model for managing its financial assets, in which case reclassification is required. The circumstances in which reclassification is required are extremely restrictive.

DIFFERENT ACCOUNTING FOR CONTRACTS CONTAINING EMBEDDED FEATURES

The terms of a financial asset may include cash flow characteristics which contain certain embedded features, such as interest rate floors and caps, early repayment features and extension provisions. Provided the host contract is within the scope of IFRS 9 and all of the conditions in IFRS 9 are met, these financial assets are measured at amortised cost and the embedded features are not bifurcated and accounted for separately. Where the host contract is not within the scope of IFRS 9, the current guidance in IAS 39 continues to apply to the analysis and accounting treatment of embedded derivatives.

In a forthcoming second article for the faculty I hope to spell out some of the practical implications of IFRS 9 for corporate entities.

IFRS: ROOM FOR IMPROVEMENT?

Bill Hicks, Group Financial Controller at Tate & Lyle plc, presents an alternative view on where IFRS are heading.

Since its evolution from the IASC (a few things to a few men) 10 years ago, not only has the International Accounting Standard Board (IASB) become one of the two most prominent standard setters, it has raised the awareness of accounting issues and promulgated genuine improvements in financial reporting. Significant credit for this must go to Sir David Tweedie, who has been an articulate and persuasive advocate of the work of the Board, despite his terrible and oft-repeated jokes. So, everything's alright then is it? Er, no, not really.

There is not a particular moment that I can point to where the wheels came off the bus and the Board began to lose the confidence of many of the group of preparer constituents to which I belong, although there were clear signs around the time of the original issue of IFRS 3 on business combinations.

So where are we now? It seems to me that the problems we face from the IASB and its direction of travel can be summarised under three broad headings:

- The accounting model is too academic, leading to financial reporting that fails to meet one of its principal objectives, that of communication.
- The Board is too dogmatic in its approach and seems unwilling or unable to respond to criticism or suggestions.
- The agenda is too crowded and the Board's goals are inappropriate.

All these issues are linked, but I will address each individually, identifying some of the roots and effects of each.

The refrain that the numbers in the financial statements bear no relationship to the results of the business is a familiar one and the recent increase in the use of non-GAAP measures by companies simply reinforces this perception (or, indeed, reality). This seems odd considering the Board's aspiration to move to a presentation of the financial information 'through the eyes of management', but a glance at the proposed conceptual framework soon clears up this apparent contradiction. In the