

IASB completes Phase 1 of IFRS 9: *Financial Instruments – Classification and Measurement*

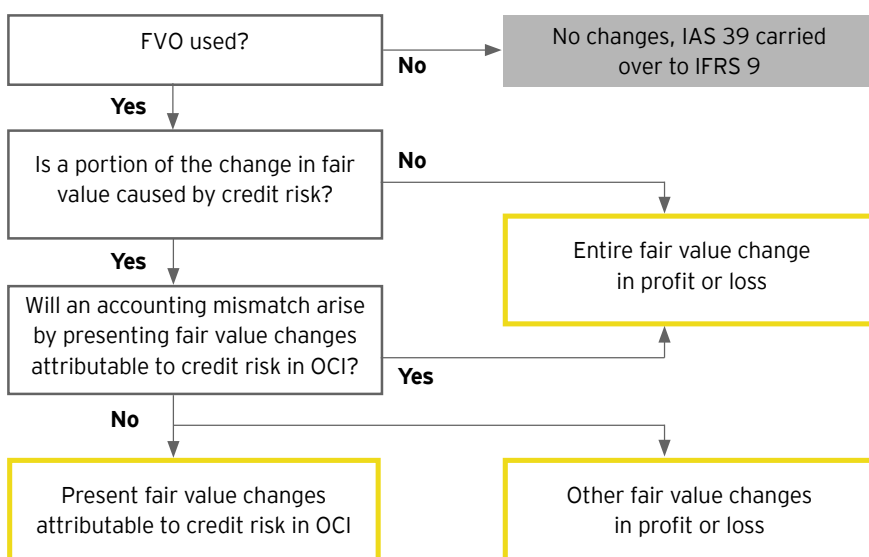
Background

In November 2009, the International Accounting Standards Board (the IASB or the Board) issued the first part of Phase 1 of IFRS 9: *Financial Instruments* dealing with the classification and measurement of financial assets within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. This year, on 28 October, the Board issued amendments to IFRS 9 (the Amendments) to address financial liabilities. The Amendments also incorporate in IFRS 9 the current derecognition principles of IAS 39. Improved disclosure requirements for the transfer of financial assets were recently published as amendments to IFRS 7: *Financial Instruments: Disclosures*.

Financial liabilities

The Board had previously decided to retain the existing IAS 39 classification and measurement requirements for financial liabilities not designated at fair value through profit or loss using the Fair Value Option (FVO) (i.e., financial liabilities at amortised cost and held for trading liabilities). The Board also decided to retain the criteria within IAS 39 for using the FVO for financial liabilities. As a result, the changes resulting from the Amendments only affect the measurement of FVO liabilities. All other requirements in IAS 39 in respect of liabilities are carried forward into IFRS 9. However, loan commitments and financial guarantee contracts which have been designated under the FVO are scoped out of the Amendments. The impact of the Amendments is summarised in the flow chart below:

Financial liabilities



Somewhat controversially, the decision to retain the requirements of IAS 39 means that while the complex embedded derivative rules are retained for liabilities, they are no longer applicable to assets under IFRS 9. The Board decided on this approach after receiving feedback that too many liabilities would need to be reported at fair value unless the embedded derivative rules were retained. In light of the difficulties experienced in interpreting and applying the embedded derivative rules under IAS 39 in the past, our preference would have been for a simplification of the rules.

The Amendments finalise the proposals that were put forward in the exposure draft, *Fair Value Option for Financial Liabilities* (the ED) earlier this year. The publication of the Amendments completes the classification and measurement phase of the Board's ongoing project to replace IAS 39 with IFRS 9.

What are the changes?

For FVO liabilities, the amount of change in the fair value of a liability that is attributable to changes in credit risk must be presented in other comprehensive income (OCI). The remainder of the change in fair value is presented in profit or loss, unless presentation of the fair value change in respect of the liability's credit risk in OCI would create or enlarge an accounting mismatch in profit or loss.

Assessment of accounting mismatch

To determine whether the treatment would create or enlarge an accounting mismatch, the entity must assess whether it expects the effect of the change in the liability's credit risk will be offset in profit or loss by a change in fair value of another financial instrument. This expectation must be based on an economic relationship between the characteristics of the liability and the other financial instrument. The

example given in the guidance to the Amendments is where a bank sells bonds that match the characteristics of its mortgage loans and the terms of the loans permit mortgage customers to prepay their loans by buying bonds in the market at fair value and delivering them to the bank. As a result, the fair value of the loans will reflect the fair value of the bonds. In this example, there is a contractual linkage between the bond and the mortgage, but the guidance states that there does not need to be a contractual linkage for an accounting mismatch to occur. If such a mismatch does arise, an entity will be required to present all fair value changes of the liability in profit or loss.

The determination of whether there will be a mismatch will need to be made at initial recognition of individual liabilities and will not be re-assessed. For existing FVO liabilities, the assessment will be carried out based on facts and circumstances that exist at the date of initial application of this phase of IFRS 9.

Guidance on the meaning and measurement of a liability's credit risk

The current guidance on how to measure the change in the fair value of a liability as a result of a change in the liability's credit risk is included in IFRS 7. The Amendments carry this guidance over to IFRS 9, but with one clarification (see below). The default method in the guidance suggests that any changes in fair value other than changes in market risk factors, such as a benchmark interest rate, are attributable to the credit risk of the liability. This would, therefore, include any liquidity premium associated with the liability. Other methods are also acceptable if they provide a more faithful representation of the changes in the fair value of the liability attributable to the changes in its credit risk.

The Amendments clarify that credit risk as defined in IFRS 7 is different from asset-specific performance risk. Credit risk is the risk that an entity will fail to discharge a particular obligation. Asset-specific performance risk is the risk that an asset or assets will perform poorly, with a direct impact on the performance of the related liability due to a contractual relationship between the assets and liabilities. Two examples are given in the guidance to the Amendments.

The first example is of a Special Purpose Entity (SPE). In this example, amounts due to the SPE's investors are restricted to the cash flows generated by the SPE's underlying assets. The assets of the SPE are legally isolated and ring-fenced for the benefit of the investors. In this example, the entire movement in the fair value of the liability is deemed to reflect the asset performance and there is no credit risk. Consequently, it is taken to profit or loss.

The second example is of a liability with a unit-linking feature whereby the amount due to investors is contractually determined based on the performance of specified assets. The effect of the unit-linking feature on the fair value of the liability is asset-specific performance risk, not credit risk. In the mortgage/bond example above, where the treatment would result in a mismatch, the fair value of the assets reflects the fair value of the liability. In contrast, in this example, the fair value of the liability is determined by the fair value of the assets.

In addition, unlike the SPE example, there is no legal isolation of the assets in the unit-linking example. As a result, potentially, the entity issuing the unit-linking feature could fail to perform on the liability due to reasons unconnected with the performance of the linked assets. Hence, although not mentioned in the guidance, the liability will presumably also give rise to credit risk and changes in the fair value of the liability reflecting this risk would, we assume, need to be recorded in OCI.

As a result of the clarification, the IFRS 7 disclosure of financial institutions in respect of the effect of changes in own credit risk on the fair values of liabilities designated using the FVO may need to change. This might be the case especially where financial institutions consolidate SPEs and do not guarantee the performance of the issued notes.

Recycling

The Amendments prohibit any recycling through profit or loss of amounts recognised in OCI upon derecognition of the liability. Instead, these amounts may be transferred to retained earnings upon derecognition. This is similar to the treatment of fair value changes on equity investments designated as fair value through OCI.

Other changes

Liabilities arising from certain derivatives on unquoted equity instruments will no longer be able to be measured at cost and will be required to be measured at fair value.

Effective date and transition

The effective date and the transition requirements for the Amendments are similar to those set out in the existing version of IFRS 9, issued in November 2009. The Amendments are mandatory for annual periods beginning on or after 1 January 2013. Early application is permitted, provided that an entity also applies the IFRS 9 requirements in respect of the classification and measurement of financial assets (Assets Phase).

In practice, entities that have not already adopted the Assets Phase will most likely apply the Assets Phase and the Amendments simultaneously. However, entities that have already adopted the Assets phase will have a different date of initial application for the Amendments.

The Amendments are required to be applied retrospectively. Entities will not be permitted to make new or revoke existing FVO designations when applying the Amendments. The FVO can only be revoked when applying the Assets Phase, unless an entity adopts both the Assets Phase and the Amendments concurrently.

There will be no relief from restating comparative information unless an entity applies the Amendments before 1 January 2012. However, if an entity decides to restate comparatives in relation to the Amendments, it will be required to do so for the Assets Phase as well, if applying both sets of provisions concurrently.

Business Impact

The Amendments will only affect those entities which have or will have designated liabilities at fair value through profit or loss. For example, entities that issue debt and designate it under the FVO will be affected as fair value changes in respect of credit risk will no longer be reflected in profit or loss unless there is an accounting mismatch. As a result, entities which recorded fair value gains in profit or loss when their credit spreads widened during the crisis (in 2007 and 2008) will not be required under IFRS 9 to record the subsequent loss through profit or loss if the spread narrows and as the liabilities mature.

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EYG no. AU0680

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