# IFRS 9: A Standard on Financial Instrument Accounting

***(IFRS) 9* has come as a replacement to International Accounting Standard *(IAS) 39*. IAS 39 has been considered as very complex and difficult to apply across countries, thus various accounting bodies urged the International Accounting Standard Board (IASB) to come out with reduced complexity of the accounting standards for financial instrument and provide a single set of high quality standard. The IASB project plan for the replacement of IAS 39 consists of three main phases. Phase 1 includes *Classification and Measurement* of financial assets and liabilities; Phase 2 includes *Amortised Cost and impairment* of financial assets; and Phase 3 involves Hedge accounting. Read on…**

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## Applicability

IFRS 9 applies to financial statements for annual periods beginning on or after 1st January 2015, though early adoption is permitted as per the Exposure Draft issued on 4th August, 2011

## Current Status

The IASB has published in November 2009 *IFRS 9 Financial Instruments*, which covered the classification and measurement of *financial assets*. In October 2010, the requirement for classifying and measuring *financial liabilities* were added to IFRS 9, which completes entirely the Phase 1 of IFRS 9.

The IASB has completed the Supplementary documents for Phase 2 and Phase 3 by adding the impairment and hedge accounting requirements to IFRS 9 and thereby replacing IAS 39 in its entirety. However, the redeliberations are in progress.

## Phase 1: Classification and measurement

***Meaning of Financial Asset:*** Financial asset consist of Debt and Equity Securities, Trade Receivables and Derivative Financial assets.

***Treatment of Financial Assets under IFRS 9 (Phase 1):*** IFRS 9 replaces the multiple classification and measurement models in IAS 39 with a single model that has only two classification categories:

- Amortised cost
- Fair value

Classification under IFRS 9 is driven by the entity's Business Model in order to manage the financial assets and the contractual characteristics of the financial assets.

### Business Model Test:

- Business model test is a new accounting concept. There can be more than one business model defined for an entity.
- Assessment is based on how key personnel actually manage the business, rather than management intent for specific financial assets and also the assessment shall not be at an individual instrument level, but at the portfolio level.

***Current Approach by Companies:*** Companies at inception establish the nature and risk of the asset and accordingly classify the category.

***Proposed Approach in the Standard by Companies:*** First to assess the nature of business and then allocate the financial asset.

IFRS 9 requires companies to focus on how risky the business strategy behind an entity's portfolio of asset and then concentrate on how risky the asset is. Companies need to accumulate more historical analysis to have clear understanding of its business and investment in financial asset when defining its business model.

***Concept of Cash Flow Characteristics Test:*** Instruments with contractual cash flows of principal and interest on principal would qualify for amortised cost measurement.

Also, interest is consideration for the time value of money and credit risk associated with the principal outstanding during a specific period.

Therefore, an investment in a convertible debt instrument would not qualify because of the inclusion of the conversion option, which is not deemed to represent payments of principal and interest.

The cash flow characteristics criterion is met when the cash flows on a loan are entirely fixed or floating and also when interest is a combination of fixed and floating.

***Measurement at Amortised Cost:*** A financial asset is measured at amortised cost if two criteria are met:

a) Objective of the business model is to hold the financial asset for the collection of the contractual cash flows,
b) The contractual cash flows under the instrument solely represent payments of principal and interest.

***Concept of Amortised Cost:*** Amortised cost is the cost of a security adjusted for the amortisation of any premium or discount.

For example, if a debt instrument with a par value of 100 is purchased at a price of 110, it will be initially recognised at 110 but the difference between 110 and 100 (par value) is amortised over the life of the asset, so that the cost of the instrument will gradually move from 110 to 100.

Financial instruments not eligible for amortised cost are measured at fair value, with gains and losses recorded in net income.

An exception is allowed, however, for equity instruments that can be accounted for at fair value through other comprehensive income.

***Concept of Fair Value:*** Under IFRS, the significant percentage of the balance sheet would have to be presented at fair value as compared with the current practices of carrying the assets and liabilities in the balance sheet at historical cost for the banking book and lower of cost or market value for trading book.

This may result in significant volatility in the income statements of the bank.

***Definition of Fair Value (existing):*** "The amount for which an asset could be exchanged, a liability settled or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction"

IASB has issued exposure draft as "Fair value measurement," and under that fair value has been defined as "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (current exit price)."

***Total Comprehensive Income:*** Comprehensive Income includes the following:

- Profit/Loss for the year from Continuing Operations
- Profit/Loss for the year from Discontinuing Operations

### Other Comprehensive income (OCI):

- Exchange differences in translating foreign operations
- Gain/Loss on fair value changes in AFS financial instruments, Cash Flow hedges
- Actuarial Gain/Loss on defined benefit pension plans
- Share of other comprehensive income of Associates
- Income tax relating to items of other comprehensive income

### Reclassification:

- Reclassifications between Fair Value and amortised cost of financial assets are expected to be few as they are only permitted when there is a change in the entity's business model objective for its financial assets.

- Additionally, reclassifications are not permitted where the entity has designated equity as fair value through other comprehensive income (FVTOCI) or where the FVTPL options have been exercised.
- Eventually it means that for debt instruments, reclassification is required between FVTPL and amortised cost or vice versa, if and only if the entity's business model objective for its financial assets changes so its previous model assessment would no longer apply.
- If reclassification is appropriate, it must be done prospectively from the reclassification date. An entity does not restate any previously recognised gains, losses, or interest.

***Equity Instruments:***

- All equity investments are measured at Fair Value through Profit and Loss Account (FVTPL).
- If an equity investment is not held for trading, then an entity can choose irrevocably to classify into fair value through other comprehensive income (FVTOCI); however, dividend income can be recognised in profit or loss.
- This FVTOCI option is only available for equity instruments.
- Under IAS 39 there was an option that unquoted equities can be taken at cost; however, under IFRS 9, it has been eliminated and all equity instruments shall be recognised at Fair value.
- Despite the fair value requirement for all equity investments, IFRS 9 includes on limited circumstances, where the cost of an equity instrument will be considered as appropriate estimate of fair value.

***Derivatives:***

- All derivatives, including those linked to unquoted equity investments, are measured at fair value. Value changes are recognised in profit or loss unless the entity has elected to treat the derivative as a hedging instrument in accordance with IFRS 9 – Hedge Accounting, in which case the requirements of IFRS 9 apply.

**Loans and Receivable:**

- Under IFRS 9, loans and receivable portfolio are accounted on amortised cost basis, provided these loans do not contain any exotic embedded derivatives.
- Basic embedded derivatives, such as caps and floor or normal prepayment or extension terms, do not taint amortisation accounting.
- A loan with a convertible option is also not eligible for amortisation accounting and will have to be accounted for on a fair value basis with changes taken to the income statement.
- Loan portfolio is accounted for on a fair value basis in cases where banks transfer/securitise their loan portfolio.
- Amortisation accounting is also not allowed for certain non-recourse loans. For example, when a loan to a real estate developer states that the principal and interest on the loan are repayable solely from the sale proceeds of a specific real estate. In such cases, the 'contractual cash flow characteristics' is not met and hence, such loans are accounted on a fair value basis.

***Summary of PHASE I***

2 measurement categories in IFRS 9 instead of 4 in IAS 39

| ***IAS 39*** | ***IFRS 9*** |
|---|---|
| *1) Financials Assets at Fair value through Profit and Loss* | *1) Financials Assets measured at Amortised cost* |
| *2) Loans and Receivable* | *2) Financials assets measured at Fair value* |
| *3) Held-to-maturity investments* | |
| *4) Available for sale Financial assets* | |

**Classification** *depends on the entity's business model for managing financial assets and on the characteristics of the financial asset in terms of cash flows*

*A* ***financial asset*** *is measured at amortised cost if both of the following conditions are met:*

- *the objective of the business model is to hold assets in order to collect contractual cash flows*
- *the contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding*

*All other financial assets (in particular, equity instruments) are measured at fair value with changes recognised in P&L; but option for recognition in other comprehensive income available for equity investments*

**ED on Fair Value Option for Financial Liabilities**

The Board has decided to retain an existing requirement for classifying and measuring financial liabilities of IAS 39, except for a particular requirement related to the fair value option.

***What does it mean by change in entity's own credit risk and how it can be accounted?***

When entities creditworthiness deteriorates, the fair value of its own issued debt decreases due to higher discount rates applied to contractual cash flows, resulting in recording the gain in income statement. Recording such type of gain was not found useful to many investors. Thus, ED has proposed the two-step approach for measuring the financial liability at fair value.

- The total fair value changes of these liabilities would be separately shown in Profit and Loss account.
- At the same time portion of change attributable to changes in liabilities credit risk would be reclassified from Profit or Loss to Other Comprehensive Income.
- The amount presented in Other Comprehensive Income would never be taken to Profit and Loss account.
- In a nutshell, it means that effect of change in liabilities credit risk would not impact reported net income.

Changes in credit risk component of financial liability will not impact profit and loss, except when the financial liability is held for trading, rather it will be presented in Other Comprehensive income.

### Phase 2: ED on Financial instruments: Amortised Cost and Impairment

- The International Accounting Standard Board (IASB) proposed standard on Impairment of loans is looking at a model that is based on expected losses, rather than incurred losses.
- In other words, the proposed standard requires estimated credit losses to be included in the determination of the effective interest rate, for purposes of amortisation accounting.
- It will lead to significant increase in subjectivity and judgment.
- Estimation of future cash flows, after adjusting for credit losses, would be operationally challenging and would need significant modification to IT systems.

**FRS 9 requires companies to focus on how risky the business strategy behind an entity's portfolio of asset and then concentrate on how risky the asset is. Companies need to accumulate a more historical analysis to have a clear understanding of its business and investment in financial asset when defining its business model.**

**ASB has issued exposure draft as "Fair value measurement," and under which fair value has been defined as "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (current exit price)."**

**Expected loss model:** A model that recognises expected losses and changes in expected losses on an existing financial asset portfolio.

***Incurred Loss Model:*** A model that recognises credit losses after it is "incurred," that is, there is evidence that losses are probable and measurable.

***Treatment of Credit Loss:*** Credit losses are viewed differently in both the Expected Loss model and the Incurred loss model.

Under Expected Loss model, initial expected credit losses are allocated to the period when the revenue is recognised for the financial asset.

Under Incurred Loss model, losses are allocated to a period when the loss is incurred.

***Defining Expected Losses:*** Estimation of expected loss requires a historical loss experience. A historical loss experience shall be adjusted to reflect effects of conditions that did not affect the period in which the historical loss experience is based and to remove the effect of conditions in the historical period that do not exist at the reporting date.

Entities with insufficient experience or no entity specific credit loss experience may use peer group experience of comparable portfolios.

***Treatment of Revenue:*** Under Expected loss model, Revenue is reduced to reflect expected future credit losses at inception, wherein under Incurred loss model, the revenue is recognised in full without considering expected credit losses, which are separately recognised as impairment charges at the time when it actually occurs.

Income under both the models would be same over the life of the asset.

The Expected loss model provides consistency with interest revenue recognition. Under this model, initially expected credit losses are reflected over a period of loan.

***Expected Cash flows:*** Expected cash flow is estimated either of the following:

- Portfolio basis
- Individual basis

***Individual basis:*** Banks and financial institutions maintain a low amount of loans on the portfolio

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basis; there would be certain loans maintained by exception at the individual basis as well based on the characteristics suitable to the type of loan.

The Expected loss model can be applied to individual loans like portfolio loans, but it will be difficult to arrive at an accurate estimate of expected cash flows as changes are less likely to be recognised until evidence of such changes become apparent.

***Portfolio basis:*** The Portfolio of financial asset is an important element when applying to both incurred and expected loss models. The Expected loss model can be more accurately determined under a homogeneous portfolio basis than an individual financial asset.

For instance: When the lender issues a loan to the borrower, it does so in expectation that the borrower will pay both Principal and Interest. Suppose the lender has issued 50 such similar loans, and it has historical evidence that 5 loans out of 50 will be default.

This shows that lender is able to estimate the loss more accurately the on portfolio basis than on individual loans.

### *Does Expected Loss Model provide More Useful Information?*

The Expected loss model provides more relevant information, since it treats credit loss on a consistent basis, thus reflecting the current economic condition at the reporting date.

*For Instance:* Suppose a financial product involving repayment over a 5-year period, priced at 15% and 3% losses would be incurred based on the historical experience.

If from the past experience a similar type of financial product always has a low incidence of loss in year 1, 2 and 3 with losses bunched in year 4 and 5, and then it would overstate the income in years 1, 2 and 3, thus failing to provide correct information to investors.

However, the operational difficulty needs to be assessed by preparers in applying the Expected loss model, as it may outweigh the benefit associated with the same.

Also, it gives far more importance to management judgment in estimating the expected cash flow and may make the audit difficult in such a situation.

*The Exposure draft has proposed to replace the incurred loss approach with the approach based on expected losses (i.e. expected cash flows)*

*The Expected loss model recognises expected losses and changes in expected losses on existing financial asset portfolio, whereas the Incurred loss model recognises credit losses after it is "incurred," that is, there is evidence that losses are probable and measurable.*

*The Expected loss model provides more relevant information, since it treats the credit loss on a consistent basis, thus reflecting the current economic condition at the reporting date. The methodology is based on the "expected loss over the life of each portfolio".*

### Advantage/Disadvantages of Expected loss Model vs. Incurred loss Model

***Advantages:***

- Prevents artificially high profits being booked upfront and delayed loss reporting
- Clearly reflects expected losses expected across a portfolio

***Disadvantages:***

- Inherent complexity and volatility
- Increased use of management expectations

### Phase 3: ED on Hedge Accounting

IFRS is principle-based accounting, whereas IAS 39 has been criticised on the basis of rule-based accounting for testing hedge effectiveness, and also it was difficult to understand and interpret, which was defeating the very purpose for companies to apply. The Exposure Draft on Hedge Accounting mainly focuses on linking hedge items to the risk management approach adopted by an entity.

There are important improvements relating to assessing the hedge effectiveness and the possibility

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**The International Accounting Standards Board (IASB) has deferred the mandatory effective date from 1st January, 2013 to 1st January, 2015. However, an early application of IFRS 9 is still permitted. It also provided relief from the requirement to restate comparative financial statements for the effect of applying IFRS.**

to apply hedge accounting to components of non-financial items.

***Meaning of Hedge:*** Under hedge, investments are made to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security.

Companies do perform hedging activity in order to mitigate or offset the risk that arises from fluctuation in interest rate, currency, and equity and commodity price.

***Objective of Applying the Hedge Accounting:*** ED clearly comes out with the objective of applying the hedge accounting, describing: "in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arises from particular risks that could affect Profit and Loss, whereas Under IAS 39, the objective was not clearly spelt out; it was based on certain rules and restrictions as to the circumstances to which the hedge accounting shall be applied.

***Hedge Effectiveness:*** We shall consider the meaning of the Hedge effectiveness: it is a degree to which changes in fair value or cash flow of the hedged item that are attributable to hedged risk are offset by changes in fair value or cash flow of the hedging instrument.

Under IAS 39, the hedge is expected to be highly effective, and 'highly effective' has been defined as a bright line quantitative test of 80-125%.

This was considered as Rule based, and it means that when hedge effectiveness is in range of 80-125%, then only it will qualify for Hedge Accounting

The Exposure draft has replaced this requirement for the hedge to be designated as neutral and un-biased, and minimises the expected ineffectiveness.

It has moved to Principle based, and the only criterion is the hedging relationship shall meet the objective of hedge effectiveness as per risk management policy laid down by an entity.

***Designation of the Risk Component as hedged item:*** Under IAS 39, an entity can designate as hedged item if the risk can be separately identifiable and reliably measurable for the Financial item, whereas for Non-Financial item, an entity can designate as hedged item for the risk component limited only to foreign currency risk.

The Exposure draft focuses on entity designation as hedged item if the risk component can be separately identifiable and reliably measurable, irrespective of the Financial or Non-financial item.

This also enables the Hedge accounting to be closely related to the risk management strategy of an organisation.

*For Instance:*

Consider the following example, where an entity buys fuel for aircraft from a supplier. The supply contract for the aircraft fuel is a variable price contract with a pricing formula that includes an indexation to the crude oil prices and other cost.

Aircraft fuel = Crude price + (Other costs + Inflation index)

As per the ED, an entity can apply hedge accounting for the crude component if it uses crude derivatives to hedge variation in the price from changes in crude price under a contractual pricing formula, ***whereas***

Under IAS 39, an entity has to compare change in fair value of the crude derivative with the entire price change of the supply contract, i.e., including the variable other costs. The results of this, combined with 80-125% hedge effectiveness assessment test, are that the hedge accounting is not possible at all.

*The hedge accounting portions of IAS 39 do contain certain rule-based criteria for testing hedge effectiveness. The proposal in the ED seeks to move away from this by making this principle-based.*

*The ED proposed model for hedge accounting combines a management view, which aims to use the information produced internally for risk management purposes, and an accounting view that addresses the timing of recognition of gain and losses.*

*If a risk component can be identified and measured, then it has to be recognised as contrary to determining what can be hedged by the type of item.*

## Transition Effective Date for All Three Phases

- The International Accounting Standards Board (IASB) has deferred the mandatory effective date from 1st January, 2013 to 1st January 2015. However, an early application of IFRS 9 is still permitted.
- It also provided relief from the requirement to restate comparative financial statements for the effect of applying IFRS.
- Instead, additional transition disclosures will be required to help investors understand the effect that the initial application of IFRS 9 has on the classification and measurement of financial instruments. ■