MNP LLP

IFRS Hot Topic: Release of Final IFRS 9 *Financial Instruments*

July 2014

Background

On July 24, 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9 *Financial Instruments.* The new standard will replace IAS 39 *Financial Instruments: Recognition and Measurement* and is mandatorily effective for annual periods beginning on or after January 1, 2018, with early application permitted. The final version of IFRS 9 includes a new expected loss impairment model and limited amendments to classification and measurement for financial assets and will supersede any previous versions.

IFRS 9 will not replace the requirements set out for portfolio fair value hedge accounting for interest rate risk. This project was separated from the IFRS 9 project, due to the longer term nature of the macro hedging project. This project is currently at the discussion paper phase.

The new standard will introduce an improved logical model for classification and measurement, impairment, derecognition and hedge accounting.

Classification and Measurement

Classification determines how financial assets and liabilities are accounted for and measured on an ongoing basis. IFRS 9 will provide a logical approach to the classification of financial assets that will be driven by cash flow characteristics and the business model in which the assets are held.

The previous rule-based requirements were generally perceived to be overly complex. The new model will result in a single impairment model for all financial instruments and reduce the complexity associated with the former accounting requirements.

Impairment

During the financial crisis the current impairment guidelines were called into question, especially for financial institutions, as accounting losses could only be booked once they were incurred, even if the credit losses were apparent. This caused an overstatement in profits upfront and it was determined that the existing standard (IAS 39) caused a delayed recognition of credit losses on loans.

IFRS 9 moves from an incurred loss model to an expected-loss impairment model that requires more timely recognition of expected credit losses. This will cause significant changes for some entities and the users of the financial statements. The new standard will require recognizing not only credit losses that have already been incurred but also losses that are expected in the future. Entities will be required to make allowances for potential credit losses that are equal to either: 12-month expected credit losses or full lifetime expected credit losses. Loss allowances for full lifetime expected credit losses will have to be recorded, where credit risks are deemed to have increased significantly since initial recognition of the financial instrument.

To assist with the transition of the new impairment requirements, the IASB has announced their intent to create a transition resource group.

Hedge Accounting

IFRS 9 has significantly overhauled the hedge accounting model and will require more enhanced disclosures about risk management activities. The new model will align the accounting treatment with the risk management activities, which will allow entities to better reflect these activities in the financial statements. This will provide users of the financial statements with more relevant information about risk management and the effect of hedge accounting on the financial statements.

Own Credit

IFRS 9 will also address the volatility in profit or loss caused by changes in the credit risk of liabilities that are elected to be measured at fair value. Gains caused by the deterioration of the entity's own credit risk will no longer be recognised in profit or loss, hence eliminating volatility.

It is permitted to early adopt this change before any other changes are adopted for financial instruments.

IFRS 9 will result in some significant changes to the accounting of financial instruments. It will introduce a greater degree of subjectivity because it is much more forward looking and professional judgment will be essential. However, it will most likely provide better transparency on an entity's credit risk and provisioning process; therefore, providing users of the financial statements with more useful and beneficial information.

History of IFRS 9

The IASB has released a project summary providing an overview of the new Standard; you can access this summary by clicking here. Furthermore, the following provides a brief overview of all versions of IFRS 9 issued to date. These versions were issued as each phase of the financial instruments project was completed.

IFRS 9 (2009)

IFRS 9 introduces new requirements for classifying and measuring financial assets, as follows:
- Debt instruments meeting both a 'business model' test and a 'cash flow characteristics' test are measured at amortised cost (the use of fair value is optional in some limited circumstances).
- Investments in equity instruments can be designated as 'fair value through other comprehensive income' with only dividends being recognised in profit or loss.
- All other instruments (including all derivatives) are measured at fair value with changes recognised in profit or loss.
- The concept of 'embedded derivatives' does not apply to financial assets within the scope of the Standard and the entire instrument must be classified and measured in accordance with the above guidelines.

Note – the above Standard is superseded by IFRS 9 (2010), IFRS 9 (2013) and IFRS 9 (2014); however, an entity may still elect to early apply IFRS (2009) for annual periods beginning before January 1, 2018 if the entity's relevant date of initial application is before February 1, 2015.

IFRS 9 (2010)

A revised version of IFRS 9 incorporating revised requirements for the classification and measurement of financial liabilities, and carrying over the existing derecognition requirements from IAS 39.

The revised financial liability provisions maintain the existing amortised cost measurement basis for most liabilities. New requirements apply where an entity chooses to measure a liability at fair value through profit or loss – in these cases, the portion of the change in fair value related to changes in the entity's own credit risk is presented in other comprehensive income rather than within profit or loss.

Note – the above Standard supersedes IFRS 9 (2009) and is superseded by IFRS 9 (2013) and IFRS 9 (2014); however, an entity may still elect to early apply IFRS (2010) for annual periods beginning before January 1, 2018 if the entity's relevant date of initial application is before February 1, 2015.

IFRS 9 (Hedge accounting and amendments to IFRS 9, IFRS 7 Financial Instruments: Disclosures and IAS 39) (2013)

A revised version of IFRS 9 which:

- Introduces a new chapter to IFRS 9 on hedge accounting, putting in place a new hedge accounting model that is designed to be more closely aligned with how entities undertake risk management activities when hedging financial and non-financial risk exposures.
- Permits an entity to apply early only the requirements introduced in IFRS 9 (2010) for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss without applying the other requirements of IFRS 9. Therefore, the portion of the change in fair value related to changes in the entity's own credit risk can be presented in other comprehensive income rather than within profit or loss.
- Removes the mandatory effective date of IFRS 9 (2013), IFRS 9 (2010) and IFRS 9 (2009), leaving the effective date open pending the finalisation of the impairment and classification and measurement requirements. Notwithstanding the removal of an effective date, each Standard remains available for application.

Note – the above Standard is superseded by the final IFRS 9 released on July 24, 2014; however, an entity may still elect to early apply IFRS (2013) for annual periods beginning before January 1, 2018 if the entity’s relevant date of initial application is before February 1, 2015.

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