



IFRS 9 Financial Instruments

Overview

(Based on the 'near final draft' posted 2 November 2009)

Kai Haussmann

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1. Background

- ED/2009/7 Financial Instruments: Classification and Measurement
 - Published 14 July 2009
 - Commenting deadline 14 September 2009
 - 244 comment letters received
- Subsequent re-deliberations by the IASB
 - Regular Board meetings in September and October 2009
 - Extra Board meetings on 22 and 29 September as well as on 6 and 15/16 October 2009
- Near final draft posted on IASB website on 5 November 2009
- Publication of the final IFRS expected shortly



2. Scope

- New IFRS initially applies to financial assets **only**.
- Financial liabilities excluded from the scope (current IAS 39 still applicable) due to the following reasons:
 - The frozen credit spread measurement method intended to be used for certain financial liabilities may have unknown or unintended consequences;
 - Some derivative features that are embedded hybrid contracts with financial liability hosts would not be measured at fair value;
 - The frozen credit spread measurement method would not apply to liabilities designated under the Fair Value option which has been the source of many constituents' concerns in the past;
 - Convergence with US GAAP would be difficult because the FASB's proposed approach does not include a frozen credit spread measurement method.



3. Classification approach (I)

- At initial recognition, an entity shall measure all financial assets at fair value and shall classify financial assets as subsequently measured at either *amortised cost* or *fair value* on the basis of both:
 - a) the entity's business model for managing financial assets; and
 - b) the contractual cash flow characteristics of the financial asset.
- A financial asset shall be measured at amortised cost if both of the following conditions are met:
 - a) the objective of the entity's business model is to hold the financial asset in order to collect the contractual cash flows; and
 - b) 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 outstanding.



3. Classification approach (II)

- For the purpose of this IFRS, interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.
- A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with the above mentioned conditions.



3. Classification approach (III)

- Comparison with the ED:
 - The generic terms *basic loan features* and *managed on a contractual yield basis* have been replaced with a more precise description of the required conditions
 - More focussing on the entity's business model but with a more basic definition of business model (no management intent on an instrument by instrument basis)
 - Application guidance in Appendix B has been extended



4. Application of the approach to particular instruments (I)

- Application of the classification approach to the following instruments results in differences compared to the ED:
 - Investments in equity instruments
 - Contractually linked instruments
 - Financial assets acquired at a discount that reflects incurred credit losses
 - Non-recourse instruments
 - Financial liabilities (excluded from the scope of this IFRS)



4. Application of the approach to particular instruments (II) Investments in equity instruments

- All investments in equity instruments and contracts on those instruments, including unquoted equity instruments, must be measured at fair value, therefore elimination of the present *cost exemption* (unchanged from the ED).
- Application guidance in Appendix B describes situations where, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to determine fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range, subject to certain indicators mentioned not being present.



4. Application of the approach to particular instruments (III) Contractually linked instruments (tranches) (1)

- In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal outstanding only if:
 - a) the contractual terms of the tranche being assessed for classification have cash flow characteristics that are solely payments of principal and interest on the principal outstanding;
 - b) the underlying pool of financial instruments has the cash flow characteristics set out below;
 - c) the credit risk of the tranche is equal to or lower than the weighted average credit risk of the underlying pool of financial instruments.
- An entity must look through until it can identify the underlying pool of instruments that have contractual cash flows that are solely payments of principal and interest on the principal that are creating (rather than passing through) the cash flows.



4. Application of the approach to particular instruments (III) Contractually linked instruments (tranches) (2)

- Ad b)(1): The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal outstanding (main instruments).
- Ad b)(2): The underlying pool may also include instruments that:
 - a) reduce the cash flow variability of the main instruments and when combined with the main instruments result in cash flows that are solely payments of principal and interest on the principal outstanding; or
 - b) align the cash flows of the tranches with the cash flows of the pool of underlying main instruments to address differences in and only in:
 - i. whether the interest rate is fixed or floating;
 - ii. the currency in which the cash flows are denominated, including inflation in that currency; or
 - iii. the timing of the cash flows.



4. Application of the approach to particular instruments (III) Contractually linked instruments (tranches) (3)

- If the holder cannot assess the above mentioned conditions at initial recognition, the tranche must be subsequently measured at fair value.
- If the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the above mentioned conditions, the tranche does not meet the conditions and must be measured at fair value.



4. Application of the approach to particular instruments (IV) Financial assets acquired at a discount that reflects incurred credit losses

- The fact that a financial asset is acquired at a discount that reflects incurred credit losses does not in itself disqualify it from being measured at amortised cost. Such instruments can meet the required conditions (i.e. its contractual cash flows are solely payments of principal and interest on the principal outstanding).



4. Application of the approach to particular instruments (V) Non-recourse instruments

- The fact that a financial asset is non-recourse does not in itself necessarily preclude it from meeting the conditions for being subsequently measured at amortised cost. In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal outstanding.



5. Embedded derivatives

- If a hybrid contract contains a host that is within the scope of this IFRS, an entity shall apply the classification approach to the entire hybrid contract.
- If a hybrid contract contains a host that is not within the scope of this IFRS, an entity shall apply the requirements in IAS 39 to determine whether it must separate the embedded derivative from the host. If the embedded derivative must be separated from the host, the entity shall:
 - classify the derivative in accordance with either the classification approach of this IFRS for derivative financial assets or IAS 39.9 for derivative financial liabilities; and
 - account for the host in accordance with other IFRSs.



6. Reclassification

- Reclassification between the fair value category and amortised cost is required when, and only when, an entity changes its business model for managing its financial assets. Such changes are expected to be very infrequent.
- Reclassification date:
The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.
- A change in the objective of the entity's business model must be determined before the reclassification date.
- Reclassification is prohibited in all other circumstances.



7. Fair Value Option

- An entity may, on initial recognition, designate a financial asset as measured at fair value through profit or loss if it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (irrevocable election, unchanged from the ED).
- On initial application of this standard, the Fair Value Option is also available for financial liabilities, regardless of the fact that financial liabilities are otherwise excluded from the scope of this IFRS.



8. Presentation exception for particular equity instruments

- At initial recognition, an entity may make an irrevocable election to present in other comprehensive income (OCI) subsequent changes in the fair value of an investment in an equity instrument within the scope of this IFRS that is not *held for trading*.
- Amounts presented in OCI shall not be subsequently transferred to profit or loss (no 'recycling').
- **But** (in contrast to the ED): Dividends shall be recognised in profit and loss when the entity's right to receive payment of the dividend is established in accordance with IAS 18 *Revenue* unless the dividend clearly represents a recovery of part of the cost of the investment in which case it is recognised in OCI.



9. Effective date

- An entity shall apply this IFRS for annual periods beginning on or after 1 January 2013.
- Earlier application is permitted, i.e. it can be applied for annual periods ending 31 December 2009.



10. Transition (I)

- Date of initial application:
 - For entities adopting this IFRS before 1 January 2011: any date between the issue of this IFRS and 31 December 2010; or
 - For entities adopting this IFRS on or after 1 January 2011: the beginning of the first reporting period in which the entity adopts this IFRS.
- Relevance of the date of initial application:
 - An entity shall assess whether financial assets meet the conditions to be measured at amortised cost on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.
 - Designating or revoking of previous designation of financial assets **and liabilities** as at fair value through profit or loss shall be done on the basis of the facts and circumstances that existed at the date of initial application. That classification shall be applied retrospectively.



10. Transition (II)

- Additional disclosures on transition are required on early adoption as well as on compulsory adoption.
- Comparative figures:
 - An entity that adopts this IFRS for reporting periods beginning before 1 January 2012 need not restate prior periods.
 - An entity that adopts this IFRS for reporting periods beginning on or after 1 January 2012 shall restate prior periods.
- Early adoption of this IFRS does not result in a requirement to adopt early the consecutive provisions (phases 2 and 3).



11. EU endorsement process

- EFRAG tentatively decided on a positive endorsement advice with two dissenting members. Its Draft Endorsement Advice Letter (DEAL) has been published on 2 November 2009.
- Due to agreed on fast track due process the commenting deadline for the DEAL ends on 13 November 2009.
- EU commission holds a stakeholder meeting on 11 November 2009.
- EFRAG will finally decide on 16 November 2009.
- ARC meeting will take place on 19 November 2009.



Kai Haussmann

Tel. 030 20 64 12 14

haussmann@drsc.de

Zimmerstr. 30

10969 Berlin

Fax 030 20 64 12 15

www.drsc.de