

# INTERNATIONAL FINANCIAL REPORTING BULLETIN 2011/02

## IFRS 9 FINANCIAL INSTRUMENTS: CLASSIFICATION AND MEASUREMENT OF FINANCIAL LIABILITIES, AND DERECOGNITION OF FINANCIAL ASSETS AND FINANCIAL LIABILITIES



### Background

IFRS 9 *Financial Instruments* was published in November 2009 and contained requirements for the classification and measurement of financial assets. Equivalent requirements for financial liabilities have now been added, with most of them being carried forward unchanged from IAS 39 *Financial Instruments: Recognition and Measurement*. In consequence:

- A financial liability is measured as at fair value through profit or loss (FVTPL) if it is held for trading, or is designated as at FVTPL using the fair value option
- Other liabilities are measured at amortised cost
- In contrast to the requirements for financial assets, the bifurcation requirements for embedded derivatives have been retained; similarly, equity conversion features will continue to be bifurcated.

However, some changes have been made, in particular to the fair value option for financial liabilities to address the issue of where changes in the fair value of an entity's financial liabilities designated as at FVTPL using the fair value option, that arise from changes in the entity's own credit risk, should be recorded. This amendment is a result of consistent feedback received by the IASB from its constituents that changes in an entity's own credit risk should not affect profit or loss unless the financial liability is held for trading.

The other changes made to the accounting requirements for financial liabilities are:

- Guidance has been added to assist in differentiating between credit risk and asset specific performance risk; and
- The exemption from fair value measurement for derivative liabilities that are linked to, and must be settled by delivery of, an unquoted equity instrument where the fair value of that equity instrument is not reliably measurable has been deleted.

A number of related disclosure requirements have been added to IFRS 7 *Financial Instruments: Disclosures*.

In addition, the IASB published an exposure draft *Derecognition* (proposed amendments to IAS 39 and IFRS 7 *Financial Instruments: Disclosures*) in March 2009. However, following revisions to its strategy and work plan in June 2010, the IASB decided to retain the existing requirements in IAS 39 for derecognition of financial assets and financial liabilities and to finalise improved disclosure requirements. These disclosure requirements were issued in October 2010 as an amendment to IFRS 7 with an effective date of 1 July 2011 (see IFRB 2010 25), and the derecognition requirements of IAS 39 have now been incorporated unchanged into IFRS 9.

### STATUS

Final

### EFFECTIVE DATE

Annual periods beginning on/after 1 January 2013. Earlier application permitted

### ACCOUNTING IMPACT

Existing guidance in IAS 39 for financial liabilities and derecognition has been incorporated into IFRS 9. Changes in the fair value of many liabilities designated as at fair value through profit or loss that relate to an entity's own credit risk are now required to be recorded in Other Comprehensive Income. The exemption from fair value measurement for derivatives linked to unquoted equity instruments that cannot be reliably fair valued has been removed.

## Requirements

### Classification and measurement of financial liabilities

As noted above, most of the existing requirements of IAS 39 for financial liabilities have been carried forward unchanged. The principal amendment is in respect of changes in the fair value of financial liabilities designated as at FVTPL that are attributable to changes in an entity's own credit risk. This follows proposals that were issued in May 2010 in the exposure draft *Fair Value Option for Financial Liabilities*. The amendment is narrow in scope, and does not affect the accounting for derivative liabilities or financial liabilities that meet the definition of 'Held for Trading', nor does it change the accounting requirements for loan commitments or financial guarantee contracts that are designated as at FVTPL.

Under the requirements of IAS 39, all changes in the fair value of a financial liability designated as at FVTPL are recorded in profit or loss. In consequence, when an entity's credit quality deteriorates the related reduction in the carrying amount of the financial liability is recorded as a gain in profit or loss; when it improves, the increase in the carrying amount of the financial liability is recorded as a loss. This accounting is considered counter intuitive, as it results in gains and losses being included in profit or loss that do not relate to how an entity is performing economically.

In order to address the issue, the guidance in IFRS 9 has been amended to require changes in the fair value of a financial liability designated as at FVTPL that relate to an entity's own credit risk to be recorded in Other Comprehensive Income. All other changes in fair value continue to be recorded in profit or loss. As noted above, the amendment does not apply to loan commitments and financial guarantee contracts that are designated as at FVTPL; all changes in fair value for those instruments will continue to be recorded in profit or loss.

As an exception to the approach of recording changes in fair value attributable to an entity's credit status in Other Comprehensive Income, if this would create or enlarge an accounting mismatch all changes in the fair value of a financial liability designated as at FVTPL are required to be recorded in profit or loss. This might be the case where an entity holds a large portfolio of financial assets that are measured at FVTPL and there is an economic relationship between changes in the fair value of those assets and the effect of changes in the entity's credit status on the fair value of its financial liabilities designated as at FVTPL. The IASB notes in the Basis for Conclusions that it anticipates those circumstances to be rare, but acknowledges that their effect could be significant for some entities.

Recycling of amounts that are recorded in Other Comprehensive Income to profit or loss is not permitted, regardless of whether the related financial liability is settled at its contractual amount (settlement at a lower amount would result in the realisation of the change in carrying amount related to the entity's credit status). However, amounts may be transferred to different categories of equity. This is consistent with the prohibition in IFRS 9 in respect of recycling gains or losses on equity investments where an entity makes use of the option to classify these assets as at Fair Value Through Other Comprehensive Income.

### Credit risk versus asset specific risk

Additional guidance has been included in IFRS 9 to clarify the meaning of 'own credit risk', including the distinction between this and asset-specific performance risk. It is clarified that asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation, instead being related to the risk that a single asset or a group of assets will perform poorly (or not at all). An example of asset-specific performance risk is where the amount due in respect of a liability is contractually linked to the performance of specified assets (which might be the case for a unit trust or similar investment entity).

### Removal of cost exemption

IAS 39 contains an exemption from fair value measurement for derivative assets and liabilities that are linked to, and must be settled by, delivery of unquoted equity instruments if the fair value of those equity instruments cannot be reliably determined. The requirements in IFRS 9 that were published in November 2009 for financial assets eliminated this exemption. Consistent with this decision, the guidance in IFRS 9 for financial liabilities also eliminates this exemption. IFRS 9 includes additional guidance for the valuation of these equity instruments, including circumstances where cost may be a best estimate of fair value and indicators of where cost might not be representative of fair value.

## Disclosure

IFRS 7 has been amended to include new disclosure requirements as a result of the changes made to IFRS 9 for financial liabilities designated as at FVTPL. These include:

1. If an entity is required to present the effect of changes in the fair value of a financial liability arising from changes in its own credit risk in Other Comprehensive Income:
  - a. The cumulative amount of the change in fair value attributable to changes in its credit risk;
  - b. The difference between the carrying amount of the financial liability and the amount contractually required to be repaid on maturity;
  - c. Any transfers of related amounts within equity, together with the reasons for those transfers; and
  - d. If a liability is derecognised, the amount included within other comprehensive income that was realised.
  
2. If an entity is required to present the entire change in the fair value of a financial liability designated as at FVTPL, including those arising from changes in its own credit risk, in profit or loss:
  - a. The amount of the change, both during the period and cumulatively, in the change in fair value of that liability that is attributable to changes in the entity's own credit risk; and
  - b. The difference between the carrying amount of the financial liability and the amount contractually required to be repaid on maturity.

In addition, disclosure is required of:

- a detailed description of how the effect of an entity's credit risk has been measured, including why the approach adopted is appropriate; and
- if appropriate, a detailed description of the methodology followed in determining whether presenting the effect of changes in the entity's own credit risk in other comprehensive income (OCI) would create or enlarge an accounting mismatch.

## Effective date and transition

The amendments are effective for annual periods commencing on/after 1 January 2013, which is the same as the effective date that which applied to IFRS 9 as issued in November 2009. Earlier application is permitted. However, if an entity elects to apply the amendments early, it is required to apply all of the other requirements of IFRS 9 at the same time.

IFRS 9 is required to be applied retrospectively, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. At the date of initial application (being the date on which an entity first applies the requirements of IFRS 9), entities are required to determine whether recording changes in the fair value, of financial liabilities designated as at FVTPL, that relate to changes in their credit status in Other Comprehensive Income would create or enlarge an accounting mismatch in profit or loss. This determination is made on the basis of the facts and circumstances that exist at the date of initial application, with the associated requirements of IFRS 9 then being applied retrospectively on that basis.

This publication has been carefully prepared, but it has been written in general terms and should be seen as broad guidance only. The publication cannot be relied upon to cover specific situations and you should not act, or refrain from acting, upon the information contained therein without obtaining specific professional advice. Please contact your respective BDO member firm to discuss these matters in the context of your particular circumstances. Neither BDO IFR Advisory Limited, Brussels Worldwide Services BVBA, BDO International Limited and/or BDO member firms, nor their respective partners, employees and/or agents accept or assume any liability or duty of care for any loss arising from any action taken or not taken by anyone in reliance on the information in this publication or for any decision based on it.

Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board, is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels.

Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network.

BDO is the brand name for the BDO network and for each of the BDO member firms.

© 2011 BDO IFR Advisory Limited, a UK registered company limited by guarantee. All rights reserved.

[www.bdointernational.com](http://www.bdointernational.com)