IFRS

First Impressions: Additions to IFRS 9 Financial Instruments

December 2010

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Foreword

A new edition of IFRS 9 *Financial Instruments* (IFRS 9 (2010)) was published at the end of October 2010. This represents the second and last step in the first phase of the IASB's[1] project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The first edition of IFRS 9 was published in November 2009 and covered the classification and measurement of financial assets. During the deliberations that led to the first edition, the IASB decided to address accounting for financial liabilities separately. This was driven by feedback from constituents, including the Financial Crisis Advisory Group, who raised concerns about recognising the impact of changes in own credit risk in profit or loss when non-trading financial liabilities are measured at fair value. Many constituents were perturbed as banks and other entities who had designated liabilities under the fair value option recognised large gains in profit or loss as credit spreads on their own debt widened during the financial crisis. Banks generally have been the biggest users of the fair value option for financial liabilities, often in the context of interest rate and other economic hedging strategies. Some have been frustrated by the profit or loss volatility caused by these changes in credit spreads, including the losses recognised as credit spreads subsequently narrowed.

The IASB has addressed constituents' concerns in IFRS 9 (2010) by requiring that changes in the fair value of liabilities designated under the fair value option that are attributable to changes in the entity's own credit risk generally should be presented in other comprehensive income and not in profit or loss.

Apart from this change, IFRS 9 (2010) largely carries forward without substantive amendment the guidance on classification and measurement of liabilities from IAS 39. It also integrates much other existing guidance unchanged from IAS 39; altogether the total size of the revised IFRS 9 (2010), together with consequential amendments to other standards, the basis for conclusions and implementation guidance, stretches to 324 pages.

Although this may represent the finalisation of the classification and measurement phase of the financial instruments project, the IASB still has to complete its work on the remaining two main phases, impairment and hedge accounting. The IASB has established a challenging deadline of June 2011. That timeframe is made even more testing by its ambition to complete several other major projects over a similar period, including revenue recognition, insurance contracts and leasing, and to do this in conjunction with the FASB[2]. Not the least of the challenges will be joint deliberations related to the financial instruments project given the big differences that currently exist between the IASB's and the FASB's proposals.

IFRS 9 (2010) is not the end of the IASB's project to reform financial instruments accounting. It is not even the beginning of the end – but it is, perhaps, the end of the beginning. As we pause in this publication to survey what has been added, the IASB itself presses on with the immense task of completing the rest of this and other projects over the coming year. As a result, constituents can continue to expect a quickening in the pace and volume of change to IFRSs in the near term.

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KPMG's global IFRS Financial Instruments leader
KPMG International Standards Group

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1. Executive summary

- The additions to IFRS 9 *Financial Instruments* are part of the IASB's plan to replace IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 currently does not deal with impairment of financial assets and hedge accounting.
- The version of IFRS 9 issued in October 2010 (IFRS 9 (2010)) expands on IFRS 9 as issued in 2009 (IFRS 9 (2009)) by adding guidance from IAS 39 and has a significant impact on the accounting for most financial liabilities designated under the fair value option.
- IFRS 9 (2010) retains substantially all the classification and measurement guidance in IAS 39 for financial liabilities as well as the guidance on derecognition of financial assets and financial liabilities. The newly integrated guidance also includes those paragraphs of IAS 39 dealing with how to measure fair value and accounting for derivatives embedded in a contract that contains a host that is not a financial asset, as well as the requirements of IFRIC 9 *Reassessment of Embedded Derivatives*.
- IFRS 9 (2010) retains the fair value option in IAS 39 under which an entity may designate a financial liability on initial recognition as measured at fair value through profit or loss if certain eligibility criteria are met. However, IFRS 9 (2010) requires generally a split presentation of changes in the fair value of designated liabilities. The portion of the fair value changes that is attributable to changes in the liability's credit risk is recognised directly in other comprehensive income. The remainder is recognised in profit or loss. The amount presented in other comprehensive income is never reclassified to profit or loss.
- IFRS 9 (2010) contains two exceptions from this split presentation. If the accounting treatment of the effects of changes in the liability's credit risk creates or enlarges an accounting mismatch in profit or loss, then all fair value changes are recognised in profit or loss. Furthermore, all gains and losses on loan commitments and financial guarantee contracts that are designated as at fair value through profit or loss are recognised in profit or loss by the issuer.
- IFRS 9 (2010) retains largely the guidance and explanation in IFRS 7 *Financial Instruments: Disclosure* on how to determine the amount of the change in fair value that is attributable to changes in a liability's credit risk. However, it emphasises that the "*default method*" is appropriate only if the only significant relevant changes in market conditions are those in an observed benchmark interest rate.
- IFRS 9 (2010) eliminates the exception from fair value measurement contained in IAS 39 for derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be measured reliably.
- IFRS 9 (2010) is effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted.

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2. Introduction

2.1 Overview of the IAS 39-replacement project

The IASB is revising its accounting requirements for financial instruments. The objectives of the project include improving the decision-usefulness of financial statements for users by simplifying the classification and measurement requirements for financial instruments. This project aims to replace the existing standard, IAS 39.

The IAS 39-replacement project, and in particular its timeline, is driven in part by requests for reform from the Group of Twenty (G20) and other constituents. Following the G20 summit in April 2009, the Leaders' Statement called on accounting standard setters, including the IASB and the FASB, to work urgently with supervisors and regulators to improve standards on valuation guidance and loan loss provisioning and achieve a single set of high-quality global accounting standards. Following the conclusion of their September 2009 summit, the G20 leaders reiterated this message and called on the international accounting standard setters to complete their convergence project by June 2011.

The IAS 39-replacement project has three main phases:

- classification and measurement of financial instruments – the first chapters of IFRS 9 were published on 12 November 2009 and addressed financial assets. These have been updated by IFRS 9 (2010) published on 28 October 2010, which is the subject of this publication and which also addresses liabilities.
- amortised cost and impairment of financial assets – Exposure Draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* was published on 5 November 2009. See our publication *New on the Horizon: ED/2009/12 Financial Instruments: Amortised Cost and Impairment* for further information on this exposure draft. The IASB is currently deliberating the responses received and plans to re-expose proposals for impairment accounting early in the first quarter of 2011. The IASB plans to finalise this phase by June 2011.
- hedge accounting – Exposure Draft ED/2010/13 *Hedge Acounting* was published on 9 December 2010. This exposure draft does not address portfolio hedging and the IASB continues to discuss proposals for hedge accounting for open portfolios. See our forthcoming publication *New on the Horizon: Hedge Accounting* for further information on the exposure draft.

A phased approach has been adopted in order to accelerate the replacement of IAS 39 and address the consequences of the financial crisis as speedily as possible, while giving interested parties an opportunity to comment on the proposals in accordance with the IASB's commitment to due process.

2.2 Classification and measurement of financial liabilities

In 2009 the IASB issued Exposure Draft ED/2009/7 *Financial Instruments: Classification and Measurement* and Discussion Paper DP/2009/2 *Credit Risk in Liability Measurement.* During its deliberations of responses to ED/2009/7 and DP/2009/2, the IASB decided to finalise the guidance on classification and measurement of financial assets first, with the issuance of IFRS 9 (2009), and to discuss further the classification and measurement of financial liabilities.

In particular, the IASB wished to consider more extensively the role of credit risk in financial liability re-measurement. Many constituents had concerns with recognising in profit or loss the effects of changes in the fair value of a liability due to changes in the liability's credit risk.. During the financial crisis, some entities reported substantial gains on their financial liabilities that were measured at fair value as a result of increases in the liabilities' credit risk. This accounting impact was perceived by many constituents as counterintuitive.

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The IASB has maintained its position that a liability's credit risk is included in determining the fair value of liabilities. This was reflected in IAS 39 and in Exposure Draft ED/2009/5 *Fair Value Measurement*, published in May 2009.

The IASB discussed several models to address the issue of a liability's credit risk. It undertook an extensive outreach programme, which included a survey on a liability's credit risk to gather opinions of users of financial statements on this issue.

In May 2010 the IASB issued Exposure Draft ED/2010/4 *Fair Value Option for Financial Liabilities*. ED/2010/4 proposed that the portion of the fair value changes that is attributable to changes in the credit risk of a liability designated as at fair value through profit or loss should be included in other comprehensive income. This proposal largely has been carried across into IFRS 9 (2010).

The only other substantive change from IAS 39 is to eliminate the exception from fair value measurement contained in IAS 39 for derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be reliably measured. Under IAS 39, such derivatives are measured at cost.

The IASB had decided to retain almost all other guidance on the classification and measurement of financial liabilities from IAS 39 and integrated it into IFRS 9 (2010).

2.3 Derecognition

IFRS 9.BC3.30

In March 2009 the IASB published Exposure Draft ED/2009//3 *Derecognition – Proposed amendments to IAS 39 and IFRS 7* seeking input on a new model for the derecognition of financial assets. Subsequently the IASB undertook an extensive outreach programme with users, preparers, regulators, auditors, trade associations and others. Also in 2009 the FASB made urgent changes to the US GAAP derecognition requirements that narrowed the differences between IFRS and US GAAP.

IFRS 9.BC3.31

In June 2010 the IASB revised its strategy and work plan. The IASB and the FASB agreed that they should focus on transparency and comparability of their standards by improving and aligning US GAAP and IFRS disclosure requirements for financial assets transferred to another entity in the short term. With that aim in mind the IASB finalised the disclosure requirements that were included in ED/2009/3 by amending IFRS 7 in October 2010.

The IASB has integrated the derecognition requirements for financial assets and financial liabilities unchanged from IAS 39 into IFRS 9 (2010). The IASB plans to continue to monitor the reporting of transferred financial assets and liabilities, particularly in light of the recent changes to US GAAP, before deciding whether to proceed with a more fundamental revision to the derecognition model.

2.4 Fair value measurement

ED/2009/5 proposed new guidance on the principles to be applied in determining fair values when IFRSs require or permit the use of fair values. The proposed guidance in ED/2009/5 also would apply to any measurements of fair values of financial instruments that would be required under the IAS 39-replacement project. The comment period closed on 28 September 2009. Currently, the IASB plans to issue a final fair value measurement standard in the first quarter of 2011.

In the meantime, the IASB has integrated the guidance regarding the determination of fair values of financial instruments from IAS 39 into IFRS 9 (2010). However, this guidance remains subject to change in 2011 by the new fair value measurement standard.

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3. Overview of IFRS 9 (2010)

IFRS 9.IN7

IFRS 9 (2010) includes all the requirements of IFRS 9 (2009) without amendment. However, IFRS 9 (2010) also incorporates requirements with respect to the classification and measurement of financial liabilities, the derecognition of financial assets and financial liabilities, and the guidance on how to measure fair value. Except as described below, these requirements have been carried forward without substantive amendment from IAS 39. The newly integrated guidance also includes those paragraphs of IAS 39 dealing with accounting for derivatives embedded in a contract that contains a host that is not a financial asset, as well as the requirements of IFRIC 9.

Insight

The guidance on scope, how to measure amortised cost, impairment of financial assets and hedge accounting remains in IAS 39 as these matters are expected to be addressed in subsequent phases of the IAS 39-replacement project.

3.1 Financial assets

IFRS 9.4.1.1

IFRS 9 (2009) provided guidance solely on recognition, classification and measurement of financial assets. IFRS 9 (2009) and IFRS 9 (2010) contain two primary measurement categories for financial assets: amortised cost and fair value. A financial asset qualifies for amortised cost measurement only if it meets both of the following conditions:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- 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 amount outstanding.

If a financial asset does not meet both of these conditions, then it is measured at fair value with fair value changes generally recognised in profit or loss.

IFRS 9 (2009) is discussed in chapter 3.6A Financial Instruments of our publication *Insights into IFRS, 7th Edition 2010/2011*.

3.2 Financial liabilities

3.2.1 Classification and measurement

IFRS 9.BC4.46-BC4.49

After issuing IFRS 9 (2009) the IASB undertook an extensive outreach program to tackle the issue of a liability's credit risk in the measurement of financial liabilities. The key message that the IASB identified was that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading. Other themes that the IASB noted were that symmetry between the accounting for financial assets and financial liabilities is not necessary and often may not result in useful information. Also, many believed that amortised cost is the most appropriate measurement attribute for many financial liabilities.

IFRS 9.BC4.51, BC4.52

Based on the feedback received the IASB decided to retain almost all of the existing requirements from IAS 39 on the classification and measurement of financial liabilities. This decision was based on an assessment that the benefits of changing practice would not outweigh the costs of the disruption that such a change would cause. Furthermore, the IASB considered that the issue of accounting for a liability's credit risk would be addressed for most liabilities by retaining the guidance in IAS 39 since they

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would continue to be measured at amortised cost or bifurcated into a host and an embedded derivative with the host measured at amortised cost.

IFRS 9.4.2.1

Therefore under IFRS 9 (2010) financial liabilities generally are measured subsequently at amortised cost except for the following instruments:

a) financial liabilities that are held for trading (including derivatives);

b) financial liabilities that upon initial recognition are designated as at fair value through profit or loss (see section 4);

c) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies;

d) financial guarantee contracts; and

e) commitments to provide a loan at a below-market interest rate.

The instruments under a) and b) are subsequently measured at fair value. The instruments under c), d) and e) are measured under specific guidance carried forward from IAS 39 into IFRS 9 (2010).

Insight

ED/2010/8

In Exposure Draft ED/2010/8 *Insurance Contracts* published in July 2010, the IASB has proposed deletion of the separate definition of a financial guarantee contract and related measurement guidance contained in IAS 39. Under the proposals in ED/2010/8, issued financial guarantee contracts, or financial guarantee contracts held as reinsurance, that meet the definition of an insurance contract would be accounted for under a new insurance contracts standard. See our publication *New on the Horizon: Insurance Contracts* for further information on ED/2010/8.

IFRS 9.4.3.1-4.3.7

Under IFRS 9 (2009) and IFRS 9 (2010), embedded derivatives in a hybrid contract with a financial asset host contract are not separated from the host but instead are included in the assessment of the classification and measurement of the hybrid instrument. Under IFRS 9 (2010) embedded derivatives in a hybrid contract with a financial liability or other type of host contract are separated if:

- the economic characteristics and risks of the embedded derivative are not related closely to the economic characteristics and risks of the host;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the hybrid contract is not measured at fair value through profit or loss.

Insight

IFRS 9.BC4.91

In deciding to retain the bifurcation methodology from IAS 39 for financial liabilities, the IASB noted that constituents had told it that the methodology is generally working well in practice and that practice has developed since the requirements were issued.

IFRS 9.BC5.35

The issue of a liability's credit risk in financial liabilities that are designated as at fair value through profit or loss has been addressed by generally requiring the effect of changes in credit risk to be presented in other comprehensive income (see section 4).

The IASB has not changed the presentation requirements for financial liabilities that are held for trading. For these liabilities, all fair value changes continue to be included in profit or loss as they arise.

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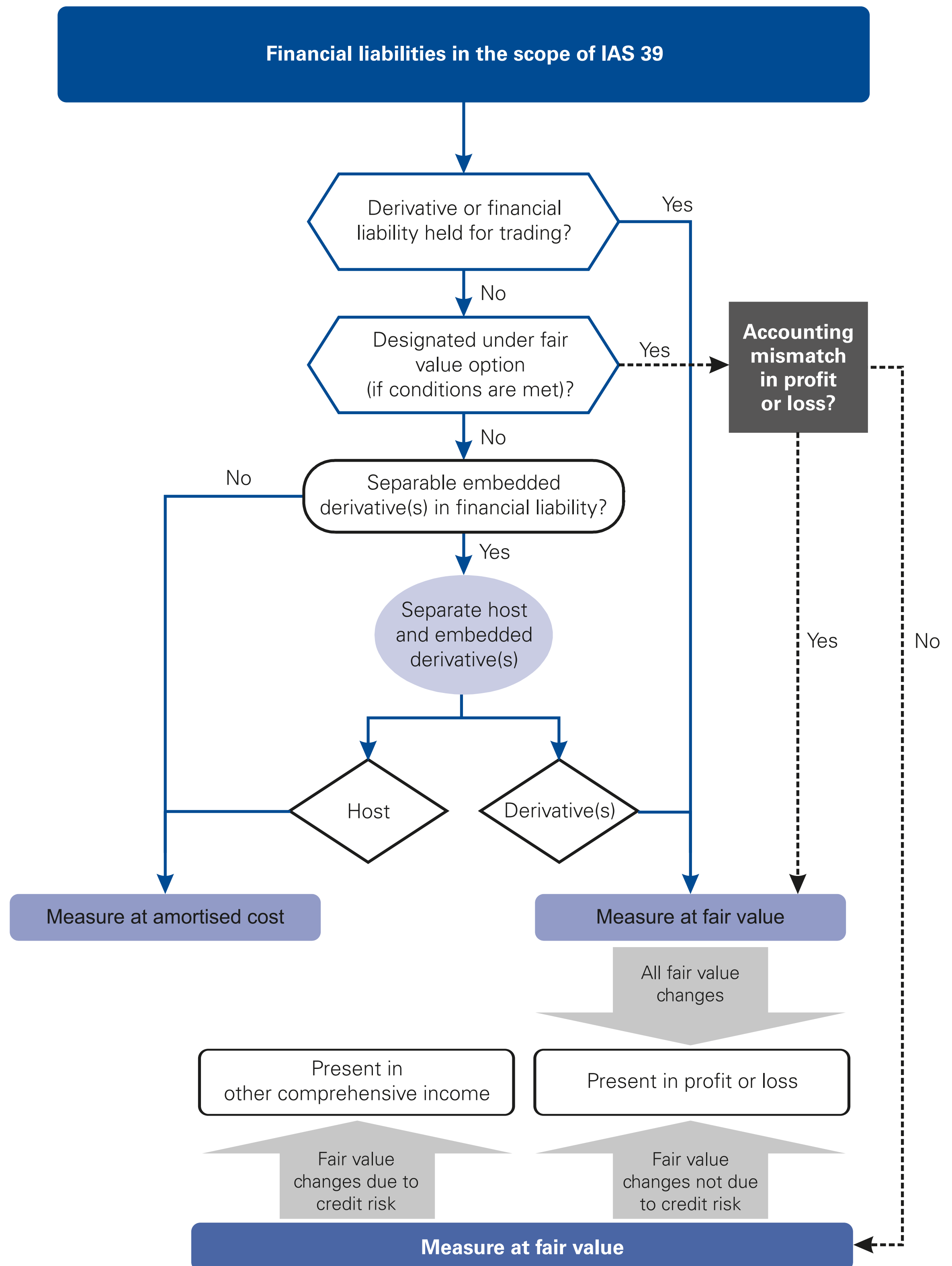
IFRS 9.5.7.1(c)

The following diagram provides an outline of the requirements for the classification and measurement of financial liabilities based on IFRS 9 (2010). The overview does not cover financial liabilities under c),d) or e) above, contingent consideration issued in a business combination and hedge accounting.



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3.2.2 Deletion of the cost exception for derivative liabilities

IFRS 9.4.2.1, BC4.53

The other substantive change introduced by IFRS 9 (2010) for financial liabilities in comparison to IAS 39 is the deletion of the exception in IAS 39 that requires measurement at cost of derivative financial liabilities linked to and settled by delivery of unquoted equity instruments whose fair value cannot be determined reliably. These liabilities are required under IFRS 9 (2010) to be measured at fair value through profit or loss, like all other derivative liabilities. This aligns with the guidance in IFRS 9 (2009) on the measurement of similar derivative assets.

3.3 Restructuring of IFRS 9

IFRS 9.IN9

With the integration of guidance from IAS 39 into IFRS 9 (2010), and to allow for future material to be inserted on completion of subsequent phases of the IAS 39-replacement project, the IASB has restructured the standard. This restructuring includes:

- renumbering and resequencing of many paragraphs;
- adding new paragraphs to accommodate the guidance carried over from IAS 39;
- adding new sections as placeholders for the guidance that will result from subsequent phases of the IAS 39-replacement project;
- expanding the Basis for Conclusions to include material from the Basis for Conclusions on IAS 39; minor necessary edits have been made to that material; and
- incorporating the Implementation Guidance that accompanied IAS 39 and that is still relevant into Implementation Guidance that now accompanies IFRS 9 (2010).

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4. Changes to the fair value option for financial liabilities

4.1 Presentation

IFRS 9.4.2.2, 4.3.5, IAS 39.9(b), 11A

IFRS 9 (2010) retains the option in IAS 39 to designate irrevocably on initial recognition a financial liability as measured at fair value through profit or loss if particular eligibility conditions are met. The eligibility conditions remain as follows:

- The designation eliminates or reduces significantly a measurement or recognition inconsistency that otherwise would arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.
- A group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.
- If a contract contains one or more embedded derivatives and the host is not a financial asset in the scope of IFRS 9 (2010), then an entity may designate the entire hybrid (combined) contract at fair value through profit or loss unless the embedded derivative is insignificant or it is obvious that separation of the embedded derivative would be prohibited.

IFRS 9.5.7.7, IAS 39.9, 55

The changes made from IAS 39 relate to the presentation and disclosure of gains and losses recognised on application of the fair value option for financial liabilities. Under IAS 39, all fair value changes are recognised in profit or loss. Under IFRS 9 (2010) gains or losses on a financial liability designated as at fair value through profit or loss generally are presented as follows:

- the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability is presented in other comprehensive income; and
- the remaining amount of change in the fair value of the liability is presented in profit or loss.

Insight

ED/2010/4.2, IFRS 9.BC5.45-BC5.51

The new guidance requires generally this split presentation approach. The split presentation is a so-called *one-step-approach* under which the gains or losses attributable to changes in credit risk are presented solely in other comprehensive income. This contrasts with the *two-step-approach proposed* in ED/2010/4. Under the two step approach the total change in the fair value of the financial liability would have been presented in profit or loss and simultaneously the amount of the change in fair value that was attributable to changes in the liability's credit risk would have been presented in other comprehensive income – with an offsetting entry presented in profit or loss. Feedback received on ED/2010/4 indicated that many constituents believe that the one-step approach is more efficient and less complicated than the two-step approach. Both approaches lead to the same net result in profit or loss and other comprehensive income. However, many thought that the extra line items under the two-step approach were unnecessary clutter. The IASB noted that no information is lost by using the one-step approach because IFRS 7 and IAS 1 *Presentation of Financial Statements* require entities to disclose all the information provided by the two-step approach.

IFRS 9.5.7.7-5.7.9, B5.7.8

There are two exceptions from this split presentation. The first exception applies if split presentation would create or enlarge an accounting mismatch in profit or loss. The second exemption applies to loan commitments and financial guarantee contracts that are designated as at fair value through profit or loss. In these cases all gains and losses are presented in profit or loss.

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IFRS 9.B5.7.9

Amounts presented in other comprehensive income under the split presentation are never reclassified to profit or loss. This prohibition applies even if a gain or loss related to a change in the liability's credit risk is realised by settling or repurchasing the liability at fair value. Although reclassification to profit or loss is prohibited, an entity may transfer the cumulative gain or loss within equity.

Insight

IFRS 9.BC5.54-BC5.56

Most respondents to ED/2010/4 asked the IASB to require reclassification of amounts recognised in other comprehensive income to profit or loss if and when they are realised. The IASB noted that it needs to address the overall objective of other comprehensive income and whether and when amounts presented in other comprehensive income should be reclassified to profit or loss. However, absent such an overall objective, the IASB noted that the decision not to allow reclassification is consistent with IFRS 9's treatment of investments in equity instruments measured at fair value through other comprehensive income. Furthermore, IFRS 9 (2010) contains consequential amendments to IFRS 7 requiring disclosure of the amount accumulated in equity that has been realised during the period (see section 4.4).

IFRS 9.BC5.53

Putting the above in context, the IASB observed that "if the entity repays the contractual amount, the cumulative effect over the life of the instrument of any changes in the liability's credit risk will net to zero because its fair value will equal the contractual amount." Based on this thought the IASB concluded that the issue of reclassification is irrelevant for many liabilities.

IFRS 9.BC5.26, BC5.57

The IASB decided in the light of jurisdiction specific restrictions on components of equity not to give any guidance on when and how the transfer of amounts within equity may or should be done. Accordingly, IFRS 9 (2010) does not state that transfers between components of equity are permitted only when amounts are realised. Also it is not specified whether a decision to transfer within equity constitutes an accounting policy that has to be applied consistently.

4.2 Accounting mismatch

IFRS 9.B5.7.6

IFRS 9 (2010) provides further guidance to determine when split presentation would create or enlarge an accounting mismatch in profit or loss. The Appendix to IFRS 9 (2010) states that in order to make that determination, "an entity must assess whether it expects that the effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument measured at fair value through profit or loss. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument."

Insight

This wording implies that an accounting mismatch can be identified only when it relates to another financial instrument that is measured at fair value through profit or loss. However, the guidance refers to another financial instrument rather than only to a financial asset. Therefore, for example, it could relate to a credit derivative, which might be a financial asset or a financial liability, linked to a financial liability of the reporting entity that has been designated as at fair value through profit or loss.

IFRS 9.B5.7.12

The standard also explains that an accounting mismatch is not caused solely by the measurement method that an entity uses to determine the effects of changes in a liability's credit risk (see section 4.3). An example given is a method that does not isolate changes in a liability's credit risk from changes in liquidity risk.

IFRS 9.B5.7.10

IFRS 9 (2010) provides one example of when the accounting mismatch exception from split presentation would apply. In the example a financial asset held by an entity (lender) can be prepaid contractually by the debtor delivering a corresponding debt instrument that was originally issued by the lender in order to fund its origination of the asset. In this case the change in the fair value of the asset reflects the debtor's

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right to prepay by transferring the liability of the lender to the lender and hence changes in the credit risk of the liability, i.e. in the financial statements of the entity, the effects of changes in the credit risk of the entity's liability will be offset in profit or loss by a corresponding change in the fair value of the financial asset.

Insight

IFRS 9.B5.7.11, BC5.39, BC5.40

In the above example, the economic relationship between the two instruments arises from a contractual linkage. The standard indicates that an accounting mismatch may also occur in the absence of a contractual linkage but it does not provide any such example. The IASB also states that it expects the circumstances in which the exception would apply to be rare and notes that an economic relationship of the type contemplated does not arise by coincidence. Accordingly, we doubt that it would be possible to argue that the exception would be applicable merely because an entity holds or has used a designated financial liability to fund financial assets whose value also happens to be exposed to changes in the general price of credit.

IFRS 9.B5.7.7

An entity need not enter into all of the financial instruments giving rise to an accounting mismatch at exactly the same time. IFRS 9 (2010) allows for a reasonable delay provided that any remaining transactions are expected to occur.

IFRS 9.B5.7.7

An entity's methodology for determining whether split presentation creates or enlarges an accounting mismatch in profit or loss is applied consistently. However, if there are different economic relationships between the characteristics of liabilities designated under the fair value option and the characteristics of the other financial instruments, different methodologies may be used.

Insight

IFRS 9.BCZ4.74-BCZ4.76

Like IAS 39, IFRS 9 (2010) permits the fair value option to be applied only to whole financial assets or liabilities and not to components or proportions. This suggests that assessment as to whether split presentation would create or enlarge an accounting mismatch in profit or loss also should be determined by reference to the entirety of the liability designated under the fair value option. The standard refers to considering whether an entity expects that effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument. However, although the IASB indicates that the exception would be applicable only in rare circumstances as described above, IFRS 9 (2010) does not specify whether any particular level of probability or confidence should attach to the expectation of offset or how precise the degree of offset should be, i.e. whether the effects of fair value changes should be expected to be (approximately) equal and opposite or whether a wider range of expected offset ratios should lead to application of the exception.

4.3 Measurement of changes in credit risk

4.3.1 The meaning of credit risk

IFRS 7.10, B4

Under IFRS 7 currently an entity discloses the amount of change in the fair value of a financial liability designated as at fair value through profit or loss, during the period and cumulatively, that is attributable to changes in the liability's credit risk.

IFRS 9.B5.7.13, IFRS 7.A

IFRS 9 (2010) repeats the definition of credit risk in IFRS 7, which is "the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation". The standard goes on to explain that there is a difference between the risk that the issuer will fail to perform on the particular liability and the general creditworthiness of the issuer. In terms of credit risk for the purpose of the application of the fair value option, the standard focuses on the failure to perform on the particular liability. For example the credit risk of a collateralised liability of an issuer will be less than the credit risk of an otherwise identical uncollateralised liability.

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IFRS 9.B5.7.14, B5.7.15

However, for the purpose of splitting gains and losses on liabilities designated under the fair value option, the standard differentiates between credit risk and *asset-specific performance risk*. Asset-specific performance risk is not related to the risk that the issuer of a liability will fail to perform but rather it is related to the risk that one or more assets will perform poorly (or not at all). The standard gives two examples. The first is a liability with a unit-linking feature. Under the contractual terms of the liability, the amount due to investors is determined on the basis of the performance of specified assets. The second example refers to a liability issued by a special purpose entity (SPE) with the following specified characteristics: the SPE is legally isolated such that its assets are ring-fenced solely for the benefit of investors, even in the event of bankruptcy; the SPE enters into no other transactions and its assets cannot be hypothecated; and amounts are due to the SPE's investors only if the ring-fenced assets generate cash flows. The standard states that the effect of the assets on the fair value of the liability is asset-specific performance risk not credit risk.

Insight

IFRS 9.B5.7.15(b)

The example in which a liability issued by an SPE contains asset-specific performance risk is described in some detail. The standard does not discuss whether all the specified characteristics, in particular the condition that the amount of the liability is conditional on the generation of cash by the underlying assets, must be present in order to identify the effect of the underlying assets on the fair value of the liability as asset-specific performance risk rather than credit risk.

IFRS 9.4.1.2, 4.1.3, B4.1.15-B4.1.17, B4.1.20-B4.1.26

The guidance above on the meaning of credit risk is given "[for] the purposes of applying" the split presentation requirement for liabilities designated under the fair value option. The standard does not discuss whether or how this analysis also is relevant for the purpose of determining the classification of financial assets. Under IFRS 9, a financial asset may qualify for measurement at amortised cost only if the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (the SPPI criterion). Interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding. IFRS 9 explains that sometimes financial assets have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest on the principal amount outstanding. The standard mentions a non-recourse financial asset as a possible example. If asset-specific performance risk is not considered "credit risk" from the issuer's perspective, then it is possible that compensation received for that risk might not be considered interest from the holder's perspective and therefore would preclude amortised cost classification by the holder. However, IFRS 9 also includes specific guidance for circumstances in which an entity holds an investment in a tranche of contractually-linked instruments. Contractually-linked instruments may be used by an issuer to prioritise payments from a pool of financial instruments so as to create concentrations of credit risk. In these cases, the holders of a tranche have a right to cash flows only if the issuer generates sufficient cash flows to satisfy higher ranking tranches. The specific guidance for these instruments indicates that the holder should perform an analysis that looks through to the pool of underlying financial instruments and that the SPPI criterion may be satisfied if, among other things, the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments.

In an agenda paper prepared for the IASB by the technical staff of the IFRS Foundation in September 2010, *Feedback on IFRS 9 – non-recourse assets and constant maturity assets*, the staff stated that the guidance on non-recourse assets was intended to reinforce the idea that the "economic nature" of payments - rather than the words used to describe them – should determine classification. The staff stated that they understand that the IASB believed that "many non-recourse assets will satisfy" the SPPI criterion but acknowledged that "the drafting could be improved".

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4.3.2 Determining the effects of changes in credit risk

IFRS 9.B5.7.16, B5.7.17

IFRS 9 (2010) largely carries forward guidance from IFRS 7 on how to determine the effect of changes in credit risk. Under IFRS 9 (2010), an entity determines the amount of the fair value change of a financial liability designated under the fair value option that is attributable to changes in its credit risk either:

a) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; these conditions may include a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates; or

b) using an alternative method the entity believes more faithfully represents the amount of change in the liability's fair value that is attributable to changes in its credit risk.

IFRS 9.B5.7.18, B5.7.19, IE5

If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, under IFRS 9 (2010) the amount of fair value changes that is attributable to changes in credit risk may be estimated using the so-called default method as follows:

a) The entity first calculates the liability's internal rate of return at the start of the period using the liability's fair value and contractual cash flows at that date. It then deducts from this internal rate of return the observed (benchmark) interest rate at the start of the period so as to arrive at an *instrument-specific component* of the internal rate of return.

b) Next, the entity computes a present value of the cash flows of the liability at the end of the period using the liability's contractual cash flows at that date and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at that date and (ii) the instrument-specific component of the internal rate of return determined in (a).

c) The entity then deducts the present value calculated in (b) from the fair value of the liability at the end of the period. The resulting difference is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate and which is presented in other comprehensive income.

IFRS 9.BC5.64

The IASB amended the guidance compared to IFRS 7 by emphasising that the default method is appropriate only if the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate and that, when other factors are significant, an alternative measure that more faithfully measures the effects of changes in the liability's credit risk should be used. For example, if the liability contains an embedded derivative, the change in fair value of the derivative would be excluded in calculating the amount to be included in other comprehensive income.

Insight

IFRS 9.BC5.53

As noted in section 4.1, the IASB states that if an entity repays the contractual amount of a liability, the cumulative effect of changes in the liability's credit risk will net to zero because its fair value will equal the contractual amount. However, if the wording of the guidance on the default method as set out in IFRS 9 (2010) were applied literally to all periods in a scenario covering more than one period, it usually would lead to a result in which the fair value changes accumulated in other comprehensive income do not accumulate to a net amount of zero on repayment of the liability at its contractual maturity. For example, assume a liability that is issued for consideration of 100, being also both its initial fair value and contractual repayment amount, has a two-year maturity and pays a coupon of 10 percent at the end of each year. The benchmark interest rate throughout the two years remains at 7 percent. Therefore the instrument-specific component of the internal rate of return is 3 percent. At the end of year one, the entity discounts the future cash flows at 10 percent (i.e. 7 percent unchanged benchmark interest rate + 3 percent risk component). The present value at the end of year one under (b) of the default method is thus 100 after payment of the interest. However, assume that the market spread on the entity's debt over the benchmark rate has increased and that the fair value at the end of year one has decreased to 98. Therefore – in accordance with (c) under the default method – the entity recognises a gain of 2 in other comprehensive income. At the end of the next year, both the present value of the cash flows calculated under (b) of the default method and the fair value of the liability are 110 immediately before repayment and zero immediately after repayment. Applying the wording of the guidance on the default method in IFRS 9 (2010) literally to the second year, the amount included in other comprehensive income for year two would be calculated as zero, meaning that there is no reversal of the gain of 2 recognised in other comprehensive income in year one.

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The example is summarised in the following table:

	Inception	**Year 1**	**Year 2**	
			Before repayment	After repayment
Fair value of the liability	100	98	110	-
Present value of the cash flows discounted at current benchmark rate plus specific component	100	100	110	-
Amount recognised in other comprehensive income for the period	n/a	2	-	-
Cumulative amount recognised in other comprehensive income	n/a	2	**2**	**2**

The problem described may be avoided by modifying the application of the default method by replacing "at the start of the period" in part (a) with "at inception" and treating the difference derived in part (c) as the cumulative amount of fair value changes attributable to changes in credit risk to be presented in other comprehensive income for the whole life to date of the liability, rather than the amount to be presented in other comprehensive income for the current period. Using this modified description, the amount presented in other comprehensive income for the current period is the difference between the cumulative amount calculated under part (c) at the end of the current period and the cumulative amount calculated under part (c) at the end of the previous period.

The default method does not include a definition of "benchmark" interest rate. In practice, it is understood commonly to include inter-bank rates such as LIBOR for US dollar or sterling liabilities or Euribor for euro liabilities. The default method treats a benchmark interest rate as akin to a risk-free rate and excludes all changes in the benchmark rate as unrelated to, and not part of, changes in the liability's credit risk. However, many consider that inter-bank rates include generally a premium above the highest-quality government bond rates for the same term and currency and this premium may vary with market perceptions of changes in the credit risk of banks. The standard does not preclude using the risk-free rate as a benchmark rate nor using an alternative method that isolates a credit component of an inter-bank rate and includes it in the determination of changes in credit risk if the entity believes that it is a more faithful representation.

4.4 Disclosure

IFRS 9.C11

IFRS 9 (2010) includes consequential amendments to the disclosure requirements of IFRS 7. This includes retaining the existing requirements of IFRS 7 with respect to the application of the fair value option. However, IFRS 9 (2010) has amended the requirements to disclose simply the methods used to determine the amount of change in fair value that is attributable to changes in credit risk for both financial assets and financial liabilities designated under the fair value option, and IFRS 7 (2010) requires disclosure of a detailed description of those methods, including an explanation of why the method is appropriate. IFRS 9 (2010) also has added new disclosure requirements that relate to the changes in the accounting guidance on the application of the fair value option for financial liabilities.

IFRS 7.10 (rev.)

If an entity has designated a financial liability as at fair value through profit or loss and presents the effects of changes in that liability's credit risk in other comprehensive income, it discloses in addition to the disclosures required previously by IFRS 7:

- Any transfers of cumulative gains or losses within equity during the period, including the reason for such transfers.

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- If a liability is derecognised during the period, the amount presented in other comprehensive income that was realised at derecognition.

IFRS 7.11 (rev.)

An entity also now discloses a detailed description of the methodology or methodologies used to determine whether presenting the effects of changes in a liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss. If an entity presents the effects of changes in a liability's credit risk in profit or loss, the disclosure includes a detailed description of the economic relationship between the characteristics of the liability and those of the other financial instrument.

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5. Effective date and transition

5.1 Effective date

IFRS 9.7.1.1

IFRS 9 (2010) is effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted. If an entity applies IFRS 9 (2010) in its financial statements for a period beginning before 1 January 2013, it discloses that fact.

IFRS 9.7.3.1-7.3.2

IFRS 9 (2010) supersedes IFRS 9 (2009) and IFRIC 9, which is incorporated into the standard. However, for annual periods beginning before 1 January 2013, entities have a choice to apply either IFRS 9 (2010) or IFRS 9 (2009).

IFRS 9.7.1.1

If an entity chooses to apply IFRS 9 (2010) early and has not already applied IFRS 9 (2009), it is required to apply all of the requirements in IFRS 9 (2010) at the same time.

Insight

The IASB published in October 2010 Request for Views on *Effective Dates and Transition Methods* (Request for Views). The Request for Views seeks input from interested parties about the time and effort that will be involved in adopting the several new IFRSs it expects to issue in 2011 and about when those IFRSs should become effective. In the light of the responses the IASB will reconsider the effective date of IFRS 9 (2010). The decision of the IASB may be affected by other phases of the IAS 39-replacement project and by other projects, including its project on accounting for insurance contracts.

5.2 Transition

IFRS 9.7.2.1-7.2.15

An entity generally has to apply IFRS 9 (2010), including the amendments to the fair value option for financial liabilities, retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, the standard contains several exceptions from this principle, mainly based around the entity's date of initial application of the standard. All the exceptions contained in IFRS 9 (2009) are retained in IFRS 9 (2010). These include the exception from the requirement to restate comparative information for entities that adopt the standard for reporting periods beginning before 1 January 2012.

IFRS 9.7.2.2

The date of initial application is the date when an entity first applies the requirements of the standard. The date of initial application may be:

- for entities initially applying the standard before 1 January 2011, any date between the issue of the standard and 31 December 2010; and
- for entities initially applying the standard on or after 1 January 2011, the beginning of the first reporting period in which the entity adopts the standard.

Insight

IFRS 9.7.3.2

This description in IFRS 9 (2010) is identical to that in IFRS 9 (2009). However, IFRS 9 (2010) was issued on 28 October 2010 whereas IFRS 9 (2009) was issued on 12 November 2009. Accordingly, for entities that initially apply IFRS 9 (2010) before 1 January 2011 without first having applied IFRS 9 (2009), the date of initial application cannot be before 28 October 2010.

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IFRS 9.7.2.9

IFRS 9 (2010) contains the same guidance as IFRS 9 (2009) as to mandatory and elective designation or de-designation of liabilities as measured at fair value through profit or loss at the date of initial application. At the date of initial application an entity:

- may choose to designate any financial liability as at fair value through profit or loss if it eliminates or reduces significantly a measurement or recognition inconsistency that otherwise would arise from measuring assets or liabilities or recognising the gains and losses on them on different bases;
- revokes an existing designation of a financial liability if it was designated originally on the basis of the above criterion but that criterion is no longer met; and
- may choose to revoke any existing designation of a financial liability (but only if the liability was designated originally on the basis of the above criterion) even if that criterion continues to be met.

Insight

IFRS 9.BC7.27

IFRS 9 (2010) does not include any new ability or requirement to designate or de-designate a liability as at fair value through profit or loss at initial application in addition to those that were included in IFRS 9 (2009).

IFRS 9.7.2.1, 7.2.12-7.2.14, BC7.29

IFRS 9 (2010) contains the following other transition reliefs from full retrospective application related to the classification and measurement of liabilities:

- The requirements of IFRS 9 (2010) are not applied to liabilities that have been derecognised at the date of initial application of IFRS 9 (2010).
- An entity assesses whether presenting the effects of changes in a liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss on the basis of facts and circumstances that exist at the date of initial application of IFRS 9 (2010). The accounting treatment is applied retrospectively on this basis. The IASB believes that the conclusion will most likely be the same regardless of whether the assessment is made on the basis of facts and circumstances that existed at initial recognition or at the date of initial application.
- Consistent with the requirements for financial assets, derivative liabilities linked to unquoted equity instruments that previously were accounted for at cost are measured at fair value at the date of initial application of IFRS 9 (2010). Any difference between the previous carrying amount and fair value is recognised in the opening retained earnings of the reporting period that includes the date of initial application.
- An entity is not required to restate prior periods if the requirements of IFRS 9 (2010) are adopted for reporting periods beginning before 1 January 2012.

Insight

IFRS 9.BC7.26

In requiring retrospective application of the new requirements for presentation of gains and losses on financial liabilities designated under the fair value option, the IASB notes that entities are already calculating information about fair value changes that are attributable to changes in the liability's credit risk, since these amounts are required to be disclosed under IFRS 7. Therefore, the information for retrospective application should be readily available for annual periods to which IFRS 7 was applicable. However, it might not be for prior interim periods for which IFRS 7 disclosures are not required. Additionally, as noted above, the chapters stemming from IFRS 9 (2009) allow an entity at the date of its initial application of those chapters to designate a financial liability as at fair value through profit or loss to avoid an accounting mismatch. This designation is applied retrospectively. In this case, information about fair value changes that are attributable to changes in the liability's credit risk may not be readily available since the entity would not have been required to disclose these amounts under IFRS 7 before.

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5.3 Sequential application of IFRS 9 (2009) and IFRS 9 (2010)

IFRS 9.7.2.16

If an entity first adopts IFRS 9 (2009) and then adopts IFRS 9 (2010), it applies the transition requirements at the relevant date of initial application. Therefore, the relevant transition requirements included in IFRS 9 (2009) are applied at the date of initial application of IFRS 9 (2009). An entity is not permitted to apply specific transition requirements more than once.

Insight

IFRS 9.7.2.14

In our view, the guidance on sequential application indicates that an entity that has adopted IFRS 9 (2009) and then adopts IFRS 9 (2010) subsequently may have two different dates of initial application; one with respect to IFRS 9 (2009) and one with respect to IFRS 9 (2010). The date of initial application related to IFRS 9 (2009) is determined when the entity adopts IFRS 9 (2009) and applies its transition requirements. The second date of initial application related to IFRS 9 (2010) is determined when the entity adopts IFRS 9 (2010). This second date of initial application generally does not impact the previous adoption of IFRS 9 (2009) but is used with respect to applying the incremental transition reliefs of IFRS 9 (2010) that relate to classification and measurement of financial liabilities described in section 5.2. However, if the entity previously elected not to restate comparative information on adoption of IFRS 9 (2009) but did restate comparative information on adoption of IFRS 9 (2010), the restated financial statements must reflect all the requirements in IFRS 9 (2010).

5.4 First-time adopters

IFRS 9 (2010) also contains consequential amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards*. This generally includes retaining the transition guidance for first-time adopters contained in IFRS 9 (2009).

IFRS 1.D19

IFRS 1 allows a first-time adopter to designate an existing financial liability under the fair value option at its date of transition, provided that the relevant criteria are met. IFRS 9 (2010) retains this exception.

IFRS 1.D19D (rev.)

Furthermore under IFRS 1 the determination whether split presentation of gains and losses on financial liabilities designated under the fair value option would create or enlarge an accounting mismatch in profit or loss is made on the basis of the facts and circumstances that exist at the date of transition to IFRSs.

IFRS 1.E1, E2

IFRS 1 retains for financial assets and extends to financial liabilities the exemption from restating comparative information in the first IFRS financial statements of an entity that adopts IFRSs for annual periods beginning before 1 January 2012 and applies IFRS 9 (2010). First-time adopters eligible for the exception still are required to present at least one year of comparative IFRS information, but the comparative information need not comply with IFRS 9 (2010) nor, for items within the scope of IFRS 9 (2010), IFRS 7. If the exemption is applied, the comparative information is prepared using the recognition and measurement requirements of previous GAAP instead of IFRS 9 (2010) and references to the “date of transition to IFRSs” mean, in the case of IFRS 7 and IFRS 9, the beginning of the first IFRS reporting period.

Insight

IFRS 1.8

The fact that an entity can apply either IFRS 9 (2009) or IFRS 9 (2010) carries through to first-time adopters. Therefore, for annual periods beginning before 1 January 2013 first-time adopters can choose either to apply IFRS 9 (2010) immediately or to apply IFRS 9 (2009) in their first IFRS financial statements and to apply IFRS 9 (2010) in a later period.

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6. Outlook

With the issuance of IFRS 9 (2010), the new requirements for the classification and measurement of financial assets and financial liabilities are established and the first phase of the IAS 39-replacement project is complete. The IASB has stated previously that it intends to undertake a preliminary post-implementation review related to classification and measurement of financial assets, which it would discuss with the FASB, although the timing of this review is not clear.

The IASB nevertheless faces enormous efforts over the coming year in completing the remainder of the IAS 39-replacement project, as well as many other – some interrelated – projects. It currently intends to finalise the second phase of the IAS 39-replacement project on impairment as well as much of the third phase on hedge accounting in the second quarter of 2011. This timetable is influenced in part by the fact that several Board members will leave the IASB in the middle of next year. In a similar timeframe, the IASB also plans to complete projects on consolidation, joint ventures, revenue recognition, insurance contracts, fair value measurement and leasing, as well as improvements to several other standards. Given the scale and complexity of these projects, as well as their wide-ranging impact and sometimes controversial nature, meeting these ambitious deadlines will be an enormous challenge for the IASB. Constituents also are faced with significant work as they endeavour to digest and respond to consultative documents, generally within relatively short comment periods, as well as beginning to prepare for the implementation of final requirements.

IFRS 9.IN10

The complexity of the IASB's task is also increased as a result of many of these projects being joint efforts with the FASB, including a commitment to "achieving increased comparability internationally in the accounting for financial instruments." The FASB published its comprehensive exposure draft on the accounting for financial instruments in May 2010. The starting points of the IASB and the FASB are quite different. Whereas IFRS 9 includes a mixed attribute model under which some financial instruments are measured at amortised cost and some at fair value, the FASB has proposed that the default measurement approach should be fair value with some exceptions, including allowing some liabilities to be measured at amortised cost. The IASBs' and the FASB's proposed approaches on impairment and hedge accounting also are not aligned. However, discussions between the IASB and the FASB continue, with intensive joint consideration of impairment approaches in recent weeks.

Request for Views.4

As noted in section 5, the IASB is consulting with constituents about effective dates and transition methods for its major projects. Currently IFRS 9 (2010) is stated to be mandatorily applicable from 2013 onwards. However, this may change in the light of comments received on the Request for Views. In particular the IASB has indicated that it may defer the effective date of IFRS 9 in order to align with the possibly later effective date of a new insurance standard.

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About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

We would like to acknowledge the efforts of the principal authors of this publication. Those authors include Dr Markus Fuchs and Chris Spall of the KPMG International Standards Group.

Content

Our *First Impressions* publications are prepared upon the release of a new IFRS or amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of *First Impressions* considers the requirements of IFRS 9 *Financial Instruments* as issued in October 2010 (IFRS 9 (2010)).

The text of this publication is referenced to IFRS 9 (2010) and to selected other current IFRSs in issue at 9 December 2010. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this standard in the light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

Abbreviations

1 IASB: International Accounting Standards Board
2 FASB: US Financial Accounting Standards Board

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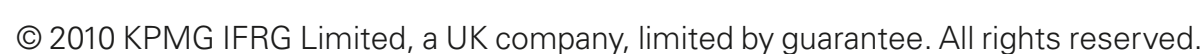

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Publication name: *First impressions: Additions to IFRS 9 Financial Instruments*

Publication number: 314561

Publication date: December 2010

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