

# IFRS Briefing Sheet

## IFRS 9 *Financial Instruments*

November 2009, **Issue 160**

This IFRS Briefing Sheet summarises the International Accounting Standard Board's (IASB or Board) IFRS 9 *Financial Instruments*, which was published on 12 November 2009.

IFRS 9 is part of the IASB's wider project to replace IAS 39 *Financial Instruments: Recognition and Measurement* over the next year.

IFRS 9 retains but simplifies the mixed measurement model and establishes two primary measurement categories for financial assets; amortised cost and fair value. The basis of classification depends on the entity's business model and the contractual cash flow characteristics of the financial asset.

The guidance in IAS 39 on impairment of financial assets, and on hedge accounting continues to apply.

### **Background**

The IASB has issued IFRS 9 as part of its comprehensive review of financial instruments accounting. The IASB aims to reduce the complexity of the current requirements and to replace IAS 39 in phases by the end of 2010.

IFRS 9 is based on ED/2009/7 *Financial Instruments: Classification and Measurement* (the ED) which was published on 14 July 2009 but it contains many important changes compared to the ED.

IFRS 9 deals with classification and measurement of financial assets only. Based on the responses to the discussion paper *Credit Risk in Liability Measurement* (DP) the IASB decided to remove financial liabilities from the scope of the first instalment of the replacement standard. The Board will consider and issue requirements for financial liabilities during 2010.

### **Summary of the Standard**

This IFRS Briefing Sheet provides an overview of the standard.

Our forthcoming publication *First Impressions: IFRS 9 Financial Instruments* will provide more detail about the standard, examples of the new requirements and our first impressions about practical implementation of the standard. Speak to your usual KPMG contact if you would like a copy of this publication.

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## Classification

Consistent with the ED, the standard requires financial assets to be classified on initial recognition as measured at:

- amortised cost; or
- fair value.

A financial asset is measured at amortised cost if:

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

All other financial assets are measured at fair value. The standard eliminates the existing IAS 39 categories of held to maturity, available for sale and loans and receivables.

## Entity's Business Model for Managing Financial Assets

The business model approach is a fundamental building block of the new standard and aligns the accounting with the way that management deploys assets in its business while also considering the characteristics of assets.

The business model is determined by the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*) and does not depend on management's intentions for an individual asset. It is instead determined at a higher level.

An entity could have more than one business model for managing financial assets and may manage different portfolios of assets with different objectives.

## Contractual Cash Flow

### Characteristics of the Financial Asset

The second condition for a financial asset to qualify for amortised cost

measurement is that the contractual terms of the asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding. Interest is defined as consideration for the time value of money and credit risk. The standard contains several examples to illustrate the application of this condition.

## Embedded Derivatives

Embedded derivatives are no longer separated from hybrid contracts that have a financial asset host. Instead, the entire hybrid contract is assessed for classification using the principles above. IAS 39 continues to apply to derivatives embedded in financial liabilities.

## Fair Value Option

The standard allows an entity to designate a financial instrument on initial recognition as measured at fair value through profit or loss regardless of it meeting the criteria to be measured at amortised cost. This election is available only if it eliminates or significantly reduces a measurement or recognition inconsistency ("accounting mismatch"). This election is retained from the ED and IAS 39.

## Reclassification

Reclassification of financial assets is required if the objective of an entity's business model changes in a manner that is both significant to the entity's operations and demonstrable to external parties. Such changes are expected to be "very infrequent".

## Investments in Equity Instruments

Investments in equity instruments are measured at fair value and, except as described below, gains and losses on remeasurement are recognised in profit or loss.

For an investment in an equity instrument that is not held for trading, IFRS 9 allows an entity on initial

recognition to elect irrevocably to present all fair value changes from the investment in other comprehensive income (OCI). No amount recognised in OCI is ever reclassified to profit or loss at a later date.

In a change from the ED, dividends on such investments are recognised in profit or loss, rather than OCI, in accordance with IAS 18 *Revenue* unless they clearly represent a recovery of the cost of the investment.

## Measurement

IFRS 9 eliminates the exception in IAS 39 that allows investments in unquoted equity instruments, and related derivatives, for which a fair value cannot be determined reliably, to be measured at cost. These instruments are now measured at fair value although the standard notes that in some limited circumstances cost may be an appropriate estimate of fair value.

As under existing IAS 39 requirements, financial assets are initially measured at fair value plus, in the case of a financial asset not at fair value through profit or loss, transaction costs. The guidance in IAS 39 on impairments of financial assets and on hedge accounting continues to apply. However, as a result of the simplified classification requirements, the numerous impairment methods in IAS 39 have been reduced to a single impairment method.

All changes in the fair value of financial assets that are measured at fair value are recognised in profit or loss, with the exception of equity investments for which the OCI option has been elected, and assets that are part of a hedge relationship. Gains or losses on assets measured at amortised cost are recognised in profit or loss upon derecognition, impairment or reclassification of the asset, and through applying the effective interest method.

**Effective Date**

The standard is effective for annual periods beginning on or after 1 January 2013 but may be applied earlier.

The standard generally requires retrospective application in accordance with IAS 8 *Accounting Policies,*

*Changes in Accounting Estimates and Errors.* However there are several exceptions to this principle and the transitional requirements are extensive. In particular, if an entity adopts the standard for reporting periods beginning before 1 January 2012 it is not required to restate prior periods.

If you would like further information on any of the matters discussed in this issue of *IFRS Briefing Sheet*, please talk to your usual local KPMG contact or call any of KPMG firms' offices.

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