



# **NEW ACCOUNTING MODEL FOR FINANCIAL INSTRUMENTS (IAS-39 Replacement Project)**

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May, 2011

## Session Agenda

- ▶ Reasons for replacement of IAS-39
- ▶ IASB's approach for replacement of IAS-39
- ▶ IFRS-9 – Classification and Measurement of financial instruments
- ▶ IASB's Exposure Draft that proposes new Impairment Approach for financial assets

## Reasons for replacement of IAS-39

- ▶ IAS-39 was issued in March, 1999 i.e. more than 12 years back from now
- ▶ Since 1999, the standard has been amended several times during 2003, 2004, 2005 and 2008. Also various interpretations relating to standard have been issued by the IFRIC
- ▶ The standard became highly popular due to its complexity particularly during the Global Financial Crisis

## Reasons for replacement of IAS-39- Cont...

- ▶ The criticism on IAS-39, in brief :
  - ▶ **Fair value accounting** was said to have created cycles of accounting write downs and distressed selling of assets during the Crisis
  - ▶ The application of IAS-39 **impairment model for loan loss** provisions results in delayed recognition of credit losses
  - ▶ The **over complexity** of IAS-39 such as mined valuation models, multiple impairment approaches, complicated category transfer rules and hedge accounting requirements

## Reasons for replacement of IAS-39- Cont...

- ▶ In view of above criticism, IASB received calls to reduce the complexity of accounting standards for financial instruments from G-20, the Financial Stability Board, the European Union and regulators and other stakeholders from around the world
- ▶ It is interesting to note that IASB and US FASB had issued a Discussion Papers, “Reducing Complexity in Reporting Financial Instruments” back in March 2008. (at an early stage of the Crisis)

# The IASB approach for replacement of IAS-39

- ▶ A phased approach has been adopted to accelerate the project. The **three** main phases are:
  - ▶ **Classification of measurement** ( IFRS-9 has been issued in November 2009 with effective date of January 2013 but available for early adoption)
  - ▶ **Impairment of Financial assets** (ED was published in November 2009 and recently in January 2011, a supplement to the ED has been published as a result of IASB and FASB subsequent discussions on this subject)
  - ▶ **Hedge accounting** (ED has been published in December 2010)

## The IASB approach for replacement of IAS-39- Cont...

- ▶ As each phase gets complete, additions would be made in the IFRS 9 and consequent deletions to IAS 39
- ▶ A final standard incorporating all the above is expected by the end of this year which will eventually replace IAS 39

# **IFRS-9 – Classification and Measurement of financial instruments**

## IFRS-9 Conceptual Foundation

- ▶ In developing IFRS-9, the IASB was faced with a challenge to reduce complexity of IAS-39 and at the same time maintain a technically sound basis for the standard
- ▶ Many believe that the primary source of complexity in IAS-39 is the diverse methods used to measure financial instruments and perhaps the solution may be to move towards full Fair Value approach
- ▶ The IASB noted that there is still widespread support for the mixed attribute measurement approach (Fair value and Amortized cost). Therefore, IFRS-9 is build on a Mixed Measurement Model.

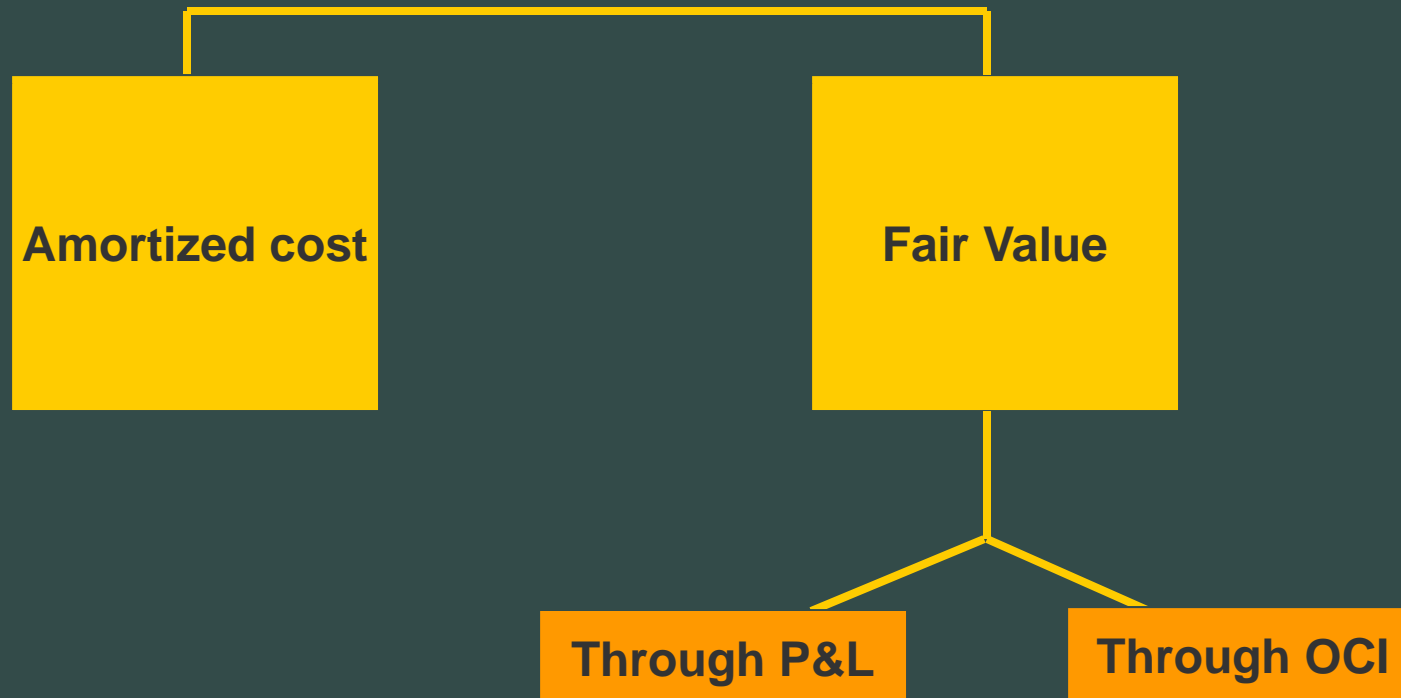
## IFRS-9 Conceptual Foundation- Cont...

The standard draws distinction between:

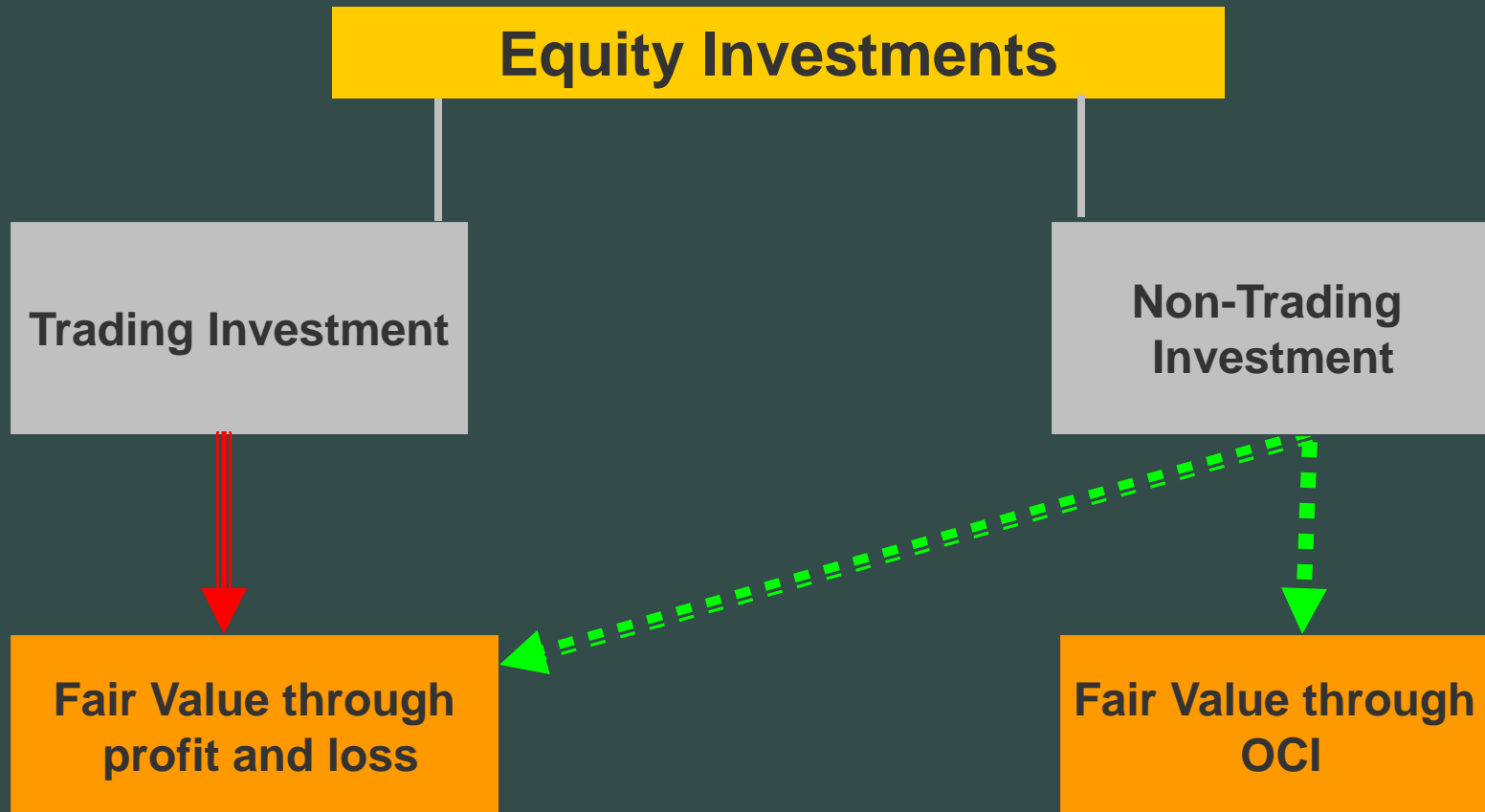
- ▶ Those **instruments that have highly variable cashflows** (Equity investments and derivatives) ; and
- ▶ Those **instruments that have cashflows which are either fixed or vary only with market interest rates** (loan ,bonds ,simple debt instruments)
  
- ▶ For **the first category** ,IASB believe that **Fair value** is the most appropriate measurement basis.
- ▶ For **the second category**, the IASB accepts that **a cost-based approach** would be feasible especially when they are held to collect contractual cashflows rather than for selling.

# IFRS-9 Classification and Measurement Overview

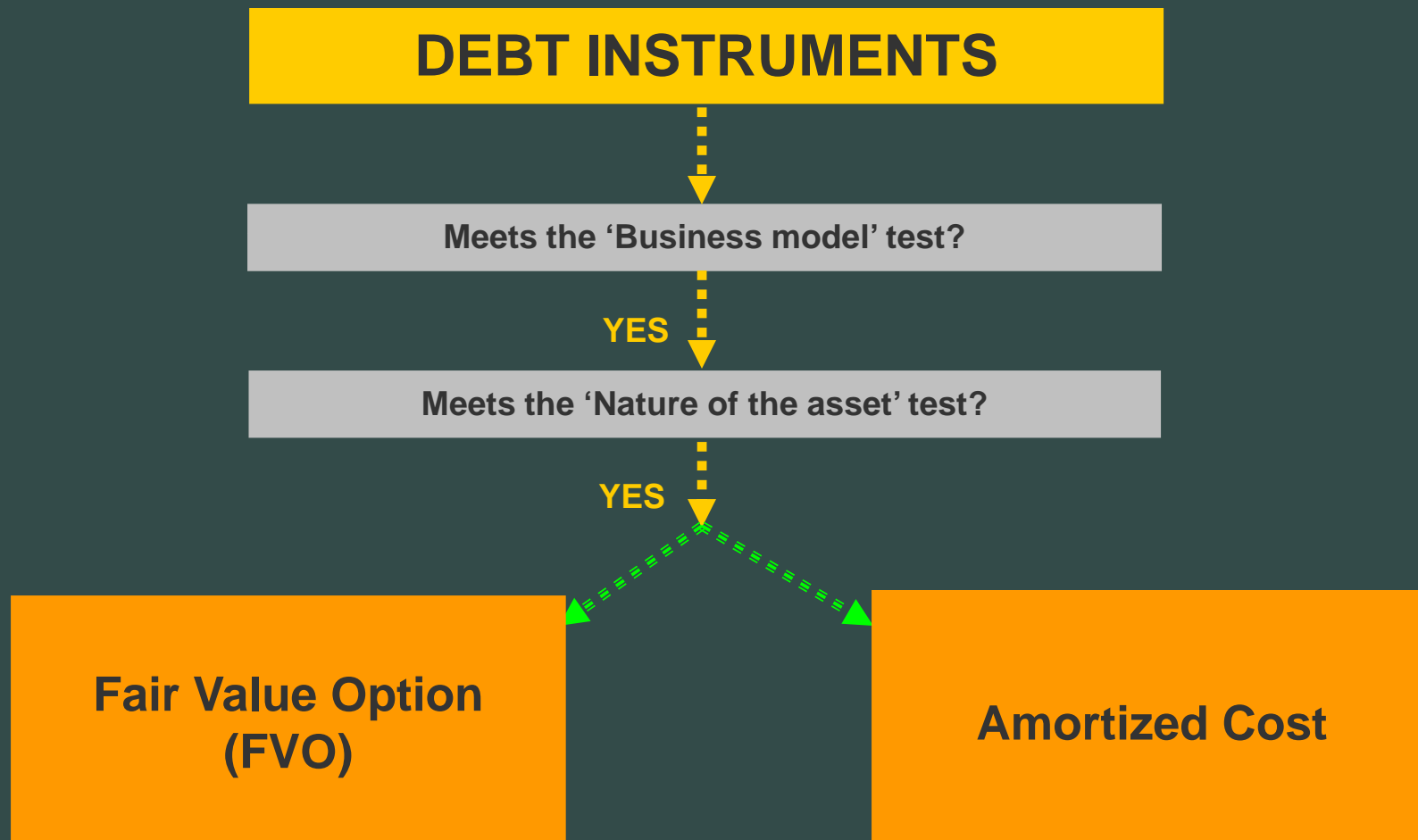
- ▶ Under IFRS-9, classification and measurement of financial assets is limited to **two categories**:



# IFRS-9 Classification and Measurement Overview- Cont...



# IFRS-9 Classification and Measurement Overview- Cont...



## IFRS-9 Closer look at Equity Instruments

- ▶ **Held for Trading** investments continue to be measured at fair value through profit and loss **as presently under IAS-39**
- ▶ **Non-Trading investment** that are presently classified an **AFS under IAS-39 are subject to option** i.e. Fair Value through profit and loss (FVTPL) or Fair Value through Other Comprehensive Income (FVTOCI)

## IFRS-9 Closer look at Equity Instruments- Cont...

- ▶ In case of non-trading investments classified under FVTOCI category, **all fair value changes** in there investments will be recognized as Other Comprehensive income/expense without **any transfer of gains and losses to P& L account on:**
  - ▶ Disposal ;or
  - ▶ Impairment
- ▶ Therefore, **impairment of AFS equity investment will no longer be an issue**
- ▶ This may result in potential tax issues and legal issues regarding availability of realized capital gains for dividend purposes

# IFRS-9 Closer look at Equity Instruments- Cont...

- ▶ No cost exemption for unquoted equity instruments → all equities at fair value
- ▶ Cost may be used as a proxy for fair value in certain circumstances
- ▶ Indicators of when cost **might not** represent fair value
  - ▶ A significant change in the performance of the investee
  - ▶ Changes in expectation that technical milestones will be achieved
  - ▶ A significant change in the market for the investee company or its products
  - ▶ A significant change in the global economy or the economic environment
  - ▶ A significant change in the observable performance of comparable companies, or in the valuations implied by the overall market.
  - ▶ Internal matters such as fraud, commercial disputes, or litigation, or changes in management or strategy.
  - ▶ Evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

# IFRS-9 Closer look at Debt Instruments

Under **IAS-39**, debt instrument may be classified in the following 4 categories:

- ▶ Fair Value Through Profit and Loss
  - ✓ Held For Trading
  - ✓ Designated as FVTPL
- ▶ Loan and Receivables
- ▶ Held to Maturity
- ▶ Available for Sale

## IFRS-9 Closer look at Debt Instruments- Cont...

- ▶ Under IFRS-9 debt instrument are classified either at Amortized Cost or Fair Value
- ▶ Amortized cost
  - ▶ Asset is held within a Business Model whose objective is to hold the asset to collect contractual cashflows (**Business Model Test**)
  - ▶ The contractual terms of the instrument give rise to cashflows, at specified date, that are solely payments of principal and interest. (**Nature of Asset Test**)
- ▶ **All other debt instrument** are measured at fair value through profit and loss account.

# IFRS-9 Closer look at Debt Instruments- Cont...

## Business Model Test

- ▶ The objective of entity's business model may be :
  - ▶ To collect all contractual cashflows of the instrument: or
  - ▶ To sell instruments prior to maturity and realize fair value changes
  
- ▶ In some cases, an entity may have more than one business model, in which case, the assessment would be made at a portfolio level rather than an entity level.

# IFRS-9 Closer look at Debt Instruments- Cont...

## Business Model Test

- ▶ Is a **matter of fact** and not management intention.
- ▶ **Not an instrument-by-instrument approach** like IAS-39.
- ▶ **May continue to be met even when some investment from portfolio are sold** before maturity for example due to:
  - ▶ Liquidity needs
  - ▶ Instrument no longer meet the entity's investment policy because of change in credit rating etc.
  - ▶ However, in case of **more than infrequent sales out of portfolio, the entity may need to reconsider** how it is consistent with the objective of its business model

# IFRS-9 Closer look at Debt Instruments- Cont...

## Nature of Asset Test

- ▶ The test requires that the debt instrument give rise, on specified dates, to cashflows that **solely represent**:
  - ▶ **Interest** on the principal outstanding ( i.e. consideration for time value of money and credit risk)
  - ▶ Repayment of **principal**
- ▶ This means that **effectively simple debt instruments** will meet the test to qualify for amortized cost measurement.

## IFRS-9 Closer look at Debt Instruments- Cont...

### Nature of Asset Test –(Instruments that will not meet the test)

- ▶ A Bond convertible into equity instruments of the issuer because the return also include premium/discount for the equity conversion feature
- ▶ Debt instruments which pays interest not in line with the market interest rates or includes embedded derivatives
- ▶ Derivative contracts such as options, swaps, futures etc. in which the return is not interest on the principal outstanding
- ▶ Debt instrument that allow issuer to defer the interest payment and deferred interest does not accrue additional interest (such as some cumulative preference shares) because interest amount is not consideration for time value of money

# IFRS-9 Closer look at Debt Instruments- Cont...

## Nature of Asset Test –(Instruments that will meet the test)

- ▶ An instrument with fixed maturity with a fixed rate of interest
- ▶ An instrument carrying variable market rate of interest
- ▶ An instrument carrying variable market rate of interest subject to a cap.
- ▶ Perpetual debt instruments (which in effect has continuous extension)
- ▶ Debt instruments with Prepayment options (may include reasonable compensation for early termination)
- ▶ Debt instruments with extension options If the terms result in payment of interest and principal during the extension period

## IFRS-9 Closer look at Debt Instruments- Cont...

Nature of Asset Test (How apply to Non-recourse loan and Securitized Debt)

- *Non-recourse loan*) : A loan in which lender is entitled only to repayments from specific asset or cashflows **For example**: a property loan in which lender's return is linked to performance of the secured property
- *Securitized Debt* :that pass through the cashflows of the underlying assets rather than generate contractual cashflows

## IFRS-9 Closer look at Debt Instruments- Cont...

Nature of Asset Test (How apply to Non-recourse loan and Securitized Debt)

- ▶ **The holder** should adopt a '**look through**' approach and apply the Test to the underlying asset pool that generate (and not only pass through) the cash flows
- ▶ If it is impracticable for the holder to look through to underlying assets, measure at **FVTPL**

## IFRS-9 Closer look at Debt Instruments- Cont...

- ▶ Like IAS-39, IFRS-9 also provides Fair Value option
- ▶ Debt instruments that qualify for amortized cost measurement may be measured at fair value through profit or loss subject to the following:
  - ▶ The choice should be made at initial recognition
  - ▶ The use of fair value is to reduce or eliminate a measurement inconsistency (Accounting mismatch)

# Impact of IFRS-9 on the measurement of Debt Instruments under IAS-39

## IAS-39

- Held For Trading
- Designated at FVTPL
  - Managed on fair value basis
  - Embedded derivative
  - Accounting Mismatch

## IFRS-9

- FVTPL as will clearly not qualify 'Business Model Test'
- FVTPL as will fail 'Business Model Test'
- FVTPL as will fail 'Nature of Asset Test)
- **FVTPL or Amortized cost (if qualify so )**

# Impact of IFRS-9 on the measurement of Debt Instruments under IAS-39

- ▶ Many debt instruments held under 'Held to Maturity, Available for Sale and Loan and Receivable category of IAS-39 will qualify for Amortized cost measurement of IAS-39 provided they meet 'Nature of Asset Test'
- ▶ IFRS-9 **remove the requirement to separate embedded derivatives** from the host contracts and the assets, in its entirety, is measured at **Amortized Cost** or **Fair Value**.
- ▶ Considering the stringent (**Nature of Asset Test**) of IFRS-9, many hybrid instruments are not expected to qualify for 'Amortized cost' measurement.

# IFRS-9 Reclassifications (between amortised cost and FVTPL)

- ▶ Reclassification will be required **only when an entity changes its business model** (not just the change in intention like IAS 39)
- ▶ **Prohibited in all other circumstances**
- ▶ **Transfer of financial assets between business models is also not allowed**
- ▶ All reclassification to be **accounted for prospectively** from the Reclassification date ( first day of the first reporting period following the change)
- ▶ Detailed disclosures will be required in the financial statements

# IFRS-9 Reclassification

## Examples from application guidance

Reclassification required	Reclassification prohibited
An entity has a portfolio of commercial loans that it held to sell in the short term. However, the entity acquires a company that manages commercial loans and has a business model that holds the loans to collect the contractual cash flows.	A change in intention related to specific financial assets (even in circumstances of significant changes in market conditions)
A financial services firm decides to shut down its retail mortgage business, and is no longer accepting new business. The firm actively market its mortgage loan portfolio for sale.	A temporary disappearance of a particular market for financial assets
	A transfer of financial assets between existing business models

# IFRS-9 Effective Date and Transition

- ▶ IASB effective date 1 January 2013
- ▶ Early adoption is permitted
- ▶ **Retrospective application** is required
  - ▶ For instrument on the entity balance sheet date at the date of initial application
  - ▶ Assessment has to be made as to whether such investment be measured at **Amortized Cost** or **Fair Value** on the basis of financial circumstances existing at the applicable date
  - ▶ The difference between the previous carrying value and IFRS-9 carrying amount **may be adjusted against opening retained earnings**. **The standard provide transitional relief for restatement of comparative figures).**

## IFRS-9 Transition relief

- ▶ Comparative figures are required to be restated, but with some transition reliefs for early adopters:

Year of adoption	2009 or 2010	2011	From 2012
Initial application date	May choose any date (after 12 Nov 2009) within the reporting period, as the initial application date	Beginning of reporting period	Beginning of reporting period
Comparative figures	Are permitted, but not required to be restated	Are permitted, but not required to be restated	Are required to be restated

## IFRS-9 Early adoption considerations

- ▶ An entity may adopt the first phase of IAS-39 replacement project i.e. IFRS-9 without necessarily committing to early adopt the remaining phases
- ▶ If an entity wishes to adopt a subsequent phase (such as impairment, hedge accounting) it must apply the requirement of phase before it

# IFRS-9 Early adoption considerations- Cont....

## Potential Benefits

### ▶ Equity investments

- ▶ Avoid recording impairment in P&L on AFS investments by recording them at Fair Value through OCI
- ▶ Reversal of previously recorded impairment through P&L by classifying them at FVTPL upon initial application of IFRS-9

### ▶ Debt instruments

- ▶ Opportunity to revoke the previous designation at FVTPL, if the instrument qualify for amortized cost accounting
- ▶ AFS debt instruments may qualify for amortized cost measurement and hence recording of full fair value decline as impairment may be avoided. Under amortized cost, impairment is restricted to the credit losses only
- ▶ No need for split accounting for instruments with embedded derivatives

# IFRS-9 Early adoption considerations- Cont....

## Challenges

- ▶ To qualify for amortized cost, entities need to **demonstrate the appropriate 'Business Model'** (management intent is not sufficient)
- ▶ Instruments reclassified to amortized cost using **October 2008 IAS-39 amendments and peculiar market conditions**, may have to be reclassified back to Face Value
- ▶ Need to consider **'Regulatory'** and **'Tax'** consequences as the change in measurement model will impact the net profit/ loss
- ▶ **A SPECIAL COMMITTEE OF ICAP IS EVALUATING THE IFRS 9 FOR ADOPTION IN PAKISTAN** particularly its interaction with the statutory reporting requirements

## European Union (EU) endorsement of IFRS-9

- ▶ Entities subject to EU regulations cannot apply IFRS-9 until it is endorsed by EU.
- ▶ EU was amongst the stakeholders that urged the IASB to make changes to IAS-39
- ▶ **EU has not yet endorsed IFRS-9**, however;
  - ▶ EU supports the approach based on mixed attribute Measurement Model
  - ▶ EU has decided to take more time to analyze the implication of the new standard including the subsequent phases of IAS-39 replacement project

## IFRS-9 Convergence with US GAAP

- ▶ FASB tentative decision to **use fair value as the only measurement basis for all financial instruments** (including loans). FASB has also issued a proposed Accounting Standard Update on financial instruments in May 2010 which proposes that for financial assets held for collection of contractual cashflow, both amortized cost and fair value information should be provided
- ▶ **Inconsistent with the two-category classification approach adopted in IFRS 9**
- ▶ **However, The IASB and FASB are still** committed to the convergence on the accounting of financial instruments



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# **IASB's Exposure Draft on Impairment of Financial Assets at Amortized cost**

## Background

- ▶ In response to the reporting issues highlighted by the Global Financial Crisis, a Financial Crisis Advisory Group (FCAG) was setup in October 2008
- ▶ The objective of FCAG was to advice IASB and US FASB to bring improvements in the financial reporting standards that could enhance investor confidence in the financial markets
- ▶ The FCAG, in its report published in July 2009, identified delayed recognition of loan losses as one of the primary weaknesses in the accounting standards and recommended to explore alternatives model which is more forward looking

## Background- Cont....

- ▶ The IASB published an Exposure Draft (ED) in November 2009, which proposes new impairment approach referred to an **Expected Loss Model** for recognizing impairment of financial assets carried at amortized cost
- ▶ In January 2011, IASB and FASB published a joint document that proposes a common approach on credit impairment of loans and other financial assets
- ▶ The Joint document has been included in the ED as a supplement to seek public comments

## Incurring Loan Model under IAS-39

- ▶ Interest income is recognized over the period of the loan on the basis of contractual cashflows (**Effective interest method**)
- ▶ **Impairment is recognized** only when there is a objective evidence of impairment i.e. **when a loss event has occurred**
- ▶ It may argued that interest income is **overstated** in periods before a loss event occurs because it is inherent in the nature of assets that certain credit losses will occur

# Expected Loss Model as proposed by ED

- ▶ Expected credit losses are included in the calculation of effective interest rate so that **credit losses are recognized over the life of the loan as a reduction of interest income**
- ▶ In other words, **a portion of the contractual interest income is allocated each year to build up an allowance account for expected credit losses**
- ▶ Expected credit losses are continuously re-evaluated and hence impairment is recognized not when **loss event** occurs but **over the period of the loan** on the basis of future expected loss events
- ▶ **Difference arising from variation in actual credit loss and expected credit loss or changes in future expectations** of credit losses are accounted for in the period of change

## Example -

- ▶ A loan of Rupees 100,000 for a period of 5 years.
- ▶ The contractual cashflows of the loan amounts to Rupees 25,000 per annum
- ▶ The expected credit loss from the loan is Rupees 3,000 in year 3 and Rupees 7,000 in year 4

# INCURRED LOSS MODEL

YEAR	OUTSTANDING LOAN	INTERST REVENUE	CASHFLOWS (without credit losses)	EFFECTIVE INTEREST RATE %
1	100,000	7,930	(25,000)	7.93
2	82,930	6,576	(25,000)	7.93
3	64,506	5,115	(25,000)	7.93
4	44,622	3,539	(25,000)	7.93
5	23,160	1,840	(25,000)	7.94
<b>TOTALS</b>		<b>25,000</b>	<b>(125,000)</b>	

# INCURRED LOSS MODEL

YEAR	INTERST REVENUE	CREDIT LOSSES	NET EFFECT ON PROFIT & LOSS	TOTAL RETURN %
1	7,930		7,930	7.93
2	6,576		6,576	7.93
3	5,115	(3,000)	2,115	3.28
4	3,539	(7,000)	(3,461)	(7.76)
5	1,840		1,840	7.94
<b>TOTALS</b>	<b>25,000</b>	<b>(10,000)</b>	<b>15,000</b>	

# EXPECTED LOSS MODEL

YEAR	OUTSTANDING LOAN	INTERST REVENUE	CASHFLOWS (without credit losses)	EXPECTED CREDIT LOSSES	EFFECTIVE INTEREST RATE %
1	100,000	4,960	(25,000)		4.96
2	79,960	3,966	(25,000)		4.96
3	58,926	2,923	(25,000)	3,000	4.96
4	39,849	1,976	(25,000)	7,000	4.96
5	23,825	1,175	(25,000)		4.93
<b>TOTALS</b>		<b>15,000</b>	<b>(125,000)</b>	<b>10,000</b>	

# EXPECTED LOSS MODEL

YEAR	GROSS INTERST REVENUE	ALLOWANCE FOR EXPECTED LOSSES	NET EFFECT ON PROFIT & LOSS	TOTAL RETURN %
1	7,930	2,970	4,960	4.96
2	6,576	2,610	3,966	4.96
3	5,115	2,192	2,923	4.96
4	3,539	1,563	1,976	4.96
5	1,840	665	1,175	4.93
<b>TOTALS</b>	<b>25,000</b>	<b>10,000</b>	<b>15,000</b>	

# EXPECTED LOSS MODEL

## Effect of Change in expectations

**Balance at the end of Year 2** **58,926**

### Revised expected cashflows

YEAR	CASHFLOWS (without credit losses)	EXPECTED CREDIT LOSSES	NET CASH FLOWS
3	(25,000)	6,000	(19,000)
4	(25,000)	7,000	(18,000)
4	(25,000)		(25,000)

**Present Value of revised expected cashflows at original EIR (4.96%)** **56,000**

**Impairment resulting from change in expectation** **2,926**

# Expected Loss Model – Operational Challenges

- ▶ The IASB recognizes the potential practical difficulties in implementing the Expected Loss Model particularly the estimation of expected credit losses over the life of the financial assets
- ▶ The ED also includes some application guidance such as:
  - ▶ Estimation of future credit losses, may be on individual loan or port folio basis
  - ▶ Use of either internal or external data of credit loss experience
  - ▶ Guidance on applying the expected loss model on loan with floating interest rate
- ▶ The IASB also formed an Expert Advisory Panel of credit risk professionals, regulators, auditors, etc to address the operational challenges and provide application guidance and identifying simplifications

## Expected Loss Model – Supplement to ED

- US FASB also published a credit impairment approach in May 2010 which proposed a different credit impairment approach
- The Expert Advisory panel of IASB also indicated that the effective interest rate approach may be difficult to apply in practice
- Therefore, **IASB and FASB held joint discussions to have a common approach for credit impairment** which led to the publication of a supplement to ED in January 2011

## Expected Loss Model – Supplement to ED Cont....

- Significant features of proposed joint approach:
- Financial assets would be **assessed for impairment in portfolios** of assets with similar characteristics
- Portfolios would be divided into a “**Good Book**” and a “**Bad Book**”
- **Good book** – portfolios from which management expects to receive regular payments **Bad Book** – from which the collectability is uncertain and the objective is recover all or a portion of asset

## Expected Loss Model – Supplement to ED Cont....

- In case of portfolios in the **Good Book**, total life time expected credit losses would be allocated systematically to income statement **over the weighted average life of portfolio to build up an allowance account**
- The allowance recorded at any reporting date would be **subject to a floor** i.e. credit losses expected to occur within the foreseeable future (12 months)
- **The life time expected losses in a portfolio would be re-estimated at each reporting date** and the allowance account would be adjusted immediately

## Expected Loss Model – Supplement to ED Cont....

- When a loan is transferred from **Good Book** to **Bad Book** , full life time expected credit losses are fully provided for in the period in which the transfer takes place
- The credit risk management policies and processes that entities use to determine when to transfer an asset from the Good Book to the Bad Book would become very important as it would have an effect on the income statement

## Expected Loss Model – Supplement to ED Cont....

- The IASB and FASB has yet to discuss the application of joint credit impairment approach on the following:
  - Short term trade receivables without a stated interest rate
  - Debt securities and financial assets that are evaluated on individual basis rather than portfolio basis
- The ED also proposes extensive presentation and disclosure requirements

## Expected loss Model - Business Impact

- ▶ **Credit impairment allowances** are expected to increase from **current levels** due to build up of an allowance account before the losses are actually incurred
- ▶ **Greater subjectivity** is assessing future credit losses
- ▶ **Diversity in application**- different entities may use different methodologies to project expected credit losses

## Expected loss Model - Business Impact Cont...

- ▶ Aim to reduce volatility in profits, however, may
  - ▶ Reduce profitability for expanding loan booked in earlier year.
  - ▶ Result in **larger losses in periods with significant changes in future credit loss expectations** (may be more pro-cyclical)
- ▶ **Significant system changes required** due to:
  - ▶ Complexity in computing credit impairment allowance
  - ▶ Extensive disclosures require data and analysis and hence a need to gather such data through the accounting system

THANK YOU !