IFRS 9: PHASE 1 OF RECASTING OF IAS 39

If you have been hating accounting standards, you would possibly love this one!

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One would hate repeating it often: accounting for financial instruments continues to be a perennial state of flux, as standard-setters continue to react to a volatile world. That is exactly a pity – standards cannot change as often as times do, as standards blend contemporariness and continuity. Standards cannot be made to yield to convenience of times that we are in. It would not be surprised is the standard-setters ultimately complete a full circle and revert to historical cost accounting after experimenting with years of fair value accounting.

Even before IAS 39 – the very complex standard that requires mark-to-market accounting for financial instruments and derivatives – is either fully understood or implemented, it is already in the process of being comprehensively rewritten. IFRS 9 completes the first phase of the rewriting process. The 3 phases in which the rewriting project has been split are:

- Phase 1: Classification and measurement of financial instruments – IFRS 9 issued in Nov 2009
- Phase 2: impairment of financial instruments – ED issued in Nov 2009
- Phase 3: Hedge accounting – exposure draft expected in Q1, 2010

Presently, the classification of financial instruments is done based on whether mark-to-market accounting is applicable or not, and further, whether the gains/losses on valuation are taken to current earnings or to shareholders' equity. Accordingly, financial assets are classed into (1) originated loans and receivables; (2) hold-to-maturity assets; (3) available for sale assets; (4) held for trade assets. In (1) and (2), there is no question of fair valuation. In (3), fair valuation is carried out, but the gains/losses are carried to shareholders' equity. In (4), fair valuation is carried out regularly, and the gains/losses are taken to current earnings.

IFRS 9 is intended to simply the classification. Accordingly, IFRS 9 talks of 3 types of assets: (a) assets carried at amortized cost; (b) assets carried at fair value; (c) equity instruments.

Assets will be carried at amortized cost if (a) the contractual cashflows of the asset give rise to principal and interest; AND (b) the assets are held under a business model whose objective is to hold such assets to collect the contractual cashflows.

All assets, other than those that are carried at amortized cost, are to be fair valued. All gains/losses on fair valuation will be taken to Profit and loss account, except in case of equity instruments.

In case of equity instruments, there is a one-time choice of whether the gains/losses on valuation will be taken to shareholders' equity (OCI) or P/L.

The are 2 notable changes in IFRS 9 over IAS 39:

- **Basis for determination of HTM changes from an asset to business model:** Under IAS 39, it is quite difficult for assets to qualify for HTM treatment, as not only has the intent to hold to maturity need to be positively asserted, even retrospectively, sale before maturity of the assets classed as HTM would lead to tainting of accounts. Under IFRS 9, this classification is more pragmatic – it is based on a business model and not individual assets. Accordingly, the HTM intent is applied to a "business model", that is, to a portfolio of assets, or all assets of an entity. It would be much easier to classify assets as HTM and thus avoid mark-to-market valuation, if the business model of the entity, for the portfolio in question, does not warrant or envisage trading or active disposal of assets. Assets forming part of such model may be disposed off. There are some illustrative situations given in Para B4.3 and B4.4 where sales of assets subject to HTM model may occur, but these situations may only be taken as illustrative. The essential idea is that the decision to sell assets is not to reap business opportunities, but to meet business exigencies or sack assets not fitting into the investment portfolio of the investor.
- **Fair value changes are routed through current profits, and not OCI**: This also may be taken as a step towards simplification, as the current practice of permitting OCI/current P/L treatment is unduly complex.

The pre-condition for amortized cost valuation, viz., that the contractual cashflows consist of interest and principal only, has given rise to some questions of details – for example, in case of non-recourse loans. However, these are nuances that are avoidable for a basic understanding.

IFRS 9 is applicable from 1 Jan 2013; however, its early application is permitted. Given its comparative simplicity, entities, particularly those that have business models satisfying the HTM test, should run to adopt it sooner than later.