Accounting evolution

As the International Accounting Standards Board develops its reporting requirements, PKF's Ben Leung and Rennie Khan examine the evolving International Financial Reporting Standard 9 and its application for insurance entities.

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The majority of an insurance captive's excess cash is invested in financial products which meet the definition of financial instruments and hence the applicability of International Financial Reporting Standards 9 (IFRS).

This article focuses on an overview of the proposed new standard including the background for issuing the IFRS, the key differences between the proposed IFRS 9 and existing International Accounting Standard (IAS) 39, a highlight of the new requirements under IFRS 9 and the current status of the International Accounting Standards Board's (IASB) project on financial instruments.

Background for issuing the IFRS

IAS 39 sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Many users of financial statements and other interested parties informed the IASB that the requirements in IAS 39 were difficult to understand, apply and interpret. They urged the IASB to develop a new standard for the financial reporting of financial instruments that was principle-based and less complex. Although the IASB amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it had not previously undertaken a fundamental reconsideration of reporting for financial instruments.

The major requirements of IFRS 9 and key differences from IAS 39

RECOGNITION AND DERECOGNITION

An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument. A regular way purchase or sale of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting. An entity shall derecognise a financial asset when, and only when:

(a) The contractual rights to the cash flows from the financial asset expire, or

(b) It transfers the financial asset and the transfer qualifies for derecognition.

If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.

An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—in other words, when the obligation specified in the contract is discharged or cancelled or expires.

CLASSIFICATION

Unless the option to designate a financial asset at fair value through profit or loss applies, an entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:

(a) The entity's business model for managing the financial assets and

(b) The contractual cash flow characteristics of the financial asset.

A financial asset shall be measured at amortised cost if both of the following conditions are met:

(a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows and

> "Companies with major investments in financial products need to closely monitor the progress and development of the IASB's project on financial instruments."

(b) 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.

A financial asset shall be measured at fair value unless it is measured at amortised cost.

Despite the above an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

KEY DIFFERENCE FROM IAS 39

Under IAS 39, financial assets were classified into four categories: (i) Financial assets at fair value through profit and loss; (ii) Held-to-maturity investments; (iii) Loans and receivables; and (iv) Available-for-sale financial assets. IFRS 9 replaces the multiple classification and measurement models with a single model that has only two classification categories: amortised cost and fair value.

An entity shall classify all financial liabilities as subsequently measured at amortised cost using the effective interest method, except for:

(a) Financial liabilities at fair value through profit or loss. Such liabilities, including derivatives that are liabilities, shall be subsequently measured at fair value.

(b) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies.

(c) Financial guarantee contracts

(d) Commitments to provide a loan at a below-market interest rate.

An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss, or when doing so results in more relevant information, because either:

(a) It eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or

(b) 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—for example to the entity's board of directors and chief executive officer.

IFRS 7 Financial Instruments: Disclosures, requires an entity to provide disclosures about financial assets and liabilities it has designated as at fair value through profit or loss.

MEASUREMENT

At initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

After initial recognition, an entity shall measure a financial asset at fair value or amortised cost. An entity shall apply the impairment requirements of IAS 39 to financial assets measured at amortised cost. After initial recognition an entity shall measure a financial liability in accordance with its classification above.

The key difference from IAS 39 depends on the financial instrument type and classification of that instrument.

Status on the IASB's approach to account for financial instruments

The IASB intends that IFRS 9 will ultimately replace IAS 39 in its entirety. However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the IASB divided its project to replace IAS 39 into three main phases. As the IASB completes each phase, it will delete the relevant portions of IAS 39 and create chapters in IFRS 9 that replace the requirements in IAS 39.

Phase 1: Classification and measurement of financial assets and financial liabilities

In November 2009 the board issued the chapters of IFRS 9 relating to the classification and measurement of financial assets. Those chapters require all financial assets to be classified on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset. In October 2010 the IASB added to IFRS 9 the requirements related to the classification and measurement of financial liabilities. Most of the added requirements were carried forward unchanged from IAS 39. However, the requirements related to the fair value option for financial liabilities were changed to address the issue of own credit risk in response to consistent feedback from users of financial statements and others 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.

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Phase 2: Impairment methodology

In June 2009 the IASB published a request for information on the feasibility of an expected loss model for the impairment of financial assets. This formed the basis of an exposure draft, Financial Instruments: Amortised Cost and Impairment, published in November 2009. The IASB also set up a panel of credit and risk experts to consider and advise on the operational issues arising from an expected cash flow approach. The IASB is redeliberating the proposals in the exposure draft to address the comments received from respondents, and suggestions from the expert advisory panel and other outreach activities.

The supplementary document Financial Instruments: Impairment was published in January 2011. The comment period closed on April 1, 2011 and redeliberations are ongoing. The board will be seeking input on the latest impairment model in early 2012.

Phase 3: Hedge accounting

The IASB is considering how to improve and simplify the hedge accounting requirements of IAS 39. The exposure draft Hedge Accounting was published in December 2010. The comment period closed on March 9, 2011 and redeliberations are ongoing.

Effective date

Subsequent to the standard issued in October 2010, on August 4, 2011, the IASB issued an exposure draft proposing to change the mandatory effective date of IFRS 9 to annual periods beginning on, or after, January 1, 2015 rather than being required to apply them for annual periods beginning on, or after, January 1, 2013 as is currently the case. Early application of both would continue to be permitted. The comment period for the exposure draft closed on October 21, 2011.

Close monitoring is key

IFRS 9 appears to be on its way to "reducing complexity in reporting financial instruments" (which was the theme of the discussion paper issued by the IASB prior to issuing IFRS 9), and there is now clear guidance on recognition, derecognition, classification and measurement. There has been slow but steady progress between the IASB and the US Financial Accounting Standards Board on the convergence of accounting standards on financial instruments. The IASB plans to issue the final standard on general hedge accounting in the first half of 2012. Companies with major investments in financial products need to closely monitor the progress and development of the IASB's project on financial instruments and adapt their business and investment strategies accordingly.

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