Bruce Pounder, CMA, CFM, Editor

Accounting for Financial Instruments: Post-Crisis Changes, Part 1

In the wake of the global financial crisis, the IASB and the FASB are overhauling their accounting standards for financial instruments.

The global financial crisis made us realize that our global financial system had become more vulnerable over time as certain business practices had become more prevalent. In particular, we now understand that the growing use of various kinds of financial instruments by banks and other entities created systemic risks that weren't recognized until disaster struck. But while there is near-universal agreement that financial instruments were part of the problem, there is less agreement about whether accounting standards for financial instruments helped or hurt the situation.

In any case, accounting standards setters in the United States and throughout the world have responded to the widespread belief among their constituents that accounting standards for financial instruments need to be changed. My column this month is the first of two that will describe recent and forthcoming changes to financial-instrument accounting standards—changes that carry significant implications for preparers, auditors, and users of financial statements. Part 1 focuses on how the International Accounting Standards Board (IASB) is changing International Financial Reporting Standards (IFRS), and Part 2 will focus on how the U.S. Financial Accounting Standards Board (FASB) is changing U.S. Generally Accepted Accounting Principles (GAAP).

The Focus Has Shifted

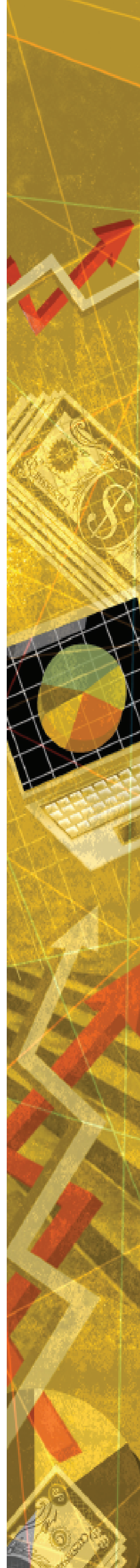
The IASB and the FASB have been working to improve and simplify the financial-instrument provisions of IFRS and U.S. GAAP for many years. But the global financial crisis caused the Boards to reconsider the priority of their financial-instrument projects relative to the many other pressing standards-setting issues on their agendas. As a result, in late 2008 the Boards began to invest an unprecedented amount of effort into overhauling financial-instrument accounting.

From its perspective, the IASB sought to replace existing International Accounting Standard (IAS) 39, "Financial Instruments: Recognition and Measurement," in three phases:

- **Phase 1:** Classification and measurement
- **Phase 2:** Impairment methodology
- **Phase 3:** Hedge accounting

On November 12, 2009, the IASB issued IFRS 9, "Financial Instruments," as a Phase 1 deliverable. IFRS 9 differs from the exposure draft that preceded its issuance and from IAS 39 in several ways. Most significantly, IFRS 9 focuses only on financial *assets*. Financial *liabilities* are specifically excluded from the scope of IFRS 9 and remain within the scope of the portions of IAS 39 that haven't been superseded by the new Standard. The IASB has indicated that the classification-and-measurement model it will eventually develop for financial liabilities won't necessarily mirror its new model for financial assets.

Under IFRS 9, all financial instruments that are assets are subject to a "business model" test in order to determine their classification for measurement purposes. If, under a reporting entity's business model, the objective of holding financial assets is to collect contractual cash flows from them rather than to realize gains by selling the assets prior to their maturity, then—and only then—is



a second test applied. Otherwise, the second test is *not* applied, and financial instruments must be measured at their fair value.

The second test focuses on the "contractual cash flow characteristics" of each instrument. If a particular financial instrument entitles the holder to receive cash payments that represent principal and interest, then the instrument must be measured at amortized cost, with a fair-value measurement option available under limited circumstances. Otherwise, the instrument must simply be measured at fair value.

Bruce Pounder's latest book, *2010 U.S. Master GAAP Guide*, was published by CCH in November 2009. It is available at http://onlinestore.cch.com/productdetail.asp?productid=5621.

Classification and Measurement

The upshot of IFRS 9's classification-and-measurement model is that traditional loans, straightforward debt instruments, and trade receivables will generally be measured at amortized cost if holding them to maturity is consistent with the reporting entity's business model, whereas financial instruments will be measured at fair value under all other circumstances. In understanding this new model, it's important to note that results of the business-model test may not vary among instruments but may change over time. If an entity's business model changes, all existing financial assets must be reexamined and potentially reclassified from fair value to amortized cost or vice versa.

IFRS 9 stipulates that financial assets measured at fair value aren't subject to impairment, whereas financial assets measured at amortized cost are. Currently, the "incurred loss" impairment model of IAS 39 applies. On November 5, 2009, however, the IASB issued an Exposure Draft (ED) of its Phase 2 deliverable, "Financial Instruments: Amortized Cost and Impairment," in which it proposes to replace the incurred-loss impairment model of IAS 39 with an "expected loss" model that incorporates expectations about future credit losses over the life of the financial asset. In many cases, this would lead to earlier recognition of impairment losses and would also alter the measurement of interest revenue. Impairment losses would still be recognized in profit or loss and would still be reversible.

Under IFRS 9, changes in the fair value of financial instruments measured at fair value are to be recognized in profit or loss, except in the case of equity instruments that aren't held for trading purposes. For such instruments, a reporting entity may elect irrevocably, at initial recognition on an instrument-by-instrument basis, to recognize fair-value changes in Other Comprehensive Income (OCI). Such recognized fair-value changes (i.e., unrealized holding gains and losses) aren't recycled from OCI to profit or loss upon realization (e.g., upon sale).

Interest and dividends receivable from financial instruments will continue to be recognized in profit or loss.

Reporting entities that prepare financial statements in accordance with IFRS as issued by the IASB must apply IFRS 9 starting January 1, 2013. Earlier application is permitted, even for reporting years ending as early as December 31, 2009, but there's some uncertainty as to whether IFRS 9 will be endorsed by the European Union (EU) soon enough for the early-application provision to be effective this year for EU companies. Also keep in mind that the IASB could change the mandatory-adoption date, but, regardless of whether it does or not, the mandatory-adoption dates for all phases of the project are likely to be synchronized with each other.

When a reporting entity adopts IFRS 9, it must generally apply the Standard retrospectively to financial assets that are already on its balance sheet. But amounts reported for comparative periods wouldn't need to be adjusted unless the entity adopts IFRS 9 after January 1, 2012.

Phase 1 financial-liability and Phase 3 hedge-accounting EDs are expected in the first quarter of 2010. All phases are expected to be completed by the end of 2010. As each phase is completed, IFRS 9 will be amended accordingly, and IAS 39 will eventually be retired.

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In next month's column, I'll explain what the FASB has been doing with regard to its financial-instrument standards. As you'll see, the FASB and IASB currently have different ideas on what the future of financial-instrument accounting should be. **SF**

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