

ACCOUNTING FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES ACCORDING TO IFRS 9

Maria Carmen HUIAN

Faculty of Economics and Business Administration
Alexandru Ioan Cuza University
Iasi, Romania
maria.huian@uaic.ro

Abstract

The most controversial accounting standards during the last decade, IAS 39 “Financial instruments: recognition and measurement” and its American equivalents FAS 133 “Accounting for derivative instruments and hedging activities” and FAS 157 “Fair value measurements” have regained their place as the global focus of the public debate since the beginning of the current crisis. Following the strong criticism received lately, the standard-setters have started several projects aimed at reviewing the accounting issues that have emerged from the crisis. So far, the result consists of the publication of IFRS 9 “Financial Instruments” issued by IASB and an exposure draft on financial instruments issued by FASB. This paper aims at analyzing the new rules, concepts and principles introduced by IFRS 9. In addition, it attempts to identify some possible consequences of its application.

Keywords: financial instruments, financial crisis, IFRS 9, fair value, classification and measurement

JEL classification: G01, G15, M41

1. INTRODUCTION

Often considered too complex and not really fitting the real business models, the accounting standards dealing with financial instruments have raised, over the years, many concerns and criticism from both preparers and users of financial statements, especially from participants in financial markets. The proponents argue that the incriminated complexity of accounting for financial instruments is inherent due to the growing investors' sophistication and the unprecedented development of financial engineering. The opponents demand for improvement and simplification. Moreover, in the US, accounting for financial instruments has been the centre of a strong debate developed around the subject of rules-based vs. principles-based standards that soon has extended to the international standards (IAS/IFRS). While there is this opinion of American financial reporting system being undesirable or inappropriate because it is rules-based (1) [Schipper, 2003], it is also true that the international referential, referred as a principles-based system, contains extensive rules and optional accounting methods [Nobes, 2004] severely criticised (2). This debate has been

brought back to public attention by the disruption of financial markets caused by the financial crisis.

World leaders and several international bodies (G20, ECOFIN Council, Financial Stability Board, etc.), in their search for solutions to end the financial crisis, have identified the accounting standards on financial instruments and their reporting rules as one of the causes of the recent financial turmoil. They urged the standard-setters to improve the accounting and reporting rules by focusing on [G20a, 2009 and G20b, 2009]:

- the complexity of existing accounting standards for financial instruments;
- the extent to which financial assets and financial liabilities should be subject to fair value accounting;
- how entities recognize and measure loan impairment.

As a consequence, both International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) have started several projects aimed at reviewing the accounting issues that have emerged from the crisis. The first projects simply aimed at improving or introducing new guidance to the old rules. However, the main goal is the *replacement* of the existing standards for financial instruments with *new* ones, less complex, more relevant and useful. The ultimate aim is to *improve* the ability of different users of financial statements to understand accounting for financial instruments and, hence, to make better business decisions. Therefore, the objective of the new projects is the enhancement of the decision-usefulness and relevance of the information reported about financial instruments and, eventually, the increase of the investors' confidence in the markets.

This paper sets out to analyze the provisions of the new IFRS 9 "Financial Instruments" issued by IASB regarding classification and measurement of financial assets and liabilities. It is intended to join the current stream of literature dealing with the replacement process of existing accounting and reporting standards on financial instruments that is still scarce due to the novelty of this standard.

The paper is organized as follows: section 2 briefly describes the main findings of the relevant literature dealing with accounting for financial assets and liabilities. Section 3 provides an overview of the main provisions of IFRS9, whereas section 4 critically analyzes these provisions and speculates on some possible consequences of their application. Section 5 concludes.

2. LITERATURE REVIEW

Accounting for financial instruments has been one of the most tackled subject in the recent literature. The ever growing interest on the topic is shown not only through the heated debates that make headlines in accounting journals and newspapers, but also through the stream of accounting literature dealing with the complexity and the fragmentation of the theme.

Early research on accounting for financial instruments focused on US GAAP as FASB was the only national standard-setter to have addressed this subject in a comprehensive manner. Many papers dwelt with the challenging topic of derivatives, both as stand-alone and hedging instruments, and the effects of the accounting rules for derivatives on earnings. Francis (1990) examined, through empirical tests, the critics' claim that accounting rules for futures contracts contained in FAS 80 increased earnings variability. Her findings, although based on a small number of time series observations, did not support the aforementioned concerns. DeMarzo and Duffie (1995) analyzed the corporate incentives for hedging and

hedge accounting and found out that standard hedge accounting improved the firm's future investment decision. They also examined the consequences of accounting rules for derivatives on management's behavior and reported an increase in manager's incentive to make an optimal investment decision. Melumad, Weynes and Ziv (1999) studied the economic consequences of alternative hedge accounting approaches in terms of managerial decisions and wealth effects for shareholders. They illustrated that the accounting approach used influenced the actual hedge position taken by managers and demonstrated the consequences of choice of the hedge accounting method for different classes of investors. More recent works [Zhang, 2009] examined whether the standard on accounting for derivative instruments (FAS 133) effected a change in corporate risk-management behavior and found out that evidence suggested that FAS 133 might have discouraged firms' speculative use of derivative instruments.

The international standards on financial instruments are critically examined by Hague (2004) that identifies the underlying IAS 39 principles on recognition, measurement and hedge accounting and their consequences for the resultant accounting requirements. Another important topic addressed by researchers is the IAS 39 adoption in the European Union (EU). This major area where IAS/IFRS has not gained universal acceptance is attentively scrutinized by several authors [Walton, 2004, Whittington, 2005] that examine both the technical and the political dimension of developing standards and the consequences of the EU carve-out adoption of IAS 39.

Several empirical studies deal with the consequences of IAS/IFRS (including IAS 39) adoption for the European companies. Armstrong et al (2008) examine the European stock market reaction to the adoption of IFRS in Europe and find out a positive reaction from the investors. Larson and Street (2004) provide evidence both on the status of convergence with IFRS and on issues perceived as affecting the drive toward accounting convergence in 17 European countries. The finding regarding these complicated standards also emphasizes the significance of the EU's reluctance to adopt IAS 32 and 39 which might jeopardize the efficiency, transparency and financial stability of European markets.

The recent financial crisis has further fuelled the interest on accounting for financial instruments. Many commentators have voiced especially against the fair value accounting, which, in their opinion, has deepened the impact of the crisis on the markets by creating artificial volatility and inducing fire sales of assets and procyclicality [Trombetta (2010), Novoa et al (2009)]. Others have praised fair value accounting for its ability of precluding the dubious practices of managers of hiding the consequences of their actions from the eyes of the outside observers [Plantin et al (2008)].

All these controversies have determined many specialists to conduct various studies and researches that either defend or attack fair value accounting and its role during the crisis. The recent literature is split between proponents of this measurement attribute and vehement opponents. In favour of fair value accounting, we quote Laux and Leuz (2009), Turner (2008), Ball (2008) who argue that there is little evidence to support a significant contribution of fair value accounting to the problems in the financial crisis. Moreover, studies conducted by SEC (2009) or FASB (2008) concluded that the percentage of financial instruments reported at fair value before and during the crisis was quite small, and the poorly performing loans having caused most of the failures and losses were not accounted for at fair value at all. Against fair value accounting there are several opinions that go from emphasising its procyclical effects [Banca d'Italia (2009), IMF (2008)], to underlying its role in

endangering financial stability [The Economist (2008), Wallison (2009), Standard&Poors (2008)] and asking for its suspension [Forbes (2009)].

Among these radical opinions, there are others highlighting both the pros and the cons of fair value accounting [Novoa et al (2009), Ryan (2008), Laux and Leuz (2009)] and pleading for an improvement of the current rules rather than for their suspension. Also, some international bodies [G20a (2009), G20b (2009)] recommended enhancement of several provisions dealing with measurement, impairment or hedge accounting.

Because our paper deals with the introduction of a new standard on financial instruments, we also analyzed the research based on the reaction of different stakeholders to the issuance of every major ED published by the IASB on the matter. Carchrae (1994) found the first ED issued in 1991 difficult to read and apply whereas the second ED, published in 1994, was considered too flexible and without a clear philosophy. More recent research [Chatham et al, 2010] examined comments letters to ED 62 from 1998 and found out that, most respondents disagreed with it and that there were differences in support and the specific issues used to support those positions by stakeholder interest group and by stakeholder nationality.

3. AN OVERVIEW OF ACCOUNTING RULES FOR FINANCIAL ASSETS AND FINANCIAL LIABILITIES ACCORDING TO IFRS 9

In November 2009, the IASB issued *IFRS 9 "Financial instruments"* on the *classification and measurement of the financial assets*. Almost a year later, in October 2010, the Board issued additions to IFRS 9 for *financial liabilities accounting*, completing the first phase of the reform of IAS 39. IFRS 9 will be complete when two other phases are released. Their status is:

- on the 2nd phase, a supplementary document *Financial Instruments: Impairment* was published in January 2011. The comment period closed on 1 April 2011 and redeliberations are on-going;
- on the 3rd phase, the exposure draft *Hedge Accounting* was published in December 2010. The comment period closed on 9 March 2011 and redeliberations are on-going.

In May 2010, the FASB published an exposure draft on accounting for financial instruments addressing classification and measurement, impairment and hedge accounting.

3.1. Accounting for financial assets

It is important to state, from the beginning, that IFRS 9 applies to all financial instruments within the scope of IAS 39 "Financial instruments: recognition and measurement". Moreover, there are no changes from the IAS 39's rules on initial recognition, which means that the recognition depends on the entity becoming party to the contractual provisions of the instrument. Thus, the specific guidance from IAS 39 still applies.

At initial recognition, a financial asset is measured at fair value plus (in the case of financial assets subsequently not measured at fair value through profit or loss) transaction costs directly attributable to the acquisition of the financial asset. After the initial recognition, financial assets are to be measured at fair value or at amortised cost. Therefore, for measurement purposes, financial assets are classified into two categories: financial *assets at*

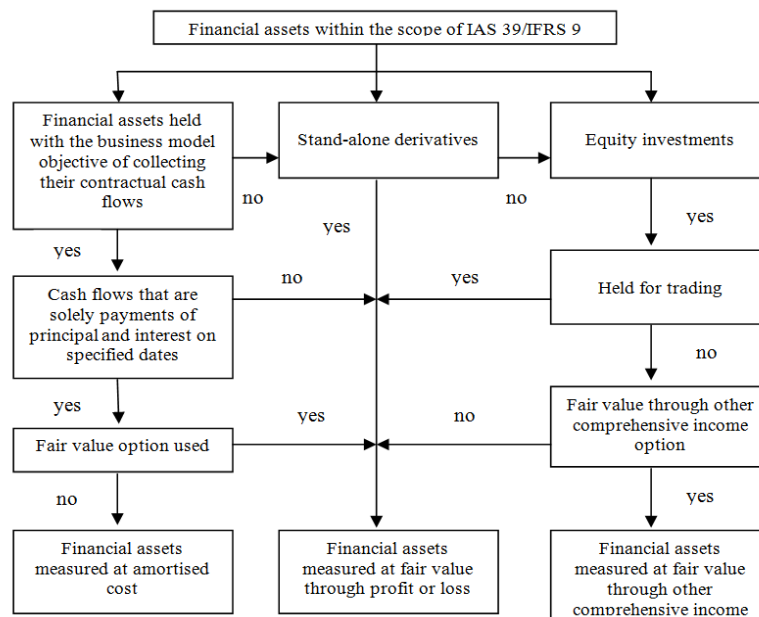
fair value through profit or loss and *financial assets at amortised cost*, based on both [IFRS 9, paragraph 4.1]:

- the entity's *business model* for managing financial assets;
- the *contractual cash flow characteristics* of the asset.

This means that the three main types of financial assets: derivatives, debt instruments and equity instruments that fall under the scope of IFRS 9 are measured according to the following flowchart (fig.1).

Each element of the previous model could be further explained:

- all derivatives are measured at fair value through profit or loss, unless they qualify for hedge accounting;
- equity instruments that are held for trading are measured at fair value through profit or loss, while all others at fair value through other comprehensive income with no recycling of the changes in fair value to profit or loss if the investment is subsequently derecognised. This means that IFRS 9 eliminates the exception existing in IAS 39 to measure certain investments in unquoted equity instruments at cost if their fair value cannot be measured reliably. The same treatment applies to derivative assets linked to and settled by delivery of such unquoted equity instruments;
- other financial instruments (e.g. debt instruments) are measured at amortised cost if they meet certain criteria (even if they are quoted in an active market), otherwise they are classified at fair value through profit or loss. Even if they meet the amortised cost criteria, they still can be measured at fair value through profit or loss by using the fair value option.



Source: [Ernst&Young, 2009, 2, Deloitte, 2009, 2]

Fig. no. 1 Classification and measurement of financial assets

As previously stated, this new classification into a measurement category takes place, for new financial assets, at inception. The existing assets, already classified according to IAS 39 as held-to-maturity (HTM), loans and receivables and available for sale (AFS), will be reassigned to the new categories (table 1).

Table no. 1 Classification categories

Classification under IAS 39	Classification under IFRS 9		
	Fair value through profit or loss	Amortised cost	Fair value through other comprehensive income
Fair value through profit or loss -trading (no derivative)	x	x	If equity investments are no longer held for trading
-trading (derivative)	x	-	-
-fair value option	x	If fair value option is revoked	Option for equity investments if not held for trading
Available for sale			
-debt instruments	x	x	-
-equity instruments	x	-	If not held for trading
Held-to-maturity	x	x	-
Loans and receivables	x	x	-

Source: [IFRS 9, 2010, KPMGb, 2009, 19]

Application guidance has been included in IFRS 9 on how to apply the conditions necessary for amortised cost measurement. Hence, financial assets are to be measured at amortised cost after the initial recognition if both of the following conditions are met [IFRS 9, paragraph 4.2]:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows;
- 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.

The most important aspects regarding the *business model* are:

- the assessment of the business model does not need to be made at the reporting entity level, nor at individual instrument level, but at an intermediate level;
- an entity may have more than one business model for managing its financial assets. For example, a bank may have 2 business models: one comprising assets (loans) whose contractual cash flows are to be collected and the other comprising assets (loans) held for trading;
- “some sales” out of the held to collect contractual cash flows portfolio do not affect the business model if their frequency is limited. When assessing “some sales” and their frequency, an entity has to take into consideration quantitative indicators

(frequency, volume and value of sales) and qualitative factors (the purpose for which financial assets are acquired, the reasons for any sales, how performance is managed, how employees are remunerated) [Ernst&Young, 2009, 3]. For example, an entity has bond investments worth €25,000 with maturities of 1-3 years. Bonds worth of €2,500 are sold and repurchased actively while the remaining investments are typically held to their maturity. The entity could apply IFRS 9's provisions by identifying:

- one business model applied to the whole portfolio of bonds classified at fair value through profit or loss (because the level of expected sales and reinvestments is more than significant);
 - two business models: one, containing the part of portfolio actively traded, is fair value through profit or loss, the other one, held to maturity is classified as amortised cost.
- the management of financial assets with the objective of realising cash flows through the sale of assets is not consistent with the "held to collect contractual cash flows" business model;
 - similarly, portfolios managed and evaluated on a fair value basis or held for trading do not meet the business model test;
 - the classification of the asset within the business model is made at initial recognition and is not to be changed when the initial circumstances become different, if the reclassification criteria are not met.

Questions arising from the business model test and not answered by the standard:

- can a single financial asset be classified into two separate business models? IFRS 9 does not provide an explicit answer, but an entity that has already applied IAS 39 (which allows loans to be classified in part as held for trading and in part as loans and receivables) may continue this practice under the new standard;
- what happens when sales are infrequent but significant in terms of proportion of assets sold? When choosing the business model, an entity needs to pay special attention to the purpose of the assets' acquisition. If the event triggering the significant sale could not be foreseen, the asset may still qualify within the same business model;
- what are the consequences of changes in the way a company manages the assets that fail to meet the reclassification criteria? The entity could have two portfolios of assets (the existing assets and the new assets) which means two business models.

The second criterion for amortised cost measurement refers to the assessment of the *contractual cash flow characteristics* of the financial asset. This approach (adapted from the one firstly applied in the IFRS for SMEs) stipulates that only assets with contractual cash flows of principal and interest on principal may qualify for amortised cost accounting. Interest is defined as consideration for the time value of money and the credit risk associated with the principal outstanding during a particular period of time [IFRS 9, paragraph 4.3]. If cash flows vary because of the credit risk, judgement has to be exercised to determine whether these variations are a compensation for credit risk or not (and whether the assets meet the criterion or not).

The standard give example of both features that result in asset qualifying for amortised cost measurement (prepayment options, extension options, fixed/variable interest rate, caps, floor, collars, unleveraged inflation index linked) and features that are inconsistent with

amortised cost accounting (leverage, conversion options, coupons paying an inverse floating interest rate, etc.).

The assessment as to whether cash flows meet the test is made in the currency in which the financial asset is denominated [IFRS 9, paragraph B 4.8]. This means that any instrument in which interest is computed based on a principal amount in another currency (e.g. EUROS while principal is denominated in US dollars) does not qualify for amortised cost measurement. Particular attention has to be paid to debt instruments that are non-recourse (the lender's claim is limited to specific assets of the borrower). The holder of such instruments must "look-through" to the underlying asset to see whether the payments meet the test. If the loan or the bond are referenced to the performance of a certain project (e.g. construction and maintenance of a road or development of a property), they would fail the "contractual cash flow characteristics" test. The failure derives from the underlying asset not having cash flow characteristics of principal and interest.

Another neuralgic aspect refers to the contractually linked instruments (tranches) used when an entity wants to prioritise payments to the holder of financial asset. One would apply amortised cost accounting for a tranche when it is regarded as containing payments of principal and interest.

In response to the criticism related to the rules applying for *hybrid contracts*, IASB choose to *remove the requirement to separate certain embedded derivatives from host contracts* represented by financial assets within the scope of IFRS 9 (financial host). Under IAS 39, the separation was required for embedded derivatives not closely related to the financial asset host. This rule continues to apply to contracts outside the scope of IAS 39, such as insurance contracts, lease contracts or purchase/sale contracts. According to IFRS 9, the entire hybrid instrument is assessed for classification at amortised cost or at fair value through profit or loss. The main change from previous requirements is that both the embedded derivative and the host contract are measured on the same basis, while according to the old rules the separated embedded derivative might have been carried at fair value and the host contract might have been measured at amortised cost. In some cases, the embedded derivative may cause the entire hybrid instrument to fail the conditions for amortised cost accounting, leading to a fair value through profit or loss classification. Thus, the new rules may result in more hybrid instruments being carried at fair value.

When initially recognising a financial asset, an entity decides whether to classify it at fair value through profit or loss or amortised cost. Subsequently, *any reclassification between categories is prohibited* even though the characteristics of the financial asset may vary over its life. The only situation that calls for a *reclassification is the change of the business model* in a way that is significant to the entity's operations. These changes are expected to be "very infrequent" and a result of internal or external changes demonstrable to external parties.

IFRS 9 gives examples of situations representing a change in the business model. But it also lists examples of no change, thus no reclassification [IFRS 9, paragraph B 5.11]:

- a change in intention related to specific financial assets (even in circumstances of significant change in market conditions);
- a temporary disappearance of a particular market for financial assets or
- a transfer of financial assets between parts of the entity with different business models.

The reclassification date is considered the first day of the next reporting period (the entity may prepare quarterly reports or just annual accounts). No prior gains, losses or interest recognised are restated.

For financial assets that are *equity investments* there are two possible accounting treatments:

- an irrevocable choice to designate them at fair value through other comprehensive income. In this situation, dividends are recognised in profit or loss unless they clearly represent a recovery of the cost of the investment. Amounts reported in other comprehensive income are not recycled to profit or loss;
- an obligation to measure them at fair value through profit or loss if they are held for trading.

In limited circumstances, cost may be the appropriate estimate of fair value. This provision is very helpful for non-financial entities for which fair value measurements of unquoted equity investments generally poses a great challenge. But then again, the facts and circumstances indicating cost is the appropriate measurement must be carefully assessed before applying this rule.

To summarize, the main differences between IAS 39 and IFRS 9 in terms of financial assets are highlighted in table no 2.

Table no. 2 Comparison between IAS 39 and IFRS 9

	IAS 39	IFRS 9
Scope	All financial assets with some exceptions	The same
Initial recognition	When entity becomes party to the contractual provisions	The same
Initial measurement	Fair value plus transaction costs (for financial assets not held for trading)	The same
Subsequent measurement	Fair value Amortised cost Cost (for equity investments with no reliable fair value measurement)	Fair value Amortised cost
Classification categories	Available for sale Held-to-maturity Loans and receivables Fair value through profit or loss	Fair value Amortised cost
Reclassification	Non-derivative financial assets out of fair value through profit or loss From AFS to loans and receivables if the entity has intention and ability to hold them for the future Into fair value through profit or loss after initial recognition prohibited	Allowed only if there is a change in the business model
Fair value option	Apart from accounting mismatches: -the portfolio is managed on a fair value basis and performance is evaluated on that basis -hybrid instruments	Election at initial recognition to avoid accounting mismatches
Embedded deriva-	If closely related, bifurcation. If not,	If host asset is in the scope of

	IAS 39	IFRS 9
tives	no bifurcation	IAS 39, no bifurcation. If not, yes.
Equity investments	All equity instruments classified as AFS securities are measured at fair value through other comprehensive income On disposal, changes are recycled	Irrevocable choice to designate as fair value through other comprehensive income Fair value through profit or loss if held for trading
Gains and losses	Generally in profit or loss For AFS in equity (except for impairment losses and foreign exchange gains and losses) till derecognition, when recycled	Generally in profit or loss Exception: equity investments classified as fair value through other comprehensive income

3.2. Accounting for financial liabilities

Accounting for financial liabilities has remained generally the same after the introduction of IFRS 9, second edition, published in October 2010. This had to do with the fact that the existing requirements from IAS 39 had worked well so far and a fundamental change was not necessary. The main concern raised during the crisis had to do with recognising the impact of changes in own credit risk in profit or loss when non-trading financial liabilities are measured at fair value. The volatility of net income brought by gains on liabilities recognised when the entity's creditworthiness deteriorated or vice-versa was the main frustration related to financial liabilities.

Thus, IFRS 9 was tailored to address the issue by requiring a split presentation of changes in the fair value of liabilities designated under the fair value option. The amount of change in fair value attributable to the changes in the liability's credit risk is recognised in other comprehensive income and the remainder in profit or loss [IFRS 9, paragraph 5.7.7]. Assume a financial liability designated under the fair value option issued at €50,000. At the end of the year, the fair value is €50,100. The €100 change is split between net income (€93) and other comprehensive income (€7). An illustration of the way in which own credit amounts are presented in financial statement is provided in table no 3.

Table no. 3 Own credit amounts in financial statements

Income statement	
Changes in fair value on liabilities at fair value (under fair value option)	93
Other comprehensive income	
Changes in fair value on liabilities at fair value (under fair value option)	7

The portion presented in other comprehensive income is never recycled to profit or loss, but any cumulative gains or losses may be transferred within equity. Due to certain restrictions existing in different jurisdictions on equity, IFRS 9 does not provide guidance on the moment or the conditions of this transfer.

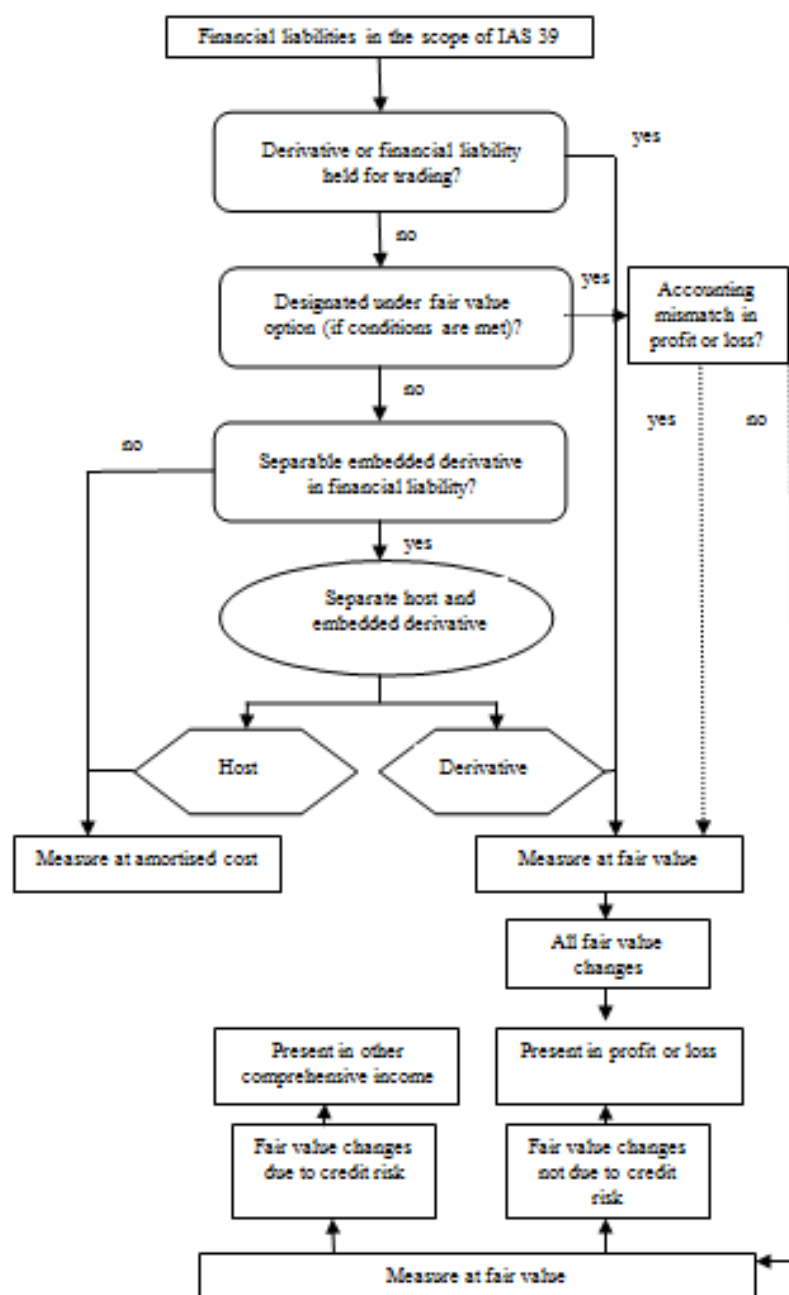
IFRS 9 contains two exceptions from the split presentation. The first applies when recognising the effects of changes in the liability's credit risk directly in other comprehensive income creates or enlarges an accounting mismatch in profit or loss. The second exception relates to gains and losses on loans commitments and financial guarantee contracts that are

designated as at fair value through profit or loss which are to be recognised in profit or loss by the issuer.

The new standard provides guidance on how to determine the amount of the change in fair value that is attributable to changes in a liability's credit risk. It retains the "default method" from IFRS 7 "Financial instruments: disclosure" and emphasises that this method is appropriate only if the only significant relevant changes in market conditions are those in an observed benchmark interest rate. If this is not the case, IFRS 9 allows preparers to use a different method that estimates the own credit amounts more faithfully.

Apart from the changes brought to the fair value option, IFRS 9 eliminates the exception from fair value measurement contained in IAS 39 for derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument whose fair value cannot be measured reliably. Thus, all derivatives that are liabilities are measured at fair value through profit or loss.

The following flowchart provides an overview of the requirements for the classification and measurement of financial liabilities according to IFRS 9 (fig. 2).



Source: [KPMG, 2009, 7]

Fig. 2 Classification and measurement of financial assets

4. A CRITICAL ANALYSIS OF THE MAIN IFRS 9 PROVISIONS

4.1. Financial assets

In our opinion, the following are the most important aspects arising from IFRS 9 application:

A. IFRS 9 *reduces the complexity of the classification of financial assets by reducing the number of measurement categories*. Instead of 4 categories required by IAS 39, the new standard contains only two: amortised cost and financial assets at fair value through profit or loss. What does this new classification bring on the table? Although at the moment it is hard to tell, there are some expected changes that can already be highlighted [KPMGb, 2009, 20 and Deloitte, 2009, 5]:

- some available for sale (AFS) debt instruments (such as vanilla government and corporate bonds) measured at fair value under IAS 39 will qualify for amortised cost accounting. If not, they will be classified at fair value through other comprehensive income;
- most held-to-maturity assets and loans and receivables will continue to be measured at amortised cost. If not, they will be classified at fair value through profit or loss;
- some contractually linked instruments previously qualified for amortised cost or AFS treatment will be more likely measured at fair value through profit or loss. In addition, many hybrid financial assets with embedded derivatives will be measured in their entirety at fair value through profit or loss rather than being separated into the host financial asset not measured at fair value and the embedded derivatives recognized at fair value through profit or loss;
- equity investments and related derivative assets previously measured at cost
- will be accounted for either at fair value through profit or loss or, for non-derivatives, at fair value through other comprehensive income

Ultimately, the real impact depends on factors such as: the types of financial assets held by the entity (while simple loans will be measured at amortised cost, more complex financial instruments, e.g. asset-backed securities or structured notes, will be measured at fair value through profit or loss), the previous classification, and the choices made under the new one. Although assessing all changes can prove difficult at the moment, it is obvious that the heavy users of financial instruments (banks, insurers, and other institutions from the financial industry) will be the most affected.

B. IFRS 9 *introduces two new principles to determine the aforementioned classification: business model and contractual cash flow*. In other words, the new criteria apply to an instrument held to maturity by the firm such that it can realize full par value [Papa, 2010, 3]. By requiring this classification criteria, IFRS 9 addresses the G20's call to consider the liquidity of financial instruments and investors' holding horizons [IASBc, 2011, 3]

The standard no 9 introduces a new accounting concept – business model - that represents an important shift from the previous principles of classification of financial instruments. It requires companies to assess more rigorously the nature of their business and the way their assets are actually managed rather than to simply establish the nature and risks of these assets. Entities need to define business models consistent with their strategies and appetite for risk. This is a broader approach that could urge companies to provide supplementary evidence or to implement a more robust system of monitoring financial assets. Therefore, management should be aware of the bigger impact of this new concept on their

strategies and policies. According to IFRS 9, the most important is not whether the asset is risky but rather if the business strategy behind the assets is risky.

The critics of the new concept argue that it introduces more subjectivity in the classification of financial instruments because it is too principle-based and the standard gives little guidance on how or what exactly constitutes the business model of an entity. It also gives a little too much flexibility by allowing companies to have more than one business model. This could result in different accounting treatment for similar instruments and could significantly reduce reporting comparability. Moreover, IFRS 9 proves to be very tolerant to modifications of the business model by removing the tainting rules (that relate to the change in management's intention and ability to hold a financial asset). Also, there are opinions claiming that the designated business model definition may end up being shaped by accounting requirements rather than simply reflecting the underlying business performance [Papa, 2010, 3].

Nevertheless, some commentators consider that the business model is a fundamental building block of IFRS 9 and aligns the accounting with the way management deploys assets in its business while also considering the characteristics of assets [KPMGc, 2009, 2].

The new rules on *reclassification* require a great deal of judgement as far as determining the changes of the business model are concerned. Also, terms like "significant to their operations", "very infrequent" or "demonstrable to external parties" are to be carefully considered by each company applying IFRS 9. Furthermore, there may be situations in which financial assets are accounted for as if the business model had not changed, due to the significant gap between the change of the business model and the reclassification date. Even though applying the old classification no longer reflects the revised business model, the reclassification takes place from the beginning of the next reporting period to prevent entities from manipulating the reclassification date in order to achieve a certain accounting result. Moreover, extensive disclosures of the reasons behind the change of the business model should be made to justify the reclassification.

C. IFRS 9 reaffirms the framework of fair value accounting. In the light of the global financial crisis and the strong criticism raised by this measurement attribute, one might think that the standard-setters took a step back from fair value and allowed historical cost and accounting conservatism to regain some of the lost ground. Well,... no. For example, IASB reaffirmed its strong support of fair value by issuing a proposal for an IFRS on fair value measurement, including guidance on how to measure it when markets are less active. FASB also issued a proposal on accounting for financial instruments that called for more fair value measurements than the current rules. All these did nothing but further fuelled the debate around fair value. Some critics say that the standard-setters have not learned their lessons from the crisis because they allow measurement at fair value through profit or loss for illiquid financial instruments or for instruments held with medium or long maturities.

The main debate is dominated by the issue of whether to apply fair value or amortised cost. Generally, bankers, insurers and representatives of other financial institutions support the mixed measurement model proposed by IFRS 9. They believe this model provides investors with a better information for evaluating financial institutions than a full fair value model [IBFed, 2008, 3]. Moreover, preparers and auditors of financial statements consider that the benefits of applying full fair value accounting would not outweigh the costs [IASBb, 2009, 4-5]. On the other hand, investors support the solution of requiring fair value for all financial instruments. A survey conducted by CFA Institute in 2010 showed that 60% of the respondents selected some variant of full fair value (40% full fair value with amortised cost in the

notes and 20% both full fair value and amortised cost in financial statements with separate presentation) and only 34% selected the mixed measurement attribute. The fair value supporters believe that only fair value can improve information quality and reduce the complexity of financial instruments accounting.

4.2. Financial liabilities

Many commentators expected a symmetrical approach for financial assets and liabilities. However, the feedback IASB received showed that accounting for financial liabilities had worked well. So the Board decided not to change the existing requirements and transferred them from IAS 39 to IFRS 9. The main change regarded the “own credit” issue that enabled entities to book profit during the crisis on the grounds of their theoretical ability to buy back their own debt at reduced prices. As a consequence, the new rules require own credit gains to be presented directly in other comprehensive income and thus, reduce volatility of the income statement.

4.3. Impairment rules

Another controversial aspect of accounting for financial instruments during the crisis was the one regarding impairment. In the Declaration on Strengthening the Financial System, the world leaders asked for an enhancement of the accounting recognition of loan-loss provisions by incorporating a broader range of credit information. Working with prudential supervisors and other market regulators, IASB has published proposals relating to the impairment of financial assets based on an incurred loss model rather than the current expected loss model. In turn, the FASB intends to switch from an incurred loss model to a more forward looking impairment model.

During the crisis, one of the most criticized accounting topic was the expected loss model of impairment. The current model recognizes provisions only after an observable “trigger” event has occurred. This was considered by many too slow in recognising potential losses. The new model consists of assessing the expected credit losses as soon as the loan is recognised by taking into consideration information such as historical experience and future expectations. It is claimed that the new approach better reflects the economics of the way financial institutions manage their loans and it is expected to result in earlier recognition of impairment.

However, the project regarding impairment, which is the 2nd phase of IAS 39 replacement, is still incomplete. Till then, IFRS 9 applies and even though it does not directly address impairment, the new rules for classification and measurement impact the way in which impairment is measured. Mostly, by eliminating the AFS category (which was assessed for impairment by reference to the fair value of the investment), IFRS 9 eliminates the AFS impairment rules. These were a source of dissatisfaction because in illiquid markets lead to reporting losses on debt securities larger than the expected credit loss and once the losses were recognized on AFS equity investments, they were not allowed to be reversed on a subsequent increase of fair value. Under IFRS 9, AFS debt investments accounted for at amortised cost qualify for a simplified impairment process, while there is no need for impairment test for equity investments carried at fair value through profit or loss (all changes in fair value being recognised in profit or loss anyway). Moreover, IFRS 9 granted a concession to the business community which showed concerns over the volatility brought by fair

value to the income statement by retaining AFS in a different version: companies are given an irrevocable option to present gains and losses in the fair value of an equity instrument not held for trading in other comprehensive income.

4.4. Derecognition and hedging activities

Although there were some proposals to modify the derecognition requirements for financial instruments, the standard-setters decided to retain the current rules as they had worked well. But they enhanced disclosure requirements for transactions involving transfers of financial assets that would help investors to better understand off-balance sheet risks.

Hedge accounting is the subject of the 3rd and final phase of the project dealing with the replacement of IAS 39. It is intended to simplify the heavily rule-based requirements by enabling entities to reflect their risk management activities more properly and by improving the quality of the corresponding information reported in financial statements.

4.5 SWOT analysis of IFRS 9

To summarize all our impressions on IFRS 9, we present the following SWOT analysis (see table 4).

Table no. 4 SWOT analysis of IFRS 9

Strengths	Weaknesses
<ul style="list-style-type: none"> • Reduces the complexity of the classification and measurement of financial assets. • Aligns accounting with the management's strategies for managing financial assets. • Requires extensive disclosures of the reasons behind any changes in accounting decisions (e.g. the business model) thus preventing manipulation of accounting results. • Addresses issues arising from the financial crisis (own credit gains, fair value accounting etc.). • Simplifies rules dealing with measurement of hybrid contracts containing embedded derivatives. 	<ul style="list-style-type: none"> • Introduces new concepts (e.g. business model) that require use of professional judgement, therefore introduces more subjectivity. • Withholds many options and different accounting treatments on several aspects, thus not eliminating complexity. • Does not provide a symmetrical approach for financial liabilities. • Does not address subject such as impairment or hedge accounting, therefore the old controversial rules from IAS 39 still apply.
Opportunities	Threats
<ul style="list-style-type: none"> • Allows the use of professional judgment when making several accounting decisions (e.g. choice of business model, use of fair value option etc.). • Gives the possibility to reclassify, on initial adoption, some financial assets previously measured at fair value to the amortized cost and vice-versa. • The completion of the second and third phases at a slower phase may allow better choices made by the standard-setter. 	<ul style="list-style-type: none"> • Reduces comparability by allowing too much flexibility when making some choices (e.g. business model). • Proves too much tolerance on several topics (e.g. removal of tainting rules) that may result in choosing certain options only to meet accounting requirements and not to faithfully present the business performances and financial position. • The benefit/cost ratio does not favour an early adoption due to the standards being

	<p>incomplete and the other two phases delayed.</p> <ul style="list-style-type: none"> • The implementation costs of many provisions (e.g. impairment rules) are difficult to assess now (e.g. impact on information systems and business processes, training personnel etc.). • Early adoption results in mixed presentation and measurement (IFRS 9 and IAS 39) that impairs usefulness of financial statements. • The phased approach may create mismatches where new requirements are incompatible or different from current rules of IAS 39 (e.g. hedge accounting). • There are risks of subsequent amendments due to decisions made in the other two stages of the project. • The EU reluctance to endorse IFRS 9 creates more uncertainty and concerns among users and preparers.
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5. CONCLUSIONS

Even though IFRS 9 is just the beginning of the process of replacing IAS 39 and its application is currently limited, it aroused a lot of interest from both proponents and opponents. The proponents of the new rules highlight the significant reduction of complexity achieved in accounting for financial assets by having only two measurement categories. They also appreciate the new principle-based criteria for determining which measurement method to apply because it provides an improved ability to align accounting with the entity's business model for managing financial assets. In addition, the simplified rules dealing with measurement of hybrid contracts containing embedded derivatives is particularly praised. Some commentators underline the opportunity given by IFRS 9 to reclassify, on initial adoption, some financial assets previously measured at fair value to the amortised cost accounting and vice-versa [Grant Thornton, 2009].

They also view as a significant disadvantage the restricted ability to reclassify them on an ongoing basis. Moreover, the opponents of IFRS 9 argue that there is a high possibility of accounting mismatches where the new requirements are different and incompatible with the current rules on hedge accounting. This shortcoming results from the phased approach adopted by IASB in order to speedily replace IAS 39. The division into 3 phases increases the risk of application problems emerging, leading to more amendments. That is why, now, it is very difficult, if not impossible, to assess the overall impact of this uncompleted project. So far IFRS 9 provides guidance on recognition, derecognition, classification and measurement of financial assets and financial liabilities. However, the new proposal, as part of a bigger set of changes, may suffer serious amendments because of the decisions made in the other two stages. That is why many jurisdictions (e.g. the European Union) have decided to put a hold on adopting the new standard until the whole project is released. There are not many signs of an early endorsement by the European Commission, which could be seen as

an admission that it is better to delay than to hastily adopt reforms in such a complex accounting area.

The amendments may arise also because of the convergence process put in place with the FASB. It is well known that accounting for financial instruments has been at the heart of the conflicting areas of this convergence programme. The two Boards want to achieve the same goal, but have chosen different approaches (the American body having been developing a single proposal) and more importantly have reached divergent conclusions on a number of important technical issues. Hence, a subsequent process of reconciliation of the different decisions is needed and that will lead to more amendments to IFRS 9. Some defended the IASB's phased approach by arguing that accounting policy should not be based on short-term objectives and should not be used for short-term regulatory interventions. Thus, the duration of this complex project should not be an issue as long as it does not expand too much. In addition, the two different projects give the opportunity to better compare and assess the merits of both proposals.

The reaction to the release of these new standard/proposal has been varied. As we have already mentioned, there is significant resistance from some of the parties involved. For example, one member of IASB was quoted saying about IFRS 9 "we hope you're smart enough not to adopt it" [Cohn, 2009, 1]. However, the big accounting firms generally support the new requirements [Deloitte, 2009, 2].

A survey conducted by CFA Institute among its members, in December 2009, showed that 47% of the respondents thought IFRS 9 improved decision-usefulness, while 22% thought it did not and 31% were neutral. The survey also focused on whether the standard reduced complexity or not. 37% of the respondents said yes while 28% thought it did not and 35% were neutral [CFA Institute, 2009, 12-17]. The results of the survey showed that respondents perceived a certain improvement in accounting for financial instruments after the release of IFRS 9 and the FASB's proposal, but the general opinion was that much more could be done to get a measurable improvement. There are still many exceptions and alternatives which can only mean that these rules are still very complex. The feeling is that IFRS 9 is a good start, but it just partially answers the need for change and improvement.

Achieving complete acceptance about IFRS 9 from all people involved is a nice but rather unrealistic goal. Seeking consensus on highly technical decisions should not be an objective of the standard-setters even though there is a great need for global accounting standards. For now, accounting for financial instruments is...unfinished business.

This paper attempted to critically analyze the new rules on accounting for financial assets and liabilities according to the most recent international standard issued by the IASB: IFRS 9. Our work was motivated by the relative shortage of accounting literature on this rather new topic. It was not based on any empirical evidence or studies due to the lack of IFRS 9's appliance by the time the paper was conceived (to our knowledge, most companies do not apply IFRS 9 yet and are still waiting for the completion of this controversial project before adopting it). The lack of published annual reports prepared on the base of IFRS 9 offered little or no information on the real impact of the new rules on companies' financial position and performances or the degree in which they reduced complexity, improved comparability and enhanced decision-usefulness.

Therefore, the paper represents only the author's view on what the new concepts, options and accounting treatments mean and on the possible consequences of their appliance. Further research is needed in order to thoroughly examine the impact of IFRS 9's adoption based on data reported by companies already applying this standard.

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Notes

1. Schipper (2003) provides examples of rules derived from the US accounting standards for financial instruments: "The scope exceptions in FAS No. 133 have led to 19 Derivatives Implementation Group Issues, all of them attempting to clarify the applicability of the exceptions. Even if a standard is firmly grounded in a principle, scope exceptions add to the volume and complexity of both the standard and, in many cases, subsequent implementation guidance [...] The only way to provide for scope exceptions is by means of rules"

2. Nobes (2004) criticises the principle called "intentions of directors" used in IAS 39 (measurement section) because it brings with it numerous rules about intermediate categories, changes of intention, and the audit of intentions.