

Proposed changes to financial instruments will affect 'typical corporate entities'

What is the issue?

The pace of change in accounting for financial instruments continues to accelerate. Some entities have assumed the proposed changes in this area are only significant for banks and other financial institutions. This is not the case; many corporate entities are expected to be impacted by financial instrument-related changes in the next few years. This edition of *IFRS in Brief* considers how corporate entities may be impacted by developments in accounting for financial instruments.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

Who does it affect?

Entities that hold financial instruments. For example, some entities that:

- hold financial assets such as investments will be impacted by the proposed changes to the classification and measurement of financial assets;
- hold complex financial liabilities such as borrowings (for example, convertible debt instruments) will be affected by the proposed changes to the classification and measurement of financial liabilities; and
- hold simple instruments such as trade receivables will be impacted by the proposed changes to impairment rules.

Changes to the classification and measurement of financial assets

The change IFRS 9 was issued in November 2009, which changes the way entities measure their financial assets. All financial assets will be measured at fair value, except those held simply to collect principal or principal and interest under a contract (these assets will be measured at amortised cost). The standard applies to 2013/2014 accounts.

Who it affects Entities that hold financial assets, such as investments or receivables.

How the new rules affect a typical corporate entity

Simple debt assets, such as trade receivables, will continue to be measured at amortised cost. Complex debt assets, such as debt with interest payments based on profits, will be measured at fair value, with any movements in fair value recognised in the income statement. This is a significant change to current practice. Under the existing rules, complex debt assets are usually recognised at amortised cost or fair value through reserves (for example debt instruments held as available for sale).

Corporate entities that hold equity investments for selling in the medium-term will no longer have the option to recognise fair value movements through reserves; these movements will be recognised in the income statement.

Entities will recognise their equity investments at fair value, even in circumstances where fair value is difficult to determine. This excludes investments in subsidiaries and associates.

The standard isn't mandatory for several years, but a small number of corporate entities have early adopted it in their December 2009 financial statements. For the most part, these entities have wanted to take advantage of no longer needing to recognise impairment in the income statement on the equity investments they hold as available for sale.

Proposed changes to the classification and measurement of financial liabilities

The proposal The IASB is considering how entities should measure their financial liabilities. It is expected to publish proposals in June 2010, which would apply to 2013/2014 accounts.

Who it affects Entities that hold financial liabilities, such as borrowings.

How the proposals may affect a typical corporate entity

The IASB has tentatively agreed to retain the current measurement requirements, with accounting changes only made in the area of financial liabilities that are designated at fair value. Most corporate entities do not designate their financial liabilities at fair value, so these entities are not expected to be significantly impacted by the proposals.

Proposed changes to financial instruments...cont'd

Proposed changes to the hedging rules

The proposal The IASB is expected to issue an ED that simplifies the current hedge accounting rules for financial instruments. The proposals are likely to apply to 2013/2014 accounts.

Who it affects Entities that currently use hedge accounting (such as interest rate swaps on their borrowings), and entities that would like to use hedge accounting but are daunted by the complexity of the existing rules.

How the proposals may affect a typical corporate entity

The IASB is planning to simplify hedge accounting; corporate entities should expect to be positively impacted in some way. For example, changes that may be considered include relaxing the rules associated with calculating hedge effectiveness (that is, removing the '80/125' test) and reconsidering the hedge documentation requirements. However, until the proposals are issued, it is difficult to determine the specific impact on the income statement.

The IASB and FASB are working together to develop one global set of rules on hedging. This is good news for subsidiaries of US entities, which may need to make fewer IFRS/US GAAP adjustments in the future.

Good news is also in sight for many entities operating in the mining, agricultural and airline industries. The IASB is examining whether risks in non-financial items can be separated for hedge accounting, which may result in more risks qualifying for hedge accounting (such as hedging components of an item).

The proposed changes to the impairment rules

The proposal The ED issued in November 2009 seeks to address the business community's concerns about impairment provisions on loan receivables (last year some regulators and analysts commented that provisions had been recognised too late). The final standard is expected to apply to 2013/2014 accounts.

Who it affects Entities that recognise assets at amortised cost, such as trade receivables.

How the proposals may affect a typical corporate entity

Entities may need to change the way they assess their financial assets for impairment.

Currently entities only recognise an impairment loss on receivables if events have occurred that have a negative effect on future cash flows (known as a credit event). Under the proposals, entities would need to recognise an impairment loss when they anticipate that a credit event will occur. For example, currently an impairment loss on a trade receivable is recognised when a customer experiences financial difficulty. However, under the proposals, initial recognition of the trade receivable should reflect the entity's expectations about whether the customer will experience financial difficulty over the collection period. This will have an impact on the income statement because the doubtful debt expense is likely to be higher earlier in the collection period. It will also affect reported gross margins, as the initial credit losses expected are offset against revenue, instead of being recognised as an operating expense within the doubtful debt expense.

Impacts of the proposed changes to the classification of debt and equity

The proposal An exposure draft is expected in 2010 that will clarify the distinction between debt and equity. A final standard is expected in early 2011, which could apply to 2012/2013 accounts.

Who it affects Entities that obtain funds by using complex instruments (for example, where an entity issues a debt instrument that can be converted into shares).

How the proposals may affect a typical corporate entity

The rules about whether complex financial instruments should be recognised as liabilities or equity may change. This will affect the income statement because payments associated with liabilities are considered to be an interest expense; whereas payments associated with equity are considered to be an equity movement.

The impacts on business will not be known until the ED is issued, but the IASB's discussions indicate plans for refinements to existing rules rather than fundamental change. For example, the rules associated with classifying a financial instrument as equity are expected to be relaxed. Currently financial instruments can be classified as equity where a fixed amount of cash will be exchanged for a fixed number of shares. Under the proposals, the definition of 'fixed amount of shares' may be expanded, which may allow more convertible instruments to qualify for equity classification.

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