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KPMG comments on IASB financial instruments standard

KPMG welcomes the publication today of IFRS 9 *Financial Instruments*. This is the first instalment of a phased project to replace the existing standard on financial instruments, IAS 39. The exposure draft on the impairment phase also has been published recently and will be followed shortly by draft proposals on hedge accounting. Rewriting the existing financial instrument standard is a very ambitious project. It is to the credit of the IASB that it has been able to achieve so much progress in a few short months in order to meet the urgent calls for change from the G20, the Financial Stability Board and others. In doing so the Board has undertaken a major outreach programme, discussing the proposals with a wide range of constituents and responding to the feedback received.

Given the far reaching nature of the IAS 39 replacement project, many companies may need to undertake changes in systems and internal reporting in order to comply with its requirements. For this reason KPMG commends the Board's decision to set a longer term time horizon for mandatory adoption of the new standard (2013). This will also allow preparers to adopt all phases of the project at once. Importantly, however, the new standard will be available for early adoption in 2009 without the need to restate comparatives.

As proposed in the exposure draft, the standard retains a mixed measurement model, with some financial assets measured at amortised cost and others at fair value. Retaining but simplifying the mixed measurement model was an important recommendation of the Financial Crisis Advisory Group, which issued its report in July 2009. In the current environment KPMG believes that this is the right approach. The distinction between the two measurement models is driven by the business model of each entity, supplemented by a requirement to assess whether the cash flows of an individual instrument are only principal and interest. This business model approach is a fundamental building block of the new standard and aligns the accounting with the way that management deploys assets in its business while also considering the characteristics of the assets.

One of the more controversial aspects of the exposure draft was the proposed accounting for investments in securitisations. The proposal was that only investments in the most senior tranche of debt issued by a securitisation vehicle could be accounted for at amortised cost. Many commentators felt that this was inappropriately restrictive. Under the final standard, an

entity holding these investments “looks through” the investment in the securitisation vehicle to the underlying cash flows of the assets within it to assess which measurement basis is appropriate using the underlying principles in the standard.

While the exposure draft’s proposals also would have applied to liabilities, the standard addresses at present only financial assets. This change in scope reflects the complexities of some of the issues around liability measurement, including the measurement of own credit risk and embedded derivatives. Addressing financial assets and liabilities separately is not ideal but KPMG believes that the Board has made a sensible decision pending further discussion on these issues.

The elimination of available for sale accounting for investments deals with some of the more controversial application issues of the current standard. Impairment for credit losses on debt instruments carried at amortised cost are calculated by reference to estimated cash flows rather than the total decline in the asset’s fair value. The current requirement to recognise all changes in fair value when there is a credit loss was criticised as inconsistent with an intent to continue holding the asset.

All equity investments will be measured at fair value and no separate impairment assessment will be necessary. In the case of equity investments that are not held for trading purposes, companies can elect on an instrument-by-instrument basis to report fair value movements outside of profit or loss. In response to comments on the exposure draft, dividends received will still flow through profit or loss rather than outside it as was proposed.

There will no longer be any need to account separately for embedded derivatives in financial assets. This has been an extremely complex area and the new approach will reduce complexity, at least for financial assets. Hybrid contracts of this type now will be assessed in their entirety by reference to the business model and whether cash flows are only principal and interest.

Andrew Vials, from KPMG’s International Standards Group, said: “The IASB has introduced a step change in financial instrument accounting in what is a very short time frame but in doing so has consulted widely and listened to many of the concerns expressed in response to the exposure draft. The option to adopt in 2009 meets the challenge set down by those who demanded change in 2009. If the new standard is not endorsed by the EU promptly, then some EU entities may find it unfortunate that they now do not have the flexibility to adopt the standard at the same time as it becomes available to other entities reporting under IFRSs.

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Nevertheless, adoption in 2009 will be a big step for any company and it remains to be seen how many choose this route. I expect that many companies will wait until the entire package, including impairment, hedge accounting and financial liabilities, has been finalised before making the change. Furthermore, although there is close dialogue between the IASB and the FASB on changes to financial instrument accounting, unfortunately it is not as yet clear to what extent convergence will be achieved on some of the issues. In the context of the G20 call for convergence and one set of global standards, I believe every effort should be made to avoid divergence in what is such a fundamental aspect of financial reporting."

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