

Accounting Alert

Special update



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This Accounting Alert provides you with information about a number of recent developments in financial reporting, including exposure drafts and discussion papers issued by the IASB and FRSB.

The beginning of the end for IAS 39 - Issue of IFRS 9 regarding Classification and Measurement of Financial Assets

IFRS 9 *Financial Instruments* is the first phase of a complete rewrite of accounting standards on financial instruments. The current standards, particularly IAS 39 *Financial Instruments: Recognition and Measurement*, are considered by many to be overly complex and difficult to apply. The IASB's project seeks to rectify these difficulties in a "fast-tracked" project. In addition to IFRS 9, the IASB has also recently released an exposure draft out of the second phase of the project covering amortised cost and impairment (refer below), and an exposure draft from the third phase of the project, hedge accounting, is expected by the end of the year.

IFRS 9 *Financial Instruments* introduces a new classification and measurement regime for financial assets within its scope. As a result of ongoing discussions about measurement of own credit risk when fair valuing financial liabilities, accounting for financial liabilities will continue to be performed under IAS 39 until further amendments are made by the IASB to IFRS 9.

In summary, IFRS 9 proposes that:

- debt instruments meeting both a 'business model' test and a 'cash flow characteristics' test are measured at amortised cost (the use of fair value is optional in some limited circumstances)
- investments in equity instruments can be designated as 'fair value through other comprehensive income' with only dividends being recognised in profit or loss
- all other instruments (including all derivatives) are measured at fair value with changes recognised in the profit or loss
- the concept of 'embedded derivatives' does not apply to financial assets within the scope of the Standard and the entire instrument must be classified and measured in accordance with the above guidelines
- unquoted equity instruments can no longer be measured at cost less impairment (must be at fair value).

The table below provides a high-level summary of some of the key changes introduced by IFRS 9:

Type of instrument	IAS 39	IFRS 9 impact
Investments in equity instruments	Often classified as 'available for sale' with gains and some losses deferred in other comprehensive income. Impairment losses recognised in profit or loss.	Measured at fair value with gains/losses recognised in profit or loss, unless designated at fair value through other comprehensive income in which case only dividends recognised in profit or loss
Available for sale debt instruments	Recognised at fair value with gains/losses deferred in other comprehensive income. Impairment losses and reversals recognised in profit and loss	May be measured on amortised cost basis if the 'business model' and 'cash flow characteristics' tests are met, otherwise measured at fair value through profit or loss
Convertible instruments	Embedded conversion option bifurcated and separately recognised at fair value, underlying debt instrument may be measured at amortised cost	Entire instrument must be classified and measured. Results in measurement at fair value with gains/losses in the profit or loss
Other hybrid debt instruments	Embedded derivatives bifurcated and separately recognised at fair value, underlying debt instrument may be measured at amortised cost	Entire instrument must be classified and measured, will generally result in measurement at fair value with gains/losses in the profit or loss
Other financial hosts with embedded derivatives	Bifurcation from underlying instrument in many cases, separately accounted for at fair value with gains/losses in profit or loss	No bifurcation, entire instrument classified and measured. Will often result in entire instrument being measured at fair value through profit or loss
Non financial hosts	Bifurcation from underlying instrument in many cases, separately accounted for at fair value with gains/losses in profit or loss	No change. Embedded derivatives must still be bifurcated
Listed debt securities	Measured at fair value (unless included in the held-to-maturity category)	Measured at amortised cost if 'business model' and 'cash flow characteristics' tests are satisfied otherwise measured at fair value through profit or loss
Held-to-maturity investments	Measured at amortised cost with a 'tainting' test	Must meet 'business model' and 'cash flow characteristics' tests to be measured at amortised cost, otherwise generally fair value through profit or loss
Limited recourse receivables	May be measured at amortised cost	'Look through' assessment may result in fair value measurement in some cases
Securitisation receivables	May be measured at amortised cost	'Look through' assessment may result in fair value measurement

What are the 'business model' and 'cash flow characteristics' tests for amortised cost classification

IFRS 9 states that in determining the measurement attribute for a financial asset (i.e., amortised cost or fair value), an entity must use two classification criteria – a business model test and a cash flow characteristics test. If the financial asset satisfies the two classification criteria, the financial asset typically must be measured at amortised cost. An entity may irrevocably elect on initial recognition to designate a financial asset as fair value through profit or loss (FVTPL) if that designation eliminates or significantly reduces an accounting mismatch had the financial asset been measured at amortised cost. This is the so-called "fair value option."

- **Business Model Test**

The business model test requires an entity to assess whether its business objective for financial assets is to collect the contractual cash flows of the assets rather than realise their fair value change from sale before their contractual maturity. This determination is made at a business unit level and not an individual financial instrument level and therefore is not based on management's intent for individual instruments.

IFRS 9 acknowledges that an entity may have different business units that are managed differently. For example, an entity may have a retail banking business whose objective is to collect contractual cash flows of loan assets and an investment banking business whose objective is to realise fair value changes through the sale of loan assets before their maturity. Therefore, financial instruments held in the retail banking business that give rise to cash flows that are payments of principal and interest (see Cash Flow Characteristics Test below) may qualify for amortised cost measurement even if similar financial instruments in the investment banking business do not. Note that all instruments that meet the existing held-for-trading definition in IAS 39 will continue to be classified as FVTPL because they are not held to collect the contractual cash flows of the instrument.

Because the assessment under the business model test is performed at the portfolio level and not the financial instrument level, an entity's business model can be to hold financial assets to collect contractual cash flows even when there are some sales of financial assets. For example, an entity's conclusion that it holds investments to collect their contractual cash flows is still valid even if the entity sells some of the investments to fund capital expenditures.

- **Cash Flow Characteristics Test**

IFRS 9 requires an entity to assess the contractual cash flow characteristics of a financial asset. The concept is that only instruments with contractual cash flows of principal and interest on principal could qualify for amortised cost measurement. IFRS 9 describes interest as consideration for the time value of money and credit risk associated with the principal outstanding during a specific period. Therefore, an investment in a convertible debt instrument would not qualify because of the inclusion of the conversion option, which is not deemed to represent payments of principal and interest.

The cash flow characteristics criterion is met when the cash flows on a loan are entirely fixed (e.g., a fixed interest rate loan or zero coupon bond), when interest is floating (e.g., when interest is contractually linked to BKM), or when interest is a combination of fixed and floating (e.g., BKM plus a fixed spread).

Financial assets that do not meet the above criteria are required to be measured at fair value, including all equity investments, all derivative assets, all trading assets, and those loans, receivables, and debt securities that do not meet the two criteria described above.



Applicable date and transition

IFRS 9 is applicable to annual reporting periods beginning on or after 1 January 2013, but can be early adopted from December 2009 year ends. IFRS 9 is applied on a modified retrospective basis, including permitting certain instruments to be reclassified based on conditions at the date of application. Exemptions from the requirement to restate comparative information are also available for early adopters.

Should I early adopt the Standard?

The impacts of early adoption will depend upon the nature of the financial assets held by the entity and those that might be expected to be held in the period to mandatory adoption in 2013.

Some companies will find the new 'fair value through other comprehensive income' category for equity investments quite attractive as it potentially removes some volatility in reported profits by eliminating the requirement to recycle losses to profit or loss where there is a significant or prolonged decline in fair value below cost i.e. fair value gains and losses will always be recognised in other comprehensive income but dividends will continue to be recognised in profit or loss.

Financial institutions and other entities with complex financial asset holdings may find early adoption less attractive due to such requirements for 'look through' assessments of certain instruments (e.g. securitisations and limited recourse debt arrangements), the removal of separate accounting for embedded derivatives and so on.

The impact on companies without significant financial assets is likely to be small and early adoption may not offer much improvement on current requirements.

IFRS 9 will continue to be amended as the IASB finalises its proposals on accounting for financial liabilities, hedging, impairment and derecognition. Changes to the existing classification and measurement requirements are likely as a result of the United States Financial Accounting Standards Board concurrent project on financial instruments. Whilst the IASB has tentatively agreed that early adopters of the existing IFRS 9 will not be required to early adopt later additions to IFRS 9, careful consideration of the impacts of early adoption is recommended.

The New Zealand equivalent to IFRS 9 (NZ IFRS 9) has been approved by the FRSB and is expected to be approved by the ASRB shortly. When approved it will be available on the [ASRB Recent Approvals](#) page on the NZICA website.

Further information can be found in the Deloitte IAS Plus Newsletter: [IFRS 9 Financial Instruments](#)



The beginning of the end for IAS 39 - Exposure Draft Proposing a New Approach to Accounting for Credit Losses

The IASB's exposure draft: *Financial Instruments: Amortised Cost and Impairment*, proposes a fundamentally new approach to accounting for credit losses to replace the existing "incurred loss" model. The global financial crisis has led to criticism of the incurred loss model for presenting an initial, over-optimistic assessment of no credit losses, which is then followed by a large adjustment later. Responding to requests by the G20 leaders and others, in June 2009 the IASB published a Request for Information on the practicalities of moving to an expected loss model. The responses were taken into account by the IASB in developing the exposure draft.

The proposed approach is designed to result in earlier loss recognition by taking into account future credit losses expected over the life of loans or other financial assets (an "expected-loss" approach) and not just after a loss event has been identified. Under this approach, an allowance for expected future losses is gradually built over the life of a financial asset by deducting a margin for future credit losses from gross interest revenue, even if no losses have yet been incurred. This avoids the front-loading of interest revenue that occurs today and is a better reflection of the lending decision. Therefore, under the proposals, a provision against credit losses would be built up over the life of the financial asset. Extensive disclosure requirements would provide investors with an understanding of the loss estimates that an entity judges necessary.

If adopted, implementation of the expected-loss approach is likely to be a significant undertaking for banks and other lending institutions where time is required to collect data and develop systems to apply the new approach.

Likely applicable date and transition

Comments are due to the IASB by 30 June 2010. The long comment period allows entities to consider the impacts of the proposals. During this time an Expert Advisory Panel will address how the proposals might be applied operationally, advise the IASB on further guidance that might be required, and will facilitate field testing of the proposals.

A standard is expected to be finalised by the end of 2010. Mandatory application will be 2013 or later.

The New Zealand request for comment and the IASB's **exposure draft** is available on the NZICA website. The FRSB is asking for comments by 1 June 2010.

Further information can be found in the IAS Plus Newsletter: **Financial Instruments: Amortised Cost and Impairment**

Amendment to IAS 24 Simplifying the Disclosure of Related Party Transactions

The IASB's amendment simplified the disclosure requirements for entities that are controlled, jointly controlled or significantly influenced by a government (referred to as government-related entities) and clarifies the definition of a related party. The amendment addresses concerns that previous disclosure requirements and the definition of a 'related party' were too complex and difficult to apply in practice, especially in environments where government control is pervasive. The amended standard:

- provides a simplified definition of a related party, in order to clarify the meaning and eliminate inconsistencies, and
- provides a partial exemption for government-related entities. Until now, if a government controlled or significantly influenced an entity, the entity was required to disclose information about all transactions with other entities controlled, or significantly influenced by the same government. The revised standard still requires disclosures that are important to users of financial statements but eliminates requirements to disclose information that is costly to gather and of less value to users. Transactions that are individually or collectively significant must still be disclosed.

The revised Standard is effective for annual periods beginning on or after 1 January 2011 with retrospective application required. Early adoption is permitted, either of the whole revised standard or just of the partial exemption for government-related entities.

The New Zealand equivalent to the amended IAS 24 (NZ IAS 24) includes an exemption for certain related party transactions with Ministers of the Crown. The **amendment** is on the NZICA website.

Further information can be found in the IAS Plus Newsletter: **IASB Issues Amendments to IAS 24**

Amendment to IAS 32 Regarding the Classification of Rights Issues

The amendments to IAS 32 *Financial Instruments:*

Presentation to change the accounting for rights issues (rights, options, or warrants) have been finalised with an amendment issued recently by the IASB. This amendment is partly a political response to the global financial crisis, which has created a widespread need for capital.

Many rights issues are denominated in a currency other than the entity's functional currency because the entity is listed in one or more jurisdictions where the local currency is not its functional currency. The current requirement to treat foreign currency denominated rights and similar issues as a derivative, with fair value movements in the profit or loss, is considered by many to be unpalatable.

To respond to constituent concern, the IASB proposed an urgent 30 day amendment in August to require certain rights issues to be treated as equity. The finally enacted amendment requires rights issues where the holder has the right to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency to be classified as an equity instrument if, and only if, the entity offers the financial instrument pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.

The amendment applies on a retrospective basis and is effective for annual periods beginning on or after 1 February 2010, with earlier application permitted.

This most recent amendment joins the 'puttable shares' amendments in muddying the waters as to the nature of 'equity' under IFRS. Share-based payments also 'override' the equity classification criteria in IFRS in some cases. It is clear that a principle-based concept of 'equity' is required – one that is clearly articulated and reflective of commercial realities, with adequate safeguards to avoid 'structuring opportunities'. However, it is unclear how these amendments will impact the IASB's existing projects in this area – including the financial instruments, liabilities with characteristics of equity and conceptual framework projects. Will the IASB have to 'carry forward' these exceptions, or can it find a workable principles based methodology for accounting for an entity's equity?

The **New Zealand equivalent amendment to NZ IAS 32** is available on the NZICA website.

Further information can be found in the IAS Plus Newsletter: **Classification of Rights Issues**

Back to the Drawing Board for Some IASB Projects

- **IASB rethinks income taxes exposure draft:** As a result of very limited support amongst respondents for finalising the Income Taxes Exposure Draft in its current form, the IASB put its fundamental overhaul of income tax accounting on hold. Some short term amendments to IAS 12 may still be made, with a group of IASB members investigating priority issues for a short-term project and considering possibilities for short-term convergence with US GAAP.
- **Exposure draft amending the discount rate for employee benefits withdrawn:** The IASB decided to abandon its proposals to require employee benefits to be measured using a discount rate determined by reference to corporate bond rates. As a result, the government bond rate will continue to be used where a deep corporate bond market does not exist (as is current practice in New Zealand).
- **Financial assets derecognition exposure draft likely to require re-exposure:** The IASB noted in its September 2009 meeting that constituents overwhelmingly disagreed with the proposed approach to derecognition as described in the exposure draft. At the October 2009 meeting the IASB discussed two possible derecognition approaches, the amended IAS 39 approach and a modified alternative approach (modified by the accounting for repos and retained interests). The Board tentatively agreed with the alternative approach, but will discuss further with the US Financial Accounting Standards Board to see if convergence is possible. As a result, re-exposure of a derecognition exposure draft is probable.

FRSB issues Amendment to NZ IFRS 8

Operating Segments

The FRSB issued an amendment to the scope of NZ IFRS 8 *Operating Segments*. The previous version applied to all entities that were not qualifying entities or public benefit entities. The FRSB has reverted to the original scope of NZ IFRS 8 so that the standard is now only applicable for an entity:

- a) *"whose debt or equity instruments are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets), or*
- b) *that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market entities whose equity or debt securities are publicly traded and entities that are in the process of issuing equity or debt securities in public securities markets."* (NZ IFRS 8.2)

This will benefit large profit-oriented entities that do not have, or intend to have, debt or equity instruments traded in a public market.

The **amendment** is available on the NZICA website.

FRSB issues Amendment to NZ IAS 34 Interim Financial Reporting - Scope

This amendment removes the New Zealand specific guidance on when NZ IAS 34 applies. In particular, it removes the scope exemption which excluded interim financial statements included in, or accompanying, a registered prospectus as such financials had to comply with the Securities Act 1978 and Securities Regulations 1983, which were not consistent with NZ IAS 34. As a result of amendments to the Securities Regulations 1983, such a distinction is no longer required.

The **amendment** is available on the NZICA website.

FRSB issues Proposed Amendment to NZ IFRS 3—Scope exemption (ED 119)

The FRSB has issued an exposure draft proposing to amend the scope of NZ IFRS 3 *Business Combinations* to provide a scope exemption for a local authority reorganisation. This is limited to situations where the assets and liabilities are transferred to a local authority from another local authority at no cost, or for nominal consideration, pursuant to legislation, ministerial directive or some other externally imposed requirement.

Comments are due to the FRSB by 23 December 2009.

Download the **Exposure Draft** from the NZICA website.

Output from the Financial Reporting Standards Board's joint meeting with the Australian Accounting Standards Board

The Australian and New Zealand Accounting Standards Boards had a joint meeting at the end of October, where they decided to take a leadership role on the convergence of financial reporting in the two countries in accordance with the goals set in the Single Economic Market Initiative established by the two Prime Ministers.

The Boards decided to:

- prioritise a joint exposure draft that includes proposals about each relevant modification from IFRSs that affects for-profit entities in order to eliminate differences from 'pure IFRSs', with any additions to IFRS being the same in both jurisdictions;
- collate these disclosure add-ons to 'pure IFRS' in a separate standard (with identical content in each jurisdiction), and
- consider developing a joint exposure draft relating to convergence of modifications to IFRSs in respect of not-for-profit/public benefit entities (PBE/NFP). This would contain proposals based on application of the Boards' Process for Modifying IFRSs for PBE/NFP subject to current work being undertaken on the reporting framework in each jurisdiction.

The Boards also discussed:

- the suitability of the IFRS for SMEs as a second tier set of reporting requirements in the two jurisdictions;
- whether the proposed Australian reduced-disclosure regime would be an option for New Zealand; and
- whether the approach to differential reporting for not-for-profit entities in the private and public sectors should differ from the approach in the for-profit private sector.

The Boards agreed in principle that, subject to legislative change in both countries, the differential reporting regime for for-profit private sector entities should be identical in both countries and a reporting regime for second tier for-profit private sector entities should involve reduced disclosures, but should not involve amendments to full IFRS recognition and measurement requirements.

The Boards discussed the potential for having the same differential reporting regime available for not-for-profit entities in the private and public sectors in the two countries based on a policy of transaction neutrality, with full recognition and measurement requirements and reduced disclosures.

In addition, the FRSB approved the release of *Process for Modifying IFRSs for PBE/NFP* which was prepared jointly with the Australian Accounting Standards Board for use in considering if and when modifications should be made to IFRSs for application by PBEs. This is available on the NZICA website.

Other Topics of Interest

International Public Sector Accounting Standards Board Activity

The International Public Sector Accounting Standards Board (IPSASB) met in September 2009. Final standards resulting from the following previously issued exposure drafts are expected by the end of the year:

- ED 36 *Agriculture*
- ED 37 *Financial Instruments: Presentation*
- ED 38 *Financial Instruments: Recognition and Measurement*
- ED 39 *Financial Instruments: Disclosures*
- ED 40 *Intangible Assets*
- ED 41 *Entity Combinations from Exchange Transactions*

In addition, the IPSASB expects to issue an exposure draft soon on Long-Term Fiscal Sustainability in the Context of General Purpose Financial Reporting.

Insurance Accounting Monthly Newsletter

Deloitte (United Kingdom) continues to issue a monthly newsletter focusing on the joint IASB and FASB project to develop a new global financial reporting standard for insurance. **Issue 8** of the *Insurance Accounting Newsletter* titled *The New Accounting Model Takes Shape* focuses on the key decision made by the IASB in September 2009 to adopt (by a bare majority vote of 8 out of 15) the 'Updated IAS 37 Model' rather than the 'Current Fulfilment Value Model'. Previous issues of this newsletter are available on the [IAS Plus Insurance Project Page](#).

IFRS and US GAAP Convergence

At a recent IFRS conference in New York, the IASB Chairman Sir David Tweedie and FASB Chairman Robert H Herz announced that the IASB and the FASB have agreed to meet monthly, for at least two days a month, starting in January 2010, to achieve the goal of converging IFRSs and US GAAP to the greatest extent possible by June 2011.

Contact

Denise Hodgkins
National Technical Partner
Ph: +64 (0) 9 303 0918
Email: dhodgkins@deloitte.co.nz

New Zealand Directory

Auckland Private Bag 115033, Shortland Street, Auckland 1140, Ph +64 (0) 9 303 0700, Fax +64 (0) 9 303 0701

Hamilton PO Box 17, Hamilton 3240, Ph +64 (0) 7 838 4800, Fax +64 (0) 7 838 4810

Wellington PO Box 1990, Wellington 6140, Ph +64 (0) 4 472 1677, Fax +64 (0) 4 472 8023

Christchurch PO Box 248, Christchurch 8140, Ph +64 (0) 3 379 7010, Fax +64 (0) 3 366 6539

Dunedin PO Box 1245, Dunedin 9054, Ph +64 (0) 3 474 8630, Fax +64 (0) 3 474 8650

Internet address <http://www.deloitte.co.nz>

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The Editor,
Accounting Alert
Private Bag 115033,
Shortland Street, Auckland 1140.
Ph +64 (0) 9 303 0700
Fax +64 (0) 9 303 0701