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P&A accounting alert

IASB issues amendments permitting the reclassification of financial instruments

Introduction

The IASB recently issued *Reclassification of Financial Assets - Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures* (the Amendments).

One of the primary considerations for these amendments is the concern from some sectors of the implications of the fair value measurements of debt securities and loans and receivables that the entities no longer intend to hold for the short term. This is especially relevant in the current economic setting and it is not surprising that the deterioration of the world's financial markets during the third quarter of this year is cited as a possible example of rare circumstances that will allow reclassification.

The amendments also address the desire of regional and international bodies to reduce the differences between IFRS and US Generally Accepted Accounting Principles (GAAP), as the latter already permit certain reclassifications of financial assets.

Summary of main changes

The Amendments permit an entity to:

- reclassify non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the fair value through profit or loss category in particular circumstances;

- transfer from the available for sale category to the loans and receivables category a financial asset that would have met the definition of loans and receivables (if it had not been designated as available for sale), if the entity has the intention and ability to hold that financial asset for the foreseeable future.

Additional disclosure requirements have been included in IFRS 7 to provide information to readers of the accounts where an entity opts to reclassify financial assets under the Amendments to IAS 39.

Background

The Amendments are part of the IASB's response to issues raised by the current credit crisis. Against the background of falling asset prices, certain sectors had expressed concern that IFRS-reporting entities were at a disadvantage compared to their counterparts in the US due to the ability of US companies to reclassify financial assets out of fair value through profit or loss in certain circumstances.

The amendments introduce into IFRSs the same possibility of reclassifications that is already permitted under US GAAP, so removing this potential disadvantage.

The Amendments to IAS 39

Reclassification of financial assets out of the fair value through profit or loss category

Under the Amendments to IAS 39, an entity may reclassify some financial assets out of the fair value through profit or loss category if they are no longer held for the purpose of being sold or repurchased in the near term (regardless that the financial asset in concern may have originally been acquired or incurred principally for the purpose of selling or repurchasing it in the near term).

However, certain types of financial instruments that were originally included in the fair value through profit or loss category cannot be reclassified under the Amendments. These are:

- derivatives as long as they are held or issued;
- financial instruments that were designated by the entity upon initial recognition as at fair value through profit or loss.

The financial assets previously classified in the fair value through profit or loss category which can be reclassified under the Amendments are as follows:

- *Loans and receivables* (if they had not been required to be classified as held for trading at initial recognition) but only if the entity has the intention and ability to hold them for the foreseeable future or until maturity.
- *Other financial assets*, in "rare circumstances," if they are no longer held for the purpose of selling or repurchasing them in the near term

The amended standards do not discuss what type of circumstances would constitute "rare circumstances." However, the IASB notes in the accompanying Basis for Conclusions that "rare circumstances" arise from a single event that is unusual and highly unlikely to recur in the near term. Also, the IASB's press release announcing the publication of the Amendments states that "the deterioration of the world's financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances cited in these IFRS amendments and therefore justifies its immediate publication."

Where reclassifications are made due to "rare circumstances," the Amendments to IFRS 7 require disclosure of the facts and circumstances that indicated the situation was rare.

What are 'rare circumstances'?

The Amendments do not discuss what type of circumstances would constitute 'rare circumstances'. The IASB's press release announcing the publication of the Amendments states however that "the deterioration of the world's financial markets that has occurred during the third quarter of this year is a possible example of rare circumstances cited in these IFRS amendments and therefore justifies its immediate publication".

Where reclassifications are made due to rare circumstances, the Amendments to IFRS 7 require disclosure of the facts and circumstances that indicated the situation was rare.

Reclassification of financial assets out of the available-for-sale category

Under the Amendments, a financial asset classified as available for sale that would have met the definition of loans and receivables (if it had not been designated as available for sale) may be reclassified out of the available-for-sale category to the loans and receivables category if the entity has the intention and ability to hold the financial asset for the foreseeable future or until maturity.

Effect of reclassification into the loans and receivables category

Where an entity reclassifies a financial asset into the loans and receivables category, it shall reclassify the financial asset at its fair value on the date of reclassification.

Where such a financial asset has previously been classified as held for trading, any gain or loss already recognized in profit or loss shall not be reversed. The fair value on the date of reclassification becomes its new cost or amortized cost, as applicable.

Where such a financial asset has previously been classified as available-for-sale, the fair value on the date of reclassification similarly becomes its new cost or amortized cost, as applicable. Any previous gain or loss on the asset that has been recognized in other comprehensive income under IAS 39.55 is to be accounted for in accordance with IAS 39.54.

This means that in the case of a financial asset with a fixed maturity, the gain or loss shall be amortized to profit or loss over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortized cost and maturity amount shall also be amortized over the remaining life of the financial asset using the effective interest method. In the case of a financial asset that does not have a fixed maturity, the gain or loss shall be recognized in profit or loss when the financial asset is sold or otherwise disposed of.

Impact on effective interest rate

The Amendments add text to the Additional Guidance in the Standard dealing with the impact of a revision of estimates of payments or receipts on use of the effective interest rate (IAS 39.AG8). The text that has been added notes that if a financial asset is reclassified in accordance with the Amendments and the entity subsequently increases its estimates of future cash receipts as a result of increased recoverability of those cash receipts, the effect of that increase shall be recognized as an adjustment to the effective interest rate from the date of the change in estimate rather than as an adjustment to the carrying amount of the asset at the date of the change in estimate.

Effective date and transition

The text dealing with the effective date and transition of the Amendments is complex. The full text is as follows:

> "Reclassification of Financial Assets (Amendments to IAS 39 and IFRS 7), issued in October 2008, amended paragraphs 50 and AG8, and added paragraphs 50B–50F. An entity shall apply those amendments from 1 July 2008. An entity shall not reclassify a financial asset in accordance with paragraph 50B, 50D or 50E before 1 July 2008. Any reclassification of a financial asset made in periods beginning on or after 1 November 2008 shall take effect only from the date when the reclassification is made. Any reclassification of a financial asset in accordance with paragraph 50B, 50D or 50E shall not be applied retrospectively to reporting periods ended before the effective date set out in this paragraph."

Essentially there are two elements to the above text:

Firstly, due to the exceptional turbulence in the world's financial markets in the third quarter of 2008, the IASB is permitting companies to reclassify financial assets in accordance with the Amendments on a partially retrospective basis from 1 July 2008. This retrospective basis is partial in that the transitional provision does not extend to reclassifying a financial asset at a date before 1 July 2008.

The second part of the text deals with the ongoing requirements for periods beginning on or after 1 November 2008. Under these requirements, reclassifications will only take effect from the date when the reclassification is made. Any such reclassification is not applied retrospectively.

In view of the urgent and exceptional nature of the Amendments, the European Union is moving to endorse the Amendments without its usual due process, with formal endorsement expected on 15 October 2008.

The Amendments to IFRS 7

Additional disclosure requirements have been added to IFRS 7 in respect of financial assets that have been reclassified as a result of the Amendments to IAS 39. Entities shall apply these from 1 July 2008.

Amongst other things, disclosure is required of the amount reclassified into and out of each category as a result of the Amendments and the reason for the reclassifications, particularly where 'rare circumstances' are given as the reason for a reclassification.

This Accounting Alert is not a comprehensive analysis of the subject matters covered and is not intended to provide accounting or other advice to specific entity. All relevant facts and circumstances, including the full text of the pertinent standards, need to be considered to arrive at decisions that relate to matters addressed in this Accounting Alert.

Should you have any questions or should you need assistance on matters covered in this Accounting Alert, please contact the P&A engagement partner assigned to your company, or send an email to any of the following partners of the Firm:

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