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Financial liabilities under IFRS 9

IASB (International Accounting Standard Board) has recently concluded on the second phase of the ongoing project of the proposed IFRS 9 (financial instruments) which is to replace the existing IAS 39(Financial instruments – Recognition and measurement) . The first part of IFRS 9, regarding financial assets - classification is already published and this one ,the second part, is proposed to cover the accounting aspects of financial liabilities and de-recognition of financial assets .

Highlights of the second part of IFRS 9 , are as follows

1. In the case of Financial liabilities that are designated on initial recognition at fair value through profit and loss, their reporting date measurement is proposed to be changed, so as not to recognize fair value changes attributed to variation in own credit risk, in the profit and loss account .
2. However, no changes are proposed to the general principles of recognition and measurement of financial liabilities. In other words , principles as they stand in IAS 39 in vogue would continue to apply generally.
3. As regards the de-recognition principles in the case of financial assets, the revised IFRS does not propose any changes except for certain additional disclosure requirements.

Although IASB has not suggested any change to the existing principles in IAS 39 , on recognition and measurement of financial liabilities , the principles in vogue as per IAS 39 are different from GAAP followed in many parts of the world. This article takes a look at challenges in the accounting of financial liability under IFRS 9.

Challenges on Initial measurement of financial liabilities

Initial measurement of all financial liabilities shall be at fair value under IFRS. However the guidance in the Standard clarifies that in an arm's length transaction the transaction value is the fair value .

a. In situations where transactions involve other considerations(than that are involved in arms length transactions) that affect the pricing or contractual terms of a liability, the fair value is likely to be different from transaction value. However application guidance provided with the Standard prescribes that on initial measurement, while recognizing a liability at its fair value no profit or

gain will be recognized in its income statement .The inference is that , where the fair value of a financial liability is less than its transaction value, the latter itself becomes the basis of measurement on initial recognition. However practices followed by entities to comply with this requirement of initial measurement at fair value are different .Loan liabilities in the accounts of a subsidiary company , payable to a parent company , taken at concessional rate of interest can be a typical example in this context. Since such transactions are not priced at market rates , fair value of financial liability is less than its transaction value . The IFRS standard is not specific as how the difference between the fair value and transaction value has to be accounted for. Appropriate application guidance would be necessary in this context, , to ensure uniform practices, across the globe.

b. Another area of challenge is related to accounting of costs incurred in connection with origination of a financial liability. Transactions costs related to financial liabilities (other than those measured at fair value through profit and loss) are to be charged to the liability itself. For instance , cost of issue of debentures or bonds has to be reduced from the proceeds of those debts and accordingly the liability will be reflected at its net of cost of issue, on initial measurement. There are a good number of economies where such cost of raising debt is a direct charge to profit and loss account. Under IFRS, accounting for interest has to be under effective interest method. Most of the third world countries follow contractual interest method in its place and that in effect require them to charge upfront fees paid on raising loans (processing fees etc..) to profit and loss account on day one. On the contrary under effective interest method, such initial charges are in substance the part of the effective interest and hence have to become part of the periodical charge of interest rather than a onetime charge as expense at the time of incurrence. During the intervening time of amortization those charges are offset from liabilities rather than shown as separate unamortized asset. This also changes the way financial liabilities will be presented under IFRS. Balances carried in the account of financial liabilities will not represent contractual obligation. That necessitates maintenance of two sets of account; one from contractual point of view and the other from accounting point.

c. In the cases of trade liabilities ,where extended credit period is allowed, the consideration includes interest for the credit period also. The requirement of measuring a financial liability at fair value for initial measurement can pose challenges in such cases as the total consideration has to be broken into fair

value of goods or services and interest . Under IFRS principles, the interest cost will not become the liability until it accrues and hence a reduced liability is measured initially.

d. There are cases where liabilities are proposed to be settled through equity shares. In the case of convertible bonds, the holders have option to get shares at a prefixed price. At the time of issue of such bonds , the management of a company may be unsure about the likelihood of the bond holders exercising the option of getting shares. However the pricing of bond is affected because of the convertible option. In other words , without a convertible option , the price(interest rate) of bond would have been different. Therefore the combination of bond bundled with an equity option is a combination, the value (issue price) of which has two components, the bond and the option to get equity shares. They require to be split so that the correct fair value of liability can be captured on initial measurement . This is a marked departure from practices followed under local GAAPs in many countries where the whole of bond value is a liability. The process of splitting pre-requires the testing whether the combination is of a liability and equity or not by virtue of the definitions as in IAS 32.

Reporting date measurement

In addition to the challenges at the time of initial measurement, the subsequent measurement of financial liabilities under IFRS also is at variance from IGAAP. Unlike in IGAAP, most of the financial liabilities under IFRS are measured at amortized cost as on reporting date. With the initial measure of financial liability at fair value, when interest (calculated according to effective rate of interest method) is applied and adjustments for the cash flows related to liabilities are done, till the date of reporting , the resultant is the amortized cost. Effective rate of interest in a variable interest contract has to be on estimated basis. Such estimations involve subjectivity. It is possible that a lender and a borrower may have different estimates about future interest scenario and hence different rates of effective rate of interest for same contract. This points to a scenario where a financial liability account as per contract will be looking different from a financial liability account as per the IFRS accounts. Entities would require to maintain multiple ledgers in that context and IT systems need appropriate modifications.

Apart from measuring financial liabilities at amortised cost , there are certain financial liabilities that are measured at fair value even for reporting date. They

are either those financial liabilities that are in the category of held for trading or designated by companies initially as items at fair value through profit or loss . In both these categories their fair value variations affect the Income Statement. Financial liabilities fall under held for trading category when they are the result of a business model of short term profit booking (including derivatives, but not designated effective hedging instruments).

Financial liabilities are designated at fair value through profit and loss under three situations . They are

(a) when the liability is a combination of debt and a derivative where from the cash flow from derivative is significantly at variance from the host liability , as per the general requirement of IFRS such combination (embedded derivatives) require to be split and the derivative needs to be measured at fair value and the host needs to be measured at amortised cost. Alternatively the whole of the combination can be designated at fair value through profit or loss as permitted by this IFRS.

(b) When the designation at fair value through profit or loss eliminates an accounting mismatch. For instance a bank manages a portfolio of asset under held for trading category and measures at fair value through profit or loss. There is a corresponding liability against it (say payable to the port folio investors). It is ideal to measure those liabilities also at fair value. The bank can designate them so.

(c) When the internal monitoring of a portfolio liability, for management objective is at fair value , its measurement for reporting can also be at fair value.

Change proposed in IFRS 9

The proposed change through IFRS 9 is regarding the measurement of the financial liabilities designated at fair value through profit or loss (covered by points(a) to (c) . According to the proposed change, fair value change on reporting date on such financial liabilities may be attributable to various reasons ;one amongst them being change in own credit rating. When the credit rating of a company decreases , recoverability of debt from that company also decreases. That means value of liability will have a lesser fair value. That would result in profit, which is undesirable. Therefore the proposed IFRS 9 prescribes bifurcating fair value changes for such liabilities as attributable to (a) own credit rating and (b) others. Fair value change attributable to the former is not recognized in profit

or loss, instead in equity through the Other Comprehensive Income Statement (OCI).

While this proposed change is a prudent step, a couple of questions are relevant here.

1. Why is that the proposed change is applicable only in the case of items designated at fair value through profit and loss and not the liabilities under Held for Trading Category. Suppose, a company had written options and defaulted on payments when the buyers have exercised the option. This is a case where the credit worthiness of the company would be impaired significantly . Market value of the same written options would decrease as a result of credit risk increase .These written options fall under HFT category and hence are to be measured at fair value through profit and loss account . However the fair value change here is attributed to own credit risk(at least partly if not fully), which if separated and kept out of profit and loss account would have a higher loss recognized in the profit and loss account. The proposed provisions in IFRS 9 ignore these situations.
2. When accounting is a means and not an end in itself, the process of separation of fair value change as attributable to (a)own credit risk and (b)others is an exercise likely to invite more cost than benefit. The best course could have been to follow a conservative method under which net losses are taken to profit and loss account and net gains are to equity , with suitable to provisions for reversal of such losses and gains to be put along side the place of origins.

In conclusion, IFRS accounting of financial liabilities is cumbersome and in an analysis of cost versus benefits , it is advantage professionals and not to entities

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