## Box 7
## Impacts of the IFRS 9 on Taiwan's financial industry and necessary measures

### *1. Main content of the International Financial Reporting Standards (IFRS) 9*

On 12 November 2009, the International Accounting Standards Board (IASB) issued the IFRS 9 "Financial Instruments." The implementation of this standard is divided into three main phases and will replace IAS 39, referring to Taiwan's SFAS 34 "Financial Instruments: Recognition and Measurement." The first phase, covering the new standards for classification and measurement of financial assets, financial liabilities and derecognition of financial instruments, is finalized and will be effective from 1 January 2013. The second phase for impairment of financial assets measured at amortized cost and the third phase for hedge accounting are still in the draft stage and are expected to be finalized in the third quarter of 2011. This box introduces the contents of the first and second phases that will have significant impacts on financial institutions and lists the main differences between the IFRS 9 and Taiwan's SFAS 34 in Table B7.1.

### 1.1 The first phase: classification and measurement of financial assets

The IFRS 9 divides financial assets into two classifications, those measured at amortized cost and those measured at fair value. It is quite different from the accounting treatment in Taiwan's SFAS 34, which breaks down all financial assets into five different classifications. If satisfying both the "business model" test and the "contractual cash flow characteristics" test[1] at initial recognition, a financial instrument must be measured at amortized cost and assess impairment losses subsequently. Otherwise, it must be measured at fair value. In addition, if a hybrid contract contains a host that is within the scope of the IFRS 9, embedded derivatives will no longer be separated from the host contract. Instead, the entire hybrid contract is assessed and measured as a whole at amortized cost or at fair value.

### 1.2 The second phase: exposure draft for impairment of financial assets measured at amortized cost

From January 2011, the banking sector in Taiwan has recognized impairment losses using the "incurred loss model" stated in the third amendment to Taiwan's SFAS 34. When there is any objective evidence of impairment for financial assets, banks need to determine whether any impairment losses should be recognized and set provisions.[2] This approach is the same as IAS 39.

Under the incurred loss model, impairment losses are recognized only when there is objective evidence of impairment or a loss event. However, it is criticized in the regard that interest revenue is overstated in the periods before a loss event occurs and an impairment allowance is recognized too little and too late under this model. Addressing this, the IASB issued the exposure draft "Financial Instruments: Amortized Cost and Impairment" (the original edition) on 5 November 2009, which proposed an expected loss model for financial assets measured at amortized cost and considered initial expected credit losses as part of effective interest rate determinants. However, the expected loss model proposed in the original was considered too complicated and was not easy to implement. Hence, the IASB and the FASB jointly published a supplement to the IASB's original edition on 31 January 2011, which improves the impairment accounting for financial assets managed in an open portfolio, such as bank loans. This supplement retains the fundamental concept of expected credit losses proposed in the original but excludes expected credit losses from the determinants of the effective interest rate, the same as IAS 39. This revised draft is expected to be finalized in the third quarter of 2011.

**Table B7.1 The main differences between the IFRS 9 and Taiwan's SFAS 34**

| Items | Taiwan's SFAS 34 | IFRS 9 |
|---|---|---|
| **Classification of financial assets** | Five classifications:<br>1. Fair value through profit or loss<br>2. Available-for-sale<br>3. Loan and receivable<br>4. Held-to-maturity<br>5. Cost less impairment | Two classifications:<br>1. Fair value through profit or loss<br>2. Amortized cost |
| **Impairment of financial assets** | Incurred loss model | Expected loss model |
| **Unquoted equity instruments** | Measured at cost | Measured at fair value |
| **Hybrid instruments** | Need to judge if embedded derivatives are closely related to the host financial asset. | If a hybrid contract contains a host that is within the scope of the IFRS 9, embedded derivatives will no longer be separated from the host contract. Instead, the hybrid contract is assessed as a whole. |
| **Reclassifications** | Allowed to reclassify assets under several circumstances. | Allowed to reclassify assets only when an entity changes its business model. |

Source: CBC.

### *2. Impacts of the IFRS 9 on the financial industry in Taiwan*

The IFRS 9 significantly changes the classification of financial assets. It is expected to have significant impacts on the financial industry, including: (1) how to implement the two aforementioned tests to determine whether financial assets are measured at amortized cost or not; (2) how to establish the fair value model for unquoted equity instruments which used to be measured at cost under IAS 39; and (3) what the impacts of new classification of financial assets on capital adequacy will be.

As for the expected loss model of the second phase, it is quite different from the current incurred loss model and requires significant changes of finance systems by enterprises. Especially for financial institutions, the implementation cost will be significant and a transition period for implementation will be needed. Therefore, financial institutions may face the following challenges and impacts, including: (1) how to develop a system to estimate future cash flows and credit losses over the life of a financial asset or group of financial assets; (2) how to collect or obtain historical loss data or credit rating information for assets with similar credit risk characteristics; and (3) how to interact with regulatory requirements, especially Basel III capital requirements.

### *3. Necessary measures for financial institutions*

The conversion to the IFRS will substantially impact not only finance and accounting, but also information systems, remuneration practices, investor relationships, as well as taxation, regulations and other legal matters. For the financial industry, the first significant impact is on information systems. In order to reduce the modifying cost for information systems, all departments within a financial institution should take enough time to adopt user acceptance tests before the new information system is in place. Secondly, though the IFRS 9 simplified the classification of financial assets, it will require more judgments when it is applied. Hence, all related departments within a financial institution should review the types of financial assets they hold and classify them according to the new classification models. Moreover, the IFRS is very different from the current accounting treatment in Taiwan and is expected to impact the financial positions, incomes and capital charges of financial institutions. Financial institutions should prepare early by evaluating the potential impacts, developing effective responsive measures and communicating with senior managers and investors in order to mitigate potential impacts.

Notes: 1. If the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows, rather than to sell the instrument prior to its contractual maturity to realize its fair value changes, it satisfies the "business model" test. If the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, it satisfies the "contractual cash flow characteristics" test.

2. In accordance with current provision regulations, banks were required to break down all assets into five categories and set aside provisions with different reserve ratios of 0.5%, 2%, 10%, 50% and 100%, respectively,. Although the banking sector adopted the “incurred loss model” to recognize impairment allowances from January 2011, the supervisory requirement is still effective as a minimum regulatory standard.