

Applying IFRS

Classification of financial instruments under IFRS 9

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What you need to know

- IFRS 9 *Financial Instruments* (IFRS 9 or the Standard) introduces a new classification model for financial assets that is more principles-based than the current requirements under IAS 39 *Financial Instruments: Recognition and Measurement*.
- Financial assets are classified according to their contractual cash flow characteristics and the business models under which they are held.
- Instruments will be classified either at amortised cost, the newly established measurement category fair value through other comprehensive income (FVOCI) or fair value through profit or loss (FVTPL).
- IFRS 9 will require an increased amount of judgement in performing the contractual cash flow characteristics test and the business model assessment.
- Entities are advised to analyse early the impact of the new classification and measurement model as it could lead to higher profit or loss volatility and could have an impact on capital.
- The classification and measurement requirements must be adopted with the other IFRS 9 requirements from 1 January 2018, with early application permitted.

1. Introduction

In July 2014, the International Accounting Standards Board (the IASB or the Board) issued the final version of IFRS 9 *Financial Instruments*, bringing together the classification and measurement, impairment and hedge accounting aspects of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and all previous versions of IFRS 9. The classification of financial instruments determines how they are accounted for and, in particular, how they are measured on an ongoing basis.

This publication highlights the factors that need to be considered in arriving at a conclusion.

The more principles-based approach of IFRS 9 requires the careful use of judgment in its application. Some fact patterns have no simple and distinct outcome. We highlight in this publication, the factors that need to be considered in arriving at a conclusion. Further issues and questions are likely to be raised during the course of implementation.

2. Classification of financial assets

IFRS 9 has the following measurement categories in which financial assets are classified:

- Debt instruments at amortised cost
- Debt instruments at fair value through other comprehensive income (FVOCI) with cumulative gains and losses reclassified to profit or loss upon derecognition
- Debt instruments, derivatives and equity instruments at fair value through profit or loss (FVTPL)
- Equity instruments designated as measured at FVOCI with gains and losses remaining in other comprehensive income (OCI), i.e., without recycling

The classification is based on both the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset. The synopsis below illustrates the thought process on which the classification of financial assets is based.

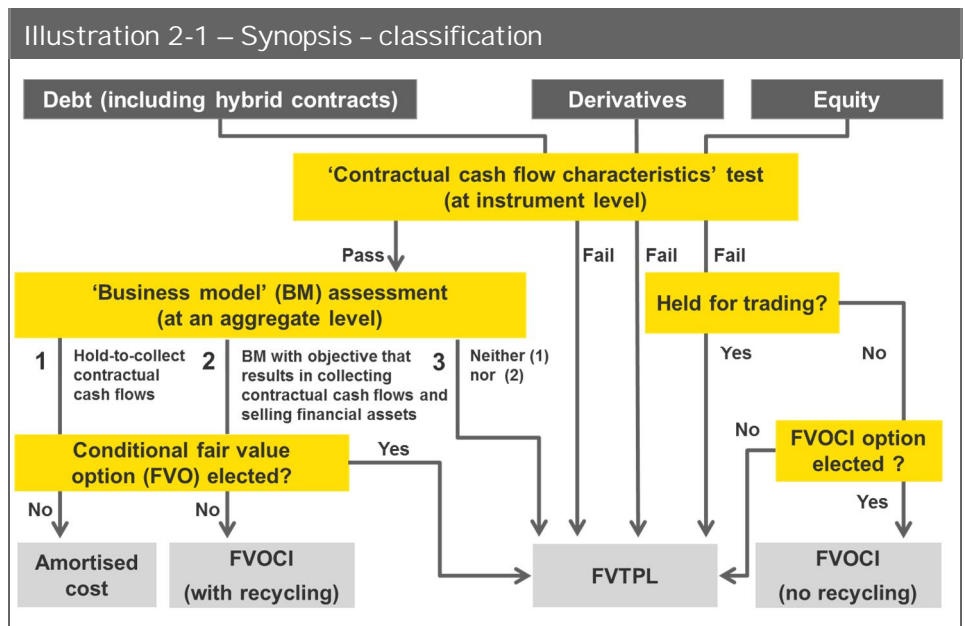


Illustration 2-2 below summarises the outcome of the thought process depicted in Illustration 2-1 above:

Illustration 2-2– Outcome chart – classification			
		Contractual cash flow characteristics test	
		Pass	Fail
Business model	Held within a business model whose objective is to hold financial assets in order to collect contractual cash flows	Amortised cost	FVTPL
	Held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets	FVOCI (with recycling)	FVTPL
	Financial assets which are neither held at amortised cost nor at FVOCI	FVTPL	FVTPL
Options	Conditional fair value option is elected	FVTPL	n/a ¹
	Option elected to present changes in fair value of an equity instrument not held for trading in OCI	n/a ²	FVOCI (no recycling)

¹ Financial assets which fail the contractual cash flow characteristics test are measured at FVTPL

² Only debt instruments can pass the contractual cash flow characteristics test. The FVOCI option does not apply to those instruments

2.1 Debt instruments

A debt instrument is generally measured at amortised cost if both of the following conditions are met:

- The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows
- 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

A debt instrument is normally measured at FVOCI if both of the following conditions are met:

- The asset is held within a business model in which assets are managed to achieve a particular objective by both collecting contractual cash flows and selling financial assets
- 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

The above requirements should be applied to an entire financial asset, even if it contains an embedded derivative. That is, in contrast with the requirements of IAS 39, a derivative embedded within a hybrid (combined) contract containing a financial asset host is not accounted for separately.

A debt instrument that is not measured at amortised cost or at FVOCI must be measured at FVTPL.

Apart from limited exceptions, only relatively simple 'plain vanilla' debt instruments qualify to be measured at amortised cost or at FVOCI.

Notwithstanding the criteria for debt instruments to be classified at amortised cost or at FVOCI, as described above, an entity may irrevocably designate a debt instrument as measured at FVTPL at initial recognition. This is allowed if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch'). Such mismatches would otherwise arise from measuring assets or liabilities, or recognising the gains and losses on them, on different bases.

The IASB noted that the FVOCI measurement category is intended for debt instruments for which both amortised cost information and fair value information are relevant and useful. This will be the case if their performance is affected by both the collection of contractual cash flows and the realisation of fair values through sales.¹

The FVOCI measurement category may help some insurers achieve a greater level of consistency of measurement for assets held to back insurance liabilities under the new IFRS 4 insurance contracts model.² It should also help to address concerns raised by preparers who expect to sell financial assets in greater volume than would be consistent with a business model whose objective is to hold financial assets to collect contractual cash flows and would, without this category, have to record such assets at FVTPL.

The FVOCI category differs from the available-for-sale (AFS) category in IAS 39 in the following three key aspects. First, the AFS category was essentially a residual classification and an unrestricted election. In contrast to that, the FVOCI classification under IFRS 9 reflects a business model evidenced by facts and circumstances and is neither a residual nor an election. Second, financial assets measured at FVOCI will be subject to the same impairment model as those measured at amortised cost. Accordingly, although recorded at fair value, the profit or loss treatment will be the same as for an amortised cost asset, with the difference between amortised cost and fair value recorded in OCI until the asset is derecognised. Third, only relatively simple debt instruments will qualify for measurement at FVOCI.

2.2 Equity instruments and derivatives

Equity instruments and derivatives are normally measured at FVTPL. However, on initial recognition, an entity may make an irrevocable election (on an instrument-by-instrument basis) to present in OCI the subsequent changes in the fair value of an investment in an equity instrument within the scope of IFRS 9. This option only applies to instruments that are neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies. For the purpose of this election, 'equity instrument' is used as defined in IAS 32 *Financial Instruments: Presentation*.

Although most gains and losses on investments in equity instruments designated at FVOCI will be recognised in OCI, dividends will normally be recognised in profit or loss. The IASB noted that dividends could represent a return *of* investment, instead of a return *on* investment. Consequently, the IASB decided that dividends that clearly represent a recovery of part of the cost of the investment are not recognised in profit or loss.³

Meanwhile, gains or losses recognised in OCI are never reclassified from equity to profit or loss. Consequently, there is no need to review such investments for possible impairment.

¹ See paragraphs IFRS 9.BC4.150-151 and 157

² See paragraphs IFRS 9.BC4.148-155

³ See paragraphs IFRS 9.5.7.6 and IFRS 9.BC5.25(a)

3. The business model assessment⁴

The business model assessment is one of the two steps to classify financial assets. An entity's business model reflects how it manages its financial assets in order to generate cash flows; its business model determines whether cash flows will result from collecting contractual cash flows, selling the financial assets, or both. This assessment is performed on the basis of scenarios that the entity reasonably expects to occur. This means, the assessment excludes so-called 'worst case' or 'stress case' scenarios. For example, an entity expects it will sell a particular portfolio of financial assets only in a stress case scenario. This scenario would not affect the entity's assessment of the business model for those assets if the entity does not reasonably expect it to occur.

There is no 'tainting' concept. However, an entity must consider information about how cash flows were realised in the past, together with all other relevant information.

If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), this does not give rise to a prior period error in the entity's financial statements (as defined in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) nor does it change the classification of the remaining financial assets held in that business model (i.e., those assets that the entity recognised in prior periods and still holds), as long as the entity has considered all relevant information that was available at the time that it made the business model assessment.

However, when an entity assesses the business model for newly originated or newly purchased financial assets, it must consider information about how cash flows were realised in the past, along with all other relevant information. This means that there is no 'tainting' concept, as in the treatment of held-to-maturity financial assets under IAS 39, but if there is a change in the way that cash flows are realised, then this will affect the classification of new assets recognised in the future.

An entity's business model for managing financial assets is a matter of fact and it is typically observable through particular activities that the entity undertakes to achieve its stated objectives. An entity will need to use judgement to assess its business model for managing financial assets and that assessment is not determined by a single factor or activity. Rather, the entity must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

- How the performance of the business model and the financial assets held within it are evaluated and reported to the entity's key management personnel
- The risks that affect the performance of the business model (and the financial assets held within) and, in particular, the way those risks are managed
- How managers of the business are compensated (e.g., whether the compensation is based on the fair value of the assets managed or the contractual cash flows collected)

In addition to these three types of evidence, in most circumstances, the expected frequency and value of sales are important elements of the assessment.

⁴ Refer to questions Q1 and Q2 in the Appendix to this publication.

3.1 Holding-to-collect contractual cash flows⁵

Financial assets that are held within a business model with the objective of holding assets in order to collect contractual cash flows are measured at amortised cost (provided the asset also meets the contractual cash flow test). Such assets are managed to realise cash flows by collecting contractual payments over the life of the instrument.

Past sales and expectations about future sales are important aspects to how the entity's stated objective for managing the financial assets is achieved.

In determining whether cash flows are going to be realised by collecting the financial assets' contractual cash flows, it is necessary to consider the frequency and value of sales in prior periods, whether the sales were of assets close to maturity, the reasons for those sales, and expectations about future sales activity. However, the standard states that sales, in themselves, do not determine the business model and cannot be considered in isolation. It goes on to say that, instead, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised. An entity must consider information about past sales in terms of the reasons for the sales and the conditions that existed at that time compared to current conditions.

Based on these considerations, an entity needs to determine the predictive value of the past sales for the expectations of future sales. When performing this assessment, the standard makes it clear that it is irrelevant whether a third party (such as a banking regulator in the case of some liquidity portfolios held by banks) imposes the requirement to sell the financial assets, or whether that activity is at the entity's discretion.

How we see it

IFRS 9 is unclear concerning the role of sales, when it says that 'sales in themselves do not determine the business model', the emphasis seems to be on past sales. Given the requirements in the standard, the magnitude and frequency of sales is certainly important evidence in determining an entity's business models. However, the key point is that the standard requires the consideration of expected future sales while past sales are of relevance only as a source of evidence. Unlike the held-to-maturity classification under IAS 39, there is no concept of 'tainting'.

3.2 Holding-to-collect contractual cash flows and selling⁶

The FVOCI measurement category is mandatory for portfolios of financial assets that are held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (provided the asset also meets the contractual cash flow test).

In this type of business model, the entity's key management personnel has made a decision that both collecting contractual cash flows and selling are fundamental to achieving the objective of the business model. There are various objectives that may be consistent with this type of business model. For example, the objective of the business model may be to manage everyday liquidity needs, to achieve a particular interest yield profile or to match the duration of financial assets to the duration of the liabilities that those assets are funding. To achieve these objectives, the entity will both collect contractual cash flows and sell the financial assets.

⁵ Refer to questions Q3-Q9 and Q13-Q19 in the Appendix to this publication

⁶ Refer to questions Q10-Q13 and Q17 in the Appendix to this publication

Compared to the business model with an objective to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the business model's objective rather than only incidental to it. There is no threshold for the frequency or value of sales that can or must occur in this business model.

3.3 FVTPL business models⁷

IFRS 9 requires financial assets to be measured at FVTPL if they are not held within either a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. A business model that results in measurement at FVTPL is where the financial assets are held for trading. Another is where the assets are managed on a fair value basis. In each case, the entity manages the financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realise those fair values. As consequence, the entity's objective will typically result in active buying and selling.

How we see it

As set out in IFRS 9, FVOCI is a defined category and is neither a residual nor an election. However, in practice, entities may identify those debt instruments that are held to collect contractual cash flows, those that are held for trading, those managed on a fair value basis and those for which the entity applies the fair value option to avoid a measurement mismatch, and then measure the remaining debt instruments at FVOCI. As a consequence, the FVOCI category might, in effect, be used as a residual, just because it is far easier to articulate business models that would be classified at amortised cost or at FVTPL.

4 Characteristics of the contractual cash flows of the instrument

The assessment of the characteristics of the contractual cash flows aims to identify whether the contractual cash flows are 'solely payments of principal and interest on the principal amount outstanding'. Hence, the assessment is colloquially referred to as the 'SPPI test'.

The SPPI test is designed to screen out financial assets on which the application of the effective interest method (EIM) either is not viable from a pure mechanical standpoint or does not provide useful information about the uncertainty, timing and amount of the financial asset's contractual cash flows.

Because the EIM is essentially an allocation mechanism that spreads interest revenue or expense over time, amortised cost or FVOCI measurement is only appropriate for simple cash flows that have low variability such as those of 'plain vanilla' loans and receivables and debt securities. Accordingly, the SPPI test is based on the premise that it is only when the variability in the contractual cash flows arises to maintain the holder's return in line with a 'basic lending arrangement' that the application of the EIM provides useful information.

The IASB believes that amortised cost would provide relevant and useful information as long as the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement.

⁷ Refer to questions Q17-Q20 in the Appendix to this publication.

In this context, the term 'basic lending arrangement' is used broadly to capture both originated and acquired financial assets, the lender or the holder of which is looking to earn a return that compensates primarily for the time value of money and credit risk. However, such an arrangement can also include other elements that provide consideration for other basic lending risks such as liquidity risks, costs associated with holding the financial asset for a period of time (e.g., servicing or administrative costs) and can also include a profit margin.

In contrast, contractual terms that introduce a more than *de minimis* exposure (see section 4.3.1) to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

The following sections cover the individual aspects of the SPPI test, starting with the meaning of the terms principal and interest in sections 4.1 and 4.2, as well as the different types of modified contractual cash flows and their effect on the SPPI test in section 4.3. Contractually linked instruments are separately covered in section 4.4.

4.1 The meaning of 'principal'

Principal is not a defined term in IFRS 9. However, the standard states that, for the purposes of applying the SPPI test, the principal is 'the fair value of the asset at initial recognition' and that it may change over the life of the financial asset (e.g., if there are repayments of principal).

The IASB believes that this meaning reflects the economics of the financial asset from the perspective of the current holder; this means that the entity would assess the contractual cash flow characteristics by comparing the contractual cash flows to the amount that it actually invested.⁸

Illustration 4-1 – The meaning of principal

Entity A issued a bond with a contractually stated principal of CU1,000. The bond was originally issued at CU990. Because interest rates have risen sharply since the bond was originally issued, Entity B, the current holder of the bond, acquired it in the secondary market for CU975. From the perspective of entity B, the principal amount is CU975.

The principal is, therefore, not necessarily the contractual par amount, nor (when the holder has acquired the asset subsequent to its origination) is it necessarily the amount that was advanced to the debtor when the instrument was originally issued.

4.2 The meaning of 'interest'

IFRS 9 states that the most significant elements of interest within a basic lending arrangement are typically the consideration for the time value of money and credit risk. In addition, interest may also include consideration for other basic lending risks (e.g., liquidity risk) and costs (e.g., administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest may include a profit margin that is consistent with a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset, in effect, pays a fee for the safekeeping of its money for a particular period of time and that fee exceeds

⁸ See paragraph IFRS 9.BC4.182(a)

the consideration the holder receives for the time value of money, credit risk and other basic lending risks and costs.

However, contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form.

The IASB acknowledges that different entities may price elements of interest differently.

The IASB noted in the Basis for Conclusions that the assessment of interest focuses on what the entity is being compensated for (i.e., whether the entity is receiving consideration for basic lending risks, costs and a profit margin or is being compensated for something else), instead of how much the entity receives for a particular element.⁹

Time value of money is the element of interest that provides consideration for only the passage of time. That is, the time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. To make this assessment, an entity considers relevant factors such as the currency in which the financial asset is denominated, and the period for which the interest rate is set.

The IASB also notes that, as a general proposition, the market in which the transaction occurs is relevant to the assessment of the time value of money element. For example, in Europe, it is common to reference interest rates to LIBOR and in the United States it is common to reference interest rates to the prime rate. However, a particular interest rate does not necessarily reflect consideration for only the time value of money merely because that rate is considered 'normal' in a particular market. For example, if an interest rate is reset every year, but the reference rate is always a 15-year rate, it would be difficult for an entity to conclude that such a rate provides consideration for only the passage of time, even if such pricing is commonly used in that particular market. Accordingly, the IASB believes that an entity must apply judgement to conclude whether the stated time value of money element meets the objective of providing consideration for only the passage of time.¹⁰

How we see it

It could be argued that the standard is not entirely clear as to the status of benchmark rates such as LIBOR. For such rates, the consideration for credit risk is neither fixed, nor varies over time to reflect the specific credit risk of the obligor, but instead varies to reflect the credit risks associated with a class of borrowers. Given that LIBOR is cited in the standard as an example of a rate that would satisfy the SPPI criteria, it would seem that this is not an issue.

⁹ See paragraph IFRS 9.BC4.182(b).

¹⁰ See paragraph IFRS 9.BC4.178.

4.3 Modified contractual cash flows¹¹

Sometimes, contractual provisions modify the cash flows of an instrument such that they do not give rise to only a straightforward repayment of principal and interest.

4.3.1 *De minimis and non-genuine features*¹²

A contractual cash flow characteristic does not affect the classification of the financial asset if it can have only a *de minimis* effect on the contractual cash flows of the financial asset. To make this determination, an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument.

In addition, if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than *de minimis* (either in a single reporting period or cumulatively) but that cash flow characteristic is *not genuine*, it does not affect the classification of a financial asset. A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

How we see it

Although the *de minimis* and *non-genuine* thresholds are high hurdles, allowing entities to disregard such features will result in more debt instruments qualifying for the amortised cost or FVOCI measurement categories than in previous versions of IFRS 9. The terms will need to be interpreted by preparers in analysing the impact of the clarified SPPI test on the debt instruments they hold.

4.3.2 *Modified consideration for the time value of money*¹³

There are contractual features that modify the time value of money element of interest (e.g., the tenor of the interest rate does not correspond with the frequency with which it resets). The standard describes such time value of money elements as 'imperfect'.¹⁴ In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal outstanding. In some circumstances, the entity may be able to make that determination by performing a qualitative assessment whereas, in other circumstances, it may be necessary to perform a quantitative analysis.

The objective of a quantitative assessment is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element were not modified (referred to as the 'the benchmark' cash flows). For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity should compare that financial asset to a financial instrument with identical contractual terms and credit risk,¹⁵

¹¹ For fact patterns including instruments without modified contractual terms, refer to questions Q21-Q24 and Q29 in the Appendix to this publication.

¹² Refer to questions Q25 and Q26 in the Appendix to this publication.

¹³ Refer to questions Q27-Q29 in the Appendix to this publication.

¹⁴ See paragraph IFRS 9.B4.1.9B.

¹⁵ Time value of money does not include credit risk, so it is important to exclude it from the assessment. The standard suggest this is done by comparing the instrument with a benchmark instrument with the same credit risk, but presumably the comparison could be against an instrument with a different credit risk, as long as the effect of the difference can be excluded.

except the variable interest rate is reset monthly to a one-month interest rate. If the modified time value of money element could result in contractual (undiscounted) cash flows that are significantly different from the (undiscounted) benchmark cash flows, the financial asset fails the SPPI test. To make this determination, the entity must consider the effect of the modified time value of money element in each reporting period as well as cumulatively over the life of the financial instrument. The reason for the interest rate being set this way is not relevant to the analysis. If it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment.

When assessing a modified time value of money element, an entity must consider factors that could affect future contractual cash flows. However, an entity must consider only reasonably possible scenarios rather than every possible scenario.

If an entity concludes that the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not pass the SPPI test and cannot be measured at amortised cost or FVOCI.

4.3.3 Regulated interest rates

In some jurisdictions, the government or a regulatory authority sets interest rates. This may be part of a broad macroeconomic policy or to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, the Board noted in the Basis for Conclusions that the rates are set for public policy reasons and thus are not subject to structuring to achieve a particular accounting result.¹⁶ Consequently, as a concession, a regulated interest rate is considered to serve as a proxy for the time value of money element for the purpose of applying the contractual cash flow characteristics test if that regulated interest rate:

- Provides consideration that is broadly consistent with the passage of time,
- Does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement

How we see it

As the standard does not establish criteria to determine whether a regulated rate provides consideration that is 'broadly consistent' with the passage of time, it will be interesting to see how this concession is applied in practice. However, in the Basis for Conclusions, the Board implies that the particular instrument described in the following extract would satisfy the SPPI criteria.

¹⁶ See paragraphs IFRS 9.BC4.179-180

Extract from the Basis for Conclusion on IFRS 9

Livret A (IFRS 9 BC4.180)

For example, the IASB noted that French retail banks collect deposits on special 'Livret A' savings accounts. The interest rate is determined by the central bank and the government according to a formula that reflects protection against inflation and an adequate remuneration that incentivises entities to use these particular savings accounts. This is because legislation requires a particular portion of the amounts collected by the retail banks to be lent to a governmental agency that uses the proceeds for social programmes. The IASB noted that the time value element of interest on these accounts may not provide consideration for only the passage of time; however the IASB believes that amortised cost would provide relevant and useful information as long as the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement.

4.3.4 Other contractual provisions that change the timing or amount of contractual cash flows¹⁷

Some financial assets contain contractual provisions that change the timing or amount of contractual cash flows. For example, the asset may be prepaid before maturity or its term may be extended. In such cases, the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to those contractual provisions are solely payments of principal and interest on the principal amount outstanding.

To make this determination, the entity must assess the contractual cash flows that could arise both before, and after, the change in contractual cash flows. The entity may also need to assess the nature of any contingent event that could change the timing or amount of contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, it may be an indicator.

For example, compare a financial instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments, to a financial instrument with an interest rate that is reset to a higher rate if a specified equity index reaches a particular level. It is more likely in the former case that the contractual cash flows over the life of the instrument will be solely payments of principal and interest on the principal amount outstanding, because of the relationship between missed payments and an increase in credit risk. In the latter case, the contingent event could introduce equity price risk which does not represent a basis lending risk.

The following are examples of contractual terms that result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding:

- A variable interest rate that is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed) and other basic lending risks and costs, as well as a profit margin (which are also likely to be fixed)

The IASB decided to provide a narrow scope exception subject to conditions for debt instruments originated or acquired at a premium or discount and prepayable at par.

¹⁷ Refer to questions Q30 and Q31 in the Appendix to this publication

- A contractual term that permits the issuer (i.e., the debtor) to prepay a debt instrument or permits the holder (i.e., the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract
- A contractual term that permits the issuer or holder to extend the contractual term of a debt instrument (i.e., an extension option) and the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract

The strict application of the standard's use of the term 'principal' would mean that debt instruments originated or acquired at a premium or discount and which are prepayable at par have to be measured at FVTPL. This is because, if the issuer prepays, the holder may receive a gain that is less than, or in excess of, a basic lending return. The IASB, however, decided to provide a narrow scope exception for some of those financial assets. Financial assets originated or acquired at a premium or discount that would otherwise have cash flows that are principal and interest, except for the effect of a prepayment option, are deemed to meet that condition, but only so long as:

- The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) interest, which may include reasonable additional compensation for the early termination of the contract
- The fair value of the prepayment feature on initial recognition of the financial asset is insignificant

How we see it

The conditions described above apply regardless of whether: (i) the prepayment provision is exercisable by the issuer or by the holder; (ii) the prepayment provision is voluntary or mandatory; or (iii) the prepayment feature is contingent.

The third criterion, that the fair value of the prepayment option was not significant on initial recognition, may in practice result in many prepayable financial assets being recorded at FVTPL, unless there is some feature that provides reasonable compensation for the contract's early termination. Without this, a prepayment option at par would normally change in fair value as market rates of interest rise or fall.

Also, because the prepayment amount may include reasonable additional compensation for the early termination of the contract, the treatment of prepayment options under IFRS 9 is very different from that under IAS 39. Under the latter, a prepayment feature is considered 'closely related' (and so is not treated as an embedded derivative that is required to be separated) only if it is prepayable at approximately the amortised cost.

However, an issue might arise for variable rate instruments acquired at a significant discount or premium. For example, a variable rate asset acquired at a deep discount includes some leverage (see section 4.3.5 below) because the variable interest is based on the nominal amount whereas the principal is the fair value on initial recognition by the acquirer. Such an instrument would fail the SPPI test. However, it is unclear if this was the IASB's intention.

4.3.5 Contractual cash flows not representing payments of principal and interest¹⁸

In some cases, financial assets may have contractual cash flows that are not solely payments of principal and interest. Unless such a feature is *de minimis* or *non-genuine*, the instrument would fail the contractual cash flow characteristics test. Examples of instruments with contractual cash flows that may not represent solely payments of principal and interest include instruments subject to leverage and instruments that represent investments in particular assets or cash flows.

Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts fail the contractual characteristics test and cannot be measured at amortised cost or FVOCI.

A financial asset may have contractual cash flows that are described as principal and interest, but those cash flows do not represent the payment of principal and interest on the principal amount outstanding. This may be the case if the financial asset represents an investment in particular assets or cash flows. For example, under some contractual arrangements, a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (described in the standard as a 'non-recourse' financial asset)

Another example in the standard¹⁹ are contractual terms stipulating that the financial asset's cash flows increase as more automobiles use a particular toll road. Those contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not pass the contractual cash flow characteristics test unless such a feature is *de minimis* or *non-genuine*.

However, the fact that a financial asset is non-recourse does not necessarily preclude the financial asset from passing the SPPI test. In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset fails the SPPI test. Whether the underlying assets are financial assets or non-financial assets does not affect this assessment.

In almost every lending transaction the creditor's instrument is ranked relative to the instruments of the debtor's other creditors. An instrument that is subordinated to other instruments may be considered to have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment arises only on a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. On the other hand, if the subordination feature limits the contractual cash flows in any other way or introduces any kind of leverage, the instrument would fail the SPPI test.

¹⁸ Refer to questions Q32-Q41 in the Appendix to this publication.

¹⁹ See paragraph IFRS 9.B4.1.16.

4.4 Contractually linked instruments²⁰

In some types of transactions, an entity may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (known as tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher ranking tranches.

These types of arrangements concentrate credit risk into certain tranches of a structure. Essentially such investments contained leveraged credit risk and accordingly, the IASB believes that measuring such investments at amortised cost or FVOCI may be inappropriate in certain circumstances.²¹

In multi-tranche transactions that concentrate credit risk in the way described above, a tranche is considered to have cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if all of the following criteria are met:

- The contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (e.g., the interest rate on the tranche is not linked to a commodity index).
- The underlying pool of financial instruments must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding (the primary instruments) and any other instruments in the underlying pool must either:
 - Reduce the cash flow variability of the primary instruments in the pool and, when combined with the primary instruments in the pool, result in cash flows that are solely payments of principal and interest on the principal amount outstandingOr
 - Align the cash flows of the tranches with the cash flows of the underlying primary instruments in the pool to address differences in (and only in):
 - Whether the interest rate is fixed or floating
 - The currency in which the cash flows are denominated, including inflation in that currencyOr
 - The timing of the cash flows

An entity should not be disadvantaged simply by holding an asset indirectly.

For these purposes, when identifying the underlying pool of financial instruments, the holder should 'look through' the structure until it can identify an underlying pool of instruments that are creating (rather than passing through) the cash flows.

²⁰ Refer to questions Q42-Q45 in the Appendix to this publication.

²¹ See paragraph IFRS 9.BC4.26.

- The exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to, or lower than, the exposure to credit risk of all of the underlying pool of instruments (e.g., the credit rating of the tranche is equal to or higher than the credit rating that would apply to a single borrowing that funded the underlying pool).

If the holder cannot assess whether a financial asset meets criteria above at initial recognition, the tranche must be measured at FVTPL.

How we see it

While contractually linked instruments could pass the SPPI test and consequently can be measured at amortised cost or FVOCI, the contractual cash flows of the individual tranches are normally based on a pre-defined waterfall structure (i.e., principal and interest are first paid on the most senior tranche and then successively paid on more junior tranches). Accordingly, one could argue that more junior tranches could never suffer a credit loss because the contractually defined cash flows under the waterfall structure are always equal to the cash flows that an entity expects to receive.²² However, consistent with treating these assets as having passed the SPPI test, we believe that the impairment requirements of IFRS 9 apply to such tranches if they are measured at amortised cost or FVOCI. Instead of the cash flows determined under the waterfall structure, an entity needs to consider deemed principal and interest payments as contractual cash flows when calculating expected credit losses.

In practice, it may be difficult for the holder to perform the look-through test because the underlying reference assets of a collateralised debt obligation (CDO) have not all yet been acquired at the time of investment. In such circumstances, the holder will need to consider, amongst other things, the stated objectives of the CDO and the manager's investment mandate in determining whether the investment qualifies for measurement at amortised cost or FVOCI. If these aspects enable the holder to conclude that all the underlying reference assets of the CDO will always have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding, the interest in the CDO can qualify for measurement at amortised cost or FVOCI. Otherwise, the interest in the CDO must be accounted for at FVTPL because it fails SPPI test

If the underlying pool of instruments can change after initial recognition in a way that does not meet the conditions above, the tranche must be measured at FVTPL. However, if the underlying pool includes instruments that are collateralised by assets that do not meet the conditions above (as will often be the case), the ability to take possession of such assets is disregarded for the purposes of applying this requirement unless (which will be rare) the entity acquired the tranche with the intention of controlling the collateral.

²² Appendix A of IFRS 9 defines credit loss as 'the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive, discounted at the original effective interest rate'.

The IASB noted that a key principle underlying the contractual cash flow provisions for contractually linked instruments is that an entity should not be disadvantaged simply by holding an asset indirectly if the underlying asset has cash flows that are solely principal and interest and the holding is not subject to more-than-insignificant leverage or a concentration of credit risk relative to the underlying assets.²³

Accordingly, the IASB clarified that a tranche may have contractual cash flows that are solely payments of principal and interest, even if the tranche is prepayable in the event that the underlying pool of financial instruments is prepaid. The Board noted that, because the underlying pool of assets must have contractual cash flows that are solely payments of principal and interest, then, by extension, any prepayment features in those underlying financial assets must also be solely payments of principal and interest.²⁴

How we see it

The Board's clarification that a prepayment feature in the underlying pool of assets does not necessarily prevent a tranche from meeting the SPPI criteria is helpful. But, unless the underlying pool can only be acquired at origination, it may be very difficult to 'look through' to the underlying pool to determine if its prepayment features would themselves be solely payments of principal and interest. This is because the information will often not be available to determine whether the assets were acquired at a premium or discount and whether the fair value of any prepayment feature was insignificant on acquisition (see 4.3.4).

4.4.1 Assessing the characteristics of the underlying pool

For the purposes of criterion (b) in 4.4 above, the underlying pool may contain financial assets or liabilities such as interest rate swaps. In order for these instruments not to preclude the use of amortised cost or FVOCI accounting for holders of a tranche, they must reduce the variability of cash flows, or align the cash flows of the tranches with the cash flows of the underlying pool of the primary instruments. If the underlying pool of financial instruments contained a purchased credit default swap, this would not preclude the use of amortised cost or FVOCI accounting provided it paid out only to compensate for the loss of principal and interest, although, in practice, it is far more common for underlying pools to contain written rather than purchased credit default swaps. As a consequence, it may well be possible to obtain amortised cost or FVOCI accounting treatment for the more senior investments in cash CDOs, i.e., those for which the underlying pool comprises the reference debt instruments. However, senior tranches of synthetic CDOs, for which the risk exposure of the tranches is generated by derivatives, would not pass the SPPI test.

4.4.2 Assessing the exposure to credit risk in the tranche held²⁵

IFRS 9 does not prescribe a method for comparing the exposure to credit risk in the tranche held to that of the underlying pool of financial instruments.

²³ See paragraph IFRS 9.BC4.206.

²⁴ See paragraph IFRS 9.BC4.206(a).

²⁵ Refer to question Q46 in the Appendix to this publication.

For the more senior and junior tranches, it may become obvious, after relatively little analysis, whether the tranche is more or less risky than the underlying assets. In some cases, it may be possible to compare the credit rating allocated to the tranche with that for the underlying pool of financial instruments, provided they are all rated.

However, in some circumstances involving complex securitisation structures, a more detailed assessment may be required. For example, it might be appropriate to prepare an analysis that involves developing various credit loss scenarios for the underlying pool of financial instruments, computing the probability-weighted outcomes of those scenarios, determining the probability-weighted effect on the tranche held, and comparing the relative variability of the tranche held with that of the underlying assets.

5. Classifying financial liabilities²⁶

The classification of financial liabilities under IFRS9 does not follow the approach for the classification of financial assets, rather it remains broadly the same as under IAS 39. Except for financial guarantee contracts and loan commitments that are scoped out of the standard, financial liabilities are measured either at FVTPL or at amortised cost.

Financial liabilities are measured at FVTPL when they meet the definition of held for trading or when they are designated as such on initial recognition using the fair value option (see section 6).

For financial liabilities designated as at FVTPL using the fair value option, the element of gains or losses attributable to changes in the entity's own credit risk should normally be recognised in OCI, with the remainder recognised in profit or loss. These amounts recognised in OCI are not recycled to profit or loss if the liability is ever repurchased at a discount.

However, if presentation of the fair value change in respect of the liability's credit risk in OCI creates or enlarges an accounting mismatch in profit or loss, gains and losses must be entirely presented in profit or loss. To determine whether the treatment would create or enlarge an accounting mismatch, the entity must assess whether it expects the effect of the change in the liability's credit risk to be offset in profit or loss by a change in fair value of another financial instrument, such as when the fair value of an asset is linked to the fair value of the liability. If such a mismatch does arise, an entity will be required to present all fair value changes of the liability in profit or loss. This exception was designed to address certain financial instruments that are issued in Denmark and, otherwise, we would expect such instances to be rare. The determination of whether there will be a mismatch will need to be made at initial recognition of individual liabilities and is not re-assessed.

Financial liabilities not held at FVTPL are subsequently measured at amortised cost using the effective interest method.

However, in contrast to the treatment for hybrid contracts with financial asset hosts, derivatives embedded within a financial liability host within the scope of IFRS 9 will often be separately accounted for, in the same manner as under IAS 39. That is, they must be separated if they are not closely related to the host contract, they meet the definition of a derivative, and the hybrid contract is not measured at FVTPL.

Apart from the requirement to record changes in own credit risk on liabilities designated to be measured at FVTPL in OCI, the classification and measurement of financial liabilities has not changed.

²⁶ Refer to question Q52 in the Appendix to this publication.

6. Designation as FVTPL²⁷

Financial assets or financial liabilities may be designated as measured at FVTPL at initial recognition using the fair value option, if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise.

Financial liabilities may also be designated as at FVTPL where a group of financial liabilities, or a group of financial assets and financial liabilities, is managed and its performance is evaluated on a fair value basis. Financial assets that are managed on a fair value basis will always be classified at FVTPL, hence, a designation option is not needed for these instruments.

Designation at FVTPL in the two situations described above is permitted, provided that doing so results in the financial statements presenting more relevant information. Such a designation can be made only at initial recognition and cannot be subsequently revoked.

In addition, a hybrid contract with a host that is not an asset within the scope of IFRS 9 that contains one or more embedded derivatives meeting particular conditions may be designated, in its entirety, at FVTPL.

7. Designation of non-derivative equity instruments as at FVOCI²⁸

An entity may acquire an investment in an equity instrument that is not held for trading. At initial recognition, the entity may make an irrevocable election (on an instrument-by-instrument basis) to present in OCI subsequent changes in the fair value of such an investment. For this purpose, the term 'equity instrument' is as defined in IAS 32.

With the exception of dividends received, the associated gains and losses (including any related foreign exchange component) are recognised in OCI. Amounts presented in OCI are not subsequently transferred to profit or loss, even on derecognition, although the cumulative gain or loss may be transferred within equity. Also unlike the treatment of 'available-for-sale' equity instruments under IAS 39, no impairment on such assets is ever recorded through profit or loss.

Dividends from such investments should be recognised in profit or loss when the right to receive payment is probable and can be measured reliably, unless the dividend clearly represents a recovery of part of the cost of the investment.

Under IFRS 9 and IAS 39, all derivatives are deemed to be held for trading. Consequently, this election cannot be applied to a derivative such as a warrant classified as equity by the issuer. However, it could be applied to investments in preference shares, 'dividend stoppers'²⁹ and similar instruments provided they are classified as equity by the issuer.

²⁷ Refer to question Q47 in the Appendix to this publication.

²⁸ Refer to questions Q48-Q51 in the Appendix to this publication.

²⁹ A dividend stopper is an instrument that contains features that stop an entity from making a dividend payment on its common shares if a dividend/coupon is not paid on the instrument containing the dividend stopper feature.

The IASB had originally intended this accounting treatment to be available only for those equity instruments that represented a 'strategic investment'.³⁰ These might include investments held for non-financial benefits rather than primarily for increases in the value of the investment, for example, where there is a requirement to hold such an investment if an entity sells its products in a particular country. However, the Board concluded that it would be difficult, and perhaps impossible, to develop a clear and robust principle that would identify investments that are different enough to justify a different presentation requirement and abandoned this requirement.

How we see it

Determining when a dividend does or does not clearly represent a recovery of cost could prove somewhat judgemental in practice, especially as the standard contains no further explanatory guidance. Also, because it is an exception to a principle, it opens up the possibility of structuring transactions to convert fair value gains into dividends through the use of intermediate holding vehicles.

8 Reclassification of financial instruments³¹

In certain rare circumstances, non-derivative debt assets are required to be reclassified between the amortised cost, FVOCI and FVTPL categories. More specifically, when (and only when) an entity changes its business model for managing financial assets, it should reclassify all affected financial assets in accordance with the new business model. The reclassification should be applied prospectively from the 'reclassification date', which is defined as, 'the first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets'.³² Accordingly, any previously recognised gains, losses or interest should not be restated.

How we see it

The reference to reporting period includes interim periods for which the entity prepares an interim report. For example, an entity with a reporting date of 31 December might determine that there is a change in its business model in August 2016. If the entity prepares and publishes quarterly reports in accordance with IAS 34 *Interim Financial Reporting*, the reclassification date would be 1 October 2016. However, if the entity prepares only half-yearly interim reports or no interim reports at all, the reclassification date would be 1 January 2017.

Changes in the business model for managing financial assets are expected to be very infrequent.

Changes in the business model for managing financial assets are expected to be very infrequent. They must be determined by an entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in the objective of an entity's business model will occur only when an entity either

³⁰ See paragraph IFRS 9.BC5.25(c).

³¹ Refer to questions Q53-Q55 in the Appendix to this publication.

³² See IFRS 9 Appendix A

begins or ceases to carry on an activity that is significant to its operations, and generally that will be the case only when the entity has acquired or disposed of a business line. Examples of a change in business model include the following:

- An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
- A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

A change in the objective of an entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (i.e., the first day of the entity's next reporting period, assuming it reports quarterly), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.

The following are not considered to be changes in the business model:

- A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions)
- A temporary disappearance of a particular market for financial assets
- A transfer of financial assets between parts of the entity with different business models

Financial liabilities must never be reclassified.

Unlike a change in business model, the contractual terms of a financial asset are known at initial recognition. However, the contractual cash flows of a financial asset may vary over its life based on its original contractual terms. Because an entity classifies a financial asset at initial recognition on the basis of the contractual terms over the life of the instrument, reclassification on the basis of a change in a financial asset's contractual cash flows is not permitted, unless the asset is sufficiently modified that it is derecognised.

If an entity reclassifies financial assets, it must apply the reclassification prospectively from the reclassification date. The entity should not restate any previously recognised gains, losses or interest. Financial liabilities must never be reclassified.

The table below summarises the treatment of gains and losses on reclassification:

Illustration 8-1 – Gains and losses on reclassification				
		Measurement category before reclassification		
		Amortised cost	FVOCI	FVTPL
Measurement category after reclassification	Amortised cost		The cumulative gain or loss previously recognised in OCI is removed from equity and adjusted against the fair value of the financial asset. The effective interest rate is not adjusted as a result of the reclassification.	The fair value of the financial asset at the reclassification date becomes its new carrying amount. The effective interest rate is calculated on the basis of that amount. For the purpose of applying the impairment requirements, the reclassification date is treated as the date of initial application.
	FVOCI	Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in OCI. The effective interest rate is not adjusted as a result of the reclassification.		The fair value of the financial asset at the reclassification date becomes its new carrying amount. The effective interest rate is calculated on the basis of that amount. For the purpose of applying the impairment requirements, the reclassification date is treated as the date of initial application.
	FVTPL	Any gain or loss arising from a difference between the previous carrying amount and fair value at the reclassification date is recognised in profit or loss.	The fair value of the financial asset at the reclassification date becomes its new carrying amount. The cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss as a reclassification adjustment.	

9 Effective date and transition³³

This section covers the requirements that are applicable when an entity that had not previously applied the November 2009, October 2010 or November 2013 versions of IFRS 9, applies the final version. Previous versions of IFRS 9 are no longer available for early adoption for initial application on or after 1 February 2015.

The final version of IFRS is mandatorily applicable for periods beginning on or after 1 January 2018. Early application is permitted and the fact should be disclosed. However, early application may be subject to approval or endorsement by the local jurisdiction.

IFRS 9 allows an entity to early apply the 'own credit' requirements for non-derivative financial liabilities before the final version of the standard is applied. These provisions require an entity to present in OCI the fair value gains and losses attributable to changes in the entity's own credit risk for non-derivative financial liabilities designated as measured at FVTPL. This would mean that, before the mandatory effective date of IFRS 9, entities may elect to change only their accounting policy for own credit risk while continuing, otherwise, to account for their financial instruments in accordance with IAS 39. If an entity chooses to apply early only those provisions, it must disclose that fact and provide the related disclosures on an ongoing basis.

IFRS 9 contains a general requirement that it should be applied retrospectively, although it also specifies a number of exceptions that are considered in the rest of this section.

9.1 Date of initial application

A number of the transition provisions refer to the date of initial application which is the date when an entity first applies the requirements of IFRS 9 and must be the beginning of a reporting period after the issue of IFRS 9 (i.e., 24 July 2014).

9.2 Applying the business model assessment

Entities must make the business model assessment (see Section 3) on the basis of the facts and circumstances that exist at the date of initial application. The resulting classification must be applied retrospectively, irrespective of the entity's business model in prior reporting periods.

9.3 Applying the SPPI test

For existing IFRS reporters, there are no transition provisions relating to the application of the contractual cash flow characteristics test. Accordingly, the contractual cash flow characteristics of an asset must be assessed based on conditions at the date of initial recognition of the instrument, not at the date of initial application of the standard.

At the date of initial application, it may be impracticable (as per IAS 8) for an entity to assess a modified time-value-of-money element (as described in section 4.3.2 above) on the basis of the facts and circumstances that existed at the initial recognition of the financial asset. In such instances, the entity must assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at its initial recognition. This is without taking into account the requirements related to the modification of the

³³ Refer to questions Q56-Q61 in the Appendix to this publication.

time value of money element. This means that, in such cases, the entity would apply the assessment of the asset's contractual cash flows characteristics, as set out in the original requirements issued in IFRS 9 (2009); i.e., without the notion of a modified economic relationship. As such, the asset would most likely be classified as measured at fair value through profit or loss.

At the date of initial application, it may be impracticable (as defined in IAS 8) for an entity to assess whether the fair value of a prepayment feature (as described in section 4.3.4) was insignificant on the basis of the facts and circumstances that existed at the initial recognition of the financial asset. If this is the case, an entity must assess the contractual cash flow characteristics of that financial asset on the basis of the facts and circumstances that existed at the initial recognition of the financial asset. The entity would not take into account the exception for prepayment features. This means that the asset would be classified as measured at fair value through profit or loss.

For contractually linked instruments, on initial application of the standard, the look-through assessment should be performed as at the date that the reporting entity (i.e., the investor in the tranche) initially recognised the contractually linked instrument. It is inappropriate to make the risk assessment based on the circumstances existing either at the date that the arrangement was first established or the date of initial application of IFRS 9.

The situation is different for first-time adopters of IFRS, who are required to apply the contractual characteristics test to previously acquired assets on the basis of the facts and circumstances that exist at the date of transition to IFRS (or the beginning of the first IFRS reporting period for entities that choose not to apply IFRS 9 in comparative periods).

9.4 Making and revoking designations

On application of IFRS 9, entities are required to revisit designations previously made in accordance with IAS 39 and are given an opportunity to make designations in accordance with IFRS 9. More specifically, at the date of initial application:

- Any previous designation of a financial asset as measured at FVTPL may be revoked in any case, but must be revoked if such designation does not, or no longer, eliminates or significantly reduces an accounting mismatch
- A financial asset or a financial liability may be designated as measured at FVTPL if such designation would now eliminate or significantly reduce an accounting mismatch
- Any previous designation of a financial liability as measured at FVTPL that was made on the basis that it eliminated or significantly reduced an accounting mismatch may be revoked in any case, but must be revoked if such designation no longer eliminates or significantly reduces an accounting mismatch
- Any investment in a non-derivative equity instrument that is not held for trading may be designated as at FVOCI

Such designations and revocations should be made on the basis of the facts and circumstances that exist at the date of initial application and that classification should be applied retrospectively. For the purposes of the last point, an entity should determine whether equity investments meet the definition of held for trading as if they had been acquired at the date of initial application.

At the date of initial application, an entity must determine whether the own credit requirements of IFRS 9 would create or enlarge an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of initial application. Those requirements must be applied retrospectively on the basis of that determination.

9.5 Restatement of comparatives

Notwithstanding the general requirement to apply the standard retrospectively, an entity that adopts the classification and measurement requirements of IFRS 9 must provide the disclosures set out in IFRS 7 *Financial Instruments: Disclosures* but need not restate prior periods. Indeed, an entity may restate prior periods if, and only if, it is possible to do so without the use of hindsight.

Where prior periods are not restated, any difference between the previous reported carrying amounts and the new carrying amounts of financial assets and liabilities at the beginning of the annual reporting period that includes the date of initial application, should be recognised in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the date of initial application. However, if an entity restates prior periods, the restated financial statements must reflect all of the requirements in IFRS 9.

Where interim financial reports are prepared in accordance with IAS 34, the requirements in IFRS 9 need not be applied to interim periods prior to the date of initial application, if it is impracticable to do so.

Entities adopting IFRS 9 are required to provide additional disclosures showing the changes, as at the date of initial application, in the classification of financial assets and financial liabilities upon transition from the classification and measurement requirements of IAS 39 to those of IFRS 9. These disclosures are required even if an entity chooses to restate the comparative figures for the effect of applying IFRS 9.

9.6 Derecognition prior to the date of initial application

If prior periods are restated, IFRS 9 should not be applied to financial assets or financial liabilities that have already been derecognised at the date of initial application. In other words, following the application of IFRS 9, to the extent those financial assets or financial liabilities were held during any period presented prior to the date of initial application, they will be accounted for under IAS 39.

How we see it

When the reporting entity elects to restate comparative information or, for example, chooses to apply IFRS 9 from the beginning of an interim reporting period, the effect of derecognition could potentially be confusing for users of the financial statements. Therefore, it may require careful explanation. This is because the information for reporting periods prior to the date of initial application would be prepared on a mixed basis, partially under IFRS 9 (for those financial instruments not derecognised before that date) and partially under IAS 39 (for those financial instruments which have been derecognised prior to that date), reducing the consistency of the information provided.

9.7 Transition adjustments and measurement

9.7.1 Hybrid financial assets

A hybrid financial asset that is measured at FVTPL in accordance with IFRS 9 may previously have been accounted for as a host financial asset and a separate embedded derivative in accordance with IAS 39. In such circumstances, if the entity restates prior periods and the fair value of the hybrid contract had not been determined in the comparative reporting periods, at the end of each comparative reporting period, the fair value of the hybrid contract is deemed to be the sum of the fair values of the components (i.e., the non-derivative host and the embedded derivative).

At the date of initial application, any difference between the fair value of the entire hybrid contract at the date of initial application and the sum of the fair values of the components of the hybrid contract should be recognised in the opening retained earnings (or other component of equity, as appropriate) of the reporting period of initial application.

9.7.2 Financial assets and liabilities measured at amortised cost

It may be impracticable to apply retrospectively the effective interest method to a financial asset or liability that is measured at amortised cost on transition to IFRS 9, e.g., if it was previously classified at FVTPL. In these circumstances, the fair value of the financial asset or liability at the end of each comparative period should be treated as its gross carrying amount or amortised cost, respectively. Also, the fair value of the financial asset or financial liability at the date of initial application should be treated as its new gross carrying amount or amortised cost, respectively, at that date.

Aside from this exception, the effective interest method should be applied retrospectively. This means that for any financial asset reclassified in accordance with the October 2008 amendments to IAS 39, for example, from trading to loans and receivables or available-for-sale, the effective interest method should be applied based on the original cost of the asset, not the amounts determined on reclassification. This is because retrospective application means that an entity presents its financial statements as if it had always applied IFRS 9. However, IFRS 9 does not have the same reclassification requirements as IAS 39. Hence, the entity has to go back to the date of initial recognition of the financial instrument in order to determine the accounting treatment.

9.7.3 Unquoted equity investments

An investment in an unquoted equity instrument (or a derivative that is linked to and must be settled by delivery of such an unquoted equity instrument) might previously have been measured at cost in accordance with IAS 39. In such circumstances, the instrument should be measured at fair value at the date of initial application of IFRS 9. Any difference between the previous carrying amount and the fair value should be recognised in the opening retained earnings (or other component of equity, as appropriate) of the reporting period that includes the date of initial application. This means that that previous periods cannot be restated. The Board explains that this is because as an entity would not have previously determined the fair value of an investment in an unquoted equity instrument and it will not now have the necessary information to determine fair value retrospectively without using hindsight.

The effective interest method has to be applied retrospectively. This could potentially affect financial assets that were reclassified in accordance with the October 2008 amendments to IAS 39.

Appendix: Q&As to the classification of financial instruments

The business model assessment

Level and granularity of the assessment

Portfolio definition

Q1: How does an entity define portfolios when performing the business model assessment?³⁴

Additional information

Entity A holds a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes.

Entity B holds a portfolio of mortgage loans and manages some of the loans with the objective of collecting contractual cash flows and manages the other loans with the objective of actively trading them to realise fair value gains.

Analysis

The assessment should be performed on the basis of the entity's business model as determined by the entity's key management personnel (as defined in IAS 24 *Related Party Disclosures*). An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation.

However, a single entity may have more than one business model for managing its financial instruments. In such a situation, classification would not be determined at the reporting entity level.

Similarly, in some circumstances, it may be appropriate to split a portfolio of financial assets into sub-portfolios to reflect how an entity manages them. The sub-portfolios would be treated as separate portfolios, provided the assets belonging to each one are defined.

For entity A, this means that it probably has two portfolios under two different business models, the first portfolio is accounted for at amortised cost and the second one at FVTPL.

Entity B may be able to achieve the same treatment as entity A by splitting the portfolio it holds into two sub-portfolios. However, a sub-portfolio approach would not be appropriate when the entity is not able to define which assets would be held to collect contractual cash flows and which assets would potentially be actively traded. It is clear that judgement will be needed to determine the level of aggregation to which the business model assessment should be applied.

³⁴ Q&A based on IFRS 9.B4.1.2

Example A-1 – Business model assessment

Entity A has debt instruments worth CU100, comprising notes with maturities of three to five years. Until the adoption of IFRS 9, all of these debt instruments were classified as AFS under IAS 39. In practice, CU10 of the portfolio is sold and reinvested at least once a year, while the remaining CU90 investments are typically held to near their maturity. First, the entity needs to use judgement to determine whether it has:

- (a) Two business models: (i) CU90 debt instruments held to near their maturity; and (ii) CU10 debt instruments which are actively bought and sold, provided those assets can be separately identified

Or

- (b) One business model applied to the overall portfolio of CU100 debt investments

If scenario (a) above is considered more appropriate, the entity could achieve amortised cost classification for a majority of the debt instruments and would probably need to account for the remaining debt instruments at FVTPL or FVOCI. This is more likely to be the case where there is clearly a different management objective for the two groups of assets and their performance is measured, and management is compensated, accordingly.

Alternatively, if scenario (b) is considered more appropriate, the entity needs to determine whether the level of expected sales and repurchases is more than infrequent and is significant in value, requiring the whole portfolio to be measured at FVTPL or FVOCI. Whether the assets are required to be measured at FVTPL instead of FVOCI depends on whether the portfolio is managed on a fair value basis and fair value information is primarily used to assess asset's performance and to make decisions.

The standard cites infrequent or significant in value as indicators (rather than as criteria) to determine whether the business model is to hold instruments to collect contractual cash flows. Other factors to consider include the reasons for the sales and how the performance of the business is reported to, and assessed by, management.

But IFRS 9 states that information about past sales and expectations of future sales provide *evidence* as to the entity's business objective and, except for sales made when there has been an increase in the assets' credit risk (see Question 7), an entity would need to assess how more than infrequent or more than significant sales would be consistent with an objective of collecting contractual cash flows.³⁵

Level for applying the business model assessment

Q2: How does an entity determine the granularity of business models in a large multinational organisation? For example, in the following scenario, for the purpose of its consolidated financial statements, how many business models does the banking group have?

³⁵ See paragraphs IFRS 9.B4.1.2C and B4.1.3B.

Additional information

A global banking group operates two business lines, retail banking and investment banking. These businesses both operate in the same five locations by means of separate subsidiaries. Each subsidiary has its own Board of Directors that is responsible for carrying out the strategic objectives as set by the group's Board of Directors.

The financial assets held by the investment banking business are measured at FVTPL in line with the group's strategy, which defines the business model, to actively trade these financial assets. Within the retail banking business, four of the five subsidiaries hold debt securities in line with the group's objective to collect contractual cash flows. However, the fifth subsidiary holds a portfolio of debt securities that it expects to sell before maturity. These assets are not held for trading, but individual assets are sold if the portfolio manager believes he or she can reinvest the funds in assets with a higher yield. As a result, a more than infrequent number of sales that are significant in value are anticipated for this portfolio and it is unlikely that this portfolio would meet the amortised cost criteria if it were assessed on a stand-alone basis.

Analysis

The bank will need to exercise judgement to determine the appropriate level at which to assess its business model(s). Hence, different conclusions are possible depending on the facts and circumstances.

This does not mean that the bank has an accounting policy choice, but it is, rather, a matter of fact that can be observed by the way the organisation is structured and managed. In many organisations, key management personnel may determine the overall strategy and then delegate their authority for executing the strategy to others. The combination of the overall strategy and the effect of the delegated authority are among the factors that can be considered in the determination of business models.

In the specified fact pattern, the determining factor is whether the fifth subsidiary is managed independently from the other four subsidiaries (and performance is assessed and management is compensated accordingly). If it is separately managed, the number of business models is three (i.e., investment banking, one business model for the first four subsidiaries and a second business model for the fifth subsidiary). If not, the number of business models is two (i.e., one for retail banking and one for investment banking). In the case of two business models, all of the debt securities held by the retail banking business would be accounted for at FVOCI.

Impact of sales on the assessment

General considerations

Q3: How do past sales influence the business models of an entity and the assets held within those business models?

Additional information

An entity initially assesses its business model as qualifying for amortised cost measurement, but assets are subsequently sold for reasons that were not previously anticipated.

Analysis

An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for the sales and demonstrate why they sales do not reflect a change in the entity's business model and, hence, sales will in future be lower in frequency or value.

This assessment is about expectations and not about intent. For instance, the fact that it is not the entity's objective to realise fair value gains or losses is not sufficient in itself to be able to conclude that measurement at amortised cost is appropriate.

If the entity comes to the conclusion that sales will be more than infrequent (and significant in value) in the future, the objective of the business model is rather to hold financial assets to collect contractual cash flows and to sell financial assets. Newly acquired financial assets under this business model will need to be accounted for at FVOCI, whereas existing financial assets remain measured at amortised cost.

Existing financial assets are only reclassified in case of a change in business model. However, this is expected to happen only 'very infrequently', for instance, when an entity begins or ceases an activity that is significant to its operations. The examples given in the standard involve the acquisition, disposal or shutting down of business lines. Unanticipated sales are very unlikely to meet that hurdle.

Q4: How will an entity interpret 'infrequent' and 'insignificant'?

Analysis

IFRS 9 requires that if more than an infrequent number of sales is made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with the objective of collecting contractual cash flows.

However, IFRS 9 does not explain how 'infrequent' and 'insignificant' should be interpreted.

We believe that the assessment is based on the cash flow patterns resulting from a portfolio and whether they are suitable for applying an internal rate of return accounting approach. That means that an entity would analyse the effect of sales on the split between what is recorded as interest revenue and gains and losses from derecognition recorded in profit or loss. These thresholds could lead to diversity in application, although it is an area where consensus and best practices may emerge over time.

Q5: Does an entity take into consideration whether sales are imposed by a third party such as a banking regulator?³⁶

Additional information

A bank is required by its regulator to routinely sell financial assets within its liquidity portfolio to demonstrate that the assets are in fact liquid. The value of the assets sold is, in aggregate, significant.

³⁶ Q&A based on IFRS 9.B4.1.4 Example 4.

Analysis

If more than an infrequent number of such sales are made out of a portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

When performing this assessment, it is irrelevant whether a third party (such as a banking regulator in the case of some liquidity portfolios held by banks) imposes the requirement to sell the financial assets, or whether that activity is at the entity's discretion.

In following these requirements, the banks will not be able to classify the financial assets in the portfolio as measured at amortised cost, but rather, as measured at FVOCI, provided the assets also meet the contractual cash flow characteristics test.

Q6: How is the business model test affected by sales close to maturity of the financial asset?

Additional information

An entity sells financial assets close to the maturity of the financial assets. The proceeds from the sales approximate the collection of the remaining contractual cash flows.

Analysis

Such sales as described in the additional information above are consistent with the objective of holding financial assets in order to collect contractual cash flows. How an entity defines 'close' and 'approximate' may be a matter of judgement.

Sales due to credit risk management activities

Q7: Would sales of financial assets as part of credit risk management activities be inconsistent with a hold-to-collect business model?³⁷

Additional information

An entity holds investments to collect their contractual cash flows. The funding needs of the entity are predictable and the maturity of its financial assets is matched to its estimated funding needs.

The entity performs credit risk management activities with the objective of maintaining the credit risk of the portfolio within defined risk limits. In the past, sales have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet the entity's documented investment policy.

Reports to key management personnel focus on the credit quality of the financial assets and the contractual return. The entity also monitors fair values of the financial assets, among other information.

Analysis

Irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows, because the credit quality

³⁷ Q&A based on IFRS 9.B4.1.4 Example 1.

of financial assets is relevant to the entity's ability to collect contractual cash flows.

Credit risk management activities that are aimed at avoiding potential credit losses due to credit deterioration are integral to such a business model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, this conclusion cannot be extended to sales to avoid excessive credit concentration (see also Q8).

Although the entity considers, among other information, the financial assets' fair values from a liquidity perspective (i.e., the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets in order to collect the contractual cash flows. Therefore, under the fact pattern specified, the entity will still be able to measure the portfolio at amortised cost.

In the absence of a documented investment or similar policy, the entity may be able to demonstrate in other ways that the sale occurred due to an increase in credit risk.

Q8: How does an entity treat sales to manage concentration risk?

Additional information

An entity sells financial assets to manage credit concentration risk without an increase in the assets' credit risk.

Analysis

Such sales may be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows, but only to the extent that they are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). That means such sales are treated no differently than sales for any other reason. Thus, such sales are likely to be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows and to sell financial assets.

Liquidity portfolio for stress case scenarios

Q9: Do sales of debt instruments that are held for liquidity purposes in stress case scenarios preclude a portfolio from being measured at amortised cost?³⁸

Additional information

A financial institution holds financial assets to meet unanticipated liquidity needs in a 'stress case' scenario (e.g., a run on the bank's deposits). The entity does not anticipate selling these assets except in such a scenario. The entity monitors the credit quality of the financial assets and its objective in managing the financial assets is to collect the contractual cash flows. The entity evaluates the performance of the assets on the basis of interest revenue earned and credit losses realised.

However, the entity also monitors the fair value of the financial assets from a liquidity perspective to ensure that the cash amount that would be realised if the entity needed to sell the assets in a stress case scenario would be sufficient

³⁸ Q&A based on IFRS 9.B4.1.4 Example 4.

to meet the entity's liquidity needs. Periodically, the entity makes sales that are insignificant in value to demonstrate liquidity.

Analysis

The objective of the entity's business model is to hold the financial assets to collect contractual cash flows.

The analysis would not change even if during a previous stress case scenario the entity made sales that were significant in value in order to meet its liquidity needs. Similarly, recurring sales activity that is insignificant in value is not inconsistent with holding financial assets to collect contractual cash flows.

However, the assessment would change in the case where the entity periodically sells debt instruments that are significant in value to demonstrate liquidity, or if the entity sells the debt instruments to cover everyday liquidity needs. See also Q5 and Q10.

Liquidity portfolio for everyday liquidity needs

Q10: Do sales of debt instruments that are held to meet everyday liquidity needs preclude a portfolio from being measured at amortised cost?³⁹

Additional information

A financial institution holds financial assets to meet its everyday liquidity needs. In the past, this has resulted in frequent sales activity and such sales have been significant in value. This activity is expected to continue in the future as everyday liquidity needs can rarely be forecast with any accuracy.

Analysis

The objective of the business model is meeting everyday liquidity needs. The entity achieves those objectives by both collecting contractual cash flows and selling financial assets. This means that both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective and the financial assets are measured at FVOCI (provided the financial assets also meet the SPPI test).

Opportunistic portfolio management

Q11: Does opportunistic portfolio management preclude a portfolio from being measured at amortised cost?⁴⁰

Additional information

A financial institution holds a portfolio of financial assets. The entity actively manages the return on the portfolio on an opportunistic basis trying to increase the return, without a clear intention of holding the financial assets to collect contractual cash flows (although it might end up holding the assets if no other investment opportunities arise). That return consists of collecting contractual payments as well as gains and losses from the sale of financial assets.

As a result, the entity holds financial assets to collect contractual cash flows and sells financial assets to reinvest in higher yielding financial assets. In the past, this strategy has resulted in frequent sales activity and such sales have been significant in value. It is expected that the sales activity will continue in the future.

³⁹ Q&A based on IFRS 9.B4.1.4C Example 6.

⁴⁰ Q&A based on IFRS 9.B4.1.4C Example 6.

Analysis

The entity achieves the objective stated above by both collecting contractual cash flows and selling financial assets. Both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective and the financial assets are measured at FVOCI (provided the financial assets also meet the SPPI test).

Replication portfolios

Q12: Is amortised cost measurement appropriate for a portfolio of instruments held to match the duration of particular liabilities?⁴¹

Fact pattern 1 – Insurance company

An insurer holds financial assets in order to fund insurance contract liabilities. The insurer uses the proceeds from the contractual cash flows on the financial assets to settle insurance contract liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle the liabilities, the insurer undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.

Analysis 1

The objective of the business model is to fund the insurance contract liabilities. To achieve this objective, the entity collects contractual cash flows as they come due and sells financial assets to maintain the desired profile of the asset portfolio. Thus, both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective and it follows that the financial assets are measured at FVOCI (provided the assets meet the SPPI test).

Fact pattern 2 – Bank

A bank allocates investments into maturity bands to match the expected duration of its time deposit accounts. The invested assets have a similar maturity profile and amount to the corresponding deposits. The ratio of assets to deposits for each maturity band has pre-determined minimum and maximum levels. For example, if the ratio exceeds the maximum level because of an unexpected withdrawal of deposits, the bank will sell some assets to reduce the ratio. The choice of assets to be sold would be based on those that would generate the highest profit or incur the lowest loss.

Meanwhile, new assets will be acquired when necessary (i.e., when the ratio of assets to deposits falls below the pre-determined minimum level). The expected repayment profile of the deposits would be updated on a quarterly basis, based on changes in customer behaviour. Under IAS 39, these assets were classified as AFS and there has been no history of active trading.

Analysis 2

The question is whether adjusting the assets/deposits ratio by selling assets to correspond with a change in the expected repayment profile of the deposits would mean that the business model is inconsistent with the objective of holding to collect the contractual cash flows. In these circumstances, an analogy can be drawn to the insurance company above.

⁴¹ Q&A based on IFRS 9.B4.1.4C Example 7.

However, if the bank had a good track record of forecasting its deposit repayments, we would expect sales to be infrequent. If numerous sales happen every year, it might be difficult to rationalise such practice with an objective of holding to collect the contractual cash flows. Due consideration will also need to be given to the magnitude of sales. Sale of significant value will require further analysis in terms of the reasons for the sales before an appropriate conclusion could be reached.

Anticipated capital expenditures

Q13: Is an entity allowed to sell financial assets for anticipated capital expenditures?⁴²

Additional information

A non-financial entity anticipates capital expenditure in a few years. The entity invests its excess cash in short-term and long-term financial assets so that it can fund the expenditure when the need arises. Many of the financial assets have contractual lives that exceed the entity's anticipated investment period.

The entity will hold financial assets to collect the contractual cash flows and, when an opportunity arises, it will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.

Analysis

The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets. The entity will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will increase the expected return on the portfolio until the need arises for the invested cash.

In contrast, consider an entity that anticipates a cash outflow in five years to fund capital expenditures and invests excess cash in short-term financial assets. When the investments mature, the entity reinvests the cash in new short-term financial assets. The entity maintains this strategy until the funds are needed, at which time, the entity uses the proceeds from the maturing financial assets to fund the capital expenditures. Only insignificant sales occur before maturity (unless there is an increase in credit risk). The objective of such a business model is to hold financial assets in order to collect contractual cash flows.

Credit-impaired financial assets and hedging activities in a hold-to-collect business model

Q14: When assessing the business model, should an entity consider the fact that it would not realise all the contractual cash flows of certain instruments?⁴³

Additional information

An entity's business model is to purchase portfolios of financial assets, such as loans. The portfolios may or may not include financial assets that are credit impaired. If interest payments and repayments of principal on the loans is not made on a timely basis, the entity attempts to realise the contractual cash flows through various means, e.g., by making contact with the debtor by mail,

⁴² Q&A based on IFRS 9.B4.1.4C Example 5.

⁴³ Q&A based on IFRS 9.B4.1.4 Example 2.

telephone or other methods. The entity's objective is to collect contractual cash flows and the entity does not manage any of the loans in this portfolio with the objective of realising cash flows by selling them.

Analysis

The objective of the entity's business model is to hold the financial assets in order to collect the contractual cash flows. The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (e.g., some of the financial assets are credit impaired at initial recognition).

The financial assets that are credit impaired may have been acquired at a discount. To conclude that the contractual cash flows of the instruments are solely payments of principal and interest on the principal outstanding, the entity has to assess prepayment features (refer to section 4.3.4 above and Q28).

Q15: When assessing the business model, should an entity consider hedging activities undertaken?⁴⁴

Additional information

In addition to question 14, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate or vice versa.

Analysis

The fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not change the entity's business model.

Financial assets that are sold in terms of legal form, but not derecognised

Q16: When assessing the business model, should an entity consider whether it 'sells' assets in terms of the contract's legal form, or whether it derecognises them for accounting purposes?

Analysis

There are a number of circumstances in which an entity may sell a financial asset, but the asset will remain on the selling entity's statement of financial position. For example, a bank may enter into a 'repo' transaction whereby it sells a debt security and, at the same time, agrees to repurchase it at a fixed price. Similarly, a manufacturer may sell trade receivables as part of a factoring programme and provide a guarantee to the buyer to compensate it for any defaults by the debtors. In each case, the seller retains substantially all risks and rewards of the assets and the financial assets would not be derecognised in line with the requirements of IFRS 9.

The inevitable question that arises in these circumstances is whether these transactions should be regarded as sales when applying the business model assessment.

In this context, IFRS 9 contains only one passing reference to derecognition, but it does suggest that it is the accounting treatment, and not the legal form of a transaction, that determines whether the entity has ceased to hold an asset to collect contractual cash flows. Application of such an approach would give an

⁴⁴ Q&A based on IFRS 9.B4.1.4 Example 2.

intuitively correct answer for repo transactions which are, in substance, secured financing transactions rather than sales. Whether the same analysis can be applied to a financial asset that is factored with recourse is not yet clear, given that the transferor does not retake possession of the asset.

Securitisation

Q17: How do planned securitisation activities impact the business model assessment?⁴⁵

Additional information

An entity has a business model with the objective of originating loans to customers and, subsequently, to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors. The originating entity controls the securitisation vehicle and thus consolidates it. The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors.

It is assumed, for the purposes of this example, that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.

Analysis

The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows and measures the debt instrument at amortised cost.

However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements, it would not be considered to be managing this portfolio in order to collect the contractual cash flows. The portfolio might even meet the definition of held-for-trading as it is incurred principally for the purpose of selling in the near term and, hence, needs to be measured at FVTPL. The same conclusion would be drawn for the consolidated group if the securitisation vehicle is not consolidated.

Loans intended to be sub-participated

Q18: How should an entity account for originated loans, when some are intended to be sold or sub-participated?

Additional information

An entity may originate loans so that it holds part of the portfolio to maturity, but sells a portion in the near term, or sub-participates a portion of the loans to other banks. The question arises whether, for the purposes of the application of IFRS 9, the entity has one business model or two.

Analysis

The entity could consider the activities of lending to hold and lending to sell or sub-participate as two separate business models, requiring different skills and processes.

⁴⁵ Q&A based on IFRS 9.B4.1.4 Example 3.

Whilst the financial assets resulting from the former activity would typically qualify for amortised cost measurement as they are held to collect contractual cash flows, those from the latter activity would not and, as they are to be sold or sub-participated in the near future, they would need to be measured at FVTPL.

If a loan is assessed, in part, to be sold or sub-participated, this raises the additional issue of whether a single financial asset can be classified into two separate business models. As it is already common under IAS 39 for loans to be classified in part as held for trading and in part at amortised cost, it is likely that this practice will continue under IFRS 9.

Q19: What happens if the sale or sub-participation referred to in Q18 fails?

Additional information

In some cases, an entity may fail to achieve the intended disposal, having previously classified a portion of a loan at FVTPL because of the intention to sell.

Analysis

The standard requires classification to be determined in accordance with the business model applicable at the point of initial recognition of the asset.

In this example, the fact that the entity fails to achieve an intended disposal does not trigger a reclassification in accordance with the standard as the threshold for reclassification is a high hurdle. Therefore, loans or portions of loans that the entity fails to dispose of would continue to be recorded at FVTPL following the arguments in Q18.

FVTPL business models

Portfolio managed on a fair value basis

Q20: What are the business models that result in measurement at FVTPL?

Additional information

An entity manages a portfolio and measures its performance on a fair value basis and makes decisions based on the fair value of the financial assets. Such an objective typically results in frequent sales and purchases of financial assets.

Analysis

A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis, is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. In addition, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets. The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions.

Even though the entity will collect contractual cash flows while it holds financial assets in the FVTPL category, this is only incidental and not integral to achieving the business model's objective. Consequently, such portfolios of financial assets must be measured at FVTPL.

The SPPI test

Instruments without 'modified' cash flows

Bond with a capped interest rate

Q21: Can an instrument with a capped interest rate meet the SPPI test?⁴⁶

Additional information

An entity holds a bond with a stated maturity date that pays a variable market interest rate. That variable interest rate is capped.

Analysis

The contractual cash flows of both an instrument that has (a) a fixed interest rate and (b) a variable interest rate, are payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money, for the credit risk associated with the instrument during the term of the instrument and for other basic lending risks and costs, as well as a profit margin.

Therefore, such an instrument can have cash flows that are solely payments of principal and interest on the principal amount outstanding. A feature such as an interest rate cap or floor may reduce cash flow variability by setting a limit on a variable interest rate or increase the cash flow variability because a fixed rate becomes variable.

There would appear to be no requirement to determine whether the cap is in the money on original recognition, as is required by the test in IAS 39 to assess whether there is a separable embedded derivative.

Unleveraged inflation-linked bond

Q22: Would an inflation-linked bond qualify for measurement at amortised cost if payments of both the principal and interest are linked to the inflation index, but the principal is not protected?⁴⁷

Additional information

An entity holds a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding of the bond are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.

Analysis

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects 'real' interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.

However, if the interest payments were indexed to another variable such as the debtor's performance (e.g., the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding (unless the indexing to the debtor's performance

⁴⁶ Q&A based on IFRS 9.B4.1.13 Instrument C.

⁴⁷ Q&A based on IFRS 9.B4.1.13 Instrument A.

results in an adjustment that only compensates the holder for changes in the credit risk of the instrument, such that contractual cash flows will represent only payments for principal and interest). That is because the contractual cash flows reflect a return that is inconsistent with a basic lending arrangement.

Q23: Further to Q22, consider Entity A which invests in euro-denominated bonds with a fixed maturity issued by Entity B. Interest on the bond is linked directly to the inflation index of Eurozone Country C, which is Entity B's principal place of business. Can Entity A measure the euro bonds at amortised cost given that interest is not linked to the inflation index of the entire Eurozone area?

Additional information

The bond is denominated in euros and Eurozone Country C is part of the Eurozone, therefore, we consider the inflation link to be acceptable. The inflation index reflects the inflation rate of the currency in which the bond is issued since it is the inflation index of Entity B's economic environment, and the euro is the currency for that economic environment.

Analysis

By linking the inflation index to the inflation rate of Eurozone Country C, Entity B is reflecting 'real' interest for the economic environment in which it operates. Hence, in these circumstances, Entity A could regard the interest as consideration for the time of value of money and credit risk associated with the principal amount outstanding on the bond.

Dual currency instruments

Q24: If the interest payments on a financial asset are denominated in a currency that is different from the principal of the financial asset, is the financial asset considered to have contractual cash flows that are solely payments of principal and interest?

Additional information

For some financial assets, the interest payments are denominated in a currency that is different from the principal of the financial asset. IFRS 9 requires the assessment of 'whether contractual cash flows are solely payments of principal and interest on the principal outstanding for the currency in which the financial asset is denominated'.⁴⁸

Analysis

This implies that any instrument on which interest is calculated based on a principal amount other than that payable on maturity will not pass the SPPI test. For instance, if variable interest payments are computed based on a fixed principal amount in another currency, e.g., US dollars, although repayment of the principal is in pounds sterling, the financial asset is not considered to have cash flows that are solely payments of principal and interest.

However, there may be instances where interest is denominated in a currency that is different from the principal currency, but the contractual cash flows could possibly constitute solely payments of principal and interest.

⁴⁸ See paragraph IFRS 9.B4.1.8.

For example, the principal amount of the bond is denominated (and redeemed at a fixed maturity) in Canadian dollars (CAD). Interest payments are fixed in Indian rupees (INR) at inception based on the market interest rates and foreign exchange spot and forward rates at that time.

While not explicit in IFRS 9, in our view, if the bond can be separated into two components that, on their own, would meet the cash flow characteristics test, then the combined instrument would do so. That is, if the bond can be viewed as the combination of a zero-coupon bond denominated in CAD and a stream of fixed payments denominated in INR, and if both instruments can be analysed as a stream of cash flows that are solely payments of principal and interest, then the sum of the two would do so as well.

The defining criterion is the fact that the interest payments have been fixed at inception and there is no exposure to changes in cash flows in the currency of denomination of the cash flows.

De-minimis and non-genuine features

De minimis features

Q25: How should an entity apply the *de minimis* criterion when conducting the SPPI test?

Analysis

The standard does not prescribe whether a qualitative or quantitative analysis should be performed to determine whether a feature is *de minimis* or not. While not defined in IFRS 9, *de minimis* is generally known to mean 'too trivial or too minor to merit consideration'.

Implicit in this definition is that if the entity has to consider whether an impact is *de minimis*, whether quantitatively or qualitatively, it is almost certainly not.

To be considered *de minimis*, the impact of the feature on the cash flows of the financial asset needs to be *de minimis* in each reporting period and cumulatively over the life of the financial asset.

Non-genuine features

Q26: How should an entity apply the non-genuine criterion when conducting the SPPI test?

Analysis

Non-genuine features, as used in this context, are contingent features. A cash flow characteristic is not genuine if it will affect the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur. This means, although the feature can potentially lead to cash flows which are not solely payments of principal and interest, and those cash flows may even be significant, the instrument would still qualify for amortised cost or FVOCI measurement, depending on the business model.

In our view, terms are included in a contract for an economic purpose and therefore are, in general, genuine. The threshold 'non-genuine' is possibly intended to deal with clauses inserted into the terms of financial instruments for legal or tax reasons, or to achieve an accounting outcome, but having no real economic purpose or consequence.

An example of a clause that has caused some debate in the context of IAS 32.AG28 which uses the term 'non-genuine' is a 'regulatory change' clause, generally found in the terms of capital instruments issued by financial institutions such as banks and insurance companies. Such entities are generally required by local regulators to maintain certain minimum levels of equity or highly subordinated debt (generally referred to as regulatory capital) in order to be allowed to do business.

A 'regulatory change' clause will typically require an instrument which, at the date of issue, is classified as regulatory capital to be repaid in the event that it ceases to be so classified. The practice so far of the regulators in many jurisdictions has been to make changes to a regulatory classification with prospective effect only, such that any instruments already in issue continue to be regarded as regulatory capital even though they would not be under the new rules. This has led some to question whether a 'regulatory change' clause can be regarded as a contingent settlement provision which is 'not genuine'. This is ultimately a matter of judgement for the entities in the context of the relevant regulatory environment(s). This judgement has not been made easier by the greater unpredictability of the markets (and, therefore, of regulators' responses to this) in the recent financial crisis. As the clause was inserted to provide regulators with flexibility in their actions, even if they do not normally exercise that flexibility, it would be difficult to argue that it is 'non-genuine'.

Modified time value of money element

Instrument with interest rate tenor mismatches

Q27: An entity invests in 15-year floating rate government bonds and the coupons are reset every six months by referencing to the 10-year rate. Would the instrument qualify for amortised cost measurement?

Analysis

The interest rate tenor mismatch feature modifies the time value of money element of the instrument. If such a modification is present in the contractual terms, the entity compares the undiscounted contractual cash flows of the instrument to the undiscounted cash flows that would arise if the time value of money element were not modified (benchmark cash flows), i.e., if the interest rate were reset to a six month floating rate every six month. If the modified time value of money element results in cash flows that are significantly different from the benchmark cash flows, the instrument does not meet the SPPI test.

In doing the assessment, an entity must consider interest rate scenarios that are reasonably possible. It cannot conclude that the contractual cash flows are SPPI simply because the interest rate curve at the time of the assessment is such that the difference between the six-month and 10-year rates does not lead to significantly different cash flows.

In some circumstances, the entity may be able to make that determination by performing a qualitative assessment of the time value of money element whereas, in other circumstances, it may be necessary to perform a quantitative assessment (refer to section 4.3.2 above).

To make this assessment, the entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument.

If the entity considers future developments, it will be unlikely that it can conclude that the contractual cash flows could not be significantly different from the benchmark cash flows, considering the magnitude of the mismatch between the interest rate tenors of the instrument specified in the question.

Therefore, the instrument specified in the question is not likely to meet the SPPI test.

Auction Rate Securities

Q28: Would the contractual cash flows of an instrument whose interest rate is set during an auction be eligible for measurement at amortised cost or FVOCI?

Analysis

Auction rate securities (ARSs) have long-term maturity dates but their interest rate resets more frequently based on the outcome of an auction. As a result of the auction process, the interest rates are short term and the instruments are treated like short-term investments.

In the event that an auction fails (i.e., there are insufficient buyers of the bond to establish a new rate), the rate resets to a penalty rate. The penalty rate is established at inception and does not necessarily reflect the market rate when the auction fails. It is often intended to compensate the holder for the instrument's lack of liquidity as demonstrated by the auction failure. The auction process for many such securities failed during the financial crisis.

The classification at initial recognition should be based on the contractual terms over the life of the instrument. Although the presumption on acquisition may have been that the auctions were not expected to fail, the potential penalty rate should still be taken into account in the assessment of the instrument's characteristics at initial recognition. If the penalty rate could be considered to compensate the holder for the longer-term credit risk of the instrument following the auction failure as a result of a reduction in market liquidity, it may be possible that the penalty rate reflects interest. However, as such instruments usually have multiple issues with different penalty rates, each case would need to be individually evaluated before a conclusion could be reached.

Interest rate period selected at the discretion of the borrower

Q29: Can an instrument meet the SPPI test when its interest rate tenor is set at the discretion of the borrower?⁴⁹

Additional information

An entity holds an instrument that is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.

Analysis

The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for basic lending risks and costs as well as a profit margin. Basic lending risks and costs involve consideration for the time

⁴⁹ Q&A based on IFRS 9.B4.1.13 Instrument B.

value of money, the credit risk associated with the instrument and other basic lending risks and costs. The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument.

However, if the borrower is able to choose to pay a one-month interest rate that is reset every three months, the interest rate is reset with a frequency that does not match the tenor of the interest rate. Therefore, the time value of money element is modified.

Similarly, if the instrument has a contractual interest rate that is based on a term that exceeds the instrument's remaining life (e.g., if an instrument with a five-year maturity pays a variable rate that is reset periodically but always reflects a five year maturity), the time value of money element is modified. That is because the interest payable in each period is disconnected from the interest period.

In such cases, the entity must qualitatively or quantitatively assess the contractual cash flows against the cash flows of a benchmark instrument to determine whether the mismatch between the two sets of cash flows could be significantly different. The benchmark instrument is identical in all respects except that the tenor of the interest rate matches the interest period. If the analysis results in the conclusion that the two sets of cash flows could be significantly different, payments would not represent principal and interest on the principal amount outstanding (see also Q25).

For example, in assessing a bond with a five-year term that pays a variable rate that is reset semi-annually, but always reflects a five-year maturity, an entity compares the contractual cash flows of the bond to the contractual cash flows on an instrument that is identical except that the interest rate resets semi-annually to a semi-annual rate.

The same analysis would apply if the borrower is able to choose between the lender's various published interest rates (e.g., the borrower can choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate).

Modified timing and amount of contractual cash flows

Prepayment features

Q30: Do prepayment features in debt instruments acquired at a premium or discount result in failure of the SPPI test?

Analysis

The strict application of the description of 'principal' (see section 4.1 above) would mean that debt instruments originated or acquired at a premium or discount and which are prepayable at par have to be measured at FVTPL. This is because, if the issuer prepays, the holder may receive a gain that is less than or in excess of a basic lending return. The IASB, however, decided to provide a narrow scope exception for such financial assets, but only if:

- The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) interest, which may include reasonable additional compensation for the early termination of the contract
- The fair value of the prepayment feature on initial recognition of the financial asset is insignificant

The above conditions apply regardless of whether: (i) the prepayment provision was exercisable by the issuer or the holder; (ii) the prepayment provision is voluntary or mandatory; or (iii) the prepayment feature is contingent.

This exception would allow some financial assets that otherwise do not have contractual cash flows that are solely payments of principal and interest to be measured at amortised cost or FVOCI (subject to the assessment of the business model in which they are held).

The IASB observed that this exception will apply to many purchased credit-impaired financial assets with contractual prepayment features. If such an asset were purchased at a deep discount, the contractual cash flows would not be solely payments of principal and interest if, contractually, the asset could be repaid immediately at the par amount. However that contractual prepayment feature would have an insignificant fair value if it is very unlikely that prepayment will occur. Prepayment might be very unlikely because the debtor of a credit-impaired financial asset might not have the ability to prepay the financial asset.⁵⁰

Similarly, the IASB observed that this exception will apply to some prepayable financial assets that are originated at below-market interest rates. This scenario could arise when an entity sells an item (e.g., a car) and, as a marketing incentive, provides financing to the customer at an interest rate that is below the prevailing market rate. At initial recognition, the entity would measure the financial asset at fair value and, as a result of the below-market interest rate, the fair value would be at a discount to the contractual par amount. The IASB observed that such a contractual prepayment feature likely would have an insignificant fair value because it is unlikely that the customer will choose to prepay, in particular, because the interest rate is below-market and thus the financing is advantageous.⁵¹

For an instrument which is prepayable at fair value see Q37.

Debt covenants

Q31: Do debt covenants result in cash flows that are solely payments of principal and interest on the principal amount outstanding?

Additional information

A loan agreement contains a covenant whereby the contractual spread above the benchmark rate will increase if the borrower's earnings before interest, tax, depreciation and amortisation (EBITDA) or its debt-to-equity ratio deteriorate by a specified amount on a specified date.

Analysis

Whether this instrument passes the SPPI test depends on the specific terms.

The loan would pass the SPPI test if the covenant serves to compensate the lender for taking on a higher credit or liquidity risks.

However, if the covenant results in more than just credit or liquidity protection, or provides for an increase in the rate of return which is not considered appropriate under a basic lending arrangement, the instrument will fail the test. For example, if the rate increases to reflect an increase in EBITDA, this would not satisfy the SPPI criteria.

⁵⁰ See paragraph IFRS 9.BC4.194.

⁵¹ See paragraph IFRS 9.BC4.195.

Non-SPPI Features

Convertible debt

Q32: Does an instrument with an equity conversion feature fail the SPPI test?⁵²

Additional information

An entity holds a bond that is convertible into equity instruments of the issuer.

Analysis

The holder would analyse a convertible bond in its entirety, since IFRS 9 does not separate embedded derivatives from financial assets.

The contractual cash flows are not payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement, i.e., the return is also linked to the value of the equity of the issuer.

The assessment would change if the issuer were to use its own shares as 'currency'. That is, if the bond is convertible into a variable number of shares with a value equal to unpaid amounts of principal and interest on the principal amount outstanding. In this case, the bond would satisfy the SPPI criteria and would be derecognised on conversion. However, such conversion features are often capped because, otherwise, the issuer could be required to deliver a potentially unlimited amount of shares. The existence of such a cap, if genuine, would result in the failure of the SPPI test.

Bail-in procedures imposed by regulator

Q33: Does the ability of a regulator to impose losses (referred to as 'write-down') on the holder of a bond, or conversion into shares, result in non-SPPI cash flows?⁵³

Fact pattern 1: the provision is not a contractual feature

A regulated bank issues an instrument with a stated maturity date. The instrument pays a fixed interest rate and all contractual cash flows are non-discretionary.

However, the issuer is subject to legislation that permits or requires a national resolution authority to impose losses on holders of particular instruments, including the above-mentioned instrument, in certain circumstances. For example, the national resolution authority has the power to write down the par amount of such an instrument or to convert it into a fixed number of the issuer's ordinary shares if the national resolution authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is failing.

Analysis 1

The holder would analyse the contractual terms of the financial instrument to determine whether they give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and thus are consistent with a basic lending arrangement.

⁵² Q&A based on IFRS 9.B4.1.14 Instrument F.

⁵³ Q&A based on IFRS 9.B4.1.13 Instrument E.

According to the standard, this analysis would not consider a write-down that arises only as a result of the national resolving authority's power under statutory law to impose losses on the holders of such an instrument. That is because that power is not a contractual term of the financial instrument.

Although this example makes use of a principle that is widely applied, we note that it is not consistent with the position taken in IFRIC 2, which requires an entity to include "relevant local laws, regulations and the entity's governing charter in effect at the date of classification" when classifying a financial instrument as a liability or equity.

Fact pattern 2: The provision is a contractual feature

The contractual terms of the financial instrument permit or require the issuer or another entity to impose losses on the holder (e.g., by writing down the par amount or by converting the instrument into a fixed number of the issuer's ordinary shares), if the issuer fails to meet particular regulatory capital requirements (a non-viability event).

Analysis 2

Provided the 'non-viability' provision is genuine, which will normally be the case, the instrument will fail the SPPI test even if the probability is remote that such a loss will be imposed.

Interest rates that are quoted as a multiple of a benchmark interest rate

Q34: Would debt instruments for which the interest rate is quoted as a multiple of a benchmark interest rate (e.g., 2 times 3-month EURIBOR for a 3-month term) be considered to have contractual cash flows that are solely payments of principal and interest?

Analysis

Such features introduce leverage and paragraph B4.1.9 of IFRS 9 is explicit that leverage increases the variability of the contractual cash flows, resulting in them not having the economic characteristics of interest. As a result, such instruments would need to be measured at FVTPL.

Inverse floater

Q35: Would an instrument with an inverse floating interest rate (e.g., 6% minus 2xLIBOR) satisfy the SPPI criteria?⁵⁴

Analysis

The contractual cash flows of a loan that pays an inverse floating interest rate (i.e., the interest rate has an inverse relationship to market interest rates) are not solely payments of principal and interest on the principal amount outstanding.

The interest amounts are not consideration for the time value of money on the principal amount outstanding.

⁵⁴ Q&A based on IFRS 9.B4.1.14 Instrument G.

Q36: Does a perpetual instrument with potentially deferrable coupons meet the SPPI test?⁵⁵

Additional information

An entity holds an instrument that is a perpetual instrument, but the issuer may call the instrument at any time, paying the holder the par amount plus accrued interest due.

The instrument pays interest, but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. There are two scenarios.

- Scenario 1: deferred interest does not accrue additional interest
- Scenario 2: interest is accrued on the deferred amounts

Analysis 1

The contractual cash flows are not payments of principal and interest on the principal amount outstanding. This is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.

Note that, in this example, the holder is not entitled to assess whether it is probable that interest may ever be deferred. As long as the feature is genuine, the deferral of interest must be taken into account in assessing whether interest amounts are consideration for the time value of money on the principal outstanding.

Analysis 2

The contractual cash flows could be payments of principal and interest on the principal amount outstanding.

The example in the standard states that the fact that the instrument is perpetual does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.

Some may find it strange that the instrument is deemed to satisfy the SPPI test even though the principal will never actually be paid. Also, the fact that the instrument is callable does not mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding, unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal amount outstanding. Even if the callable amount includes an amount that reasonably compensates the holder for the early termination of the instrument, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.

⁵⁵ Q&A based on IFRS 9.B4.1.14 Instrument H.

Fixed rate bond prepayable by the issuer at fair value

Q37: Would a plain vanilla bond that is prepayable at fair value (i.e., the issuer has a call option that is exercisable at fair value) give rise to contractual cash flows that are solely payments of principal and interest?

Additional information

A company acquires a bond which requires the issuer to pay a fixed rate of interest and repay the principal on a fixed date. However, the issuer has the right to prepay (or call) the bond before maturity, although the amount the issuer must pay is the fair value of the bond at the time of prepayment, i.e., the fair value of the contractual interest and principal payments that remain outstanding at the point of exercise. For example, if the bond has a term of five years and the call option was exercised at the end of the second year, the fair value would be calculated by discounting the principal and interest payments due over the remaining three years at the current market interest rate for a three-year bond with similar characteristics.

The exercise price represents the fair value of unpaid amounts of principal and interest on the principal amount outstanding at the date of exercise, albeit discounted at the current market interest rate rather than the original market interest rate.

Analysis

The fact that the exercise price is the fair value could be interpreted as providing reasonable additional compensation to the holder for early termination. Some argue that this holds true only where the market rate has fallen since the issue of the bond. If interest rates rise, the holder will not receive additional compensation for early termination and will receive less than the principal amount. In these circumstances, due to the negative compensation, the bond holder would not receive principal and interest.

In cases where the prepayment amount is set so that there is a 'floor' equal to the par amount plus accrued interest, i.e., the prepayment amount received by the holder cannot be less than the par amount of the bond, the prepayment amount would probably be regarded as representing unpaid amounts of principal and interest.

Investments in open-ended money market or debt funds

Q38: Would an entity that invests in units issued by an open-ended money market or debt fund be able to measure such investments at amortised cost or FVOCI?

Additional information

In an open-ended fund, new investors are accepted by the fund after inception and existing investors have the option of leaving the fund at any time. The price at which new entrants invest in the fund or leavers exit the fund is normally based on the fair value of the fund's assets.

Analysis

Given that investors enter and exit the fund based on fair value, the cash flows of an investment in such a fund are not likely to be solely payments of principal and interest.

In addition, such investments would not normally qualify for the FVOCI option for equity instruments as they do not normally meet the definition of an equity instrument from the perspective of the fund (i.e., the issuer). See Q48-Q50 regarding equity investments that can or cannot be classified at fair value through OCI.

Subordination features, non-recourse and full-recourse loans

Conventional subordination features

Q39: Would a conventional subordination feature preclude a financial asset from passing the SPPI test?

Analysis

In almost every lending transaction, the creditor's instrument is ranked relative to the debtor's other creditors' instruments. An instrument that is subordinated to other instruments may be considered to have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment arises only on a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy.

For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are collateralised which, in the event of bankruptcy, would give that loan holder priority over the claims of the general creditor in respect of the collateral, but does not affect the contractual right of the general creditor to unpaid principal and other amounts due.

Non-recourse loans

Q40: Would project finance loans pass the SPPI test?

Analysis

The lender should apply the non-recourse provisions of IFRS 9 and 'look-through' to the underlying assets or cash flows.

Where a loan is given for the construction and maintenance of a toll road and the payments of cash flows to the lender are reduced or cancelled if less than a certain number of vehicles travel on that road, the loan will not pass the SPPI test.

Similarly, a loan with cash flows specifically referenced to the performance of an underlying business will not pass the test.

In other cases, in which there is no such reference and there is adequate equity in the project to absorb losses before affecting the ability to meet payments on the loan, it may well pass the SPPI test.

Q41: Would a loan to an SPE that funds the acquisition of other assets pass the SPPI test?

Analysis

Where a loan is provided to an SPE that funds the acquisition of other assets, whether that loan passes the SPPI test will depend on the specific circumstances of the arrangement.

For example, if the SPE uses the loan from the entity to fund investments in assets which will not themselves pass the SPPI test, such as equity securities or non-financial assets, and the loan is the only source of finance to the SPE so that it absorbs any losses from the equity securities, it would probably not pass the cash flow characteristics test.

Whether the loan is legally non-recourse or full-recourse does not matter in this scenario because the SPE has limited other assets. If the loan was legally full-recourse and if the SPE would have sufficient equity to cover losses on its investments, the loan may pass the SPPI test.

In addition, if the assets were all debt instruments which would themselves pass the cash flow characteristics test, the loan to the SPE might well pass it too.

If the SPE was consolidated by the lender, the question becomes less relevant, since the loan to the SPE would be eliminated in the lender's consolidated financial statements.

Contractually linked instruments

The effect of credit enhancement on the contractually linked instruments test

Q42: What would be the effect on the look-through test for contractually linked instruments if the SPE benefits from credit enhancement through the purchase of a credit default swap?

Analysis

Purchased credit default swaps (CDSs) would generally be viewed as reducing the risk of the underlying pool of financial instruments, provided that, in combination with the underlying instruments, the cash flows are solely payments of principal and interest. This would require that the derivative pays out only to compensate for loss of principal and interest and not, for instance, the instruments' fair value.

This may be difficult to achieve, as most CDS will repay the par amount, which will not equal the principal if the assets are acquired at a discount or a premium.

Also, in practice, many SPE structures contain written rather than purchased CDSs, which will not be viewed as reducing the credit risk of the underlying pool. Also see the response to Q43.

Investments in collateralised debt obligations (CDOs)

Q43: How would investments in CDOs be accounted for under IFRS 9?

Analysis

It is necessary to distinguish between cash CDOs (in which the SPE holds the underlying reference assets) and synthetic CDOs (in which the reference exposure is achieved through a derivative). Investments in cash CDOs may qualify for amortised cost or FVOCI measurement, as long as the underlying assets also qualify for amortised cost or FVOCI accounting and the other requirements of IFRS 9 are met. But an investment in a synthetic CDO would not qualify, as the derivatives on the reference portfolio would not reduce the variability of the cash flows of the assets in the pool or align the cash flows in the manner permitted by IFRS 9 (see the response to Q42).

A practical point to note is that it may be difficult for the holder to perform the look-through test if all the underlying reference assets of the CDO have not been acquired at the time of the investment in the CDO. As a result, the holder may not be able to assess whether all the underlying reference assets of the CDO would qualify for measurement at amortised cost or FVOCI. In such circumstances, we believe that the holder will need to consider amongst other things, the objectives of the CDO as well as the investment mandate of the CDO's manager before determining whether the investment qualifies for measurement at amortised cost or FVOCI.

Seizure of a CDO's collateral and its effect on a tranche's classification

Q44: How would the seizure of collateral (in the circumstances described below) affect the classification of an investment in a tranche of a CDO that would otherwise be eligible for measurement at amortised cost or FVOCI?

Analysis

The underlying pool of instruments of a CDO may contain only assets eligible for measurement at amortised cost or FVOCI, but could then change to include property or equity securities if collateral is seized following default by the underlying borrower of an asset in the CDO. The seizure of the collateral may result in derecognition of the original secured asset and recognition of the property/equity security as a new asset by the issuer of the CDO. The property/equity security may then be sold at the discretion of the CDO's investment manager.

Note that paragraph B4.1.26 of IFRS 9 explicitly states that if the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the contractually linked instruments test, then the tranche shall be measured at FVTPL.

However, if the underlying pool includes instruments that are collateralised by assets that do not meet the conditions above, the ability to take possession of such assets should be disregarded for the purposes of performing the SPPI test in the context of a contractually linked instrument, unless the entity acquired the tranche with the intention of controlling the collateral.

Single tranche CDO

Q45: Would an investment in a single tranche CDO qualify for amortised cost or FVOCI?

Analysis

The contractually linked instrument test refers to 'multiple contractually linked instruments that create concentrations of credit risk (tranches)'.⁵⁶ Also, the Basis for Conclusions refers to classic waterfall structures with different tranches, rather than a single tranche structure.⁵⁷ Hence, an investment in a single tranche securitisation would not be assessed under this test.

⁵⁶ See paragraph IFRS 9.B4.1.20.

⁵⁷ See paragraphs IFRS 9.BC4.26.

However, the non-recourse provisions of IFRS 9 probably apply in such cases, and it will be necessary to look through to the underlying assets to determine whether the cash flows on the tranche relate only to payments of principal and interest that represent compensation only for the time value of money and credit risk.

Determining the exposure to credit risk in the tranche held

Q46: How should entities determine whether or not the 'exposure to credit risk' in the tranche is less than that of the underlying pool of financial instruments?

Analysis

IFRS 9 does not prescribe a method for comparing the exposure to credit risk in the tranche held by the entity to that of the underlying pool of financial instruments. In some cases, it may be possible to compare the credit rating allocated to the tranche with that for the underlying pool of financial instruments, if they are all rated. Also, for the more senior and junior tranches, it may be obvious, with relatively little analysis, whether the tranche is less risky or more risky than the underlying assets.

However, in other circumstances involving complex securitisation structures, a detailed assessment may be required. An example is given below. The analysis would involve developing various credit loss scenarios for the underlying pool of financial instruments, computing the probability-weighted outcomes of those scenarios, determining the probability-weighted effect on the tranche held, and comparing the variability of the tranche held with that of the underlying assets.

Example A-2 – Assessment of exposure to credit risk

Bank A is the sponsor of a securitisation vehicle (the SPE) and holds the junior notes issued by the SPE. The SPE's assets consist of a portfolio of residential mortgages that were originated and transferred to the SPE by Bank A. The SPE does not hold any derivatives. A number of other banks invest in the mezzanine, senior and super senior tranches of notes issued by the SPE. None of the banks has any further involvement with the SPE and all banks have assessed that the SPE should not be consolidated in their respective financial statements. The total notional amount of mortgage assets and notes issued is CU 1,000.*

The following table shows a range of expected credit losses for the portfolio of mortgages as at inception and the estimated probability that those scenarios will occur:

	Loss CU	Estimated probability of loss %	Estimated weighted average loss CU
Scenario I	40	10	4
Scenario II	70	25	18
Scenario III	110	30	33
Scenario IV	180	25	45
Scenario V	230	10	23
Weighted average loss expectancy			123

* The example does not address the question of non-consolidation of the SPE and should not be referred to for the purpose of a control assessment in similar fact patterns.

Example A-2 – Assessment of exposure to credit risk *continued*

The probability weighted expected losses of the underlying assets represent therefore 12.3%. The following table illustrates how an entity may compare the credit risk of the tranche with that of the underlying pool of financial instruments:

Tranche		Super senior	Senior one	Senior two	Mezzanine	Junior	Total
Notional amount in CU (A)		630	150	100	40	80	1,000
	Probability	Probability-weighted expected losses of the tranches**					
Scenario I	10%	–	–	–	–	4	4
Scenario II	25%	–	–	–	–	18	18
Scenario III	30%	–	–	–	9	24	33
Scenario IV	25%	–	–	15	10	20	45
Scenario V	10%	–	1	10	4	8	23
Expected loss by tranche (B)		–	1	25	23	74	123
Expected loss in % by tranche (B)/(A)		0.0	0.01	25.0	57.5	92.5	12.3
Credit risk of tranche is less than the credit risk of the underlying assets?		Yes	Yes	No	No	No	
Tranche passes the SPPI test		Yes	Yes	No	No	No	

** For each scenario, expected losses are first allocated to the junior tranches and progressively to the more senior tranches until all expected losses are absorbed. For example, in Scenario IV, the loss of CU180 would be absorbed by the Junior tranche (CU80), mezzanine tranche (CU40) and senior two tranche (CU60). The probability weight of 25% for Scenario IV is then applied to the expected losses allocated to each tranche.

The junior notes have an expected loss which is, in percentage terms, greater than the overall expected loss on the underlying portfolio. Therefore, these notes must be accounted for at FVTPL. Similarly, the mezzanine notes and senior two notes have a greater expected loss than the underlying pool and would not pass the SPPI test.

The expected losses on the senior notes and the super senior notes are lower than the overall expected loss on the underlying pool of instruments and may qualify for amortised cost or FVOCI treatment, provided all other IFRS 9 requirements are met and the instruments are not held for trading.

In this example, it might have been possible to come to the same conclusion without a numerical calculation for the junior and super senior tranches, but the technique is helpful to determine the treatment of the intermediary notes. In practice, it may also be necessary to apply judgement through a qualitative assessment of specific facts and circumstances.

FVTPL and FVOCI Options

Designation of a financial asset as at FVTPL

Fail value option to a portion of an instrument

Q47: Can the fair value option be applied to a portion of a financial asset or a financial liability, e.g., changes in the fair value of a debt instrument attributable to one risk, such as changes in a benchmark interest rate, but not credit risk?

Analysis

The fair value option may not be applied to a portion or component of a financial asset or a financial liability, e.g., changes in the fair value of a debt instrument attributable to one risk such as changes in a benchmark interest rate, but not credit risk because the standard explicitly says 'a financial asset' and 'a financial liability'.⁵⁸ Further, it may not be applied to proportions of an instrument.

However, if an entity simultaneously issues two or more identical financial instruments, it is not precluded from designating only some of those instruments as being subject to the fair value option (e.g., if doing so achieves a significant reduction in an accounting mismatch). Therefore, if an entity issued a bond totalling US\$100 million in the form of 100 certificates of US\$1 million each, the entity could designate ten specified certificates if to do so would meet the criteria set out in section 6.

Designation of non-derivative equity instruments as at FVOCI

Classification of puttable instruments

Q48: Are puttable instruments that are classified as equity instruments by the issuer under the IAS 32 exception eligible for classification as at fair value through OCI by the holder?

Analysis

Certain puttable instruments are classified as equity instruments by the issuer in accordance with IAS 32. This is by virtue of an exception to the general definitions of financial liabilities and equity instruments. However, such instruments do not actually meet the definition of an equity instrument under IAS 32.⁵⁹ Therefore, they are not eligible for classification in the FVOCI category by the holder.

Appendix A of IFRS 9 refers to the definition of 'equity instrument' in IAS 32. That definition excludes puttable instruments, since they meet the definition of financial liabilities. Whilst the amendments to IAS 32 regarding puttable instruments permit, as an exception to the normal rules, certain puttable instruments to be classified as equity by the issuer, they do not change the definition of equity.

⁵⁸ See paragraphs IFRS 9.4.1.5 and 4.2.2.

⁵⁹ See paragraph IFRS 9.BC5.21.

Callable, perpetual 'Tier 1' debt instrument

Q49: Can a callable perpetual 'Tier 1' debt instrument be designated at fair value through OCI (for equity instruments) by the holder?

Analysis

Such an instrument may be designated as FVOCI (for equity instruments) if it meets the definition of 'equity instrument' from the perspective of the issuer.

Consider the example where entity A invests in a perpetual Tier 1 debt instrument, which is redeemable at the option of the issuer (entity B). The instrument carries a fixed coupon that is deferred if entity B does not pay a dividend to its ordinary shareholders. If a coupon is not paid it will not accrue additional interest.

The instrument does not have a maturity date. However, the coupon steps up to a higher rate of interest 20 years after issue and entity B has the right to purchase the instrument after that date for its nominal amount and any unpaid interest. Under IFRS 9, such an instrument would not pass the SPPI test. But given that Entity B does not have a contractual obligation to pay cash, the instrument will, unless it is held for trading, qualify for designation as FVOCI (for equity instruments), as it meets the definition of equity from the perspective of the issuer in accordance with IAS 32.

Equity derivatives

Q50: Are equity derivatives (such as warrants or options) that meet the definition of equity from the issuer's perspective eligible to be measured at fair value through OCI by the holder?

Analysis

Equity instruments that are held for trading are not eligible to be designated as FVOCI under IFRS 9. 'Held for trading' is defined in Appendix A of IFRS 9 and that definition is identical to the definition in IAS 39.

Since all derivatives are required to be treated as held for trading, equity derivatives should be considered as trading instruments and thus are not eligible to be designated as FVOCI under IFRS 9.

IFRS 7 disclosures for equity instruments designated as at FVOCI

Q51: The consequential amendment to IFRS 7 requires disclosure of the fair value at the reporting date of each investment in equity instruments designated as FVOCI. Do entities really need to disclose this for each individual instrument?

Analysis

The standard is specific that this is required for each such investment, if material. Paragraph 11A of IFRS 7 states that if an entity designates investments in equity instruments to be measured at fair value through OCI, it shall identify those investments and disclose, among other information, the fair value for each such investment at the end of the reporting period.

The disclosure requirement may be onerous if an entity makes significant use of the fair value through OCI option and may act as a disincentive for its use, so entities will need to be careful when making the choices available within the standard. A further question is whether it is necessary to provide disclosures at

length if each individual instrument is immaterial. We believe that the concept of materiality will need to be applied, such that the disclosures required are provided separately for investments that are themselves material and aggregated disclosures may suffice for immaterial items.

Designation of a financial liability as at FVTPL

Own credit risk of financial liabilities designated as at FVTPL

Q52: How does an entity measure the element of gains and losses attributable to changes in the entity's own credit risk?

Analysis

Unless an alternative method more faithfully represents the change in fair value of a financial liability that is attributable to credit risk, this amount should be determined as the amount of change in the fair value of the liability that is not attributable to changes in market conditions that give rise to market risk. Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, foreign exchange rate or index of prices or rates. The following extract from IFRS 9 describes one possible method:

Extract from IFRS 9

(IFRS 9.B5.7.18)

If the only significant relevant changes in market conditions for a financial liability are changes in an observed (benchmark) interest rate, the amount to be recognised in other comprehensive income can be estimated, as follows:

- (a) First, the liability's internal rate of return at the start of the period is computed using the fair value and contractual cash flows at that time and from this is deducted the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return
- (b) Next, the present value of the cash flows associated with the liability is calculated using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of the observed (benchmark) interest rate at the end of the period and the instrument-specific component of the internal rate of return at the start of the period as determined in (a)
- (c) The difference between the fair value of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate and this is the amount to be presented in OCI

This method assumes that changes in fair value other than those arising from changes in the instrument's credit risk or from changes in observed (benchmark) interest rates are not significant. It would not be appropriate to use this method if changes in fair value arising from other factors are significant. In such cases, an alternative method should be used that more faithfully measures the effects of changes in the liability's credit risk. For example, if the instrument in the above example contained an embedded derivative, the change in fair value of the embedded derivative should be excluded when determining the amount to be presented in other comprehensive income.

The above method will produce an amount which includes any changes in the liquidity spread charged by market participants, since such changes are not considered to be 'attributable to changes in market conditions that give rise to market risk'.⁶⁰ This solution is applied in practice as the effect of a liquidity spread cannot normally be isolated from that of the credit spread.

As with all estimates of fair value, the measurement method used for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk should make maximum use of market inputs. This method is illustrated in the following example:

Example A-3 – Estimating the change in fair value of an instrument attributable to its credit risk⁶¹

On 1 January 2014, Company J issues a 10-year bond with a par value of CU150,000 and an annual fixed coupon rate of 8%, which is consistent with market rates for bonds with similar characteristics. J uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5%. At the end of the first year:

- LIBOR has decreased to 4.75%
- The fair value of the bond is CU153,811, which is consistent with an interest rate of 7.6% (i.e., the remaining cash flows on the bond, CU12,000 per year for nine years and CU150,000 at the end of nine years, discounted at 7.6% equals CU153,811)

To keep the example simple, J assumes a flat yield curve, that all changes in interest rates result from a parallel shift in the yield curve, and that the changes in LIBOR are the only relevant changes in market conditions. The amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk is estimated as follows:

Step (a): The bond's internal rate of return at the start of the period is 8%. Because the observed (benchmark) interest rate (LIBOR) is 5%, the instrument-specific component of the internal rate of return is 3%.

Step (b): The contractual cash flows of the instrument at the end of the period are:

- Interest: CU12,000 [CU150,000 × 8%] per year for each of years 2015 to 2023
- Principal: CU150,000 in 2023

The discount rate to be used to calculate the present value of the bond is thus 7.75%, which is the 4.75% end of period LIBOR rate, plus the 3% instrument-specific component calculated as at the start of the period. This gives a notional present value of CU152,367 [CU12,000 × (1 - 1.0775⁹) / 0.0775] + CU150,000 × 1.0775⁹, on the assumption that there has been no change in the instrument-specific component.

Step (c): The market price of the liability at the end of the period (which will reflect the real instrument-specific component at the end of the period within the 7.6% yield) is CU153,811, therefore J should disclose CU1,444 [CU153,811 - CU152,367] as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.

⁶⁰ See paragraph IFRS 9.B5.7.16(a).

⁶¹ Example based on paragraphs IFRS 9 IE1-IE5.

Reclassification of financial assets

Change in the way a portfolio is managed

Q53: An entity's objective for a portfolio meets the business model criteria to be recorded at amortised cost but, subsequently, the entity changes the way it manages the assets. How should the entity measure: (i) the existing assets; and (ii) any newly acquired assets?

Additional information

The objective of the business model for a portfolio originally was hold to collect contractual cash flows. If the entity subsequently changes the way it manages the assets (e.g., that results in a more than an infrequent number of sales), so that the business model would no longer qualify for amortised cost accounting, the question of how the entity should measure the existing assets and any newly acquired assets then arises.

Analysis

Although more than an infrequent number of sales have occurred, unless there has been a fundamental change in the entity's business model, the requirements of the standard regarding reclassification are unlikely to be triggered. Changes in the business model for managing financial assets that trigger reclassification of financial assets must be significant to the entity's operations and demonstrable to external parties. They are expected to be very infrequent.

Assuming that the assets are not reclassified, it is likely that the entity will have to divide the portfolio into two sub-portfolios going forward – one for the old assets and one for any new assets acquired.

Financial assets previously recognised will remain at amortised cost. New financial assets acquired will be measured at FVTPL or at FVOCI. Whether the assets are measured at FVTPL or FVOCI depends on the new business model and the characteristics of the assets.

The date for recording reclassifications

Q54: An entity changes its business model during the year, and is required to reclassify all affected financial assets. When is the reclassification recorded?

Analysis

A change in the entity's business model must be accounted for prospectively from the reclassification date, which is defined in the standard as 'the first day of the first reporting period following the change in business model'.

For example, an entity with a reporting year-end of 31 December might determine that there is a change in its business model in August.

If the entity prepares and publishes quarterly reports under IFRS, it should apply the old classification up to 30 September and, as of 1 October, reclassify all affected financial assets and apply the new classification prospectively from that date. However, if the entity only prepares annual accounts, the entity is required to reclassify all affected financial assets and apply the new classification as of 1 January of the following year.

Changes in a financial asset's characteristics

Q55: Is reclassification permitted or required when the characteristics of a financial asset change, e.g., when the conversion option of a convertible bond lapses? Does the answer differ if the convertible bond is converted into shares of the issuer?

Analysis

Reclassifications are neither permitted nor required when the characteristics of a financial asset vary over the asset's life based on its original contractual terms. Unlike a change in the business model, the contractual terms of a financial asset are known at initial recognition and an entity classifies the financial asset at initial recognition based on the contractual terms over the life of the instrument.⁶²

Thus, no reclassification is permitted or required when, for instance, the conversion option of a convertible bond lapses. If, however, a convertible bond is converted into shares, the shares represent a new financial asset to be recognised by the entity. The entity would then need to determine the classification category for the new equity investment.

Effective date and transition

The standard's date of initial application

Q56: What is the date of initial application of IFRS 9?

Analysis

If IFRS 9 is adopted in 2016 or 2017, the date of initial application will be the first day of the reporting period in which it is adopted. For an entity that publishes quarterly financial statements that comply with IAS 34, we consider reporting period to include interim periods and not only annual reporting periods. Hence, such an entity could designate the start of any quarterly period as its date of initial application.

However, for entities that do not adopt IFRS 9 early, the date of initial application will be the start of the annual period beginning on or after 1 January 2018.

Impact of early adopting and not restating comparatives on the annual financial statements

Q57: An entity with a financial year ending on 31 December decides to adopt IFRS 9 with a date of initial application of 1 October 2017. If the entity elects not to restate comparative information, what is the effect on its 2017 financial statements?

Analysis

The business model assessment will need to be made for financial assets recorded on the entity's balance sheet as at the date of initial application (i.e., 1 October 2017), based on facts and circumstances existing as at that date. After the assessment is made at the date of initial application, the entity is required to apply the classification under IFRS 9 retrospectively. The difference between

⁶² See paragraphs IFRS 9 BC4.117.

the previous carrying amounts and the revised carrying amounts of those assets will be recognised in opening retained earnings, as at the beginning of the annual reporting period (1 January 2017 in this example, assuming the entity is preparing annual financial statements).⁶³

If the entity does not restate comparative figures, the comparative figures for 2016 would remain as previously reported. Consequently, the previous classification categories under IAS 39 (held-to-maturity, available-for-sale, etc.) will need to be presented as the prior year numbers in the 2017 statement of financial position.

Note also that there would be no adjustment to the 2017 results for financial instruments derecognised during the first three quarters of the year. This could be confusing and may require explanation. This complexity can be avoided by applying IFRS 9 at the beginning of the annual reporting period rather than an interim reporting period.

Loans previously reclassified from held for trading under IAS 39

Q58: How does IFRS 9 interact with the Reclassification Amendments of October 2008?

Additional information

At the date of initial application of IFRS 9, a bank holds a portfolio of loans that it intends to sell as soon as possible, but is currently unable to do so due to illiquidity in the market. The bank had taken advantage of the October 2008 amendments to IAS 39 and because it had the intention and ability to hold the assets for the foreseeable future, it had reclassified this portfolio from held for trading to loans and receivables.

Analysis

An entity applying IFRS 9 for the first time should apply the business model assessment at the date of initial application. Given management's intention to sell the assets as soon as possible, the presumption would be that the portfolio should be classified as at FVTPL. It does not matter that the bank may have to hold the portfolio for the foreseeable future due to the market's illiquidity. The standard is clear that the entity's objective should be to hold the assets to collect the contractual cash flows if it is to qualify for amortised cost classification. Such a portfolio would not meet the FVOCI criteria either if the intention is to sell all of the financial assets in the near term.

Loans held within a business intended for disposal

Q59: At the date of transition to IFRS 9, how should an entity assess the business model of a portfolio of loans that is part of a business that a bank has decided to dispose of?

Additional information

An international bank has a variety of businesses (in the sense of IFRS 3 *Business Combinations*), each of which is managed separately. Before the date of initial application of IFRS 9, the bank makes a strategic decision to dispose of its auto finance business, which originates loans. The portfolio of

⁶³ See paragraph IFRS 9.7.2.15.

loans is held under a business model whose objective is to collect contractual cash flows of the loans. The bank intends to dispose of the entire business, including personnel, IT systems and buildings, and not merely a portfolio of loans.

Analysis

There is no right answer in respect of these facts and circumstances. Arguments can be articulated to support either classification of the loans at amortised cost or at FVTPL.

Proponents of amortised cost classification would argue that, at the date of initial application, even though the bank intends to sell the business at some point in the future, the loans are still held within a business model whose objective is to hold them to collect their contractual cash flows. That objective continues regardless of whether the bank intends or is able to sell the business. In addition, some of the loans may be fully collected even before the business is sold.

Therefore, based on facts and circumstances at the date of initial application, the loans are considered to be held within a business model whose objective is to hold them to collect their contractual cash flows.

On the other hand, proponents of FVTPL classification would argue that on the date of initial application, the expectation is that the bank will dispose of the loans rather than hold them to collect their contractual cash flows. Therefore, from the bank's perspective, the loans are no longer held within a business model whose objective is to hold assets to collect their contractual cash flows.

Due to the diversity in views and the fact that this is a prevailing issue as a result of both regulatory and government initiatives to require banks to dispose of non-core business activities or selected businesses, this is an area where further guidance from the IASB or the IFRS Interpretations Committee would be welcome.

Renegotiation of a hybrid instrument prior to transitioning to IFRS 9

Q60: Before transition to IFRS 9, is it possible to re-negotiate a hybrid instrument as two separate instruments in order to enable the host instrument to be measured at amortised cost or FVOCI?

Additional information

Consider the example where an entity extends a loan that includes a profit participation feature. The entity expects to hold that instrument to maturity. The instrument provides not only a return of principal and interest, but also an additional return based on a share of the profit of the entity being financed.

Analysis

IFRS 9 abolishes the separation of embedded derivatives from financial assets required by IAS 39. Under IFRS 9, most instruments with separable embedded derivatives would be required to be classified in its entirety as at FVTPL. However, in some cases, it might be possible to renegotiate the transaction as two separate instruments before transition to IFRS 9 – one instrument being a loan, the host instrument (which could be recorded at amortised cost or FVOCI) and the other being the profit-sharing derivative (to be recorded at FVTPL).

This would only be possible, we believe, if after the renegotiation, the two instruments are, in substance, separate financial instruments. Indicators that this is the case would include:

- i) Each instrument can be closed out or transferred separately from the other, which will be a test of commercial practicality as well as legal possibility.
- ii) There are no clauses that have the effect that the cash flows on one instrument will affect those on the other, except for typical master netting arrangements.

The case for recognising the instrument as two separate instruments would be strengthened if the two new contracts are entered into at prevailing market prices – so that the old hybrid instrument is derecognised under IAS 39 and a profit or loss is recognised when the two new instruments are first recorded at their fair values.

Assessment date for the contractually linked instruments test

Q61: For the purpose of applying the contractually linked instruments test, at what date should the relative risks of the tranche held and the underlying assets be measured?

Analysis

The standard requires the classification to be made when the entity becomes party to the contractual provisions of the instrument.⁶⁴ The look-through assessment should be performed at the date that the entity (i.e., the investor) initially recognised the contractually linked instrument. It is inappropriate to make the risk assessment based on the circumstances existing either at the date that the SPE was first established or the date of initial application of IFRS 9.

The transition guidance in paragraph 7.2.4 of IFRS 9 provides that an entity should assess the business model based on the facts and circumstances that exist at the date of initial application, and that the resulting classification should be applied retrospectively. However, this transition relief is not extended to the SPPI test.

⁶⁴ See paragraph IFRS 9.3.1.1.

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