NEED TO KNOW

IFRS 9 (2014) *Financial Instruments* – Classification and Measurement

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1. INTRODUCTION

IFRS 9 (2014) *Financial Instruments* has been developed by the International Accounting Standards Board (IASB) to replace IAS 39 *Financial Instruments: Recognition and Measurement*. The IASB completed IFRS 9 in July 2014, by publishing a final standard which incorporates the final requirements of all three phases of the financial instruments projects, being:

- Classification and Measurement,
- Impairment, and
- Hedge Accounting.

This *Need to Know* sets out the final requirements in relation to the classification and measurement of financial assets and financial liabilities in IFRS 9 (2014) and compares these requirements to those in IAS 39 and previous versions of IFRS 9.

The classification and measurement phase was largely completed through the issue of requirements for financial assets in November 2009 and for financial liabilities in October 2010. Those requirements are summarised as:

Financial assets

Financial assets are 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 financial assets in order to collect contractual cash flows; and
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding.

Interest is defined as being consideration for the time value of money (a risk free rate) plus an amount relating to the credit risk associated with the outstanding principal amount.

In addition, an irrevocable option was available for investments in equity instruments that are not held for trading, to be measured at fair value with changes being recorded in other comprehensive income.

Financial liabilities

The existing requirements in IAS 39 were brought forward largely unchanged, with those instruments held for trading being measured at fair value through profit or loss and most others at amortised cost. However, for those financial liabilities designated as at fair value through profit or loss, IFRS 9 (2010) introduced a requirement for most changes in fair value related to an entity's own credit risk to be recorded in other comprehensive income and not profit or loss. This change was made to eliminate the counter intuitive effect of a decline in an entity's creditworthiness resulting in gains being recorded in profit or loss for those liabilities.

Further amendments were made to the classification and measurement of financial assets in July 2014.

The key changes in IFRS 9 (2014) compared to previous versions are:

i. Additional application guidance to clarify the requirements for contractual cash flows of a financial asset to give rise to payments that are Solely Payments of Principal and Interest (SPPI) (see Section 4.1.2.)

ii. The introduction of a third business model for debt instruments – fair value through other comprehensive income (FVOCI). (see Section 4.2.2.).

Key differences between IFRS 9 and IAS 39 (see Appendix A1 for further information) are:

i. Elimination of the ‘held to maturity’ (HTM) category

ii. Elimination of the ‘available-for-sale’ (AFS) category

iii. Elimination of the requirement to separately account for (i.e. bifurcate) embedded derivatives in financial assets. However, the concept of embedded derivatives has been retained for financial liabilities and for non-financial assets.

iv. The changes in the fair value of financial liabilities measured at FVTPL, attributable to changes in the entity’s own credit status, are presented in other comprehensive income (OCI) rather than profit or loss

v. Elimination of the limited exemption to measure unquoted equity investments at cost rather than at fair value, in the rare circumstances in which the range of reasonable fair value measurements is significant and the probabilities of the various estimates cannot reasonably be assessed.

The effective date of the fully completed version of IFRS 9 is for annual reporting periods beginning on or after 1 January 2018 with retrospective application. Early adoption is permitted. Entities that report in accordance with EU-endorsed IFRS cannot adopt IFRS 9 until its endorsement by the European Union, which is currently scheduled for the second half of 2015.

2. BACKGROUND

In response to the global financial crisis of 2008, the International Accounting Standards Board (IASB) accelerated its project to replace IAS 39 *Financial Instruments: Recognition and Measurement* with a new financial instruments standard, IFRS 9 *Financial Instruments*. The project contained three phases:

– **Phase I**: Classification and measurement

– **Phase II**: Impairment

– **Phase III**: Hedge accounting.

The IASB's project was initially carried out as a joint project with the US Financial Accounting Standards Board (FASB). However, the FASB ultimately decided to make more limited changes to the classification and measurement of financial instruments, and to develop a more US specific impairment model for financial assets.

Phase I: Classification and measurement

In November 2009, the IASB published its first version of IFRS 9 containing the requirements for classification and measurement of financial assets. This was supplemented in October 2010 by the accounting requirements for financial liabilities. The October 2010 version of IFRS 9 also carried over the scope and recognition and derecognition requirements from IAS 39. For more information about the previous finalised version of IFRS 9 (2010), please refer to BDO's publication *Need to Know – IFRS 9 (2010) Financial Instruments – Classification and Measurement*, available from the IFRS section of our website (www.bdointernational.com) at the link below:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/NTK_IFRS9_print.pdf

Following the publication of IFRS 9, the IASB received questions on the application of IFRS 9 to certain types of financial instruments and, in particular, how to apply the 'solely payments of principal and interest' notion to particular types of financial instruments. The IASB was also asked to consider the interaction of IFRS 9 for financial assets with the insurance project which deals with the accounting for insurance liabilities. In light of the feedback that the IASB received, the IASB decided to reconsider limited aspects of accounting for financial assets and issued Exposure Draft ED/2012/4 *Limited Improvements to IFRS 9* in November 2012. The proposals in ED/2012/4 have now been finalised with the issue of IFRS 9.

Phase II: Impairment

In March 2013, the IASB released Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* proposing a three-stage credit deterioration model for impairment.

The publication of ED/2013/3 followed the publication of two previous ED's. The need for additional exposure drafts arose from modifications which were found necessary to make the IASB's original expected credit loss proposals operational, together with a desire to reach a converged solution with the FASB (prior to the FASB withdrawing from the project and developing a US specific model).

For more information about the final impairment requirements in IFRS 9, please refer to BDO's publication *Need to Know – IFRS 9 Financial Instruments – Impairment of Financial Assets*, available from the IFRS section of our website (www.bdointernational.com) at the link below:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/NTK_IFRS9_print.pdf

Phase III: Hedge Accounting

The hedge accounting model in IAS 39 has been criticised as being complex, rules based, and failing to reflect risk management activities of organisations. In November 2013, the IASB published IFRS 9 (2013) which added a new hedge accounting model to IFRS 9. This new model is easier to implement and links better to the risk management activities of organisations.

The IASB decided to split the hedge accounting phase into two separate work projects due to the complexity of the topic:

– General hedge accounting – for one-to-one or 'static' hedge relationships, and
– Macro hedge accounting.

The general hedge accounting model was finalised with the issue of IFRS 9 (2013). For more information about the hedge accounting chapter of IFRS 9 (2013), please refer to BDO's publication *Need to Know – Hedge Accounting (IFRS 9 Financial Instruments)*, available from the IFRS section of our website (www.bdointernational.com) at the link below:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/Need%20to%20Know%20-%20Hedge%20Accounting%20%28IFRS%209%29%20%28print%29.pdf

Under a macro-hedging model, the amounts of both the hedging instrument and the hedged item change constantly (on a daily, hourly or a more frequent basis). Financial institutions such as banks often use a macro-hedging strategy to manage their interest rate risk exposure of a portfolio of financial assets and liabilities e.g. hedging the net position of fixed rate financial assets and fixed rate financial liabilities. The IASB published a discussion paper on macro hedge accounting in April 2014. Any final requirements are expected to be issued as a separate standard.

3. SCOPE

The scope of IFRS 9 *Financial Instruments* remains broadly the same as IAS 39 *Financial Instruments: Recognition and Measurement*.

The International Accounting Standards Board (IASB) noted that although the scope of IAS 39 and its interaction with other IFRSs have resulted in some application and interpretation issues, the scope of IAS 39 has not been raised as a matter of major concern.

Therefore, the IASB decided that the scope of IFRS 9 should remain the same as IAS 39 until it reconsiders the scope more generally.

The following are examples of assets and liabilities that fall within the scope of IFRS 9:

- Cash
- Trade receivables/payables
- Loans receivables/payable
- Certain loan commitments
- Bank borrowings
- Investments in shares in listed and unlisted companies
- Investments in convertible notes
- Overdraft facilities
- Derivative financial instruments, including:
  - Forward contracts, futures and option contracts
  - Certain commodity contracts
  - Interest rate swaps.

4. FINANCIAL ASSETS – CLASSIFICATION AND MEASUREMENT

IFRS 9 *Financial Instruments* has introduced a number of new measurement categories, whilst eliminating some of the previous categories under IAS 39 *Financial Instruments: Recognition and Measurement*. Under IFRS 9, financial assets are classified into one of the four categories:

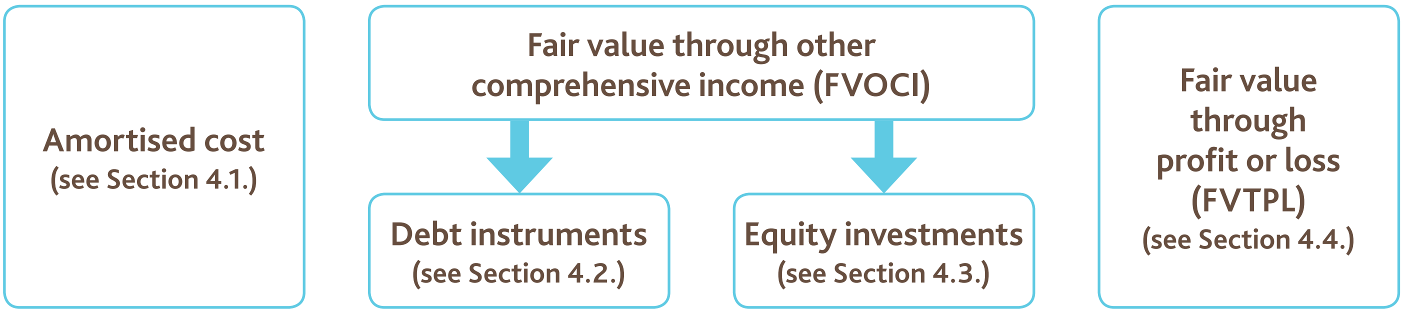

Figure 1: Categories of financial assets under IFRS 9

4.1. Amortised cost

A financial asset is classified as subsequently measured at amortised cost under IFRS 9 if it meets both of the following criteria:

- The asset is held within a business model whose objective is to hold the financial asset in order to collect contractual cash flows (known as the 'hold-to-collect' business model test), and
- The contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding on a specified date (the 'SPPI' contractual cash flow characteristics test).

Examples of financial instruments that are likely to be classified and accounted for at amortised cost under IFRS 9 include:

- Trade receivables
- Loan receivables with 'basic' features
- Investments in government bonds that are not held for trading
- Investments in term deposits at standard interest rates.

4.1.1. 'Hold-to-collect' business model

To qualify for 'amortised cost' classification, the financial asset must be in a 'hold-to-collect' business model. That is, it must be in a business model in which the entity's objective is to hold the financial asset to collect the contractual cash flows from the financial asset rather than with a view to selling the asset to realise a profit or loss.

For example, trade receivables held by a manufacturing entity are likely to fall within the 'hold-to-collect' business model, as the manufacturing entity is likely to have the intention to collect the cash flows from those trade receivables. The 'hold to collect' business model does not require that financial assets are always held until its maturity. An entity's business model can still be to hold financial assets to collect contractual cash flows, even when sales of financial assets occur. However, if more than an infrequent number of sales are made out of a portfolio, the entity should assess whether and how the sales are consistent with the 'hold-to-collect' objective. This assessment should include the reason(s) for the sales, the expected frequency of sales, and whether the assets that are sold are held for an extended period of time relative to their contractual maturities.

BDO comment

Examples of sales that would not contradict holding financial assets to collect contractual cash flows include selling the financial asset close to its maturity (meaning that there is little difference between the fair value of the remaining contractual cash flows and the cash flows arising from sale), selling the financial asset to realise cash to deal with an unforeseen need for liquidity, selling the financial asset as a result of changes in tax laws, or selling the financial asset due to significant internal restructuring or business combinations. Selling due to concerns about the collectability of the contractual cash flows (i.e. increase in credit risk) is also consistent with the objective of a hold-to-collect business model.

Allowing for infrequent sales without compromising the ability to measure financial assets at amortised cost under IFRS 9 is a key difference in comparison with the 'held to maturity' category under IAS 39. The IAS 39 'held to maturity' category 'penalises' the entity (by prohibiting the entity to use the held to maturity category for two years, other than in strictly limited circumstances) if the entity sells a more than insignificant amount of financial assets that it has classified as held to maturity, prior to their maturity.

Example 1 – Hold-to-collect business model

Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity to invest its funds so it buys short dated (6 month maturity) high quality government bonds in order to generate interest income. It is not considered likely but, if a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise it will hold the bonds to their maturity date.

Question: Is the 'hold-to-collect' business model test met?

Answer: Consideration of the facts and circumstances are required. It is likely that the government bonds would meet the hold-to-collect business model test, as the entity's objective appears to be holding the government bonds and collecting the contractual cash flows which consist of the contractual interest payments and, on maturity, the principal amount. If the bond were to be sold prior to its maturity date, the fair value of the cash flows arising would be similar to those which would be collected by continuing to hold the bonds.

Key management personnel (KMP) determine whether a financial asset meets the business model test. The business model can be observed based on the facts and circumstances of the entity, how an entity is managed, and by the type of information that is provided to its management.

The business model test under IFRS 9 is based on how the entity manages its business and not on an instrument-by-instrument basis (i.e. the test is applied on an 'entity wide' basis and not on an individual asset basis).

However, it is also acknowledged that an entity might have more than one business model (for example, a bank might have a trading division and a retail division). Where an entity has a number of different objectives (or business models) for managing financial assets, KMP will have to make an assessment of at what level the business model is to be applied.

For example, an entity (such as a bank) may hold different portfolios of debt investments:

– Some are managed in order to collect contractual cash flows
– Some are managed for trading in order to realise changes in fair value.

The following would not be consistent with the 'hold-to-collect' business model:

– The objective for managing the debt investments is to realise cash flows through sale
– The performance of the debt investment is evaluated on a fair value basis.

4.1.2. The 'SPPI' contractual cash flow characteristics test

The second condition for a financial asset to qualify for amortised cost classification is that the financial asset must meet the 'solely payments of principal and interest' (SPPI) contractual cash flow characteristics test.

Contractual cash flows are considered to be SPPI if the contractual terms of the financial asset only give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding on specified dates i.e. the contractual cash flows are consistent with a basic lending arrangement.

Whilst the consideration for the time value of money and credit risk is typically the most significant element of 'interest', in a change from previous versions of IFRS 9, IFRS 9 (2014) acknowledges that it can also contain other elements such as liquidity, profit margin and service or administrative costs.

However, if the contractual cash flows are linked to features such as changes in equity or commodity prices, they would not pass the SPPI test because they introduce exposure to risks or volatility that is unrelated to a basic lending arrangement.

BDO comment

The SPPI contractual cash flow test means that only debt instruments can qualify to be measured at amortised cost.

Example 2 – SPPI test for loan with zero interest and no fixed repayment terms

Parent A provides a loan to Subsidiary B. The loan has no interest and no fixed repayment terms. The loan is repayable on demand and is classified as a current liability in Subsidiary B's books.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: Yes. The terms provide for the repayment of the principal amount on demand.

Example 3 – SPPI test for a loan with interest rate cap

Entity B lends Entity C CU5 million for 5 years at the prevailing variable market interest rate. In addition, the variable interest rate is capped at 8%.

Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Answer: Yes. Contractual cash flows of both a fixed rate instrument and a floating rate instrument are payments of principal and interest as long as the interest reflects consideration for the time value of money and credit risk.

Therefore, a loan that contains a combination of a fixed and variable interest rate would also meet the contractual cash flow characteristics test.

Example 4 – SPPI test for loan with profit linked element

Entity D lends Entity E CU500 million for 5 years at an interest rates of 5%.

Entity E is a property developer that will use the funds to buy a piece of land and construct residential apartments for sale. In addition to the 5% interest, Entity D will be entitled to an additional 10% of the final net profits from this project.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: No. The profit linked element means that the contractual cash flows do not reflect only payments of principal and interest that reflect only the time value of money and credit risk.

Therefore, the loan will fail the requirements for amortised cost classification and Entity D will account for the loan at fair value through profit or loss.

BDO comment

Under previous versions of IFRS 9, the SPPI test was restrictive, and the changes in the application of the SPPI test may result in additional financial assets being measured at amortised cost. For example, certain instruments with regulated interest rates may now qualify for amortised cost measurement, as might some instruments which only marginally fail the strict SPPI test that was included in earlier versions of IFRS 9.

4.1.2.1. Modified time value of money

In some financial assets in certain jurisdictions, the time value of money element of interest may be modified. Examples of modifications include:

- Instruments with variable interest rates where the frequency of interest rate reset does not match the tenor (or maturity) of the instrument (for example, where interest is reset monthly to a quarterly rate. Certain Japanese government bonds have a semi-annual interest rate reset but the rate is always reset to a 10-year rate regardless of maturity (known as Japanese 10 year constant maturity bonds)
- Instruments with a variable interest rate but the variable interest is reset before the start of the interest period (for example, two months before so that the rate at the date of reset is not the current floating rate, but is instead the floating rate two months before).

Where the time value component of the interest rate has been modified (such as for the instruments set out above), a further assessment is required to determine whether the time value component is significantly different from a benchmark instrument. The assessment can be qualitative or quantitative. An entity needs 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 was not modified (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 would compare that financial asset to a financial instrument with identical contractual terms and the identical credit quality except the variable interest rate is reset monthly to a one-month interest rate.

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. The term 'significantly different' is not defined and no quantitative threshold is provided, but in practice only a small variation would be permitted.

4.1.2.2. Regulated interest rates

In some jurisdictions, the government or a regulatory authority establishes interest rates. For example, such government regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. Under IFRS 9, a regulated interest rate may be used as a proxy for the time value of money element for the purpose of applying the SPPI test if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

BDO comment

The exception to regulated interest rates would apply in jurisdictions such as China, where the government determines interest rates and other interest rates are not permitted for similar transactions.

4.1.2.3. Prepayment and extension terms

Debt instruments often contain prepayment and extension option terms. These do not necessarily violate the SPPI contractual cash flow characteristics test.

A debt instrument with a **prepayment option** can still meet the SPPI contractual cash flow characteristics test if the prepayment amount represents substantially all the unpaid amounts of principal and interest outstanding (the prepayment amount may include reasonable additional compensation for early repayment) and the prepayment is not contingent on any future events other than to protect:

a) The holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer, or

b) The holder or issuer against changes in relevant taxation or law.

Similarly, a debt instrument with an **extension option** would still meet the contractual cash flow characteristics test if the terms in the extension period result in contractual cash flows that also meet the contractual cash flow characteristics test and the extension provision is not contingent on future events other than the criteria set out in subparagraphs a) and b) above.

Example 5 – SPPI test for loan with prepayment option

Entity D lends Entity E CU5 million at a fixed interest rate. The loan is repayable in 5 years.
Entity E has the option to repay the loan at any time at CU5 million plus any accrued interest plus a prepayment penalty fee of 3%.

Question: Does the loan meet the 'SPPI' contractual cash flows characteristic test?

Answer: **Yes**. The prepayment option is not contingent on any future event.

The prepayment penalty of 3% is considered to be reasonable additional compensation for early contract termination.

4.1.2.4. Financial assets that are acquired or originated at a significant premium or discount and prepayable at par plus accrued and unpaid interest

In Example 5 above, the origination amount is equal to the principal repayment amount. However, when a financial asset is originated or acquired for less than the principal repayment amount (i.e. par amount) e.g. a financial asset that is acquired at CU90 and is prepayable at CU100 at any time before maturity, in order to meet the SPPI contractual cash flows test:

- The prepayment amount must substantially represent the contractual par amount and accrued (but unpaid) contractual interest (the prepayment amount may include reasonable additional compensation for early repayment), and
- On initial recognition, the fair value of the prepayment feature must be insignificant.

4.1.2.5. Acquired financial assets with incurred credit losses (‘distressed assets’)

An entity may acquire distressed assets at a discount, either in a portfolio by themselves or forming part of an overall portfolio of financial assets, such as loans. The recovery of cash flows from distressed debt is not by itself inconsistent with a business model to collect contractual cash flows. This could include taking steps to recover those cash flows, such as by making contact with the debtor(s) by post or telephone, or by other methods.

4.1.2.6. Other provisions that change the timing or amount of cash flows

Other contractual provisions that change the timing or amount of cash flows can still meet the SPPI test if their effect is consistent with the return of a basic lending arrangement.

For example, an instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments can still meet the SPPI test as the resulting change in the contractual terms is likely to represent consideration for the increase in credit risk of the instrument. Other instruments where the interest payment is linked to net debt/earnings before interest tax, depreciation and amortisation (EBITDA) ratio (where the ratio is intended to be a proxy reflecting the borrower’s credit risk) are unlikely to meet the SPPI test, except in rare cases when a genuine link can be made between the linkage feature and the required SPPI features.

However, a financial instrument with an interest rate that resets to a higher rate if a specified equity index reaches a particular level (e.g. FTSE 100 reaching 8,000 points) will not meet the SPPI test, because there is no relationship between the change in equity index and credit risk.

A non-recourse provision does not in itself preclude a financial asset from meeting the contractual cash flow characteristics test. A non-recourse provision has the effect that, if the borrower defaults, the lender would only be able to recover its claim through the asset that has been pledged as security over the loan. The borrower has no further obligation beyond the asset that has been pledged. When there is a non-recourse provision, a lender needs to ‘look through’ to the underlying assets or cash flows to determine whether the contractual cash flows of the financial assets are solely payments of principal and interest on the principal amount outstanding. If the terms of the financial asset (including the effect of the non-recourse provision) give rise to any other cash flows or limit the cash flows in a manner that is inconsistent with SPPI, then the loan does not meet the contractual cash flow characteristics test.

4.2. Fair value through other comprehensive income – Debt instruments

A financial asset is measured at fair value through other comprehensive income (FVOCI) under IFRS 9 if it meets both of the following criteria:

– The asset is held within a business model whose objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset (known as the 'hold-to-collect and sell' business model test), and
– 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 'SPPI' contractual cash flow characteristics test).

Examples of financial instruments that may be classified and accounted for at fair value through other comprehensive income under IFRS 9 include:

– Investments in government bonds where the investment period is likely to be shorter than maturity
– Investments in corporate bonds where the investment period is likely to be shorter than maturity.

BDO comment

This business model would typically not be expected to apply to intercompany loans/trade receivables.

This business model typically involves greater frequency and volume of sales than 'hold-to-collect' business model discussed in 4.1.1. above. Integral to this business model is an intention to sell the instrument before the investment matures.

BDO comment

Whilst, the standard does not specify a threshold value or frequency of sales that must occur under the 'hold-to-collect and sale' business model, in its Basis for Conclusions, the IASB has noted that information about sales and sales patterns are useful in determining how an entity manages its financial assets and how cash flows will be realised. This is because information about past sales and expectations about future sales (including the frequency, value and nature of such sales) provide evidence about the objective of the business model. Information about historical sales helps an entity to support and verify its business model assessment. Nevertheless, entities should consider the reasons for any sales (e.g. whether it is an isolated event) and whether they are consistent with a hold-to-collect and sale business objective.

Example 6 – Hold-to-collect business model test for sale before maturity

Same facts as Example 1:

Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity to invest its funds so it buys short dated (6 month maturity) high quality government bonds in order to generate interest income. It is not considered likely but, if a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise it will hold the bonds to their maturity date.

Additional information:

It is likely that a suitable investment opportunity will be found before the maturity date, and so the entity will sell the bonds and use the proceeds for the acquisition of a business operation.

Question: Is the 'hold-to-collect' or 'hold-to-collect and sell' business model test met?

Answer: Consideration of the facts and circumstances are required. It is likely that the government bonds would not meet the hold-to-collect business model test, but would meet the hold-to-collect and sell business model test.

BDO comment

In comparison with previous versions of IFRS 9, the introduction of the FVOCI category may result in less profit or loss volatility. For example corporate entities that hold a government or a corporate bond and are collecting interest, but may also have the intention to sell the asset at any time before maturity, will now classify the bond at FVOCI rather than fair value through profit or loss (FVTPL).

For entities such as insurance companies which hold large portfolios with periodic buying and selling activities, the amendments could lead to significant reclassification of debt instruments across the different measurement categories: amortised cost, FVOCI, and FVTPL. This may lead to less volatility in profit or loss for debt investment portfolios, but greater equity volatility if assets are reclassified from amortised cost to FVOCI (which could affect regulatory capital). The IASB has given significant consideration to these aspects during its development of its new standard for insurance contract.

4.2.1. 'SPPI' test

To qualify for FVOCI, the financial instrument must also meet the SPPI test as discussed in 4.1.2. above.

4.2.2. Accounting requirements for FVOCI for debt instruments

The accounting requirements for debt instruments classified as FVOCI are:

- Interest income is recognised in profit or loss using the effective interest method that is applied to financial assets measured at amortised cost
- Credit impairment losses/reversals are recognised in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost (please refer to BDO's *Need to Know* publication *Financial Instruments: Impairment* for further details).
- Other changes in the carrying amount on remeasurement to fair value are recognised in OCI
- The cumulative fair value gain or loss recognised in OCI is recycled from OCI to profit or loss when the related financial asset is derecognised.

BDO comment

For debt instruments that are classified as FVOCI entities will need to track both the amortised cost and fair value. The amounts recorded in profit or loss will reflect amortised cost and the balance sheet will reflect the fair value of the financial asset.

Example 7 – FVOCI for debt instruments

On 1.1.20X1 a financial asset is purchased at its face value of CU1,000. The contractual term is 10 years with an annual coupon of 6%. Expected credit losses as determined under the impairment model are CU20.

On 31.12.20X1 the fair value decreases to CU950. Expected losses increase by CU10 to CU30. A coupon payment is received.

On 1.1.20X2 the financial asset is sold for CU950.

Question: What are the journal entries on initial recognition, 31.12.X1 and 1.1.X2 under the FVOCI category?

Answer:

1.1.20X1			CU	CU
Dr		Financial asset	1,000	
	Cr	Cash		1,000
Dr		Impairment loss (P&L)	20	
	Cr	OCI (loss allowance)		20

Being the initial recognition of the financial asset at FVOCI and the recognition of the initial impairment within the loss allowance in OCI.

31.12.20X1			CU	CU
Dr		Cash	60	
	Cr	Interest income		60
Dr		Impairment loss (P&L)	10	
Dr		OCI (of which CU20 loss allowance)	40	
	Cr	Financial asset		50

Being the receipt of the coupon payment, recognition of additional impairment loss and the fair value movement of the financial asset.

1.1.20X2			CU	CU
Dr		Cash	950	
	Cr	Financial asset		950
Dr		Loss on sale (P&L)	20	
	Cr	OCI		20

Being the sale of the financial asset and recognition of the loss on sale.

4.3. Fair value through other comprehensive income – Equity investments

IFRS 9 requires all equity investments (investments in equity instruments issued by listed and unlisted companies) to be measured at fair value. The default approach is for all changes in fair value to be recognised in profit or loss.

However, for equity investments that are not held for trading, entities can make an irrevocable election at initial recognition to classify the instruments as at fair value through other comprehensive income (FVOCI), with all subsequent changes in fair value being recognised in other comprehensive income (OCI).

Under this new FVOCI category, fair value changes are recognised in OCI while dividends are recognised in profit or loss. Although it might appear similar, it is important to note that this is a new measurement category which is different from the available-for-sale category under IAS 39 (refer to Appendix A1 for more details on the differences between the two). In particular under the new model, on disposal, the cumulative fair value changes are required to remain in OCI and are not recycled to profit or loss. However entities have the ability to transfer amounts between reserves within equity (i.e. between the FVOCI reserve and retained earnings).

BDO comment

The International Accounting Standards Board (IASB)'s original intention was that the FVOCI category would be used for 'strategic' investments (e.g. equity instruments held for long term strategic purposes, such as to enhance a trading relationship).

However in finalising its proposals, the IASB concluded that it would be difficult to develop a clear and robust principle to identify what would exactly be considered a 'strategic investment'.

Therefore the IASB subsequently decided to leave the FVOCI category undefined and to allow entities an irrevocable choice of classification on initial recognition.

Example 8 – Equity instruments classified at FVOCI

Entity X has a 31 December financial year end and pays tax at a rate of 30%.

On 1 January 20X3, Entity X acquires 100 shares of List Co for CU10,000.

The journal entry at 1 January 20X3 is as follows:

1 January 20X3				
Dr		Financial asset (Equity investment at FVOCI)	CU10,000	
	Cr	Cash		CU10,000

Being the purchase of 100 shares in List Co for CU10,000.

On 31 December 20X3, the fair value of the 100 shares in List Co has declined to CU8,000.

The journal entries at 31 December 20X3 are as follows:

31 December 20X3				
Dr		Other comprehensive income	CU2,000	
	Cr	Financial asset (Equity investment at FVOCI)		CU2,000
Dr		Deferred tax asset	CU600	
	Cr	Other comprehensive income		CU600

Being the change in fair value of the equity investment and its related tax effects.

Carrying values at 31 December 20X3 are:

	Carrying Value
Financial asset (Equity investment at FVOCI)	CU8,000
Deferred tax asset	CU600
Accumulated OCI	CU(1,400)

On 31 March 20X4, Entity X receives a cash dividend of CU500.

The journal entry at 31 March 20X4 to record the dividend is as follows:

31 March 20X4				
Dr		Cash	CU500	
	Cr	Profit or loss		CU500

Being the receipt of the cash dividend of CU500.

On 31 December 20X4, the fair value of the 100 shares in List Co is CU13,000 and Entity X decides to dispose of the shares.

The journal entries at 31 December 20X4 are as follows (before recording the disposal):

31 December 20X4				
Dr		Financial asset (Equity investment at FVOCI)	CU5,000	
	Cr	Other comprehensive income		CU5,000
Dr		Other comprehensive income	CU1,500	
	Cr	Deferred tax asset		CU600
	Cr	Deferred tax liability		CU900

Being the change in fair value of the equity investments during the period to 31 December 2014 and the related tax effects.

Carrying values at 31 December 20X3 before recording the disposal are:

	Carrying Value
Financial asset (Equity investment at FVOCI)	CU13,000
Deferred tax liability	CU900
Accumulated OCI	CU2,100

The journal entry for the disposal is:

31 December 2014				
Dr		Cash	CU13,000	
	Cr	Financial asset (Equity investment at FVOCI)		CU13,000
Dr		Deferred tax liability	CU900	
	Cr	Tax payable		CU900

Being disposal of the equity investment and the related tax effects.

The following table sets out the carrying values at 31 December 2014 after disposal:

	Carrying Value
Cash	CU13,000
Financial asset (Equity investment at FVOCI)	-
Tax payable	CU900
Accumulated OCI	CU2,100

NOTE: On disposal, the cumulative changes in fair value remain in OCI. Entities can transfer the cumulative OCI balance to another reserve within equity, such as retained earnings.

4.4. Fair value through profit or loss

A financial asset is classified and measured at fair value through profit or loss (FVTPL) if the financial asset is:

- A held-for-trading financial asset (a derivative that has not been designated in a hedging relationship, or a financial asset that is held for the purposes of short term sale or repurchase)
- A debt instrument that does not qualify to be measured at amortised cost or fair value through other comprehensive income (FVOCI) (for example, because the interest cash flows do not represent only compensation for time value and credit risk)
- An equity investment which the entity has not elected to classify as at FVOCI (refer Section 4.3.)
- A financial asset where the entity has elected to measure the asset at FVTPL under the fair value option (FVO).

Examples of financial instruments that are likely to fall under the FVTPL category include:

- Investments in shares of listed companies that the entity has not elected to account for as at fair value through other comprehensive income (FVOCI) (refer Section 4.3. above)
- Derivatives that have not been designated in a hedging relationship:
  - Interest rate swaps
  - Commodity futures/options contracts
  - Foreign exchange future/options contracts
- Investments in convertible notes, commodity linked bonds
- Contingent consideration receivable from the sale of a business.

BDO comment

Other than for held for trading financial assets, such as derivatives, that must be carried at FVTPL, the FVTPL category under IFRS 9 is essentially a residual category.

That is, consideration is first given to whether a financial asset is to be measured at amortised cost or FVOCI and, if it is not, it will be measured at FVTPL.

The fair value option (FVO)

IFRS 9 provides an option at initial recognition (commonly referred to as the 'fair value option' (FVO)) to designate a financial asset to be measured as at fair value through profit or loss (rather than at amortised cost or FVOCI) if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities, or recognising the gains and losses arising from them, on different bases.

The designation is irrevocable, and is most commonly used by financial institutions.

5. RECLASSIFICATION

IFRS 9 *Financial Instruments* requires the reclassification of financial assets between amortised cost, fair value through other comprehensive income for debt instruments (FVOCI) and fair value through profit or loss, if an entity changes its business model.

The reclassification must be determined by senior management as a result of an external or internal change, and it must be a significant change to the entity's operations.

Reclassifications are expected to be rare and infrequent events.

If an entity changes its intention in relation to a specific financial asset (or specific financial assets), this is not considered a change in the overall business model of the entity, and accordingly reclassification is not permitted.

Other factors that do not lead to a change in business model for the purposes of IFRS 9 include:

- The temporary disappearance of a particular market for financial assets, and
- The transfer of financial assets between different parts of an entity that have different business models.

BDO comment

Reclassifications only apply to financial assets that are debt instruments.

Reclassification for investments in equity instruments is not possible as the choice to designate an equity investment at FVOCI arises from an irrevocable election on initial recognition.

Reclassifications are applied prospectively from the date of reclassification i.e. there is no restatement of any previously recognised gains and losses (including any impairment gains or losses) or interest.

The following table sets out the reclassification mechanics:

	Measurement after reclassification		
Initial measurement	**Amortised cost**	**FVOCI**	**FVTPL**
Amortised cost		**Measurement** Fair value on date of reclassification.	**Measurement** Fair value on date of reclassification.
Amortised cost		**Differences** Between the previous carrying amount and fair value are recognised in OCI.	**Differences** Between carrying amount and fair value are recognised in profit or loss.
Amortised cost		**EIR** No adjustments to effective interest rate (EIR) and credit loss allowance account.	
FVOCI	**Accumulated OCI** Removed and adjusted against the fair value of the financial asset.		**Measurement** Continues to be measured at fair value.
FVOCI	**EIR** No adjustments to EIR and credit loss allowance account.		**Accumulated OCI** Reclassified from OCI to profit or loss.
FVTPL	**Measurement** Fair value on the date of reclassification becomes the new gross carrying amount.	**Measurement** Continues to be measured at fair value.	
FVTPL	**EIR** Calculated based on fair value at the reclassification date.	**EIR** Calculated based on fair value at the reclassification date.	
FVTPL		**Impairment** Impairment requirements apply from reclassification date.	

Figure 2: Reclassification

Additional disclosures apply when an entity reclassifies its debt instruments (refer to Section 9.) below).

6. FINANCIAL LIABILITIES – CLASSIFICATION AND MEASUREMENT

The classification and measurement of financial liabilities in accordance with IFRS 9 *Financial Instruments* remains largely unchanged from IAS 39 *Financial Instruments: Recognition and Measurement*.

IFRS 9 contains two categories of financial liabilities:

- Financial liabilities at amortised cost
- Financial liabilities as at fair value through profit or loss (FVTPL).

Financial liabilities classified as at amortised cost are subsequently measured at amortised cost using the effective interest method. Financial liabilities classified as at fair value through profit or loss are subsequently measured at fair value with changes in fair value recognised in profit or loss.

IFRS 9 requires all financial liabilities to be measured at amortised cost unless either:

- The financial liability is required to be measured at FVTPL because it is held for trading (e.g. derivatives that have not been designated in a hedging relationship), or
- The entity elects to measure the financial liability at FVTPL (using the fair value option).

In contrast to financial assets, the existing requirements in IAS 39 for the separation of embedded derivatives have been continued for financial liabilities, meaning that financial liabilities to be measured at amortised cost will still need to be analysed to determine whether they contain any embedded derivatives that are required to be accounted for separately at FVTPL.

Examples of financial liabilities that are likely to be classified and measured either at amortised cost or at FVTPL include:

Amortised cost	FVTPL
– Trade payables – Loan payables with standard interest rates (such as a benchmark rate plus a margin) or the host contract arising from a loan agreement which contains separable embedded derivatives – Bank borrowings.	– Interest rate swaps (not designated as part of a hedging relationship) – Commodity futures/options contracts (not designated as part of a hedging relationship) – Foreign exchange future/options contracts (not designated as part of a hedging relationship) – Convertible note liabilities that have been designated at FVTPL – Contingent consideration payable that arise from business combinations.

Figure 3: Examples for classification of financial liabilities

The key change under IFRS 9 for financial liabilities is the presentation of changes in fair value arising from changes in an entity's own credit status for financial liabilities that have been designated as at FVTPL. This change is expected mainly to affect financial institutions (but can also apply to entities that have used the fair value option, such as those which have designated convertible notes which contain derivative liabilities as at FVTPL) and is discussed in more detail below.

Fair value option

IFRS 9 permits an entity to designate financial liabilities at FVTPL if any of the following apply:

i. If electing fair value will eliminate or reduce an accounting mismatch

ii. If the financial liability is managed and evaluated on a fair value basis with other financial liabilities or financial assets and liabilities as a group

iii. A hybrid contract (e.g. a convertible note or a loan with a leveraged interest rate) contains an embedded derivative that would otherwise be required to be separated.

BDO comment

The option to designate liabilities at fair value through profit or loss (commonly referred to as the fair value option (FVO)) in the circumstances described in points i. and ii. above is typically used by entities that are financial institutions.

Generally, it would be expected that a non-financial institution would normally only use the FVO in scenario iii. above. That is, in circumstances in which it has entered into a hybrid contract that contains an embedded derivative that would otherwise be required to be separately accounted for, it elects to measure the entire contract at fair value. This approach is often followed because it simplifies future fair value calculations and the accounting requirements.

For example, an entity issues a convertible note and has assessed that the note contains a debt host liability and an embedded derivative liability. Instead of separately accounting for the debt host liability at amortised cost and the embedded derivative liability at FVTPL, the issuer elects to account for the entire convertible note at FVTPL.

Financial liabilities at FVTPL – Changes in own credit

IFRS 9 requires that when an entity designates a financial liability at FVTPL, the changes in fair value that relate to changes in the entity's own credit status are normally presented in other comprehensive income instead of profit or loss. This is a change in comparison with the requirements of IAS 39.

An exception to the general approach of recognising changes in fair value that relate to an entity's own credit status is where this would create or enlarge an accounting mismatch, in which case the entire change in fair value is recognised in profit or loss. The circumstances in which this would arise are generally only found in financial institutions (for example, where a lender funds loans granted to its customers by issuing bonds with identical features in the financial markets).

This means that, under IFRS 9, entities will typically have to determine the change in fair value of the financial liability as a whole, and then perform a separate calculation to determine the change in fair value that is attributable to changes in their own credit status, and present those changes in other comprehensive income (OCI), while the remaining fair value changes will be presented in profit or loss.

For example, if the total fair value change of the financial liability is CU10, and the change due to own credit is CU2, an entity would present:

- CU8 in profit or loss, and
- CU2 in OCI.

Guidance on measuring changes in fair value that arise from a change in an entity's own credit status is provided in the application guidance in IFRS 9.B5.7.16-20. This can be achieved by determining the amount of the change in fair value that is attributable to changes in market conditions that have changed market risk (and therefore pricing) and comparing this to the total change in fair value of the entity's financial liability, with other methods being permitted if it is considered that these represent more clearly the change in fair value attributable to changes in the entity's own credit risk. In all cases, the approach followed must make maximum use of observable inputs (that is, those derived from observable market prices) and minimum use of unobservable inputs.

The cumulative changes in fair value arising from changes in an entity's own credit status that is recognised in OCI is not subsequently recycled to profit or loss when the financial liability is derecognised. However, IFRS 9 permits entities to transfer the amount within equity after derecognition of the financial liability.

BDO comment

Under IAS 39, all changes in the fair value of a financial liability designated as at FVTPL were recognised in profit or loss. As a result a counter-intuitive gain/loss resulted when the issuer's credit worthiness deteriorated/improved.

Many constituents have indicated to the International Accounting Standard Board (IASB) that changes in the issuer's credit risk should not affect profit or loss unless the liability is held for trading. Therefore, this change was made in IFRS 9. The transitional provisions of IFRS 9 permit the 'own credit' requirements to be adopted early without applying any of the other requirements in IFRS 9.

7. HYBRID CONTRACTS CONTAINING EMBEDDED DERIVATIVES

A hybrid contract is an instrument that contains both a non-derivative host contract and a derivative.

Under IAS 39 *Financial Instruments: Recognition and Measurement*, the derivative embedded within a hybrid contract is bifurcated (i.e. accounted for separately) from the host contract if:

- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative
- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract, and
- The hybrid (combined) instrument is not measured at fair value through profit or loss.

If all of the above criteria are met, the host contract and the embedded derivative are accounted for separately as if they are two separate stand-alone financial instruments under IAS 39. This accounting, which has been criticised as being complex and without a clear definition of what 'closely related' means, has ultimately resulted in the requirements being difficult to apply in practice.

In order to simplify the accounting, IFRS 9 *Financial Instruments* has eliminated the requirement to separately account for embedded derivatives for financial assets. Instead, IFRS 9 requires entities to assess the hybrid contract as a whole for classification. If the terms of the hybrid contract still meet the criteria for subsequent measurement at amortised cost or FVOCI for debt instruments (see Section 4.1. and 4.2. above) then it is accounted for at amortised cost or FVOCI, otherwise it would be measured at fair value through profit or loss.

However, the existing requirements for embedded derivatives still apply to financial liabilities, and to contracts for assets that are not within the scope of IFRS 9.

Example 9 – Hybrid contracts: difference between IAS 39 and IFRS 9

Entity A invests in a CU1,000 convertible note issued by Entity B. The convertible note pays a 5% annual coupon with a maturity of 3 years. At any point prior to its maturity, Entity A has the option to convert the note into 1,000 shares of Entity B.

The market rate of interest for a similar instrument without the conversion feature would be 8%.

IAS 39	IFRS 9
The instrument contains: – A debt host contract – an annual coupon receivable of 5% and CU1,000 on maturity, and – Embedded equity option – option to buy shares at CU1. The equity option derivative is not closely related to the debt host contract. The entity therefore has two options: i. Bifurcate the instrument, that is: – Equity option in B accounted for at FVTPL – Host debt contract at amortised cost. ii. Designate entire contract at FVTPL.	Consider the instrument in its entirety: – The coupon rate is lower than the market interest rate, and therefore does not reflect the consideration for the time value of money and credit risk – Return is also linked to the value of the equity conversion. Therefore, the instrument fails classification and measurement at amortised cost. Accordingly, the entity must account for the entire instrument at FVTPL.

Figure 4: Accounting for an investment in a convertible note under IFRS 9 and IAS 39

8. EFFECTIVE DATE AND TRANSITION

IFRS 9 *Financial Instruments* applies for annual reporting periods beginning on or after 1 January 2018. Early application is permitted. Entities that report in accordance with EU-endorsed IFRS cannot adopt IFRS 9 until its endorsement by the European Union, which is expected in the second half of 2015.

IFRS 9 includes the final requirements from all three phases of the financial instrument project (i.e. classification and measurement, impairment and hedge accounting).

The following table sets out the different versions of IFRS 9 and the topics each version covers:

	Classification and measurement of financial assets	Classification and measurement of financial liabilities	Impairment	Hedge accounting
IFRS 9 (2009)	X			
IFRS 9 (2010)	X	X		
IFRS 9 (2013)	X	X		X
IFRS 9 (2014)	X (limited amendments)	X	X	X

Figure 5: Different versions of IFRS 9

If an entity's date of initial application (the start of the period in which IFRS 9 is adopted) is before 1 February 2015, there is a choice of which version of IFRS 9 to adopt (2009, 2010, 2013 or 2014). In addition to that, entities have the option exclusively to apply the 'own credit risk' exemption, which requires entities to present changes in own credit risk on liabilities designated at FVTPL in other comprehensive income. Due to the fact that the macro hedging project of the IASB is not yet finalised, entities are allowed to apply the related hedge accounting requirements of IAS 39 until completion of the macro hedging project.

Entities need to consider which version of IFRS 9 to apply. The following options to apply IFRS 9, or selected parts of it exist:

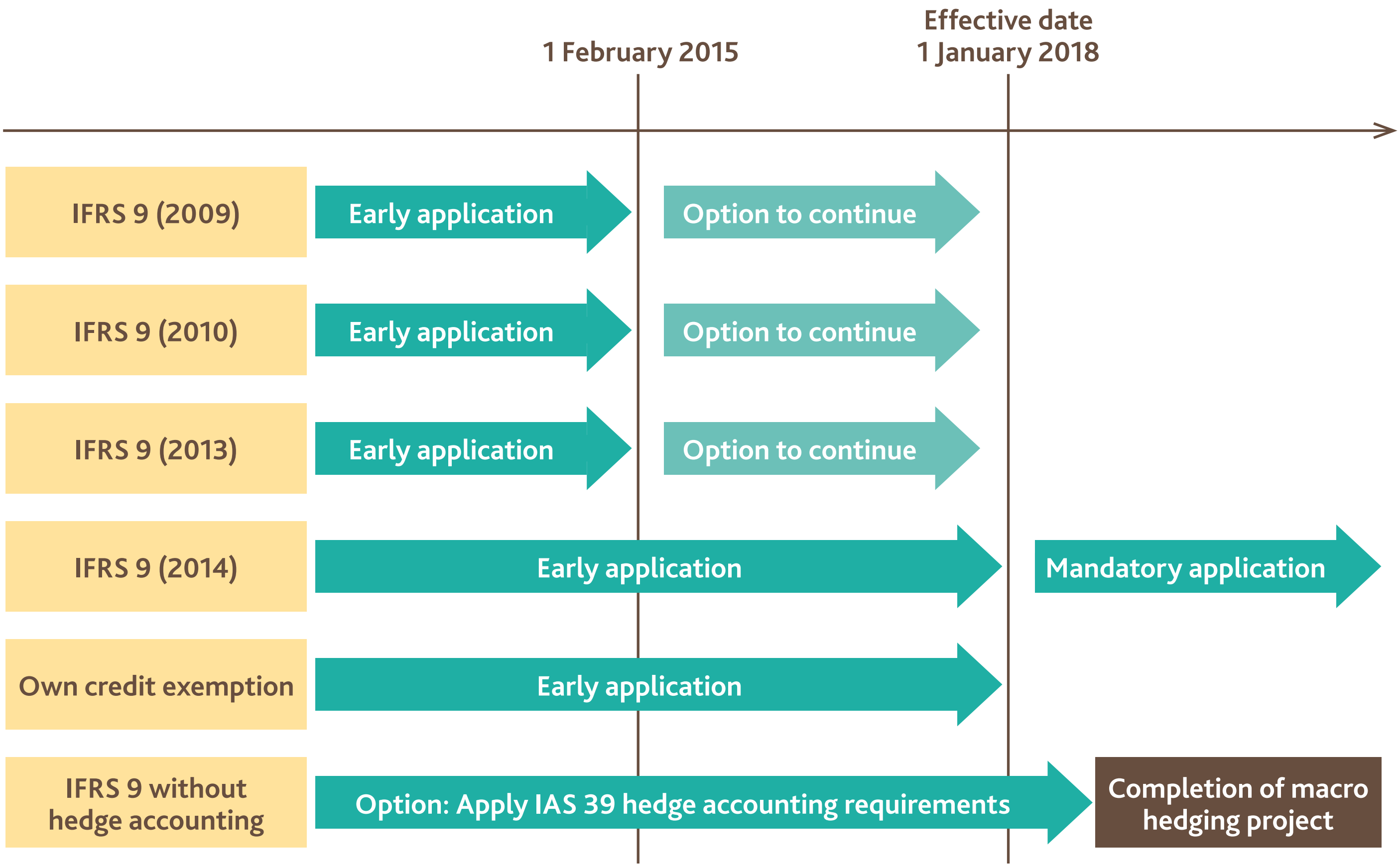

Figure 6: Options to apply different versions of IFRS 9

The date when an entity first applies IFRS 9 *Financial Instruments* is referred to as the date of initial application. For entities adopting IFRS 9 the date of initial application is the beginning of the reporting period when an entity first applies IFRS 9.

At its date of initial application, an entity must assess whether a financial asset meets the conditions for amortised cost, fair value through other comprehensive income (FVOCI) for debt, FVOCI for equity, or fair value through profit or loss (FVTPL), on the basis of the facts and circumstances that exist at the date of initial application. Once the classification assessment is made, that classification applies to the financial asset retrospectively (irrespective of the entity's business model in prior reporting periods). The standard does not apply to items that have already been derecognised at the date of initial application.

The following diagram sets out the likely reclassifications from the IAS 39 categories to the IFRS 9 categories for financial assets.

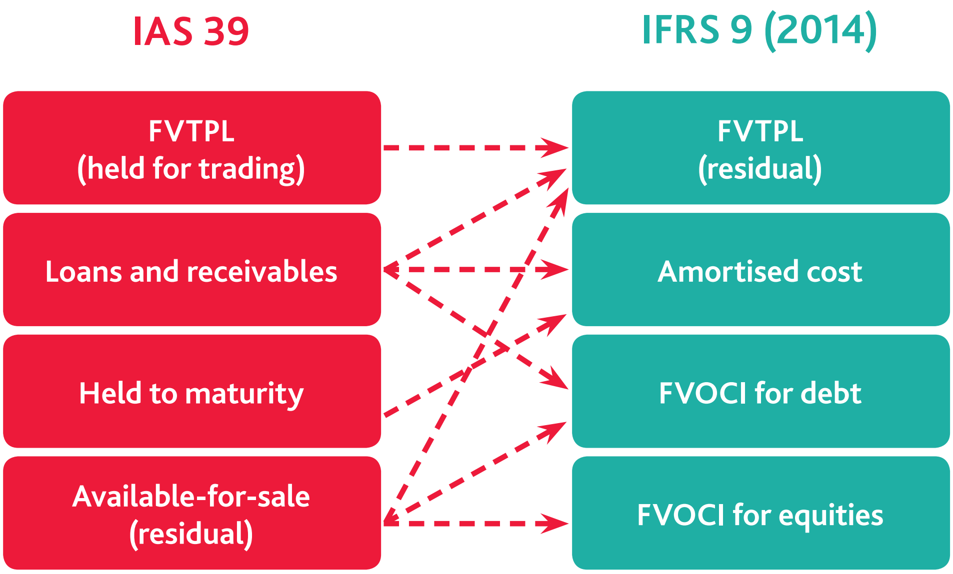

Figure 7: The likely reclassifications of financial assets from IAS 39 to IFRS 9

BDO comment

Although the categories of IFRS 9 might appear similar to those of IAS 39, there are key differences. Under IAS 39, the available for sale category (measured at FVOCI) was a residual category to be used if a financial asset did not fall into any of the other three categories; it was also optional unless a financial asset was required to be measured at fair value through profit or loss (FVTPL). In contrast, the FVOCI category in IFRS 9 would be for a clearly defined group of financial assets.

Despite the fact that the standard is to be adopted retrospectively in accordance with IAS 8 *Accounting Polices, Changes in Accounting Estimates and Errors*, an entity is not required on initial application to restate comparatives. Instead it is required to provide the disclosures set out in paragraphs 42L-O of IFRS 7 *Financial Instruments: Disclosures* (see Section 9 below).

Example 10 – Adjustments on the date of initial application

Entity A decides to apply IFRS 9 on 1 January 2015.

On 30 September 2014, Entity A sold an available-for-sale equity investment and recognised a gain of CU30 which included the effect of reclassifying the related amount from the available-for-sale reserve to profit or loss.

Question: Are there any adjustments required on transition?

Answer: **No**. The date of initial application is 1 January 2015, and IFRS 9 does not apply to financial instruments that have already been derecognised by the date of initial application.

Equity investments at fair value through other comprehensive income

At the date of initial application, an entity may designate an investment in an equity instrument at FVOCI unless the investment meets the definition of held for trading. The election is to be applied retrospectively.

For unquoted equity investments measured at cost under IAS 39, an entity will need to determine the fair value of the equity investment at the date of initial application. The difference between the previous carrying amount and the fair value at the date of initial application is recognised in opening retained earnings.

Example 11 – Impairment loss before transation

Entity B bought an equity investment in an unlisted company on 1 January 2013 for CU100. As the equity instrument was not held for trading it was classified by Entity B as an available-for-sale financial asset.

However, because the investment did not have a quoted market price in an active market and fair value could not be reliably determined, the equity investment was measured at cost under IAS 39. On 31 December 2013 Entity B recognised an impairment loss of CU40 in profit or loss. Entity B applies IFRS 9 for the first time in the annual reporting period ended 31 December 2015. Date of initial application is 1 January 2015. In accordance with the transitional provisions of IFRS 9, Entity B is not required to restate comparatives but is required to provide the disclosures set out in IFRS 7.42L-42O.

The fair value of the investment on 1 January 2015 is determined to be CU75. The carrying value of the investment under IAS 39 at 31 December 2014 is CU60.

Question: How should Entity B account for the investment on transition?

Answer: Entity B recognises the difference of CU15 in its opening retained earnings at 1 January 2015.

The CU40 impairment loss previously recognised in profit or loss would be reclassified from retained earnings to accumulated OCI on transition.

Hybrid contracts (contracts with embedded derivatives)

A hybrid contract that is to be classified as at fair value through profit or loss (FVTPL) under IFRS 9 may have been accounted for under IAS 39 as a host contract and a separable embedded derivative. This means that the entire hybrid contract will not have been measured at fair value in the comparative period, with the two components being dealt with separately. On transition, the holder would recognise in its opening retained earnings any difference between the fair value of the entire hybrid contract and the sum of the fair values of the two components of the hybrid contract.

Example 12 – Convertible note on transition

Entity C acquired an investment in a convertible note on 1 January 2013. Under IAS 39 the convertible note was bifurcated where:

– The embedded derivative was accounted for at FVTPL (carrying value at 31 December 2014: CU30), and

– The debt host contract was measured at amortised cost (carrying value at 31 December 2014: CU990).

Entity C applies IFRS 9 for the first time in its annual reporting period ending 31 December 2015.

Question: How should Entity B account for the investment on transition?

Answer:

The date of initial application is 1 January 2015. In accordance with the transitional provisions of IFRS 9, Entity C is not required to restate comparatives but is required to provide the disclosures set out in IFRS 7.42L-42O. On 1 January 2015 the fair value of the convertible note (as a single combined instrument) is CU980. The fair values of the two components on 1 January 2015 were as follows:

– Embedded derivative is CU30

– Host debt contract is CU960 (note that in this case the fair value is lower than the previous amortised cost carrying amount).

The total fair value of the components is CU 990. Entity C recognises the differences of CU10 in opening retained earnings at 1 January 2015.

Impracticable to apply the effective interest method retrospectively

If it is impracticable for an entity retrospectively to apply the effective interest method, or the IAS 39 impairment requirements to financial instruments classified at amortised cost in accordance with IFRS 9 that were previously measured at fair value, the transitional requirements depend on whether an entity restates its comparatives.

If an entity restates its comparatives, then the fair value of the financial instrument at the end of each comparative period is used as a proxy for its amortised cost.

If an entity does not restate comparatives, the entity treats the fair value of the financial instrument at the date of initial application as its new amortised cost.

Assessing modified time value of money

At the date of initial application, when determining whether a financial asset is to be measured at amortised cost, it may be impracticable (as defined in IAS 8) to assess a modified time value of money element (see Section 4.1.2.1. above) based on facts and circumstances at initial recognition of the financial asset. In such cases, it is necessary to assess the contractual cash flows characteristics (as at initial recognition) using the classification requirements as set out in previous versions of IFRS 9.

Financial assets that are acquired or originated at a significant premium or discount and are prepayable at par plus accrued and unpaid interest

At the date of initial application, if it is impracticable (as defined in IAS 8) to assess whether the fair value of a prepayment feature was insignificant (see Section 4.1.2.4. above) based on facts and circumstances at initial recognition of the financial asset, it is necessary to assess the contractual cash flow characteristics of that financial asset without taking into account the exception for prepayment features set out in Section 4.1.2.4. above.

Designating financial assets at FVTPL

At the date of initial application, an entity may designate a financial asset measured at fair value through profit or loss (FVTPL) if it eliminates/reduces an accounting mismatch.

For financial assets that were previously designated at FVTPL under IAS 39, an entity may continue this designation under IFRS 9 if it continues to eliminate/reduce an accounting mismatch or it can choose to revoke the election (even if an accounting mismatch may arise).

Designating financial liabilities at FVTPL

At the date of initial application, an entity may designate a financial liability to be measured at FVTPL if it eliminates/reduces an accounting mismatch.

For financial liabilities that were previously designated at FVTPL under IAS 39, an entity may upon the initial application of IFRS 9:

(i) Continue to designate the financial liability at FVTPL if the designation eliminates/reduces an accounting mismatch, or

(ii) Revoke the election.

However, revocation is not permitted for financial liabilities designated at FVTPL that are hybrid contracts or groups of financial instruments where they are managed and their performance evaluated on a fair value basis. That is, revocation of the designation as at FVTPL is only permitted for financial liabilities that were previously designated as at FVTPL due to an accounting mismatch.

9. DISCLOSURES

Additional transitional disclosures were added to IFRS 7 *Financial Instruments: Disclosure* (see Sections 9.1 and 9.2). In addition, other new disclosures were included in IFRS 7 as a result of the new classification and measurement model (see Section 9.3).

9.1. Transitional disclosures on first time adoption of IFRS 9

The following disclosures only apply on transition from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9 (i.e. the first time that IFRS 9 classification and measurement is applied).

Entities are required to disclose the changes in the classification of financial assets and financial liabilities separately for (IFRS 7.42L):

– Reclassifications, based on the carrying amounts measured in accordance with IAS 39
– Changes in the carrying amount arising from a change in measurement basis on transition to IFRS.

Entities should provide the disclosures that permit reconciliation between the:

– Measurement categories in accordance with IAS 39 and IFRS 9, and
– The class of financial instrument at the date of initial application (IFRS 7.42O).

For financial assets and financial liabilities that have been reclassified to amortised cost or for financial assets that have been classified to FVOCI as a result of the transition to IFRS 9, an entity must disclose:

a) The fair value of the financial assets or financial liabilities at the end of the reporting period
b) The fair value gain or loss that would have been recognised in profit or loss or other comprehensive income during the reporting period if the financial assets or financial liabilities had not been reclassified (IFRS 7.42M).

The above disclosures are only required in the first annual reporting period that IFRS 9 is first applied. For financial assets and financial liabilities that have been reclassified out of FVTPL into either amortised cost (or FVOCI for financial assets that are debt instruments), an entity must disclose:

a) The effective interest rate determined on the date of reclassification, and
b) Interest income or expense recognised (IFRS 7.42N).

If an entity treats the fair value of a financial asset or liability at the date of initial application as its new carrying amount, the disclosures set out above must be made for each subsequent reporting period until derecognition of the financial asset or liability. Otherwise, the disclosures are only required in the first annual reporting period that IFRS 9 is first applied.

For financial assets with a modified time value of money element where an entity found it impracticable (as defined in IAS 8) to assess a modified time value of money based on facts and circumstances at initial recognition of the financial asset, and has assessed the contractual cash flows characteristics (as at initial recognition) using the requirements as set out in previous versions of IFRS 9, the entity must disclose those financial assets' carrying amount at the reporting date until those financial assets are derecognised (IFRS 7.42R).

For financial assets that are acquired or originated at a significant premium or discount and are prepayable at par plus accrued and unpaid interest, where it is impracticable (as defined in IAS 8) to assess whether the fair value of a prepayment feature was insignificant based on facts and circumstances at initial recognition of the financial asset, and the entity has assessed the contractual cash flow characteristics of that financial asset without taking into account the exception for prepayment features, the entity must disclose those financial assets' carrying amount at the reporting date until those financial assets are derecognised (IFRS 7.42S).

9.2. Transitional disclosures each time IFRS 9 is adopted

For each class of financial assets and financial liabilities at the date of initial application, entities are required to disclose (IFRS 7.42I):

- The original measurement category and carrying amount under IAS 39 (or a previous version of IFRS 9, if a previous version of IFRS 9 have already been adopted)
- The new measurement category and carrying amount, and
- The amount of any financial assets and financial liabilities in the statement of financial position that were previously designated as measured at fair value through profit or loss but are no longer so designated.

Entities are also required to disclose qualitative information that allows users to understand:

- How they applied the classification requirements in IFRS 9 *Financial Instruments* to those financial assets whose classification has changed
- The reason for any designation or de-designation of financial assets or financial liabilities measured at fair value through profit or loss (FVTPL) (IFRS 7.42J).

9.3. Other new disclosures

This section sets out the new disclosure requirements in IFRS 7 that apply as a result of the classification and measurement requirements in IFRS 9.

Equity investments at FVOCI

For equity investments that have been designated at fair value through other comprehensive income (FVOCI), entities must disclose (IFRS 7.11A-11B):

- Which equity investments have been designated at FVOCI
- Reasons for using this FVOCI alternative
- The fair value of each investment at reporting date
- Dividends recognised during the period, showing separately those that:
  - Relate to investments that have already been derecognised
  - Relate to investments held at reporting date.
  - Any transfers of cumulative loss or gain within equity during the period and the reason.

Reclassifications

If an entity has made a reclassification between amortised cost, FVOCI or FVTPL for debt instruments as a result of a change in its business model (see Section 5), the following disclosures are required (IFRS 7.12B-D):

- Date of reclassification
- Detailed explanation of the change in business model and a qualitative description of its effects
- Amount reclassified into and out of each category
- For debt instruments that are reclassified out of FTVPL into amortised cost or FVOCI:
  - Disclose for each subsequent reporting period after reclassification:
    - The effective interest rate determined on date of reclassification and interest income or expense recognised for each subsequent reporting period after reclassification
  - Disclose for the period of reclassification:
    - Fair value of the financial asset at the end of the reporting period
    - Fair value of gain or loss that would have been recognised in profit or loss during the reporting period if there has been no reclassification.

Derecognition of financial assets measured at amortised cost

If an entity has derecognised a financial asset measured at amortised cost (that is, it has disposed of it before maturity), it must disclose (IFRS 7.20A):

- Separately the gain or loss from the derecognition of the financial assets at amortised cost, and
- Reasons for the derecognition.

Financial liabilities designated as at fair value through profit or loss

For financial liabilities designated as at fair value through profit or loss (FVTPL) where an entity is required to present the effects of changes in 'own credit' in other comprehensive income (OCI), the entity is required to disclose:

- The amount of cumulative change in the fair value of the financial liability that is attributable to changes in 'own credit'
- The difference between the financial liability's carrying amount and the amount that is due at maturity
- Transfers of cumulative gains or loss within equity during the period and the reasons for transfers
- If a liability is derecognised during the period, the amount in OCI that was realised at derecognition (IFRS 7.10).

The gains or losses from financial liabilities designated at FVTPL are required to be disclosed separately from those financial assets or financial liabilities that are required to be measured at FVTPL (e.g. derivatives). For financial liabilities designated at FVTPL, an entity is required to show separately the amount of net gains or losses recognised in other comprehensive income and the amount recognised in profit or loss (IFRS 7.20(a)(i)).

If an entity presents all gains or losses on a financial liability designated at FVTPL in profit or loss because presenting the effects of 'own credit' in OCI would create or enlarge an accounting mismatch, the entity is required to disclose:

- The cumulative fair value change, and the fair value change during the period that is attributable to changes in 'own credit', and
- The difference between the carrying amount of the financial liability and the amount that is due at maturity.

APPENDIX A1 – KEY DIFFERENCES BETWEEN IFRS 9 AND IAS 39

Overview

This section discusses the key differences between IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*.

The following table provides a comparison of key aspects of IAS 39 and IFRS 9:

	IAS 39	IFRS 9
Scope	No substantive changes	
Recognition/Derecognition	No substantive changes	
Classification of financial assets	Four categories: – Fair value through profit or loss (FVTPL) – Loans and receivables – Held to maturity (HTM) – Available-for-sale financial assets.	Four categories: – Amortised cost – Equity investments at fair value through other comprehensive income (FVOCI for equities) – Debt instruments at fair value through other comprehensive income (FVOCI for debt)* – Fair value through profit or loss (FVTPL).
Classification of financial liabilities	Two categories: – Fair value through profit or loss (FVPTL) – Amortised cost.	No change. However, for financial liabilities designated at FVTPL under the fair value option, the fair value changes arising from changes in the entity's own credit risk are typically recognised in other comprehensive income (OCI).
Hybrid contracts (contracts with embedded derivatives)	Separate (bifurcate) if the embedded derivative is not closely related to the host contract and the entire contract is not measured at FVTPL.	No separation (bifurcation) for financial assets. Separation (bifurcation) remains for financial liabilities and contracts for non-financial assets and liabilities.

* *New category added under IFRS 9 compared to previous versions of IFRS 9.*

Figure 8: Comparison of the key differences between IAS 39 and IFRS 9

Unquoted equity instruments

IFRS 9 requires all investments in equity instruments (e.g. investments in shares of a listed company) within its scope to be measured at fair value. This represents a change from IAS 39, which contains (a very limited) exception for unquoted equity instruments to be measured at cost if their fair value cannot be reliably measured (refer to IAS 39.46(c)).

IFRS 9, however does note that, in certain limited circumstances, cost may be an appropriate estimate of fair value for unquoted equity instruments. That may be the case if there is not enough recent information available to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within the range. However, IFRS 9 is clear that the use of cost as an approximation of fair value applies in very limited and rare circumstances. The following list details indicators of circumstances in which this approach would not be appropriate:

- Significant changes in the performance of the investee compared with budgets, plans or milestones
- Changes in expectation that the investee's technical product milestones will be achieved
- Significant changes in the market for the investee's equity or its products or potential products
- A significant change in the performance of comparable entities, or in the valuations implied by the overall market
- Internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy
- Evidence of fair value from external transactions in the investee's equity, either by the investee, (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

The IASB has noted in its Basis for Conclusions to IFRS 9, that the use of cost as an approximation of fair value would never apply to equity instruments held by entities such as financial institutions or investment funds.

The IFRS Foundation has published educational material to assist entities in determining the fair value of unquoted equity instruments.

Available-for-sale (IAS 39) vs. debt and equity investments at FVOCI (IFRS 9)

Although they might initially appear similar, a number of differences exist between the IAS 39 'available-for-sale' (AFS) category and the IFRS 9 'fair value through other comprehensive income' (FVOCI) category.

The IFRS 9 FVOCI category is available on an optional basis for equity investments, and is mandatory for certain financial assets. In contrast, the AFS category under IAS 39 is either mandatory (as a residual category) or on an optional basis for items that are not required to be classified as at FVTPL for both debt and equity instruments.

On disposal of an equity investment, there is no recycling of the cumulative fair value changes from OCI to profit or loss under IFRS 9, whereas under IAS 39 the cumulative fair value changes in OCI are reclassified to profit or loss on disposal of the AFS financial asset.

On disposal of a financial asset that is required by IFRS 9 to be measured at FVOCI, the cumulative gain or loss previously recognised in OCI is recycled to profit or loss. While IAS 39 would also require this recycling, the amounts may be different.

Under IAS 39, where there is a 'significant or prolonged' decline in fair value below cost of an equity investment, the difference between the fair value and cost is recognised as an impairment loss in profit or loss. Subsequent recoveries in fair value of the equity investment are recorded in OCI (not profit or loss). However under the FVOCI category in IFRS 9, there is no 'significant or prolonged' impairment test, instead all fair value changes are recognised in OCI.

For other financial assets, IAS 39 requires impairment losses to be recorded in profit or loss. However, impairment losses can be reversed through profit or loss if the fair value of the financial asset subsequently increases. For financial assets that are required by IFRS 9 to be measured at FVOCI, impairment losses (and any reversals) are recorded in profit or loss as if the financial assets were measured at amortised cost.

BDO comment

Under IAS 39, when considering the impairment of investments in equity instruments, issues arise in practice when determining what constitutes a significant or prolonged decline below cost, and there is diversity among different entities and (more particularly) different jurisdictions. The issue became especially prominent during the financial crisis where there was significant volatility and substantial declines in asset values in financial markets. Many entities were reluctant to record an impairment charge against the carrying value of an equity investment because of the inability to reverse that impairment write-down in profit or loss (any subsequent fair value recoveries are to be recorded in OCI in accordance with IAS 39).

Example 13 – Difference between available for sale under IAS 39 and FVOCI under IFRS 9 for an equity instrument

Entity X has a 31 December financial year end. On 1 January 20X3, Entity X acquires 100 shares of List Co for CU100. On 31 December 20X3, there has been a significant decline in the share price of List Co and the fair value of 100 shares in List Co is CU60. On 31 December 20X4, the fair value of 100 shares in List Co is CU110 and Entity K decides to dispose of the shares. Tax effects have been ignored in this example. The journal entries under IAS 39 and IFRS 9 are as follows:

1 January 20X3

IAS 39 AFS category			
Dr	AFS asset	CU100	
Cr	Cash		CU100

Being the purchase of 100 shares in List Co.

IFRS 9 FVOCI category			
Dr	FVOCI equity investment	CU100	
Cr	Cash		CU100

Being the purchase of 100 shares in List Co.

31 December 20X3

IAS 39 AFS category			
Dr	Profit or loss	CU40	
Cr	AFS asset		CU40

Being the impairment of List Co shares.

IFRS 9 FVOCI category			
Dr	OCI	CU40	
Cr	FVOCI equity investment		CU40

Being the change in fair value of List Co shares.

31 December 20X4

IAS 39 AFS category			
Dr	AFS asset	CU50	
Cr	AFS reserve		CU50

Being the change in fair value of List Co shares.

IFRS 9 FVOCI category			
Dr	FVOCI equity investment	CU50	
Cr	OCI		CU50

Being the change in fair value of List Co shares.

IAS 39 AFS category			
Dr	Cash	CU110	
Dr	AFS reserve	CU50	
Cr	AFS asset		CU110
Cr	Profit or loss		CU50

Being the disposal of the List Co shares and the recycling of the accumulated AFS reserve to profit or loss.

IFRS 9 FVOCI category			
Dr	Cash	CU110	
Cr	FVOCI equity investment		CU110

Being the disposal of the List Co shares.
Note that there is no recycling of accumulated other comprehensive income to profit or loss.

Financial liabilities designated at fair value through profit or loss

A key change under IFRS 9 for financial liabilities is the presentation of the fair value changes relating to own credit risk for financial liabilities that have been designated at fair value through profit or loss.

This change mainly affects financial institutions (but can also apply to entities that have issued convertible notes with derivative liabilities and have designated them as at FVTPL, or have used the fair value option as an alternative to fair value hedge accounting).

See Section 6 for more details.

Embedded derivative in financial asset contracts

IAS 39 requires an embedded derivative to be separately accounted (bifurcated) from its host contract if certain conditions are met.

IFRS 9 eliminates the requirement to bifurcate embedded derivatives for financial assets. Instead, IFRS 9 requires entities to assess the hybrid contract as a whole for classification.

Note that the requirement to bifurcate embedded derivatives still applies for financial liabilities and to all contracts that are not financial instruments within the scope of IFRS 9.

See Section 7 above for more details.

Example 14 – Classification of a government bond

Entity A is a property developer. It has recently completed a property development project and has CU100 million of cash. It decides to invest the cash in a 5 year government bonds to generate interest income. Government bonds are quoted and actively traded in this particular market. Entity A is currently actively looking for the next suitable property development project. When a suitable project arises, Entity A intends to sell the government bonds and use the proceeds to fund the new project.

Question: How should the 5 year government bond be classified under IAS 39 and IFRS 9?

Answer:

Classification under IAS 39

Under IAS 39, the government bond:

- Will not qualify for classification as loans and receivables (as it is quoted)
- Will not qualify for classification as held-to-maturity (as Entity A does not have the positive intention of holding the government bond to maturity).

Therefore, Entity A would classify the government bond as available-for-sale, unless it opts to designate the bond as at FVTPL.

Classification under IFRS 9

IFRS 9 does allow some sales under the hold-to-collect business model test.

Given the circumstances described above, the bond is unlikely to meet the hold-to-collect business model test and the SPPI test (see Section 4.1. for more details). This is because Entity A effectively 'stands ready' to sell the bond at any point at which a suitable property development project arises.

The government bond may meet the 'hold-to-collect and sell' business model, in which case it will be measured at FVOCI under IFRS 9 (see Section 4.2 for more details).

Example 15 – Contingent consideration receivable

Entity B owns five retail chains. It sells one of its retail chains to Entity C. As part of the sales consideration receivable, Entity B is entitled to additional consideration if the retail chain meets certain profit targets over the next 3 years.

Question: How should the contingent consideration receivable be classified under IAS 39 and IFRS 9?

Answer:

Under IAS 39, Entity B would classify the contingent consideration receivable as available for sale financial asset.

Under IFRS 9, the contingent consideration receivable would be measured at fair value through profit or loss because the contingent consideration does not meet the 'SPPI' contractual cash flow test and therefore does not qualify for amortised cost or FVOCI measurement.

List of Examples

CONTACT

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below. Alternatively, please visit **www.bdointernational.com/Services/Audit/IFRS/IFRS Country Leaders** where you can find full lists of regional and country contacts.

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