

In depth

A look at current financial reporting issues



IFRS 9 – Classification and measurement

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At a glance

On July 24, 2014 the IASB published the complete version of IFRS 9, *Financial Instruments*, which replaces most of the guidance in IAS 39. This includes amended guidance for the classification and measurement of financial assets by introducing a fair value through other comprehensive income category for certain debt instruments. It also contains a new impairment model which will result in earlier recognition of losses.

No changes were introduced for the classification and measurement of financial liabilities, except for the recognition of changes in own credit risk in other comprehensive income for liabilities designated at fair value through profit or loss. It also includes the new hedging guidance that was issued in November 2013. These changes are likely to have a significant impact on entities that have significant financial assets and in particular financial institutions. IFRS 9 will be effective for annual periods beginning on or after January 1, 2018, subject to endorsement in certain territories.

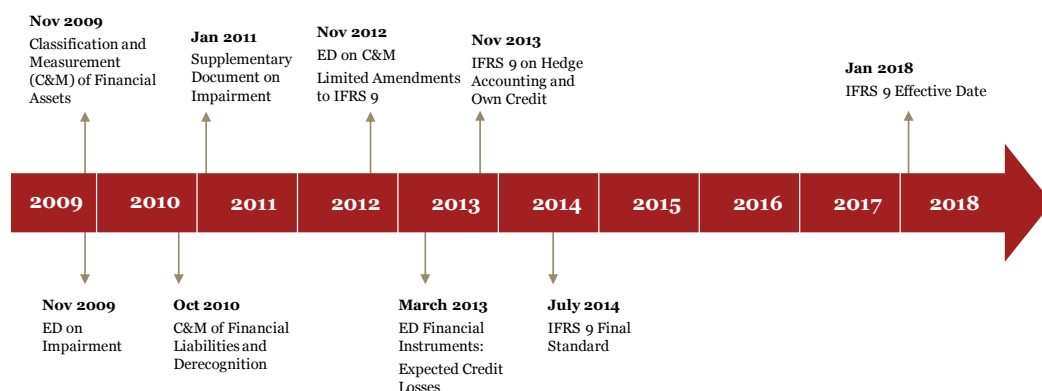
This publication considers the changes to classification and measurement of financial assets. Further details on the new impairment model are included in [In depth US2014-06, IFRS 9 - Expected credit losses](#). The general hedging model is covered in [Dataline 2014-03, Accounting for hedging activities - IASB new general hedge accounting requirements](#).

Background

.1 During the financial crisis, the G20 tasked global accounting standard setters to work towards the objective of creating a single set of high-quality global standards. In response to this request, the IASB and FASB began to work together on the development of new financial instruments standards. The IASB decided to accelerate its project to replace IAS 39, and sub-divided it into three main phases: classification and measurement; impairment; and hedging. Macro hedging¹ is being considered as a separate project.

¹ The Discussion Paper on Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging was issued in April 2014.

Brief history and timeline of IFRS 9



.2 In November 2009, the IASB issued IFRS 9 (2009), the first milestone in the project to replace IAS 39. This standard required the classification and measurement of financial assets into only two categories: amortized cost, and fair value through profit or loss (“FVPL”).

.3 In October 2010, the IASB published the updated IFRS 9 (2010), *Financial instruments*, to include guidance on financial liabilities and derecognition of financial instruments, and in particular the requirement to present changes in own credit risk on liabilities at fair value in other comprehensive income (“OCI”).

.4 In March 2013, the IASB issued an exposure draft (ED) on limited amendments to IFRS 9 (2010), to address specific application questions raised by interested parties as well as to try and reduce differences with the FASB. However, the FASB tentatively decided that it would not continue to pursue a classification and measurement model similar to the IASB. As a consequence, the FASB’s classification and measurement project is expected to result in few changes to current US GAAP.

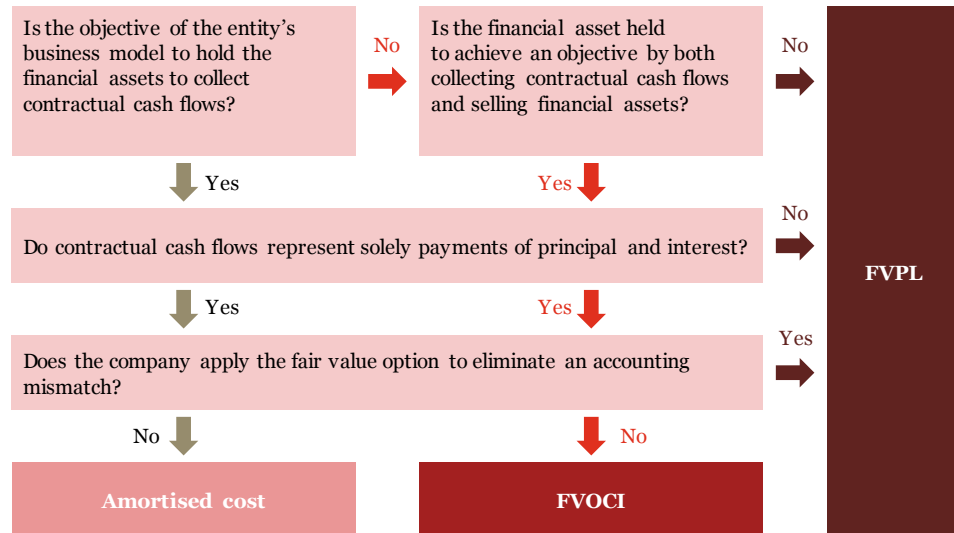
.5 In November 2013, the IASB published the final hedging requirements excluding macro hedging.

.6 In July 2014, the IASB published the new and complete version of IFRS 9 (hereafter “IFRS 9” or “the new standard”), which includes the new hedge accounting, impairment and classification and measurement requirements.

Overview of the model

.7 Classification under IFRS 9 for investments in debt instruments² is driven by the entity’s business model for managing financial assets and their contractual cash flow characteristics:

² Accounting for investments in equity instruments is addressed in a separate section of this In depth.



.8 A financial asset is measured at amortized cost if both of the following criteria are met:

- The asset is held to collect its contractual cash flows; and
- The asset's contractual cash flows represent 'solely payments of principal and interest' ("SPPI")³.

.9 Financial assets included within this category are initially recognized at fair value and subsequently measured at amortized cost.

.10 A financial asset is measured at fair value through other comprehensive income ("FVOCI") if both of the following criteria are met:

- The objective of the business model is achieved both by collecting contractual cash flows and selling financial assets; and
- The asset's contractual cash flows represent SPPI.

.11 Financial assets included within the FVOCI category are initially recognized and subsequently measured at fair value. Movements in the carrying amount should be recorded through OCI, except for the recognition of impairment gains or losses, interest revenue and foreign exchange gains and losses which are recognized in profit and loss. Where the financial asset is derecognized, the cumulative gain or loss previously recognized in OCI is reclassified from equity to profit or loss.

.12 Under the new model, FVPL is the residual category. Financial assets should be classified as FVPL if they do not meet the criteria of FVOCI or amortized cost.

.13 Financial assets included within the FVPL category should be measured at fair value with all changes recorded through profit or loss.

³ The meaning of "solely payments of principal and interest" is addressed in detail in the following sections.

.14 Regardless of the business model assessment, an entity can elect to classify a financial asset at FVPL if doing so reduces or eliminates a measurement or recognition inconsistency (“accounting mismatch”).

.15 Reclassifications between the categories are permitted, although they are expected to be rare.

.16 This is a summary of the classification and measurement model, more information on the business model assessment and SPPI condition is included below.

The model in detail

Business model assessment

.17 IFRS 9 requires that all financial assets are subsequently measured at amortized cost, FVOCI or FVPL based on the business model for managing the financial assets and their contractual cash flow characteristics. The business model is determined by the entity’s key management personnel in the way that assets are managed and their performance is reported to them.

.18 The business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. It is not an instrument-by-instrument analysis; rather it can be performed at a higher level of aggregation.

PwC observation:

A single entity can have more than one business model for managing its financial instruments. For example, an entity can hold one portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to sell to realize fair value changes.

In some circumstances, it might be appropriate to separate a portfolio of financial assets into sub-portfolios to reflect how an entity manages those financial assets. For example, that might be the case if an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them. Another example is a liquidity portfolio where some assets are held for a “stress case” scenario, (that is, holding them to collect contractual cash flows), while the remaining assets are held with the purpose of meeting an entity’s everyday liquidity needs resulting in recurring sales.

It is expected that management will divide portfolios into sub-portfolios in order to reflect the business model. This will be a highly judgmental area as it might be difficult to distinguish within a portfolio which financial assets are held to collect, to collect and sell, or to trade.

.19 An entity’s business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the objective of the business model. The business model for managing financial assets is not determined by a single factor or activity. Instead, management has to 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) is 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 that those risks are managed; and
- How managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or the contractual cash flows collected).

PwC observation:

The business model assessment is highly judgmental. It depends on facts and circumstances and the intentions of an entity as it relates to particular instruments. An entity might have the same type of instrument (such as government bonds) in all three categories depending on its intention and model for managing the assets.

Hold to collect business model

.20 If the entity’s objective is to hold the asset (or portfolio of assets) to collect the contractual cash flows, the asset (or the portfolio) will be classified under the hold to collect business model, subject to meeting the SPPI requirements.

.21 Although the objective of an entity’s business model might be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity’s business model can be to hold financial assets to collect contractual cash flows even where sales of financial assets occur or are expected to occur in the future.

.22 IFRS 9 provides guidance on the particular considerations that should be taken into account when assessing sales within the hold to collect business model:

- The historical frequency, timing and value of sales.
- The reason for the sales (such as credit deterioration).
- Expectations about future sales activity.

.23 Sales themselves do not determine the business model and therefore cannot be considered in isolation. Rather, information about past sales and expectations about future sales provide evidence related to the entity’s objective for managing the financial assets and, specifically, how cash flows are realized and value is created. Credit risk management activities aimed at minimizing potential losses due to credit deterioration are not inconsistent with the hold to collect 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, in the absence of such a policy, the entity could demonstrate in other ways that the sale occurred due to an increase in credit risk.

.24 Some sales or transfers of financial instruments before maturity not related to credit risk management activities might be consistent with such a business model if they are infrequent (even if significant in value) or insignificant in value either individually or in aggregate (even if frequent).

.25 There is no bright line for how many sales constitute “infrequent” or “insignificant”; an entity will need to use judgment based on the facts and circumstances. 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 those sales and demonstrate why those sales do not reflect a

change in the business model. In addition, sales might be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets and the proceeds from the sales approximate to the collection of the remaining contractual cash flows. The new standard includes a number of examples of how to perform the business model assessment.

PwC observation:

Even if sales do not drive the business model assessment, management should be clear about the reason for such sales when determining if sales would prevent a financial asset, or group of financial assets, from being classified within the hold to collect business model. Entities might consider setting up a process in order to track this information.

Hold to collect and sell business model

.26 An entity can hold financial assets in order to achieve a particular objective by both collecting contractual cash flows and selling financial assets; this will qualify for the “hold to collect and sell business model” (also known as the FVOCI business model). The objective of this business model is achieved by collecting contractual cash flows and selling financial assets, unlike the hold to collect business model in which the objective was to only collect contractual cash flows.

.27 Examples of business model objectives that could be consistent with the FVOCI business model are:

- Managing everyday liquidity needs;
- Maintaining a particular interest yield profile; and
- Matching the duration of the financial assets to the duration of the liabilities that those assets are funding.

.28 As previously noted, the new standard includes a number of examples of how to perform the business model assessment.

PwC observation:

The FVOCI category is intended to acknowledge the practical reality that entities might invest in debt instruments to generate yield but might also sell if the price is considered advantageous or it is necessary to periodically adjust or rebalance the entity’s net risk, duration or liquidity position. Both fair value and amortized cost information is useful in helping financial statement users to predict future cash flows for instruments in this category because of the two potential value realization paths that can be taken.

Financial institutions will need to carefully assess the overall business objective to determine whether their portfolios of financial assets are more aligned with this FVOCI business model (hold to collect and sell) or the amortized cost business model (hold to collect) or whether they fall in the residual FVPL category. Business models for such portfolios can vary widely and hence judgment will be needed to evaluate the factors for each individual portfolio.

FVPL business model

.29 If a financial asset or group of financial assets is not held within the hold to collect or the hold to collect and sell business model, then it should be measured at FVPL.

.30 FVPL is the residual category within the new standard. Nevertheless, the new standard provides certain guidance on how to identify the hold to sell business model. It states that it is the business model in which an entity manages financial assets with the objective of realizing cash flows through the sale of the assets.

.31 The entity makes decisions based on the asset's fair values and manages the assets to realize their fair values (for example, this would be the case for a trading portfolio). Even though the entity will collect contractual cash flows while it holds the financial assets, the objective of such a business model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the business model's objective; instead, it is incidental to it.

PwC observation:

Under IAS 39, assets held as part of a group that were managed and their performance evaluated on a fair value basis were eligible to be classified at FVPL, but this classification was not mandatory. Under the new requirements, these financial assets would have to be classified at FVPL.

Example 1: Business model assessment - FVPL

An entity originates loans with a view to later selling them to a securitization vehicle. On the sale to the vehicle, the loans continue to be recognized in the consolidated financial statements, but are derecognized in the separate financial statements of the originating entity.

Analysis: In the consolidated financial statements, assuming the vehicle is consolidated, the loans might be part of a portfolio managed to collect the contractual cash flows since they are not derecognized (that is, are not considered "sold" for accounting purposes). But, in the separate financial statements of the originating entity, where they will be derecognized, they cannot be considered part of a portfolio whose objective is to collect contractual cash flows or collect contractual cash flows and sell. Therefore the loans should be classified within the FVPL category in the separate financial statements.

Contractual cash flows analysis

.32 Once the business model assessment has been performed, management should assess whether the asset's contractual cash flows represent solely payments of principal and interest ("the SPPI condition"). This condition is necessary for the financial asset, or group of financial assets, to be classified at amortized cost or FVOCI.

.33 IFRS 9 provides definitions of "principal" and "interest" that will help management to make a preliminary assessment of whether contractual cash flows represent payments of solely principal and interest:

Principal: is the fair value of the financial asset at initial recognition. However, that principal amount might change over the life of the financial asset (for example if there are repayments of principal).

Interest: Is typically the compensation for the time value of money and credit risk. However, interest can also include consideration for other basic lending risks (for example liquidity risk) and costs (for example, servicing or administrative costs) associated with holding the financial asset for a period of time, as well as a profit margin.

.34 IFRS 9 establishes that instruments with contractual cash flows that are SPPI on the principal amount outstanding are consistent with a basic lending arrangement.

.35 Management has to assess whether contractual cash flows are SPPI in the currency in which the financial asset is denominated.

.36 Contractual features that introduce exposure to risks or volatility in the contractual cash flows unrelated to a basic lending arrangement, such as exposure to changes in equity or commodity prices, do not give rise to contractual cash flows that are SPPI. For example, convertible bonds and profit participating loans will not meet the SPPI condition.

PwC observation:

Many embedded derivatives introduce variability to cash flows that is not consistent with the notion that the instrument's contractual cash flows solely represent the payment of principal and interest. However, if an embedded derivative was not considered closely related under IAS 39 requirements, this does not automatically mean that the instrument will not qualify for amortized cost or FVOCI under the new standard.

There are some embedded derivatives (such as caps and floors) that might have required bifurcation under IAS 39 but might pass the SPPI condition in IFRS 9. Conversely, some hybrid contracts that would be regarded as closely related under IAS 39 might fail the SPPI condition and be measured at FVPL. See Example 2 below.

Example 2: Assessing contractual cash flows

The new standard includes a number of examples of how to assess contractual cash flows. We have included below one of the examples for illustration purposes. Instrument G is a perpetual instrument but the issuer can call the instrument at any point and pay to the holder the par amount plus accrued interest due. Instrument G pays a market interest rate but payments of interest cannot be made unless the issuer is able to remain solvent immediately afterwards. Deferred interest does not accrue additional interest.

Analysis: The fact that Instrument G 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 can result in contractual cash flows that meet the SPPI condition if interest payments are mandatory and must be paid in perpetuity.

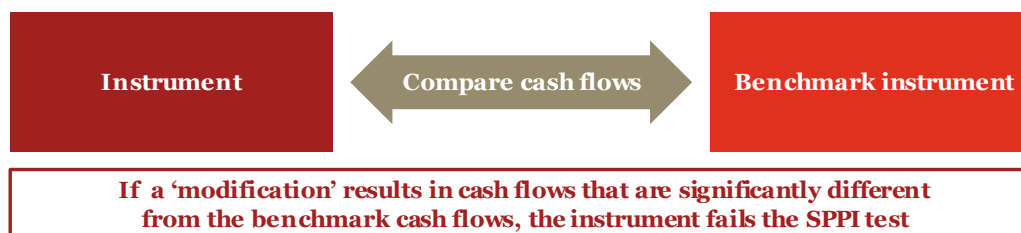
However, in this example, the contractual cash flows do not meet the SPPI condition; that is because the issuer could be required to defer interest payments, and additional interest does not accrue in those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding. If interest would have been accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.

Modified solely payments of principal and interest

.37 The new standard provides guidance on how to assess whether contractual cash flows represent SPPI where the time value of money element of interest⁴ has been modified (“the modified time value of money element”).

.38 Both qualitative and quantitative approaches can be used to determine whether the time value of money element of the interest rate provides consideration for just the passage of time.

.39 When assessing a financial asset with a modified time value of money element, the new standard proposes that an entity should compare the financial asset under assessment to the “perfect” (“benchmark”) instrument (that is, the cash flows that would arise if the time value of money element was not modified). If the difference between the cash flows of the benchmark instrument and the cash flows of the instrument under assessment are significantly different, its contractual cash flows are not considered SPPI and the instrument must be measured at FVPL.



.40 It is not necessary to perform a detailed quantitative assessment if it is clear with little or no analysis that the cash flows of the instrument with a modified time value of money element are or are not significantly different from the benchmark cash flows (that is, “qualitative assessment” only).

.41 In performing a quantitative assessment for the instruments in scope of this test, several factors need to be considered:

- An entity compares contractual undiscounted cash flows of the instrument with the contractual undiscounted cash flows that would arise if the time value of money element was not modified (that is, the benchmark cash flows).
- The appropriate comparable “benchmark” instrument is one with the same credit quality and the same contractual terms (for example, the same reset terms) except for the modification being evaluated.
- The benchmark instrument can be an actual or a hypothetical financial asset (that is, it does not need to exist in the market nor is it based on a market norm).
- An entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the instrument.
- An entity considers only reasonably possible scenarios rather than every possible scenario. However, the new standard requires a range of scenarios, which means that more than one scenario needs to be evaluated.

⁴ Time value of money is the element of interest that provides consideration for the passage of time.

PwC observation:

A debt instrument with a modified time value of money element is assessed at initial recognition in order to appropriately classify and measure it. For example, consider a bond that matures in ten years containing a constant maturity reset feature where the interest rate resets annually to a ten-year rate of interest. The interest is linked to the bond's original maturity.

The test compares the contractual undiscounted cash flows on this bond to those on a bond that resets annually to a one-year rate. It should consider whether the cash flows of the two bonds could be significantly different. The test should consider a number of different interest rate scenarios, and how the relationship between the one-year rate and a ten-year rate could change over the life of the instrument. However, it is only necessary to consider reasonably possible scenarios rather than every possible scenario. If in any reasonably possible scenario, the cash flows are significantly different from the benchmark cash flows (that is, based on a one-year rate), the bond will not meet the SPPI condition (and must be measured at FVPL).

.42 In some jurisdictions, the government or a regulatory authority establishes interest rates. In some cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, a regulated interest rate could be used as a proxy for the time value of money element for the purpose of applying the SPPI condition 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. In this case a qualitative assessment would be sufficient to assess that the financial asset meets the SPPI condition.

PwC observation:

This exception for regulated interest rates provides relief for certain jurisdictions where regulated interest rates would otherwise make the instrument fail the SPPI condition and therefore be classified as FVPL.

During deliberations, the IASB analyzed the case of certain loans in China, where interest rates are regulated by the government and are reset according to the original maturity of the loan rather than according to the remaining maturity or the period until the next reset date (for example, where the interest rate is reset to a three-year rate because the instrument has an original maturity of three years); or in some cases are not reset at all.

Under the exception, this type of feature would not make the instrument fail the SPPI condition, as long as the 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.

'De minimis' features

.43 An entity does not need to take into consideration any contractual cash flows characteristics that do not represent SPPI if they could only have a 'de minimis' effect on the contractual cash flows of the asset.

.44 In considering whether the effect is 'de minimis', 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. Additionally, if a contractual cash

flow characteristic could have an effect on the contractual cash flows that is more than de minimis, but that cash flow characteristic is not genuine, it does not affect the classification of a financial asset.

PwC observation:

The new standard establishes that a feature is non 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. In practice it will require judgment to assess whether a contractual feature could be considered non-genuine, and therefore be disregarded when assessing whether cash flows are SPPI.

Example 3: Cash flow characteristics with a 'de minimis' effect

A financial asset contains a contractual provision that requires the issuer to comply with applicable regulatory requirements, including filing its financial statements with a regulatory body on a timely basis. If the issuer fails to do so, it is required to pay a small fixed fee for each day until the financial statements are filed.

Analysis: The existence of a fee that could be triggered if the issuer fails to file its financial statements on time is not inconsistent with the SPPI condition, because its impact on the asset's contractual cash flows is always 'de minimis'. This would apply to any feature regardless of its nature or trigger, as long as its impact on the asset's contractual cash flows is always 'de minimis'.

Contingent events affecting cash flows

.45 The new standard clarifies whether contingent events affecting cash flows are considered SPPI. The entity must determine whether the contractual cash flows that could arise over the life of the instrument due to the contingent event meet the SPPI condition. Management has to assess the contractual cash flows that would arise, both before and after the change in contractual cash flows arising from the contingent event. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are SPPI, it might be an indicator.

Example 4: Contingent contractual cash flows

A non-financial institution holds a bond which pays LIBOR + 2%. The contractual provisions of the instrument establish that if the issuer credit rating deteriorates, the interest rate of the entire instrument will be reset to LIBOR + 3%.

Analysis: The resulting change in contractual cash flows is likely to represent consideration for the increased credit risk of the instrument; therefore, it would meet the SPPI condition. However, if the interest rate is reset to a higher rate in the event that a specified equity index reaches a particular level, that change in the contractual cash flows is unlikely to result in contractual cash flows over the life of the instrument that are SPPI on the principal amount outstanding.

Prepayment and extension options

.46 The new standard includes some additional considerations for financial assets that include a prepayment or an extension option.

IFRS 9 establishes that management must still determine whether the contractual cash flows that could arise over the life of the instrument due to those contractual provisions meet the SPPI condition. The following are examples of contractual provisions that meet the SPPI condition:

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

.47 In addition, the new standard establishes an exception for those instruments that do not meet the SPPI condition because of the prepayment feature and comply with the following conditions:

- The entity acquires or originates the financial asset at a premium or discount to the contractual par amount;
- The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which might include reasonable additional compensation for the early termination of the contract; and
- When the entity initially recognizes the financial asset, the fair value of the prepayment feature is insignificant.

.48 If these conditions are met, the financial asset could still be included within the amortized cost or FVOCI category even if it does not meet the SPPI condition.

PwC observation:

In the context of a business combination or the acquisition of a portfolio of fixed interest rate loans, the acquirer will recognize the loan portfolio at fair value on the balance sheet. The acquirer must then classify the acquired loans based on facts and circumstances that exist on the date of acquisition.

In many European countries, retail mortgages are required by law to include prepayment options with penalties being capped at a certain threshold. Therefore, when interest rates fall, this increases the likelihood that borrowers may exercise their prepayment options. Statistically, although borrowers might have a financial incentive to prepay their mortgages (that is, to refinance at a more favorable interest rate), a significant proportion of borrowers do not exercise their prepayment options. This is why, in a period of falling interest rates, the fair value of such mortgages might continue to be worth more than the exercise price of the prepayment option despite such prepayment options having value to the respective borrowers.

Under the new model, this feature might cause such loans to fail the SPPI condition and be classified as FVPL following a business combination, unless the conditions set out above are met.

Contractually linked instruments (tranches)

.49 The payments on some financial assets are contractually linked to payments received on a pool of other instruments. These are referred to as contractually linked instruments. The holders of such instruments 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.

.50 The classification criteria for the holder of such contractually linked instruments (tranches) should be assessed based on the conditions at the date that the entity initially recognized the investment using a “look through” approach. This approach looks at the terms of the instrument itself, as well as through to the pool of underlying instruments. The assessment considers both the characteristics of these underlying instruments and the tranche’s exposure to credit risk relative to the pool of underlying instruments.

.51 The tranche itself (without looking through to the pool of underlying instruments) must give rise to cash flows that are SPPI to measure the individual tranche at amortized cost or FVOCI. The underlying pool must contain one or more instruments that have contractual cash flows that are SPPI on the principal outstanding. In this context, the underlying pool is that which creates (rather than passes through) the cash flows.

.52 The underlying pool of instruments might also include instruments that:

- Reduce the variability of the instruments in the underlying pool (for example, an interest rate cap or floor or a contract that reduces the credit risk of the underlying pool of instruments); and
- Align the cash flows of the tranches with the cash flows of the pool of underlying instruments 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 currency; or
 - The timing of the cash flows.

.53 In addition, the credit rating of the tranche being assessed must be equal to or higher than the credit rating that would apply to a single tranche funding the underlying pool of financial instruments.

PwC observation:

The new standard does not address how the weighted average credit risk test should be performed. A simple way might involve comparing the credit rating of the tranche to the average credit rating of the underlying pool of assets if that gives a clear answer. If not, a more complex quantitative assessment might be required that compares the relative variability of the tranche held with that of the underlying assets.

.54 The tranche is required to be measured at FVPL if any instrument in the pool:

- Does not meet the conditions outlined above; or
- The composition of the underlying pool might change after the initial recognition such that it would no longer meet the qualifying conditions; or

- It is impracticable to look through.

.55 However, if the underlying pool includes instruments that are collateralized by assets that do not meet the conditions set out above, the collateral is disregarded, unless the entity acquired the tranche with the intention of controlling the collateral.

PwC observation:

It is not necessary to perform a detailed instrument-by-instrument analysis. However, management must use appropriate judgment and perform sufficient analysis to determine whether the instruments in the pool meet the conditions explained above.

Non-recourse

.56 A non-recourse provision is an agreement that allows the creditor to look only to the securing assets (whether financial or non-financial) to recover its claim when the debtor defaults on a secured obligation. If the debtor fails to pay and the specific assets fail to satisfy the full claim, the creditor has no legal recourse against the debtor's other assets. The fact that a financial asset is non-recourse does not necessarily preclude the financial asset from meeting the condition to be classified at amortized cost or FVOCI.

.57 If a non-recourse provision exists, the creditor is required to assess (that is, to “look through to”) the particular underlying assets or cash flows to determine whether the financial asset's contractual cash flows are SPPI. If the instrument's terms give rise to any other cash flows or limit the cash flows in a manner inconsistent with the SPPI condition, the instrument will be measured in its entirety at FVPL. Examples that might be inconsistent with the SPPI condition are:

- Where the amount of the cash flows that are contractually due varies with the asset's performance (such as where the number of cars that drive down a toll road determines the amounts to be paid); or
- A loan that can be pre-paid at an amount that varies with the value of an underlying asset.

PwC observation:

There is limited guidance as to how the existence of a non-recourse feature might impact the classification of non-recourse loans at amortized cost or FVOCI. Judgment will be needed to assess these types of lending relationships.

Example 5: Non-recourse to portfolio of equity instruments

A bank has provided a loan to a borrower with a fixed rate of interest and fixed maturity date. The loan is secured on a non-recourse basis on a portfolio of equity instruments (shares). As such, at maturity of the loan, the borrower intends to sell the shares and use the proceeds to repay the loan. The borrower would keep any upside in the share price, but the bank would suffer any loss. The pricing in this case is the same as a written put option on the shares.

Analysis: This loan is likely to fail the SPPI requirement, as the amount of cash to be repaid varies with the performance of the equity instruments.

Reclassification

.58 Once the initial classification has been determined, the new standard provides guidance on when an entity should reclassify a (group of) financial instrument(s).

.59 IFRS 9 establishes that, if cash flows are realized in a way that is different from the entity's expectations at the date that management assessed the business model, this fact does not give rise to a prior period error in the entity's financial statements (in accordance with IAS 8). For example, if the entity sells more or fewer financial assets than it expected when it classified the assets. It also does not change the classification of the remaining financial assets held in that business model (that is, those assets that the entity recognized in prior periods and still holds), as long as the entity considered all relevant and objective information that was available at the time that it made the business model assessment.

.60 Reclassifications should be accounted for only when an entity changes its business model for managing financial assets. Changes to the business model are expected to be infrequent; the change is determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and should be evident to external parties. A change in an entity's business model will occur when an entity either begins or ceases to perform an activity that is significant to its operations.

.61 Reclassifications should be accounted for prospectively from the reclassification date. An entity should not restate any previously recognized gains, losses (including impairment gains or losses) or interest.

.62 The following table shows the different reclassification scenarios and their accounting consequences:

Original category	New category	Accounting impact
Amortized cost	FVPL	Fair value is measured at reclassification date. Difference from carrying amount should be recognized in profit or loss.
FVPL	Amortized Cost	Fair value at the reclassification date becomes its new gross carrying amount ⁵ .
Amortized cost	FVOCI	Fair value is measured at reclassification date. Difference from amortized cost should be recognized in OCI. Effective interest rate is not adjusted as a result of the reclassification.
FVOCI	Amortized cost	Fair value at the reclassification date becomes its new amortized cost carrying amount. Cumulative gain or loss in OCI is adjusted against the fair value of the financial asset at reclassification date.
FVPL	FVOCI	Fair value at reclassification date becomes its new carrying amount ⁵ .
FVOCI	FVPL	Fair value at reclassification date becomes carrying amount. Cumulative gain or loss on OCI is reclassified to profit or loss at

⁵ Effective interest rate is determined on the basis of the fair value at reclassification date.

Equity instruments

.63 Investments in equity instruments are always measured at fair value. Equity instruments are those that meet the definition of “equity” from the perspective of the issuer as defined in IAS 32. Equity instruments that are held for trading are required to be classified at FVPL. For all other equities, management has the ability to make an irrevocable election on initial recognition, on an instrument-by-instrument basis, to present changes in fair value in OCI rather than profit or loss. If this election is made, all fair value changes, excluding dividends that are a return on investment, will be included in OCI. There is no recycling of amounts from OCI to profit and loss (for example, on sale of an equity investment), nor are there any impairment requirements. However, the entity might transfer the cumulative gain or loss within equity.

Example 6: Investment in a puttable share

An entity (the holder) invests in a fund that has puttable shares in issue – that is, the holder has the right to put the shares back to the fund in exchange for its pro rata share of the net assets.

Analysis: The puttable shares might meet the requirements to be classified as equity from the issuer’s perspective, but this is an exception within IAS 32. Instruments meeting the provisions of paragraphs 16A-16E of IAS 32 do not meet the definition of equity in IAS 32.

So, investments in puttable shares are required to be classified as FVPL, as they cannot be regarded as equity instruments for IFRS 9. Although they are considered investments in debt, they do not meet the SPPI condition.

Example 7: Equity instruments

An entity (the holder) invests in a subordinated perpetual note, redeemable at the issuer's option, with a fixed coupon that can be deferred indefinitely if the issuer does not pay a dividend on its ordinary shares.

Analysis: The issuer has no contractual obligation to pay the cash flows associated with the instrument, so it classifies the instrument as equity under IAS 32. The holder has the option to classify this investment at FVOCI under IFRS 9 or to classify it as at FVPL.

.64 Additionally, the new standard removes the requirement in IAS 39 to measure unquoted equity investments at cost where the fair value cannot be determined reliably. But it indicates that, in limited circumstances, cost might be used as an estimate of fair value⁶. For example, this might include where more recent available information is insufficient to determine fair value; or where there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.

.65 IFRS 9 includes indicators of where cost might not be representative of fair value. These are:

⁶ In the Basis for Conclusions, the IASB states that this would not be applicable to equity investments held by financial institutions or investment funds.

- A significant change in the investee's performance compared with budgets, plans or milestones.
- Changes in expectation that the investee's technical product milestones will be achieved.
- A significant change in the market for the investee's equity or its products or potential products.
- A significant change in the global economy or the economic environment in which the investee operates.
- 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, or changes in management or strategy.
- Evidence 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.

Financial liabilities

.66 The classification and measurement of financial liabilities under IFRS 9 remains the same as in IAS 39, except where an entity has chosen to measure a financial liability at FVPL. For such liabilities, changes in fair value related to changes in own credit risk, are presented separately in OCI.

.67 Amounts in OCI relating to own credit are not recycled to profit or loss even when the liability is derecognized and the amounts are realized. However, the new standard does allow transfers within equity.

.68 Entities are still required to separate derivatives embedded in financial liabilities where they are not closely related to the host contract. The guidance for separating embedded derivatives is consistent with that in IAS 39.

Transition

.69 IFRS 9 allows entities to early adopt the new standard. However, after February 1, 2015, entities can only early adopt the final version of IFRS 9 (and not previous versions).

.70 If an entity elects to early apply the new standard, it is required to apply all the provisions in the new standard including hedge accounting and own credit risk. However, entities have an accounting policy choice, either to apply IFRS 9 hedge accounting or to continue applying IAS 39 hedge accounting. This accounting policy choice is available until the macro hedging project is completed and should be applied consistently to all hedge relationships.

.71 In addition, an entity can choose to early apply the own credit risk requirements only, without applying the rest of the requirements in the new standard; this option is available until the mandatory effective date of January 1, 2018.

.72 The new standard is applied retrospectively (although some exceptions apply); however, at the date of initial application⁷ management is required to perform the business model assessment based on the facts that existed at that date.

PwC observation:

Management is required to perform the business model assessment based on the circumstances that exist as at the date of initial application. However they will need to determine whether a financial asset complied with the SPPI condition based on the facts that existed at the date of the instrument's initial recognition.

.73 Restatement of comparatives is not required but entities are permitted to restate comparatives if they can do so without the use of hindsight. If an entity does not restate comparatives, it should adjust the opening balance of its retained earnings to take account of the effect of applying the new standard in the year of initial application.

.74 IFRS 9 includes some operational simplifications in order to ease retrospective application. All of these simplifications apply at the date of initial application, which must be the beginning of a reporting period after the issue of the new standard.

- If at the date of initial application it is impracticable to:
 - Assess a modified time value of money element (that is, contractual cash flow test) based on the facts and circumstances that existed at the initial recognition of the financial asset; or
 - Assess whether the fair value of a prepayment feature was insignificant, based on the facts and circumstances that existed at the initial recognition of the financial asset;

Management should assess the contractual cash flow characteristics of that financial asset, based on the facts and circumstances that existed at the initial recognition of the asset, without taking into account the requirements related to the modification of the time value of money element or the exception for prepayment features.

- If it is impracticable for an entity to apply retrospectively the effective interest method, the entity should treat:
 - the fair value of the financial asset or the financial liability at the end of each comparative period presented as its amortized cost if the entity restates prior periods; or
 - the fair value of the financial asset or the financial liability at the date of initial application as the new amortized cost of that financial asset or financial liability.

Transition disclosures

.75 On transition an entity needs to provide detailed financial information for users to understand the changes arising from the initial application of IFRS 9. For example, an entity needs to disclose:

- For each class of financial assets and financial liabilities, the original measurement category and carrying amount (determined in accordance with IAS 39 or a previous

⁷ The date of initial application is the date in which the entity first applies the new standard and must be the beginning of a reporting period.

version of IFRS 9) and the new measurement category and carrying amount determined in accordance with IFRS 9.

- The amount of any financial assets and financial liabilities in the statement of financial position that were previously designated as measured at FVPL but are no longer designated as such, distinguishing between those that IFRS 9 requires an entity to reclassify and those that an entity elects to reclassify at the date of initial application.
- Information to enable users to understand: (i) how it applied the classification requirements in the new standard; and (ii) the reasons for any designation or de-designation of financial assets or financial liabilities, as measured at FVPL at the date of initial application.
- Information to enable users to understand changes in carrying amounts and information about the reclassifications out of the FVPL category.

.76 Sample disclosures are included as part of the IFRS 7 Implementation Guidance (as amended by the final IFRS 9).

PwC observation:

If an entity treats the fair value of a financial asset or a financial liability as the new gross carrying amount at the date of initial application (see Operational Simplifications above), disclosures should be provided for each reporting period until derecognition.

Implementation challenges

.77 The new classification and measurement requirements will represent a challenge, especially for financial institutions, as management will need to assess their financial assets classification in light of the new business model requirements. This new model is substantially different from the previous guidance in IAS 39. The business model assessment is a highly judgmental area that depends mostly on facts and circumstances, so entities are expected to document the reasons behind their assessment (including the SPPI condition) as well as monitor sales in order to determine whether they meet the requirements in the new standard.

.78 Since part of the business model assessment is also dependent on the history of how the entity has achieved the objective in the business model (for example, whether there has been significant recurring sales), entities should start tracking this information as soon as possible in order to have sufficient history to make the comparison.

.79 This process might take a significant amount of time, so it is advisable that entities should start planning their transition to IFRS 9 in order to make sure that they are ready for when the new standard becomes effective.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (1-973-236-7803).

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