

Practical guide to IFRS

IASB completes first phase of IFRS 9 – accounting for financial instruments

At a glance

- The IASB completed part of the first phase of this project on financial assets and issued IFRS 9, 'Financial instruments', in November 2009.
- IFRS 9 was updated in November 2010 to include guidance on financial liabilities and derecognising financial instruments.
- IFRS 9 replaces the multiple classification and measurement models for financial assets in IAS 39, 'Financial Instruments: Recognition and measurement', with a model that has only two classification categories: amortised cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets.
- The accounting and presentation for financial liabilities and for derecognising financial instruments has been relocated from IAS 39 without change except for financial liabilities that are designated at fair value through profit or loss.

IFRS 9 is effective for annual periods beginning on or after 1 January 2013. Early application is permitted, although IFRS 9 has not yet been endorsed for use in the EU.

Background

The IASB has been reviewing accounting issues that have emerged as a result of the recent global financial crisis, including those identified by the

G20 and other international bodies such as the Financial Stability Board. The IASB is working with the FASB to produce a globally consistent response to the crisis. As part of this, the IASB has accelerated its project to replace IAS 39 and sub-divided it into three main phases: classification and measurement, impairment and hedging. The IASB completed part of the first phase of this project (classification and measurement) for financial assets in November 2009; it completed financial liabilities in November 2010.

The IASB also considered changes to the guidance that addresses when financial instruments are derecognised, (this was in response to concerns over whether off-balance-sheet structures were appropriately treated during the financial crisis). No changes were made to the accounting, but improved disclosures are now required.

IFRS 9 now contains guidance for:

- recognising and derecognising financial instruments;
- classifying and measuring financial assets; and
- classifying and measuring financial liabilities.

This 'practical guide' explains the requirements in IFRS 9 for accounting for financial assets and financial liabilities. The other phases of the project cover impairment and hedge accounting. A final standard on these is expected by June 2011.

Structure of this practical guide

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Objective

IFRS 9's objective is to establish principles for the financial reporting of financial instruments that will present relevant and useful information to users of financial statements for their assessment of amounts, timing and uncertainty of the entity's future cash flows.

Scope

IFRS 9 generally has to be applied by all entities preparing their financial statements in accordance with IFRS and to all types of financial instruments within the scope of IAS 39, including derivatives. Any financial instruments that are currently accounted for under IAS 39 will fall within the IFRS 9's scope.

Recognition and derecognition

Initial recognition

Consistent with IAS 39, all financial instruments in IFRS 9 are to be initially recognised at fair value, plus or minus – in the case of a financial instrument that is not at fair value through profit or loss – transaction costs that are directly attributable to the acquisition or issue of the financial instrument.

Derecognition

The guidance (including associated application and implementation guidance) on derecognising financial assets and financial liabilities in IAS 39 has been relocated unchanged to IFRS 9.

PwC observation: The accounting guidance has not changed in IFRS 9 for derecognising financial asset and liabilities, but the IASB issued new disclosure requirements for transferred assets in October 2010. These disclosures are discussed later.

Classification and measurement – financial assets

Classification model

If the financial asset is a debt instrument (or does not meet the definition of an equity instrument in its entirety from an IAS 32 perspective), management should consider whether both the following tests are met:

- The objective of the entity's business model is to hold the asset to collect the contractual cash flows; and
- The asset's contractual cash flows represent only payments of principal and interest. Interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time.

If both these tests are met, the financial asset falls into the amortised cost measurement category. If the financial asset does not pass both tests, it is measured at fair value through profit or loss.

Even if both tests are met, management also has the ability to designate a financial asset as at fair value through profit or loss if doing so reduces or eliminates a measurement or recognition inconsistency ('accounting mismatch').

PwC observation: IFRS 9 has two measurement categories: amortised cost and fair value. In order to determine the financial assets that fall into each category, it may be helpful for management to consider whether the financial asset is an investment in an equity instrument as defined in IAS 32, 'Financial instruments: Presentation'. If the financial asset is not an investment in an equity instrument, management should consider the guidance for debt instruments.

Business model test

Financial assets are subsequently measured at amortised cost or fair value based on the entity's business model for managing the financial assets. An entity assesses whether its financial assets meet this condition based on its business model as determined by the entity's key management personnel (as defined in IAS 24, 'Related party disclosures').

Management will need to apply judgement to determine at what level the business model condition is applied. That determination is made on the basis of how an entity manages its business; it is not made at the level of an individual asset. The entity's business model is not therefore a choice and does not depend on management's intentions for an individual instrument; it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management.

Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, some sales or transfers of financial instruments before maturity may not be inconsistent with such a business model.

The following are examples of sales before maturity that would not be inconsistent with a business model of

holding financial assets to collect contractual cash flows:

- an entity may sell a financial asset if it no longer meets the entity's investment policy, because its credit rating has declined below that required by that policy;
- when an insurer adjusts its investment portfolio to reflect a change in the expected duration (that is, the timing of payout) for its insurance policies; or
- when an entity needs to fund unexpected capital expenditure.

However, if more than an infrequent number of sales are made out of a portfolio, management should assess whether and how such sales are consistent with an objective of collecting contractual cash flows. There is no rule for how many sales constitutes 'infrequent'; management will need to use judgement based on the facts and circumstances to make its assessment.

An entity's business model is not to hold instruments to collect the contractual cash flows – for example, where an entity manages the portfolio of financial assets with the objective of realising cash flows through sale of the assets. Another example is when an entity actively manages a portfolio of assets in order to realise fair value changes arising from changes in credit spreads and yield curves, which results in active buying and selling of the portfolio.

PwC observation: The 'tainting' concept does not exist in IFRS 9 – that is, sales of 'held to maturity' assets under IAS 39 before maturity jeopardise amortised cost accounting for the entire portfolio. However, sales of financial assets prior to their maturity will impact the determination of the business model. It is therefore important to understand the nature, frequency and pattern of sales of financial assets in order to determine the business model and to assess whether sales are 'infrequent'.

Examples

The following common examples might be helpful in considering an entity's business model test.

Example 3.1 – Factoring

An entity has a past practice of factoring its receivables. If the significant risks and rewards have transferred from the entity, resulting in the original receivable being derecognised from the balance sheet, the entity is not holding these receivables to collect its cash flows but to sell them. However, if the significant risks and rewards of these receivables are not transferred from the entity, and the receivables do not therefore qualify for derecognition, the client's business objective may still be to hold the assets in order to collect the contractual cash flows.

Example 3.2 – Syndicated loans

An entity's business model is to lend to customers and hold the resulting loans for the collection of contractual cash flows. However, sometimes the entity syndicates out portions of loans that exceed their credit approval limits. This means that, at inception, part of such loans may be held to collect contractual cash flows and part may be held for sale. The entity therefore has two business models to apply to the respective portions of the loans.

Example 3.3 – Portfolio of subprime loans

An entity that operates in the sub-prime lending market purchases a portfolio of sub-prime loans from a competitor that has gone out of business. The loans are purchased at a substantial discount from their face value, as most of the loans are not currently performing (that is, no payments are being received, in many cases because the borrower has failed to make payments when due). The entity has a good record of collecting sub-prime loan arrears. It plans to hold the purchased loan balances to recover the outstanding cash amounts relating to the loans that have been purchased. As the business model is to hold the acquired loans and not to sell them, the business model test is met.

Contractual cash flows that are solely payments of principal and interest

The other condition that must be met in order for a financial asset to be eligible for amortised cost accounting is that 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*'. In this case, interest is defined as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.

In order to meet this condition, there can be no leverage of the contractual cash flows. Leverage increases the variability of the contractual cash flows, with the result that they do not have the economic characteristics of interest.

PwC observation: IFRS 9 does not quantify what constitutes 'leverage', but any multiple above one is generally viewed as leverage.

However, unlike leverage, certain contractual provisions will not cause the 'solely payments of principal and interest' test to be failed. For example, contractual provisions that permit the issuer to pre-pay a debt instrument or permit the holder to put a debt instrument back to the issuer before maturity result in contractual cash flows that are solely payments of principal and interest as long as the following certain conditions are met:

- The pre-payment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding (which may include reasonable additional compensation for the early termination of the contract).

- The pre-payment amount is not contingent on future events (other than to protect the holder against the issuer's credit deterioration, or a change of control of the issuer or against changes in tax or law).

Contractual provisions that permit the issuer or holder to extend the contractual term of a debt instrument are also regarded as being solely payments of principal and interest, provided that, during the term of the extension, the contractual cash flows are solely payments of principal and interest as well (for example, the interest rate does not step up to some leveraged multiple of LIBOR) and the provision is not contingent on future events.

The following are examples of contractual cash flows that are not solely payments of principal and interest:

- Bonds where the amount of interest varies inversely to a market rate of interest (inverse floaters).

- Links to equity index, borrower's net income or other non-financial variables.
- Deferrals of interest payments where additional interest does not accrue on those deferred amounts.
- Variable rate loan where, at each reset date, the borrower can choose to pay one-month LIBOR for a three-month term and one-month LIBOR is not reset each month.
- Five-year constant maturity bond at variable rate, which is reset periodically but always reflects a five-year maturity (that is, the tenor of the interest rate is disconnected with the term of the instrument except at origination).
- Convertible bond (from the holder's perspective).

If a contractual cash flow characteristic is not genuine, it does not affect the financial asset's classification. In this context, 'not genuine' means the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

Examples

The following are some further common examples for consideration in the solely payments of principal and interest test:

Example 3.4 – Changing credit spread

An entity has a loan agreement that specifies that the interest rate will change depending on the borrower's credit rating, EBITDA or gearing ratio. Such a feature will not fail the 'solely payments of principal and interest' test provided the adjustment is considered to reasonably approximate the credit risk of an instrument with that level of EBITDA, gearing or credit rating. That is, if such a covenant appropriately compensates the lender with higher interest when the borrower's credit risk increases, this is consistent with interest being defined as the consideration for the credit risk and the time value of money. However, if the covenant results in more than just compensation for credit risk or provides for some level of interest based on the entity's profitability, it will not meet the test.

Example 3.5 – Average rates

An entity has a loan agreement where interest is based on an average LIBOR rate over a period. That is, the loan has no defined maturity but rolls every two years with reference to the two year LIBOR rate. The interest rate is reset every two years to equal the average two-year LIBOR rate over the last two years. The economic rationale is to allow borrowers to benefit from a floating rate, but with an averaging mechanism to protect them from short-term volatility. Such a feature will not fail the 'solely payments of principal and interest' test provided the average rate represents compensation for only the time value of money and credit risk.

Non-recourse

A non-recourse provision is an agreement that, should the debtor default on a secured obligation, the creditor can look only to the securing assets (whether financial or non-financial) to recover its claim. Should the debtor fail 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 amortised cost

If a non-recourse provision exists, the creditor is required to assess (to 'look through to') the particular underlying assets or cash flows to determine whether the financial asset's contractual cash flows are solely payments of principal and interest. If the instrument's terms give rise to any other cash flows or limit the cash flows in a manner inconsistent with 'solely payments of principal and interest', the instrument will be measured in its entirety at fair value through profit or loss.

PwC observation: There is limited guidance as to how the existence of a non-recourse feature may impact the classification of non recourse loans at amortised cost. Judgement will therefore be needed to assess these types of lending relationships.

Contractually linked instruments (tranches)

The payments on some financial assets are contractually linked to the payments received on a pool of other instruments. These are referred to as contractually linked instruments. They are often issued by special purpose entities (SPEs) in various tranches, with the more senior tranches being repaid in priority to the more junior ones. The classification criteria for the holder of such contractually linked instruments (tranches) should be assessed based on the conditions at the date the entity initially recognised 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, to assess both the characteristics of these underlying instruments and the tranche's exposure to credit risk relative to the pool of underlying instruments.

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

The underlying pool of instruments may 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; or
 - the timing of the cash flows.

Any derivatives in the SPE structure should therefore reflect a risk that is present in either the assets or the liabilities or both to achieve amortised cost accounting for the tranche.

In addition, the credit risk of the tranche must be equal to or lower than the weighted average credit risk of the underlying pool of financial instruments.

PwC observation: The 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 may be required that compares the relative variability of the tranche held with that of the underlying assets.

Fair value measurement is required if any instrument in the pool does not meet the conditions outlined above, or if the composition of the underlying pool might change after the initial recognition such that it would no longer meet the qualifying conditions, or if it is impracticable to look through.

Examples

The following are other common features in contractual linked instruments that should be considered.

Example 3.6 – Investments in units issued by mutual funds

An entity invests in units issued by a close-ended fund. The fund holds only debt instruments that themselves would qualify for amortised cost classification under IFRS 9 had these instruments been directly held by the unit holder. The objective of the fund is to hold the assets to maturity rather than to realise fair value changes. Payments made by this fund to the holder may therefore represent solely payments of principal and interest, and the holder may be able to measure its investment at amortised cost. However, if the fund does not hold debt instruments, the investor will not be able to measure its investment at amortised cost.

Example 3.7 – Derivatives in underlying pool of assets

SPE holds floating-rate EUR assets and issued fixed-rate GBP notes contractually linked to the assets. The SPE has entered into one swap that is a pay EUR floating and receive GBP floating, and a second swap that is a pay GBP floating and receive GBP fixed. Both these swaps would meet the requirements in paragraph B4.24(b) of IFRS 9 of aligning the cash flows of the tranches with the cash flows of the pool of underlying instruments. The holder may therefore be able to measure its investment at amortised cost. However, if the SPE had a derivative that introduced a third currency – say USD – or had derivatives with a nominal value in excess of the amount of assets, this would not align the cash flows. The tranche would have to be measured at fair value through profit or loss.

Example 3.8 – Derivative with optionality in underlying pool of assets

An SPE holds a fixed-for-floating swap that also hedges pre-payment risk such that if the underlying pool of fixed rate assets pays down early, the derivative is cancelled with no further amounts to pay. This is to ensure there are no excess derivatives and no fair value gains/losses on settlement, as when the assets pre-pay, the notes pre-pay. This feature would not fail the requirements of paragraph B4.24 of IFRS 9; the holder may therefore be able to measure its investment at amortised cost.

Example 3.9 – Investments in CDOs

An entity has an investment in a cash CDO where the issuing SPE holds the underlying referenced assets. Cash CDOs may qualify for amortised cost accounting as long as the underlying assets qualify for amortised cost accounting and the other requirements of IFRS 9 for contractually linked instruments are met. However, investments in synthetic CDOs (where the SPE has a credit derivative that references particular exposures) would not qualify, as the derivatives on the reference exposures do not have cash flows that are solely payments of principal or interest, nor do they align the cash flows in a way permitted by IFRS 9.

Equity instruments

Investments in equity instruments (that meet the definition of equity as defined in IAS 32 from the perspective of the issuer) are always measured at fair value. Equity instruments that are held for trading are required to be classified as at fair value through profit or loss. 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 other comprehensive income (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 reported 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 may transfer the cumulative gain or loss within equity.

Examples

The following examples provide some further considerations as regards equity investments.

Example 3.10 – Investment in perpetual note

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. The issuer classifies this instrument as equity under IAS 32. The holder has the option to classify this investment at fair value through OCI under IFRS 9, as it is an equity instrument as defined in IAS 32.

Example 3.11 – 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. Although, the puttable shares may meet the requirements to be classified as equity from the fund's perspective, they do not meet the definition of equity in IAS 32. The holder does not therefore have the ability to classify this investment as fair value through OCI. Paragraph 96C of IAS 32 states that puttables should not be considered an equity instrument under other guidance. Investments in puttable shares are therefore required to be classified as fair value through profit or loss.

Example 3.12 – Dividend return on investment

An entity invests in shares at a cost of C12 and designates these at fair value through OCI. The fair value then increases to C22, giving rise to an unrealised gain of C10 in OCI. The issuer then pays a dividend of C10. This dividend is recorded in profit or loss in accordance with IAS 18, 'Revenue', as such a dividend does not represent a recovery of part of the cost of the investment.

Example 3.13 – Dividend return of investment

An entity invests in shares at a cost of C12 and designates these at fair value through OCI. The issuer shortly after pays a special dividend of C10. This dividend is not recorded in profit or loss in accordance with IAS 18, as such a dividend represents a recovery of part of the cost of the investment, which is required to remain in OCI.

Example 3.14 – Hybrid equity instrument

An entity invests in preference shares that have a maturity date for the repayment of principal but that also pay discretionary dividends based on the profits of the issuing entity and give a right to share in the net assets on liquidation. These shares are considered a compound instrument by the issuer and are treated as part liability and part equity. Under paragraph 4.7 of IFRS 9, a hybrid financial

asset is to be classified in its entirety. This investment in its entirety does not meet the definition of an equity instrument in IAS 32; it is not therefore eligible to use the fair value through OCI classification. The contractual cash flows of this investment would need to be assessed. As it is not solely receiving payments of principal and interest, it would be measured at fair value through profit or loss.

Example 3.15 – Investments in associates

A venture capital organisation has an investment in an associate that it has previously designated at fair value through profit or loss in accordance with IAS 39, as is permitted by the scope exclusion in IAS 28, 'Investments in associates'. This investment is not permitted to be accounted for at fair value through OCI under IFRS 9, as IAS 28, 'Investments in associates', has not been amended to permit such accounting.

The standard removes the requirement in IAS 39 to measure unquoted equity investments at cost when the fair value cannot be determined reliably. However, it indicates that, in limited circumstances, cost may be an appropriate estimate of fair value – for example, when insufficient more recent information is available from which to determine fair value; or when there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. However, IFRS 9 includes indicators of when cost might not be representative of fair value. These are:

- 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.

This is not an exhaustive list. Entities should consider all available information in deciding whether cost is representative of fair value and other factors also may be relevant.

PwC observation: Given the indicators above, it is not expected that cost will be representative of fair value for an extended period of time. Entities may therefore need to develop an estimate of fair value for their unquoted equity instruments.

Embedded derivatives

The accounting for embedded derivatives in host contracts that are financial assets is simplified by removing the requirement to consider whether or not they are closely related and should therefore be separated. The classification approach in the new standard applies to all financial assets, including those with embedded derivatives.

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 the existing requirements, this does not automatically mean the instrument will fail to qualify for amortised cost treatment under the new standard. There are some embedded derivatives such as interest caps and floors that may have required bifurcation under IAS 39 but may pass the 'solely

payments of principal and interest test'. Nevertheless, most hybrid contracts with financial asset hosts are likely to fail the 'solely payments of principal and interest' test and be measured at fair value in their entirety.

The accounting for embedded derivatives in non-financial host contracts and financial liabilities currently remains unchanged.

Reclassifications

An instrument's classification is made at initial recognition and is not changed subsequently, with one exception. Reclassifications between fair value and amortised cost (and *vice versa*) are required only when the entity changes how it manages its financial instruments (that is, it changes its business model). Such changes are expected to be infrequent. The reclassification must be significant to the entity's operations and demonstrable to external parties.

Any reclassification should be accounted for prospectively. Entities are not therefore allowed to restate any previously recognised gains or losses. The asset should be re-measured at fair value at the date of a reclassification of a financial asset from amortised cost to fair value; this value will be the new carrying amount. Any difference between the previous carrying amount and the fair value is recognised in a separate line item in the income statement. At the date of a reclassification of a financial asset from fair value to amortised cost, its fair value at that reclassification date becomes its new carrying amount.

An example of a change in the business model that requires reclassification would be an entity that has a portfolio of commercial loans that it holds to sell in the short term. Following an acquisition of an entity whose business model is to hold commercial loans to collect the contractual cash flows, that portfolio is managed together with the acquired portfolio to collect the contractual cash flows.

The following are not changes in business model:

- A change in intention related to particular financial assets.
- A temporary disappearance of a particular market for financial assets. A transfer of financial assets between parts of the entity with different business models

All other reclassifications are prohibited.

PwC observation: Reclassifications are expected to be rare. The lapse of a contractual feature does not constitute a reclassification event. For example, if an entity holds a convertible bond where the conversion feature lapses after a certain period of time, this would not give rise to reclassification event. It is only when an entity changes its business model that instruments can be reclassified.

Classification and measurement – financial liabilities

Classification model

Financial liabilities are measured at amortised cost unless they are required to be measured at fair value through profit or loss or where an entity has chosen to measure a liability at fair value through profit or loss.

The main concern in revising IAS 39 for financial liabilities was potentially showing, in the income statement, the impact of 'own credit risk' for liabilities recognised at fair value – that is, fluctuations in value due to changes in the liability's credit risk. This can result in gains being recognised in income when the liability has had a credit downgrade, and losses being recognised when the liability's credit risk improves. Many users found these results counterintuitive, especially when there is no expectation that the change in the liability's credit risk will be realised. This issue would have been problematic if the IASB had adopted an approach similar to the

classification and measurement of financial assets in IFRS 9, where hybrid instruments (that is, financial instruments that contain embedded derivatives) are accounted for at fair value.

In view of this concern, the IASB has retained the existing guidance in IAS 39 regarding classifying and measuring financial liabilities, except for those liabilities where the fair value option has been elected.

Financial liabilities (except those designated at fair value through profit or loss using the fair value option)

The classification and measurement of financial liabilities under IFRS 9 remains the same except where an entity has chosen to measure a liability at fair value through profit or loss. There continue to be two measurement categories for financial liabilities: fair value and amortised cost. Certain liabilities are required to be at fair value through profit or loss, such as liabilities held for trading and derivatives. Other liabilities are measured at amortised cost, unless the liability has embedded derivatives or the entity elects the fair value option.

The existing guidance in IAS 39 for embedded derivatives has been retained in this new part of IFRS 9. Entities are still required to separate derivatives embedded in financial liabilities where they are not closely related to the host contract – for example, a structured note where the interest is linked to an equity index. The separated embedded derivative continues to be measured at fair value through profit or loss, and the residual debt host is measured at amortised cost.

The accounting for embedded derivatives in non financial host contracts also remains unchanged.

PwC observation: The treatment of financial assets and liabilities under IFRS 9 is not symmetrical. The existing embedded derivative guidance in IAS 39 is retained in IFRS 9 for financial liabilities and non-financial instruments; this results in some embedded derivatives being separately accounted for at fair value through profit or loss. However, embedded derivatives are no longer separated from financial assets. Instead, they are part of the contractual terms that are considered in determining whether the entire financial asset meets the cash flow test (solely payments of principal and interest) to be measured at amortised cost or whether it must be measured at fair value through profit or loss.

Financial liabilities designated at FVTPL using fair value option

The new part of IFRS 9 changes the accounting for financial liabilities that an entity chooses to account for at fair value through profit or loss, using the fair value option. For such liabilities, changes in fair value related to changes in own credit risk are presented separately in OCI.

The eligibility criteria for the fair value option remain the same and are based on whether:

- the liability is managed on a fair value basis;
- electing fair value will eliminate or reduce an accounting mismatch; or
- the instrument is a hybrid that would require separation of an embedded derivative.

A common reason for electing the fair value option is where entities have embedded derivatives that they do not wish to separate from the host liability. In addition, entities may elect the fair value option where they have accounting mismatches with assets that are required to be held at fair value through profit or loss.

Financial liabilities that are required to be measured at fair value through profit or loss (as distinct from those that the entity has chosen to measure at fair value through profit or loss) continue to have all fair value movements recognised in profit or loss with no transfer to OCI. This includes all derivatives (such as foreign currency forwards or interest rate swaps), or an entity's own liabilities that it considers as 'trading'.

In addition, financial guarantees and loan commitments that entities choose to measure at fair value through profit or loss will have all fair value movements in profit or loss, with no transfer to OCI.

PwC observation: The IASB decided that financial guarantees and loan commitments are very similar to derivatives and should therefore continue to have all movements recorded in profit and loss where they have been designated at fair value through profit or loss.

However, if presenting the changes in own credit of a financial liability in OCI would create an accounting mismatch in profit or loss, all fair value movements are recognised in profit or loss.

The accounting mismatch must arise due to an economic relationship between the financial liability and a financial asset that results in the liability's credit risk being offset by a change in the fair value of the asset.

The accounting mismatch:

- is required to be determined when the liability is first recognised;
- is not reassessed subsequently; and
- must not be caused solely by the measurement method that an entity

uses to determine the changes in a liability's credit risk.

See example 4.1 below.

PwC observation: This exemption from the requirement to present movements in the own credit risk of a liability in OCI is expected to be rare. Staff papers prepared for the IASB's discussions in finalising IFRS 9 indicated that the mortgage bank example (Example 4.1 below) was the only accounting mismatch they had discovered so far to arise due to an offsetting economic relationship between the financial liability and a financial asset.

Measuring the credit risk of liabilities

The first step is to calculate the amount of the fair value movement that relates to the credit risk of the liability. IFRS 7 'Financial instrument: disclosures', already requires disclosure of the amount of fair value changes that are attributable to own credit risk for liabilities designated at fair value through profit or loss. The existing guidance on how to calculate own credit risk in IFRS 7 is retained but has been relocated to IFRS 9, and some aspects have been clarified.

Own credit risk can be determined as either:

- (a) the amount of fair value change not attributable to changes in market risk (for example, benchmark interest rates). This is often referred to as the default method; or
- (b) an alternative method that the entity believes more faithfully represents the changes in fair value due to 'own credit' (for example, a

Example 4.1

A mortgage bank provides loans to customers and funds the loans by selling matching bonds in the market. The customer can repay the mortgage by buying the bond and delivering it to the mortgage bank. If the fair value of the bond (the financial liability of the mortgage bank) decreases due to own credit risk, it is offset by changes in the fair value of the mortgage (financial asset). Therefore, recognising the credit risk of the bond in OCI would create an accounting mismatch in profit or loss.

method that computes credit risk directly based on credit default swap rates)

However, if the changes in fair value arising from factors other than changes in the liability's credit risk or changes in observed interest rates (that is, benchmark rates such as LIBOR) are significant, an entity is required to use an alternative method and not the default method. For example, changes in the fair value of a liability may arise due to changes in value of a derivative embedded in that liability rather than changes in benchmark interest rates. In that situation, changes in the value of the embedded derivative must be excluded in determining the amount of own credit risk that is presented in OCI.

The expanded guidance in IFRS 9 confirms that the credit risk of a liability with collateral is likely to be different from the credit risk of an equivalent liability without collateral issued by the same entity.

It also clarifies that unit-linking features usually contain specific asset performance risk rather than credit risk – that is, the value of the liability changes due to changes in value of the linked asset(s) and not because of changes in the own credit risk of the liability. This means that changes in the fair value of a unit-linked liability due to changes in the fair value of the linked asset will continue to be recognised in the income statement, as they are not regarded as being part of the own credit risk of the liability that is recognised in OCI. See example 4.2 below.

PwC observation: Entities are already required to disclose the impact of changes in own credit risk on liabilities designated at fair value through profit or loss, so there should be minimal additional or new data or system requirements. This additional measurement guidance does not change the existing methodology but does clarify some practical questions. The guidance recognises that the amount of fair value changes that relate to changes in own credit risk may be minimal for some types of financial liabilities, such as unit-linked liabilities and liabilities with collateral.

New presentation model

Elements of the fair value movement of the liability are presented in different parts of the performance statement; changes in own credit risk are presented in OCI, and all other fair value changes are presented in profit or loss. This means that the amount of the overall fair value movement does change but is presented in separate sections of the statement of comprehensive income. See example 5.1 below.

Amounts in OCI relating to own credit are not recycled to the income statement even when the liability is derecognised and the amounts are realised. However, the standard does allow transfers within equity.

PwC observation: The treatment of own credit risk presented in OCI is consistent with the requirements in IFRS 9 that prohibit recycling to profit or loss for investments in equity instruments that are measured at fair value with changes presented in OCI. However, entities that wish to transfer realised balances to retained earnings, for example, could do so, as transfers within equity are permitted.

Example 4.2

An entity issues unit-linked liabilities that it has designated at fair value through profit or loss, and it holds the related assets at fair value. At the beginning of the period, the assets and the liabilities both have a fair value C100. During the period, the fair value of the assets decreases by C20. The fair value of the liability also decreases by C20 during the period due to the change in the value of the linked assets. As this change in fair value is attributable to the change in the fair value of the related assets, the entire fair value change of C20 is recognised in profit or loss.

Example 5.1

Assume a liability recognised under the FVO has a fair value movement of C100 for the period. Of that C100, C10 relates to changes in own credit risk. This would be presented as follows:

Profit and loss

Change in fair value other than from own credit risk	90
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Other comprehensive income

Change in fair value from own credit risk	10
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Presentation and disclosure

Balance sheet presentation

IFRS 9 has had a minimal impact on the presentation of financial assets in the balance sheet except to reduce the categories of financial assets from the previous four categories in IAS 39 (fair value through profit or loss, held to maturity, available for sale and loans and receivables) to two in IFRS 9 (fair value and amortised cost).

The new guidance for financial liabilities has no impact on the balance sheet presentation because a liability is recognised under the fair value option at its fair value. Income statement presentation is discussed above as part of the classification and measurement section.

Disclosures

IFRS 9 made some consequential amendments to IFRS 7. The majority of the changes were to align the disclosure requirements with the new measurement categories for financial assets; however, some additional disclosures are required.

Financial assets at fair value through profit or loss

Entities that have designated a financial asset at fair value through profit or loss that would otherwise be measured at amortised cost are required to disclose:

- the financial asset's maximum exposure to credit risk at the end of the reporting period;
- the amount by which any related credit derivatives or similar instruments mitigate that credit risk and their fair value; and
- the amount of change during the period and cumulatively in the financial asset's fair value that is attributable to changes in its credit risk.

Financial assets at fair value through OCI

Entities that apply IFRS 9 are required to disclose the following in relation to financial assets measured at fair value through OCI:

- which investments in equity instruments have been designated to be measured at fair value through OCI;
- the reasons for using this presentation alternative;

- the fair value of each such investment at the end of the reporting period;
- dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period;
- any transfers of the cumulative gain or loss within equity during the period and the reason for such transfers; and
- for any equity investments that were derecognised during the period, the reason for disposing of the investments, the fair value of the investments at the date of derecognition and the cumulative gain or loss on disposal.

Reclassified financial assets

There are also new disclosure requirements for assets that are required to be reclassified under IFRS 9 because of the change in business model, as follows:

- the date of reclassification;
- a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements;
- the amount reclassified into and out of each category;
- for each reporting period following reclassification until derecognition, the effective interest rate determined on the date of reclassification and the interest income or expense recognised; and
- if the entity has reclassified financial assets so that they are measured at amortised cost since its last annual reporting date, the financial assets' fair value at the end of the reporting period and the fair value gain or loss that would have been recognised in profit or loss during the reporting period if the financial assets had not been reclassified.

An entity is required to disclose an analysis of the gain or loss recognised in the statement of comprehensive income arising from derecognising the

financial assets measured at amortised cost, showing separately gains and losses arising from derecognition of those financial assets. This disclosure should include the reasons for derecognising those financial assets.

Financial liabilities designated at fair value through profit or loss

Entities that have designated a financial liability at fair value through profit or loss have new disclosures in addition to the requirement to present changes in own credit risk for liabilities separately in OCI. The following new information should now be provided:

- details of transfers of cumulative gains/losses within equity and the reasons for the transfer; and
- the amount presented in OCI that was realised on derecognition of liabilities during the period.

PwC observation: Although the standard prohibits recycling of cumulative gains/losses relating to own credit risk to profit and loss, the disclosures provide users of the financial statements with the same information that recycling through the profit and loss would have provided.

Disclosures on initial application of IFRS 9

When an entity first applies IFRS 9, there are additional disclosures required for each class of financial assets on the date of initial application, as follows:

- the original measurement category and carrying amount determined in accordance with IAS 39;
- the new measurement category and carrying amount determined in accordance with IFRS 9;
- the amount of any financial assets in the statement of financial position that were previously designated as measured at fair value through profit or loss but that are no longer so designated, distinguishing between those that IFRS 9 requires an entity to reclassify and those that an entity elects to reclassify;

- qualitative information about how it applied the classification requirements in IFRS 9 to those financial assets whose classification has changed as a result of applying IFRS 9; and
- qualitative information about the reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss.

The quantitative disclosures should be presented in a tabular format.

Disclosures for transferred assets

This amendment to IFRS 7 applies to periods from 1 July 2011 onwards; it will be relevant to financial instruments accounted for under IFRS 9. The amendment includes a requirement to disclose by class of asset the nature, carrying amount and a description of the risks and rewards of financial assets that have been transferred to another party yet remain on the entity's balance sheet.

Disclosures are also required to enable a user to understand the amount of any associated liabilities, and the relationship between the financial assets and associated liabilities.

Where financial assets have been derecognised but the entity is still exposed to certain risks and rewards associated with the transferred asset, additional disclosure is required to enable the effects of those risks to be understood. These disclosures include:

- the carrying amount and fair value of recognised assets or liabilities that give rise to the ongoing involvement in the transferred asset;
- information showing the maximum exposure to loss; and
- the timing and amount of potential and contractual cash outflows that may be necessary as a result of the ongoing involvement.

These disclosures should be presented by type of ongoing involvement. For example, the retained exposure could be presented by type of financial instrument (for example, guarantees, call options or put options) or by type

of transfer (for example, factoring of receivables, securitisations or securities lending).

The gain or loss on the transferred assets and on any retained interest in those assets should also be disclosed. Additional disclosures are required where the total amount of proceeds from transfer activity that qualifies for derecognition is not evenly distributed throughout the reporting period.

Effective date and transition

Effective date

The effective date of IFRS 9 is 1 January 2013, with early application permitted. However, the standard has not yet been endorsed for use in the EU.

The effective date and transition requirements for financial liabilities are consistent with IFRS 9 issued in November 2009 for the classification and measurement of financial assets. Entities may choose to adopt early, but it is not possible to adopt the part for financial liabilities without adopting the requirements for financial assets. However, entities are still permitted, before 1 January 2013, to adopt the requirements for financial assets in IFRS 9 without adopting the requirements for financial liabilities.

Transition

The requirements in IFRS 9 are generally applied retrospectively to assets and liabilities held at the date of initial application with some exceptions. For example, if it is impracticable to retrospectively apply the effective interest method or impairment requirements to a financial asset, the entity should determine the amortised cost, or any impairment on the financial asset, in each period, by using its fair value at the end of each comparative period.

Additional disclosures are required by IFRS 7, 'Financial instruments: Disclosures', when the entity adopts the standard (see above).

The standard provides transition relief from restating comparative information for entities that adopt IFRS 9 for reporting periods before 1 January 2012.

Date of initial application

IFRS 9 introduces the concept of a 'date of initial application'. This date is important for:

- identifying the assets and liabilities to which IFRS 9 should be applied (the standard is not applied to instruments derecognised by the date of initial application);
- assessing the business model;
- designations or de-designations for using the fair value option; and
- designations of non-trading equity investments as at fair value through other comprehensive income.

For example, at the date of initial application an entity assesses the business model for holding a

particular asset on the basis of the facts and circumstances that exist at that date. The resulting classification is then applied retrospectively, irrespective of the entity's business model in prior reporting periods. Similarly, at the date of initial application, an entity may designate a financial asset at fair value through profit or loss or an investment in an equity instrument as at fair value through other comprehensive income on the basis of the facts and circumstances that exist at that date. That classification is then applied retrospectively.

The date of initial application may be any date between the issue of the new standard (November 2009) and 31 December 2010 for entities adopting the new IFRS before 1 January 2011. For entities adopting this IFRS on or after 1 January 2011, the date of initial application is the beginning of the first reporting period in which the entity adopts this IFRS.

Examples

The transition rules might seem complex. The following examples help provide a bit more clarity as to how they should be applied.

Example 6.1 – From AFS to amortised cost

Management has decided to apply IFRS 9 on 15 December 2010 (the date of initial application) and not to restate its comparatives as permitted under IFRS 9. The entity has a debt instrument that is accounted for as AFS under IAS 39. On the date of initial application of IFRS 9, it is determined that the asset is held to collect the contractual cash flows and those cash flows solely represent payments of principal and interest. It will therefore be measured at amortised cost under IFRS 9. This will require, on transition, the debt instrument to be measured at amortised cost at 1 January 2010 (as if it had always been measured at amortised cost since it was initially recognised by the entity). Any existing AFS reserve is reclassified against the carrying value of the asset at 1 January 2010.

Example 6.2 – From AFS to FVTPL for equities

Management has decided to apply IFRS 9 on 15 December 2010 (the date of initial application) and not to restate its comparatives as permitted under IFRS 9. On the date of initial application, management decides that its holding of equity investments will be classified as FV through profit and loss. The original cost of these equities was C100. At 31 December 2009, fair value was C30, so the AFS reserve was negative C70. It was determined at that date that those equities were impaired; C70 was therefore reflected in the income statement. At 31 December 2010, the fair value of the equities is C55. The entity is not restating its comparatives for 2009. Therefore, in 2010, when it first applies IFRS 9 and measures the equities at fair value through profit and loss, it will record the equity

at its fair value of C30 on 1 January 2010 and at C55 on 31 December 2010 with the 25 change in value recorded in profit or loss.

Example 6.3 – From FVTPL to amortised cost

Management has decided to apply IFRS 9 on 15 December 2010 (the date of initial application) and not to restate its comparatives as permitted under IFRS 9. The entity has a debt instrument that was held at fair value through profit and loss under IAS 39. On the date of initial application of IFRS 9, it is determined that the asset is held to collect its cash flows and that its cash flows solely represent payments of principal and interest. On transition, the debt instrument is measured at amortised cost (as if it had always been measured at amortised cost since it was initially recognised by the entity). Any difference between that and its fair value under IAS 39 is reflected in opening retained earnings at 1 January 2010. Interest income will be recognised based on the EIR as computed on the date the debt instrument was acquired; any impairment is assessed under IAS 39.

Example 6.4 – From FVTPL to FVTOCI

Management has decided to apply IFRS 9 on 15 December 2010 (the date of initial application) and not to restate its comparatives as permitted under IFRS 9. The entity has an equity investment that it currently classifies as fair value through profit and loss under IAS 39. On the date of initial application of IFRS 9, management decides that it will classify the equity investment as fair value through OCI, as it is not held for trading. On transition, as this measurement has to be applied retrospectively, a reserve will be created in OCI (that is, reclassified from opening retained earnings to OCI at 1 January 2010), based on the difference between the instrument's original cost and its fair value at the opening balance sheet date. Subsequent changes in fair value will be recorded in OCI; any dividends will be recorded in profit or loss.

Example 6.5 – AFS investments disposed of during period of adoption

Management has decided to apply IFRS 9 on 15 December 2010 (the date of initial application). On 30 June 2010, the entity disposed of an AFS debt security (original cost of C100, and fair value on date of disposal of C110) and recognised a gain of C10 as a result of reclassifying the AFS reserve to profit and loss. There are no adjustments to be made for that AFS investment when the entity adopts IFRS 9 in its 2010 financial statements, as IFRS 9 is not applied to financial assets that have already been derecognised by the date of initial application. The entity would apply the same AFS accounting to that debt security as it had under IAS 39 in its 2010 financial statements.

Example 6.6 – 2008 IAS 39 reclassification amendment

The transition provisions in IFRS 9 require an entity to apply it retrospectively, with a few exceptions. The reclassification amendment of October 2008 allowed certain instruments to be reclassified out of held-for-trading and AFS; upon reclassification, the fair value at the date of reclassification becomes the new amortised cost of reclassified assets. Upon initial application of IFRS 9, assuming these reclassified assets will continue to be measured at amortised cost, management is required to go back to the asset's initial recognition and then measure it as if it had always been measured at amortised cost under IFRS 9. Its amortised cost for IFRS 9 will not therefore be the same amortised cost that was determined when these assets were reclassified under IAS 39.

Example 6.7 – Date of initial application determined retrospectively

On 30 June 2010, management set its date of initial application as 31 December 2009. Setting the date of initial application retrospectively is supported by the ability to select any date between the issue of the new standard and 31 December 2010. After 1 January 2011, the date of initial application should be the beginning of the reporting period when the standard is first adopted.

Fair value option for existing instruments

Entities are normally restricted to designating financial instruments at fair value through profit and loss when they are initially recognised. However, there are some additional rules on transition to IFRS 9 in relation to existing financial instruments.

In most circumstances where the fair value option was elected for financial assets (for example, the asset was managed on a fair value basis or to avoid separating an embedded derivative), the fair value option is no longer needed as it is likely the asset will be required to be recognised at fair value through profit and loss under IFRS 9. However, the fair value option may or may not be needed for accounting mismatches because adopting IFRS 9 may eliminate or create new accounting mismatches.

The transition rules in IFRS 9 for the classification and measurement of financial assets allow entities to make or revoke some designations at fair value through profit or loss for financial assets and liabilities. A new fair value option election only applies for accounting mismatches and no new elections are permitted for financial assets and liabilities where the fair value option was elected for other reasons (for example, solely to avoid separating an embedded derivative).

Entities are still permitted, before 1 January 2013, to adopt the requirements

for financial assets in IFRS 9 without adopting the requirements for financial liabilities. The opportunity to change fair value option elections only arises when entities adopt the financial asset requirements of IFRS 9.

When entities adopt the financial liability requirements of IFRS 9 later than the date they adopt the financial asset requirements, they may not make or revoke designations at fair value through profit or loss for existing financial assets or liabilities.

PwC observation: Entities may wish to consider carefully any liabilities they currently designate at fair value through profit or loss using the FVO and any new liabilities they may want to designate at fair value through profit or loss as part of their planning for transition to IFRS 9, and whether they wish to adopt the asset and liabilities sections together or in phases. Entities should continue to monitor the other board projects that may have an impact on the mandatory date of IFRS 9 these include; the later phases of the IFRS 9 project (hedging and impairment), the insurance project and the Board's request for views on effective dates and transition requirements issued in October 2010.

Where to go for more information

If you have questions on the application of the IFRS 9 or require further information, speak to your regular PwC contact. Please also see PwC 'Straight aways' numbers 7, 32 and 34.

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