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Basis for Conclusions on IFRS 9 Financial Instruments

This Basis for Conclusions accompanies, but is not part of, IFRS 9.

The Board expects that IFRS 9 will replace IAS 39 Financial Instruments: Recognition and Measurement in its entirety. When revised in 2003 IAS 39 was accompanied by a Basis for Conclusions summarising the considerations of the Board, as constituted at the time, in reaching some of its conclusions in that Standard. That Basis for Conclusions was subsequently updated to reflect amendments to the Standard. For convenience the Board has incorporated into its Basis for Conclusions on IFRS 9 material from the Basis for Conclusions on IAS 39 that discusses matters that the Board has not reconsidered. That material is contained in paragraphs denoted by numbers with the prefix BCZ. In those paragraphs cross-references to the IFRS have been updated accordingly and minor necessary editorial changes have been made. In 2003 and later some Board members dissented from the issue of IAS 39 and subsequent amendments, and portions of their dissenting opinions relate to requirements that have been carried forward to IFRS 9. Those dissenting opinions are set out after the Basis for Conclusions on IAS 39.

Paragraphs describing the Board’s considerations in reaching its own conclusions on IFRS 9 are numbered with the prefix BC.


Introduction

BCIN.1 This Basis for Conclusions summarises the International Accounting Standards Board’s considerations in developing IFRS 9 Financial Instruments. Individual Board members gave greater weight to some factors than to others.

BCIN.2 The Board has long acknowledged the need to improve the requirements for financial reporting of financial instruments to enhance the relevance and understandability of information about financial instruments for users of financial statements. To meet the urgency of that need in the light of the financial crisis, the Board decided to replace IAS 39 Financial Instruments: Recognition and Measurement in its entirety as expeditiously as possible. To make progress quickly the Board divided the project into several phases. In adopting this approach, the Board acknowledged the difficulties that might be created by differences in timing between this project and others, in particular phase II of the project on insurance contracts. (Paragraphs BC7.2(b), BC7.4 and BC7.30–BC7.34 discuss issues relating to insurance contracts.)

BCIN.3 IFRS 9 is a new standard dealing with the accounting for financial instruments. In developing IFRS 9, the Board considered the responses to its exposure draft Financial Instruments: Classification and Measurement, published in July 2009.

BCIN.4 That exposure draft contained proposals for all items within the scope of IAS 39. However, some respondents said that the Board should finalise its proposals on classification and measurement of financial assets while retaining the existing requirements for financial liabilities (including the requirements for embedded derivatives and the fair value option) until the Board had more fully considered
and debated the issues relating to financial liabilities. Those respondents pointed out that the Board accelerated its project on financial instruments because of the global financial crisis, which placed more emphasis on issues in the accounting for financial assets than for financial liabilities. They suggested that the Board should consider issues related to financial liabilities more fully before finalising the requirements for classification and measurement of financial liabilities.

BCIN.5 The Board noted those concerns and, as a result, in November 2009 it finalised the first chapters of IFRS 9, dealing with classification and measurement of financial assets. In the Board’s view, requirements on classification and measurement are the foundation for a financial reporting standard on accounting for financial instruments, and requirements on associated matters (for example, on impairment and hedge accounting) have to reflect those requirements. In addition, the Board noted that many of the application issues that have arisen in the financial crisis are related to the classification and measurement of financial assets in accordance with IAS 39.

BCIN.6 Thus, financial liabilities, including derivative liabilities, remained within the scope of IAS 39. Taking that course enabled the Board to obtain further feedback on the accounting for financial liabilities, including how best to address accounting for changes in own credit risk.

BCIN.7 Immediately after issuing IFRS 9, the Board began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities. The Board obtained information and views from its Financial Instruments Working Group (FIWG) and from users, regulators, preparers, auditors and others from a range of industries across different geographical regions. The primary messages that the Board received were that the requirements in IAS 39 for classifying and measuring financial liabilities are generally working well but that the effects of changes in a liability’s credit risk ought not to affect profit or loss unless the liability is held for trading. As a result of the feedback received, the Board decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities and carry them forward to IFRS 9 (see paragraphs BC4.46-BC4.53).

BCIN.8 By taking that course, the issue of credit risk does not arise for most liabilities and would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010 the Board published an exposure draft Fair Value Option for Financial Liabilities, which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The Board considered the responses to that exposure draft and finalised requirements that were added to IFRS 9 in October 2010.

BCIN.9 The Board is committed to completing its project on financial instruments expeditiously. The Board is also committed to increasing comparability between IFRSs and US generally accepted accounting principles (GAAP) requirements for financial instruments.
Scope (chapter 2)

BC2.1 The Board has not yet considered the scope of IFRS 9. The scope of IAS 39 and its interaction with other IFRSs have resulted in some application and interpretation issues. However, the Board believes that it should address the issue of scope comprehensively rather than only in the context of classification and measurement. The scope of IAS 39 has not been raised as a matter of concern during the financial crisis and, hence, the Board believes that the scope of IFRS 9 should be based on that of IAS 39 until it considers the scope more generally in a later phase of the project to replace IAS 39.

Recognition and derecognition (chapter 3)

Derecognition of a financial asset

The original IAS 39

BCZ3.1 Under the original IAS 39, several concepts governed when a financial asset should be derecognised. It was not always clear when and in what order to apply those concepts. As a result, the derecognition requirements in the original IAS 39 were not applied consistently in practice.

BCZ3.2 As an example, the original IAS 39 was unclear about the extent to which risks and rewards of a transferred asset should be considered for the purpose of determining whether derecognition is appropriate and how risks and rewards should be assessed. In some cases (eg transfers with total returns swaps or unconditional written put options), the Standard specifically indicated whether derecognition was appropriate, whereas in others (eg credit guarantees) it was unclear. Also, some questioned whether the assessment should focus on risks and rewards or only risks and how different risks and rewards should be aggregated and weighed.

BCZ3.3 To illustrate, assume an entity sells a portfolio of short-term receivables of CU100† and provides a guarantee to the buyer for credit losses up to a specified amount (say CU20) that is less than the total amount of the receivables, but higher than the amount of expected losses (say CU5). In this case, should (a) the entire portfolio continue to be recognised, (b) the portion that is guaranteed continue to be recognised or (c) the portfolio be derecognised in full and a guarantee be recognised as a financial liability? The original IAS 39 did not give a clear answer and the IAS 39 Implementation Guidance Committee—a group set up by the Board’s predecessor body to resolve interpretative issues raised in practice—was unable to reach an agreement on how IAS 39 should be applied in this case. In developing proposals for improvements to IAS 39, the Board concluded that it was important that IAS 39 should provide clear and consistent guidance on how to account for such a transaction.

* In this Basis for Conclusions, the phrase ‘the original IAS 39’ refers to the Standard issued by the Board’s predecessor body, the International Accounting Standards Committee (IASC) in 1999 and revised in 2000.

† In this Basis for Conclusions, monetary amounts are denominated in ‘currency units (CU)’.
Exposure draft of proposed amendments to IAS 39 published in 2002

BCZ3.4 To resolve the problems, the exposure draft published in 2002 proposed an approach to derecognition under which a transferor of a financial asset continues to recognise that asset to the extent the transferor has a continuing involvement in it. Continuing involvement could be established in two ways: (a) a reacquisition provision (such as a call option, put option or repurchase agreement) and (b) a provision to pay or receive compensation based on changes in value of the transferred asset (such as a credit guarantee or net cash-settled option).

BCZ3.5 The purpose of the approach proposed in the exposure draft was to facilitate consistent implementation and application of IAS 39 by eliminating conflicting concepts and establishing an unambiguous, more internally consistent and workable approach to derecognition. The main benefits of the proposed approach were that it would greatly clarify IAS 39 and provide transparency on the balance sheet about any continuing involvement in a transferred asset.

Comments received

BCZ3.6 Many respondents to the exposure draft agreed that there were inconsistencies in the existing derecognition requirements in IAS 39. However, there was limited support for the proposed continuing involvement approach. Respondents expressed conceptual and practical concerns, including:

(a) any benefits of the proposed changes did not outweigh the burden of adopting a different approach that had its own set of (as yet unidentified and unsolved) problems;

(b) the proposed approach was a fundamental change from that in the original IAS 39;

(c) the proposal did not achieve convergence with US GAAP;

(d) the proposal was untested; and

(e) the proposal was not consistent with the Framework for the Preparation and Presentation of Financial Statements.

BCZ3.7 Many respondents expressed the view that the basic approach in the original IAS 39 should be retained and the inconsistencies removed. The reasons included: (a) the existing IAS 39 had proven to be reasonable in concept and operational in practice and (b) the approach should not be changed until the Board developed an alternative comprehensive approach.

Revisions to IAS 39

BCZ3.8 In response to the comments received, the Board decided to revert to the derecognition concepts in the original IAS 39 and to clarify how and in what order the concepts should be applied. In particular, the Board decided that an evaluation of the transfer of risks and rewards should precede an evaluation of the transfer of control for all types of transactions.
BCZ3.9 Although the structure and wording of the derecognition requirements were substantially amended, the Board concluded that the requirements in the revised IAS 39 should not be substantially different from those in the original IAS 39. In support of this conclusion, it noted that the application of the requirements in the revised IAS 39 generally resulted in answers that could have been obtained under the original IAS 39. In addition, although there would be a need to apply judgement to evaluate whether substantially all risks and rewards had been retained, this type of judgement was not new compared with the original IAS 39. However, the revised requirements clarified the application of the concepts in circumstances in which it was previously unclear how IAS 39 should be applied (this guidance is now in IFRS 9). The Board concluded that it would be inappropriate to revert to the original IAS 39 without such clarifications.

BCZ3.10 The Board also decided to include guidance in the Standard that clarified how to evaluate the concepts of risks and rewards and of control. The Board regarded such guidance as important to provide a framework for applying the concepts in IAS 39 (this guidance is now in IFRS 9). Although judgement was still necessary to apply the concepts in practice, the guidance was expected to increase consistency in how the concepts were applied.

BCZ3.11 More specifically, the Board decided that the transfer of risks and rewards should be evaluated by comparing the entity’s exposure before and after the transfer to the variability in the amounts and timing of the net cash flows of the transferred asset. If the entity’s exposure, on a present value basis, had not changed significantly, the entity would conclude that it had retained substantially all risks and rewards. In this case, the Board concluded that the asset should continue to be recognised. This accounting treatment was consistent with the treatment of repurchase transactions and some assets subject to deep in-the-money options under the original IAS 39. It was also consistent with how some interpreted the original IAS 39 when an entity sells a portfolio of short-term receivables but retains all substantive risks through the issue of a guarantee to compensate for all expected credit losses (see the example in paragraph BCZ3.3).

BCZ3.12 The Board decided that control should be evaluated by looking to whether the transferee has the practical ability to sell the asset. If the transferee could sell the asset (eg because the asset was readily obtainable in the market and the transferee could obtain a replacement asset if it needed to return the asset to the transferor), the transferor had retained control because the transferor did not control the transferee’s use of the asset. If the transferee could not sell the asset (eg because the transferor had a call option and the asset was not readily obtainable in the market, so that the transferee could not obtain a replacement asset), the transferor had retained control because the transferee was not free to use the asset as its own.

BCZ3.13 The original IAS 39 also did not contain guidance on when a part of a financial asset could be considered for derecognition. The Board decided to include such guidance in the Standard to clarify the issue (this guidance is now in IFRS 9). It decided that an entity should apply the derecognition principles to a part of a financial asset only if that part contained no risks and rewards relating to the part not being considered for derecognition. Accordingly, a part of a financial asset would be considered for derecognition only if it comprised:
IFRS 9 BC

(a) only specifically identified cash flows from a financial asset (or a group of similar financial assets);

(b) only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or

(c) only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).

In all other cases the derecognition principles would be applied to the financial asset in its entirety.

**Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients**

BCZ3.14 The original IAS 39 did not provide explicit guidance about the extent to which derecognition is appropriate for contractual arrangements in which an entity retains its contractual right to receive the cash flows from an asset, but assumes a contractual obligation to pay those cash flows to another entity (a 'pass-through arrangement'). Questions were raised in practice about the appropriate accounting treatment and divergent interpretations evolved for more complex structures.

BCZ3.15 To illustrate the issue using a simple example, assume the following. Entity A makes a five-year interest-bearing loan (the 'original asset') of CU100 to Entity B. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU90, Entity A agrees to pass to Entity C 90 per cent of all principal and interest payments collected from Entity B (as, when and if collected). Entity A accepts no obligation to make any payments to Entity C other than 90 per cent of exactly what has been received from Entity B. Entity A provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90 per cent of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B. In the example above, does Entity A have a loan asset of CU100 and a liability of CU90 or does it have an asset of CU10? To make the example more complex, what if Entity A first transfers the loan to a consolidated special purpose entity (SPE), which in turn passes through to investors the cash flows from the asset? Does the accounting treatment change because Entity A first sold the asset to an SPE?

BCZ3.16 To address these issues, the exposure draft of proposed amendments to IAS 39 in 2002 included guidance to clarify under which conditions pass-through arrangements could be treated as a transfer of the underlying financial asset. The Board concluded that an entity does not have an asset and a liability, as defined in the Framework, when it enters into an arrangement to pass through cash flows from an asset and that arrangement meets specified conditions. In these cases, the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset. Accordingly, to the extent that those conditions are met the arrangement is treated as a transfer and considered for
derecognition even though the entity may continue to collect cash flows from the asset. Conversely, to the extent the conditions are not met, the entity acts more as an owner of the asset with the result that the asset should continue to be recognised.

BCZ3.17 Respondents to the exposure draft (2002) were generally supportive of the proposed changes. Some respondents asked for further clarification of the requirements and the interaction with the requirements for consolidation of special purpose entities (in SIC-12 Consolidation–Special Purpose Entities). Respondents in the securitisation industry noted that under the proposed guidance many securitisation structures would not qualify for derecognition.

BCZ3.18 Considering these and other comments, the Board decided to proceed with its proposals to issue guidance on pass-through arrangements and to clarify that guidance in finalising the revised IAS 39 (this guidance is now in IFRS 9).

BCZ3.19 The Board concluded that the following three conditions must be met for treating a contractual arrangement to pass through cash flows from a financial asset as a transfer of that asset:

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. However, the entity is allowed to make short-term advances to the eventual recipient so long as it has the right of full recovery of the amount lent plus accrued interest.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, during the short settlement period, the entity is not entitled to reinvest such cash flows except for investments in cash or cash equivalents and where any interest earned from such investments is remitted to the eventual recipients.

BCZ3.20 These conditions followed from the definitions of assets and liabilities in the Framework. Condition (a) indicates that the transferor has no liability (because there is no present obligation to pay cash), and conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset).

BCZ3.21 The Board decided that the derecognition tests that apply to other transfers of financial assets (ie the tests of transferring substantially all the risks and rewards and control) should also apply to arrangements to pass through cash flows that meet the three conditions but do not involve a fully proportional share of all or specifically identified cash flows. Thus, if the three conditions are met and the entity passes on a fully proportional share, either of all cash flows (as in the example in paragraph BCZ3.15) or of specifically identified cash flows (eg 10 per cent of all interest cash flows), the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, in the example in paragraph BCZ3.15, Entity A would report a loan asset of CU10 and derecognise CU90. Similarly, if an entity enters into an arrangement that meets the three conditions above, but the arrangement is not on a fully
proportionate basis, the contractual arrangement would have to meet the
general derecognition conditions to qualify for derecognition. This ensures
consistency in the application of the derecognition model, whether a transaction
is structured as a transfer of the contractual right to receive the cash flows of a
financial asset or as an arrangement to pass through cash flows.

BCZ3.22 To illustrate a disproportionate arrangement using a simple example, assume
the following. Entity A originates a portfolio of five-year interest-bearing loans
of CU10,000. Entity A then enters into an agreement with Entity C in which, in
exchange for a cash payment of CU9,000, Entity A agrees to pay to Entity C the
first CU9,000 (plus interest) of cash collected from the loan portfolio. Entity A
retains rights to the last CU1,000 (plus interest), ie it retains a subordinated
residual interest. If Entity A collects, say, only CU8,000 of its loans of CU10,000
because some debtors default, Entity A would pass on to Entity C all of the
CU8,000 collected and Entity A keeps nothing of the CU8,000 collected.
If Entity A collects CU9,500, it passes CU9,000 to Entity C and retains CU500.
In this case, if Entity A retains substantially all the risks and rewards of
ownership because the subordinated retained interest absorbs all of the likely
variability in net cash flows, the loans continue to be recognised in their
entirety even if the three pass-through conditions are met.

BCZ3.23 The Board recognised that many securitisations might fail to qualify for
derecognition either because one or more of the three conditions (now in
paragraph 3.2.5 of IFRS 9) were not met or because the entity has retained
substantially all the risks and rewards of ownership.

BCZ3.24 Whether a transfer of a financial asset qualifies for derecognition does not differ
depending on whether the transfer is direct to investors or through a
consolidated SPE or trust that obtains the financial assets and, in turn, transfers
a portion of those financial assets to third-party investors.

**Transfers that do not qualify for derecognition**

BCZ3.25 The original IAS 39 did not provide guidance about how to account for a transfer
of a financial asset that does not qualify for derecognition. The amendments
included such guidance (that guidance is now in IFRS 9). To ensure that the
accounting reflects the rights and obligations that the transferee has in relation to
the transferred asset, there is a need to consider the accounting for the asset as well
as the accounting for the associated liability.

BCZ3.26 When an entity retains substantially all the risks and rewards of the asset (eg in
a repurchase transaction), there are generally no special accounting
considerations because the entity retains upside and downside exposure to gains
and losses resulting from the transferred asset. Therefore, the asset continues to
be recognised in its entirety and the proceeds received are recognised as a
liability. Similarly, the entity continues to recognise any income from the asset
along with any expense incurred on the associated liability.
Continuing involvement in a transferred asset

BCZ3.27 The Board decided that if the entity determines that it has neither retained nor transferred substantially all of the risks and rewards of an asset and that it has retained control, the entity should continue to recognise the asset to the extent of its continuing involvement. This is to reflect the transferor’s continuing exposure to the risks and rewards of the asset and that this exposure is not related to the entire asset, but is limited in amount. The Board noted that precluding derecognition to the extent of the continuing involvement is useful to users of financial statements in such cases, because it reflects the entity’s retained exposure to the risks and rewards of the financial asset better than full derecognition.

BCZ3.28 When the entity transfers some significant risks and rewards and retains others and derecognition is precluded because the entity retains control of the transferred asset, the entity no longer retains all the upside and downside exposure to gains and losses resulting from the transferred asset. Therefore, the revised IAS 39 required (and IFRS 9 now requires) the asset and the associated liability to be measured in a way that ensures that any changes in value of the transferred asset that are not attributed to the entity are not recognised by the entity.

BCZ3.29 For example, special measurement and income recognition issues arise if derecognition is precluded because the transferor has retained a call option or written a put option and the asset is measured at fair value. In those situations, in the absence of additional guidance, application of the general measurement and income recognition requirements for financial assets and financial liabilities may result in accounting that does not represent the transferor’s rights and obligations related to the transfer.

Improved disclosure requirements issued in October 2010

BC3.30 In March 2009 the Board published an exposure draft, Derecognition (proposed amendments to IAS 39 and IFRS 7 Financial Instruments: Disclosures). In June 2009 the Board held public round tables in North America, Asia and Europe to discuss the proposals in the exposure draft. In addition to the round tables, the Board undertook an extensive outreach programme with users, preparers, regulators, auditors, trade associations and others.

BC3.31 However, in June 2010 the Board revised its strategy and work plan. The Board and the US Financial Accounting Standards Board (FASB) decided that their near-term priority should be to increase the transparency and comparability of their standards by improving and aligning US GAAP and IFRS disclosure requirements for financial assets transferred to another entity. The boards also decided to conduct additional research and analysis, including a post-implementation review of the FASB’s recently amended requirements, as a basis for assessing the nature and direction of any further efforts to improve or align IFRSs and US GAAP. As a result, the Board finalised the disclosure requirements that were included in the exposure draft with a view to aligning the disclosure requirements in IFRSs with US GAAP requirements.
for transfers of financial assets. Those disclosure requirements were issued in October 2010 as an amendment to IFRS 7. In October 2010 the requirements in IAS 39 for derecognition of financial assets and financial liabilities were carried forward unchanged to IFRS 9.

**Classification (chapter 4)**

**Classification of financial assets**

**BC4.1** In IFRS 9 as issued in 2009 the Board aimed to help users to understand the financial reporting of financial assets by:

(a) reducing the number of classification categories and providing a clearer rationale for measuring financial assets in a particular way that replaces the numerous categories in IAS 39, each of which has specific rules dictating how an asset can or must be classified;

(b) applying a single impairment method to all financial assets not measured at fair value, which replaces the many different impairment methods that are associated with the numerous classification categories in IAS 39; and

(c) aligning the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics, thus providing relevant and useful information to users for their assessment of the amounts, timing and uncertainty of the entity’s future cash flows.

**BC4.2** The Board believes that IFRS 9 both helps users to understand and use the financial reporting of financial assets and eliminates much of the complexity in IAS 39. The Board disagrees with the assertion made by a dissenting Board member that IFRS 9 does not meet the objective of reducing the number of classification categories for financial assets and eliminating the specific rules associated with those categories. Unlike IAS 39, IFRS 9 provides a clear rationale for measuring a financial asset at either amortised cost or fair value, and hence helps users to understand the financial reporting of financial assets. IFRS 9 aligns the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics. In so doing, IFRS 9 significantly reduces complexity by eliminating the numerous rules associated with each classification category in IAS 39. Consistently with all other financial assets, hybrid contracts with financial asset hosts are classified and measured in their entirety, thereby eliminating the complex and rule-based requirements in IAS 39 for embedded derivatives. Furthermore, IFRS 9 requires a single impairment method, which replaces the different impairment methods associated with the many classification categories in IAS 39. The Board believes that these changes will help users to understand the financial reporting of financial assets and to better assess the amounts, timing and uncertainty of future cash flows.
**Measurement categories for financial assets**

**BC4.3** Some users of financial statements support a single measurement method—fair value—for all financial assets. They view fair value as more relevant than other measurements in helping them to assess the effect of current economic events on an entity. They assert that having one measurement attribute for all financial assets promotes consistency in valuation, presentation and disclosure and improves the usefulness of financial statements.

**BC4.4** However, many users and others, including many preparers and auditors of financial statements and regulators, do not support the recognition in the statement of comprehensive income of changes in fair value for financial assets that are not held for trading or are not managed on a fair value basis. Some users say that they often value an entity on the basis of its business model and that in some circumstances cost-based information provides relevant information that can be used to predict likely actual cash flows.

**BC4.5** Some, including some of those who generally support the broad application of fair value for financial assets, raise concerns about the use of fair value when fair value cannot be determined within a narrow range. Those views were consistent with the general concerns raised during the financial crisis. Many also believe that other issues, including financial statement presentation, need to be addressed before a comprehensive fair value measurement requirement would be feasible.

**BC4.6** In response to those views, the Board decided that measuring all financial assets at fair value is not the most appropriate approach to improving the financial reporting for financial instruments. Accordingly, the exposure draft published in 2009 proposed that entities should classify financial assets into two primary measurement categories: amortised cost and fair value (the ‘mixed attribute approach’). The Board noted that both of those measurement methods can provide useful information to users of financial statements for particular types of financial assets in particular circumstances.

**BC4.7** Almost all respondents to the exposure draft published in 2009 supported the mixed attribute approach, stating that amortised cost provides relevant and useful information about particular financial assets in particular circumstances because it provides information about the entity’s likely actual cash flows. Some respondents said that fair value does not provide such information because it assumes that the financial asset is sold or transferred on the measurement date.

**BC4.8** Accordingly, IFRS 9 requires some financial assets to be measured at amortised cost if particular conditions are met.

*Fair value information in the statements of financial position and financial performance*

**BC4.9** Some respondents to the exposure draft published in 2009 proposed that fair value information should be presented in the statement of financial position for financial assets measured at amortised cost. Some of those supporting such presentation said that the information provided would be more reliable and timely if it were required to be presented in the statement of financial position rather than in the notes.
BC4.10 The Board also considered whether the total gains and losses for the period related to fair value measurements in Level 3 of the fair value measurement hierarchy (paragraph 27A of IFRS 7 describes the levels in the fair value hierarchy) should be presented separately in the statement of comprehensive income. Those supporting such presentation said that its prominence would draw attention to how much of the total fair value gain or loss for the period was attributable to fair value measurements that are subject to more measurement uncertainty.

BC4.11 The Board decided that it would reconsider both issues at a future date. The Board noted that the Level 3 gains or losses for the period are required to be disclosed in the notes to the financial statements in accordance with IFRS 7. The Board also noted that neither proposal had been exposed for public comment and further consultation was required. The Board decided that these two issues should form part of convergence discussions with the FASB.

Approach to classifying financial assets

BC4.12 The exposure draft published in 2009 proposed that an entity should classify its financial assets into two primary measurement categories on the basis of the financial assets’ characteristics and the entity’s business model for managing them. Thus, a financial asset would be measured at amortised cost if two conditions were met:

(a) the financial asset has only basic loan features; and
(b) the financial asset is managed on a contractual yield basis.

A financial asset that did not meet both conditions would be measured at fair value.

BC4.13 Most respondents supported classification on the basis of the contractual terms of the financial asset and how an entity manages groups of financial assets. Although they agreed with the principles proposed in the exposure draft, some did not agree with the way the approach was described and said that more application guidance was needed, in particular to address the following issues:

(a) the order in which the two conditions are considered;
(b) how the ‘managed on a contractual yield basis’ condition should be applied; and
(c) how the ‘basic loan features’ condition should be applied.

BC4.14 Most respondents agreed that the two conditions for determining how financial assets are measured were necessary. However, many questioned the order in which the two conditions should be considered. The Board agreed with those who commented that it would be more efficient for an entity to consider the business model condition first. Therefore, the Board clarified that entities would consider the business model first. However, the Board noted that the contractual cash flow characteristics of any financial asset within a business model that has the objective of collecting contractual cash flows must also be assessed to ensure that amortised cost provides relevant information to users.
The entity’s business model

BC4.15 The Board concluded that an entity’s business model affects the predictive quality of contractual cash flows—ie whether the likely actual cash flows will result primarily from the collection of contractual cash flows. Accordingly, the exposure draft published in 2009 proposed that a financial asset should be measured at amortised cost only if it is ‘managed on a contractual yield basis’. This condition was intended to ensure that the measurement of a financial asset provides information that is useful to users of financial statements in predicting likely actual cash flows.

BC4.16 Almost all respondents to the exposure draft agreed that classification and measurement should reflect how an entity manages its financial assets. However, most expressed concern that the term ‘managed on a contractual yield basis’ would not adequately describe that principle and that more guidance was needed.

BC4.17 In August 2009 the FASB posted on its website a description of its tentative approach to classification and measurement of financial instruments. That approach also considers the entity’s business model. Under that approach, financial instruments would be measured at fair value through profit or loss unless:

... an entity’s business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party ...

The FASB also provided explanatory text:

... an entity’s business strategy for a financial instrument would be evaluated based on how the entity manages its financial instruments rather than based on the entity’s intent for an individual financial instrument. The entity also would demonstrate that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms.

BC4.18 The Board had intended ‘managed on a contractual yield basis’ to describe a similar condition. However, it decided not to use the FASB’s proposed guidance because the additional guidance included would still necessitate significant judgement. In addition, the Board noted that the FASB’s proposed approach might be viewed as very similar to the notion of ‘held to maturity’ in IAS 39, which could result in ‘bright line’ guidance on how to apply it. Most respondents believed the Board should avoid such bright lines and that an entity should be required to exercise judgement.

BC4.19 Therefore, in response to the concerns noted in paragraph BC4.16, the Board clarified the condition by requiring an entity to measure a financial asset at amortised cost only if the objective of the entity’s business model is to hold the financial asset to collect the contractual cash flows. The Board also clarified in the application guidance that:

(a) it is expected that an entity may sell some financial assets that it holds with an objective of collecting the contractual cash flows. Very few business models entail holding all instruments until maturity. However, frequent buying and selling of financial assets is not consistent with a business model of holding financial assets to collect contractual cash flows.
IFRS 9 BC

(b) an entity needs to use judgement to determine at what level this condition should be 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 financial asset.

BC4.20 The Board noted that an entity’s business model does not relate to a choice (ie it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management.

BC4.21 For example, if an investment bank uses a trading business model, it could not easily become a savings bank that uses an ‘originate and hold’ business model. Therefore, a business model is very different from ‘management intentions’, which can relate to a single instrument. The Board concluded that sales or transfers of financial instruments before maturity would not be inconsistent with a business model with an objective of collecting contractual cash flows, as long as such transactions were consistent with that business model, rather than with a business model that has the objective of realising changes in fair values.

Contractual cash flow characteristics

BC4.22 The exposure draft published in 2009 proposed that only financial instruments with basic loan features could be measured at amortised cost. It specified that a financial instrument has basic loan features if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. For the purposes of this condition, 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, which may include a premium for liquidity risk.

BC4.23 The objective of the effective interest method for financial instruments measured at amortised cost is to allocate interest revenue or expense to the relevant period. Cash flows that are interest always have a close relation to the amount advanced to the debtor (the ‘funded’ amount) because interest is consideration for the time value of money and the credit risk associated with the issuer of the instrument and with the instrument itself. The Board noted that the effective interest method is not an appropriate method to allocate cash flows that are not principal or interest on the principal amount outstanding. The Board concluded that if a financial asset contains contractual cash flows that are not principal or interest on the principal amount outstanding then a valuation overlay to contractual cash flows (fair value) is required to ensure that the reported financial information provides useful information.

BC4.24 Most respondents to the exposure draft agreed with the principle that classification should reflect the contractual terms of the financial asset. However, many objected to the label ‘basic loan features’ and requested more guidance to apply the principle to particular financial assets. Respondents were also concerned that the exposure draft did not discuss ‘immaterial’ or ‘insignificant’ features that they believed ought not to affect classification.
The Board decided to clarify how contractual cash flow characteristics should affect classification and improve the examples that illustrate how the condition should be applied. It decided not to add application guidance clarifying that the notion of materiality applies to this condition, because that notion applies to every item in the financial statements. However, it did add application guidance that a contractual cash flow characteristic does not affect the classification of a financial asset if it is ‘not genuine’.

Application of the two classification conditions to particular financial assets

Investments in contractually linked instruments (tranches)

A structured investment vehicle may issue different tranches to create a ‘waterfall’ structure that prioritises the payments by the issuer to the holders of the different tranches. In typical waterfall structures, multiple contractually linked instruments effect concentrations of credit risk in which payments to holders are prioritised. Such structures specify the order in which any losses that the issuer incurs are allocated to the tranches. The exposure draft published in 2009 concluded that tranches providing credit protection (albeit on a contingent basis) to other tranches are leveraged because they expose themselves to higher credit risk by writing credit protection to other tranches. Hence their cash flows do not represent solely payments of principal and interest on the principal amount outstanding. Thus, only the most senior tranche could have basic loan features and might qualify for measurement at amortised cost, because only the most senior tranche would receive credit protection in all situations.

The exposure draft proposed that the classification principle should be based on whether a tranche could provide credit protection to any other tranches in any possible scenario. In the Board’s view, a contract that contains credit concentration features that create ongoing subordination (not only in a liquidation scenario) would include contractual cash flows that represent a premium for providing credit protection to other tranches. Only the most senior tranche does not receive such a premium.

In proposing this approach, the Board concluded that subordination in itself should not preclude amortised cost measurement. The ranking of an entity’s instruments is a common form of subordination that affects almost all lending transactions. Commercial law (including bankruptcy law) typically sets out a basic ranking for creditors. This is required because not all creditors’ claims are contractual (eg claims regarding damages for unlawful behaviour and for tax liabilities or social insurance contributions). Although it is often difficult to determine exactly the degree of leverage resulting from this subordination, the Board believes that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for general creditors such as trade creditors. Thus, the Board believes that the credit risk associated with general creditors does not preclude the contractual cash flows representing the payments of principal and interest on the principal amount outstanding. Consequently, the credit risk associated with any secured or senior liabilities ranking above general creditors should also not preclude the contractual cash flows from representing payments of principal and interest on the principal amount outstanding.
Almost all respondents disagreed with the approach in the exposure draft for investments in contractually linked instruments for the following reasons:

(a) It focused on form and legal structure rather than the economic characteristics of the financial instruments.

(b) It would create structuring opportunities because of the focus on the existence of a waterfall structure, without consideration of the characteristics of the underlying instruments.

(c) It would be an exception to the overall classification model, driven by anti-abuse considerations.

In particular, respondents argued that the proposals in the exposure draft would conclude that some tranches provide credit protection and therefore were ineligible for measurement at amortised cost, even though that tranche might have a lower credit risk than the underlying pool of instruments that would themselves be eligible for measurement at amortised cost.

The Board did not agree that the proposals in the exposure draft were an exception to the overall classification model. In the Board’s view, those proposals were consistent with many respondents’ view that any financial instrument that creates contractual subordination should be subject to the proposed classification criteria and no specific guidance should be required to apply the classification approach to these instruments. However, it noted that, for contractually linked instruments that effect concentrations of credit risk, many respondents did not agree that the contractual cash flow characteristics determined by the terms and conditions of the financial asset in isolation best reflected the economic characteristics of that financial asset.

Respondents proposed other approaches in which an investor ‘looks through’ to the underlying pool of instruments of a waterfall structure and measures the instruments at fair value if looking through is not possible. They made the following points:

(a) Practicability: The securitisation transactions intended to be addressed were generally over-the-counter transactions in which the parties involved had sufficient information about the assets to perform an analysis of the underlying pool of instruments.

(b) Complexity: Complex accounting judgement was appropriate to reflect the complex economic characteristics of the instrument. In particular, in order to obtain an understanding of the effects of the contractual terms and conditions, an investor would have to understand the underlying pool of instruments. Also, requiring fair value measurement if it were not practicable to look through to the underlying pool of instruments would allow an entity to avoid such complexity.

(c) Mechanics: Amortised cost measurement should be available only if all of the instruments in the underlying pool of instruments had contractual cash flows that represented payments of principal and interest on the principal amount outstanding. Some also suggested that instruments that change the cash flow variability of the underlying pool of instruments in a way that is consistent with representing solely payments of principal and
interest on the principal amount outstanding, or aligned currency/interest rates with the issued notes, should not preclude amortised cost measurement.

(d) **Relative exposure to credit risk**: Many favoured use of a probability-weighted approach to assess whether an instrument has a lower or higher exposure to credit risk than the average credit risk of the underlying pool of instruments.

BC4.33 The Board was persuaded that classification solely on the basis of the contractual features of the financial asset being assessed for classification would not capture the economic characteristics of the instruments when a concentrated credit risk arises through contractual linkage. Therefore, the Board decided that, unless it is impracticable, an entity should ‘look through’ to assess the underlying cash flow characteristics of the financial assets and to assess the exposure to credit risk of those financial assets relative to the underlying pool of instruments.

BC4.34 The Board concluded that the nature of contractually linked instruments that effect concentrations of credit risk justifies this approach because the variability of cash flows from the underlying pool of instruments is a reference point, and tranching only reallocates credit risk. Thus, if the contractual cash flows of the assets in the underlying pool represent payments of principal and interest on the principal amount outstanding, any tranche that is exposed to the same or lower credit risk (as evidenced by the cash flow variability of the tranche relative to the overall cash flow variability of the underlying instrument pool) would also be deemed to represent payments of principal and interest on the principal amount outstanding. The Board also took the view that such an approach would address many of the concerns raised in the comment letters with regard to structuring opportunities and the focus on the contractual form of the financial asset, rather than its underlying economic characteristics. The Board also noted that in order to understand and make the judgement about whether particular types of financial assets have the required cash flow characteristics, an entity would have to understand the characteristics of the underlying issuer to ensure that the instrument’s cash flows are solely payments of principal and interest on the principal amount outstanding.

BC4.35 To apply this approach, the Board decided that an entity should:

(a) determine whether the contractual terms of the issued instrument (the financial asset being classified) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. The Board concluded that the issued instrument must have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

(b) look through to the underlying pool of instruments until it can identify the instruments that are creating (rather than simply passing through) the cash flows.

(c) determine whether one or more of the instruments in the underlying pool has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. The Board concluded that 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 amount outstanding.

(d) assess whether any other instruments in the underlying pool only:

(i) reduce the cash flow variability of the underlying pool of instruments in a way that is consistent with representing solely payments of principal and interest on the principal amount outstanding, or

(ii) align the cash flows of the issued financial assets with the underlying pool of financial instruments.

The Board concluded that the existence of such instruments does not preclude the cash flows from representing solely payments of principal and interest on the principal amount outstanding. The Board determined that the existence of other instruments in the pool would, however, preclude the cash flows representing solely payments of principal and interest on the principal amount outstanding. For example, an underlying pool that contains government bonds and an instrument that swaps government credit risk for (riskier) corporate credit risk would not have cash flows that represent solely principal and interest on the principal amount outstanding.

(e) measure at fair value any issued instrument in which any of the financial instruments in the underlying pool:

(i) have cash flows that do not represent solely payments of principal and interest on the principal amount outstanding; or

(ii) could change so that cash flows may not represent solely payments of principal and interest on the principal amount outstanding at any point in the future.

(f) measure at fair value any issued instrument whose exposure to credit risk in the underlying pool of financial instruments is greater than the exposure to credit risk of the underlying pool of financial instruments. The Board decided that if the range of expected losses on the issued instrument is greater than the weighted average range of expected losses on the underlying pool of financial instruments, then the issued instrument should be measured at fair value.

BC4.36 The Board also decided that if it were not practicable to look through to the underlying pool of financial instruments, entities should measure the issued instrument at fair value.

Financial assets acquired at a discount that reflects incurred credit losses

BC4.37 The exposure draft published in 2009 proposed that if a financial asset is acquired at a discount that reflects incurred credit losses, it cannot be measured at amortised cost because:

(a) the entity does not hold such financial assets to collect the cash flows arising from those assets’ contractual terms; and
(b) an investor acquiring a financial asset at such a discount believes that the actual losses will be less than the losses that are reflected in the purchase price. Thus, that asset creates exposure to significant variability in actual cash flows and such variability is not interest.

BC4.38 Almost all respondents disagreed with the Board’s conclusion that these assets cannot be held to collect the contractual cash flows. They regarded that conclusion as an exception to a classification approach based on the entity’s business model for managing the financial assets. In particular, they noted that entities could acquire and subsequently manage such assets as part of an otherwise performing asset portfolio for which the objective of the entity’s business model is to hold the assets to collect contractual cash flows.

BC4.39 Respondents also noted that an entity’s expectations about actual future cash flows are not the same as the contractual cash flows of the financial asset. Those expectations are irrelevant to an assessment of the financial asset’s contractual cash flow characteristics.

BC4.40 The Board agreed that the general classification approach in IFRS 9 should apply to financial assets acquired at a discount that reflects incurred credit losses. Thus, when such assets meet the conditions in paragraph 4.1.2, they are measured at amortised cost.

**Alternative approaches to classifying assets**

BC4.41 In its deliberations leading to the exposure draft published in 2009, the Board discussed alternative approaches to classification and measurement. In particular, it considered an approach in which financial assets that have basic loan features, are managed on a contractual yield basis and meet the definition of loans and receivables in IAS 39 would be measured at amortised cost. All other financial assets would be measured at fair value. The fair value changes for each period for those financial assets with basic loan features that are managed on a contractual yield basis would be disaggregated and presented as follows:

(a) changes in recognised value determined on an amortised cost basis (including impairments determined using the incurred loss impairment requirements in IAS 39) would be presented in profit or loss; and

(b) any difference between the amortised cost measure in (a) and the fair value change for the period would be presented in other comprehensive income.

BC4.42 The Board also considered variants in which all financial assets and financial liabilities would be measured at fair value. One variant would be to present both the amounts in paragraph BC4.41(a) and (b) in profit or loss, but separately. Another variant would be to measure all financial instruments (including financial assets that meet the two conditions specified in the exposure draft published in 2009 and meet the definition of loans and receivables in IAS 39) at fair value in the statement of financial position. All financial instruments (including financial liabilities) with basic loan features that are managed on a contractual yield basis would be disaggregated and presented as described in paragraph BC4.41(a) and (b).
Respondents noted that the alternative approach described in paragraph BC4.41 and both variants described in paragraph BC4.42 would result in more financial assets and financial liabilities being measured at fair value. Respondents also noted that the alternative approach would apply only to financial assets. Lastly, almost all respondents noted that splitting gains and losses between profit or loss and other comprehensive income would increase complexity and reduce understandability. The Board concluded that those approaches would not result in more useful information than the approach in IFRS 9 and did not consider them further.

The Board also considered and rejected the following approaches to classification:

(a) *Classification based on the definition of held for trading:* A few respondents suggested that all financial assets and financial liabilities that are not ‘held for trading’ should be eligible for measurement at amortised cost. However, in the Board’s view, the notion of ‘held for trading’ is too narrow and cannot appropriately reflect all situations in which amortised cost does not provide useful information.

(b) *Three-category approach:* Some respondents suggested retaining a three-category approach, i.e., including a third category similar to the available-forsale category in IAS 39. However, in the Board’s view, such an approach would neither significantly improve nor reduce the complexity of the reporting for financial instruments.

(c) *Classification based only on the business model:* A small number of respondents thought the contractual terms of the instrument condition was unnecessary and that classification should depend solely on the entity’s business model for managing financial instruments. However, in the Board’s view, determining classification solely on the basis of how an entity manages its financial instruments would result in misleading information that is not useful to a user in understanding the risks associated with complex or risky instruments. The Board concluded, as had almost all respondents, that the contractual cash flow characteristics condition is required to ensure that amortised cost is used only when it provides information that is useful in predicting the entity’s future cash flows.

(d) *Amortised cost as the default option:* The Board considered developing conditions that specified when a financial asset must be measured at fair value, with the requirement that all other financial instruments would be measured at amortised cost. The Board rejected that approach because it believes that new conditions would have to be developed in the future to address innovative financial products. In addition, the Board noted that such an approach would not be practical because an entity can apply amortised cost only to some types of financial instruments.

(e) *Originated loan approach:* In developing an approach to distinguish between financial assets measured at fair value and amortised cost the Board considered a model in which only loans originated by the entity would qualify for amortised cost measurement. The Board acknowledged that for originated instruments the entity potentially has better information about the future contractual cash flows and credit risk than for purchased loans.
However, the Board decided not to pursue that approach, mainly because some entities manage originated and purchased loans in the same portfolio. Distinguishing between originated and purchased loans, which would be done mainly for accounting purposes, would involve systems changes. In addition, the Board noted that ‘originated loans’ might easily be created by placing purchased loans into an investment vehicle. The Board also noted that the definition of loans and receivables in IAS 39 had created application problems in practice.

### Tainting

**BC4.45** The Board considered whether it should prohibit an entity from classifying a financial asset as measured at amortised cost if the entity had previously sold or reclassified financial assets rather than holding them to collect the contractual cash flows. A restriction of this kind is often called ‘tainting’. However, the Board believes that classification based on the entity’s business model for managing financial assets and the contractual cash flow characteristics of those financial assets provides a clear rationale for measurement. A tainting provision would increase the complexity of application, be unduly prohibitive in the context of that approach and could give rise to classification that is inconsistent with the classification approach in IFRS 9. However, in 2009 the Board amended IAS 1 *Presentation of Financial Statements* to require an entity to present separately in the statement of comprehensive income all gains and losses arising from the derecognition of financial assets measured at amortised cost. The Board also amended IFRS 7 in 2009 to require an entity to disclose an analysis of those gains and losses, including the reasons for derecognising those financial assets. Those requirements enable users of financial statements to understand the effects of derecognising before maturity instruments measured at amortised cost and also provides transparency in situations where an entity has measured financial assets at amortised cost on the basis of having an objective of managing those assets in order to collect the contractual cash flows but regularly sells them.

### Classification of financial liabilities

**BC4.46** Immediately after issuing the first chapters of IFRS 9 in November 2009, the Board began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities, in particular how best to address the effects of changes in the fair value of a financial liability caused by changes in the risk that the issuer will fail to perform on that liability. The Board obtained information and views from its FIWG and from users, regulators, preparers, auditors and others from a range of industries across different geographical regions. The Board also developed a questionnaire to ask users of financial statements how they use information about the effects of changes in liabilities’ credit risk (if at all) and what their preferred method of accounting is for selected financial liabilities. The Board received over 90 responses to that questionnaire.

**BC4.47** During the outreach programme, the Board explored several approaches for classification and subsequent measurement of financial liabilities that would exclude the effects of changes in a liability’s credit risk from profit or loss, including:
(a) measuring liabilities at fair value and presenting in other comprehensive income the portion of the change in fair value that is attributable to changes in the liability's credit risk. A variant of this alternative would be to present in other comprehensive income the entire change in fair value.

(b) measuring liabilities at an 'adjusted' fair value whereby the liability would be remeasured for all changes in fair value except for the effects of changes in its credit risk (ie 'the frozen credit spread method'). In other words, the effects of changes in its credit risk would be ignored in the primary financial statements.

(c) measuring liabilities at amortised cost. This would require estimating the cash flows over the life of the instrument, including those cash flows associated with any embedded derivative features.

(d) bifurcating liabilities into hosts and embedded features. The host contract would be measured at amortised cost and the embedded features (eg embedded derivatives) would be measured at fair value through profit or loss. The Board discussed either carrying forward the bifurcation requirements in IAS 39 for financial liabilities or developing new requirements.

BC4.48 The primary message that the Board received from users of financial statements and others during its outreach programme was that the effects of changes in a liability’s credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability’s credit risk unless the liability is held for trading.

BC4.49 In addition to that view, there were several other themes in the feedback that the Board received:

(a) Symmetry between how an entity classifies and measures its financial assets and its financial liabilities is not necessary and often does not result in useful information. Most constituents said that in its deliberations on financial liabilities the Board should not be constrained or biased by the requirements in IFRS 9 for financial assets.

(b) Amortised cost is the most appropriate measurement attribute for many financial liabilities because it reflects the issuer’s legal obligation to pay the contractual amounts in the normal course of business (ie on a going concern basis) and in many cases, the issuer will hold liabilities to maturity and pay the contractual amounts. However, if a liability has structured features (eg embedded derivatives), amortised cost is difficult to apply and understand because the cash flows can be highly variable.

(c) The bifurcation methodology in IAS 39 is generally working well and practice has developed since those requirements were issued. For many entities, bifurcation avoids the issue of own credit risk because the host is measured at amortised cost and only the derivative is measured at fair value through profit or loss. Many constituents, including users of financial statements, favoured retaining bifurcation for financial liabilities even though they supported eliminating it for financial assets. That was because bifurcation addresses the issue of own credit risk, which is only relevant for financial liabilities. Users preferred structured assets to be measured at fair value in their entirety. Many constituents were
sceptical that a new bifurcation methodology could be developed that was less complex and provided more useful information than using the bifurcation methodology in IAS 39. Moreover, a new bifurcation methodology would be likely to have the same classification and measurement outcomes as the existing methodology in most cases.

(d) The Board should not develop a new measurement attribute. The almost unanimous view was that a ‘full’ fair value amount is more understandable and useful than an ‘adjusted’ fair value amount that ignores the effects of changes in the liability’s credit risk.

(e) Even for preparers with sophisticated valuation expertise, it is difficult to determine the amount of change in the fair value of a liability that is attributable to changes in its credit risk. Under existing IFRSs only entities that elect to designate liabilities under the fair value option are required to determine that amount. If the Board were to extend that requirement to more entities and to more financial liabilities, many entities would have significant difficulty determining that amount and could incur significant costs in doing so.

BC4.50 Although there were common themes in the feedback received, there was no consensus on which of the alternative approaches being explored by the Board was the best way to address the effects of changes in liabilities’ credit risk. Many constituents said that none of the alternatives being discussed was less complex or would result in more useful information than the existing bifurcation requirements.

BC4.51 As a result of the feedback received, the Board decided to retain almost all of the existing requirements for the classification and measurement of financial liabilities. The Board decided that the benefits of changing practice at this point do not outweigh the costs of the disruption that such a change would cause. Accordingly, in October 2010 the Board carried forward almost all of the requirements unchanged from IAS 39 to IFRS 9.

BC4.52 By retaining almost all of the existing requirements, the issue of credit risk is addressed for most liabilities because they would continue to be subsequently measured at amortised cost or would be bifurcated into a host, which would be measured at amortised cost, and an embedded derivative, which would be measured at fair value. Liabilities that are held for trading (including all derivative liabilities) would continue to be subsequently measured at fair value through profit or loss, which is consistent with the widespread view that all fair value changes for those liabilities should affect profit or loss.

BC4.53 The issue of credit risk would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010 the Board published an exposure draft Fair Value Option for Financial Liabilities, which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The Board considered the responses to that exposure draft and finalised amendments to IFRS 9 in October 2010 (see paragraphs BC5.35–BC5.64). Those amendments also eliminated the cost exception for particular derivative liabilities that will be settled by delivering unquoted equity instruments whose fair values cannot be reliably determined (see paragraph BC5.20).
Option to designate a financial asset or financial liability at fair value through profit or loss

Background to the fair value option in IAS 39

BCZ4.54 In 2003 the Board concluded that it could simplify the application of IAS 39 (as revised in 2000) for some entities by permitting the use of fair value measurement for any financial instrument. With one exception, this greater use of fair value is optional. The fair value measurement option does not require entities to measure more financial instruments at fair value.

BCZ4.55 IAS 39 (as revised in 2000)* did not permit an entity to measure particular categories of financial instruments at fair value with changes in fair value recognised in profit or loss. Examples included:

(a) originated loans and receivables, including a debt instrument acquired directly from the issuer, unless they met the conditions for classification as held for trading (now in Appendix A of IFRS 9).

(b) financial assets classified as available for sale, unless as an accounting policy choice gains and losses on all available-for-sale financial assets were recognised in profit or loss or they met the conditions for classification as held for trading (now in Appendix A of IFRS 9).

(c) non-derivative financial liabilities, even if the entity had a policy and practice of actively repurchasing such liabilities or they formed part of an arbitrage/customer facilitation strategy or fund trading activities.

BCZ4.56 The Board decided in IAS 39 (as revised in 2003) to permit entities to designate irrevocably on initial recognition any financial instruments as ones to be measured at fair value with gains and losses recognised in profit or loss (‘fair value through profit or loss’). To impose discipline on this approach, the Board decided that financial instruments should not be reclassified into or out of the category of fair value through profit or loss. In particular, some comments received on the exposure draft of proposed amendments to IAS 39 published in June 2002 suggested that entities could use the fair value option to recognise selectively changes in fair value in profit or loss. The Board noted that the requirement (now in IFRS 9) to designate irrevocably on initial recognition the financial instruments for which the fair value option is to be applied results in an entity being unable to ‘cherry pick’ in this way. This is because it will not be known at initial recognition whether the fair value of the instrument will increase or decrease.

BCZ4.57 Following the issue of IAS 39 (as revised in 2003), as a result of continuing discussions with constituents on the fair value option, the Board became aware that some, including prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately. These constituents were concerned that:

(a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss.

* IFRS 9 eliminated the loans and receivables and available-for-sale categories.
(b) the use of the option might increase, rather than decrease, volatility in
profit or loss, for example if an entity applied the option to only one part
of a matched position.

(c) if an entity applied the fair value option to financial liabilities, it might
result in an entity recognising gains or losses in profit or loss associated
with changes in its own creditworthiness.

BCZ4.58 In response to those concerns, the Board published in April 2004 an exposure
draft of proposed restrictions to the fair value option contained in IAS 39
(as revised in 2003). After discussing comments received from constituents and
a series of public round-table meetings, the Board issued an amendment to IAS 39
in June 2005 permitting entities to designate irrevocably on initial recognition
financial instruments that meet one of three conditions as ones to be measured
at fair value through profit or loss.

BCZ4.59 In those amendment to the fair value option, the Board identified three
situations in which permitting designation at fair value through profit or loss
either results in more relevant information ((a) and (b) below) or is justified on
the grounds of reducing complexity or increasing measurement reliability ((c)
below). These are:

(a) when such designation eliminates or significantly reduces a measurement
or recognition inconsistency (sometimes referred to as an ‘accounting
mismatch’) that would otherwise arise (paragraphs BCZ4.61–BCZ4.63);

(b) when a group of financial assets, financial liabilities or both is managed
and its performance is evaluated on a fair value basis, in accordance with a
documented risk management or investment strategy (paragraphs
BCZ4.64–BCZ4.66); and

(c) when an instrument contains an embedded derivative that meets
particular conditions (paragraphs BCZ4.67–BCZ4.70).

BCZ4.60 The ability for entities to use the fair value option simplifies the application of
IAS 39 by mitigating some anomalies that result from the different measurement
attributes. In particular, for financial instruments designated in this way:

(a) it eliminates the need for hedge accounting for hedges of fair value
exposures when there are natural offsets, and thereby eliminates the
related burden of designating, tracking and analysing hedge effectiveness.

(b) it eliminates the burden of separating embedded derivatives.

(c) it eliminates problems arising from a mixed measurement model when
financial assets are measured at fair value and related financial liabilities
are measured at amortised cost. In particular, it eliminates volatility in
profit or loss and equity that results when matched positions of financial
assets and financial liabilities are not measured consistently.

(d) the option to recognise realised gains and losses on available-for-sale
financial assets in profit or loss is no longer necessary.

(e) it de-emphasises interpretative issues around what constitutes trading.
Designation eliminates or significantly reduces an accounting mismatch

BCZ4.61 IAS 39, like comparable standards in some national jurisdictions, imposed (and IFRS 9 now imposes) a mixed attribute measurement model. It required some financial assets and liabilities to be measured at fair value, and others to be measured at amortised cost. It required some gains and losses to be recognised in profit or loss, and others to be recognised initially as a component of equity. This combination of measurement and recognition requirements could result in inconsistencies, which some refer to as ‘accounting mismatches’, between the accounting for an asset (or group of assets) and a liability (or group of liabilities). The notion of an accounting mismatch necessarily involves two propositions. First, an entity has particular assets and liabilities that are measured, or on which gains and losses are recognised, inconsistently; second, there is a perceived economic relationship between those assets and liabilities. For example, a liability may be considered to be related to an asset when they share a risk that gives rise to opposite changes in fair value that tend to offset, or when the entity considers that the liability funds the asset.

BCZ4.62 Some entities could overcome measurement or recognition inconsistencies by using hedge accounting or, in the case of insurers, shadow accounting. However, the Board recognised that those techniques are complex and do not address all situations. In developing the amendment to the fair value option in 2004, the Board considered whether it should impose conditions to limit the situations in which an entity could use the option to eliminate an accounting mismatch. For example, it considered whether entities should be required to demonstrate that particular assets and liabilities are managed together, or that a management strategy is effective in reducing risk (as is required for hedge accounting to be used), or that hedge accounting or other ways of overcoming the inconsistency are not available.

BCZ4.63 The Board concluded that accounting mismatches arise in a wide variety of circumstances. In the Board’s view, financial reporting is best served by providing entities with the opportunity to eliminate perceived accounting mismatches whenever that results in more relevant information. Furthermore, the Board concluded that the fair value option may validly be used in place of hedge accounting for hedges of fair value exposures, thereby eliminating the related burden of designating, tracking and analysing hedge effectiveness. Hence, the Board decided not to develop detailed prescriptive guidance about when the fair value option could be applied (such as requiring effectiveness tests similar to those required for hedge accounting) in the amendment on the fair value option. Rather, the Board decided to require disclosures (now in IFRS 7) about:

- the criteria an entity uses for designating financial assets and financial liabilities as at fair value through profit or loss
- how the entity satisfies the conditions for such designation
- the nature of the assets and liabilities so designated

* As a consequence of the revision of IAS 1 Presentation of Financial Statements in 2007 these other gains and losses are recognised in other comprehensive income.
• the effect on the financial statement of using this designation, namely the carrying amounts and net gains and losses on assets and liabilities so designated, information about the effect of changes in a financial liability’s credit quality on changes in its fair value, and information about the credit risk of loans or receivables and any related credit derivatives or similar instruments.

A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis

BCZ4.64 IAS 39 required financial instruments to be measured at fair value through profit or loss in only two situations, namely when an instrument is held for trading or when it contains an embedded derivative that the entity is unable to measure separately. However, the Board recognised that some entities manage and evaluate the performance of financial instruments on a fair value basis in other situations. Furthermore, for instruments managed and evaluated in this way, users of financial statements may regard fair value measurement as providing more relevant information. Finally, it is established practice in some industries in some jurisdictions to recognise all financial assets at fair value through profit or loss. (This practice was permitted for many assets in IAS 39 (as revised in 2000) as an accounting policy choice in accordance with which gains and losses on all available-for-sale financial assets were reported in profit or loss.)

BCZ4.65 In the amendment to IAS 39 relating to the fair value option issued in June 2005, the Board permitted financial instruments managed and evaluated on a fair value basis to be measured at fair value through profit or loss. The Board also introduced two requirements to make this category operational. These requirements are that the financial instruments are managed and evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and that information about the financial instruments is provided internally on that basis to the entity’s key management personnel.

BCZ4.66 In looking to an entity’s documented risk management or investment strategy, the Board made no judgement on what an entity’s strategy should be. However, the Board noted that users, in making economic decisions, would find useful both a description of the chosen strategy and how designation at fair value through profit or loss is consistent with it. Such disclosures are required (now in IFRS 7). The Board also noted that the required documentation of the entity’s strategy need not be item by item, nor need it be in the level of detail required for hedge accounting. However, it should be sufficient to demonstrate that using the fair value option is consistent with the entity’s risk management or investment strategy. In many cases, the entity’s existing documentation, as approved by its key management personnel, should be sufficient for this purpose.

The instrument contains an embedded derivative that meets particular conditions

BCZ4.67 IAS 39 required virtually all derivative financial instruments to be measured at fair value. This requirement extended to derivatives that are embedded in an instrument that also includes a non-derivative host if the embedded derivative met particular conditions. Conversely, if the embedded derivative did not meet those conditions, separate accounting with measurement of the embedded
derivative at fair value is prohibited. Therefore, to satisfy these requirements, the entity must:

(a) identify whether the instrument contains one or more embedded derivatives,

(b) determine whether each embedded derivative is one that must be separated from the host instrument or one for which separation is prohibited, and

(c) if the embedded derivative is one that must be separated, determine its fair value at initial recognition and subsequently.

BCZ4.68 For some embedded derivatives, like the prepayment option in an ordinary residential mortgage, this process is fairly simple. However, entities with more complex instruments have reported that the search for and analysis of embedded derivatives (steps (a) and (b) in paragraph BCZ4.67) significantly increase the cost of complying with the IFRS. They report that this cost could be eliminated if they had the option to fair value the combined contract.

BCZ4.69 Other entities report that one of the most common uses of the fair value option is likely to be for structured products that contain several embedded derivatives. Those structured products will typically be hedged with derivatives that offset all (or nearly all) of the risks they contain, whether or not the embedded derivatives that give rise to those risks are separated for accounting purposes. Hence, the simplest way to account for such products is to apply the fair value option so that the combined contract (as well as the derivatives that hedge it) is measured at fair value through profit or loss. Furthermore, for these more complex instruments, the fair value of the combined contract may be significantly easier to measure and hence be more reliable than the fair value of only those embedded derivatives that are required to be separated.

BCZ4.70 The Board sought to strike a balance between reducing the costs of complying with the embedded derivatives provisions and the need to respond to the concerns expressed regarding possible inappropriate use of the fair value option. The Board determined that allowing the fair value option to be used for any instrument with an embedded derivative would make other restrictions on the use of the option ineffective, because many financial instruments include an embedded derivative. In contrast, limiting the use of the fair value option to situations in which the embedded derivative must otherwise be separated would not significantly reduce the costs of compliance and could result in less reliable measures being included in the financial statements. Therefore, the Board decided to specify situations in which an entity cannot justify using the fair value option in place of assessing embedded derivatives—when the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract or is one for which it is clear with little or no analysis when a similar hybrid instrument is first considered that separation is prohibited.

The role of prudential supervisors

BCZ4.71 The Board considered the circumstances of regulated financial institutions such as banks and insurers in determining the extent to which conditions should be placed on the use of the fair value option. The Board recognised that regulated financial institutions are extensive holders and issuers of financial instruments
and so are likely to be among the largest potential users of the fair value option. However, the Board noted that some of the prudential supervisors that oversee these entities expressed concern that the fair value option might be used inappropriately.

**BCZ4.72** The Board noted that the primary objective of prudential supervisors is to maintain the financial soundness of individual financial institutions and the stability of the financial system as a whole. Prudential supervisors achieve this objective partly by assessing the risk profile of each regulated institution and imposing a risk-based capital requirement.

**BCZ4.73** The Board noted that these objectives of prudential supervision differ from the objectives of general purpose financial reporting. The latter is intended to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the Board acknowledged that for the purposes of determining what level of capital an institution should maintain, prudential supervisors may wish to understand the circumstances in which a regulated financial institution has chosen to apply the fair value option and evaluate the rigour of the institution’s fair value measurement practices and the robustness of its underlying risk management strategies, policies and practices. Furthermore, the Board agreed that certain disclosures would assist both prudential supervisors in their evaluation of capital requirements and investors in making economic decisions. In particular, the Board decided to require an entity to disclose how it has satisfied the conditions for using the fair value option, including, for instruments that are now within paragraph 4.2.2(b) of IFRS 9, a narrative description of how designation at fair value through profit or loss is consistent with the entity’s documented risk management or investment strategy.

**Application of the fair value option to a component or a proportion (rather than the entirety) of a financial asset or a financial liability**

**BCZ4.74** Some comments received on the exposure draft of proposed amendments to IAS 39 published in June 2002 argued that the fair value option should be extended so that it could also be applied to a component of a financial asset or a financial liability (eg changes in fair value attributable to one risk such as changes in a benchmark interest rate). The arguments included (a) concerns regarding inclusion of own credit risk in the measurement of financial liabilities and (b) the prohibition on using non-derivatives as hedging instruments (cash instrument hedging).

**BCZ4.75** The Board concluded that IAS 39 should not extend the fair value option to components of financial assets or financial liabilities. It was concerned (a) about difficulties in measuring the change in value of the component because of ordering issues and joint effects (ie if the component is affected by more than one risk, it may be difficult to isolate accurately and measure the component); (b) that the amounts recognised in the balance sheet would be neither fair value nor cost; and (c) that a fair value adjustment for a component might move the carrying amount of an instrument away from its fair value. In finalising the 2003 amendments to IAS 39, the Board separately considered the issue of cash instrument hedging (see paragraphs BC144 and BC145 of the Basis for Conclusions on IAS 39).
Other comments received on the April 2004 exposure draft of proposed restrictions on the fair value option contained in IAS 39 (as revised in 2003) suggested that the fair value option should be extended so that it could be applied to a proportion (ie a percentage) of a financial asset or financial liability. The Board was concerned that such an extension would require prescriptive guidance on how to determine a proportion. For example, if an entity were to issue a bond totalling CU100 million in the form of 100 certificates each of CU1 million, would a proportion of 10 per cent be identified as 10 per cent of each certificate, CU10 million specified certificates, the first (or last) CU10 million certificates to be redeemed, or on some other basis? The Board was also concerned that the remaining proportion, not being subject to the fair value option, could give rise to incentives for an entity to ‘cherry pick’ (ie to realise financial assets or financial liabilities selectively so as to achieve a desired accounting result). For these reasons, the Board decided not to allow the fair value option to be applied to a proportion of a single financial asset or financial liability (that restriction is now in IFRS 9). However, if an entity simultaneously issues two or more identical financial instruments, it is not precluded from designating only some of those instruments as being subject to the fair value option (for example, if doing so achieves a significant reduction in a recognition or measurement inconsistency). Thus, in the above example, the entity could designate CU10 million specified certificates if to do so would meet one of the three criteria in paragraph BC4.59.

### Option to designate a financial asset at fair value

As noted above, IAS 39 allowed entities an option to designate on initial recognition any financial asset or financial liability as measured at fair value through profit or loss if one (or more) of the following three conditions is met:

(a) Doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’) that would otherwise arise from measuring assets or liabilities on different bases or recognising the gains and losses on them on different bases.

(b) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel.

(c) The financial asset or financial liability contains one or more embedded derivatives (and particular other conditions now described in paragraph 4.3.5 of IFRS 9 are met) and the entity elects to account for the hybrid contract in its entirety.

However, in contrast to IAS 39, IFRS 9 requires:

(a) any financial asset that is not managed within a business model that has the objective of collecting contractual cash flows to be measured at fair value; and

(b) hybrid contracts with financial asset hosts to be classified in their entirety, hence eliminating the requirement to identify and account for embedded derivatives separately.
Accordingly, the Board concluded that the conditions described in paragraph BC4.77(b) and (c) are unnecessary for financial assets.

BC4.79 The Board retained the eligibility condition described in paragraph BC4.77(a) because it mitigates some anomalies that result from the different measurement attributes used for financial instruments. In particular, it eliminates the need for fair value hedge accounting of fair value exposures when there are natural offsets. It also avoids problems arising from a mixed measurement model when some financial assets are measured at amortised cost and related financial liabilities are measured at fair value. A separate phase of the project is considering hedge accounting, and the fair value option will be better considered in that context. The Board also noted that particular industry sectors believe it is important to be able to mitigate such anomalies until other IASB projects are completed (eg insurance contracts). The Board decided to defer consideration of changes to the eligibility condition set out in paragraph BC4.77(a) as part of the future exposure draft on hedge accounting.

BC4.80 Almost all the respondents to the exposure draft published in 2009 supported the proposal to retain the fair value option if such designation eliminates or significantly reduces an accounting mismatch. Although some respondents would prefer an unrestricted fair value option, they acknowledged that an unrestricted fair value option has been opposed by many in the past and it is not appropriate to pursue it now.

**Option to designate a financial liability at fair value**

**Eligibility conditions**

BC4.81 During its discussions about subsequent classification and measurement of financial liabilities in 2010 (see paragraphs BC4.46–BC4.53), the Board considered whether it was necessary to propose any changes to the eligibility conditions for designating financial liabilities under the fair value option. However, the Board decided that such changes were not necessary because the Board was not changing the underlying classification and measurement approach for financial liabilities. Therefore, the exposure draft published in May 2010 proposed to carry forward the three eligibility conditions.

BC4.82 Most respondents agreed with that proposal in the exposure draft. The Board confirmed the proposal and decided to carry forward to IFRS 9 the three eligibility conditions in October 2010. Some would have preferred an unrestricted fair value option. However, they acknowledged that an unrestricted fair value option had been opposed by many in the past and it was not appropriate to pursue it now.

**Embedded derivatives**

**Hybrid contracts with a host that is an asset within the scope of IFRS 9**

BC4.83 An embedded derivative is a derivative component of a hybrid contract that also includes a non-derivative host, with the effect that some of the cash flows of the combined contract vary like the cash flows of a stand-alone derivative contract. IAS 39 required an entity to assess all contracts to determine whether they contain one or more embedded derivatives that are required to be separated from the host and accounted for as stand-alone derivatives.
Many respondents to the discussion paper *Reducing Complexity in Reporting Financial Instruments* commented that the requirements and guidance in IAS 39 were complex, rule-based and internally inconsistent. Respondents, and others, also noted the many application problems that arose from requirements to assess all non-derivative contracts for embedded derivatives and, if required, to account for and measure those embedded derivatives separately as stand-alone derivatives.

In 2009 the Board discussed three approaches for accounting for embedded derivatives:

(a) to maintain the requirements in IAS 39;

(b) to use ‘closely related’ (used in IAS 39 to determine whether an embedded derivative is required to be separated from the host) to determine the classification for the contract in its entirety; and

(c) to use the same classification approach for all financial assets (including hybrid contracts).

The Board rejected the first two approaches. The Board noted that both would rely on the assessment of whether an embedded derivative is ‘closely related’ to the host. The ‘closely related’ assessment is based on a list of examples that are inconsistent and unclear. That assessment is also a significant source of complexity. Both approaches would result in hybrid contracts being classified using conditions different from those that would be applied to all non-hybrid financial instruments. Consequently, some hybrid contracts whose contractual cash flows do not solely represent payments of principal and interest on the principal amount outstanding might be measured at amortised cost. Similarly, some hybrid contracts whose contractual cash flows do meet the conditions for measurement at amortised cost might be measured at fair value. The Board also believes that neither approach would make it easier for users of financial statements to understand the information that financial statements present about financial instruments.

Therefore, the exposure draft published in 2009 proposed that entities should use the same classification approach for all financial instruments, including hybrid contracts with hosts within the scope of the proposed IFRS (‘financial hosts’). The Board concluded that a single classification approach for all financial instruments and hybrid contracts with financial hosts was the only approach that responded adequately to the criticisms described above. The Board noted that using a single classification approach improves comparability by ensuring consistency in classification, and hence makes it easier for users to understand the information that financial statements present about financial instruments.

In the responses to the exposure draft, some respondents, mainly preparers, stated their preference for keeping or modifying the bifurcation model that was in IAS 39. They noted that:

(a) eliminating the requirement to account for embedded derivatives as stand-alone derivatives would lead to increased volatility in profit or loss and result in accounting that did not reflect the underlying economics and risk management or business model considerations in a transaction. For example, the components of some hybrid financial instruments may be managed separately.
(b) structuring opportunities would be created, for example if an entity entered into two transactions that have the same economic effect as entering into a single hybrid contract.

BC4.89 However, the Board confirmed the proposals in the exposure draft for the following reasons:

(a) The elimination of the embedded derivatives guidance for hybrid contracts with financial hosts reduces the complexity in financial reporting of financial assets by eliminating another classification approach and improves the reporting for financial instruments. Many constituents agreed with this conclusion.

(b) In the Board’s view, the underlying rationale for separate accounting for embedded derivatives is not to reflect risk management activities, but to avoid entities circumventing the recognition and measurement requirements for derivatives. Accordingly it is an exception to the definition of the unit of account (the contract) motivated by a wish to avoid abuse. It would reduce complexity to eliminate an anti-abuse exception.

(c) The Board noted the concerns about structuring opportunities referred to in paragraph BC4.88(b). However, two contracts represent two units of account. Reconsideration of the unit of account forms part of a far broader issue for financial reporting that is outside the scope of the Board’s considerations in IFRS 9. In addition, embedded derivative features often do not have contractual cash flows that represent payments of principal and interest on the principal amount outstanding and thus the entire hybrid contract would not be eligible to be measured at amortised cost. However, the Board noted that this would provide more relevant information because the embedded derivative feature affects the cash flows ultimately arising from the hybrid contract. Thus, applying the classification approach to the hybrid contract in its entirety would depict more faithfully the amount, timing and uncertainty of future cash flows.

(d) In the Board’s view, accounting for the hybrid contract as one unit of account is consistent with the project’s objective—to improve the usefulness for users in their assessment of the timing, amount and uncertainty of future cash flows of financial instruments and to reduce the complexity in reporting financial instruments.

This decision applies only to hybrid contracts with a host that is an asset within the scope of IFRS 9.

BC4.90 The Board decided not to consider at this time changes to the requirements in IAS 39 for embedded derivatives in hybrid contracts with non-financial hosts. The Board acknowledged that those requirements are also complex and have resulted in some application problems, including the question of whether particular types of non-financial contracts are within the scope of IAS 39. The Board accepted the importance of ensuring that any proposals for hybrid contracts with non-financial hosts should also address which non-financial contracts should be within the scope of IFRS 9. The Board also noted the importance for many non-financial entities of hedge accounting for non-financial
IFRS 9 BC

items, and the relationship to both scope and embedded derivative requirements. Therefore, the Board concluded that the requirements for hybrid contracts with non-financial hosts should be addressed in a later phase of the project to replace IAS 39.

Hybrid contracts with a host that is not an asset within the scope of IFRS 9

BC4.91 As discussed in paragraphs BC4.46–BC4.53, in 2010 the Board decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities. Therefore, those requirements (including the requirements related to embedded derivatives) were carried forward unchanged to IFRS 9. Constituents told the Board that the bifurcation methodology in IAS 39 for financial liabilities is generally working well in practice and practice has developed since those requirements were issued. Many constituents, including users of financial statements, favoured retaining bifurcation for financial liabilities even though they supported eliminating it for financial assets. That was because bifurcation addresses the issue of own credit risk, which is only relevant for financial liabilities.

Embedded foreign currency derivatives

BCZ4.92 A rationale for the embedded derivatives requirements is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract, for example, a commodity forward in a debt instrument. To achieve consistency in accounting for such embedded derivatives, all derivatives embedded in financial instruments that are not measured at fair value with gains and losses recognised in profit or loss ought to be accounted for separately as derivatives. However, as a practical expedient, an embedded derivative need not be separated if it is regarded as closely related to its host contract. When the embedded derivative bears a close economic relationship to the host contract, such as a cap or a floor on the interest rate on a loan, it is less likely that the derivative was embedded to achieve a desired accounting result.

BCZ4.93 The original IAS 39 specified that a foreign currency derivative embedded in a non-financial host contract (such as a supply contract denominated in a foreign currency) was not separated if it required payments denominated in the currency of the primary economic environment in which any substantial party to the contract operates (their functional currencies) or the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (such as the US dollar for crude oil transactions). Such foreign currency derivatives are regarded as bearing such a close economic relationship to their host contracts that they do not have to be separated.

BCZ4.94 The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as
the US dollar, euro or yen) rather than the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent.

BCZ4.95 In revising IAS 39, the Board concluded that an embedded foreign currency derivative may be integral to the contractual arrangements in the cases mentioned in the previous paragraph. It decided that a foreign currency derivative in a contract should not be required to be separated if it is denominated in a currency that is commonly used in business transactions (that are not financial instruments) in the environment in which the transaction takes place (that guidance is now in IFRS 9). A foreign currency derivative would be viewed as closely related to the host contract if the currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a relatively stable foreign currency, and prices may be quoted in that foreign currency (see IAS 29 Financial Reporting in Hyperinflationary Economies).

Embedded prepayment penalties

BCZ4.96 The Board identified an apparent inconsistency in the guidance in IAS 39 (as issued in 2003). The inconsistency related to embedded prepayment options in which the exercise price represented a penalty for early repayment (ie prepayment) of the loan. The inconsistency related to whether these are considered closely related to the loan.

BCZ4.97 The Board decided to remove this inconsistency by amending paragraph AG30(g) in April 2009 (now paragraph B4.3.5(e) of IFRS 9). The amendment makes an exception to the examples in paragraph AG30(g) of embedded derivatives that are not closely related to the underlying. This exception is in respect of prepayment options, the exercise prices of which compensate the lender for the loss of interest income because the loan was prepaid. This exception is conditional on the exercise price compensating the lender for loss of interest by reducing the economic loss from reinvestment risk.

Reassessment of embedded derivatives

BC4.98 In October 2010 the Board incorporated into IFRS 9 the consensus in IFRIC 9 Reassessment of Embedded Derivatives. This section summarises the considerations of the International Financial Reporting Interpretations Committee (IFRIC) in reaching that consensus, as approved by the Board, and the Board’s consideration for amending IFRIC 9 in April 2009.

BCZ4.99 When an entity first becomes a party to particular hybrid contracts it is required to assess whether any embedded derivative contained in the contract needs to be separated from the host contract and accounted for as a derivative. However, the issue arises whether an entity is required to continue to carry out this assessment after it first becomes a party to a contract, and if so, with what frequency.
The question is relevant, for example, when the terms of the embedded derivative do not change but market conditions change and the market was the principal factor in determining whether the host contract and embedded derivative are closely related. Instances when this might arise are given in paragraph B4.3.8(d) of IFRS 9. Paragraph 4.3.8(d) states that an embedded foreign currency derivative is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(a) the functional currency of any substantial party to that contract;

(b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

(c) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

Any of the currencies specified in (a)–(c) above may change. Assume that when an entity first became a party to a contract, it assessed the contract as containing an embedded derivative that was closely related and hence not accounted for separately. Assume that subsequently market conditions change and that if the entity were to reassess the contract under the changed circumstances it would conclude that the embedded derivative is not closely related and therefore requires separate accounting. (The converse could also arise.) The issue was whether the entity should make such a reassessment.

When the IFRIC considered this issue in 2006, it noted that the rationale for the requirement to separate particular embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract (for example, by embedding a commodity forward in a debt instrument). Changes in external circumstances are not ways to circumvent the requirements. The IFRIC therefore concluded that reassessment was not appropriate for such changes.

The IFRIC noted that as a practical expedient IAS 39 did not require the separation of embedded derivatives that are closely related (that guidance is now in IFRS 9 for hybrid contracts with a host that is not an asset within the scope of that IFRS). Many financial instruments contain embedded derivatives. Separating all of these embedded derivatives would be burdensome for entities. The IFRIC noted that requiring entities to reassess embedded derivatives in all hybrid instruments could be onerous because frequent monitoring would be required. Market conditions and other factors affecting embedded derivatives would have to be monitored continuously to ensure timely identification of a change in circumstances and amendment of the accounting treatment accordingly. For example, if the functional currency of the counterparty changes
during the reporting period so that the contract is no longer denominated in a currency of one of the parties to the contract, then a reassessment of the hybrid instrument would be required at the date of change to ensure the correct accounting treatment in future.

BCZ4.104 The IFRIC also recognised that although IAS 39 was silent on the issue of reassessment it gave relevant guidance when it stated that for the types of contracts now covered by paragraph B4.3.8(b) of IFRS 9 the assessment of whether an embedded derivative is closely related was required only at inception. Paragraph B4.3.8(b) of IFRS 9 states:

An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (e.g. a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged. [Emphasis added]

BCZ4.105 The IFRIC also considered the implications of requiring subsequent reassessment. For example, assume that an entity, when it first becomes a party to a contract, separately recognises a host asset* and an embedded derivative liability. If the entity were required to reassess whether the embedded derivative was to be accounted for separately and if the entity concluded some time after becoming a party to the contract that the derivative was no longer required to be separated, then questions of recognition and measurement would arise. In the above circumstances, the IFRIC identified the following possibilities:

(a) The entity could remove the derivative from its balance sheet and recognise in profit or loss a corresponding gain or loss. This would lead to recognition of a gain or loss even though there had been no transaction and no change in the value of the total contract or its components.

(b) The entity could leave the derivative as a separate item in the balance sheet. The issue would then arise as to when the item was to be removed from the balance sheet. Should it be amortised (and, if so, how would the amortisation affect the effective interest rate of the asset), or should it be derecognised only when the asset is derecognised?

(c) The entity could combine the derivative (which is recognised at fair value) with the asset (which is recognised at amortised cost). This would alter both the carrying amount of the asset and its effective interest rate even though there had been no change in the economics of the whole contract. In some cases, it could also result in a negative effective interest rate.

The IFRIC noted that, under its view that subsequent reassessment is appropriate only when there has been a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required by the contract, the above issues do not arise.

* Hybrid contracts with a host that is an asset within the scope of IFRS 9 are now classified and measured in their entirety in accordance with section 4.1 of that IFRS.
BCZ4.106 The IFRIC noted that IAS 39 required (and now IFRS 9 requires) an entity to assess whether particular embedded derivatives need to be separated from particular host contracts and accounted for as a derivative when it first becomes a party to a contract. Consequently, if an entity purchases a contract that contains an embedded derivative it assesses whether the embedded derivative needs to be separated and accounted for as a derivative on the basis of conditions at that date.

**Improvements to IFRSs issued in April 2009**

BCZ4.107 In 2009 the Board observed that the changes to the definition of a business combination in the revisions to IFRS 3 *Business Combinations* (as revised in 2008) caused the accounting for the formation of a joint venture by the venturer to be within the scope of IFRIC 9. Similarly, the Board noted that common control transactions might raise the same issue depending on which level of the group reporting entity is assessing the combination.

BCZ4.108 The Board observed that during the development of the revised IFRS 3, it did not discuss whether it intended IFRIC 9 to apply to those types of transactions. The Board did not intend to change existing practice by including such transactions within the scope of IFRIC 9. Accordingly, in **Improvements to IFRSs issued in April 2009**, the Board amended paragraph 5 of IFRIC 9 (now paragraph B4.3.12 of IFRS 9) to clarify that IFRIC 9 did not apply to embedded derivatives in contracts acquired in a combination between entities or businesses under common control or the formation of a joint venture.

BCZ4.109 Some respondents to the exposure draft *Post-implementation Revisions to IFRIC Interpretations* published in January 2009 expressed the view that investments in associates should also be excluded from the scope of IFRIC 9. Respondents noted that paragraphs 20–23 of IAS 28 *Investments in Associates* state that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.

BCZ4.110 In its redeliberations, the Board confirmed its previous decision that no scope exemption in IFRIC 9 was needed for investments in associates. However, in response to the comments received, the Board noted that reassessment of embedded derivatives in contracts held by an associate is not required by IFRIC 9 in any event. The investment in the associate is the asset the investor controls and recognises, not the underlying assets and liabilities of the associate.

**Reclassification**

**Reclassification of financial assets**

BC4.111 The exposure draft published in 2009 proposed to prohibit reclassification of financial assets between the amortised cost and fair value categories. The Board’s rationale for that proposal was as follows:

(a) Requiring (or permitting) reclassifications would not make it easier for users of financial statements to understand the information that financial statements provide about financial instruments.
(b) Requiring (or permitting) reclassifications would increase complexity because detailed guidance would be required to specify when reclassifications would be required (or permitted) and the subsequent accounting for reclassified financial instruments.

(c) Reclassification should not be necessary because classification is based on the entity’s business model and that business model is not expected to change.

BC4.112 In their responses, some users questioned the usefulness of reclassified information, noting concerns about the consistency and rigour with which any requirements would be applied. Some were also concerned that opportunistic reclassifications would be possible.

BC4.113 However, almost all respondents (including most users) argued that prohibiting reclassification is inconsistent with a classification approach based on how an entity manages its financial assets. They noted that in an approach based on an entity’s business model for managing financial assets, reclassifications would provide useful, relevant and comparable information to users because it would ensure that financial statements faithfully represent how those financial assets are managed at the reporting date. In particular, most users stated that, conceptually, reclassifications should not be prohibited when the classification no longer reflects how the instruments would be classified if the items were newly acquired. If reclassification were prohibited, the reported information would not reflect the amounts, timing and uncertainty of future cash flows.

BC4.114 The Board was persuaded by these arguments and decided that reclassification should not be prohibited. The Board noted that prohibiting reclassification decreases comparability for like instruments managed in the same way.

BC4.115 Some respondents contended that reclassifications should be permitted, rather than required, but did not explain their justification. However, the Board noted that permitting reclassification would decrease comparability, both between different entities and for instruments held by a single entity, and would enable an entity to manage its profit or loss by selecting the timing of when future gains or losses are recognised. Therefore, the Board decided that reclassification should be required when the entity’s business model for managing those financial assets changes.

BC4.116 The Board noted that, as highlighted by many respondents, such changes in business model would be very infrequent, significant and demonstrable and determined by the entity’s senior management as a result of external or internal change.

BC4.117 The Board considered arguments that reclassification should also be permitted or required when contractual cash flow characteristics of a financial asset vary (or may vary) over that asset’s life based on its original contractual terms. However, the Board noted that, unlike a change in business model, the contractual terms of a financial asset are known at initial recognition. An entity classifies the financial asset at initial recognition on the basis of the contractual terms over the life of the instrument. Therefore the Board decided that reclassification on the basis of a financial asset’s contractual cash flows should not be permitted.
BC4.118 The Board considered how reclassifications should be accounted for. Almost all respondents said that reclassifications should be accounted for prospectively and should be accompanied by robust disclosures. The Board reasoned that if classification and reclassification are based on the business model within which they are managed, classification should always reflect the business model within which the financial asset was managed at the reporting date. To apply the reclassification retrospectively would not reflect how the financial assets were managed at the prior reporting dates.

BC4.119 The Board also considered the date at which reclassifications could take effect. Some respondents stated that reclassifications should be reflected in the entity’s financial statements as soon as the entity’s business model for the relevant instruments changes. To do otherwise would be contradictory to the objective of reclassification—ie to reflect how the instruments are managed. However, the Board decided that reclassifications should take effect from the beginning of the following reporting period. In the Board’s view, entities should be prevented from choosing a reclassification date to achieve an accounting result. The Board also noted that a change in an entity’s business model is a significant and demonstrable event; therefore, an entity will most likely disclose such an event in its financial statements in the reporting period in which the change in business model takes place.

BC4.120 The Board also considered and rejected the following approaches:

(a) Disclosure approach: Quantitative and qualitative disclosure (instead of reclassification) could be used to address when the classification no longer reflects how the financial assets would be classified if they were newly acquired. However, in the Board’s view, disclosure is not an adequate substitute for recognition.

(b) One-way reclassification: Reclassification would be required only to fair value measurement, ie reclassification to amortised cost measurement would be prohibited. Proponents of this approach indicated that such an approach might minimise abuse of the reclassification requirements and result in more instruments being measured at fair value. However, in the Board’s view, there is no conceptual reason to require reclassification in one direction but not the other.

Reclassification of financial liabilities

BC4.121 Consistently with its decision in 2010 to retain most of the existing requirements for classifying and measuring financial liabilities (and relocate them to IFRS 9), the Board decided to retain the requirements that prohibit reclassifying financial liabilities between amortised cost and fair value. The Board noted that IFRS 9 requires reclassification of assets in particular circumstances. However, in line with the feedback received during the Board’s outreach programme, the classification and measurement approaches for financial assets and financial liabilities are different; therefore the Board decided that it is unnecessary and inappropriate to have symmetrical requirements for reclassification. Moreover, although the reclassification of financial assets has been a controversial topic in recent years, the Board is not aware of any requests or views that support reclassifying financial liabilities.
Changes in circumstances that are not reclassifications

BCZ4.122 The definition of a financial asset or financial liability at fair value through profit or loss excludes derivatives that are designated and effective hedging instruments. Paragraph 50 of IAS 39 prohibited (and unless particular conditions are met, paragraphs 4.4.1 and 4.4.2 of IFRS 9 prohibit) the reclassification of financial instruments into or out of the fair value through profit or loss category after initial recognition. The Board noted that the prohibition on reclassification might be read as preventing a derivative financial instrument that becomes a designated and effective hedging instrument from being excluded from the fair value through profit or loss category in accordance with the definition. Similarly, it might be read as preventing a derivative that ceases to be a designated and effective hedging instrument from being accounted for at fair value through profit or loss.

BCZ4.123 The Board decided that the prohibition on reclassification should not prevent a derivative from being accounted for at fair value through profit or loss when it does not qualify for hedge accounting and vice versa. Therefore, in Improvements to IFRSs issued in May 2008, the Board addressed this point (now in paragraph 4.4.3 of IFRS 9).

Measurement (chapter 5)

Fair value measurement considerations

BCZ5.1 The Board decided to include in the revised IAS 39 (published in 2002) expanded guidance about how to determine fair values (the guidance is now in IFRS 9), in particular for financial instruments for which no quoted market price is available (now paragraphs B5.4.6–B5.4.13 of IFRS 9). The Board decided that it is desirable to provide clear and reasonably detailed guidance about the objective and use of valuation techniques to achieve reliable and comparable fair value estimates when financial instruments are measured at fair value.

Use of quoted prices in active markets

BCZ5.2 The Board considered comments received that disagreed with the proposal in the exposure draft published in 2002 that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market. Some respondents argued that (a) valuation techniques are more appropriate for measuring fair value than a quoted price in an active market (eg for derivatives) and (b) valuation models are consistent with industry best practice, and are justified because of their acceptance for regulatory capital purposes.

BCZ5.3 However, the Board confirmed that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market, notably because (a) in an active market, the quoted price is the best evidence of fair value, given that fair value is defined in terms of a price agreed by a knowledgeable, willing buyer and a knowledgeable, willing seller; (b) it results in consistent measurement across entities; and (c) fair value (now defined in IFRS 9) does not depend on entity-specific factors. The Board further clarified that a quoted price includes market-quoted rates as well as prices.
Entities that have access to more than one active market

BCZ5.4 The Board considered situations in which entities operate in different markets. An example is a trader that originates a derivative with a corporate in an active corporate retail market and offsets the derivative by taking out a derivative with a dealer in an active dealers’ wholesale market. The Board decided to clarify that the objective of fair value measurement is to arrive at the price at which a transaction would occur at the balance sheet date in the same instrument (ie without modification or repackaging) in the most advantageous active market to which an entity has immediate access. Thus, if a dealer enters into a derivative instrument with the corporate, but has immediate access to a more advantageously priced dealers’ market, the entity recognises a profit on initial recognition of the derivative instrument. However, the entity adjusts the price observed in the dealer market for any differences in counterparty credit risk between the derivative instrument with the corporate and that with the dealers’ market.

Bid-ask spreads in active markets

BCZ5.5 The Board confirmed the proposal in the exposure draft published in 2002 that the appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. It concluded that applying mid-market prices to an individual instrument is not appropriate because it would result in entities recognising upfront gains or losses for the difference between the bid-ask price and the mid-market price.

BCZ5.6 The Board discussed whether the bid-ask spread should be applied to the net open position of a portfolio containing offsetting market risk positions, or to each instrument in the portfolio. It noted the concerns raised by constituents that applying the bid-ask spread to the net open position better reflects the fair value of the risk retained in the portfolio. The Board concluded that for offsetting risk positions, entities could use mid-market prices to determine fair value, and hence may apply the bid or asking price to the net open position as appropriate. The Board believes that when an entity has offsetting risk positions, using the mid-market price is appropriate because the entity (a) has locked in its cash flows from the asset and liability and (b) potentially could sell the matched position without incurring the bid-ask spread.

BCZ5.7 Comments received on the exposure draft published in 2002 revealed that some interpret the term ‘bid-ask spread’ differently from others and from the Board. Thus, the Board clarified that the spread represents only transaction costs.

No active market

BCZ5.8 The exposure draft published in 2002 proposed a three-tier fair value measurement hierarchy as follows:

(a) For instruments traded in active markets, use a quoted price.

(b) For instruments for which there is not an active market, use a recent market transaction.
(c) For instruments for which there is neither an active market nor a recent market transaction, use a valuation technique.

BCZ5.9 The Board decided to simplify the proposed fair value measurement hierarchy by requiring the fair value of financial instruments for which there is not an active market to be determined by using valuation techniques, including recent market transactions between knowledgeable, willing parties in an arm’s length transaction.

BCZ5.10 The Board also considered constituents’ comments regarding whether an instrument should always be recognised on initial recognition at the transaction price or whether gains or losses may be recognised on initial recognition when an entity uses a valuation technique to estimate fair value. The Board concluded that an entity may recognise a gain or loss at inception only if fair value is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or is based on a valuation technique incorporating only observable market data. The Board concluded that those conditions were necessary and sufficient to provide reasonable assurance that fair value was other than the transaction price for the purpose of recognising upfront gains or losses. The Board decided that in other cases, the transaction price gave the best evidence of fair value. The Board also noted that its decision achieved convergence with US GAAP.

Measurement of financial liabilities with a demand feature

BCZ5.11 Some comments received on the exposure draft published in 2002 requested clarification of how to determine fair value for financial liabilities with a demand feature (e.g., demand deposits), when the fair value measurement option is applied or the liability is otherwise measured at fair value. In other words, could the fair value be less than the amount payable on demand, discounted from the first date that an amount could be required to be paid (the ‘demand amount’), such as the amount of the deposit discounted for the period that the entity expects the deposit to be outstanding? Some commentators believe that the fair value of financial liabilities with a demand feature is less than the demand amount, for reasons that include the consistency of such measurement with how those financial liabilities are treated for risk management purposes.

BCZ5.12 The Board agreed that this issue should be clarified. It confirmed that the fair value of a financial liability with a demand feature is not less than the amount payable on demand discounted from the first date that the amount could be required to be paid (this guidance is now in paragraph 5.4.3 of IFRS 9). This conclusion is the same as in the original IAS 32 (issued by the Board’s predecessor body, IASC, in 1999 and revised in 2000). The Board noted that in many cases, the market price observed for such financial liabilities is the price at which they are originated between the customer and the deposit-taker—i.e., the demand amount. It also noted that recognising a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit, which the Board believes is inappropriate.
Exception in IAS 39 from fair value measurement for some unquoted equity instruments (and some derivative assets linked to those instruments)

BC5.13 The Board believes that measurement at amortised cost is not applicable to equity investments because such financial assets have no contractual cash flows and hence there are no contractual cash flows to amortise. IAS 39 contained an exception from fair value measurement for investments in equity instruments (and some derivatives linked to those investments) that do not have a quoted price in an active market and whose fair value cannot be reliably measured. Such equity investments were required to be measured at cost less impairment, if any. Impairment losses are measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

BC5.14 The exposure draft published in 2009 proposed that all investments in equity instruments (and derivatives linked to those investments) should be measured at fair value for the following reasons:

(a) For investments in equity instruments and derivatives, fair value provides the most relevant information. Cost provides little, if any, information with predictive value about the timing, amount and uncertainty of the future cash flows arising from the instrument. In many cases, fair value will differ significantly from historical cost (this is particularly true for derivatives measured at cost under the exception).

(b) To ensure that a financial asset accounted for under the cost exception is not carried above its recoverable amount, IAS 39 required an entity to monitor instruments measured at cost for any impairment. Calculating any impairment loss is similar to determining fair value (ie the estimated future cash flows are discounted using the current market rate of return for a similar financial asset and compared with the carrying amount).

(c) Removing the exception would reduce complexity because the classification model for financial assets would not have a third measurement attribute and would not require an additional impairment methodology. Although there might be an increase in the complexity of determining fair values on a recurring basis that complexity would be offset (at least partially) by the fact that all equity instruments and derivatives have one common measurement attribute; thus the impairment requirements would be eliminated.

BC5.15 Many respondents agreed that cost does not provide useful information about future cash flows arising from equity instruments and that conceptually such equity instruments should be measured using a current measurement attribute such as fair value. Some of those respondents generally agreed with the removal of the exception, but suggested that disclosures would have to include information about the uncertainties surrounding measurement.

BC5.16 However, many respondents (mainly preparers from non-financial entities and some auditors) disagreed with the proposal to eliminate the current cost exception on the grounds of the reliability and usefulness of fair value measurement and the cost and difficulty involved in determining fair value on a recurring basis. They
generally preferred to keep a cost exception, similar to that in IAS 39. Some noted that the proposals would not reduce complexity, because they would increase complexity in measurement. Furthermore, a few believed that cost could provide useful information if the financial asset is held for the long term.

BC5.17 The Board considered those arguments as follows:

(a) Reliability and usefulness of fair value measurement

Respondents noted that IAS 39 included a cost exception because of the lack of reliability of fair value measurement for particular equity instruments and contended that this rationale is still valid. They believed that, given the lack of available reliable information, any fair value measurement would require significant management judgement or might be impossible. They also believed that comparability would be impaired by the requirement to measure such equity instruments at fair value. However, those respondents had considered the question of reliability of fair value for the instruments concerned in isolation. In the Board’s view, the usefulness of information must be assessed against all four of the qualitative characteristics in the Framework: reliability, understandability, relevance and comparability. Thus, cost is a reliable (and objective) amount, but has little, if any, relevance. In the Board’s view measuring all equity instruments at fair value, including those that are currently measured using the cost exception in IAS 39, meets the criteria in the Framework for information to be reliable if appropriate measurement techniques and inputs are employed. The Board noted that its project on fair value measurement will provide guidance on how to meet that objective.

(b) Cost and difficulty involved in determining fair value on a recurring basis

Many respondents, particularly in emerging economies, said that they faced difficulty in obtaining information that might be relied on to use in valuation. Others said that they would inevitably rely heavily on external experts at significant cost. Many questioned whether the requirement to determine fair value on a recurring basis would involve significant costs and efforts that are not offset by the incremental benefit to usefulness from fair value. The Board considered the costs of requiring such equity investments to be measured at fair value from the perspectives of valuation methodology and expertise, as well as the ability to obtain the information required for a fair value measurement. The Board noted that valuation methods for equity investments are well-developed and are often far less complex than those required for other financial instruments that are required to be measured at fair value, including many complex derivative products. Although some expressed concern that smaller entities applying IFRSs might not have internal systems or expertise to determine easily the fair value of equity investments held, the Board noted that basic shareholder rights generally enable an entity to obtain the necessary information to perform a valuation. The Board acknowledged that there are circumstances in which the cost of determining fair value could outweigh the benefits from fair value measurement. In particular, the Board noted that, in some jurisdictions, entities hold high numbers of unquoted equity instruments that are currently accounted for under the cost exception and the value of a single investment is considered low.
However, the Board concluded that if the volume of the investments individually or aggregated is material the incremental benefit of fair value generally outweighs the additional cost because of the impact of the investments on the financial performance and position of the entity.

BC5.18 The Board noted that there are some circumstances in which cost might be representative of fair value and decided to provide additional application guidance on those circumstances to alleviate some of the concerns expressed. However, the Board also noted that those circumstances would never apply to equity investments held by particular entities such as financial institutions and investment funds.

BC5.19 The Board considered whether a simplified approach to measurement should be provided for equity instruments when fair value measurement was impracticable. The Board also discussed possible simplified measurement approaches, including management’s best estimate of the price it would accept to sell or buy the instrument, or changes in the share of net assets. However, the Board concluded that a simplified measurement approach would add complexity to the classification approach and reduce the usefulness of information to users of financial statements. Those disadvantages would not be offset by the benefit of reduced cost to preparers of financial statements.

**Elimination of the cost exception for particular derivative liabilities**

BC5.20 Consistently with the requirements in IFRS 9 for some investments in equity instruments and some derivative assets linked to those instruments (see paragraphs BC5.13–BC5.19), the Board decided in 2010 that the cost exception should be eliminated for derivative liabilities that will be physically settled by delivering unquoted equity instruments whose fair values cannot be reliably determined. That proposal was included in the exposure draft published in July 2009.

**Gains and losses**

**Investments in equity instruments**

BC5.21 IFRS 9 permits an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading. The term ‘equity instrument’ is defined in IAS 32 Financial Instruments: Presentation. The Board noted that in particular circumstances a puttable instrument (or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) is classified as equity. However, the Board noted that such instruments do not meet the definition of an equity instrument.

BC5.22 In the Board’s view, fair value provides the most useful information about investments in equity instruments to users of financial statements. However, the Board noted arguments that presenting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of
the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment. An example could be a requirement to hold such an investment if an entity sells its products in a particular country.

BC5.23 The Board also noted that, in their valuation of an entity, users of financial statements often differentiate between fair value changes arising from equity investments held for purposes other than generating investment returns and equity investments held for trading. Thus, the Board believes that separate presentation in other comprehensive income of gains and losses for some investments could provide useful information to users of financial statements because it would allow them to identify easily, and value accordingly, the associated fair value changes.

BC5.24 Almost all respondents to the exposure draft published in 2009 supported recognition of fair value gains and losses in other comprehensive income for particular equity investments. They agreed that an entity should make an irrevocable election to identify those equity instruments. However, some users did not support these proposals in the exposure draft.

BC5.25 The concerns expressed in the comment letters were as follows:

(a) **Dividends:** The exposure draft proposed that dividends on equity instruments measured at fair value with changes recognised in other comprehensive income would also be recognised in other comprehensive income. Nearly all respondents objected to that proposal. They argued that dividends are a form of income that should be presented in profit or loss in accordance with IAS 18 Revenue and noted that those equity investments are sometimes funded with debt instruments whose interest expense is recognised in profit or loss. As a result, presenting dividends in other comprehensive income would create a ‘mismatch’. Some listed investment funds stated that without recognising dividend income in profit or loss their financial statements would become meaningless to their investors. The Board agreed with those arguments. The Board noted that structuring opportunities might remain because dividends could represent a return of investment, rather than a return on investment. Therefore, the Board decided that dividends that clearly represent a recovery of part of the cost of the investment are not recognised in profit or loss. However, in the Board’s view, those structuring opportunities would be limited because an entity with the ability to control or significantly influence the dividend policy of the investment would not account for those investments in accordance with IFRS 9. Furthermore, the Board decided to require disclosures that would allow a user to compare easily the dividends recognised in profit or loss and the other fair value changes.

(b) **Recycling:** Many respondents, including many users, did not support the proposal to prohibit subsequent transfer (‘recycling’) of fair value changes to profit or loss (on derecognition of the investments in an equity instrument). Those respondents supported an approach that maintains a distinction between realised and unrealised gains and losses and said that an entity’s performance should include all realised gains and losses.
However, the Board concluded that a gain or loss on those investments should be recognised once only; therefore, recognising a gain or loss in other comprehensive income and subsequently transferring it to profit or loss is inappropriate. In addition, the Board noted that recycling of gains and losses to profit or loss would create something similar to the available-for-sale category in IAS 39 and would create the requirement to assess the equity instrument for impairment, which had created application problems. That would not significantly improve or reduce the complexity of the financial reporting for financial assets. Accordingly, the Board decided to prohibit recycling of gains and losses into profit or loss when an equity instrument is derecognised.

(c) Scope of exception: Some respondents asked the Board to identify a principle that defined the equity instruments to which the exception should apply. However, they did not specify what that principle should be. The Board previously considered developing a principle to identify other equity investments whose fair value changes should be presented in profit or loss (or other comprehensive income), including a distinction based on whether the equity instruments represented a ‘strategic investment’. However, the Board decided that it would be difficult, and perhaps impossible, to develop a clear and robust principle that would identify investments that are different enough to justify a different presentation requirement. The Board considered whether a list of indicators could be used to support the principle, but decided that such a list would inevitably be rule-based and could not be comprehensive enough to address all possible situations and factors. Moreover, the Board noted that such an approach would create complexity in application without necessarily increasing the usefulness of information to users of financial statements.

(d) Irrevocability of the exception: A small number of respondents believed that an entity should be able to reclassify equity instruments into and out of the fair value through other comprehensive income category if an entity starts or ceases to hold the investments for trading purposes. However, the Board decided that the option must be irrevocable to provide discipline to its application. The Board also noted that the option to designate a financial asset as measured at fair value is also irrevocable.

An entity may transfer the cumulative gain or loss within equity. In the light of jurisdiction-specific restrictions on components of equity, the Board decided not to provide specific requirements related to that transfer.

IFRS 9 amended IFRS 7 in 2009 to require additional disclosures about investments in equity instruments that are measured at fair value through other comprehensive income. The Board believes those disclosures will provide useful information to users of financial statements about instruments presented in that manner and the effect of that presentation.

The Board noted that permitting an option for entities to present some gains and losses in other comprehensive income is an exception to the overall classification and measurement approach and adds complexity. However, the Board believes that the requirement that the election is irrevocable, together with the additional disclosures required, addresses many of those concerns.
Liabilities designated as at fair value through profit or loss

Previous discussions related to the effects of changes in a liability’s credit risk

BCZ5.29 In 2003 the Board discussed the issue of including changes in the credit risk of a financial liability in its fair value measurement. It considered responses to the exposure draft of proposed amendments to IAS 39 published in June 2002 that expressed concern about the effect of including this component in the fair value measurement and that suggested the fair value option should be restricted to exclude all or some financial liabilities. However, the Board concluded that the fair value option could be applied to any financial liability, and decided not to restrict the option in IAS 39 (as revised in 2003) because to do so would negate some of the benefits of the fair value option set out in paragraph BCZ4.60.

BCZ5.30 The Board considered comments on the exposure draft published in 2002 that disagreed with the view that, in applying the fair value option to financial liabilities, an entity should recognise income as a result of deteriorating credit quality (and expense as a result of improving credit quality). Commentators noted that it is not useful to report lower liabilities when an entity is in financial difficulty precisely because its debt levels are too high, and that it would be difficult to explain to users of financial statements the reasons why income would be recognised when a liability’s creditworthiness deteriorates. These comments suggested that fair value should exclude the effects of changes in the instrument’s credit risk.

BCZ5.31 However, the Board noted that because financial statements are prepared on a going concern basis, credit risk affects the value at which liabilities could be repurchased or settled. Accordingly, the fair value of a financial liability reflects the credit risk relating to that liability. Therefore, it decided to include credit risk relating to a financial liability in the fair value measurement of that liability for the following reasons:

(a) Entities realise changes in fair value, including fair value attributable to the liability’s credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives.

(b) Changes in credit risk affect the observed market price of a financial liability and hence its fair value.

(c) It is difficult from a practical standpoint to exclude changes in credit risk from an observed market price.

(d) The fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects its credit risk. The Board believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.

BCZ5.32 In 2003 the Board also considered whether the component of the fair value of a financial liability attributable to changes in credit quality should be specifically disclosed, separately presented in the income statement, or separately presented in equity. The Board decided that whilst separately presenting or disclosing such changes might be difficult in practice, disclosure of such information would be
useful to users of financial statements and would help alleviate the concerns expressed. Therefore, it decided to require a disclosure to help identify the changes in the fair value of a financial liability that arise from changes in the liability’s credit risk. The Board believes this is a reasonable proxy for the change in fair value that is attributable to changes in the liability’s credit risk, in particular when such changes are large, and will provide users with information with which to understand the profit or loss effect of such a change in credit risk.

BCZ5.33 The Board decided to clarify that this issue relates to the credit risk of the financial liability, rather than the creditworthiness of the entity. The Board noted that this more appropriately describes the objective of what is included in the fair value measurement of financial liabilities.

BCZ5.34 The Board also noted that the fair value of liabilities secured by valuable collateral, guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity’s creditworthiness.

Requirements added to IFRS 9 in October 2010 to address the effects of changes in credit risk for liabilities designated as at fair value through profit or loss

BC5.35 As noted above, if an entity designates a financial liability under the fair value option, IAS 39 required the entire fair value change to be presented in profit or loss. However, many users and others told the Board over a long period of time that changes in a liability’s credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability’s credit risk unless the liability is held for trading.

BC5.36 To respond to that long-standing and widespread concern, in May 2010 the Board proposed that the effects of changes in a liability’s credit risk should be presented in other comprehensive income. The proposals in the exposure draft would have applied to all liabilities designated under the fair value option.

BC5.37 However, in its deliberations leading to the exposure draft published in 2010, the Board discussed whether such treatment would create or enlarge an accounting mismatch in profit or loss in some limited cases. The Board acknowledged that this might be the case if an entity holds large portfolios of financial assets that are measured at fair value through profit or loss and there is an economic relationship between changes in the fair value of those assets and the effects of changes in the credit risk of the financial liabilities designated under the fair value option. A mismatch would arise because the entire change in the fair value of the assets would be presented in profit or loss but only a portion of the change in the fair value of the liabilities would be presented in profit or loss. The portion of the liabilities’ fair value change attributable to changes in their credit risk would be presented in other comprehensive income. To address potential mismatches, the Board set out an alternative approach in the exposure draft whereby the effects of changes in the liabilities’ credit risk would be presented in other comprehensive income unless such treatment would create or enlarge an accounting mismatch in profit or loss (in which case, the entire fair value change
would be presented in profit or loss). The exposure draft stated that the
determination about potential mismatches would be made when the liability is
initially recognised and would not be reassessed. The Board asked respondents
for feedback on the alternative approach.

BC5.38 Many respondents preferred the alternative approach. They agreed that in
almost all cases the effects of changes in credit risk ought not to be presented in
profit or loss. However, those respondents said that if such treatment would
create or enlarge an accounting mismatch in profit or loss, the entire fair value
change should be presented in profit or loss. Respondents thought such cases
would be rare and asked the Board to provide guidance on how to determine
whether presenting the effects of changes in credit risk in other comprehensive
income would create or enlarge an accounting mismatch in profit or loss.

BC5.39 The Board agreed with the responses and finalised the alternative approach.
Therefore entities are required to present the effects of changes in the liabilities’
credit risk in other comprehensive income unless such treatment would create
or enlarge an accounting mismatch in profit or loss (in which case, the entire
fair value change is required to be presented in profit or loss). The Board
acknowledged that that approach will introduce some additional complexity to
financial reporting because not all liabilities designated under the fair value
option will be treated the same. However, the Board decided that it was
necessary to address circumstances in which the proposals would create or
enlarge a mismatch in profit or loss. Although the Board expects those
circumstances to be rare, they could be significant in some industries in some
jurisdictions.

BC5.40 The Board discussed how an entity should determine whether a mismatch would
be created or enlarged. It decided that an entity has to assess whether it expects
that changes in the credit risk of a liability will be offset by changes in the fair
value of another financial instrument. The Board decided that such an
assessment must be based on an economic relationship between the
characteristics of the liability and the characteristics of the other financial
instrument. Such a relationship does not arise by coincidence.

BC5.41 The Board believes that in many cases the relationship will be contractual (as
described in paragraph 5B.7.10 of IFRS 9) but decided that a contractual
relationship is not required. Requiring a contractual relationship would have
created a very high threshold for presenting the effects of changes in a liability’s
credit risk in profit or loss and the Board decided that such a high threshold was
too strict to accommodate all of the possible scenarios in which a mismatch
would be created or enlarged by presenting those amounts in other
comprehensive income.

BC5.42 However, to increase transparency about an entity’s determination about
potential mismatches, the Board decided to require disclosures about an entity’s
methodology for making that determination. Also, an entity is required to apply
its methodology consistently. The determination must be made at initial
recognition of the liability and is not reassessed, which is consistent with the
entity’s overall election to use the fair value option.
Some respondents to the exposure draft asked whether the Board intended that the proposals should apply to loan commitments and financial guarantee contracts that are designated under the fair value option. Those respondents suggested that the proposals should not apply to those items because the Board’s intention seemingly had always been to address the issue of own credit risk for non-derivative liabilities. The respondents noted that loan commitments and financial guarantee contracts either meet the definition of a derivative or are very similar to a derivative from an economic perspective and therefore changes in their fair value should always be presented in profit or loss. The Board agreed with those respondents and decided that all changes in the fair value of loan commitments and financial guarantee contracts designated under the fair value option should be presented in profit or loss. In addition to the comments put forward by respondents, the Board also noted that phase II of the insurance project was discussing whether all financial guarantee contracts should be within the scope of that proposed IFRS.

Alternative approaches to address the issue of own credit risk

In 2010 the Board discussed and rejected the following approaches for addressing the issue of credit risk:

(a) Present the effects of changes in credit risk directly in equity: Some believe that the effects of changes in credit risk should not affect the entity’s performance; therefore they believe that those amounts should be presented directly in equity. The Board rejected this approach in the exposure draft because it believes that changes in the liability’s credit risk ought to affect the entity’s performance if the liability is measured at fair value. If those amounts were presented directly in equity, they would never be presented in the entity’s statement of comprehensive income. The Board acknowledged that IFRSs do not provide a clear objective for when an item should be presented in other comprehensive income instead of in profit or loss or whether the amounts in other comprehensive income should be reclassified to profit or loss. However, the Board believes that presenting the effects of changes in credit risk in other comprehensive income is preferable to presenting them directly in equity because the latter would create a new problem by causing confusion or creating inconsistencies in what items are presented directly in equity. The Board noted that remeasurements of assets and liabilities should not be presented directly in equity because remeasurements are not transactions with equity holders. The Board asked respondents for feedback on presenting directly in equity the effects of changes in a liability’s credit risk and almost all respondents, including users, did not support it. Accordingly the Board did not pursue this alternative.

(b) Present the entire change in the fair value of liabilities in other comprehensive income: Some believe that the entire change in fair value (not just the portion attributable to changes in credit risk) should be presented in other comprehensive income. They argue that this approach would avoid the difficult question of how to measure the effects of changes in credit risk. The Board rejected this approach because it believes that at least some of the change in fair value should be presented in profit or loss. The Board’s
objective was to address issues related to the effects of changes in
liabilities’ credit risk; therefore, presenting the entire change in fair value
in other comprehensive income is not appropriate. Also, this approach
would result in mismatches in profit or loss because changes in the fair
value of an entity’s assets would be presented in profit or loss and changes
in the fair value of its liabilities would be presented in other
comprehensive income (see similar discussion in paragraph BC5.37).
Moreover, this alternative would raise difficult questions about what
(if any) amounts should be presented in profit or loss during the life of the
liability (eg interest or other financing costs). The Board has discussed the
topic of disaggregating finance costs from other fair value changes on
numerous occasions without reaching any conclusions.

**Presenting the effects of changes in credit risk in other comprehensive
income via a one-step or two-step approach.**

BC5.45 The exposure draft published in 2010 proposed a ‘two-step approach’ for
presenting a liability’s credit risk in the statement of comprehensive income,
with the result that those changes would not affect profit or loss. In the first step,
the entity would present the entire fair value change in profit or loss. In the second step, the entity would ‘back out’ from profit or loss the portion of the fair
value change that is attributable to changes in the liability’s credit risk and
present that amount in other comprehensive income.

BC5.46 The exposure draft also set out a ‘one-step approach’, which would present the
portion of the fair value change that is attributable to changes in the liability’s
credit risk directly in other comprehensive income. All other portions of the fair
value change would be presented in profit or loss.

BC5.47 The Board acknowledged that the only difference between those two approaches is
how the effects of changes in the liability’s credit risk are presented. The two-step
approach would present those amounts first in profit or loss and then transfer
them to other comprehensive income, whereas the one-step approach would
present them directly in other comprehensive income.

BC5.48 The Board proposed the two-step approach in the exposure draft because it
thought that it would present more clearly all of the relevant information in the
primary financial statements, but it decided to ask respondents which approach
they supported.

BC5.49 Almost all respondents, including users, supported the one-step approach. They
said that the one-step approach is more efficient and less complicated than the
two-step approach. They pointed out that both approaches have the same net
result in profit or loss and other comprehensive income. Respondents said that
there is little (if any) added benefit of the ‘gross’ presentation in the two-step
approach and the extra line items on the face of the performance statement
result in unnecessary clutter. Furthermore, respondents noted the Board’s
exposure draft published in May 2010 on the presentation of items in other
comprehensive income. That exposure draft proposes that the profit or loss
section and other comprehensive income should be displayed as separate
components within an overall statement of profit or loss and other comprehensive income. Respondents questioned whether the two-step approach would have any added benefit if the Board finalised the proposals in that exposure draft.

BC5.50 Users told the Board that the two-step approach would not be more helpful to their analysis than the one-step approach. Some users noted that the effects of changes in a liability’s credit risk should not be presented in profit or loss, even if those effects were subsequently backed out.

BC5.51 The Board was persuaded by respondents’ arguments and decided to require the one-step approach. The Board noted that no information is lost by using the one-step approach because IFRS 7 and IAS 1 Presentation of Financial Statements require entities to disclose (either on the financial statements or in the notes) all of the information required by the two-step approach.

Reclassifying amounts to profit or loss

BC5.52 The exposure draft published in 2010 proposed to prohibit reclassification of gains or losses to profit or loss (on derecognition of the liability or otherwise)—sometimes called ‘recycling’. In the Basis for Conclusions on that exposure draft, the Board noted that the proposal was consistent with the requirements in IFRS 9 that prohibit recycling for investments in equity instruments that are measured at fair value with changes presented in other comprehensive income.

BC5.53 Moreover, the Board noted that if the entity repays the contractual amount, the cumulative effect over the life of the instrument of any changes in the liability’s credit risk will net to zero because its fair value will equal the contractual amount. Therefore, for many liabilities, the issue of reclassification is irrelevant.

BC5.54 Most respondents to the exposure draft disagreed with that proposal and urged the Board to require reclassification if the liability was derecognised and the effects of changes in its credit risk were realised. They acknowledged that there would not be any amount to reclassify if the entity repays the contractual amount. But they believe that if the entity repays an amount other than the contractual amount, the realised amounts in other comprehensive income should be reclassified. Those respondents view other comprehensive income as a ‘temporary holding place’ for unrealised gains and losses. They believe that unrealised and realised amounts are fundamentally different and thus should not be treated the same. The former are still uncertain and may never be crystallised. In contrast, the latter have crystallised and are backed by cash flows.

BC5.55 However, the Board was not persuaded and confirmed the proposal to prohibit reclassification. The Board acknowledged that it needs to address the overall objective of other comprehensive income, including when an item should be presented in other comprehensive income instead of in profit or loss and whether amounts in other comprehensive income should be reclassified to profit or loss (and if so, when). However, in the absence of such an objective, the Board noted that its decision is consistent with the requirements in IFRS 9 that prohibit recycling for investments in equity instruments that are measured at fair value with changes presented in other comprehensive income.
BC5.56 However, to provide users with information about how much of the accumulated other comprehensive income balance has been realised during the current reporting period (ie how much would have been reclassified if the Board had required reclassification upon derecognition), the Board decided to require entities to disclose that amount.

BC5.57 Also, consistently with the requirements for equity investments measured at fair value with changes presented in other comprehensive income, the Board decided that an entity may transfer the cumulative gain or loss within equity.

Determining the effects of changes in the liability’s credit risk

BC5.58 IFRS 7 required an entity, when designating a financial liability under the fair value option, to disclose the amount of the change in fair value that is attributable to changes in the liability’s credit risk. The application guidance in IFRS 7 provided a default method for determining that amount. If the only relevant changes in market conditions for the liability are changes in an observed (benchmark) interest rate, that method attributes all changes in fair value, other than changes in the benchmark interest rate, to changes in the credit risk of the liability. In the Basis for Conclusions on IFRS 7, the Board acknowledged that quantifying the change in a liability’s credit risk might be difficult in practice. It noted that it believes that the default method provides a reasonable proxy for changes in the liability’s credit risk, in particular when such changes are large, and would provide users with information with which to understand the effect on profit or loss of such a change in credit risk. However, IFRS 7 permitted entities to use a different method if it provides a more faithful representation of the changes in the liability’s credit risk.

BC5.59 During the Board’s outreach programme preceding the publication of the exposure draft in 2010, preparers told the Board that the default method in IFRS 7 is appropriate in many circumstances but a more sophisticated method is sometimes needed to reflect faithfully the effects of changes in the liabilities’ credit risk (eg when the volume of liabilities outstanding significantly changed during the reporting period).

BC5.60 In the user questionnaire conducted during that outreach programme, the Board asked users whether the default method in IFRS 7 was appropriate for determining the change in a liability’s credit risk. Most users said that it was an appropriate method. Many users noted the difficulty in determining that amount more precisely.

BC5.61 Therefore, for the purposes of measuring the effects of changes in the credit risk of a liability, the exposure draft proposed to use the guidance in IFRS 7. Under the proposals, the default method would be carried forward but entities would continue to be permitted to use a different method if it provides a more faithful representation of the amount of the change in fair value that is attributable to changes in the liability’s credit risk.

BC5.62 Most respondents agreed with the proposals in the exposure draft. Those respondents agreed that the guidance in IFRS 7 for measuring the effects of changes in a liability’s credit risk is appropriate and operational. They noted that determining the effects of changes in a liability’s credit risk can be complex, and therefore it was necessary to allow some flexibility in how it is
measured. They acknowledged that the default method described in IFRS 7 is imprecise but said that it is a reasonable proxy in many cases. Moreover, although some respondents acknowledged that the default method does not isolate changes in a liability's credit risk from some other changes in fair value (e.g., general changes in the price of credit or changes in liquidity risk), those respondents said that it is often very difficult or impossible to separate those items. However, some respondents (including those who supported the Board’s proposals in the exposure draft) asked for some clarification on particular aspects of the guidance in IFRS 7.

BC5.63 Consistently with the majority of responses, the Board decided to confirm the proposals in the exposure draft to use the guidance in IFRS 7 related to determining the effects of changes in a liability’s credit risk. Thus, that guidance was carried forward from IFRS 7 to IFRS 9. However, to respond to some of the questions raised in the comment letters, the Board decided to clarify the difference between the creditworthiness of the entity and the credit risk of a liability. Moreover, the Board addressed the difference between a liability’s credit risk and asset-specific performance risk—and confirmed that a change in a liability’s credit risk does not include changes in asset-specific performance risk. Furthermore, the Board noted that in some cases a liability might not have credit risk. Therefore, the Board included additional examples in the application guidance to clarify those points.

BC5.64 Also, the Board clarified that the default method illustrated in IFRS 7 (and relocated to IFRS 9) is appropriate only if the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate. If that is not the case, an entity is required to use a more precise method. Moreover, an entity is always permitted to use a different method if that method more faithfully represents the effects of changes in a liability’s credit risk.

Effective date and transition (chapter 7)

Effective date

BC7.1 The Board recognises that many countries require time for translation and for introducing the mandatory requirements into law. In addition, entities require time to implement new standards. The Board usually sets an effective date of between six and eighteen months after issuing an IFRS. However, the Board has adopted a phased approach to publishing IFRS 9, so this is not possible.

BC7.2 In the response to the exposure draft published in 2009, respondents urged that:

(a) it would be helpful to preparers if the Board were to permit all phases of the project to replace IAS 39 to be adopted at the same time.

(b) it would be helpful to entities that issue insurance contracts if the effective date of IFRS 9 were aligned with the forthcoming IFRS on accounting for insurance contracts. Most of an insurer’s assets are financial assets and most of its liabilities are insurance liabilities or financial liabilities. Thus, if an insurer applies IFRS 9 before it applies any new IFRS on insurance, it might face two rounds of major change in a short period. This would be disruptive for both users and preparers.
(c) because a number of countries will adopt IFRSs in the next few years, it would be helpful to entities in those countries if the Board did not require them to make two changes in a short period of time.

BC7.3 With these factors in mind, the Board decided it should require entities to apply the requirements of IFRS 9 for annual periods beginning on or after 1 January 2013. The Board intends that this date will allow entities to adopt at the same time the guidance from all phases of the project to replace IAS 39.

BC7.4 The Board will consider delaying the effective date of IFRS 9 if the impairment phase of the project to replace IAS 39 makes such a delay necessary, or if the new IFRS on insurance contracts has a mandatory effective date later than 2013, to avoid an insurer having to face two rounds of changes in a short period.

BC7.5 The Board decided to permit earlier application of IFRS 9 to allow an entity to apply the new requirements on classification and measurement of financial assets. This enables entities to use IFRS 9 (as issued in November 2009) in their 2009 annual financial statements and meets one of the objectives of the phased approach, ie to have improved classification and measurement requirements for financial assets in place for 2009 year-ends.

BC7.6 The effect of transition will be significant for some entities. As a result, there will be less comparability between entities that apply IFRS 9 and those that do not. Accordingly, IFRS 9 includes additional disclosures about the transition to IFRS 9.

Requirements added to IFRS 9 in October 2010

BC7.7 The Board chose to complete the project to replace IAS 39 in phases to respond to requests that the accounting for financial instruments should be improved quickly. However, the Board is concerned that if an entity is permitted to adopt one phase early without also adopting early all of the preceding phases, there would be a period of significant incomparability among entities until all of the phases of the project are mandatorily effective. That is because there will be many possible combinations of which requirements are adopted early and which are not. Moreover, the period of incomparability would be significant because the phases will not be mandatorily effective before 1 January 2013.

BC7.8 Therefore, in the exposure draft published in 2010 the Board proposed that if an entity elects to apply any finalised requirements early, the entity must also apply any preceding requirements in IFRS 9 that it does not already apply. Some respondents did not agree with this proposal and urged the Board to permit an entity to adopt the proposals in the exposure draft early without also adopting early the requirements in IFRS 9 for financial assets. As an alternative, some respondents asked the Board to finalise the proposals as an amendment to IAS 39, which could be applied immediately, rather than add the proposals to IFRS 9. Those respondents thought that the proposals in the exposure draft are unrelated to the requirements for financial assets and would be less complex to implement. However, the Board was not persuaded that the benefits of permitting an entity to adopt early only the proposals in the exposure draft exceeded the significant incomparability that would result. Moreover, the Board noted that the transition requirements in IFRS 9 for financial assets require an entity to reassess some financial liabilities designated under the fair value option. Therefore there is a linkage between the two phases and to permit
entities to adopt early only the proposals in the exposure draft would be inappropriate and confusing. Moreover, the Board decided that it would be inappropriate to amend IAS 39 while it was in the process of replacing it. For those reasons, the Board decided to confirm the proposals in the exposure draft.

BC7.9 However, if an entity chooses to adopt a phase early, the Board does not require the entity to adopt subsequent phases early. The Board decided that it would be unfair to require an entity to anticipate the outcomes of unfinished phases in order to make a decision about adopting a phase early. Moreover, the Board decided that an entity is permitted to adopt early the requirements in IFRS 9 issued in 2009 without adopting early the requirements that were added to IFRS 9 in 2010.

**Transition related to IFRS 9 as issued in November 2009**

BC7.10 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users because the information presented for all periods is comparable. Therefore, the exposure draft published in 2009 proposed retrospective application subject to some transition relief in particular circumstances. The Board considered the difficulties and associated costs of full retrospective application of the proposals in the exposure draft.

BC7.11 Most respondents agreed, in principle, with requiring retrospective application, but many questioned the practicability of the approach. In particular, many noted that the extensive exceptions to retrospective application that would be required to make such transition practicable significantly reduced (and possibly eliminated) any benefit that users might obtain from requiring comparative information to be restated.

BC7.12 The Board considered whether to require prospective application, but noted that such an approach does not provide comparable information for users of financial statements. In addition, the Board noted that any transition approach (such as prospective application) that requires resetting the effective interest rate for financial assets measured at amortised cost reduces the usefulness of information about interest income.

BC7.13 The Board decided to require retrospective application but provide transition relief to address particular difficulties that might arise from retrospective application. The Board also noted that IAS 8 sets out transition requirements that apply if retrospective application is impracticable and prohibits the use of hindsight when applying a new accounting policy to a prior period.

**Transition relief**

*Impracticability exceptions*

BC7.14 The Board acknowledged that it may be impracticable for an entity to apply the effective interest method or impairment requirements in IAS 39 retrospectively in some situations. The process would be cumbersome, in particular for an entity with a large number of financial assets that were previously measured at fair value but are measured at amortised cost in accordance with the approach in IFRS 9. Several loss events and reversals might have occurred between the date when the asset was initially recognised and the date of initial application of the
IFRS. IFRS 9 requires that if applying the impairment requirements is impracticable or requires the use of hindsight, an entity should use previously determined fair value information to determine whether a financial asset was impaired in comparative periods. IFRS 9 also requires that the fair value at the date of initial application of the new requirements should be treated as the new amortised cost carrying amount of that financial asset in that case. The Board rejected proposals that entities should be permitted, but not required, to treat the fair value at the date of initial application as amortised cost because it would impair comparability and require significant guidance about when such an option should be permitted.

BC7.15 The Board noted that an entity would not have determined the fair value of an investment in an unquoted equity instrument (or a derivative on such an investment) that was previously accounted for in accordance with paragraphs 46(c) and 66 of IAS 39. Moreover, an entity will not have the necessary information to determine fair value retrospectively without using hindsight. Accordingly, IFRS 9 requires such instruments to be measured at fair value at the date of initial application.

Hybrid contracts

BC7.16 An entity may not have previously determined the fair value of a hybrid contract in its entirety. Moreover, an entity will not have the necessary information to determine fair value retrospectively without using hindsight. However, an entity would have been required to measure both the embedded derivative and host separately at fair value to apply the disclosure requirements in IFRS 7. Therefore, in comparative periods, IFRS 9 requires the sum of the fair value of the embedded derivative and the host to be used as an approximation of the fair value of the entire hybrid contract.

BC7.17 The proposals in the exposure draft published in 2009 would have resulted in fair value measurement for many hybrid contracts for which the embedded derivative was accounted for separately in accordance with IAS 39. Some respondents asked for such treatment under IAS 39 to be ‘grandfathered’. The Board noted that many such requests had been related to the proposed treatment of hybrid contracts with financial liability hosts, which are not included in the IFRS. Therefore the Board decided not to permit an option to grandfather hybrid contracts with financial asset hosts that were bifurcated in accordance with IAS 39 as an accounting policy choice because it would impair comparability, and because some such contracts may still have a significant remaining maturity.

Assessment of the objective of the entity’s business model for managing financial assets

BC7.18 IFRS 9 requires an entity to assess whether the objective of an entity’s business model is to manage financial assets to collect the contractual cash flows on the basis of circumstances at the date of initial application. The Board believes it would be difficult, and perhaps impossible, to assess that condition on the basis of circumstances when the instrument first satisfied the recognition criterion in IAS 39.
Assessment of qualifying criteria for the fair value option

BC7.19 The Board decided that the assessment of whether a financial asset or financial liability meets the eligibility criterion for designation under the fair value option should be based on the circumstances at the date of initial application. IFRS 9 changes the classification of some financial assets, including eliminating two of the three eligibility criteria in IAS 39 for the fair value option for financial assets. Therefore, the Board believes that an entity should reconsider at transition its original assessment of whether to designate a financial asset or financial liability as at fair value through profit or loss.

Comparative information

BC7.20 As noted above, many respondents were concerned that the inevitable exceptions to full retrospective application would result in restated information that is incomplete. They proposed an approach similar to that used on first-time adoption of IFRSs and when entities adopted IAS 39 in 2005, in which the requirement to provide comparative information was waived. Some respondents believe that such an approach would address the concerns that, although IAS 1 requires only one year of comparative information, the legal and regulatory frameworks in many jurisdictions require further comparative periods to be presented. In those situations, the restatement of comparatives would be virtually impossible for an entity wishing to adopt IFRS 9 early.

BC7.21 In the Board’s view, waiving the requirement to restate comparatives strikes a balance between the conceptually preferable method of full retrospective application (as stated in IAS 8) and the practicability of adopting the new classification model within a short time frame. Accordingly, the Board decided that it would permit, but not require, restatement of comparative periods by entities that implement IFRS 9 for reporting periods beginning before 1 January 2012. However, those considerations would be less applicable for entities that adopted outside a short time frame. Therefore, restated comparative information is required if an entity adopts IFRS 9 for reporting periods beginning after 1 January 2012.

Date of initial application

BC7.22 The exposure draft stated that the date of initial application would be the date when an entity first applies the requirements in the IFRS. Many respondents questioned whether the date of initial application could be an arbitrary date between the date of issue of the IFRS (or even earlier) and the mandatory effective date, resulting in a loss of comparability over a long period of time. The Board agreed that a free choice would impair comparability, but noted it intended that entities should be able to apply the IFRS in 2009 or 2010 financial statements. Accordingly, the IFRS requires the date of initial application to be the beginning of a reporting period, but provides relief from this requirement for entities applying the IFRS for reporting periods beginning on or before 1 January 2011.

Hedge accounting

BC7.23 The Board decided not to carry forward the specific transition provisions on hedge accounting proposed in the exposure draft because they are not necessary.
Transitional disclosures

BC7.24 The exposure draft published in July 2009 proposed disclosures for entities that apply the new IFRS 9 early. However, many noted that such disclosures would be useful for all entities applying IFRS 9 for the first time, and not only early adopters. The Board noted that the information necessary to make those disclosures would be readily available to the entity to make the necessary journal entries on transition and to account for the financial assets in the future. Accordingly, IFRS 9 requires all entities to supply additional disclosures on transition.

BC7.25 The Board rejected a proposal in the comment letters that entities should apply disclosures similar to those based on IFRS 1 First-time Adoption of International Financial Reporting Standards explaining the transition to the new IFRS. The Board noted that the disclosures in IFRS 1 relate to first-time adoption and not to changes in accounting policies. Disclosures about changes in an accounting policy are required by IAS 8.

Transition related to the requirements added to IFRS 9 in October 2010

BC7.26 As noted above, IAS 8 states that retrospective application results in the most useful information to users because the information presented for all periods is comparable. The Board noted that IFRS 7 already requires disclosure of the amount of the change in fair value that is attributable to changes in the credit risk of the liability. Therefore, entities are already calculating the information necessary to present the effects of changes in liabilities’ credit risk in other comprehensive income. Thus, the exposure draft published in 2010 proposed retrospective application and almost all respondents agreed. The Board confirmed that proposal.

BC7.27 The Board did not change the classification and measurement approach for financial liabilities, including the eligibility conditions for the fair value option for financial liabilities. Therefore, the proposals in the exposure draft did not permit entities to make new designations or revoke its previous designations as a result of the proposals. Some respondents believed that the Board should permit entities to reassess their designations in the light of the new requirements related to own credit risk.

BC7.28 However, the Board was not persuaded that there is a compelling reason to permit entities to reassess their elections, especially because the underlying classification and measurement approach has not changed. As noted in paragraph BC7.19, when an entity initially applies IFRS 9 to assets, it is required to reassess particular liabilities designated under the fair value option. That was necessary because IFRS 9 (issued in 2009) introduced a new classification and measurement approach for financial assets, which would change the classification of some (and perhaps many) financial assets. Those changes require an entity to reassess liabilities designated under the fair value option to the extent that designation was originally elected to address an accounting mismatch. However, the Board believed that a similar case could not be made for
the requirements added to IFRS 9 in 2010. And because IFRS 9 (issued in 2009) already requires reassessment of particular liabilities, the Board believes that a second reassessment would make transition unnecessarily complex. Therefore, the Board decided to confirm the proposal in the exposure draft.

Transition relief

BC7.29 When the Board issued the new requirements for financial assets in November 2009, it granted some transition relief from full retrospective transition. To be consistent with the transition requirements for assets, the Board decided to grant similar transition relief for the requirements added to IFRS 9 in October 2010:

(a) The requirements are not applied to liabilities that have been derecognised at the date of initial application. The Board concluded that applying the requirements in IFRS 9 to some derecognised items but not others would be confusing and unnecessarily complex.

(b) An entity is required to assess whether presenting the effects of changes in a liability’s credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss on the basis of facts and circumstances that exist at the date of initial application. This is consistent with the other transition requirements in IFRS 9 related to the fair value option. Moreover, the Board noted that the conclusion will most likely be the same regardless of whether it is made on the basis of facts and circumstances that existed at initial recognition of the liability or at the date of initial application.

(c) Derivative liabilities that were previously accounted for at cost are measured at fair value at the date of initial application. Consistently with the requirements for financial assets, an entity will not have the necessary information to determine fair value retroactively without using hindsight.

(d) An entity is not required to restate prior periods if the requirements are adopted for reporting periods beginning before 1 January 2012. The Board decided that it would be inappropriate and confusing to require an entity to restate prior periods for some of the requirements in IFRS 9 but not others. However, the Board decided that if the entity elects to restate prior periods to reflect the requirements added to IFRS 9 in October 2010, it must also restate prior periods to reflect the other requirements in IFRS 9. That conclusion is consistent with the Board’s decision that if an entity elects to adopt the requirements early, it must at the same time adopt early all of the requirements in IFRS 9 that it does not already apply.

Transitional insurance issues

BC7.30 The Board noted that insurers may face particular problems if they apply IFRS 9 before they apply the phase II standard on insurance contracts (the new IFRS 4). To avoid accounting mismatches in profit or loss, many insurers classify many of their financial assets as available for sale. If those insurers apply IFRS 9 before the new IFRS 4, they might decide to classify many of their financial assets at amortised cost (assuming they meet the relevant conditions in IFRS 9). When those insurers later apply the new IFRS 4, they may wish to reclassify those assets from amortised cost to fair value through profit or loss, but that may not
generally be possible in accordance with IFRS 9. Thus, those insurers might have either to classify those assets at fair value through profit or loss during the intervening period or to continue to classify them at amortised cost when they apply the new IFRS 4. Either choice might lead to an accounting mismatch.

BC7.31 The Board considered whether it could reduce such mismatches by maintaining the available-for-sale category for insurers until they can apply the new IFRS 4. However, if the Board did so, it would have to create detailed and arbitrary descriptions of the entities and instruments to which that approach would apply. The Board concluded that permitting the continuation of that category would not provide more useful information for users.

BC7.32 The Board will consider in developing the new IFRS 4 whether to provide an option for insurers to reclassify some or all financial assets when they first apply the new IFRS 4. This would be similar to the option in paragraph 45 of IFRS 4 Insurance Contracts and paragraph D4 of IFRS 1. The Board included such an option in IFRS 4 for reasons that may be equally valid for phase II.

**Shadow accounting for participating contracts**

BC7.33 Some insurers expressed concerns that an accounting mismatch will arise if the assets backing participating insurance liabilities include equity investments and the insurer elects to present gains and losses on those investments in other comprehensive income. That accounting mismatch would arise because paragraph 30 of IFRS 4 does not give explicit authority to apply ‘shadow accounting’ in such cases.

BC7.34 The Board acknowledges that this accounting mismatch is undesirable. However, for the following reasons, the Board did not amend paragraph 30 of IFRS 4:

(a) This accounting mismatch will arise only if an insurer elects to present gains and losses on equity investments in other comprehensive income.

(b) As described in paragraph BC5.23, in creating the option to present gains and losses on equity investments in other comprehensive income, the Board’s intention was to provide a presentation alternative for some equity investments in which presenting fair value gains and losses in profit or loss may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily to generate increases in the value of the investment. The Board did not intend to provide an alternative for investments in any other circumstances, including if an entity intends to hold an equity investment over a long time frame. In the Board’s view, if an insurer holds investments with the primary objective of realising a profit from increases in their value, for the benefit of either the insurer itself or its policyholders, the most transparent place to present those value changes is in profit or loss.
General

Summary of main changes from the exposure draft
Financial Instruments: Classification and Measurement

BCG.1 The main changes made by IFRS 9 issued in 2009 from the exposure draft published in 2009 were:

(a) IFRS 9 dealt with the classification and measurement of financial assets only, rather than financial assets and financial liabilities as proposed in the exposure draft.

(b) IFRS 9 requires entities to classify financial assets on the basis of the objective of the entity’s business model for managing the financial assets and the characteristics of the contractual cash flows. It points out that the entity’s business model should be considered first, and that the contractual cash flow characteristics should be considered only for financial assets that are eligible to be measured at amortised cost because of the business model. It states that both classification conditions are essential to ensure that amortised cost provides useful information.

(c) Additional application guidance was added on how to apply the conditions necessary for amortised cost measurement.

(d) IFRS 9 requires a ‘look through’ approach for investments in contractually linked instruments that effect concentrations of credit risk. The exposure draft had proposed that only the most senior tranche could have cash flows that represented payments of principal and interest on the principal amount outstanding.

(e) IFRS 9 requires (unless the fair value option is elected) financial assets purchased in the secondary market to be recognised at amortised cost if the instruments are managed within a business model that has an objective of collecting contractual cash flows and the financial asset has only contractual cash flows representing principal and interest on the principal amount outstanding even if such assets were acquired at a discount that reflects incurred credit losses.

(f) IFRS 9 requires that when an entity elects to present gains and losses on equity instruments measured at fair value in other comprehensive income, dividends are to be recognised in profit or loss. The exposure draft had proposed that those dividends would be recognised in other comprehensive income.

(g) IFRS 9 requires reclassifications between amortised cost and fair value classifications when the entity’s business model changes. The exposure draft had proposed prohibiting reclassification.

(h) For entities that adopt IFRS 9 for reporting periods before 1 January 2012, IFRS 9 provides transition relief from restating comparative information.

(i) IFRS 9 requires additional disclosures for all entities when they first apply the IFRS.
Summary of main changes from the exposure draft Fair Value Option for Financial Liabilities

BCG.2 The main changes from the exposure draft published in 2010 are:

(a) For liabilities designated under the fair value option, IFRS 9 requires an entity to present the effects of changes in the liability’s credit risk in other comprehensive income unless that treatment would create or enlarge an accounting mismatch in profit or loss. If that treatment would create or enlarge an accounting mismatch in profit or loss, the entire fair value change is presented in profit or loss. That was the alternative approach set out in the exposure draft. The proposed approach in the exposure draft had treated all liabilities designated under the fair value option in the same way and had not addressed cases in which the proposed treatment would create or enlarge an accounting mismatch in profit or loss.

(b) IFRS 9 requires a 'one-step' approach for presenting the effects of changes in a liability's credit risk in the performance statement. That approach requires the effects of changes in a liability's credit risk to be presented directly in other comprehensive income, with the remaining amount of fair value change presented in profit or loss. The exposure draft had proposed a 'two-step' approach, which would have required the total fair value change to be presented in profit or loss. The effects of changes in a liability’s credit risk would have been backed out and presented in other comprehensive income.

Cost-benefit considerations

BCG.3 The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. To attain this objective, the Board endeavours to ensure that an IFRS will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Although the costs to implement a new IFRS might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

BCG.4 The evaluation of costs and benefits is necessarily subjective. In making its judgement, the Board considered the following:

(a) the costs incurred by preparers of financial statements;

(b) the costs incurred by users of financial statements when information is not available;

(c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information;

(d) the benefit of better economic decision-making as a result of improved financial reporting; and

(e) the costs of transition for users, preparers and others.
IFRS 9 BC

BCG.5 The objective of IFRS 9 is to present information that is useful to users for their assessment of the amounts, timing and uncertainty of future cash flows of financial assets. However, the Board also considered the cost of implementing IFRS 9 and applying it on a continuous basis. During the development of IFRS 9 the Board conducted an extensive outreach programme to consult users, preparers, auditors, regulators and others. Those activities helped the Board evaluate the relative costs and benefits of IFRS 9.

BCG.6 IFRS 9 should improve the ability of users to understand the financial reporting for financial assets by:

(a) reducing the number of classification categories. All financial assets will be subsequently measured at either amortised cost or fair value. Hybrid contracts with financial asset hosts will be classified and measured in their entirety thereby eliminating the complex and rule-based requirements in IAS 39.

(b) having a single impairment methodology that is applied to all financial assets that are not measured at fair value. Many constituents criticised the multitude of impairment methodologies in IAS 39.

(c) providing a clear rationale for why financial assets are measured in a particular way, which aligns the measurement attribute to the way that an entity manages its financial assets and their contractual cash flow characteristics.

BCG.7 There are costs involved in the adoption and ongoing application of IFRS 9. Those costs will depend on an entity’s volume and complexity of financial instruments as well as the industry and jurisdiction in which the entity operates. However, those costs should be minimised because IFRS 9 is less complex and rule-based than the equivalent requirements in IAS 39. Consequently, the Board believes that the benefits of IFRS 9 outweigh the costs.
**IFRS 9 Financial Instruments**

**Illustrative example**

This example accompanies, but is not part of, IFRS 9

**Financial liabilities at fair value through profit or loss**

IE1 The following example illustrates the calculation that an entity might perform in accordance with paragraph B5.7.18 of IFRS 9.

IE2 On 1 January 20X1 an entity issues a 10-year bond with a par value of CU150,000* and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.

IE3 The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:

(a) LIBOR has decreased to 4.75 per cent.

(b) the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.†

IE4 The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.

IE5 The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

<table>
<thead>
<tr>
<th>(paragraph B5.7.18(a))</th>
<th>At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond’s internal rate of return is 8 per cent. Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.</th>
</tr>
</thead>
<tbody>
<tr>
<td>First, the entity computes the liability’s internal rate of return at the start of the period using the observed market price of the liability and the liability’s contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.</td>
<td>continued...</td>
</tr>
</tbody>
</table>

* In this guidance monetary amounts are denominated in ‘currency units (CU)’.

† This reflects a shift in LIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.
...continued

| Paragraph B5.7.18(b) | The contractual cash flows of the instrument at the end of the period are:
| --- | --- |
| Next, the entity calculates the present value of the cash flows associated with the liability using the liability’s contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph B5.7.18(a). | • interest: CU12,000\(^{(a)}\) per year for each of years 2–10.
| | • principal: CU150,000 in year 10.
| | The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is 4.75 per cent end of period LIBOR rate, plus the 3 per cent instrument-specific component.
| | This gives a present value of CU152,367\(^{(b)}\). |
| Paragraph B5.7.18(c) | The market price of the liability at the end of the period is CU153,811.\(^{(c)}\) |
| The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph B5.7.18(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a). | Thus, the entity presents CU1,444 in other comprehensive income, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk. |

\(^{(a)}\) \(CU150,000 \times 8\% = CU12,000\)  
\(^{(b)}\) \(PV = [CU12,000 \times (1 - (1 + 0.0775)^9)](0.0775) + CU150,000 \times (1 + 0.0775)^9\)  
\(^{(c)}\) \(\text{market price} = [CU12,000 \times (1 - (1 + 0.076)^9)](0.076) + CU150,000 \times (1 + 0.076)^9\)
QUESTIONS AND ANSWERS ON IMPLEMENTING
IFRS 9 FINANCIAL INSTRUMENTS

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B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)
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B.7 Definition of a derivative: option not expected to be exercised
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   E.1.1 Initial measurement: transaction costs

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Guidance on implementing IFRS 9 Financial Instruments

This guidance accompanies, but is not part of, IFRS 9. The numbers used for the questions are carried forward from the implementation guidance accompanying IAS 39 Financial Instruments: Recognition and Measurement.

Section B Definitions

B.1 Definition of a financial instrument: gold bullion

Is gold bullion a financial instrument (like cash) or is it a commodity?

It is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

B.2 Definition of a derivative: examples of derivatives and underlyings

What are examples of common derivative contracts and the identified underlying?

IFRS 9 defines a derivative as follows:

A derivative is a financial instrument or other contract within the scope of this IFRS with all three of the following characteristics.

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’).

(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(c) It is settled at a future date.

<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Main pricing-settlement variable (underlying variable)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate swap</td>
<td>Interest rates</td>
</tr>
<tr>
<td>Currency swap (foreign exchange swap)</td>
<td>Currency rates</td>
</tr>
<tr>
<td>Commodity swap</td>
<td>Commodity prices</td>
</tr>
<tr>
<td>Equity swap</td>
<td>Equity prices (equity of another entity)</td>
</tr>
<tr>
<td>Credit swap</td>
<td>Credit rating, credit index or credit price</td>
</tr>
<tr>
<td>Total return swap</td>
<td>Total fair value of the reference asset and interest rates</td>
</tr>
</tbody>
</table>

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## IFRS 9 IG

<table>
<thead>
<tr>
<th>Type of contract</th>
<th>Main pricing-settlement variable (underlying variable)</th>
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<tbody>
<tr>
<td>...continued</td>
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<tr>
<td>Purchased or written treasury bond option</td>
<td>Interest rates</td>
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<tr>
<td>(call or put)</td>
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<tr>
<td>Purchased or written currency option</td>
<td>Currency rates</td>
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<tr>
<td>(call or put)</td>
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<tr>
<td>Purchased or written commodity option</td>
<td>Commodity prices</td>
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<tr>
<td>(call or put)</td>
<td></td>
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<tr>
<td>Purchased or written stock option (call or put)</td>
<td>Equity prices (equity of another entity)</td>
</tr>
<tr>
<td>Interest rate futures linked to government debt</td>
<td>Interest rates</td>
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<tr>
<td>(treasury futures)</td>
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<tr>
<td>Currency futures</td>
<td>Currency rates</td>
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<tr>
<td>Commodity futures</td>
<td>Commodity prices</td>
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<tr>
<td>Interest rate forward linked to government debt</td>
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<tr>
<td>(treasury forward)</td>
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<tr>
<td>Currency forward</td>
<td>Currency rates</td>
</tr>
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<td>Commodity prices</td>
</tr>
<tr>
<td>Equity forward</td>
<td>Equity prices (equity of another entity)</td>
</tr>
</tbody>
</table>

The above list provides examples of contracts that normally qualify as derivatives under IFRS 9. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions may apply, for example, if it is a weather derivative (see IAS 39.AG1), a contract to buy or sell a non-financial item such as commodity (see IAS 39.5 and IFRS 9.BA.2) or a contract settled in an entity’s own shares (see IAS 32.21–IAS 32.24). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

### B.3 Definition of a derivative: settlement at a future date, interest rate swap with net or gross settlement

For the purpose of determining whether an interest rate swap is a derivative financial instrument under IFRS 9, does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined on the basis of a CU100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.
B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)

If a party pre pays its obligation under a pay-fixed, receive-variable interest rate swap at inception, is the swap a derivative financial instrument?

Yes.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 per cent per year. Entity S pre pays its fixed obligation under the swap of CU50 million (CU100 million × 10 per cent × 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the CU100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfils the ‘no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors’ provision of IFRS 9. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under IFRS 9.

B.5 Definition of a derivative: prepaid pay-variable, receive-fixed interest rate swap

If a party pre pays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the ‘no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors’ criterion of a derivative.
To illustrate: Entity S enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap’s notional amount, i.e. CU10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the ‘no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors’ criterion of IFRS 9. Therefore, the contract is not accounted for as a derivative under IFRS 9.

By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.6 Definition of a derivative: offsetting loans

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of principal at inception of the two loans, since A and B have a netting agreement. Is this a derivative under IFRS 9?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- they are entered into at the same time and in contemplation of one another
- they have the same counterparty
- they relate to the same risk
- there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IFRS 9 does not require net settlement.

B.7 Definition of a derivative: option not expected to be exercised

The definition of a derivative in IFRS 9 requires that the instrument ‘is settled at a future date’. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?
Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.8 Definition of a derivative: foreign currency contract based on sales volume

Entity XYZ, whose functional currency is the US dollar, sells products in France denominated in euro. XYZ enters into a contract with an investment bank to convert euro to US dollars at a fixed exchange rate. The contract requires XYZ to remit euro based on its sales volume in France in exchange for US dollars at a fixed exchange rate of 6.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. IFRS 9 does not exclude from its scope derivatives that are based on sales volume.

B.9 Definition of a derivative: prepaid forward

An entity enters into a forward contract to purchase shares of stock in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the ‘no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors’ test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase one million T ordinary shares in one year. The current market price of T is CUS50 per share; the one-year forward price of T is CUS55 per share. XYZ is required to prepay the forward contract at inception with a CUS50 million payment. The initial investment in the forward contract of CUS50 million is less than the notional amount applied to the underlying, one million shares at the forward price of CUS55 per share, ie CUS55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T’s shares could be purchased at inception for the same price of CUS50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.10 Definition of a derivative: initial net investment

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.
B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit-taking

The definition of a financial asset or financial liability held for trading states that 'a financial asset or financial liability is classified as held for trading if it is ... part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking'. What is a 'portfolio' for the purposes of applying this definition?

Although the term 'portfolio' is not explicitly defined in IFRS 9, the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (Appendix A of IFRS 9). If there is evidence of a recent actual pattern of short-term profit-taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

B.28 Regular way contracts: no established market

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. IFRS 9 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace, as that term is used in Appendix A of IFRS 9, is not limited to a formal stock exchange or organised over-the-counter market. Rather, it means the environment in which the financial asset is customarily exchanged. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.29 Regular way contracts: forward contract

Entity ABC enters into a forward contract to purchase one million of M's ordinary shares in two months for £10 per share. The contract is with an individual and is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty £10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.30 Regular way contracts: which customary settlement provisions apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.
To illustrate: Entity XYZ purchases one million shares of Entity ABC on a US stock exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

**B.31 Regular way contracts: share purchase by call option**

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of CUI100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

**B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting**

IFRS 9 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. IFRS 9 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in paragraphs 3.1.1 and 3.3.1 of IFRS 9 apply. Paragraph 3.1.1 of IFRS 9 states that financial liabilities are recognised on the date the entity ‘becomes a party to the contractual provisions of the instrument’. Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IFRS 9. Paragraph 3.3.1 of IFRS 9 specifies that financial liabilities are derecognised only when they are extinguished, ie when the obligation specified in the contract is discharged or cancelled or expires.
Section C Embedded derivatives

C.1 Embedded derivatives: separation of host debt instrument

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgement of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid contract, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of CU40,000 annually and a principal payment at maturity of CU1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays CU40,000 annually because there are no floating interest rate cash flows in the hybrid contract.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid contract. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid contract could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid contract. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid contract. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 Embedded derivatives: separation of embedded option

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid contract. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid contract?

No. The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid contract, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid contract) should be based on the stated terms of the option feature documented in the hybrid contract. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract.
If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid contract being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid contract to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid contract. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid contract, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid contract.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid contract. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid contract, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid contract.

**C.4 Embedded derivatives: equity kicker**

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an ‘equity kicker’) in addition to interest and repayment of principal. As a result of the equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognised in profit or loss (paragraph 4.3.3(c) of IFRS 9), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (paragraph 4.3.3(a) of IFRS 9). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and it is settled at a future date (paragraph 4.3.3(b) and Appendix A of
IFRS 9. The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. Paragraph BA.1 of IFRS 9 states that a derivative could require a payment as a result of some future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.6 Embedded derivatives: synthetic instruments

Entity A issues a five-year floating rate debt instrument. At the same time, it enters into a five-year pay-fixed, receive-variable interest rate swap with Entity B. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument. Entity A contends that separate accounting for the swap is inappropriate since paragraph B4.3.8(a) of IFRS 9 requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument (‘synthetic instrument’ accounting) for the purpose of applying IFRS 9. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

C.7 Embedded derivatives: purchases and sales contracts in foreign currency instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under IFRS 9?

Yes. To illustrate: a Norwegian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contract as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in profit or loss unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.
C.8 Embedded foreign currency derivatives: unrelated foreign currency provision

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IFRS 9 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements (paragraph 5 of IAS 39 and paragraph B4.2 of IFRS 9). The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under paragraph 4.3.3 of IFRS 9, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No. That leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (paragraph B4.3.8(d) of IFRS 9).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A’s nor Entity B’s functional currency. This foreign currency derivative would not be separated because it follows from paragraph B4.3.8(d) of IFRS 9 that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under paragraph 4.3.3 of IFRS 9.

C.9 Embedded foreign currency derivatives: currency of international commerce

Paragraph B4.3.8(d) of IFRS 9 refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.
C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment

If the terms of a combined contract permit, but do not require, the holder to settle the combined contract in a manner that causes it not to recover substantially all of its recognised investment and the issuer does not have such a right (for example, a puttable debt instrument), does the contract satisfy the condition in paragraph B4.3.8(a) of IFRS 9 that the holder would not recover substantially all of its recognised investment?

No. The condition that ‘the holder would not recover substantially all of its recognised investment’ is not satisfied if the terms of the combined contract permit, but do not require, the investor to settle the combined contract in a manner that causes it not to recover substantially all of its recognised investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that ‘the holder would not recover substantially all of its recognised investment’ applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognised investment.
Section D Recognition and derecognition

D.1 Initial recognition

D.1.1 Recognition: cash collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (for example, a securities borrowing transaction). The cash is not legally segregated from Entity A’s assets. Should Entity A recognise the cash collateral it has received as an asset?

Yes. The ultimate realisation of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realised by Entity A. Therefore, Entity A recognises the cash as an asset and a payable to Entity B while Entity B derecognises the cash and recognises a receivable from Entity A.

D.2 Regular way purchase or sale of a financial asset

D.2.1 Trade date vs settlement date: amounts to be recorded for a purchase

How are the trade date and settlement date accounting principles in IFRS 9 applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in IFRS 9 for a purchase of a financial asset. On 29 December 20X1, an entity commits itself to purchase a financial asset for CU1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On 31 December 20X1 (financial year-end) and on 4 January 20X2 (settlement date) the fair value of the asset is CU1,002 and CU1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.
### Settlement date accounting

<table>
<thead>
<tr>
<th></th>
<th>Financial assets measured at amortised cost</th>
<th>Financial assets measured at fair value with changes presented in other comprehensive income</th>
<th>Financial assets measured at fair value through profit or loss</th>
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<tbody>
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<td><strong>Balances</strong></td>
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<td>Other comprehensive income (fair value adjustment)</td>
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<tr>
<td>Retained earnings (through profit or loss)</td>
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<td>Other comprehensive income (fair value adjustment)</td>
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<td>Retained earnings (through profit or loss)</td>
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### Trade date accounting

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<th>Balances</th>
<th>Financial assets measured at amortised cost</th>
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<tr>
<td>Retained earnings (through profit or loss)</td>
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<td>(3)</td>
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</tbody>
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#### D.2.2 Trade date vs settlement date: amounts to be recorded for a sale

**How are the trade date and settlement date accounting principles in IFRS 9 applied to a sale of a financial asset?**

The following example illustrates the application of the trade date and settlement date accounting principles in IFRS 9 for a sale of a financial asset. On 29 December 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its amortised cost is CU1,000. On 31 December 20X2 (financial year-end), the fair value of the asset is CU1,012. On 4 January 20X3 (settlement date), the fair value is CU1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any interest that might have accrued on the asset is disregarded).
A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller’s right to changes in the fair value ceases on the trade date.

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<th>Settlement date accounting</th>
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<td>Other comprehensive income</td>
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<td>Retained earnings</td>
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<td>(through profit or loss)</td>
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### Trade date accounting

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<tr>
<th></th>
<th>Financial assets measured at amortised cost</th>
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<td>Receivable</td>
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<td>Other comprehensive income (fair value adjustment)</td>
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<td>Retained earnings (through profit or loss)</td>
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<td><strong>31 December 20X2</strong></td>
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<td>Retained earnings (through profit or loss)</td>
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### D.2.3 Settlement date accounting: exchange of non-cash financial assets

If an entity recognises sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognised in accordance with paragraph 5.7.4 of IFRS 9?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under paragraph 5.7.4 of IFRS 9 if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognised on the trade date as described in paragraph B3.1.5 of IFRS 9. In that case, the entity recognises a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on 29 December 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is measured at amortised cost, in exchange for Bond B, which meets the definition of held for trading and is measured at fair value. Both assets have a fair value of £U1,010 on 29 December, while the amortised cost of Note Receivable A is £U1,000. Entity A uses settlement date accounting for financial assets measured at amortised cost and trade date accounting for assets that meet the definition of held for trading. On 31 December 20X2
IFRS 9 IG

(financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009. On 4 January 20X3, the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007. The following entries are made:

**29 December 20X2**
Dr  Bond B  CU1,010
    Cr  Payable  CU1,010

**31 December 20X2**
Dr  Trading loss  CU1
    Cr  Bond B  CU1

**4 January 20X3**
Dr  Payable  CU1,010
    Dr  Trading loss  CU2
    Cr  Note Receivable A  CU1,000
    Cr  Bond B  CU2
    Cr  Realisation gain  CU10
Section E Measurement

E.1 Initial measurement of financial assets and financial liabilities

E.1.1 Initial measurement: transaction costs

Transaction costs should be included in the initial measurement of financial assets and financial liabilities other than those at fair value through profit or loss. How should this requirement be applied in practice?

For financial assets not measured at fair value through profit or loss, transaction costs are added to the fair value at initial recognition. For financial liabilities, transaction costs are deducted from the fair value at initial recognition.

For financial instruments that are measured at amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.3 Gains and losses

E.3.3 IFRS 9 and IAS 21 Exchange differences arising on translation of foreign entities: other comprehensive income or profit or loss?

IAS 21.32 and IAS 21.48 state that all exchange differences resulting from translating the financial statements of a foreign operation should be recognised in other comprehensive income until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include financial assets measured at fair value through profit or loss in accordance with IFRS 9.

If the foreign operation is a subsidiary whose financial statements are consolidated with those of its parent, in the consolidated financial statements how are IFRS 9 and IAS 21.39 applied?

IFRS 9 applies in the accounting for financial instruments in the financial statements of a foreign operation and IAS 21 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). A has a foreign subsidiary (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which meets the definition of held for trading and is therefore measured at fair value.

In B’s financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A’s consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 (= LCY100 × 2.00) in the consolidated financial statements.
At the end of year 20X1, the fair value of the debt instrument has increased to LCY110 in the local currency of Country Y. B recognises the trading asset at LCY110 in its statement of financial position and recognises a fair value gain of LCY10 in its profit or loss. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from LCX200 to LCX330 (= LCY110 × 3.00) in the currency of Country X. Therefore, Entity A recognises the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of comprehensive income of B ‘at the exchange rates at the dates of the transactions’ (IAS 21.39(b)). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ([3.00 + 2.00] / 2 = 2.50, in accordance with IAS 21.22). Therefore, while the fair value of the trading asset has increased by LCX130 (= LCX330 − LCX200), Entity A recognises only LCX25 (= LCY10 × 2.5) of this increase in consolidated profit or loss to comply with IAS 21.39(b). The resulting exchange difference, ie the remaining increase in the fair value of the debt instrument (LCX130 − LCX25 = LCX105), is accumulated in equity until the disposal of the net investment in the foreign operation in accordance with IAS 21.48.

E.3.4 IFRS 9 and IAS 21 Interaction between IFRS 9 and IAS 21

IFRS 9 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in profit or loss. IAS 21 includes rules about the reporting of foreign currency items and the recognition of exchange differences in profit or loss. In what order are IAS 21 and IFRS 9 applied?

Statement of financial position

Generally, the measurement of a financial asset or financial liability at fair value or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with IFRS 9. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IAS 21 (paragraph 85.7.2 of IFRS 9). For example, if a monetary financial asset (such as a debt instrument) is measured at amortised cost in accordance with IFRS 9, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity’s financial statements (IAS 21.23). That applies regardless of whether a monetary item is measured at amortised cost or fair value in the foreign currency (IAS 21.24). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is measured at fair value in the foreign currency (IAS 21.23(c)).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under IAS 39, the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under IAS 21 (IAS 39.89), ie the foreign currency amount is recognised using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (IAS 21.23(b)).
Profit or loss

The recognition of a change in the carrying amount of a financial asset or financial liability in profit or loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognising changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.5).

Any exchange difference arising on recognising a monetary item at a rate different from that at which it was initially recognised during the period, or recognised in previous financial statements, is recognised in profit or loss in accordance with IAS 21 (paragraph B5.7.2 of IFRS 9, IAS 21.28 and IAS 21.32), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges in IAS 39 apply (IAS 39.95). Differences arising from recognising a monetary item at a foreign currency amount different from that at which it was previously recognised are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the statement of financial position measurement of a monetary item are recognised in profit or loss in accordance with IFRS 9.

Any changes in the carrying amount of a non-monetary item are recognised in profit or loss or in other comprehensive income in accordance with IFRS 9. If the non-monetary item is designated as a cash flow hedge of an unrecognised firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges in IAS 39 apply (IAS 39.95).

When some portion of the change in carrying amount is recognised in other comprehensive income and some portion is recognised in profit or loss, an entity cannot offset those two components for the purposes of determining gains or losses that should be recognised in profit or loss or in other comprehensive income.