CA

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

IFRS 9 - Financial instruments

Replacement of IAS 39

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Differences from IAS 39

Scope & objective	No change
Initial measurement & Derecognition	No change
Classification and Measurement- Assets	Substantial Change
Classification and Measurement-Liabilities	Some changes
Presentation and disclosures	Some changes

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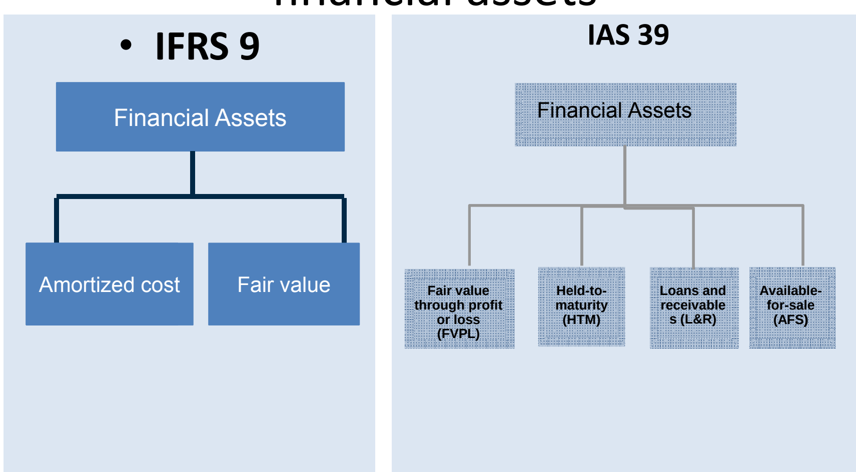
Classification and measurement of financial assets



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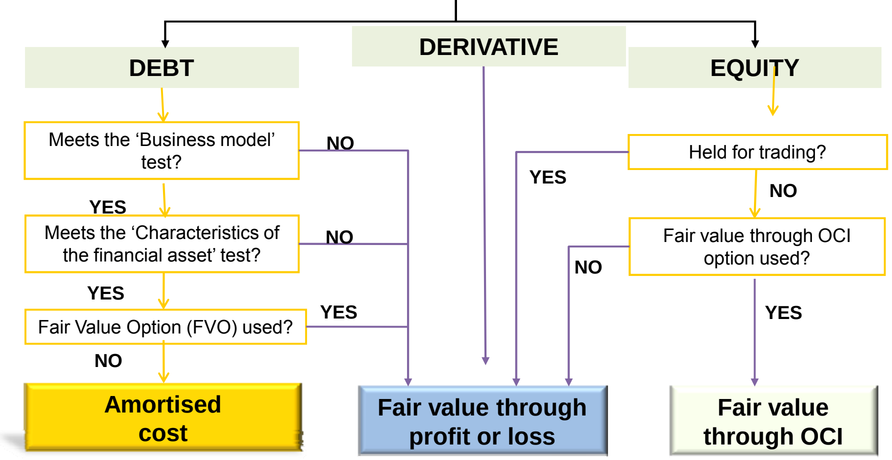
Classification and measurement
Financial assets- Overview

Is the financial asset a DEBT instrument or an EQUITY investment?



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Classification and measurement
Financial assets –Amortized cost

Amortised cost

A debt instrument is measured at amortized cost only ;

- If business model is to hold instruments to collect contractual cash flows (the 'business model test'); AND
- The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest ('characteristics of the financial asset test')

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Classification and measurement

Amortised cost criteria

- ‘Business model’ test and ‘Characteristics of the financial asset’ test
  - → Application guidance examples to help explain the concept
- Both principles are equally important – but, as recommended by many respondents, the standard discusses the business model first

‘Business model’ test

- To be assessed on the basis of the objective of an entity's business model as determined by the entity's key management personnel.
- Does not depend on management's intentions for an individual instrument
- Applied to a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments. Therefore, classification need not be determined at the reporting entity level either.

THE BUSINESS MODEL TEST

The business model test

- The objective of the entity's business model must be to hold instruments to collect contractual cash flows (ie principal and interest)
- Some sales *may* be permitted, for example:
  - If the asset no longer meets investment policy (e.g., decline in credit rating)
  - The entity is an insurer and it adjusts its investment portfolio to match the duration of its liabilities
  - If the asset is sold to fund unexpected cash outflows or losses
- Amortised cost may not be appropriate if "more than infrequent" sales occur
- Disclosures required
  - On derecognition of amortised cost assets, gains or losses are to be disclosed on the face of the income statement
  - Additional qualitative disclosures of the reasons for the sale

The business model test (cont.)

Areas requiring judgement

- Entity A wants to maximise the use of amortised cost, and is considering whether to stratify investments into smaller portfolios
  - Entity A defines time buckets for current accounts, savings accounts and term deposits, based on expected repayment
  - There are 2 buckets – (i) 3 year for CU100 (ii) 6 year for CU 50
  - Assets invested have similar maturity profiles and values
  - If the savings accounts behaviour changes, can the asset mix be adjusted (and not fail the business model test)?
- Analysis:
  - The Standard is not prescriptive – the level at which the test is applied is depends on facts and circumstances
  - Analogise to insurance example in B4.3(b)
  - May not be acceptable if indicators suggest fair value management

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The business model test (cont.)

Areas requiring judgement

- Financial assets are sold due to an infrequent event, would the business model still qualify for amortised cost?
  - Note: The incidence may be 'infrequent', but the proportion of assets sold may be large ie, more than 'some' – for eg., to fund capital expenditure or an acquisition
- Analysis:
  - Consider purpose of originally acquiring the assets
  - If reasons for sale were previously ***not*** anticipated, business model may still qualify for amortised cost
  - If the sale ***was*** previously anticipated, consider if maturities of the asset are consistent with expected timing of sale

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The business model test (cont.)

Liquidity buffer example

- Bank M holds a liquidity buffer of high grade vanilla securities
- The bank's strategy is to always have a buffer – so the overall portfolio size remains roughly stable within pre-defined currency and maturity bands
- The traders are measured based on achieving a buffer that meets the predefined currency and maturity criteria
  - they are not compensated or measured on fair value basis
- However they churn the portfolio (i) As the regulators require regular sales to prove the assets are liquid, (ii) they want to maintain a presence in the market so if they actually need to sell in a crisis it will not 'look' unusual
- The churn rate is about 20% per month. Portfolio is roughly 6m duration, although it is anticipated that the gross gains and losses will be substantial
- Does the business model qualify for amortised cost?

The business model test (cont.)

Areas requiring judgement

- Bank 2 purchases certain debt securities – at initial recognition, these assets are classified as held for trading
- The assets deteriorate over time and several are impaired. The bank reclassifies these assets as Available-for-sale (using the Oct 2008 amendments to IAS 39) because there is no active market
- At the date of initial application (when the business model test has to be applied), there is no market for the assets and practically they cannot be sold
- At the date of initial application, the bank's intent is to sell the assets 'as and when' it can find a private buyer or if the general market picks up although this could take up to several years
- The bank believes that they hold assets to collect contractual cash flows for the ***foreseeable future*** and that such a portfolio will qualify for amortised cost. Do you agree? Why or why not?
- **Analysis:** We do not believe that holding for the foreseeable future is sufficient to achieve amortised cost classification

The business model test (cont.)

Areas requiring judgement

- Bank B originates loans, holds one part of the portfolio to maturity, and sells or sub-participates another part to banks C and D.
- Are the lending and sub-participating activities separate – ie., does Bank B have one business model or two?
- Analysis: Could consider as two –
  - » assets from lending may typically qualify for amortised cost
  - » assets from sub-participation, may need measuring at FVTPL
- What happens if a sub-participation fails?
  - » NOT a trigger for reclassification
  - » If business model correctly determined at outset, will need to continue measuring at FVTPL

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The business model test (cont.)

Areas requiring judgement

- A business model initially meets amortised cost, but subsequent sales are "more than infrequent"
  - » Should the portfolio continue to be at amortised cost?
  - » How are any newly acquired assets accounted for?
- Analysis:
  - » NOT a trigger for reclassification
  - » Existing portfolio of assets can continue at amortised cost
  - » But new assets will need measuring at FVTPL (ie, they are considered to have a new business model)

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The business model test (cont.)

Further examples for discussion

1. An entity has 2 main segments A and B; certain financial assets are transferred/sold from A to B (internal sale for the purpose of consolidated financials). Should the reclassified assets be measured based on B's business model?
2. Bank P is approached by a telecoms client for a significant loan. The bank already has a significant exposure to that industry, but really wants to provide the loan to maintain client relationship. After a few months, Bank P reaches its maximum limits to the telecom industry and decides to sell a part of the loan to reduce its exposure and to be able to serve an important new client in the same industry. Is the loan eligible for amortised cost at initial recognition?

The business model test (cont.)

Further examples

3. Entity X holds a portfolio of fixed rate debt instruments. The entity decides to 'synthetically sell' the portfolio through a derivative (rather than selling the asset itself). How should the portfolio be measured?

Applying Business model in practice

- **Example - Factoring**

•An entity has a past practice of factoring its receivables. If the significant risks and rewards have transferred from the entity, resulting in the original receivable being derecognised from the balance sheet, the entity is not holding these receivables to collect its cash flows but to sell them.

•However, if the significant risks and rewards of these receivables are not transferred from the entity, and the receivables do not therefore qualify for derecognition, the client's business objective may still be to hold the assets in order to collect the contractual cash flows.

The business model test (cont.) Summary

Factors that indicate that a portfolio is being held to collect contractual cash flows:

– A mandate to optimise long term yield / switching assets to lock in long-term yield
– Yield of the portfolio as basis for remuneration of the investment manager
– Management reporting based on yield rather than fair value
– Management's documented strategy and defined KPIs point to long term yield rather than fair value
– A portfolio that does not change significantly in size over time and includes approximately the same type of investments
– Expected sales will not result in significant gains/losses
– ***Consider all factors together – not on a standalone basis – cumulative assessment of all facts and circumstances***

The business model test (cont.) Summary

Factors that indicate that a portfolio is **NOT** being held to collect contractual cash flows:

- History of large gains realised from the portfolio in the past
- A mandate for the investment manager to maximise fair value gains
- Management reporting based on fair value
- Remuneration of investment manager based on fair value results
- Use of market risk / investment management techniques (eg., VaR)
- Portfolios where duration management techniques are being actively used (such as Macauley duration measure)
- Portfolios that have been strategically ear marked for disposal, but not yet within scope of IFRS 5
- ***Consider all factors together – not on a standalone basis – cumulative assessment of all facts and circumstances***

CHARACTERISTICS OF THE FINANCIAL ASSET TEST

‘Characteristics of the financial asset’ test

- Contractual terms of the financial asset give rise, on specified dates, to cash flows that solely represent principal and interest payments
- ‘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

► Features that will still qualify for amortised cost:
- ► Prepayment options, extension options
- ► Fixed/variable interest rates
- ► Caps, floors, collars
- ► Unleveraged inflation index linked

► Features/assets that will not qualify:
- ► Leverage (options, forwards and swaps)
- ► Inverse floaters
- ► Convertible bonds, constant maturity rate bonds
- ► Catastrophe bonds

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‘Characteristics of the financial asset’ test (continued)

- Contractual cash flow characteristic that introduces leverage do not have the characteristics of interest e.g. option, forward and swap contracts
- An instrument that is subordinated to other instruments (e.g. to general creditors) may still have contractual cash flows that are principal and interest
- Whether or not the instrument is quoted in active market is not relevant for the measurement basis under IFRS 9

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'Characteristics of the financial asset' test

Prepayment, extension options and similar provisions

May be recorded at amortised cost only if several conditions are met:

► The provision is not contingent on future events, other than terms that protect:

i. The holder against credit deterioration of the issuer (e.g., defaults, credit downgrades, loan covenant violations), or a change in control of the issuer; or
ii. The holder or issuer against changes in relevant taxation or law;

(additional criteria on next slide)

'Characteristics of the financial asset' test

Prepayment, extension options and similar provisions

Additional criteria

Prepayment options

- the prepayment amount substantially represents unpaid principal and interest (may include early termination compensation)

Extension options

- the terms can only result in payments of principal and interest during the extension period

‘Characteristics of the financial asset’ test

Other contractual provisions

- All other contractual provisions that could change the timing or amount of payments do not result in contractual cash flows that are solely principal and interest unless a variable rate represents consideration for the time value of money and the credit risk associated with the principal amount outstanding

‘Characteristics of the financial asset’ test

Examples

Instruments that will qualify	Instruments that will NOT qualify
A bond with a stated maturity date. Principal and interest are linked to an inflation index that is not leveraged.	A convertible bond that is convertible into equity instruments of the issuer.
A variable interest rate loan with a stated maturity date that permits the borrower to change the period of the market interest rate at each interest reset date on an ongoing basis.	A loan that pays an inverse floating rate, i.e. the interest rate has an inverse relationship to the market interest rates.
A bond with a stated maturity date and pays a variable market interest rate which is capped.	A constant maturity bond with a five-year term that pays a variable rate that is reset periodically but always reflects a five-year maturity.
A full recourse loan secured by collateral.	

Characteristics of the financial asset test

Features which could be problematic

- A mortgage is indexed to 12 month Euribor and the borrower pays this rate monthly, bi-monthly or quarterly, however, the rate resets after 6 months
- A mortgage is indexed to an average Libor rate over a period of time. The interest rate is equal to the average 2 year Libor rate over the last 2 years (plus a fixed spread). The economic rationale is to allow borrowers to benefit from a floating rate but with an averaging mechanism to protect them from short term volatility.

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Characteristics of the financial asset test

Features which could be problematic

- 15 year floating rate Government bonds, coupons are reset every 6 months by referencing to the 10 year rate. Similar to Chinese bonds where the rate is set is set to a two year rate.
- Loan agreement with covenant: spread above benchmark rate increases if borrower's EBITDA or debt to equity ratio deteriorates by a specified amount by a specified date.
- Dual currency bonds
  - Principal denominated in JPY but interest in USD
  - Coupon is fixed in USD at inception
  - At maturity, bond is redeemed in JPY

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Characteristics of the financial asset test

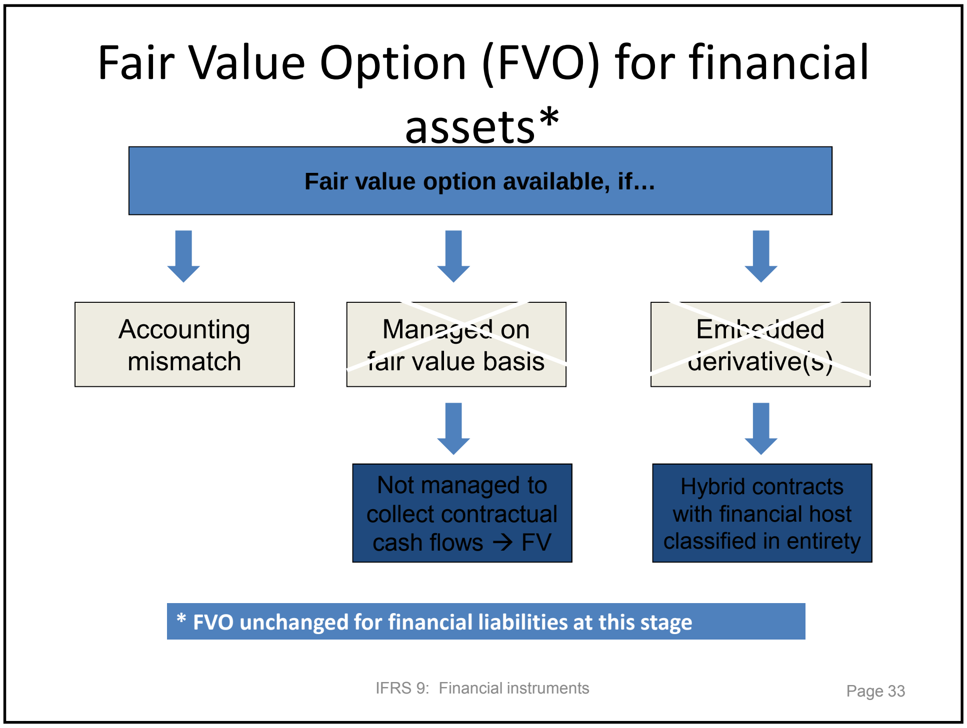
Features which could be problematic (continued)

- Inflation indexed Euro bonds (e.g. Euro denominated bonds but indexed to the Italian inflation rate)
- Investments in units issued by money market or debt funds
- Loans with step-up rates
- Products with a time lag in setting interest rates
  - (e.g. interest is paid monthly and is referenced to the one month rate but using last month's rate and not this month's rate)

Classification and measurement Financial assets – Fair value

Fair value

- FVTPL (fair value through profit or loss) → all other instruments, except where FVTOCI option is used
- FVTOCI (fair value through OCI) → non trading equity investments (by choice), but dividends through profit or loss
- No cost exception for unquoted equity investments


Fair Value Option (FVO) for financial assets*
Fair value option available, if…
Accounting mismatch
~~Managed on fair value basis~~
~~Embedded derivative(s)~~
Not managed to collect contractual cash flows → FV
Hybrid contracts with financial host classified in entirety
* FVO unchanged for financial liabilities at this stage
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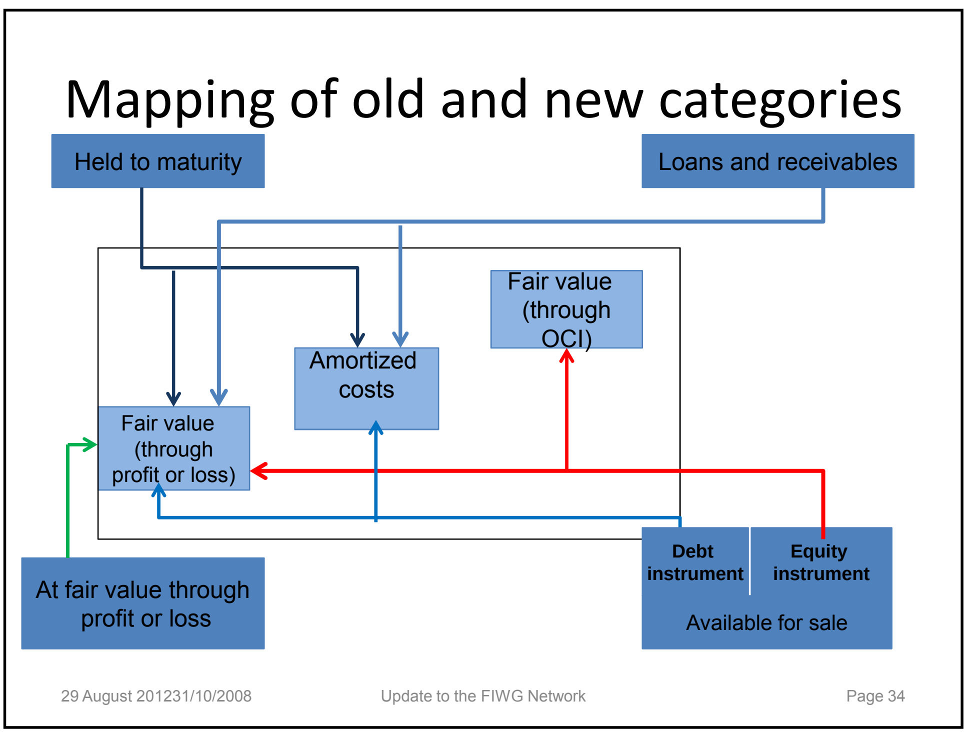
Mapping of old and new categories
Held to maturity
Loans and receivables
Fair value (through OCI)
Amortized costs
Fair value (through profit or loss)
Debt instrument
Equity instrument
Available for sale
At fair value through profit or loss
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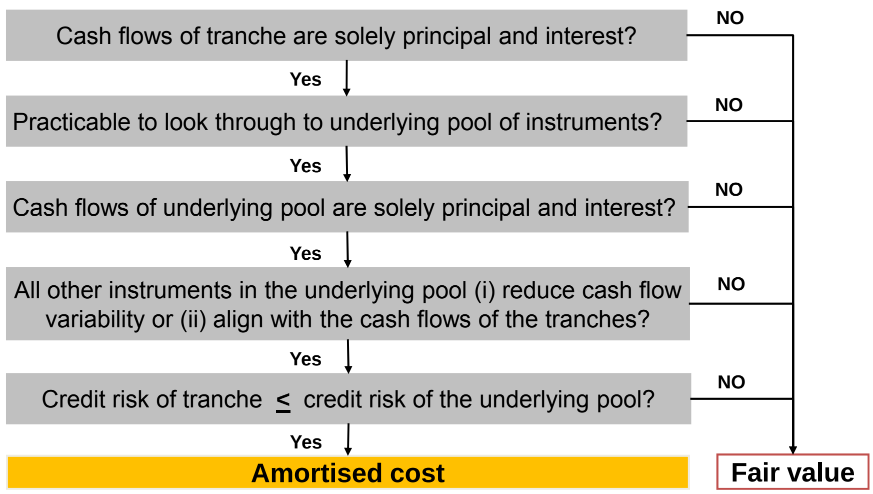
Embedded derivatives

- Bifurcation of embedded derivatives is eliminated for host financial assets within the scope of IAS 39
  - Only one classification approach → Do the embedded derivatives together with the host instrument meet the 'contractual cash flow characteristics' test?
  - Yes → the hybrid contract (as a whole) qualifies for amortised cost classification
  - No → the hybrid contract (as a whole) is measured at fair value
- Embedded derivatives with non-financial hosts are not addressed at this stage → existing requirements maintained

Non-recourse loans

- Some financial assets may have cash flows described as 'principal and interest' but may not, in fact, represent such payments. Guidance is not clear, but
  - A non-recourse instrument may still qualify for amortised cost, but holder must look through to the underlying assets or cash flows
  - Amortised cost not appropriate if cash flows are linked to the performance of underlying assets/project, etc, e.g., 'interest' based on traffic on toll road

Contractually linked assets



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Contractually linked assets (cont.)

- Calculate comparative risks, based on conditions at original recognition

Considerations:

- What would be the effect on the look through test for contractually linked instruments if the SPE benefits from credit enhancement through the purchase of a credit default swap?
- What about where the linkage is in substance rather than by contract?

Practical difficulties in applying the look-through for:

- Synthetic CDOs
- CDO squared or cubed
- Blind pools

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EQUITIES

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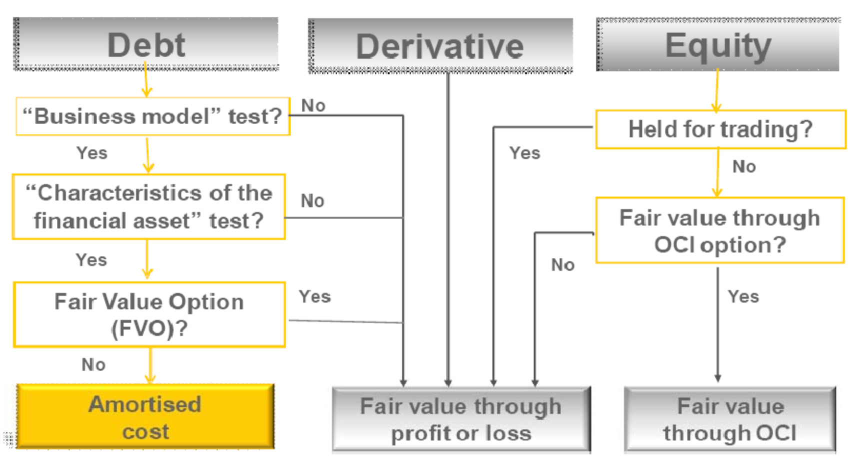
Equities



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Equity instruments

- Presentation of FV changes in OCI
  - Available for all equity instruments that are not held for trading
  - Free choice for each holding of an instrument at initial recognition
  - Irrevocable for that holding (no reclassification)
- Dividends will be recognised in profit or loss, if return on investment (*not* return of investment)
- No recycling of fair value changes to profit or loss on impairment, disposal or in any other circumstances
  - No impairment testing required
- Additional disclosures

Unquoted equity instruments

- No cost exemption for unquoted equity instruments → all equities at fair value
- Cost may be used as a proxy for fair value in certain circumstances
- Indicators of when cost might not represent fair value
  - A significant change in the performance of the investee
  - Changes in expectation that technical milestones will be achieved
  - A significant change in the market for the investee company or its products
  - A significant change in the global economy or the economic environment
  - A significant change in the observable performance of comparable companies, or in the valuations implied by the overall market.
  - Internal matters such as fraud, commercial disputes, or litigation, or changes in management or strategy.
  - Evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

Practical challenges for FVTOCI equities

- Question (Ref: B5.12)
  - How should an entity determine whether a dividend represents a recovery of part of the cost of the investment?
- Scenario A
- An entity invests in shares at a cost of CU2 and designates these at FVTOCI. The fair value then increases to CU22, resulting in an unrealised gain in OCI of CU20. The entity then pays a special dividend of CU20.
- Question: Is it appropriate to record the dividend of CU20 in profit or loss?
- Scenario B
- What if the dividend received was CU21 instead of CU20?
- Would that mean that CU20 could be taken to profit or loss while CU1 would represent a recovery of the original cost of investment?

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Practical challenges for FVTOCI equities (continued)

- Question
  - Where should transaction costs on disposal of FVTOCI equities be recorded? (OCI or the Income Statement)
  - Tension between Par 5.1.1 of IFRS 9 and B5.4
- 5.1.1 At initial recognition, an entity shall measure a financial asset at its fair value (see paragraphs 48, 48A and AG69–AG82 of IAS 39) plus, in the case of a **financial asset not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition of the financial asset.**
- B5.4 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income in accordance with paragraph 5.4.4. An entity acquires an asset for CU100 plus a purchase commission of CU2. Initially, the entity recognises the asset at CU102. The reporting period ends one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognises a loss of CU2 in other comprehensive income.

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Disclosures for FVTOCI equities

- IFRS 7 requirements
  - Which investments have been designated at FVTOCI and the reasons for using this approach
  - Fair values at the end of the reporting period
  - Dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period
  - Any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers
  - If an entity derecognised FVTOCI investments during the reporting period, disclose the reasons for disposal, their fair value at the derecognition date and the cumulative gain or loss on disposal.

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Reclassifications (between amortised cost and FVTPL)

- Reclassification will be required when an entity changes its business model
  - Prohibited in all other circumstances
- Any reclassification is to be accounted for prospectively from the *Reclassification date*
  - Which is the first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets
  - Reclassification from amortised cost to fair value → measure instrument at fair value on that date; recognise difference between carrying amount and fair value in a separate line in profit or loss
  - Reclassification from fair value to amortised cost → fair value of the instrument on the date of reclassification becomes its new carrying amount
- Detailed disclosures will be required in interim reports and annual financial statements

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Reclassification
Examples from application guidance

Reclassification required	Reclassification prohibited
An entity has a portfolio of commercial loans that it held to sell in the short term. However, the entity acquires a company that manages commercial loans and has a business model that holds the loans to collect the contractual cash flows.	A change in intention related to specific financial assets (even in circumstances of significant changes in market conditions)
A financial services firm decides to shut down its retail mortgage business, and is no longer accepting new business. The firm actively market its mortgage loan portfolio for sale.	A temporary disappearance of a particular market for financial assets
	A transfer of financial assets between existing business models

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Classification and measurement
Main challenges

- To qualify for amortised cost, entities need to demonstrate that financial assets are held and managed within an appropriate 'business model' (management intent is not sufficient)
- Entities need to assess instruments impacted due to the new measurement criteria and make changes to accounting systems
- A number of areas will require judgment and interpretation by preparers and auditors
- Instruments reclassified using the October 2008 amendment to IAS 39 may need to be reclassified back to fair value
- Classification of tranches of securitised debt will be complex, as they are subject to 'look-through'

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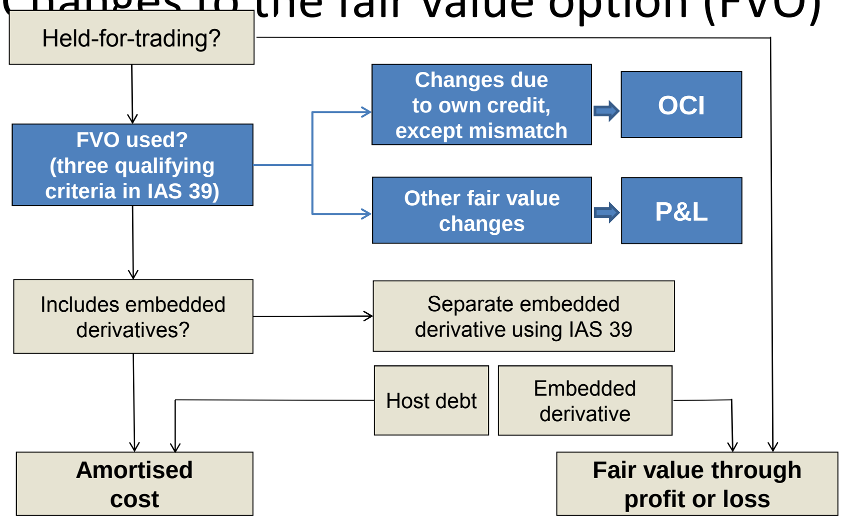
Classification and measurement Main challenges (continued)

- If a financial asset is reclassified from FVTPL to amortised cost, it is not possible to amend hedge accounting retrospectively
  - Restated information may be difficult to explain if fair value gains and losses on those assets had been previously been offset by the change in value of derivatives
- Additional transition disclosures will be required upon adopting IFRS 9
- Depending on the choices exercised, there could be a change in the geography of where certain gains and losses are recognised
- Entities need to determine regulatory and tax consequences
  - Adopting IFRS 9 would mean changes to the measurement model, with a consequential impact on the net profit or loss for the reporting period
- As financial liabilities and hedge accounting have been scoped out of the current phase, there may be some difficulties in understanding the overall implications

IFRS 9 CLASSIFICATION AND MEASUREMENT: FINANCIAL LIABILITIES

Financial liabilities
Changes to the fair value option (FVO)



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Amendments to the measurement of Fair Value Option liabilities

- Amendments to IFRS 9 released on 28 October 2010, completes Phase 1 of IFRS 9, Classification and Measurement
- For liabilities, maintain IAS 39, except when Fair Value Option is used:
  - Record effect of changes in own credit risk in OCI, without recycling
  - Other fair value changes in profit or loss
    - » Unless an accounting mismatch would be created, in which case, FV changes in respect of own credit would be recorded in profit or loss as well
  - Clarification re meaning of credit risk and how to compute own credit risk
- The three eligibility criteria in IAS 39 will remain for FVO
  - Cannot revoke previous designations or make new ones, except when adopting phase 1 (assets) of IFRS 9
- Mandatory application 1 January 2015
  - Earlier application permitted, if adopting Assets phase
- Transition-similar to Assets

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Amendments to the measurement of Fair Value Option liabilities (continued)

- Determination of accounting mismatch
  - Example:
    - » Danish mortgages
  - Whether the effects of changes in the liability's credit risk will be offset in P&L by changes in the FV of an asset
  - Based on facts and circumstances on the date of initial application, not the initial recognition of the liability
  - Cannot be re-assessed after initial recognition (for new liabilities)

Amendments to the measurement of Fair Value Option liabilities (continued)

- Clarifications re what is credit risk and how to compute it
  - Distinction made between credit risk and asset specific performance risk
    - » Examples of asset-specific performance risk (SPEs & liability with a unit-linking feature)
    - » IFRS 7 disclosure for banks with consolidated SPEs may need to change
  - To measure credit risk, can use IFRS 7 methodology with clarification that credit risk may include any associated liquidity premium OR
  - Appropriate alternative method
- Example: See extract of UBS 2009 disclosure

DERECOGNITION OF FINANCIAL ASSETS

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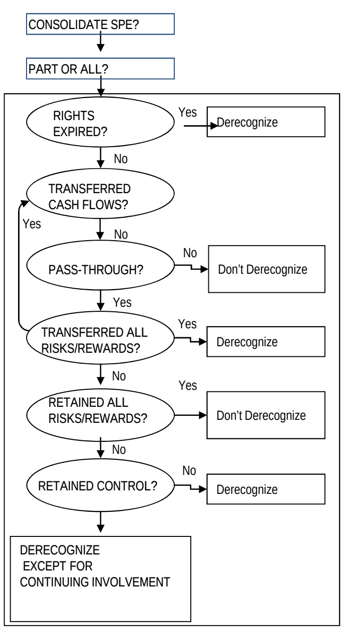

Flow Chart – Steps

- Setting the frame
  - Who is the entity?
  - What is the transferred asset?
- Transfer or pass-through of cash flows
  - Have the contractual rights expired?
  - Is there a transfer of rights to receive payments?
  - Is there a qualifying pass-through of cash flows?
- Risks and rewards
  - Has the entity transferred substantially all risks and rewards?
  - Has the entity retained substantially all risks and rewards?
- Control and continuing involvement
  - Has entity retained control of assets?
  - What is the continuing involvement?

Transition & date of initial application

Mandatory for accounting periods beginning on or after 1 January 2015

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THANK YOU

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