First Impressions: IFRS 9 Financial Instruments

International Financial Reporting Standards
December 2009
Foreword

IFRS 9 Financial Instruments was published in November 2009. This is the first instalment of a phased project to replace the existing standard on financial instruments, IAS 39 Financial Instruments: Recognition and Measurement. The exposure draft (ED) on the impairment phase of the project also has been published recently and will be followed shortly by draft proposals on hedge accounting. Rewriting the existing financial instruments standard is a very ambitious project. It is to the credit of the International Accounting Standards Board (IASB or Board) that it has been able to achieve so much progress in a few short months in order to meet the urgent calls for change from the Group of Twenty (G20), the Financial Stability Board and others. In doing so the Board has undertaken a major outreach programme, discussing the proposals with a wide range of constituents and responding to the feedback received.

As proposed in the ED, the standard retains a mixed measurement model, with some financial assets measured at amortised cost and others at fair value. Retaining but simplifying the mixed measurement model was an important recommendation of the Financial Crisis Advisory Group. In the current environment we believe that this is the right approach. The distinction between the two measurement models is based on the business model of each entity and a requirement to assess whether the cash flows of an individual instrument are only principal and interest. This business model approach is a fundamental building block of the new standard and aims to align the accounting with the way that management deploys assets in its business, while also considering the characteristics of the assets.

While the ED’s proposals also would have applied to liabilities, the standard addresses at present only financial assets. This change in scope reflects the complexities of some of the issues around liability measurement, including the remeasurement of own credit risk and embedded derivatives. Addressing financial assets and liabilities separately is not ideal, but we believe that the Board has made a sensible decision pending further discussion on these issues.

Given the far-reaching nature of the IAS 39 replacement project, many entities may need to undertake changes in systems and internal reporting in order to comply with its requirements. For this reason we support the Board’s decision to set a longer term time horizon for mandatory adoption of the new standard (2013). This also will allow preparers to adopt all phases of the project at once. Importantly, however, the new standard will be available for early adoption before 2012 without the need to restate comparatives.

Early adoption will be a big step for any entity and it remains to be seen how many will choose this route. In some jurisdictions new standards have to be formally adopted before they can be applied. In others there may be specific restrictions on early application. In any event, we expect that many companies will wait until the entire package, including impairment, hedge accounting and financial liabilities, has been finalised before making the change. Furthermore, although there is close dialogue between the IASB and the U.S. Financial Accounting Standards Board (FASB) on changes to financial instruments accounting, it is not as yet clear to what extent full convergence will be achieved on some of the issues.

The objective of this publication is to summarise the key aspects of the standard and to highlight some of the implementation issues which we have identified to date. This publication does not offer our views or interpretations as it would be premature to do so. More time will be needed to discuss the requirements of the standard and consider them in the context of specific transactions.

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About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

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Content

Our First Impressions publications are prepared upon the release of a new IFRS, interpretation or other significant amendment to the requirements of IFRSs. They include a discussion of the key elements of the new requirements and highlight areas that may impact or change practice. Examples are provided to assist in assessing the impact of implementation.

This edition of First Impressions considers IFRS 9 Financial Instruments issued in November 2009. Other aspects of accounting for financial instruments are dealt with in Insights into IFRS.

The text of this publication is referenced to IFRS 9 and to selected other IFRSs in issue at 1 December 2009. References in the left-hand margin identify the relevant paragraphs.

In most cases further analysis and interpretation will be needed in order for an entity to apply IFRSs to its own facts, circumstances and individual transactions. Further, the information contained in this publication is based on the initial observations of the KPMG International Standards Group, and these observations may change as practice develops.

Updates to KPMG’s views and interpretative guidance and examples on IFRS 9 may be included in Insights into IFRS.

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1. Executive summary

- The standard is part of the International Accounting Standards Board’s (IASB) wider project to replace IAS 39 Financial Instruments: Recognition and Measurement over the next year.

- The standard applies only to financial assets, and not to financial liabilities, within the scope of IAS 39. An exposure draft on classification and measurement of financial liabilities is planned for the first quarter of 2010.

- The standard contains two primary measurement categories for financial assets: amortised cost and fair value. The existing IAS 39 categories of “Held-to-maturity”, “Loans and receivables” and “Available-for-sale” are eliminated and so are the existing tainting provisions for disposals before maturity of certain financial assets.

- A financial asset is measured at amortised cost if: the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest. All other financial assets are measured at fair value.

- The standard contains specific guidance on classifying non-recourse financial assets and contractually linked instruments that create concentrations of credit risk (e.g., securitisation tranches). Financial assets acquired at a discount that may include incurred credit losses are not precluded from the amortised cost classification automatically.

- The standard contains an option to classify financial assets that meet the amortised cost criteria as at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch.

- Embedded derivatives with host contracts that are financial assets in the scope of IAS 39 are not bifurcated; instead the hybrid financial instrument is assessed as a whole for classification under the standard. There is no change to the accounting for embedded derivatives with host contracts that are not financial assets within the scope of IAS 39, such as financial liabilities and non-financial host contracts.

- If a financial instrument is measured at fair value, then all changes in fair value are recognised in profit or loss, with one exception. For equity investments which are not held for trading, an entity can choose, on an instrument-by-instrument basis, to recognise gains and losses in other comprehensive income with no recycling of gains and losses into profit or loss and no impairments recognised in profit or loss. If an equity investment is so designated, then dividend income generally is recognised in profit or loss.

- The standard eliminates the exemption allowing some unquoted equity investments and related derivative assets to be measured at cost. However, it includes guidance on limited circumstances where the cost of such an instrument may be an appropriate estimate of fair value.

- The classification of an instrument is determined on initial recognition. Reclassifications are made only upon a change in an entity’s business model, and are expected to be very infrequent. No other reclassifications are permitted.

- The standard is effective for annual periods beginning on or after 1 January 2013. Early application is permitted. The standard requires retrospective application with certain exemptions and there are detailed transition requirements. If an entity adopts the standard before 1 January 2012, then it does not have to restate comparative information.
2. Introduction and background

The IASB currently is revising its accounting requirements for financial instruments. The objectives of the project include improving the decision-usefulness of financial statements for users by simplifying the classification and measurement requirements for financial instruments. This project aims to replace the existing standard IAS 39 Financial Instruments: Recognition and Measurement.

The IAS 39 replacement project, and in particular its timeline, is driven in part by requests for reform from the Group of Twenty (G20) and other constituents. Following the G20 summit in April 2009, the Leaders’ Statement called on accounting standard setters, including the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB), to work urgently with supervisors and regulators to improve standards and achieve a single set of high-quality global accounting standards. Following the conclusion of their September 2009 summit, the G20 leaders reiterated this message and called on the accounting setters to complete their convergence project by June 2011.

A phased approach has been adopted in order to accelerate the replacement of IAS 39 and address the consequences of the financial crisis as speedily as possible, while giving interested parties an opportunity to comment on the proposals in accordance with the IASB’s commitment to due process. The three main phases are:

- Classification and measurement of financial instruments. IFRS 9 Financial Instruments (the standard) on classification and measurement of financial assets, the subject of this publication, was published on 12 November 2009. An exposure draft (ED) on classification and measurement of financial liabilities is scheduled to be published in the first quarter of 2010, with comments due by the end of June 2010.
- Impairment of financial assets. ED/2009/12 Financial Instruments: Amortised Cost and Impairment was published on 5 November 2009 with a comment deadline of 30 June 2010. See our publication New on the Horizon ED/2009/12 Financial Instruments: Amortised Cost and Impairment for further detail on this ED.
- Hedge accounting. An ED is scheduled to be published in the first quarter of 2010.

A final standard incorporating all three phases is scheduled for the fourth quarter of 2010.

The Board has not considered the scope of IAS 39 yet. Although the interaction of the scope of IAS 39 with other standards has resulted in some application and interpretation issues, the scope of the financial instruments replacement standard has not been identified as an immediate priority and it will be considered as part of a later phase of the replacement project.

At the time of publication, the IASB has issued a number of other exposure documents that form part of, or are relevant to, the IAS 39 replacement project.

In March 2009 the IASB published ED/2009/3 Derecognition, which proposes new guidance on when a financial asset should be removed from an entity’s statement of financial position, and increased disclosures about transfers of assets. The comment period closed on 31 July 2009.

In May 2009 the IASB published ED/2009/5 Fair Value Measurement (the fair value measurement ED) which proposes new guidance on the principles to be applied in determining fair values when IFRSs require or permit use of fair values. The proposed guidance in the fair value measurement ED also would apply to any measurements of the fair values of financial instruments that would be required under the IAS 39 replacement project. The comment period for the fair value measurement ED closed on 28 September 2009.
The IASB and the FASB recently reiterated their commitment to working together to develop a converged solution on financial instruments accounting and published a joint statement on 5 November 2009 detailing how they intend to fulfil this commitment. The FASB intends to publish its proposals on financial instruments accounting in the first quarter of 2010 in a comprehensive ED that would address classification and measurement, impairment and hedge accounting.

On derecognition of financial instruments, the IASB and the FASB have agreed to assess in the first half of 2010 the differences between IFRS and U.S. GAAP and consider together the alternative model that the IASB has been developing. The IASB and the FASB are aiming to complete the project by mid-2011, with an effective date that is aligned with consolidation requirements that also are in the pipeline.

On fair value measurement, the IASB and the FASB will consider together in the first quarter of 2010 comments received on the IASB ED. The IASB plans to issue a new standard in the third quarter of 2010. The FASB will decide whether it will need to propose any amendments to U.S. GAAP and, if needed, such amendments also would be finalised in the third quarter of 2010 with the objective of attaining convergence.

The purpose of this publication is to summarise the key aspects of the new standard and highlight potential implementation issues identified to date.
3. Classification

3.1 Overview

The flowchart below provides an overview of the classification and measurement model in IFRS 9. Each element of the model is explained further in the succeeding paragraphs.

Financial assets in the scope of IAS 39

- Objective of business model: hold asset in order to collect contractual cash flows?
  - Yes
  - Cash flows that are solely payments of principal and interest on specified dates?
    - Yes
    - Equity investment?
      - Yes
      - Held for trading?
        - Yes
        - OCI option?
          - Yes
          - Fair value option?
            - Yes
            - Fair value
              - Changes in fair value recognised in OCI
              - Dividends generally recognised in profit or loss
            - No
            - Amortised cost
          - No
          - Fair value
            - Changes in fair value recognised in profit or loss
        - No
        - Fair value
          - Changes in fair value recognised in profit or loss
      - No
      - Fair value
        - Changes in fair value recognised in OCI
        - Dividends generally recognised in profit or loss
    - No
    - No
    - No
    - Yes
    - OCI option?
      - Yes
      - Fair value option?
        - Yes
        - Fair value
          - Changes in fair value recognised in OCI
          - Dividends generally recognised in profit or loss
        - No
        - Fair value
          - Changes in fair value recognised in profit or loss
      - No
      - Fair value
        - Changes in fair value recognised in profit or loss
  - No
  - No
  - Yes
  - OCI option?
    - Yes
    - Fair value option?
      - Yes
      - Fair value
        - Changes in fair value recognised in OCI
        - Dividends generally recognised in profit or loss
      - No
      - Fair value
        - Changes in fair value recognised in profit or loss
    - No
    - Fair value
      - Changes in fair value recognised in profit or loss

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3.2 Classification guidance in IFRS 9

3.2.1 Introduction

**Key changes from the ED**

Whereas the ED would have applied to both financial assets and financial liabilities, the standard applies to financial assets only. Pending a new standard on the classification and measurement of financial liabilities, the guidance on accounting for financial liabilities in IAS 39 continues to apply.

**IFRS 9.2.1**

IFRS 9 provides guidance on recognition, classification and measurement of financial assets. It does not change the scope of IAS 39 or its guidance on when a financial asset should be recognised.

**IFRS 9.4.1, 3.1.1**

The standard contains two primary measurement categories:

- amortised cost; and
- fair value.

A financial asset is classified into a measurement category at inception.

**IFRS 9.4.2**

A financial asset qualifies for amortised cost measurement only if it meets both of the following conditions:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

If a financial asset does not meet both of these conditions, then it is measured at fair value.

**Insight**

The existing categories under IAS 39 of “held-to-maturity”, “loans and receivables” and “available-for-sale” are eliminated. Financial assets that meet the conditions stated above qualify for amortised cost measurement even if they are quoted in an active market.

**IAS 39.46, 47**

IFRS 9 eliminates the previous exception in IAS 39 to measure certain investments in unquoted equity instruments at cost if their fair value cannot be measured reliably. Similarly, the exemption for derivative assets that are linked to and settled by delivery of such unquoted equity instruments was eliminated. However, as IFRS 9 deals only with assets, the parallel exception in paragraph 47 of IAS 39 for financial liabilities, is retained. Therefore derivative liabilities that are linked to and settled by delivery of unquoted equity instruments whose fair value cannot be reliably measured, are measured at cost.

**IAS 39.31**

There is no change to the special IAS 39 measurement guidance relating to a transferred asset that continues to be recognised to the extent of the entity’s continuing involvement in the asset. Accordingly, such assets and the associated liabilities continue to be measured on a basis that reflects the rights and obligations retained by the entity.
3.2.2 Business model

Key changes from the ED
The ED precluded financial assets acquired with a discount that reflects incurred losses from being classified at amortised cost. There is no such restriction in the standard.

More guidance and examples have been added to illustrate the “business model” condition.

IFRS 9.B4.1, B4.2
The standard states that the assessment of the objective of an entity’s business model for managing financial assets is not based on management’s intentions with respect to an individual instrument, but rather is determined at a higher level of aggregation. This assessment of the business model objective should reflect the way an entity manages its business – or businesses. The standard explains that a reporting entity may have more than one business model for managing financial assets and provides an example of different “portfolios” being managed on different bases.

IFRS 9.B4.3
Not all of the assets in a portfolio have to be held to maturity in order for the objective of the business model to qualify as holding assets in order to collect contractual cash flows (for convenience this criterion is referred to as “HTC”). The Board has acknowledged that very few business models entail holding all instruments until maturity. Some sales out of a HTC portfolio are possible, but if there is “more than an infrequent number,” then an entity has to assess whether and how those sales are consistent with a HTC objective. The standard illustrates this principle by providing a number of examples in which sales of financial assets may be regarded as being consistent with a HTC business model:

- a financial asset no longer meets the entity’s investment policy (e.g., the credit rating of the asset declines below that required by the entity’s investment policy);
- an insurer adjusts its investment portfolio to reflect a change in expected duration (i.e., the expected timing of payouts); or
- an entity needs to fund capital expenditures.

IFRS 9.B4.4
Acquiring financial assets with incurred losses is not in itself inconsistent with a HTC model. For example, an entity may have a business model to acquire impaired loans and then collect the contractual cash flows by chasing the debtors for payment.

IFRS 9.B4.5, B4.6
Active management of a portfolio in order to realise fair value changes is not consistent with a HTC business model. Similarly, a portfolio that is managed and whose performance is evaluated on a fair value basis does not meet the definition of a HTC business model. Also, a portfolio of financial assets that meets the definition of held for trading is not consistent with a HTC business model.

IFRS 9.B4.4
Acquiring financial assets with incurred losses is not in itself inconsistent with a HTC business model. For example, an entity may have a business model to acquire impaired loans and then collect the contractual cash flows by chasing the debtors for payment.

Insight
In implementing the standard, an entity will have to consider at what level of its business activities the business model should be assessed. In the Basis for Conclusions to the standard, the Board noted that an entity’s business model is a matter of fact which can be observed from the way an entity is managed and the information provided to management. However, there may be circumstances in which it is not clear whether a particular activity involves one business model with some infrequent sales of assets, or whether these anticipated sales mean that in fact an entity has two different business models and only one qualifies as HTC. Similarly, there is no bright line in the standard as to what frequency of anticipated sales would preclude a single business model from qualifying as HTC. In many cases, entities may have to exercise significant judgement to determine the appropriate classification of financial assets.

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The standard does not state explicitly what the consequences are of an entity concluding that sales out of a portfolio that was previously considered HTC are no longer consistent with a HTC business model, but when the reclassification criteria (see section 4.3) have not been met. For example, an entity may conclude that it no longer holds a particular portfolio of financial assets for collection of contractual cash flows, but the change is not sufficiently significant to the entity’s operations to trigger reassessment of the classification of the existing items in the portfolio. However, when new financial assets are acquired subsequent to the change in intention, the HTC criterion would not be met and so the new assets would fail the amortised cost criteria. This may lead to some financial assets in the portfolio being measured at amortised cost and others, acquired after the change in intention, being measured at fair value. This may mean that, following this assessment, the entity effectively has two portfolios rather than one.

A portfolio of financial assets acquired with the objective of selling to a securitisation vehicle still may be consistent with a HTC business model. The standard gives an example of a business model in which an entity originates loans for the purpose of selling them to a securitisation vehicle. The originating entity controls the vehicle and consolidates it. The loans are derecognised from the originating entity’s statement of financial position and recognised by the securitisation vehicle. On consolidation, the loans remain within the consolidated group. The standard concludes that in this scenario:

- in the consolidated financial statements, the HTC criterion is met as the consolidated group originated the loans with the objective of collecting the contractual cash flows; and
- for the originating entity’s stand alone financial statements, the criterion is not met as the individual entity has originated the loans with the objective of selling them to the securitisation vehicle rather than holding them to collect the contractual cash flows.

### Cash flow characteristics

#### Key changes from the ED
Guidance and examples have been added to illustrate the cash flow characteristics condition. This includes guidance on contractual terms that are not genuine.

The standard includes guidance on non-recourse financial assets that requires a “look through” approach to assess the nature of contractual cash flow characteristics.

The standard also requires a look through approach to investments in contractually linked instruments that create concentrations of credit risk. The ED had proposed that only the most senior tranche of notes issued by a vehicle could qualify for amortised cost accounting.

In order to qualify for amortised cost measurement, the cash flows from a financial asset should represent, on specified dates, solely payments of principal and interest on the principal amount outstanding (this criterion is for convenience referred to as “SPPI”). Interest is defined as: “consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.” The assessment as to whether cash flows meet this test is made in the currency in which the financial asset is denominated.

Leverage is not consistent with the SPPI criterion. Leverage is described as increasing the variability of the contractual cash flows such that they do not have the economic characteristics of interest. The standard lists freestanding swaps, options and forwards as instruments that contain leverage.
Contractual terms that permit the issuer to prepay before maturity, the holder to put the financial asset back to the issuer before maturity or either party to extend the term of a financial asset meet the SPPI criterion only if:

- the feature is not contingent on future events or, if it is, it protects:
  - the holder against a credit deterioration or change in control of the issuer; or
  - the holder or the issuer against changes in relevant taxation or law; and
- in the case of a prepayment or put feature, the prepayment amount substantially represents unpaid principal and interest, but may include reasonable additional compensation for early termination; or
- in the case of an extension option, it results only in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.

Any other contractual term that changes the timing or amount of cash flows does not meet the SPPI criterion unless it is a variable interest rate that represents consideration for the time value of money and credit risk. The credit spread element may be determined at inception and hence may be fixed.

The standard contains several examples to illustrate the application of the SPPI criterion.

Examples when the SPPI criterion may be met:

- A bond with stated maturity and payments of principal and interest linked to an unleveraged inflation index of the currency in which the instrument is issued (subject to protection of the principal amount). This linkage resets the time value of money to the current level and therefore the bond's cash flows may be solely payments of principal and interest on the principal outstanding.
- An instrument with a stated maturity and variable interest for which the borrower can choose a market interest rate that corresponds to the reset period on an ongoing basis. The fact that the interest rate is reset during the life of the instrument does not disqualify the instrument from meeting the SPPI criterion. However, if the borrower was able to choose to pay the one-month LIBOR rate for a three-month term without reset each month, the SPPI test would be failed.
- A bond with variable interest and an interest cap. The instrument is like a combination of a fixed and floating rate bond, as the cap reduces the variability of cash flows.
- A full recourse loan secured by collateral. The fact that a full recourse loan is secured by collateral does not affect the analysis.

The fact that an instrument is perpetual does not preclude it from meeting the SPPI criterion.

Examples when the SPPI criterion is not met:

- A bond convertible into equity of the issuer. The SPPI criterion is not met as the return on the bond is not just consideration for the time value of money and credit risk but also reflects the value of the issuer’s equity.
- An inverse floating interest rate loan (e.g., the interest rate on the loan increases if an interest rate index decreases). The SPPI criterion is not met as interest has an inverse relationship to market rates and so does not represent consideration for the time value of money and credit risk.
- A perpetual instrument that is callable at any time by the issuer at par plus accrued interest, but for which interest is only payable if the issuer remains solvent after payment and any deferred interest does not accrue additional interest. The SPPI criterion is not met as the issuer may defer payments and additional interest does not accrue on the amounts deferred. As a result the holder is not entitled to the consideration for the time value of money and credit risk.
An instrument with interest payments indexed to the debtor’s performance (e.g., the debtor’s net income) or an equity index. The SPPI criterion is not met as a return linked to performance or an equity index is not consideration for the time value of money and credit risk.

IFRS 9.B4.18 A contractual term that is not genuine does not affect the classification of a financial asset. The standard describes a characteristic as not genuine if it affects the instrument’s contractual cash flows only on the occurrence of an event that is “extremely rare, highly abnormal and very unlikely to occur.”

Insight
The standard states that interest is compensation for the time value of money and credit risk, which may be fixed at initial recognition. It appears that the standard contemplates that compensation for credit risk may not be fixed at inception and can vary to reflect changes in the creditworthiness of the borrower. If there are variations in the contractual cash flows of an instrument relating to credit risk, then entities will have to consider whether the variation can be regarded as compensation for credit risk and therefore whether the instrument may meet the SPPI criterion.

Equity investments do not give rise to cash flows that are solely principal and interest. In addition, the dates of cash flows usually are not specified. Derivatives also do not have cash flows that are solely principal and interest since they are leveraged.

Entities may need to exercise judgement to determine whether cash flows from an instrument are leveraged, that is, whether they increase the variability of the contractual cash flows in a manner inconsistent with the SPPI criterion.

IFRS 9.B4.18, BC31, BC32, Framework 30, IAS 32.AG28 A contractual term that is not genuine is not taken into account in assessing whether a financial asset meets the SPPI criterion. A not genuine concept already exists in paragraph AG28 of IAS 32 Financial Instruments: Presentation which describes a non-genuine term in a similarly narrow way. Demonstrating that a term is not genuine may be difficult in practice as it would be unusual for the parties to an agreement to negotiate a term that they considered to be of no real significance. So, for example, a term may fail the SPPI criterion if it gives rise to cash flows in circumstances that are rare (but not extremely rare) or unlikely (but not very unlikely) to occur. In the Basis for Conclusions, the Board noted that respondents were concerned that the ED did not discuss “insignificant” features and explains that it decided not to include in the standard a statement that materiality applies to the SPPI criterion as materiality applies to all items in the financial statements. Paragraph 30 of the Framework states that: “information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.”

IAS 39.AG30 The standard does not preclude amortised cost classification for a financial asset with a prepayment or put option when, inter alia, the prepayment amount substantially represents unpaid amounts of principal and interest, including reasonable additional compensation for early termination. These requirements appear less restrictive than the existing IAS 39 guidance on when a prepayment or put option is closely related to a host debt instrument. For example, IAS 39 limits the exercise price of a prepayment option to an amount up to the approximate present value of lost interest, or requires that the price is approximately equal on each exercise date to the amortised cost of the host debt instrument. Accordingly, in some cases, amortised cost accounting may be possible for the entire hybrid contract, while under IAS 39 separation of the prepayment or put option may have been required.
Similarly, the standard does not preclude amortised cost classification for a financial asset with a term extension option, provided, *inter alia*, that the terms of the extension option meet the SPPI criterion. Again, these requirements may be less restrictive that the current guidance in IAS 39 on when a term extension feature is closely related to a host debt instrument. For example, IAS 39 requires that there be a concurrent adjustment to the approximate current market rate of interest at the time of the extension.

As the scope of the standard excludes financial liabilities, they will continue to be subject to the IAS 39 guidance on prepayment options. Accordingly, there may not be symmetry in the accounting by the issuer and the holder.

**Non-recourse assets**

The standard states that in some cases a financial asset may have contractual cash flows that are described as principal and interest, but those cash flows do not represent the payment of principal and interest. The standard explains that this may be the case if the instrument represents an investment in particular assets or cash flows, or when the creditor’s claims are limited to specified assets, which may be financial or non-financial assets. An example is a non-recourse loan.

The standard states that the fact that a financial asset is non-recourse does not in itself mean that the SPPI criterion is not met. The standard says that it is necessary to assess whether the non-recourse feature limits the cash flows in a manner that means they cannot be regarded as being solely principal and interest.

The standard recognises that in almost every lending transaction an instrument is ranked relative to other instruments and the SPPI criterion would not fail just because of such relative ranking. For example, a creditor may have issued collateralised debt which, in the event of bankruptcy, would give the holder priority over other creditors in respect of the collateral, but this arrangement would not affect the contractual rights of other creditors to the amounts due to them.

**Insight**

Judgement will be required in applying the above guidance to non-recourse or limited-recourse loans, for example non-recourse mortgage loans, that are within the scope of the standard. In some cases of substantial over-collateralisation (i.e., when the fair value of the collateral is substantially greater than the amount of the loan), it may be possible to conclude that the cash flows of the financial asset are not limited in a manner inconsistent with them being payments of solely principal and interest. In other cases it may be apparent with little analysis that the non-recourse feature limits the cash flows to an extent that the payments are for something other than principal and interest (e.g., a non-recourse loan to an entity whose only asset is an equity investment and whose only funding is the non-recourse loan). If the underlying assets meet the SPPI criterion, it may be possible to conclude that the loan referenced to them also meets the criterion.

Non- or limited-recourse characteristics may arise from explicit contractual limitations on recourse, or may be achieved through isolating a specific asset in a single asset entity and granting what is nominally a full-recourse loan to that entity. In the latter case, judgement also may be required to determine whether a specific lending arrangement meets the SPPI criterion.

The standard makes a distinction between non-recourse loans and collateralised loans with full recourse. It states that the fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the loan meets the SPPI criterion.
Contractually linked instruments

IFRS 9.B4. The standard provides specific guidance for circumstances in which an entity prioritises payments to the holders of multiple contractually linked instruments that create concentrations of credit risk, i.e., tranches. The right to payments on more junior tranches depends on the issuer’s generation of sufficient cash flows to pay more senior tranches. The standard requires a look through approach to determine whether the SPPI criterion is met.

A tranche meets the SPPI criterion only if all the following conditions are met:

- the contractual terms of the tranche itself have only SPPI characteristics;
- the underlying pool of financial instruments:
  - contains one or more instruments that meet the SPPI criterion
  - also may contain instruments that
    - reduce the cash flow variability of the instruments under a) and the combined cash flows meet the SPPI criterion (e.g., interest rate caps and floors, credit protection), or
    - align the cash flows of the tranches with the cash flows of the instruments under a) arising as a result of differences in whether interest rates are fixed or floating or the currency or timing of cash flows; and
- the exposure to credit risk inherent in the tranche equals or is less than the exposure to credit risk of the underlying pool of financial instruments. The standard states as an example that this condition would be met if, in all circumstances in which the underlying pool of instruments loses 50 percent as a result of credit losses, the tranche would lose 50 percent or less.

If any instrument in the underlying pool does not meet the conditions under a) or b), or if the pool can change later on in a way that would not meet those conditions, then the tranche does not meet the SPPI criterion.

The look through approach is carried through to the underlying pool of instruments that create, rather than pass through, the cash flows. For example, if an entity invests in contractually-linked notes issued by SPE 1 whose only asset is an investment in contractually-linked notes issued by SPE 2, the entity looks through to the assets of SPE 2 in performing the assessment.

If an entity is not able to make an assessment based on the above criteria, then it measures its investment in the tranche at fair value.

Example

Entity A, a special-purpose entity, has issued two tranches of debt that are contractually linked. The Class I tranche amounts to CU 15,000,000 and the Class II tranche amounts to CU 10,000,000. Class II is subordinated to Class I and receives distributions only after payments have been made to the holders of Class I.

A’s assets are loans of CU 25,000,000 that all meet the SPPI criterion.

Investor X has invested in Class I. It determines that the contractual terms of the tranche give rise only to payments of principal and interest on the principal. X then has to look through to the underlying pool of investments of A. Since A has invested in loans that meet the SPPI criterion, the pool contains at least one instrument with cash flows that are solely principal and interest. A has no other financial instruments. Therefore, the underlying pool of financial instruments held by A does not have features that would prohibit the tranche from meeting the SPPI criterion.

The last step in the analysis is for the investor to assess whether the exposure to credit risk inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments. If the underlying pool of loans were to lose 50 percent, then a total
loss of CU 12,500,000 would arise. Of that loss, CU 10,000,000 would be absorbed by Class II, leaving CU 2,500,000 to be absorbed by Class I. This means that the ratio of loss suffered by the holders of Class I would be 17 percent (CU 2,500,000 / CU 15,000,000). The ratio of 17 percent is less than 50 percent which means that the credit risk of Class I is lower than the credit risk of the underlying pool of assets. Accordingly, X concludes that Class I meets the SPPI criterion.

Investor Y has invested in Class II. This tranche does not meet the credit risk test. When the underlying pool suffers a loss of 50 percent, investors in Class II suffer a loss of 100 percent. Therefore, Investor Y should measure any investment in Class II at fair value.

The above analysis may be more complex where, for example, financial instruments in the pool include permitted derivative instruments, as it is often the case that the derivative counterparty has a priority of payments in a waterfall structure.

3.3 Option to designate financial assets at fair value through profit or loss

An entity can choose to designate a financial asset which otherwise would qualify for amortised cost accounting as measured at fair value through profit or loss (FVTPL). This optional designation is permitted only if it eliminates or significantly reduces a measurement or recognition inconsistency (an “accounting mismatch”) that otherwise would arise from measuring assets or liabilities, or recognising gains or losses on them, on different bases. The election is available only on initial recognition of the asset and is irrevocable.

This option is retained from IAS 39 and the application guidance in IAS 39 continues to apply.

Insight

The Board concluded that the two other fair value designation conditions available currently in IAS 39 are rendered redundant for financial assets by the requirements of IFRS 9. The two conditions that are eliminated with respect to financial assets relate to:

- Assets that are managed on a fair value basis. Under IFRS 9, financial assets managed on a fair value basis cannot qualify for amortised cost measurement (see 3.2.2) and therefore are required to be measured at fair value.
- Hybrid financial instruments containing an embedded derivative that otherwise might require separation. Under IFRS 9, embedded derivatives with a financial asset host are not subject to separation (see 3.4).

The Board has indicated that the eligibility conditions for the fair value option will be reconsidered in the context of the hedge accounting phase of the IAS 39 replacement project.

3.4 Embedded derivatives

IAS 39 requires separation of certain embedded derivatives. IFRS 9 removes this requirement when the host contract is a financial asset within the scope of IAS 39. This change was made in response to the criticism of the existing requirements as being complex, rules-based and internally inconsistent.

Features embedded in hybrid financial instruments for which the host asset is within the scope of IAS 39 are no longer subject to an assessment to determine whether they should be accounted for separately as derivatives. Instead, the entire hybrid financial instrument, including all embedded features, is assessed for classification.
Insight

Existence of a derivative feature in a hybrid instrument might not preclude amortised cost classification of the entire contract when the feature still meets the SPPI criterion. Thus, for some financial assets from which an embedded derivative is separated under IAS 39 because its economic risks and characteristics are not considered closely related to the host contract, amortised cost accounting for the entire instrument may be possible under IFRS 9. This could be the case when a prepayment or term extension option satisfies the IFRS 9 requirements for amortised cost classification, but fails the existing IAS 39 “closely related” requirements.

However, many embedded derivative features may cause the entire hybrid instrument to fail the SPPI test, and result in the whole instrument being classified as at FVTPL. This represents a change from current IAS 39 whereby an embedded derivative might be accounted for separately at FVTPL while the host instrument is measured at amortised cost. Accordingly, it may lead to more hybrid instruments being accounted for at FVTPL in their entirety.

Entities that use freestanding derivatives to hedge risks in previously separated embedded derivatives may find that accounting for the whole hybrid instrument at FVTPL creates an accounting mismatch. This can be caused by the fact that the host contract was carried before at amortised cost so as to match an amortised cost liability and the embedded derivative was carried at fair value thereby matching the freestanding hedging derivative. Under the standard the whole hybrid instrument is measured at fair value while the related liability would, absent use of the fair value option on transition (see section 6), continue to be measured at amortised cost.

Example

An entity might have an investment in a conventional convertible bond. Under the terms of the bond, the holder has the option to convert it into a fixed number of equity shares of the issuer. Under current IAS 39, unless the bond is held for trading or designated as FVTPL, the bond is bifurcated into the conversion option (an embedded derivative) and the host debt instrument. This is required because the economic characteristics and risks of the conversion option, primarily equity price risk, are not closely related to those of the host debt instrument. The conversion option is separately accounted for at FVTPL while the host debt instrument may be classified as a loan and receivable or as available-for-sale. However, under IFRS 9, the convertible bond is analysed for classification in its entirety. The presence of the conversion option causes the instrument to fail the SPPI test, so under the standard the convertible bond in its entirety would be accounted for at FVTPL.

The standard does not change the accounting for embedded derivatives with host contracts that are not financial assets, e.g., financial liabilities, or host contracts that are financial assets that are not within the scope of IAS 39, such as rights under leases or insurance contracts. The requirements for these hybrid contracts will be addressed in later phases of the project to replace IAS 39.
The following flowchart gives an overview of accounting for hybrid contracts:

### Designation of investments in equity instruments

**Key changes from the ED**
For investments in equity instruments designated as at fair value though other comprehensive income (FVOCI), the standard requires dividends on the investments generally to be recognised in profit or loss. This is a change from the ED which required those dividends to be recognised in other comprehensive income (OCI).

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**IFRS 9.5.4.4**
The standard allows an entity, at initial recognition only, to elect to present changes in the fair value of an investment in an equity instrument that is not held for trading in OCI. The election is irrevocable and can be made on an instrument-by-instrument (e.g., individual share) basis.

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The amounts recognised in OCI are not recycled to profit or loss on disposal of the investment or in any other circumstances, although they may be reclassified within equity. Accordingly, there is no need for impairment testing for these assets. Dividend income on investments classified as FVOCI is recognised in profit or loss in accordance with IAS 18 Revenue unless the dividend clearly represents a repayment of part of the cost of the investment. In this case, the dividend is recognised in OCI.

IFRS 9 modifies the scope exemptions in IAS 28 Investments in Associates and IAS 31 Interests in Joint Ventures for venture capital organisations, mutual funds, unit trusts and similar entities, which allows investments in associates and joint ventures held by those entities to be accounted for under IAS 39. Currently, this exemption is available if the eligible entity upon initial recognition, designates the investments as at FVTPL or classifies the investments as trading. The consequential amendment makes the exemption available in respect of all equity investments held by eligible entities, as under IFRS 9, all equity investments may be accounted for as at FVTPL.

Insight – dividends from equity investments
Recognition of dividends from equity investments, in respect of which the OCI election has been made, avoids an accounting mismatch to the extent that finance costs are reflected in profit or loss.

Entities will have to consider when a dividend clearly represents a repayment of part of the cost of the investment. In many cases, for example when a dividend paid is less than the increase in the investee’s retained earnings since acquisition, it may be easier to conclude that a dividend does not clearly represent a repayment of part of the cost of the investment.

Insight – change in scope exemption for certain entities
The consequential amendments to IAS 28 and IAS 31 potentially widen the scope exemption for venture capital organisations, mutual funds, unit trusts and similar entities as, under IFRS 9, all equity investments may be accounted for as at FVTPL, not just those meeting the definition of held for trading or meeting the criteria for designation under the fair value option. However the amendments do not permit such an investor to elect for fair value through OCI treatment in lieu of equity accounting or proportional consolidation.

Insight – definition of equity instruments
Equity instruments are defined consistently with IAS 32. This means that the holder of an investment in an equity instrument should assess whether the instrument meets the definition of equity from the perspective of the issuer. Sometimes it may be difficult for the holder of an instrument to obtain sufficient information to reach a definitive conclusion. In some other cases, even when the required information is available, determining the classification from the perspective of the issuer may be challenging. For example, an entity may hold an investment in members’ shares of a co-operative entity. The co-operative may be obliged to redeem members’ shares subject to a right to refuse redemptions in excess of a certain amount, meaning that it might treat a proportion of the total shares in issue as equity and the remaining proportion as liabilities.

IAS 32 defines an equity instrument and provides guidance on what other instruments should be classified as equity, for example, certain puttable instruments or certain instruments that impose an obligation to deliver a pro rata share of net assets of the entity only on liquidation. The FVOCI option in the standard refers only to equity instruments defined as such by IAS 32 and not to instruments defined as liabilities but classified as equity by the issuer.

An entity may invest in a derivative instrument that meets the definition of an equity instrument of the issuer because it satisfies the “fixed for fixed criterion” in IAS 32. However, the entity
could not classify its investment as FVOCI as the election only pertains to investments that are not held for trading and IAS 39, as amended by IFRS 9, continues to include derivatives within the definition of held for trading.

3.6 Mapping of old and new categories

The following diagram gives an overview of how the initial classification of financial assets under IAS 39 and their classification under IFRS 9 differs. This overview does not take into account the fair value option under existing IAS 39 or IFRS 9. It also assumes that non-derivative assets held for trading are not held within a portfolio whose objective is to collect contractual cash flows.
Insight – mapping of old and new categories

One of the questions most frequently asked about the IAS 39 replacement project is whether it will lead to more or less financial assets being measured at fair value. The answer seems to be that it depends on the circumstances of each entity in terms of the way in which it manages the instruments it holds, the nature of those instruments and the classification elections it chooses to make. However, some major directional changes can be highlighted:

- Many available-for-sale (AFS) debt investments that currently are measured at fair value will qualify for amortised cost accounting, for example, simple debt instruments that are quoted in an active market (such as vanilla government and corporate bonds). However, those that do not qualify will be measured at FVTPL rather than through OCI.
- We expect that many loans and receivables and held-to-maturity assets will continue to qualify for amortised cost accounting. However, some will not and will have to be measured instead at FVTPL.
- Some financial assets currently may be disaggregated into host financial assets that are not at fair value through profit or loss and separated embedded derivatives that are measured at FVTPL. Although the SPPI test is different from the current requirements for separation of embedded derivatives, in many cases the presence of an embedded derivative feature that previously required separation because it was not closely related to the host asset is likely to cause the entire hybrid financial instrument, rather than just the embedded feature, to be accounted for at FVTPL. However, in some cases, a previously separated embedded derivative feature may not cause an asset to fail the SPPI test for amortised cost classification (see 3.2.3).
- The guidance on contractually linked instruments will mean that some asset-backed securities that may have qualified previously for amortised cost or AFS treatment will be required to be accounted for at FVTPL if they do not satisfy the conditions for amortised cost accounting for contractually linked tranches. This impacts particularly junior tranches that have an exposure to credit risk that is greater than a pari passu investment in the pool of underlying assets. Many investments in senior tranches that were previously accounted for as AFS assets may qualify for amortised cost measurement.
- Equity investments and related derivative assets previously measured at cost would be accounted for either at FVTPL or, for non-derivatives, at FVOCI. However, the standard also provides guidance on limited circumstances where cost may be regarded as an appropriate estimate of fair value (see 4.2).

Insight – impairment

Although IFRS 9 currently does not address accounting for impairment directly, the changes in classification and measurement requirements for financial assets will impact whether and how impairment is measured for many assets. In particular, impairment of AFS assets is measured currently by reference to the fair value of the investment. Some commentators had expressed dissatisfaction with two aspects of the current requirements. Firstly, they believe that, especially in illiquid markets, measuring impairment losses on debt securities based on fair value may lead to reporting an impairment loss that exceeds the expected credit loss that management expects to bear. Secondly, IAS 39 does not allow impairment losses recognised on AFS equity investments to be reversed if the fair value of the investment subsequently increases. As IFRS 9 eliminates the AFS category, it also eliminates the AFS impairment rules. Impairment of AFS debt investments that qualify for amortised cost accounting are measured instead under the amortised cost model, while no impairments are recognised on AFS equity investments for which FVOCI treatment is elected. For an AFS equity investment measured instead at FVTPL, then declines in fair value are recognised as losses in profit or loss as they occur. However, these losses also are reversed through profit or loss if the fair value of the equity investment subsequently increases.
4. Measurement

4.1 Recognition and measurement

The standard retains the guidance in IAS 39 with respect to recognition and initial measurement. A financial asset is recognised when and only when the entity becomes party to its contractual terms. The financial asset initially is measured at fair value. If the financial asset is not accounted for subsequently at FVTPL, then the initial measurement also includes transaction costs that are directly attributable to its acquisition.

Subsequently financial assets are measured at fair value or amortised cost. The standard refers to the guidance in IAS 39 with respect to the following:

- fair value measurement
- effective interest method
- impairment of financial assets measured at amortised cost
- derecognition
- hedge accounting.

**Insight**

The guidance on these topics is expected to be replaced during 2010 and 2011 by the remaining stages of the IAS 39 replacement project and by new standards on derecognition and fair value measurement (see section 2).

4.2 Investments in equity instruments

**Key changes from the ED**

The standard includes new guidance on when the cost of an unquoted equity investment may be an appropriate estimate of fair value.

The standard requires all investments in equity instruments to be measured at fair value.

For investments in unquoted equity instruments and contracts linked to them that are settled by delivery of such instruments, the standard states that: “... in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to determine fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range.” The standard gives examples of indicators of the circumstances in which cost may not be the best estimate of fair value:
The requirement to reclassify financial assets if the business model for managing those assets changes is a difference from the ED. The ED prohibited reclassification under any circumstances.

**Insight**

The guidance indicating that there may be limited circumstances when cost may be an appropriate estimate of fair value may be welcomed by many entities outside the financial sector who find measuring the fair value of unquoted equity investments challenging. However, application of that guidance will require careful consideration of all facts and circumstances. For example, one of the indicators given of situations in which cost may not be an appropriate estimation of fair value is if there is a significant change in performance of the investee in comparison with budgets or significant changes in expectations whether the investee’s technical product milestones will be achieved. In some cases, for example start up companies, even performance in accordance with original plans, or the launch of a new product as expected, may lead to a significant increase in the fair value of the investment as uncertainty over those events is removed. This may mean that even if there are no significant changes in performance against plan, then cost may not be an appropriate estimate of fair value.

**IFRS 9. BC80**

In the Basis for Conclusions to the standard, the Board noted that the limited circumstances suggesting that cost may be an appropriate estimate of fair value never apply to equity investments held by particular entities such as financial institutions and investment funds.

ED/2009/5 *Fair Value Measurement* proposes largely removing the existing IAS 39 paragraphs containing guidance on how to measure fair value. Therefore substantially all guidance relating to the fair value measurement of financial instruments, as well as for other assets and liabilities, would be contained in a single fair value measurement standard. The guidance in IFRS 9 on when cost may be considered to be an appropriate estimate of fair value is not included in the exposure draft on fair value measurement.

### 4.3 Reclassifications

**Key changes from the ED**

The requirement to reclassify financial assets if the business model for managing those assets changes is a difference from the ED. The ED prohibited reclassification under any circumstances.

**IFRS 9.4.9, B5.9**

Classification of financial instruments is determined on initial recognition. Subsequent reclassification between categories generally is prohibited. However, when an entity changes its business model in a way that is significant to its operations, a re-assessment is required of whether the initial determination remains appropriate. If it is not, a reclassification of financial assets in
accordance with the guidance on initial classification is required. The standard states that such changes to business models are expected to be “very infrequent.” They are determined by the senior management of the entity as a result of internal or external changes and are “demonstrable” to external parties.

**IFRS 9.B5.9** IFRS 9 gives the following examples of a change in business model:

- An entity holds a portfolio of commercial loans for sale. Subsequently it acquires a company whose business model is to hold similar loans in order to collect contractual cash flows and the commercial loans originally held for sale are transferred to the acquired company to be managed together with the company’s other loans.
- An entity decides to shut down part of its business.

**IFRS 9.B5.11** The following changes are listed in IFRS 9 as not representing a change in the business model:

- a change in intention related to particular financial assets, even in circumstances of significant changes in market conditions;
- a temporary disappearance of a particular market for financial assets; or
- a transfer of financial assets between parts of the entity with different business models.

**Insight**

Entities will have to use judgement to determine whether their business model has changed in a way which is “significant” to their operations. The standard expects such changes to be “very infrequent” and “demonstrable” to external parties.

**IFRS 9.5.3, B5.10** If an entity determines that its business model has changed, then all affected assets are reclassified from the first day of the next reporting period (reclassification date). No prior periods are restated.

**IFRS 9.5.3, B5.10** If a financial asset is reclassified from amortised cost measurement to fair value measurement, then it is measured at fair value at the reclassification date and any gain or loss arising from the difference between amortised cost and the fair value is recognised in profit or loss. If a financial asset is reclassified from fair value measurement to amortised cost measurement, then the fair value at the reclassification date becomes the new carrying amount.

**Overview of reclassifications**

Fair value measurement – Impact on profit or loss

\[
\text{Amortised cost} \quad \text{Fair value}
\]

Fair value = new carrying amount

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Insight – date of recategorization

The date at which financial assets are recategorized is the beginning of the next reporting period following the change in the business model that led to the recategorization. In some cases, there may be a long gap between the change in the business model taking place and the recategorization date. During this gap, the financial assets continue to be accounted for as if the business model had not changed, although this no longer reflects the actual business model in operation. The Board decided that recategorization should take effect from the beginning of the next reporting period to prevent entities from choosing a recategorization date to achieve an accounting result.

Insight – disclosure of a change in an entity’s business model

The standard does not require specific disclosures relating to significant changes in the business model in the period the business model changes but only in periods following the change once assets are recategorized. However, it generally would be appropriate for any significant changes in an entity’s operations to be explained in the financial statements or management’s commentary for that period. In particular, IFRS 7 Financial Instruments: Disclosures requires disclosure of an entity’s objectives and policies for managing risks from financial instruments and any changes to those objectives and policies. If no such disclosure is made in the period in which an entity’s business model changes, then it may be difficult to argue that the change was significant enough to justify a recategorization of financial assets at the start of the next period if it was not considered significant enough to warrant disclosure in the period of change.
5. Presentation and disclosures

Key changes from the ED

The standard contains some additional disclosures relating principally to reclassified financial assets and also dividends recognised in respect of investments in equity instruments classified as at FVOCI.

IFRS 9 contains consequential amendments to IFRS 7. These include the following:

IFRS 9 C8 If equity investments are designated as FVOCI, then an entity discloses:

- which investments in equity instruments have been designated;
- the reasons for doing so;
- the fair value of each investment at the end of the reporting period;
- dividends recognised during the period, with separate disclosure for derecognised investments and those held at the end of the reporting period;
- any transfers of gains or losses within equity and the reasons for them;
- upon derecognition of a financial asset during the reporting period:
  - the reasons for disposing of the investments;
  - the fair value at the date of derecognition; and
  - the cumulative gain or loss on disposal.

IFRS 9 C8.11A If an entity has reclassified financial assets in the current or the previous period, then it discloses:

- the date of reclassification;
- a detailed explanation of the change in business model and a qualitative description of its effect on the entity’s financial statements; and
- the amount reclassified into and out of each category.

IFRS 9 C8.12C An entity discloses for each reporting period until derecognition, the following in respect of financial assets reclassified to the amortised cost category:

- the effective interest rate determined on the date of reclassification; and
- the interest income or expense recognised.

IFRS 9 C8.12D An entity discloses for financial assets reclassified into the amortised cost category during the reporting period:

- the fair value of the assets at the end of the period; and
- the fair value gain or loss that would have been recognised in profit or loss during the reporting period if the financial assets had not been reclassified.

IFRS 9 C8.20A For derecognised financial assets measured at amortised cost, an entity should provide an analysis of the gain or loss arising from derecognition and the reasons for derecognising those financial assets.

IFRS 9 C12 IAS 1 *Presentation of Financial Statements* is amended so that the following have to be presented separately in the statement of comprehensive income:
• gains and losses arising from the derecognition of financial assets measured at amortised cost; and
• any gain or loss arising on reclassification of a financial asset from measurement at amortised cost to measurement at fair value, i.e., the difference between its previous amortised cost and its fair value at the reclassification date.
6. Effective date and transition

Key changes from the ED

The standard provides optional relief from restatement of comparatives for entities that adopt it for periods beginning before 1 January 2012. The ED did not contain such relief.

IFRS 9.8.1.1, BC93

The standard is effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted. Entities that adopt the standard early are required to disclose that fact and apply all the consequential amendments to other standards at the same time. In the Basis for Conclusions the Board states that it would consider delaying the effective date of the standard if the impairment phase of the project makes it necessary or if the expected new IFRS on insurance has a mandatory effective date later than 2013.

IFRS 9.8.2.1

The standard has to be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors with certain exemptions which are set out below.

6.1 Date of initial application

IFRS 9.8.2.2

The transition requirements refer to the date of initial application (DIA). The DIA is the date on which an entity initially applies the standard. The DIA can be:

a) for initial application of the standard before 1 January 2011, any date between the issue of IFRS 9 (12 November 2009) and 31 December 2010.
b) for initial application of the standard on or after 1 January 2011, the beginning of the first reporting period in which an entity adopts IFRS 9.

IFRS 9.8.2.3

If the DIA is not the beginning of a period, then this fact and the reasons for using a different date have to be disclosed.

Example

We will illustrate the application of certain of the transition requirements explained throughout this section using as an example an entity (Entity X) that adopts IFRS 9 in the annual period ending 31 December 2010. X reports financial information in accordance with IFRS annually.

As X applies the standard before 1 January 2011, the DIA does not have to be the beginning of the reporting period. If the DIA is not the beginning of the reporting period, then the entity has to disclose that fact and has to set out the reasons for its decision.

Insight

The standard does not define the DIA, beyond stating that it is “the date when an entity first applies the requirements of this IFRS.” Accordingly, entities will have to determine what is the date when they first apply the standard, in particular if the date is not a beginning of a reporting period but a date during the period. The DIA is relevant to several assessments necessary to apply IFRS 9 as outlined below and so may have important implications.

In calculating the transition adjustments, the general requirements of IAS 8 for changes in accounting policies apply, unless IFRS 9 contains more specific provisions for a particular aspect of the transition.
The standard does not apply to financial assets that have been derecognised at the DIA.

**Example**
Continuing with the example of Entity X, also assume that X determines its DIA is 1 December 2010. Assume also that in November 2010, X sold an investment in a debt security that was classified as AFS under IAS 39. X determines that under IFRS 9, this investment would have been measured at amortised cost.

As the standard does not apply to financial assets that have been derecognised prior to the DIA, the debt security will be measured in accordance with the requirements of IAS 39 relating to AFS assets both in 2010 and in all comparative periods presented.

However, if the DIA was determined to be the beginning of the accounting period, i.e., 1 January 2010, the exemption would not apply as the asset would not have been derecognised prior to the DIA. Accordingly, the debt security would have been accounted for in accordance with the requirements of IFRS 9 throughout the year ending 31 December 2010 and in any comparative period in which X applies IFRS 9.

### Classification

On adoption of the standard an entity will have to determine which of its financial assets meet the standard’s criteria for amortised cost accounting. As a general rule, the standard requires retrospective application in accordance with IAS 8, except where it sets out specific requirements. IAS 8 states that retrospective application requires adjustment to the opening balance of equity for the earliest period presented as if the new accounting policy had always been applied. However, IFRS 9 contains significant exemptions from this principle.

The assessment whether the objective of an entity’s business model is to hold an asset in order to collect the contractual cash flows is based on facts and circumstances at the DIA.

**Insight**
There are no specific requirements in the standard as to the date at which an entity should assess whether the SPPI criterion is met. Therefore the general provisions would apply and an entity would make this assessment on the basis of the facts and circumstances existing at the time of initial recognition of the financial asset.

**Example**
The standard specifically requires that, on transition, an assessment of whether the HTC criterion is met should be made; this is at the DIA. Therefore, continuing with the example of Entity X which has determined that its DIA is 1 December 2010, the assessment of whether the HTC criterion is met for financial assets recognised by X at 1 December 2010 would be made as at that date.

At the DIA, an entity may designate an equity investment as at fair value through OCI (FVOCI).
Insight

The paragraph that deals with designation of equity investments as FVOCI at the DIA includes the statement that “such designation shall be made on the basis of facts and circumstances that exist at the date of initial application.” In accordance with the requirements of the standard dealing with the FVOCI designation, the election is available only for equity investments that are not held for trading. The standard does not explain the interaction of these requirements. The standard retains the current definition of “held for trading” in IAS 39 in so far as an asset is considered held for trading if it was acquired for sale in the near term or on initial recognition was part of a portfolio for which there is evidence of a recent actual pattern of short-term profit taking. It might therefore be argued that, if the instrument was initially classified as held for trading based on facts and circumstances at initial recognition, it continues to meet the definition of held for trading notwithstanding any changes in circumstances through to the DIA. However, given the reference in the transition provisions to basing designation on facts and circumstances at the DIA, it may have been the Board’s intention that the assessment of whether the investment is held for trading should be based on whether the investment is held for sale in the near term, or part of a portfolio for which there is evidence of short-term profit taking, as of the DIA.

Insight

Although financial liabilities are generally excluded from the scope of the standard, its transitional provisions allow limited re-opening of the designation of financial liability as at FVTPL, but only in relation to the accounting mismatch criterion. If, at the time of transition, an entity had a financial liability that had been designated as at FVTPL on the basis of accounting mismatch criterion in IAS 39, but the criterion is no longer met at the DIA then the designation is revoked; if the criterion is still met revocation of the designation is optional. Additionally, an entity may entity choose to designate an existing financial liability as FVTPL if the accounting mismatch criterion is met based on facts and circumstances at the DIA.

Example

Entity X has a financial asset that was accounted for as a loan and receivable under IAS 39 but is required to be reclassified as FVTPL on transition to IFRS 9. X manages the asset in conjunction with an existing liability that has been accounted for at amortised cost. If, at the DIA, X determines that designating the liability as FVTPL would reduce an accounting mismatch compared to measuring the liability at amortised cost and the financial asset at FVTPL, X may so designate the liability at the DIA.
Although the above classification decisions are made at or based on facts and circumstances at the DIA, the classifications are applied retrospectively.

6.3 Hybrid instruments

**IFRS 9.8.2.5, 8.2.6**

If a hybrid instrument is measured at fair value in its entirety, but the fair value of the hybrid instrument has not been determined in previous periods, then the sum of the fair values of the components at the end of each comparative period is deemed to be the fair value at those dates. At the DIA any difference between the fair value of the entire hybrid contract at that date and the sum of the fair values of the components of the hybrid contract at that date is recognised:

a) in opening retained earnings if the standard is applied at the beginning of a reporting period; or
b) in profit or loss if the standard is initially applied during a reporting period.

**Insight**

Alternative b) above is only applicable if an entity applies the standard before 1 January 2011 since after that date the DIA is always the beginning of a reporting period.

**Example**

In the example, Entity X has determined that its DIA is 1 December 2010, which is not the beginning of a reporting period, and restates its comparatives in accordance with IFRS 9. Assume that X has a hybrid instrument with a financial asset host. Under IAS 39, the host was accounted for at amortised cost and the embedded derivative was separated and accounted for at FVTPL. In accordance with IFRS 7, X also had previously disclosed the fair value of the host at each reporting date. The entity determines that under IFRS 9 the hybrid instrument will be accounted for at FVTPL. The fair value of the hybrid instrument in its entirety had not been determined in previous periods. Relevant amounts relating to the hybrid instrument are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Fair value embedded derivative</th>
<th>Fair value host</th>
<th>Fair value hybrid instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 2009</td>
<td>CU 5</td>
<td>CU 87</td>
<td>n/a</td>
</tr>
<tr>
<td>31 December 2009</td>
<td>CU 8</td>
<td>CU 90</td>
<td>n/a</td>
</tr>
<tr>
<td>1 December 2010</td>
<td>CU 6</td>
<td>CU 91</td>
<td>CU 95</td>
</tr>
<tr>
<td>31 December 2010</td>
<td>n/a</td>
<td>n/a</td>
<td>CU 94</td>
</tr>
</tbody>
</table>

Amortised cost of the host at 1 January 2009 is CU88.

X recognises the following amounts in its statement of financial position under IFRS 9:

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount recognised for hybrid contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 2009</td>
<td>CU 92 (= CU 5 + CU 87)</td>
</tr>
<tr>
<td>31 December 2009</td>
<td>CU 98 (= CU 8 + CU 90)</td>
</tr>
<tr>
<td>1 December 2010</td>
<td>CU 95</td>
</tr>
<tr>
<td>31 December 2010</td>
<td>CU 94</td>
</tr>
</tbody>
</table>
X recognises the following amounts in profit or loss under IFRS 9:

<table>
<thead>
<tr>
<th>Period</th>
<th>Amount recognised in profit or loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 January 2009 - 31 December 2009</td>
<td>CU 6 gain (= CU 98 - CU 92)</td>
</tr>
<tr>
<td>1 January 2010 - 1 December 2010</td>
<td>CU 3 loss (= CU 95 - CU 98)</td>
</tr>
<tr>
<td>1 December 2010 - 31 December 2010</td>
<td>CU 1 loss (= CU 94 - CU 95)</td>
</tr>
</tbody>
</table>

X would record a transition adjustment in opening retained earnings as at 1 January 2009 of CU 1 (debit) being the difference between the amortised cost of the host of CU 88 and its fair value of CU 87. The difference between the sum of the fair values of the host and the embedded derivative at 1 December 2010 (CU 91 + CU 6) and the fair value of the hybrid instrument at that date (CU 95) of CU 2 are included in the profit for the year 2010. By contrast, if X’s DIA were 1 January 2010, then the difference between the sum of the fair values of the host and the embedded derivative at 1 January 2010 would be included in opening retained earnings at 1 January 2010 and not in profit or loss for the period.

6.4 Effective interest method and impairment

IFRS 9.8.2.10

If retrospective application of the effective interest method and impairment requirements for financial instruments reclassified to the amortised cost category is impracticable, then the fair value at the end of each comparative period is treated as amortised cost. The fair value at the DIA is treated as the new amortised cost at that date.

IAS 8.5

Impracticable is defined in IAS 8: “Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so.” IAS 8 expands this guidance by stating that retrospective application is impracticable when: the effects are not determinable; it requires assumptions about what management’s intent would have been in the past; or it requires significant estimates of amounts and it is impossible to distinguish objectively what information relates to a prior reporting date and would have been available then.

Insight

The standard does not state how the profit and loss impact of financial assets in respect of which the above impracticable exemption has been used, should be presented. For example, whether the difference between the opening and closing period values should be presented as interest or impairment.

If an entity held a debt investment that was classified as AFS in prior periods, then the effective interest method would have been applied under IAS 39 to determine the recognition of interest income. However, if the investment was impaired, the amortised cost under IAS 39 could have been reset to fair value at the date of impairment, giving an amortised cost under IAS 39 that is different from the amortised cost that would have been calculated if the investment had been measured on an amortised cost basis.
6.5 Unquoted equity investments measured at cost

If unquoted equity investments or related derivatives previously were measured at cost, then those investments would be measured at fair value at the DIA with any difference between the carrying amount and fair value recognised in opening retained earnings of the reporting period of initial application.

**Insight**

As the difference between the fair value and the carrying amount of the instrument at the DIA is recorded as an adjustment to opening retained earnings of the reporting period of initial application, only fair value changes after the DIA are recognised in profit or loss or OCI. This means that the impact on profits in the first period of reporting in accordance with IFRS 9 may depend on the choice of the DIA.

**Example**

Continuing with the example of Entity X, assume that X had an equity investment that was measured at cost less impairment under IAS 39. The carrying amount of the investment was CU 450. Under IFRS 9 Entity X determines the fair value of the investment at the DIA as CU 630. The difference between the carrying amount of CU 450 and the fair value on the DIA of 1 December 2010 (CU 630) is recognised in opening retained earnings of the reporting period of initial application, which for Entity X is 1 January 2010. Any fair value changes arising between 1 December 2010 and 31 December 2010 are recognised in profit or loss unless X designates the investment as at FVOCI.

6.6 Hedge accounting

The standard does not contain specific transition rules in respect of hedge accounting.

**Insight**

The ED contained guidance on transition with respect to hedge accounting. This guidance was deleted from the final version of the standard. Therefore the general guidance of IAS 39 and IAS 8 applies.

If fair value hedge accounting was applied to an asset that was measured at amortised cost or as AFS under IAS 39, but is measured at fair value through profit or loss under IFRS 9, then hedge accounting will be discontinued and the hedged item will be subject to full fair value measurement through profit or loss rather than re-measurement only in respect of the risk being hedged. No adjustment to periods before the DIA will be required in respect of the derivative hedging instrument as gains and losses would have been already reflected in profit or loss.

If the cash flow hedge accounting model was applied to hedge variability of future cash flows from an asset accounted for at amortised cost or as AFS under IAS 39, but the asset is measured at fair value under IFRS 9, then entities will have to determine the appropriate treatment at transition and for subsequent accounting. This situation may arise, for example, in respect of a bond which pays a coupon of LIBOR plus a margin or a bond for which cash flows are linked to inflation. We note that U.S. GAAP specifically prohibits application of cash flow hedge accounting where the hedged cash flows relate to instruments accounted for at FVTPL.
Comparatives

If an entity adopts IFRS 9 for reporting periods beginning before 1 January 2012, then it can elect not to restate prior periods. If it so elects, any difference between the carrying amount of a financial asset prior to the adoption of the standard and the new carrying amount calculated in accordance with the standard at the beginning of the reporting period that includes the DIA is recognised in opening retained earnings (or another component of equity if appropriate) of the reporting period that includes the DIA.

Example

Continuing with the example of Entity X, as the entity adopts the standard prior to 1 January 2012, it may elect not to restate comparative information in accordance with the standard. If so the comparatives would be unchanged and would reflect previous accounting for financial assets under IAS 39. The impact of the retrospective application according to IAS 8 will be recognised in opening equity as of 1 January 2010.

To illustrate, assume that X has an investment in a financial asset that was measured at amortised cost under IAS 39. The carrying amount of the asset was CU 350 on 31 December 2008 and CU 368 on 31 December 2009. The fair value of the asset was CU 355 on 31 December 2008 and CU 370 on 31 December 2009. The entity has determined that under the standard the asset will be measured at FVTPL. X presents one year of comparative information.

Under the general rules of retrospective application of IAS 8 in the December 2010 financial statements, the difference between the fair value and the previous carrying amount at the beginning of the earliest period presented is recognised in opening equity as of 1 January 2009. This would mean that CU5 (being the difference between the fair value at 31 December 2008 of CU 355 and the previous carrying amount at that date of CU 350) would be recognised as a credit adjustment to opening equity at 1 January 2009. The change in fair value between 31 December 2008 of CU 355 and at 31 December 2009 of CU 370 (CU 15 gain ) would be recognised in profit or loss for the year ended 31 December 2009.

However, if X decided to take the exemption from restatement of comparative information, the difference between fair value at 31 December 2009 of CU370 and the carrying amount at that date of CU 368 (CU 2) would be recognised in opening equity as of 1 January 2010. The comparative figures for 2009 would remain unchanged, i.e., an amount of CU 368 would be recognised in the statement of financial position as at 31 December 2009.
The diagram below illustrates how different dates of initial application of the standard impact the DIA and the presentation of comparatives.
6.8 **Interim reporting**

For interim reporting, the standard need not be applied to interim periods before the DIA, if impracticable.

6.8.1 **Disclosures on initial adoption**

In the period of initial application, an entity is required to provide the disclosures specified in paragraph 28 of IAS 8. This includes, to the extent practicable, the effect of adoption of the standard on each financial statement line item and on basic and diluted earnings per share for the current and each prior period presented.

The following disclosures in tabular format (unless another format is more appropriate) are required for each class of financial assets at the DIA:

- the original measurement category and carrying amount under IAS 39;
- the new measurement category and carrying amount under the standard; and
- the amount of any financial assets that were previously designated as at FVTPL, but for which the designation has been revoked, distinguishing between mandatory and elective de-designations.

Entities are required to provide qualitative disclosure to enable users to understand:

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

6.8.2 **Overview of transitional reclassifications**

The table below illustrates potential reclassifications of financial assets from the existing to the new measurement categories on initial application of IFRS 9. The table does not specifically address embedded derivatives that are accounted for separately under current IAS 39. If those instruments are embedded in a financial asset within the scope of IAS 39, then the classification of the hybrid instrument, including the embedded derivative, would follow the principles below.

<table>
<thead>
<tr>
<th>Transfer from existing measurement categories</th>
<th>Transfer to measurement categories in the standard</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amortised cost</td>
</tr>
<tr>
<td>FVTPL – Trading (excluding derivatives)</td>
<td>Financial assets meeting HTC and SPPI criteria and for which no fair value option is chosen at the DIA</td>
</tr>
<tr>
<td>Derivatives</td>
<td>n/a</td>
</tr>
<tr>
<td>FVTPL – Designated under fair value option</td>
<td>Financial assets meeting HTC and SPPI criteria and for which the fair value option is revoked at the DIA</td>
</tr>
</tbody>
</table>
### Transfer from existing measurement categories

<table>
<thead>
<tr>
<th><strong>Held-to-maturity</strong></th>
<th><strong>Amortised cost</strong></th>
<th><strong>FVTPL</strong></th>
<th><strong>FVOCI</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets meeting HTC and SPPI criteria for which the fair value option is not chosen or available at the DIA</td>
<td></td>
<td>Financial assets that do not meet SPPI criterion and for which the fair value option is not chosen or available at the DIA</td>
<td>n/a</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Loans and receivables</strong></th>
<th><strong>Amortised cost</strong></th>
<th><strong>FVTPL</strong></th>
<th><strong>FVOCI</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets meeting HTC and SPPI criteria and for which the fair value option is not chosen or available at the DIA</td>
<td></td>
<td>Financial assets that do not meet the HTC and SPPI criteria and for which the fair value option is not chosen or available at the DIA</td>
<td>n/a</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Available-for-sale debt investments</strong></th>
<th><strong>Amortised cost</strong></th>
<th><strong>FVTPL</strong></th>
<th><strong>FVOCI</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets meeting HTC and SPPI criteria at the DIA and for which the fair value option is not chosen or available at that date</td>
<td></td>
<td>Financial assets that do not meet the HTC and SPPI criteria and for which the fair value option is not chosen or available at that date</td>
<td>n/a</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Available-for-sale equity investments</strong></th>
<th><strong>Amortised cost</strong></th>
<th><strong>FVTPL</strong></th>
<th><strong>FVOCI</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>n/a</td>
<td>All equity investments other than those for which the FVOCI option is selected</td>
<td></td>
<td>Option for equity investments if not held for trading</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Cost (certain unquoted equity investments and related derivative assets)</strong></th>
<th><strong>Amortised cost</strong></th>
<th><strong>FVTPL</strong></th>
<th><strong>FVOCI</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>n/a</td>
<td>All equity investments other than those for which the FVOCI option is selected</td>
<td></td>
<td>Option for equity investments if not held for trading</td>
</tr>
</tbody>
</table>
7. First-time adopters

**Key changes from the ED**

The standard provides relief from restatement of comparatives for first-time adopters that first adopt it for periods beginning before 1 January 2012. The ED did not contain such relief.

**IIFRS 9.C2**

The standard amends the requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards*, which deals with first-time adoption of IFRSs. Generally IFRS 1 requires full retrospective application of IFRSs that are effective at the end of the entity’s first IFRS reporting period. However, the consequential amendment introduced by IFRS 9 prohibits retrospective application. Instead, the assessment whether a financial asset meets the criteria for amortised cost classification (the HTC and SPPI criteria) is made on the basis of facts and circumstances that exist at the date of transition to IFRSs. This is in contrast to the transition provisions of IFRS 9 for entities that already report under IFRSs which require an assessment of the business model based on facts and circumstances as at the DIA and an assessment of the SPPI criterion as at the inception of the instrument. The date of transition to IFRSs is the beginning of the earliest period for which an entity presents full comparative information under IFRSs.

**Insight**

In contrast to the transition provisions of IFRS 9 which require an assessment of the business model at the DIA and an assessment of the SPPI criterion at the inception of the instrument, the exception in IFRS 1 requires the assessment of both at the date of transition.

**IIFRS 9.C3**

In addition, the amended IFRS 1 includes some exemptions that may be applied voluntarily:

- A financial asset may be designated as at FVTPL to avoid an accounting mismatch based on facts and circumstances at the date of transition. A similar rule is retained for financial liabilities.
- An equity investment may be designated as at FVOCI based on facts and circumstances at the date of transition.

Additionally, if it is impracticable to apply the effective interest method or the impairment requirements of IAS 39 retrospectively, the fair value at the date of transition is the new amortised cost at that date.
The diagram below illustrates application of the above requirements, assuming one year of comparative information is presented.

**IFRS 9.C3** If a first-time adopter adopts IFRSs for an annual period beginning before 1 January 2012 and chooses to apply IFRS 9, then comparative information in the first IFRS financial statements does not have to be restated in accordance with IFRS 9. This exemption also includes IFRS 7 disclosures related to assets in the scope of IAS 39. If this option is taken:

- With respect to the application of IFRS 9, the date of transition is defined as the beginning of the first IFRS reporting period.
- For assets in the scope of IAS 39, previous GAAP is applied in comparative periods (rather than IFRS 9 or IAS 39).
- The fact that the exemption is applied, as well as the basis of preparation of the comparative information, is disclosed.
- The differences arising on adopting IFRS 9 are treated as a change in accounting policy; all adjustments resulting from applying IFRS 9 are recognised in the statement of financial position at the beginning of the first IFRS reporting period and certain disclosures required by IAS 8 are given.
**Insight**
On transition to IFRS, a first time adopter before 1 January 2012 may take advantage of an exemption from restating comparative information in accordance with IFRS 9. This means that, in comparative periods, information relating to financial assets will be presented on the basis of previous GAAP. However, as there is no similar relief for financial liabilities, they would have to be fully restated in comparative periods in accordance with IAS 39.

**Example**
The example below illustrates the application by a first time adopter in 2010 who has elected not to provide comparative information in accordance with IFRS 9.
8. Future developments

A question often asked is whether the standard may be amended in the near future as a result of the IASB and FASB’s (together the Boards) efforts to achieve convergence. Currently the FASB is deliberating its proposed changes to accounting for financial instruments under U.S. GAAP with a view to issuing an exposure draft in the first quarter of 2010. The table below, based on information available from the FASB website and posted in November 2009, summarises the key differences between IFRS 9 and the current tentative decisions of the FASB.

<table>
<thead>
<tr>
<th></th>
<th>IFRS 9</th>
<th>FASB tentative decisions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement attributes</strong></td>
<td>Fair value and amortised cost</td>
<td>Fair value and amortised cost</td>
</tr>
<tr>
<td><strong>Classification categories</strong></td>
<td>• FVTPL</td>
<td>• FVTPL</td>
</tr>
<tr>
<td></td>
<td>• Amortised cost</td>
<td>• Amortised cost (limited option)</td>
</tr>
<tr>
<td></td>
<td>• FVOCI (limited option)</td>
<td>• FVOCI</td>
</tr>
<tr>
<td><strong>Default category</strong></td>
<td>n/a</td>
<td>• FVTPL</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Certain changes in fair value may be recognised in OCI</td>
</tr>
<tr>
<td><strong>FVOCI classification criteria</strong></td>
<td>Option to designate equity investments not held for trading</td>
<td>Debt instruments with principal amounts if the entity’s business strategy is to hold the debt instruments for collection or payment(s) of contractual cash flows rather than to sell or settle the instruments with a third party</td>
</tr>
<tr>
<td><strong>Amortised cost classification criteria</strong></td>
<td>Classification criteria based on:</td>
<td>Option for certain types of own debt (if FVOCI classification criteria are met and fair value measurement results in an accounting mismatch)</td>
</tr>
<tr>
<td></td>
<td>• entity’s business model; and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• cash flow characteristics</td>
<td></td>
</tr>
<tr>
<td><strong>Fair value option</strong></td>
<td>Election at initial recognition to avoid accounting mismatch</td>
<td>No tentative decision yet</td>
</tr>
<tr>
<td><strong>Hybrid financial instruments</strong></td>
<td>If host asset is in the scope of IAS 39, instrument is classified in its entirety (i.e., no bifurcation of embedded derivatives)</td>
<td>Hybrid contracts containing embedded derivatives that require separate accounting under current U.S. GAAP are measured at FVTPL</td>
</tr>
<tr>
<td></td>
<td>For hybrid contracts with hosts that are not financial assets within the scope of IAS 39, IAS 39 guidance continues to apply</td>
<td>Hybrid contracts that do not require bifurcation under current U.S. GAAP and meet FVOCI criteria – certain changes in fair value may be recognised in OCI</td>
</tr>
</tbody>
</table>
## IFRS 9

<table>
<thead>
<tr>
<th>IFRS 9</th>
<th>FASB tentative decisions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gains and losses from sales and settlements</strong></td>
<td>Generally recognised in profit or loss – exception: equity investments classified as FVOCI</td>
</tr>
<tr>
<td><strong>Interest and dividends</strong></td>
<td>Recognised in profit or loss (unless recovery of cost of investment classified as FVOCI)</td>
</tr>
<tr>
<td><strong>Reclassifications</strong></td>
<td>Required following change in business model</td>
</tr>
</tbody>
</table>

In the introduction to the standard the IASB reiterated the IASB and FASB’s commitment “to achieving by the end of 2010 a comprehensive and improved solution that provides comparability internationally in the accounting for financial instruments.”

In their joint statement on 5 November 2009 the Boards stated that in the first quarter of 2010 the IASB will publish a request for views on the FASB comprehensive proposal covering classification and measurement, impairment and hedging (expected in the first quarter of 2010). At the same time the FASB will solicit views on the IASB proposals for recognition and measurement (including IFRS 9), impairment and hedging. In the second quarter of 2010 the IASB will review the application of its requirements for classification and measurement of financial assets by early adopters. In the fourth quarter of 2010 the Boards expect to publish their final standards.

The IASB still has to consider classification and measurement of financial liabilities. In the joint statement of 5 November 2009 the Boards stated that they will discuss these proposals together, including how and whether to account for changes in own credit risk.