

Welcome to the series

Our series of *IFRS for Investment Funds* publications addresses practical application issues that investment funds may encounter when applying IFRS. It discusses the key requirements and includes guidance and illustrative examples. The issues cover such topics as presentation and measurement of financial assets carried at fair value, liability vs equity classification for financial instruments issued by investment funds and segment reporting.

This series considers accounting issues from currently effective IFRS as well as forthcoming requirements. Further discussion and analysis about IFRS is included in our publication *Insights into IFRS*.

In this issue: Classification of financial assets and liabilities under IFRS 9

IFRS 9 *Financial Instruments* is to supersede IAS 39 *Financial Instruments: Recognition and Measurement*. Its classification requirements represent a significant change from IAS 39 for financial assets and a limited one for financial liabilities. This publication covers the following key questions related to classification under IFRS 9 which may be of particular interest to investment funds.

1. What are the new classification requirements for financial assets?
2. How are debt investments classified?
3. How is the objective of the business model in which the asset is held assessed?
4. Are the cash flows solely payments of principal and interest?
5. How are contractually linked instruments classified?
6. How are debt investments classified on initial application of IFRS 9?
7. How are investments in equity instruments classified?
8. How are investments in equity instruments classified on initial application of IFRS 9?
9. How are financial liabilities classified?
10. What are the new presentation requirements for financial liabilities designated at fair value through profit or loss?
11. What about reclassification of financial assets and transitional provisions?

The standard is effective for annual periods beginning on or after 1 January 2015, with early application permitted.

In November 2011 the IASB initiated a project of limited amendments to IFRS 9. In January 2012 the IASB and the FASB decided to jointly redeliberate selected aspects of their classification and measurement models to seek to reduce key differences. The redeliberations are to include the following topics relevant to the classification of financial assets:

- business model and cash flow characteristics of financial assets eligible for classification and measurement at amortised cost;
- a possible 'fair value through other comprehensive income' category for debt investments; and
- whether to re-introduce bifurcation of embedded derivatives for financial assets.

The target date for issuing an exposure draft with the proposed changes is the second half of 2012. This publication includes the IASB's tentative decisions on this project up to and including the April 2012 meeting. We have highlighted in each question a potential impact from the IASB discussions assuming that the tentative decisions made up to and including the April 2012 meeting remain unchanged.

This publication does not consider financial instruments designated in hedging relationships.

1.

What are the new classification requirements for financial assets?

IFRS 9 *Financial Instruments* has introduced new classification categories for financial assets. The classification depends on the type of business model within which those financial assets are held and on the contractual characteristics of a financial asset. There are two classifications: at fair value and at amortised cost.

Classification of financial assets upon initial recognition	
Financial assets under IFRS 9:	Financial assets under IAS 39:
<ul style="list-style-type: none"> • amortised cost; and • fair value. 	<ul style="list-style-type: none"> • fair value through profit or loss; • held to maturity; • loans and receivables; and • available-for-sale.

This publication considers separately classification of debt investments, investments in equity instruments and derivatives. Only debt instruments can be classified as measured at amortised cost. Investments in equity instruments and derivatives are always classified as measured at fair value.

Equity instruments are defined in the same way as in IAS 32 *Financial Instruments: Presentation*. This means that a holder of an investment assesses whether the instrument meets the definition of equity from the perspective of the issuer.

The table below summarises the classification and measurement requirements of IFRS 9.

Classification and measurement requirements for financial assets under IFRS 9		
Debt investments	Investments in equity instruments	Derivatives
<p>Eligible for classification as measured at amortised cost, if both of the following conditions are met.</p> <ul style="list-style-type: none"> • The investment is held in a business model whose objective is to collect contractual cash flows (held-to-collect (HTC) business model). • 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 (SPPI). <p>If a financial asset does not meet both of the above criteria, then it is classified as measured at fair value through profit or loss.</p>	<p>Classified as measured at fair value.</p> <p>Changes in fair value are recognised:</p> <ul style="list-style-type: none"> • in profit or loss; or • in other comprehensive income (OCI) if optional election is made. <p>The OCI option does not apply to:</p> <ul style="list-style-type: none"> • instruments held-for-trading; • puttable instruments and obligations arising on liquidation classified as equity by the issuer by exception; and • derivative instruments that meet the definition of equity of the issuer. 	<p>Classified as measured at fair value.</p> <p>Gains and losses on re-measurement are recognised in profit or loss.</p>

Classification and measurement requirements for financial assets under IFRS 9		
Debt investments	Investments in equity instruments	Derivatives
On initial recognition, an investment fund may choose to designate a financial asset that otherwise would qualify for amortised cost accounting as measured as at fair value through profit or loss. This optional designation is permitted only if it eliminates or significantly reduces an accounting mismatch.		
Further discussed in Questions 2-6.	Further discussed in Questions 7-8.	

Another significant change from IAS 39 is the removal of the requirement to separate embedded derivatives from a financial asset host (if the host is within the scope of IFRS 9). Instead, under IFRS 9 the whole combined instrument is assessed for classification either as at fair value or amortised cost.

Under IAS 39 an embedded derivative is separated if:

- the embedded feature meets the definition of a derivative;
- the embedded derivative is not closely related to the host; and
- the entire contract is not measured at fair value through profit or loss.

IFRS 9 retains the IAS 39 requirement to separate embedded derivatives from host contracts that are:

- financial liabilities;
- financial assets not within the scope of IFRS 9; and
- other contracts not within the scope of IFRS 9.

The IASB discussion on limited amendments to IFRS 9

Business model and cash flows characteristics assessment for amortised cost classification for financial assets

Under the current version of IFRS 9, a financial asset is required to meet two tests to be eligible for classification at other than fair value. The first test relates to the entity's business model (see Question 3) and the second test relates to the asset's cash flow characteristics (see Question 4).

The IASB tentatively decided that a financial asset would qualify for amortised cost classification if:

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

These tentative decisions are largely in line with the current requirements of IFRS 9.

The IASB also tentatively decided to clarify the primary objective of 'hold to collect' by providing additional implementation guidance on the types of business activities and the frequency and nature of sales that would prohibit financial assets from qualifying for amortised cost measurement. This may help preparers in navigating the current guidance and examples in IFRS 9 about assessing whether a more than infrequent level of sales is consistent with a 'hold to collect' business model (see Question 3).

Bifurcation of financial assets and financial liabilities

IFRS 9 currently does not permit bifurcation of financial assets but requires bifurcation of embedded derivatives from financial liabilities if they are not closely related.

At their April 2012 meeting the IASB tentatively decided to retain the current IFRS 9 guidance on bifurcation. This means that financial assets that do not qualify for amortised cost classification (see Question 2) would not be bifurcated; instead, they would be classified and measured in their entirety at fair value through profit or loss. Financial liabilities, on the other hand, would be bifurcated using the existing 'closely-related' bifurcation requirements currently in IFRS 9 (see Question 9).

In relation to their decision to bifurcate financial liabilities, the IASB also confirmed that the 'own credit' guidance in IFRS 9 would be retained (see Question 10).

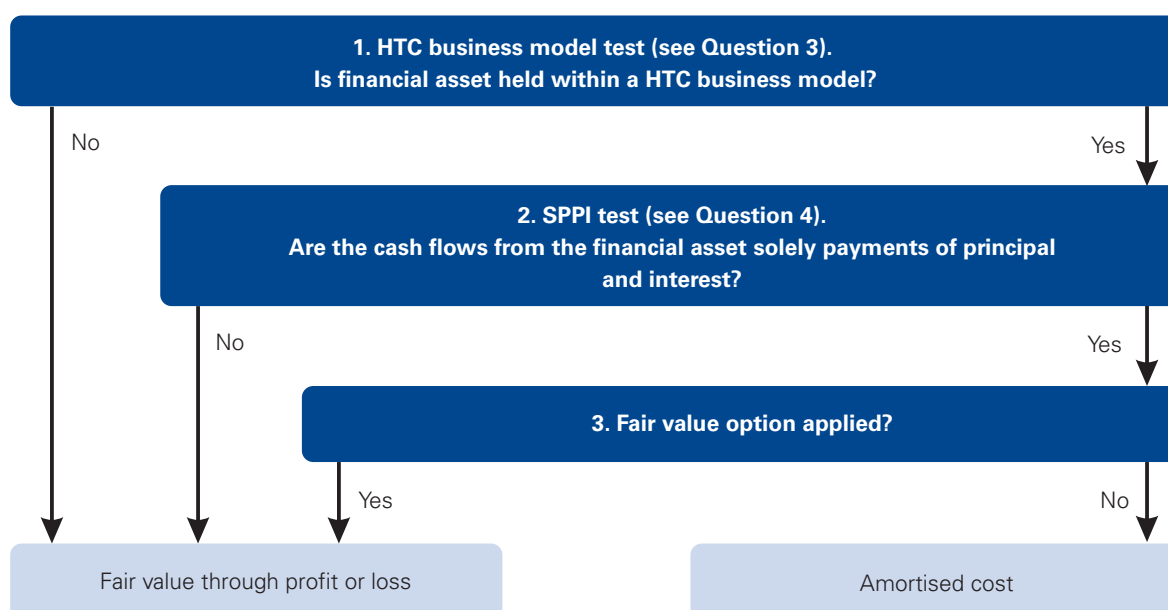
A possible 'fair value through OCI' classification category for debt investments

At future meetings on the classification and measurement of financial instruments, the IASB will consider a possible third classification category for financial assets – debt instruments measured at fair value through OCI.

2.

How are debt investments classified?

The assessment of whether a debt investment is eligible for classification at amortised cost may involve judgement. Investment funds can use the steps in the flowchart below to help determine the appropriate classification.



IFRS 9 retains the option in IAS 39 to voluntarily designate a financial asset as at fair value through profit or loss. This optional designation is permitted only if it eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch') that otherwise would arise from measuring financial assets or financial liabilities, or recognising gains or losses on them, on different bases.

The following other two fair value designation conditions currently available for financial assets in IAS 39 are not retained in IFRS 9 because the requirements of IFRS 9 rendered them redundant.

- Instruments managed on a fair value basis: under IFRS 9, financial assets managed on a fair value basis cannot qualify for amortised cost measurement and therefore are mandatorily measured at fair value.
- Certain hybrid instruments: under IFRS 9, embedded derivatives with a host that is a financial asset within the scope of the standard are not subject to separation.

As with IAS 39, the election is available only on initial recognition and is irrevocable.

The IASB discussion on limited amendments to IFRS 9

See Question 1 for a discussion of a potential impact on:

- the business model and cash flows characteristics assessment for amortised cost classification for financial assets; and
- a possible 'fair value through OCI' classification category for debt investments.

3.

How is the objective of the business model in which the asset is held assessed?

In order to determine whether a financial asset may be measured at amortised cost, the investment fund needs to identify and assess the objective of the business model in which this asset is held.

The objective of an investment fund's business model is not based on management's intentions with respect to an individual instrument, but is determined at a higher level of aggregation. The assessment of the business model should reflect the way an investment fund manages its business. A single entity may have more than one business model for managing its investments and the standard provides examples of different portfolios being managed on different bases. Some investment funds may have more than one business model for managing investments – e.g. one portfolio to collect the contractual cash flows and one to realise fair value changes. In such cases, each business model's objective is assessed separately rather than at the investment fund level.

HTC model considerations	
Sales of assets	<p>Not all investments in a HTC portfolio have to be held to maturity. Some sales are permitted because the standard acknowledges that there are very few business models that entail holding all instruments in the portfolio to maturity. An example of sales that may be regarded as being consistent with the HTC business model are sales of investments that no longer comply with the investment mandate as a result of a significant decrease in the credit rating of the issuer.</p> <p>However, if the number of sales is more than infrequent, then the investment fund should assess whether such sales are consistent with a HTC objective. There is no quantitative bright-line measure of an acceptable frequency of anticipated sales to meet the HTC criterion and in many cases judgement may be required to determine the appropriate classification.</p>
Factors to be considered	<p>Among the factors considered in the analysis of the business model are:</p> <ul style="list-style-type: none"> • management's stated policies and objectives for the portfolio and operation of these policies in practice; • how management evaluates portfolio performance; • whether the investment strategy focuses on earning contractual interest; • frequency of expected sales out of the portfolio and reasons for sales; and • whether debt investments sold are held for an extended period of time relative to their contractual maturity.
Features not consistent with HTC business model	<p>The following features are not consistent with a HTC objective:</p> <ul style="list-style-type: none"> • active management of a portfolio to realise fair value changes; • management and evaluation of performance of a portfolio on a fair value basis; and • trading intention (IFRS 9 retains the IAS 39 concept of 'held-for-trading').

In our experience, many investment funds have a strategy of generating profits through frequent buying and selling. Accordingly, they would be regarded as managing their debt portfolio on a fair value basis and therefore would fail the HTC business model test. However, investment funds that hold debt investments to collect the contractual cash flows would be able to meet the HTC criterion – e.g. some money market funds.

It is unclear what the consequences are of a fund concluding that the management of a portfolio that was previously HTC is no longer consistent with the HTC business model following a change to an ongoing frequent level of sales of financial assets from that portfolio, but where the reclassification criteria (see Question 11) have not been met. This may be the case where an

investment fund concludes that it no longer holds a particular portfolio of investments for collection of contractual cash flows but the change is not sufficiently significant to the fund's operations to trigger reassessment of the classification of the existing portfolio. However, when new investments are acquired subsequent to the change in business model, the HTC criterion would not be met in respect of those assets and accordingly, these assets would not be eligible for measurement at amortised cost. This may lead to some financial assets in the portfolio being measured at amortised cost and others, acquired after the change, being measured at fair value. Effectively, following the assessment, the fund would have two portfolios rather than one.

The IASB discussion on limited amendments to IFRS 9

See Question 1 for discussion of a potential impact on the business model assessment for amortised cost classification for financial assets.

4.

Are the cash flows solely payments of principal and interest?

Once it is established that a particular debt investment is held in a HTC business model, the next step is an assessment of the instrument's contractual cash flows to determine if they meet the SPPI (solely payments of principal and interest on the principal amount outstanding) criterion.

The assessment is made for the debt instruments as a whole without separating any embedded derivative features.

One of the challenges of this assessment is that the contractual cash flows may be called principal and interest in a contractual agreement, but may not meet the IFRS 9 definition of principal and interest. The following table provides guidance on the assessment.

SPPI criterion considerations	
Definition of interest	Interest (variable or fixed) for the purposes of the SPPI test is defined as consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time.
Currency	The assessment is made in the currency of the instrument's denomination.
Leverage	Leverage increases variability of the contractual cash flows so that they do not have the economic characteristics of interest. As a result, an instrument with leverage would fail the SPPI test.
Changes in timing or amount of contractual payments	Any contractual changes to the timing or amount of cash flows are not SPPI, unless they are: <ul style="list-style-type: none"> • a variable interest rate that represents consideration for the time value of money and credit risk; or • a qualifying prepayment, put or term extension option (see below).
Prepayment, put or extension options	Instruments with extension, put or prepayment options meet the SPPI criterion only if the feature: <ul style="list-style-type: none"> • is not contingent on future events, except for protecting the holder against credit deterioration/ change in control of the issuer, or protecting the holder or the issuer against changes in relevant taxation/law; and • for prepayment or put options: the prepayment amount substantially represents unpaid principal and interest but may also include reasonable compensation for early termination; or • for term extension options: results in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.

Examples of debt investment features that are:	
Consistent with the SPPI criterion	Not consistent with the SPPI criterion
<ul style="list-style-type: none"> • Variable interest reset at the rate of one-month LIBOR for a one-month term. • Variable interest with an interest rate cap (this is a combination of fixed and floating rate, as the cap reduces variability of cash flows). • Interest linked to the unleveraged inflation index in the currency of the instrument (in this case the linkage to inflation resets the time value of money to the current level). • Variation in contractual interest that represents compensation for credit risk in response to perceived changes in the creditworthiness of the borrower. 	<ul style="list-style-type: none"> • Interest rate of two times LIBOR (leveraged). • Bond that is convertible to an equity instrument of the issuer (return on the bond is linked to the value of the issuer's equity). • Inverse floating interest rate loan (e.g. the interest rate on the loan increases if the market rate of interest decreases).

IFRS 9 provides specific guidance for non-recourse financial assets and for contractually linked instruments (see Question 5). The fact that a financial asset is non-recourse does not in itself mean that the SPPI criterion is not met. The investment fund holding such an instrument has to assess the underlying cash flows to determine if the non-recourse feature limits the cash flows in a manner inconsistent with the SPPI criterion. For example, in our view the SPPI criterion is not met for a loan to a property developer where the contractual terms of the loan state that interest is payable only if specified rental income is received.

The IASB discussion on limited amendments to IFRS 9

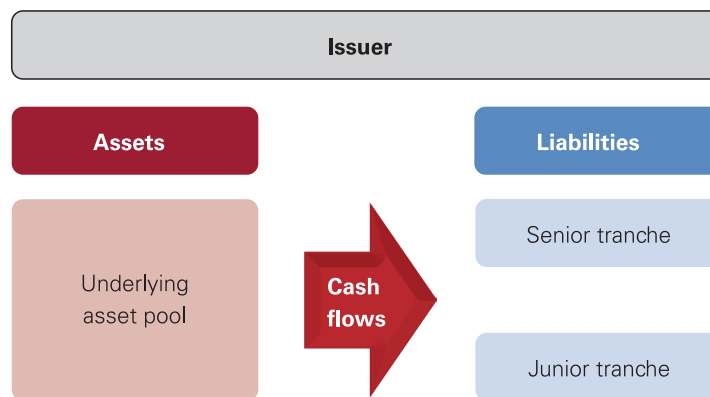
See Question 1 for discussion of a potential impact on:

- the cash flows characteristics assessment for amortised cost classification for financial assets; and
- bifurcation of financial assets and financial liabilities.

5.

How are contractually linked instruments classified?

IFRS 9 provides specific guidance for circumstances in which an issuer prioritises payments to the holders of multiple contractually linked instruments so that it creates concentration of credit risk – i.e. tranches. The right to payments on more junior tranches (exposed to higher credit risk) depends on the issuer's generation of sufficient cash flows to pay more senior tranches (exposed to lower credit risk). This could be the case in a securitisation arrangement, where a homogeneous pool of assets such as consumer loans, credit card receivables or trade receivables is transferred to a special purpose entity that then issues securities to investors collateralised on this pool of assets. The securities issued to investors commonly have different seniority and so bear different levels of credit risk.



A tranche meets the SPPI test if:

- the contractual terms of the tranche itself (without looking through to the underlying pool of financial instruments) give rise to cash flows that are SPPI;
- the underlying pool of financial instruments contains one or more instruments that gives rise to cash flows that are SPPI; and
- the exposure to credit risk inherent in the tranche is equal to or less than the exposure to credit risk of the underlying pool of financial instruments.

The underlying pool of financial instruments also may include derivatives that:

- reduce the variability of cash flows (e.g. interest rate caps, floors or credit protection); or
- align the cash flows of the tranches with the cash flows of the underlying pool (e.g. interest rates swaps changing interest streams from fixed to floating or a foreign exchange swap changing the currency of receipts).

To make the assessment about the instruments in the pool, an investor looks through to the underlying pool that creates rather than passes through the cash flows. For example, if Fund B invests in contractually linked notes issued by C whose only asset is a contractually linked note issued by D, then B looks through to the underlying pool of assets held by D to assess if that pool meets the relevant requirements.

The investment fund measures its investments in a tranche at fair value if:

- the fund is unable to make the assessment as to whether the tranche or the underlying pool of instruments meet the SPPI criterion; or
- the instruments in the underlying pool can change later in a way that would not meet the SPPI test.

Example 1 – Investment in credit-linked notes

Fund Y invests in senior and subordinated junior tranches of credit linked notes issued by Z. The subordinated junior tranche receives distribution only after payments have been made to the holders of the senior tranche. The total senior tranche issued by Z is 20 and the subordinated junior tranche is 10 (total of 30).

The tranches' cash flows meet the SPPI criterion and the underlying pool consists only of loans that are SPPI.

Y holds investments in Z's notes in its HTC business model.

Are the investments of Y in junior and senior notes eligible for measurement at amortised cost?

As both the tranches in which Y has invested and the underlying pool of investments meet the SPPI criterion, the only remaining test to consider is whether the credit risk inherent in each tranche is equal to or less than the exposure to credit risk of the underlying pool of instruments. This condition would be met in respect of a tranche if, for example, in the event of the underlying pool of instruments losing 50% as a result of credit losses, under all circumstances the tranche would lose 50% or less.

In this example if the underlying pool of loans lost 50% (i.e. 15), 10 of those losses would be absorbed by the junior tranche and the remaining 5 by the holders of the senior tranche. The resultant percentage of loss for the holders of the senior tranche would be 25% (5 divided by 20). Because 25% is less than 50%, the senior tranche would be eligible for classification at amortised cost.

However, in such a scenario the holders of the junior tranche would lose their entire investment. The junior tranche does not meet the credit risk test because whenever the underlying pool suffers a loss, investors in the junior tranche always suffer a proportionately greater loss.

IFRS 9 does not mandate a single method to determine whether the credit risk condition is satisfied and in our view it is not necessary to demonstrate that the 50% test in the example is passed in all circumstances in order to conclude that the credit risk condition is satisfied. We believe that a fund also may adopt an approach that models probability-weighted expectations of credit losses to derive a weighted average range of expected losses within the pool and their allocation to each tranche to determine whether the exposure of a tranche is proportionately more or less than the average exposure in the pool. If the range of expected losses on the tranche is greater than the weighted average range of expected losses on the underlying pool of financial instruments, then the investment in the tranche should be measured at fair value.

6.

How are debt investments classified on initial application of IFRS 9?

The following table illustrates how the IAS 39 categories for debt investments may align with IFRS 9 classifications.

IAS 39		IFRS 9	
Category	Rationale	Category	Rationale
At fair value through profit or loss, held-for-trading	<ul style="list-style-type: none"> Acquired for sale in the near term. or On initial recognition was part of a portfolio with a recent actual pattern of short-term profit taking. 	At fair value through profit or loss – mandatory	Not held in a HTC business model.
Designated as at fair value through profit or loss	Investments are managed and their performance is evaluated and reported to key management personnel on a fair value basis.		
Designated as at fair value through profit or loss	<ul style="list-style-type: none"> Eliminates or significantly reduces an accounting mismatch. Hybrid contracts with embedded derivatives if certain conditions are met.¹ 	Based on the assessment of the whole instrument and measured either at: <ul style="list-style-type: none"> amortised cost; or fair value through profit or loss. 	At amortised cost if held in a HTC business model, fulfils the SPPI criterion <i>and</i> not designated as at fair value through profit or loss. In other cases measured at fair value through profit or loss.
Held-to-maturity investments	Non-derivative financial assets (other than loans and receivables) with fixed or determinable payments and a fixed maturity that an entity has the positive intention and ability to hold to maturity.		
Loans and receivables	Non-derivative financial assets with fixed or determinable payments, not quoted in an active market, other than held-for-trading, designated as at fair value through profit or loss or available-for-sale.		
Available-for-sale	Designated as available-for-sale or not classified into other categories.		

An investment fund is permitted, but not required, at the date of initial application of IFRS 9 to:

- revoke a previous designation of a debt investment as measured at fair value through profit or loss even if the designation would continue to mitigate an accounting mismatch; or
- designate a debt investment as measured at fair value through profit or loss if doing so mitigates an accounting mismatch.

An investment fund revokes its previous designation of a financial asset as at fair value through profit or loss made on the basis that it mitigated an accounting mismatch if it no longer mitigates an accounting mismatch at the date of initial application of IFRS 9.

The designation or revocation is made on the basis of the facts and circumstances that exist at the date of initial application and the revised classification is applied retrospectively.

¹ Some derivative features in a hybrid contract may pass the SPPI test and the entire contract may be classified at amortised cost – e.g. a prepayment or term extension option that is SPPI. However, many embedded derivative features may cause the entire hybrid contract to fail the SPPI test and as a result be classified as at fair value through profit or loss.

The IASB discussion on limited amendments to IFRS 9

See Question 1 for discussion of a potential impact on:

- the business model and cash flows characteristics assessment for amortised cost classification for financial assets;
- bifurcation of financial assets and financial liabilities; and
- a possible 'fair value through OCI' classification category for debt investments.

7.

How are investments in equity instruments classified?

An investment in equity instruments is measured at fair value through profit or loss, unless the fund elects to present fair value changes in OCI.

Because the term 'equity' is defined consistently with IAS 32, the investor that wishes to make the fair value through OCI election has to assess first whether the instrument meets the definition of equity in the financial statements of the issuer. Investments in instruments that do not meet the definition of equity in the financial statements of the issuer are not eligible for the fair value through OCI election. As the majority of units issued by investment funds do not meet the definition of equity under IAS 32, the OCI classification for investments in such units is not available.

The election to present fair value changes in OCI can be made at initial recognition only on an instrument-by-instrument basis (e.g. individual share) and is irrevocable.

Fair value with changes in OCI considerations		
1	Not applicable for held-for-trading investments	<p>Held-for-trading investments in equity instruments cannot be measured at fair value through OCI.</p> <p>The concept of held-for-trading is carried forward unchanged from IAS 39 to IFRS 9: financial instruments are 'held-for-trading' if they are acquired for sale in the near term, or on initial recognition are part of a portfolio for which there is evidence of a recent actual pattern of short term profit taking, or if the instrument is a derivative.</p> <p>An investment fund 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 fund could not classify such an investment as at fair value through OCI because derivative instruments are within the concept of 'held-for-trading' in IFRS 9.</p>
2	Not applicable for puttable instruments and certain obligations arising only on liquidation	<p>The Basis for Conclusions (BC5.21) for IFRS 9 notes that the fair value through OCI option refers only to equity instruments defined as such by IAS 32 and not to instruments defined as financial liabilities but classified as equity by the issuer – e.g. puttable instruments or instruments (or components of instruments) that impose on the entity an obligation to deliver a pro rata share of its net assets to another party only on liquidation such as interests in limited-life funds.</p>
3	Not applicable for certain investments in associates	<p>This option is not available for investments in associates and joint ventures accounted for under the exception from equity method accounting in IAS 28 <i>Investments in Associates</i> for venture capital organisations, mutual funds, unit trusts and similar entities because the optional exception requires measurement at fair value through profit or loss.</p>
4	Gains and losses and impairment	<p>Fair value changes are accumulated in OCI and are not transferred to profit or loss on disposal or in any other circumstances, although they may be reclassified within equity. Accordingly, there is no need for impairment testing of these assets.</p>
5	Dividend income	<p>Dividend income is recognised in profit or loss in accordance with IAS 18 <i>Revenue</i> unless the dividend clearly represents a recovery of part of the cost of the investment. In the latter case, the right to the dividend is recognised as a separate asset with the corresponding decrease in the fair value of the investment and has no net effect on OCI.</p> <p>In our view, a dividend has to meet the definition of dividend income under IAS 18 to be recognised in profit or loss.</p>

Fair value with changes in OCI considerations		
6	Transaction costs	<p>In our view, transaction costs incurred on initial recognition of investments in equity instruments in respect of which the OCI election has been made are treated differently to those incurred on disposal.</p> <p>Transaction costs incurred on initial recognition are effectively recognised in OCI, because the investment in equity instruments is initially measured at fair value plus those transaction costs, but subsequently at fair value with gains and losses recognised in OCI.</p> <p>However, in our view transaction costs incurred on disposal of an investment in equity instruments classified at fair value through OCI are recognised in profit or loss as presentation in OCI is not specifically permitted or required by the standard.</p>
7	Classification by the issuer is key	In our view, the option cannot be applied if the holder cannot determine if the instrument meets the definition of equity from the perspective of the issuer.

Example 2 – Investment in redeemable shares

Feeder fund F invests in the redeemable units of Master fund M. F does not consolidate M.

The units meet the definition of a financial liability under the general classification in IAS 32, but are presented as equity in M's financial statements, because they meet the criteria in paragraphs 16A and 16B of IAS 32.

Can F measure the investment in M's units at fair value through OCI?

The election to present fair value changes in OCI is not available for puttable instruments, irrespective of the issuer's presentation. F measures its investment in M's units at fair value through profit or loss.

Example 3 – Investment in convertible bonds

Fund C invests in a convertible bond and classifies it as measured at fair value through profit or loss because the bond does not meet the SPPI criterion (see Question 4).

C exercises the conversion option and converts the bonds to shares that are classified as equity by the issuer.

Can C measure the investment in shares after conversion at fair value through OCI?

In our view, if C exercises the conversion option in a convertible bond and converts the bond to the equity instruments of the issuer, then C should account for the equity instrument as a new asset. Accordingly, at initial recognition, C may elect to classify the shares as at fair value through OCI if they are not held for trading.

IFRS 9 removes the IAS 39 exception for investments in equity instruments that do not have a quoted market price in an active market to be measured at cost if their fair value cannot be measured reliably. Similarly, it has no exception for derivative assets that are linked to and settled by delivery of such unquoted equity instruments.

8.

How are investments in equity instruments classified on initial application of IFRS 9?

The following table illustrates how the IAS 39 categories for investments in equity instruments may align with IFRS 9 classifications.

IAS 39		IFRS 9	
Category	Rationale	Category	Rationale
At fair value through profit or loss, held-for-trading	<ul style="list-style-type: none"> Acquired for sale in the near term. or On initial recognition was part of a portfolio with a recent actual pattern of short-term profit taking. 	At fair value through profit or loss – mandatory	<ul style="list-style-type: none"> Fail the SPPI criteria. Fail the OCI designation criteria as held for trading.
Designated as at fair value through profit or loss	<ul style="list-style-type: none"> Eliminates or significantly reduces an accounting mismatch. Investments are managed and their performance is evaluated and reported to key management personnel on a fair value basis. Hybrid contracts with embedded derivatives if certain conditions are met. 	<ul style="list-style-type: none"> At fair value through profit or loss or Designated as at fair value through OCI 	<ul style="list-style-type: none"> Fail the SPPI criteria. Optional designation at fair value through OCI at initial recognition.
Available-for-sale	Designated as available-for-sale or not classified into other categories.		

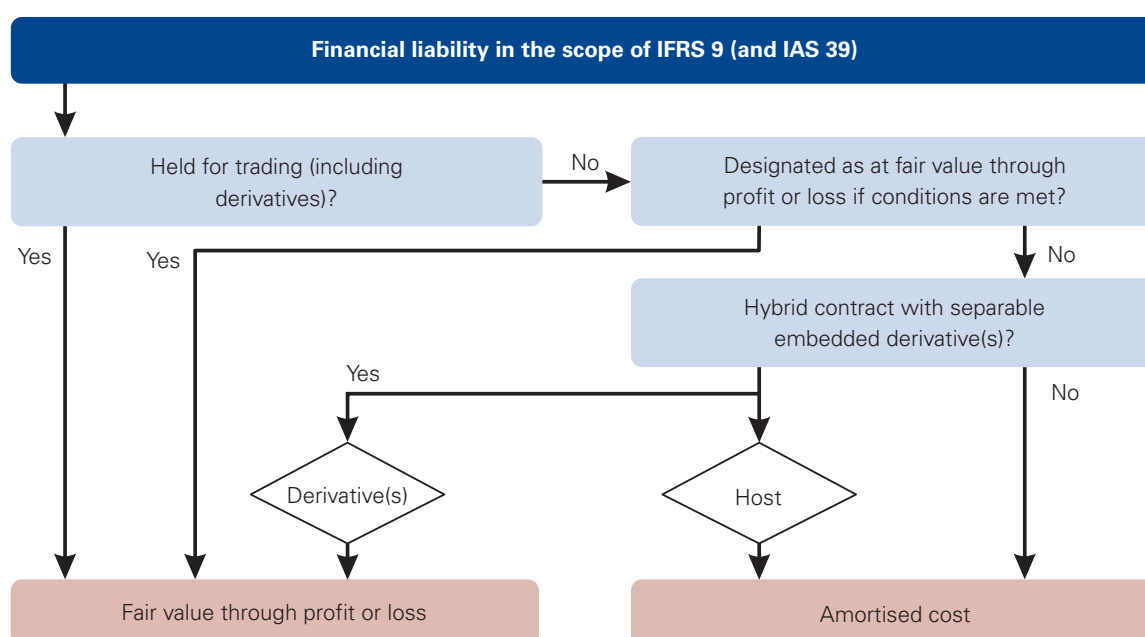
At the date of initial application of IFRS 9 an investment fund may designate an investment in an equity instrument as at fair value through OCI. The designation is made on the basis of facts and circumstances (see Question 7) that exist at the date of initial application of the standard and is applied retrospectively.

IFRS 9 retains the concept of 'held-for-trading' used in IAS 39. However, for the purpose of determining eligibility for the fair value through OCI election on transition, an investment fund determines whether an asset is held for trading as if it had acquired the asset on the date of initial application. Therefore, in our view it is possible to designate as at fair value through OCI an investment in an equity instrument that was classified as held-for-trading at the investment's original acquisition date if it does not meet the held-for-trading definition at the date of initial application.

9.

How are financial liabilities classified?

Classification of financial liabilities under IFRS 9 remains unchanged from IAS 39. This includes classification of financial liabilities such as puttable instruments and obligations arising on liquidation that do not meet the requirements of IAS 32 for equity classification by exception. For completeness, the flowchart below outlines the decision tree for classification of financial liabilities under both IAS 39 and IFRS 9.



In contrast to financial assets, an investment fund may allocate financial liabilities classified under IAS 39 directly into IFRS 9 categories as there are generally no changes in measurement basis.

The principal change from IAS 39 in respect of financial liabilities is the new presentation requirements for financial liabilities designated as at fair value through profit or loss (see Question 10). In addition, IFRS 9 has removed the cost exception for derivative financial liabilities linked to and settled by delivery of unquoted equity instruments whose fair value cannot be determined reliably.

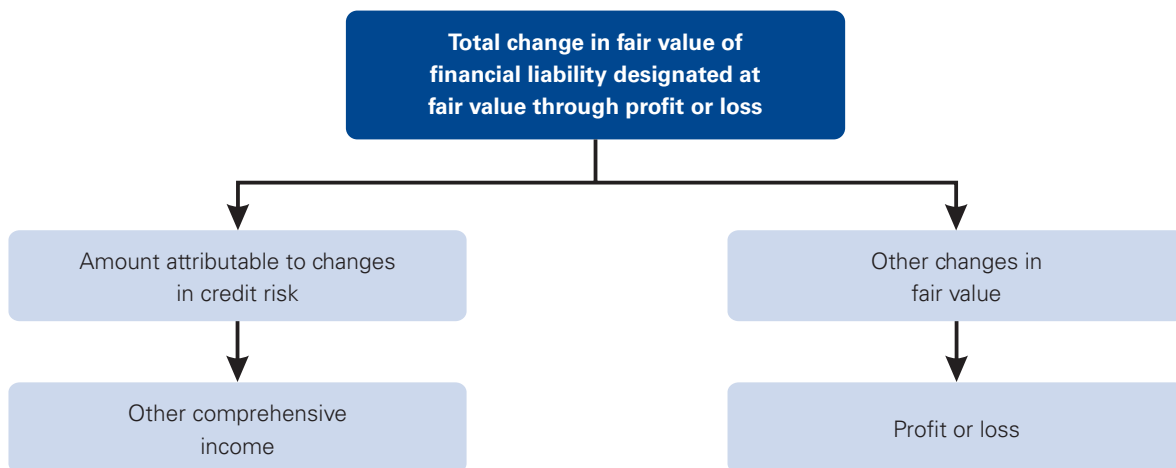
Also, at the date of initial application of IFRS 9 an investment fund:

- may designate a financial liability as measured at fair value through profit or loss if doing so mitigates an accounting mismatch;
- may revoke a previous designation of a financial liability as measured at fair value through profit or loss if the designation was previously made on the basis that it mitigated an accounting mismatch, even if it still mitigates such a mismatch; and
- revokes its previous designation made on the basis that it mitigated an accounting mismatch if it no longer mitigates such a mismatch.

The designation and revocation is made on the basis of the facts and circumstances that exist at the date of initial application and the revised classification is applied retrospectively.

10. What are the new presentation requirements for financial liabilities designated at fair value through profit or loss?

IFRS 9 introduced new presentation requirements for financial liabilities that are designated at fair value through profit or loss. For such liabilities, the effect of changes in credit risk is generally presented in OCI and the remainder of the fair value changes is presented in profit or loss ('split presentation').



However, the gains and losses on a financial liability designated as at fair value through profit or loss in their entirety are presented in profit or loss in the following cases:

- if split presentation would create or enlarge an accounting mismatch in profit or loss; or
- if the financial liability is a loan commitment or a financial guarantee.

The determination of whether split presentation would create or enlarge an accounting mismatch in profit or loss is made at initial recognition and is not re-assessed.

To determine when split presentation would create or enlarge an accounting mismatch in profit or loss, an investment fund assesses whether it expects that the effects of changes in the financial liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument. Such an expectation is based on an economic relationship between the characteristics of the financial liability and the characteristics of another financial instrument. For example, an economic relationship may result from a contractual linkage between the financial liability and another financial instrument, but it may also occur in the absence of such linkage. However, an economic relationship does not arise by coincidence.

The key application challenge of presenting separately the effect of changes in a liability's credit risk is to select an appropriate method for splitting credit risk changes from the total changes in the fair value of the instrument.

For the purposes of this presentation requirement, credit risk is defined as the risk that the issuer will fail to perform on that particular liability and not as the overall creditworthiness of the issuer. The amount of the fair value change attributable to changes in credit risk is calculated as either:

- total changes in fair value of the financial liability less changes attributable to market conditions that give rise to market risk (so called 'default method'); or
- an alternative method that more faithfully represents the amount of change in fair value attributable to credit risk.

Any method used to separate the changes attributable to credit risk makes maximum use of observable inputs and minimum use of unobservable inputs.

The default method is appropriate only where changes in fair value arising from factors other than changes in the liability's credit risk and changes in observed benchmark market risk are not significant. The table below outlines how this method can be implemented in our experience.

Calculation of changes in credit risk for a debt liability – default method	
Step 1	<p>At the start of the period</p> <p>Calculate the financial liability's internal rate of return using the financial liability's fair value and contractual cash flows at that date.</p> <p>Deduct from this internal rate of return the observed (benchmark) interest rate at that date so as to arrive at an instrument-specific component of the internal rate of return.</p>
Step 2	<p>At the end of the period</p> <p>Compute a present value of the cash flows of the financial liability using the financial liability's contractual cash flows at that date and a discount rate equal to the sum of:</p> <ul style="list-style-type: none"> • the observed (benchmark) interest rate at that date; and • the instrument-specific component of the internal rate of return determined in Step 1.
Step 3	<p>At the end of the period</p> <p>Deduct the present value calculated in Step 2 from the fair value of the financial liability at that date.</p> <p>The resulting difference is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate and that is presented in OCI.</p>

The IASB states that if an entity repays the contractual amount of a financial liability, then the cumulative effect of changes in the financial liability's credit risk will net to zero because its fair value will equal the contractual amount. However, if the wording of the guidance on the default method (as set out in the above table) were applied literally to all periods in a scenario covering more than one period, it usually would lead to a result in which the fair value changes accumulated in OCI do not accumulate to a net amount of zero on repayment of the financial liability at its contractual maturity. Under the default method as described above, the calculation of the credit risk component of the change in fair value is calculated separately for each period and without reference to the cumulative position since inception.

Amounts presented in OCI under the split presentation are never reclassified to profit or loss. This prohibition applies even if a gain or loss related to a change in the financial liability's credit risk is realised by settling or repurchasing the financial liability at fair value. However, the cumulative gain or loss may be transferred to a different component of equity.

11. What about reclassification of financial assets and transitional provisions?

Reclassification of financial assets

Classification of financial assets is determined on their initial recognition. Subsequent reclassification between categories is generally prohibited.

The only exception is when an entity changes its business model in a way that is significant to its operations. Such changes to the business model are:

- determined by senior management as a result of internal or external changes;
- demonstrable to external parties; and
- are expected to be very infrequent.

When such changes take place an entity has to re-assess whether the initial classification of the relevant financial assets remains appropriate. If it is no longer appropriate, then the relevant financial assets are reclassified.

Transitional provisions

The transition requirements of IFRS 9 are detailed and complex.

As the first step in applying IFRS 9, an investment fund has to determine the date of initial application (DIA) of the standard. For initial application on or after 1 January 2011, the DIA is the beginning of the first reporting period in which an entity adopts IFRS 9. Identification of the DIA is relevant to several assessments necessary to apply IFRS 9, some of which have been outlined in Questions 6, 8 and 9. Other such assessments include:

- whether a financial asset is held within HTC business model; and
- whether presenting the effects of changes in a financial liability's credit risk in OCI would create or enlarge an accounting mismatch in profit or loss.

Transitional provisions contain certain reliefs from full retrospective application. For example, IFRS 9 is not applied to financial assets and liabilities that have been derecognised by the DIA. Accordingly, such instruments continue to be accounted for under IAS 39 in the comparative period. However, this relief means that on adoption of IFRS 9 an entity cannot fully calculate the information required on transition (or restate its comparative information, if such information is provided), until it reaches the DIA when it becomes clear which financial assets have to be restated.

IFRS 9 does not require a restatement of comparative information on transition. Instead the requirements are as follows.

Initial application of IFRS 9	Required disclosures
Periods beginning after 1 January 2012 and before 1 January 2013	A fund elects to: <ul style="list-style-type: none"> • provide the specific information set out in IFRS 9; or • restate prior periods.
Periods beginning on or after 1 January 2013	A fund provides the specific information set out in IFRS 9.

Our publication: *Insights into IFRS*, 8th Edition provides more guidance on the application of transitional provisions of IFRS 9.

The IASB discussion on limited amendments to IFRS 9

The IASB is still to reconsider transition and disclosure requirements.

Other KPMG publications

A more detailed discussion of the general accounting issues that arise from the application of IFRS can be found in our publication *Insights into IFRS*. In addition, we have a range of publications that can help you further, including:

- Illustrative financial statements: Investment funds
- Illustrative financial statements for interim and annual periods
- IFRS compared to US GAAP
- IFRS Handbooks, which include extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard, including IFRS Handbook: First-time adoption of IFRSs
- New on the Horizon publications, which discuss consultation papers
- First Impressions publications, which discuss new pronouncements
- Newsletters, which highlight recent accounting developments
- IFRS Practice Issues publications, which discuss specific requirements of pronouncements
- Disclosure checklist.

IFRS-related technical information is also available at kpmg.com/ifrs.

For access to an extensive range of accounting, auditing and financial reporting guidance and literature, visit KPMG's Accounting Research Online. This web-based subscription service can be a valuable tool for anyone who wants to stay informed in today's dynamic environment. For a free 15-day trial, go to aro.kpmg.com and register today.

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