

MEMBERS' HANDBOOK

Update No. 97

(Issued 25 November 2010)

This Update relates to the issuance of:

- Additions to HKFRS 9 *Financial Instruments* – Financial Liabilities

<u>Document Reference and Title</u>	<u>Instructions</u>	<u>Explanations</u>
<u>VOLUME II</u>		
Contents of Volume II	Discard existing pages i & ii and replace with revised pages i and ii.	Revised contents pages
HONG KONG FINANCIAL REPORTING STANDARDS (HKFRS)		
HKFRS 9 <u>Financial Instruments</u>	Discard the existing HKFRS 9 and replace with revised HKFRS 9.	Additions to HKFRS 9—Note

Note:

Additions to HKFRS 9 *Financial Instruments* prescribe requirements on the accounting for financial liabilities. These requirements will be added to the Standard and complete the classification and measurement phase of the project to replace HKAS 39 *Financial Instruments: Recognition and Measurement*.

The new requirements address the problem of volatility in profit or loss arising from an issuer choosing to measure its own debt at fair value. This is often referred to as the 'own credit' problem.

With the new requirements, an entity choosing to measure a liability at fair value will present the portion of the change in its fair value due to changes in the entity's own credit risk in the other comprehensive income section of the income statement, rather than within profit or loss.

HKFRS 9 applies to financial statements for annual periods beginning on or after 1 January 2013. Entities are permitted to apply the new requirements in earlier periods, however, if they do, they must also apply the requirements in HKFRS 9 that relate to financial assets.



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HKFRS 9
~~Issued November 2009~~ Revised November 2010

Effective for annual periods
beginning on or after 1 January 2013

Hong Kong Financial Reporting Standard 9

Financial Instruments



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Hong Kong Financial Reporting Standard 9 *Financial Instruments* (HKFRS 9) is set out in paragraphs 1.1–7.3.2 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Terms defined in Appendix A are in *italics* the first time they appear in the HKFRS. HKFRS 9 should be read in the context of its objective and the Basis for Conclusions, the *Preface to Hong Kong Financial Reporting Standards* and the *Framework for the Preparation and Presentation of Financial Statements*. HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

Introduction

Reasons for issuing the HKFRS

- IN1 The objective of Hong Kong Institute of Certified Public Accountants (HKICPA) issuing HKFRS 9 is to maintain international convergence with the International Accounting Standards Board (IASB) further to its issuance of IFRS 9.
- IN2 HKAS 39 *Financial Instruments: Recognition and Measurement* sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Many users of financial statements and other interested parties have expressed that the requirements in HKAS 39 are difficult to understand, apply and interpret. They have urged the development of a new standard for financial reporting for financial instruments that is principle-based and less complex. Although HKAS 39 has been amended several times to clarify requirements, add guidance and eliminate internal inconsistencies, it has not previously undertaken a fundamental reconsideration of reporting for financial instruments.
- IN3 Since 2005, the IASB and the US Financial Accounting Standards Board (FASB) have had a long-term objective to improve and simplify the reporting for financial instruments. This work resulted in the publication of a discussion paper, *Reducing Complexity in Reporting Financial Instruments*, in March 2008. Focusing on the measurement of financial instruments and hedge accounting, the paper identified several possible approaches for improving and simplifying the accounting for financial instruments. The responses to the paper indicated support for a significant change in the requirements for reporting financial instruments. In November 2008 the IASB added this project to its active agenda, and in December 2008 the FASB also added the project to its agenda.
- IN4 In April 2009, in response to the input received on its work responding to the financial crisis, and following the conclusions of the G20 leaders and the recommendations of international bodies such as the Financial Stability Board, the IASB announced an accelerated timetable for replacing IAS 39. As a result, in July 2009 the IASB published an exposure draft *Financial Instruments: Classification and Measurement*, followed by IFRS 9 *Financial Instruments* in November 2009.

Approach to replacing HKAS 39

- IN5 It is intended that HKFRS 9 will ultimately replace HKAS 39 in its entirety. However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the project to replace HKAS 39 is divided into three main phases. As each phase is completed, the relevant portions of HKAS 39 will be deleted and chapters in HKFRS 9 will be created to replace the requirements in HKAS 39.
- IN6 The three main phases of the project to replace HKAS 39 are:
- (a) **Phase 1: Classification and measurement of financial assets and financial liabilities.** In November 2009 the chapters of HKFRS 9 relating to the classification and measurement of financial assets were issued. Those chapters require all financial assets to be classified on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset. Assets are initially measured at fair value plus, in the case of a financial asset not at fair value through profit or loss, particular transaction costs. Assets are subsequently measured at amortised cost or fair value. In November 2010 the requirements related to the classification and measurement of financial liabilities were added to HKFRS 9. Those additional requirements are described further in paragraph IN7.

- (b) **Phase 2: Impairment methodology.** In June 2009 the IASB published a Request for Information on the feasibility of an expected loss model for the impairment of financial assets. This formed the basis of an exposure draft, *Financial Instruments: Amortised Cost and Impairment*, published in November 2009. The IASB also set up a panel of credit and risk experts to consider and advise on the operational issues arising from an expected cash flow approach. The IASB is redeliberating the proposals in the exposure draft to address the comments received from respondents, and suggestions from the expert advisory panel and other outreach activities.
- (c) **Phase 3: Hedge accounting.** The IASB is considering how to improve and simplify the hedge accounting requirements of IAS 39. It expects to publish proposals for a comprehensive new approach before the end of 2010.

IN7 In November 2010 the requirements for classification and measurement of financial liabilities were added to HKFRS 9:

- (a) Most of the requirements in HKAS 39 for classification and measurement of financial liabilities were carried forward unchanged to HKFRS 9. Under HKAS 39 most liabilities were subsequently measured at amortised cost or bifurcated into a host, which is measured at amortised cost, and an embedded derivative, which is measured at fair value. Liabilities that are held for trading (including all derivative liabilities) were measured at fair value. Although a symmetrical approach for financial assets and financial liabilities had been proposed in the exposure draft published in 2009, it is decided to retain most of the requirements in HKAS 39 for classifying and measuring financial liabilities because constituents told that those requirements were working well in practice. Consistently with its objective to replace HKAS 39 in its entirety, those requirements from HKAS 39 are relocated to HKFRS 9.
- (b) Consistently with the requirements in HKFRS 9 for investments in unquoted equity instruments (and derivative assets linked to those investments), the exception from fair value measurement was eliminated for derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument. Under HKAS 39, if those derivatives were not reliably measurable, they were required to be measured at cost. HKFRS 9 requires them to be measured at fair value.
- (c) The requirements related to the fair value option for financial liabilities were changed to address own credit risk. Those improvements respond to consistent feedback from users of financial statements and others that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. The improvements followed from the proposals published in May 2010 in the exposure draft *Fair Value Option for Financial Liabilities*.

IN8 In addition to the three phases described above, the IASB published in March 2009 an exposure draft *Derecognition* (proposed amendments to IAS 39 and IFRS 7 *Financial Instruments: Disclosures*). However, in June 2010 the IASB revised its strategy and work plan and decided to retain the existing requirements in IAS 39 for the derecognition of financial assets and financial liabilities but to finalise improved disclosure requirements. The new requirements were issued by the HKICPA in October 2010 as an amendment to HKFRS 7 and have an effective date of 1 July 2011 in accordance with the HKICPA convergence policy. Later in November 2010 the requirements in HKAS 39 related to the derecognition of financial assets and financial liabilities were carried forward unchanged to HKFRS 9.

- IN9 As a result of the added requirements described in paragraphs IN7 and IN8, HKFRS 9 and its Basis for Conclusions were restructured. Many paragraphs were renumbered and some were re-sequenced. New paragraphs were added to accommodate the guidance that was carried forward unchanged from HKAS 39. Also, new sections were added to HKFRS 9 as placeholders for the guidance that will result from subsequent phases of this project. Otherwise, the restructuring did not change the requirements in HKFRS 9 issued in 2009. The Basis for Conclusions on HKFRS 9 has been expanded to include material from the Basis for Conclusions on HKAS 39 that discusses guidance that was carried forward without being reconsidered. Minor necessary edits have been made to that material.
- IN10 The IASB and the FASB are committed to achieving increased comparability internationally in the accounting for financial instruments. However, those efforts have been complicated by the differing project timetables established to respond to the respective stakeholder groups. In May 2010 the FASB published a proposed Accounting Standards Update (ASU) on accounting for financial instruments that contained proposals for a new comprehensive standard on financial instruments, including proposals on the classification and measurement of financial assets and financial liabilities, impairment methodology and hedge accounting. The proposed ASU had a comment deadline of 30 September 2010 and the FASB has begun to redeliberate its proposals. The IASB asked its constituents to provide feedback to the FASB on the proposals in the FASB's exposure draft because this is a joint project with an objective of increasing international comparability. Feedback from IFRS constituents will be helpful to the FASB as it redeliberates its proposals. Moreover, after the FASB redeliberates its proposals, the IASB will use that feedback to consider what steps (if any) should be taken to reconcile any remaining differences between IFRSs and US GAAP. Any possible changes as a result of that comparison will be subject to the IASB's normal due process.

Hong Kong Financial Reporting Standard 9

Financial Instruments

Chapter 1 Objective

- 1.1 The objective of this HKFRS is to establish principles for the financial reporting of *financial assets* and *financial liabilities* that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.

Chapter 2 Scope

- 2.1 An entity shall apply this HKFRS to all items within the scope of HKAS 39 *Financial Instruments: Recognition and Measurement*.

Chapter 3 Recognition and derecognition

3.1 Initial recognition

- 3.1.1 An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument (see paragraphs B3.1.1 and B3.1.2). When an entity first recognises a financial asset, it shall classify it in accordance with paragraphs 4.1.1–4.1.5 and measure it in accordance with paragraphs 5.1.1 and 5.1.2. When an entity first recognises a financial liability, it shall classify it in accordance with paragraphs 4.2.1 and 4.2.2 and measure it in accordance with paragraph 5.1.1.

Regular way purchase or sale of financial assets

- 3.1.2 A *regular way purchase or sale* of financial assets shall be recognised and derecognised, as applicable, using trade date accounting or settlement date accounting (see paragraphs B3.1.3–B3.1.6).

3.2 Derecognition of financial assets

- 3.2.1 In consolidated financial statements, paragraphs 3.2.2–3.2.9, B3.1.1, B3.1.2 and B3.2.1–B3.2.17 are applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with HKAS 27 *Consolidated and Separate Financial Statements* and HK(SIC)-Int12 *Consolidation—Special Purpose Entities* and then applies paragraphs 3.2.2–3.2.9, B3.1.1, B3.1.2 and B3.2.1–B3.2.17 to the resulting group.
- 3.2.2 Before evaluating whether, and to what extent, *derecognition* is appropriate under paragraphs 3.2.3–3.2.9, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.
- (a) Paragraphs 3.2.3–3.2.9 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

- (i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 3.2.3–3.2.9 are applied to the interest cash flows.
 - (ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 3.2.3–3.2.9 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.
 - (iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 3.2.3–3.2.9 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.
- (b) In all other cases, paragraphs 3.2.3–3.2.9 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 3.2.3–3.2.9 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 3.2.3–3.2.12, the term ‘financial asset’ refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.

3.2.3 An entity shall derecognise a financial asset when, and only when:

- (a) the contractual rights to the cash flows from the financial asset expire, or
- (b) it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6.

(See paragraph 3.1.2 for regular way sales of financial assets.)

3.2.4 An entity transfers a financial asset if, and only if, it either:

- (a) transfers the contractual rights to receive the cash flows of the financial asset, or

- (b) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 3.2.5.

3.2.5 When an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if, all of the following three conditions are met.

- (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.
- (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
- (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except for investments in cash or cash equivalents (as defined in HKAS 7 *Statement of Cash Flows*) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.

3.2.6 When an entity transfers a financial asset (see paragraph 3.2.4), it shall evaluate the extent to which it retains the risks and rewards of ownership of the financial asset. In this case:

- (a) if the entity transfers substantially all the risks and rewards of ownership of the financial asset, the entity shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.
- (b) if the entity retains substantially all the risks and rewards of ownership of the financial asset, the entity shall continue to recognise the financial asset.
- (c) if the entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset, the entity shall determine whether it has retained control of the financial asset. In this case:
 - (i) if the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer.
 - (ii) if the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset (see paragraph 3.2.16).

- 3.2.7 The transfer of risks and rewards (see paragraph 3.2.6) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset. An entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (eg because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset (eg because the entity has sold a financial asset subject only to an option to buy it back at its *fair value* at the time of repurchase or has transferred a fully proportionate share of the cash flows from a larger financial asset in an arrangement, such as a loan sub-participation, that meets the conditions in paragraph 3.2.5).
- 3.2.8 Often it will be obvious whether the entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computations. In other cases, it will be necessary to compute and compare the entity's exposure to the variability in the present value of the future net cash flows before and after the transfer. The computation and comparison are made using as the discount rate an appropriate current market interest rate. All reasonably possible variability in net cash flows is considered, with greater weight being given to those outcomes that are more likely to occur.
- 3.2.9 Whether the entity has retained control (see paragraph 3.2.6(c)) of the transferred asset depends on the transferee's ability to sell the asset. If the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer, the entity has not retained control. In all other cases, the entity has retained control.

Transfers that qualify for derecognition

- 3.2.10 **If an entity transfers a financial asset in a transfer that qualifies for derecognition in its entirety and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised for the servicing right at an amount determined on the basis of an allocation of the carrying amount of the larger financial asset in accordance with paragraph 3.2.13.**
- 3.2.11 **If, as a result of a transfer, a financial asset is derecognised in its entirety but the transfer results in the entity obtaining a new financial asset or assuming a new financial liability, or a servicing liability, the entity shall recognise the new financial asset, financial liability or servicing liability at fair value.**
- 3.2.12 **On derecognition of a financial asset in its entirety, the difference between:**
- (a) **the carrying amount (measured at the date of derecognition) and**
 - (b) **the consideration received (including any new asset obtained less any new liability assumed)**
- shall be recognised in profit or loss.**

3.2.13 If the transferred asset is part of a larger financial asset (eg when an entity transfers interest cash flows that are part of a debt instrument, see paragraph 3.2.2(a)) and the part transferred qualifies for derecognition in its entirety, the previous carrying amount of the larger financial asset shall be allocated between the part that continues to be recognised and the part that is derecognised, on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, a retained servicing asset shall be treated as a part that continues to be recognised. The difference between:

- (a) the carrying amount (measured at the date of derecognition) allocated to the part derecognised and
- (b) the consideration received for the part derecognised (including any new asset obtained less any new liability assumed)

shall be recognised in profit or loss.

3.2.14 When an entity allocates the previous carrying amount of a larger financial asset between the part that continues to be recognised and the part that is derecognised, the fair value of the part that continues to be recognised needs to be determined. When the entity has a history of selling parts similar to the part that continues to be recognised or other market transactions exist for such parts, recent prices of actual transactions provide the best estimate of its fair value. When there are no price quotes or recent market transactions to support the fair value of the part that continues to be recognised, the best estimate of the fair value is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part that is derecognised.

Transfers that do not qualify for derecognition

3.2.15 If a transfer does not result in derecognition because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.

Continuing involvement in transferred assets

3.2.16 If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity's continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:

- (a) When the entity's continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity's continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').
- (b) When the entity's continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity's continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in the case of a written put option on an asset that is measured at fair value, the extent of the entity's continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph B3.2.13).

- (c) When the entity's continuing involvement takes the form of a cashsettled option or similar provision on the transferred asset, the extent of the entity's continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.

3.2.17 When an entity continues to recognise an asset to the extent of its continuing involvement, the entity also recognises an associated liability. Despite the other measurement requirements in this HKFRS, the transferred asset and the associated liability are measured on a basis that reflects the rights and obligations that the entity has retained. The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is:

- (a) the *amortised cost* of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost, or
- (b) equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.

3.2.18 The entity shall continue to recognise any income arising on the transferred asset to the extent of its continuing involvement and shall recognise any expense incurred on the associated liability.

3.2.19 For the purpose of subsequent measurement, recognised changes in the fair value of the transferred asset and the associated liability are accounted for consistently with each other in accordance with paragraph 5.7.1, and shall not be offset.

3.2.20 If an entity's continuing involvement is in only a part of a financial asset (eg when an entity retains an option to repurchase part of a transferred asset, or retains a residual interest that does not result in the retention of substantially all the risks and rewards of ownership and the entity retains control), the entity allocates the previous carrying amount of the financial asset between the part it continues to recognise under continuing involvement, and the part it no longer recognises on the basis of the relative fair values of those parts on the date of the transfer. For this purpose, the requirements of paragraph 3.2.14 apply. The difference between:

- (a) the carrying amount (measured at the date of derecognition) allocated to the part that is no longer recognised and
- (b) the consideration received for the part no longer recognised

shall be recognised in profit or loss.

3.2.21 If the transferred asset is measured at amortised cost, the option in this HKFRS to designate a financial liability as at fair value through profit or loss is not applicable to the associated liability.

All transfers

- 3.2.22** If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability (see HKAS 32 *Financial Instruments: Presentation* paragraph 42).
- 3.2.23** If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or repledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:
- (a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (eg as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.
 - (b) If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.
 - (c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.
 - (d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.

3.3 Derecognition of financial liabilities

- 3.3.1** An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires.
- 3.3.2** An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.
- 3.3.3** The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

- 3.3.4 If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any noncash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.

Chapter 4 Classification

4.1 Classification of financial assets

- 4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:
- (a) the entity's business model for managing the financial assets and
 - (b) the contractual cash flow characteristics of the financial asset.
- 4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:
- (a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
 - (b) 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.

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

- 4.1.3 For the purpose of applying paragraph 4.1.2(b), interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.
- 4.1.4 A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with paragraph 4.1.2.

Option to designate a financial asset at fair value through profit or loss

- 4.1.5 Despite paragraphs 4.1.1–4.1.4, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32).
- 4.1.6 HKFRS 7 *Financial Instruments: Disclosures* requires the entity to provide disclosures about financial assets it has designated as at fair value through profit or loss.

4.2 Classification of financial liabilities

4.2.1 An entity shall classify all financial liabilities as subsequently measured at amortised cost using the *effective interest method*, except for:

- (a) *financial liabilities at fair value through profit or loss*. Such liabilities, including *derivatives* that are liabilities, shall be subsequently measured at fair value.
- (b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies. Paragraphs 3.2.15 and 3.2.17 apply to the measurement of such financial liabilities.
- (c) *financial guarantee contracts* as defined in Appendix A. After initial recognition, an issuer of such a contract shall (unless paragraph 4.2.1(a) or (b) applies) subsequently measure it at the higher of:
 - (i) the amount determined in accordance with HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and
 - (ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, cumulative amortisation recognised in accordance with HKAS 18 *Revenue*.
- (d) commitments to provide a loan at a below-market interest rate. After initial recognition, an issuer of such a commitment shall (unless paragraph 4.2.1(a) applies) subsequently measure it at the higher of:
 - (i) the amount determined in accordance with HKAS 37 and
 - (ii) the amount initially recognised (see paragraph 5.1.1) less, when appropriate, cumulative amortisation recognised in accordance with HKAS 18.

Option to designate a financial liability at fair value through profit or loss

4.2.2 An entity may, at initial recognition, irrevocably designate a financial liability as measured at fair value through profit or loss when permitted by paragraph 4.3.5, or when doing so results in more relevant information, because either

- (a) it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as ‘an accounting mismatch’) that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- (b) a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in HKAS 24 *Related Party Disclosures*), for example the entity’s board of directors and chief executive officer.

- 4.2.3 HKFRS 7 requires the entity to provide disclosures about financial liabilities it has designated as at fair value through profit or loss.

4.3 Embedded derivatives

- 4.3.1 An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract. A derivative that is attached to a *financial instrument* but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

Hybrid contracts with financial asset hosts

- 4.3.2 If a hybrid contract contains a host that is an asset within the scope of this HKFRS, an entity shall apply the requirements in paragraphs 4.1.1–4.1.5 to the entire hybrid contract.

Other hybrid contracts

- 4.3.3 If a hybrid contract contains a host that is not an asset within the scope of this HKFRS, an embedded derivative shall be separated from the host and accounted for as a derivative under this HKFRS if, and only if:
- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host (see paragraphs B4.3.5 and B4.3.8);
 - (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
 - (c) the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (ie a derivative that is embedded in a financial liability at fair value through profit or loss is not separated).
- 4.3.4 If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate HKFRSs. This HKFRS does not address whether an embedded derivative shall be presented separately in the statement of financial position.
- 4.3.5 Despite paragraphs 4.3.3 and 4.3.4, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of this HKFRS, an entity may designate the entire hybrid contract as at fair value through profit or loss unless:
- (a) the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract; or

- (b) it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited, such as a prepayment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost.

4.3.6 If an entity is required by this HKFRS to separate an embedded derivative from its host, but is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period, it shall designate the entire hybrid contract as at fair value through profit or loss.

4.3.7 If an entity is unable to determine reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative is the difference between the fair value of the hybrid contract and the fair value of the host, if those can be determined under this HKFRS. If the entity is unable to determine the fair value of the embedded derivative using this method, paragraph 4.3.6 applies and the hybrid contract is designated as at fair value through profit or loss.

4.4 Reclassification

4.4.1 When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets in accordance with paragraphs 4.1.1–4.1.4.

4.4.2 An entity shall not reclassify any financial liability.

4.4.3 The following changes in circumstances are not reclassifications for the purposes of paragraphs 4.4.1 and 4.4.2:

- (a) A derivative that was previously a designated and effective *hedging instrument* in a cash flow hedge or net investment hedge no longer qualifies as such.

- (a) A derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge.

Chapter 5 Measurement

5.1 Initial measurement

5.1.1 At initial recognition, an entity shall measure a financial asset or financial liability at its fair value (see paragraphs 5.4.1–5.4.3 and B5.4.1–B5.4.17) plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, *transaction costs* that are directly attributable to the acquisition or issue of the financial asset or financial liability.

5.1.2 When an entity uses settlement date accounting for an asset that is subsequently measured at amortised cost, the asset is recognised initially at its fair value on the trade date (see paragraphs B3.1.3–B3.1.6).

5.2 Subsequent measurement of financial assets

- 5.2.1 After initial recognition, an entity shall measure a financial asset in accordance with paragraphs 4.1.1–4.1.5 at fair value (see paragraphs 5.4.1, 5.4.2 and B5.4.1–B5.4.17) or amortised cost (see paragraphs 9 and AG5–AG8 of HKAS 39).
- 5.2.2 An entity shall apply the impairment requirements in paragraphs 58–65 and AG84–AG93 of HKAS 39 to financial assets measured at amortised cost.
- 5.2.3 An entity shall apply the hedge accounting requirements in paragraphs 89–102 of HKAS 39 to a financial asset that is designated as a *hedged item* (see paragraphs 78–84 and AG98–AG101 of HKAS 39).

5.3 Subsequent measurement of financial liabilities

- 5.3.1 After initial recognition, an entity shall measure a financial liability in accordance with paragraphs 4.2.1–4.2.2 (see paragraphs 5.4.1–5.4.3 and B5.4.1–B5.4.17 and paragraphs 9 and AG5–AG8 of HKAS 39).
- 5.3.2 An entity shall apply the hedge accounting requirements in paragraphs 89–102 of HKAS 39 to a financial liability that is designated as a hedged item (see paragraphs 78–84 and AG98–AG101 of HKAS 39).

5.4 Fair value measurement

- 5.4.1 In determining the fair value of a financial asset or a financial liability for the purpose of applying this HKFRS, HKAS 32, HKAS 39 or HKFRS 7, an entity shall apply paragraphs B5.4.1–B5.4.17.
- 5.4.2 The best evidence of fair value is quoted prices in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique. The chosen valuation technique makes maximum use of market inputs and relies as little as possible on entity-specific inputs. It incorporates all factors that market participants would consider in setting a price and is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data.
- 5.4.3 The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid.

5.5 Amortised cost measurement – *not used*

5.6 Reclassification of financial assets

- 5.6.1 If an entity reclassifies financial assets in accordance with paragraph 4.4.1, it shall apply the reclassification prospectively from the *reclassification date*. The entity shall not restate any previously recognised gains, losses or interest.
- 5.6.2 If, in accordance with paragraph 4.4.1, an entity reclassifies a financial asset so that it is measured at fair value, its fair value is determined at the reclassification date. Any gain or loss arising from a difference between the previous carrying amount and fair value is recognised in profit or loss.
- 5.6.3 If, in accordance with paragraph 4.4.1, an entity reclassifies a financial asset so that it is measured at amortised cost, its fair value at the reclassification date becomes its new carrying amount.

5.7 Gains and losses

- 5.7.1 A gain or loss on a financial asset or financial liability that is measured at fair value shall be recognised in profit or loss unless:
- (a) it is part of a hedging relationship (see paragraphs 89-102 of HKAS 39);
 - (b) it is an investment in an *equity instrument* and the entity has elected to present gains and losses on that investment in other comprehensive income in accordance with paragraph 5.7.5; or
 - (c) it is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's *credit risk* in other comprehensive income in accordance with paragraph 5.7.7.
- 5.7.2 A gain or loss on a financial asset that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 89–102 of HKAS 39) shall be recognised in profit or loss when the financial asset is derecognised, impaired or reclassified in accordance with paragraph 5.6.2, and through the amortisation process. A gain or loss on a financial liability that is measured at amortised cost and is not part of a hedging relationship (see paragraphs 89–102 of HKAS 39) shall be recognised in profit or loss when the financial liability is derecognised and through the amortisation process.
- 5.7.3 A gain or loss on financial assets or financial liabilities that are hedged items (see paragraphs 78–84 and AG98–AG101 of HKAS 39) shall be recognised in accordance with paragraphs 89–102 of HKAS 39.
- 5.7.4 If an entity recognises financial assets using settlement date accounting (see paragraph 3.1.2 and paragraphs B3.1.3 and B3.1.6), any change in the fair value of the asset to be received during the period between the trade date and the settlement date is not recognised for assets measured at amortised cost (other than impairment losses). For assets measured at fair value, however, the change in fair value shall be recognised in profit or loss or in other comprehensive income, as appropriate under paragraph 5.7.1.

Investments in equity instruments

- 5.7.5** At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this HKFRS that is not *held for trading*.
- 5.7.6** If an entity makes the election in paragraph 5.7.5, it shall recognise in profit or loss dividends from that investment when the entity's right to receive payment of the dividend is established in accordance with HKAS 18.

Liabilities designated as at fair value through profit or loss

- 5.7.7** An entity shall present a gain or loss on a financial liability designated as at fair value through profit or loss as follows:
- (a) The amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability shall be presented in other comprehensive income (see paragraphs B5.7.13–B5.7.20), and
 - (b) the remaining amount of change in the fair value of the liability shall be presented in profit or loss

unless the treatment of the effects of changes in the liability's credit risk described in (a) would create or enlarge an accounting mismatch in profit or loss (in which case paragraph 5.7.8 applies). Paragraphs B5.7.5–B5.7.7 and B5.7.10–B5.7.12 provide guidance on determining whether an accounting mismatch would be created or enlarged.

- 5.7.8** If the requirements in paragraph 5.7.7 would create or enlarge an accounting mismatch in profit or loss, an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.
- 5.7.9** Despite the requirements in paragraphs 5.7.7 and 5.7.8, an entity shall present in profit or loss all gains and losses on loan commitments and financial guarantee contracts that are designated as at fair value through profit or loss.

Chapter 6 Hedge accounting – *not used*

Chapter 7 Effective date and transition

7.1 Effective date

- 7.1.1** An entity shall apply this HKFRS for annual periods beginning on or after 1 January 2013. Earlier application is permitted. However, if an entity elects to apply this HKFRS early and has not already applied HKFRS 9 issued in 2009, it must apply all of the requirements in this HKFRS at the same time (but see also paragraph 7.3.2). If an entity applies this HKFRS in its financial statements for a period beginning before 1 January 2013, it shall disclose that fact and at the same time apply the amendments in Appendix C.

7.2 Transition

- 7.2.1 An entity shall apply this HKFRS retrospectively, in accordance with HKAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, except as specified in paragraphs 7.2.4–7.2.15. This HKFRS shall not be applied to items that have already been derecognised at the date of initial application.
- 7.2.2 For the purposes of the transition provisions in paragraphs 7.2.1 and 7.2.3–7.2.16, the date of initial application is the date when an entity first applies the requirements of this HKFRS. The date of initial application may be:
- (a) any date between the issue of this HKFRS and 31 December 2010, for entities initially applying this HKFRS before 1 January 2011; or
 - (b) the beginning of the first reporting period in which the entity adopts this HKFRS, for entities initially applying this HKFRS on or after 1 January 2011.
- 7.2.3 If the date of initial application is not at the beginning of a reporting period, the entity shall disclose that fact and the reasons for using that date of initial application.
- 7.2.4 At the date of initial application, an entity shall assess whether a financial asset meets the condition in paragraph 4.1.2(a) on the basis of the facts and circumstances that exist at the date of initial application. The resulting classification shall be applied retrospectively irrespective of the entity's business model in prior reporting periods.
- 7.2.5 If an entity measures a hybrid contract at fair value in accordance with paragraph 4.1.4 or paragraph 4.1.5 but the fair value of the hybrid contract had not been determined in comparative reporting periods, the fair value of the hybrid contract in the comparative reporting periods shall be the sum of the fair values of the components (ie the non-derivative host and the embedded derivative) at the end of each comparative reporting period.
- 7.2.6 At the date of initial application, an entity shall recognise any difference between the fair value of the entire hybrid contract at the date of initial application and the sum of the fair values of the components of the hybrid contract at the date of initial application:
- (a) in the opening retained earnings of the reporting period of initial application if the entity initially applies this HKFRS at the beginning of a reporting period, or
 - (b) in profit or loss if the entity initially applies this HKFRS during a reporting period.
- 7.2.7 At the date of initial application, an entity may designate:
- (a) a financial asset as measured at fair value through profit or loss in accordance with paragraph 4.1.5, or
 - (b) an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5.

Such designation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

- 7.2.8 At the date of initial application, an entity:

- (a) shall revoke its previous designation of a financial asset as measured at fair value through profit or loss if that financial asset does not meet the condition in paragraph 4.1.5.
- (b) may revoke its previous designation of a financial asset as measured at fair value through profit or loss if that financial asset meets the condition in paragraph 4.1.5.

Such revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

7.2.9 At the date of initial application, an entity:

- (a) may designate a financial liability as measured at fair value through profit or loss in accordance with paragraph 4.2.2(a).
- (b) shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if such designation was made at initial recognition in accordance with the condition now in paragraph 4.2.2(a) and such designation does not satisfy that condition at the date of initial application.
- (c) may revoke its previous designation of a financial liability as measured at fair value through profit or loss if such designation was made at initial recognition in accordance with the condition now in paragraph 4.2.2(a) and such designation satisfies that condition at the date of initial application.

Such designation and revocation shall be made on the basis of the facts and circumstances that exist at the date of initial application. That classification shall be applied retrospectively.

7.2.10 If it is impracticable (as defined in HKAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58–65 and AG84–AG93 of HKAS 39, the entity shall treat the fair value of the financial asset at the end of each comparative period as its amortised cost. In those circumstances, the fair value of the financial asset at the date of initial application shall be treated as the new amortised cost of that financial asset at the date of initial application of this HKFRS.

7.2.11 If an entity previously accounted for an investment in an unquoted equity instrument (or a derivative asset that is linked to and must be settled by delivery of such an unquoted equity instrument) at cost in accordance with HKAS 39, it shall measure that instrument at fair value at the date of initial application. Any difference between the previous carrying amount and fair value shall be recognised in the opening retained earnings of the reporting period that includes the date of initial application.

7.2.12 If an entity previously accounted for a derivative liability that is linked to and must be settled by delivery of an unquoted equity instrument at cost in accordance with HKAS 39, it shall measure that derivative liability at fair value at the date of initial application. Any difference between the previous carrying amount and fair value shall be recognised in the opening retained earnings of the reporting period that includes the date of initial application.

7.2.13 At the date of initial application, an entity shall determine whether the treatment in paragraph 5.7.7 would create or enlarge an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of initial application. This HKFRS shall be applied retrospectively on the basis of that determination.

- 7.2.14 Despite the requirement in paragraph 7.2.1, an entity that adopts this HKFRS for reporting periods beginning before 1 January 2012 need not restate prior periods. If an entity does not restate prior periods, the entity shall recognise any difference between the previous carrying amount and the carrying amount at the beginning of the annual reporting period that includes the date of initial application in the opening retained earnings (or other component of equity, as appropriate) of the reporting period that includes the date of initial application. However, if an entity restates prior periods, the restated financial statements must reflect all of the requirements in this HKFRS.
- 7.2.15 If an entity prepares interim financial reports in accordance with HKAS 34 *Interim Financial Reporting* the entity need not apply the requirements in this HKFRS to interim periods prior to the date of initial application if it is impracticable (as defined in HKAS 8).

Entities that have applied early HKFRS 9 issued in 2009

- 7.2.16 An entity shall apply the transition requirements in paragraphs 7.2.1–7.2.15 at the relevant date of initial application. In other words, an entity shall apply paragraphs 7.2.4–7.2.11 if it applies HKFRS 9 (issued in 2009) or, not having done so, when it applies HKFRS 9 (issued in 2010) in its entirety. An entity is not permitted to apply those paragraphs more than once.

7.3 Withdrawal of HK(IFRIC)-Int 9 and HKFRS 9 (2009)

- 7.3.1 This HKFRS supersedes HK(IFRIC)-Int 9 *Reassessment of Embedded Derivatives*. The requirements added to HKFRS 9 in November 2010 incorporated the requirements previously set out in paragraphs 5 and 7 of HK(IFRIC)-Int 9. As a consequential amendment, HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards* incorporated the requirements previously set out in paragraph 8 of HK(IFRIC)-Int 9.
- 7.3.2 This HKFRS supersedes HKFRS 9 issued in 2009. However, for annual periods beginning before 1 January 2013, an entity may elect to apply HKFRS 9 issued in 2009 instead of applying this HKFRS.

Appendix A

Defined terms

This appendix is an integral part of the HKFRS.

derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.
derivative	<p>A financial instrument or other contract within the scope of this HKFRS (see paragraph 2.1) with all three of the following characteristics.</p> <p>(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').</p> <p>(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.</p> <p>(c) It is settled at a future date.</p>
fair value	The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.*
financial guarantee contract	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
financial liability at fair value through profit or loss	<p>A financial liability that meets either of the following conditions.</p> <p>(a) It meets the definition of held for trading.</p> <p>(b) Upon initial recognition it is designated by the entity as at fair value through profit or loss in accordance with paragraph 4.2.2 or 4.3.5.</p>

* Paragraphs 5.4.1–5.4.3 and B5.4.1–B5.4.17 contain requirements for determining the fair value of a financial asset or financial liability.

- held for trading** A financial asset or financial liability that:
- (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
 - (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

reclassification date The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.

regular way purchase or sale A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

The following terms are defined in paragraph 11 of HKAS 32, paragraph 9 of HKAS 39 or Appendix A of HKFRS 7 and are used in this HKFRS with the meanings specified in HKAS 32, HKAS 39 or HKFRS 7:

- (a) amortised cost of a financial asset or financial liability
- (b) credit risk
- (c) effective interest method
- (d) equity instrument
- (e) financial asset
- (f) financial instrument
- (g) financial liability
- (h) hedged item
- (i) hedging instrument
- (j) transaction costs.

Appendix B

Application guidance

This appendix is an integral part of the HKFRS.

Recognition and derecognition (chapter 3)

Initial recognition (section 3.1)

B3.1.1 As a consequence of the principle in paragraph 3.1.1, an entity recognises all of its contractual rights and obligations under derivatives in its statement of financial position as assets and liabilities, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph B3.2.14). If a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset (see paragraph B3.2.15).

B3.1.2 The following are examples of applying the principle in paragraph 3.1.1:

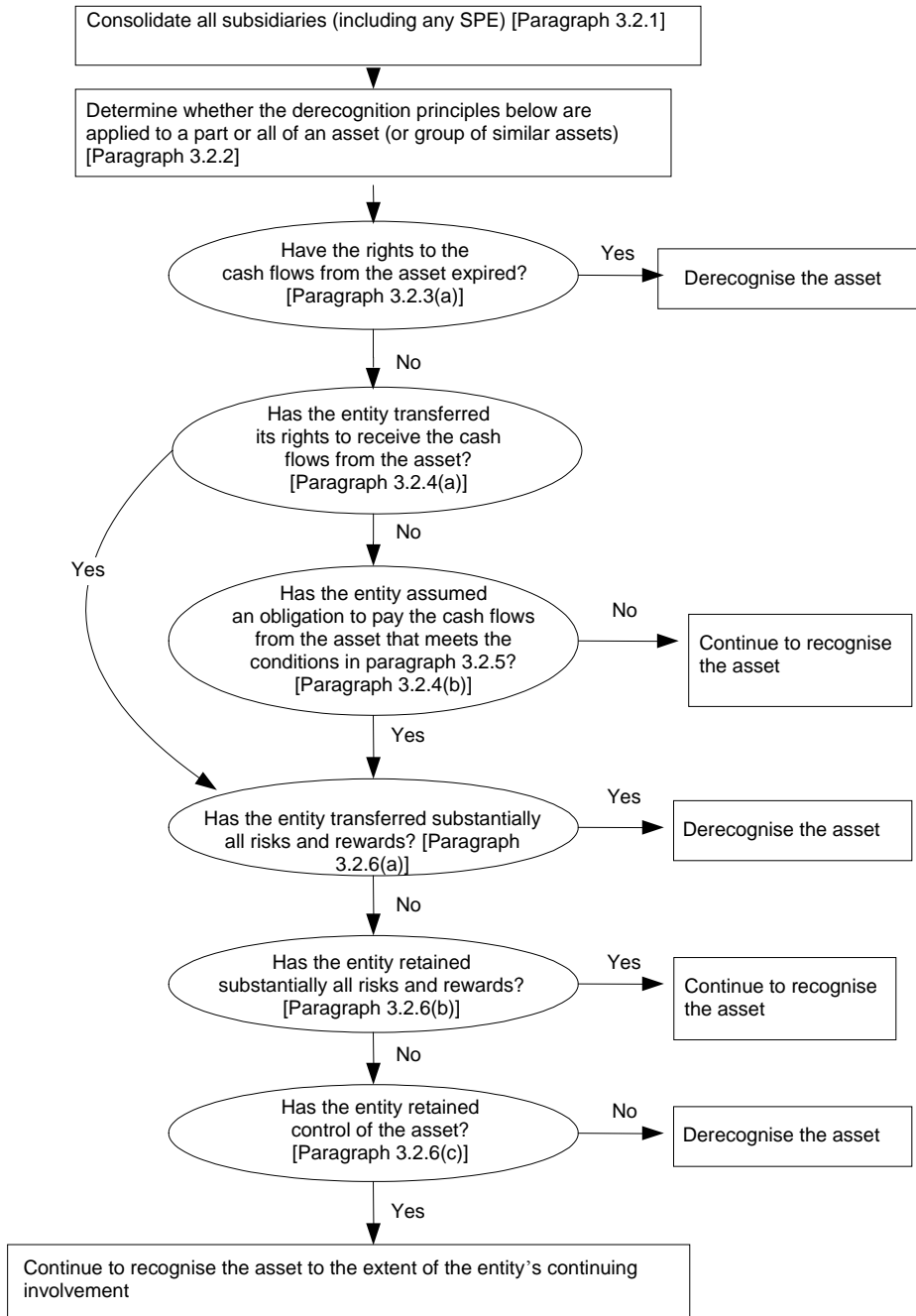
- (a) Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay cash.
- (b) Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not generally recognise an asset (and the entity that places the order does not recognise a liability) at the time of the commitment but, rather, delays recognition until the ordered goods or services have been shipped, delivered or rendered. If a firm commitment to buy or sell non-financial items is within the scope of this HKFRS in accordance with paragraphs 5–7 of HKAS 39, its net fair value is recognised as an asset or liability on the commitment date (see (c) below). In addition, if a previously unrecognised firm commitment is designated as a hedged item in a fair value hedge, any change in the net fair value attributable to the hedged risk is recognised as an asset or liability after the inception of the hedge (see paragraphs 93 and 94 of HKAS 39).
- (c) A forward contract that is within the scope of this HKFRS (see paragraph 2.1) is recognised as an asset or a liability on the commitment date, rather than on the date on which settlement takes place. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or liability.
- (d) Option contracts that are within the scope of this HKFRS (see paragraph 2.1) are recognised as assets or liabilities when the holder or writer becomes a party to the contract.
- (e) Planned future transactions, no matter how likely, are not assets and liabilities because the entity has not become a party to a contract.

Regular way purchase or sale of financial assets

- B3.1.3 A regular way purchase or sale of financial assets is recognised using either trade date accounting or settlement date accounting as described in paragraphs B3.1.5 and B3.1.6. An entity shall apply the same method consistently for all purchases and sales of financial assets that are classified in the same way in accordance with this HKFRS. For this purpose assets that are mandatorily measured at fair value through profit or loss form a separate classification from assets designated as measured at fair value through profit or loss. In addition, investments in equity instruments accounted for using the option provided in paragraph 5.7.5 form a separate classification.
- B3.1.4 A contract that requires or permits net settlement of the change in the value of the contract is not a regular way contract. Instead, such a contract is accounted for as a derivative in the period between the trade date and the settlement date.
- B3.1.5 The trade date is the date that an entity commits itself to purchase or sell an asset. Trade date accounting refers to (a) the recognition of an asset to be received and the liability to pay for it on the trade date, and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date when title passes.
- B3.1.6 The settlement date is the date that an asset is delivered to or by an entity. Settlement date accounting refers to (a) the recognition of an asset on the day it is received by the entity, and (b) the derecognition of an asset and recognition of any gain or loss on disposal on the day that it is delivered by the entity. When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognised for assets measured at amortised cost; it is recognised in profit or loss for assets classified as financial assets measured at fair value through profit or loss; and it is recognised in other comprehensive income for investments in equity instruments accounted for in accordance with paragraph 5.7.5.

Derecognition of financial assets (section 3.2)

- B3.2.1 The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients (paragraph 3.2.4(b))

B3.2.2 The situation described in paragraph 3.2.4(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a special purpose entity or trust, and issues to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 3.2.5 and 3.2.6 are met.

B3.2.3 In applying paragraph 3.2.5, the entity could be, for example, the originator of the financial asset, or it could be a group that includes a consolidated special purpose entity that has acquired the financial asset and passes on cash flows to unrelated third party investors.

Evaluation of the transfer of risks and rewards of ownership (paragraph 3.2.6)

B3.2.4 Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

- (a) an unconditional sale of a financial asset;
- (b) a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase; and
- (c) a sale of a financial asset together with a put or call option that is deeply out of the money (ie an option that is so far out of the money it is highly unlikely to go into the money before expiry).

B3.2.5 Examples of when an entity has retained substantially all the risks and rewards of ownership are:

- (a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
- (b) a securities lending agreement;
- (c) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity;
- (d) a sale of a financial asset together with a deep in-the-money put or call option (ie an option that is so far in the money that it is highly unlikely to go out of the money before expiry); and
- (e) a sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

B3.2.6 If an entity determines that as a result of the transfer, it has transferred substantially all the risks and rewards of ownership of the transferred asset, it does not recognise the transferred asset again in a future period, unless it reacquires the transferred asset in a new transaction.

Evaluation of the transfer of control

- B3.2.7 An entity has not retained control of a transferred asset if the transferee has the practical ability to sell the transferred asset. An entity has retained control of a transferred asset if the transferee does not have the practical ability to sell the transferred asset. A transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase the transferred asset in the market if it needs to return the asset to the entity. For example, a transferee may have the practical ability to sell a transferred asset if the transferred asset is subject to an option that allows the entity to repurchase it, but the transferee can readily obtain the transferred asset in the market if the option is exercised. A transferee does not have the practical ability to sell the transferred asset if the entity retains such an option and the transferee cannot readily obtain the transferred asset in the market if the entity exercises its option.
- B3.2.8 The transferee has the practical ability to sell the transferred asset only if the transferee can sell the transferred asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without imposing additional restrictions on the transfer. The critical question is what the transferee is able to do in practice, not what contractual rights the transferee has concerning what it can do with the transferred asset or what contractual prohibitions exist. In particular:
- (a) a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset, and
 - (b) an ability to dispose of the transferred asset has little practical effect if it cannot be exercised freely. For that reason:
 - (i) the transferee's ability to dispose of the transferred asset must be independent of the actions of others (ie it must be a unilateral ability), and
 - (ii) the transferee must be able to dispose of the transferred asset without needing to attach restrictive conditions or 'strings' to the transfer (eg conditions about how a loan asset is serviced or an option giving the transferee the right to repurchase the asset).
- B3.2.9 That the transferee is unlikely to sell the transferred asset does not, of itself, mean that the transferor has retained control of the transferred asset. However, if a put option or guarantee constrains the transferee from selling the transferred asset, then the transferor has retained control of the transferred asset. For example, if a put option or guarantee is sufficiently valuable it constrains the transferee from selling the transferred asset because the transferee would, in practice, not sell the transferred asset to a third party without attaching a similar option or other restrictive conditions. Instead, the transferee would hold the transferred asset so as to obtain payments under the guarantee or put option. Under these circumstances the transferor has retained control of the transferred asset.

Transfers that qualify for derecognition

- B3.2.10 An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up upon termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 3.2.13, the fair values of the servicing asset and interest-only strip receivable are used to allocate the

carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If there is no servicing fee specified or the fee to be received is not expected to compensate the entity adequately for performing the servicing, a liability for the servicing obligation is recognised at fair value.

B3.2.11 In estimating the fair values of the part that continues to be recognised and the part that is derecognised for the purposes of applying paragraph 3.2.13, an entity applies the fair value measurement requirements in paragraphs 5.4.1–5.4.3 and B5.4.1–B5.4.13 in addition to paragraph 3.2.14.

Transfers that do not qualify for derecognition

B3.2.12 The following is an application of the principle outlined in paragraph 3.2.15. If a guarantee provided by the entity for default losses on the transferred asset prevents a transferred asset from being derecognised because the entity has retained substantially all the risks and rewards of ownership of the transferred asset, the transferred asset continues to be recognised in its entirety and the consideration received is recognised as a liability.

Continuing involvement in transferred assets

B3.2.13 The following are examples of how an entity measures a transferred asset and the associated liability under paragraph 3.2.16.

All assets

- (a) If a guarantee provided by an entity to pay for default losses on a transferred asset prevents the transferred asset from being derecognised to the extent of the continuing involvement, the transferred asset at the date of the transfer is measured at the lower of (i) the carrying amount of the asset and (ii) the maximum amount of the consideration received in the transfer that the entity could be required to repay ('the guarantee amount'). The associated liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). Subsequently, the initial fair value of the guarantee is recognised in profit or loss on a time proportion basis (see HKAS 18) and the carrying value of the asset is reduced by any impairment losses.

Assets measured at amortised cost

- (b) If a put option obligation written by an entity or call option right held by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at amortised cost, the associated liability is measured at its cost (ie the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the expiration date of the option. For example, assume that the amortised cost and carrying amount of the asset on the date of the transfer is CU98 and that the consideration received is CU95. The amortised cost of the asset on the option exercise date will be CU100. The initial carrying amount of the associated liability is CU95 and the difference between CU95 and CU100 is recognised in profit or loss using the effective interest method. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss.

Assets measured at fair value

- (c) If a call option right retained by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the asset continues to be measured at its fair value. The associated liability is measured at (i) the option exercise price less the time value of the option if the option is in or at the money, or (ii) the fair value of the transferred asset less the time value of the option if the option is out of the money. The adjustment to the measurement of the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the call option right. For example, if the fair value of the underlying asset is CU80, the option exercise price is CU95 and the time value of the option is CU5, the carrying amount of the associated liability is CU75 (CU80 – CU5) and the carrying amount of the transferred asset is CU80 (ie its fair value).
- (d) If a put option written by an entity prevents a transferred asset from being derecognised and the entity measures the transferred asset at fair value, the associated liability is measured at the option exercise price plus the time value of the option. The measurement of the asset at fair value is limited to the lower of the fair value and the option exercise price because the entity has no right to increases in the fair value of the transferred asset above the exercise price of the option. This ensures that the net carrying amount of the asset and the associated liability is the fair value of the put option obligation. For example, if the fair value of the underlying asset is CU120, the option exercise price is CU100 and the time value of the option is CU5, the carrying amount of the associated liability is CU105 (CU100 + CU5) and the carrying amount of the asset is CU100 (in this case the option exercise price).
- (e) If a collar, in the form of a purchased call and written put, prevents a transferred asset from being derecognised and the entity measures the asset at fair value, it continues to measure the asset at fair value. The associated liability is measured at (i) the sum of the call exercise price and fair value of the put option less the time value of the call option, if the call option is in or at the money, or (ii) the sum of the fair value of the asset and the fair value of the put option less the time value of the call option if the call option is out of the money. The adjustment to the associated liability ensures that the net carrying amount of the asset and the associated liability is the fair value of the options held and written by the entity. For example, assume an entity transfers a financial asset that is measured at fair value while simultaneously purchasing a call with an exercise price of CU120 and writing a put with an exercise price of CU80. Assume also that the fair value of the asset is CU100 at the date of the transfer. The time value of the put and call are CU1 and CU5 respectively. In this case, the entity recognises an asset of CU100 (the fair value of the asset) and a liability of CU96 [(CU100 + CU1) – CU5]. This gives a net asset value of CU4, which is the fair value of the options held and written by the entity.

All transfers

B3.2.14 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transfer are not accounted for separately as derivatives if recognising both the derivative and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.

B3.2.15 To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the

transferor. If the transferor has both a right and an obligation to reacquire control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may measure its receivable at amortised cost if it meets the criteria in paragraph 4.1.2.

Examples

B3.2.16 The following examples illustrate the application of the derecognition principles of this HKFRS.

- (a) *Repurchase agreements and securities lending.* If a financial asset is sold under an agreement to repurchase it at a fixed price or at the sale price plus a lender's return or if it is loaned under an agreement to return it to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership. If the transferee obtains the right to sell or pledge the asset, the transferor reclassifies the asset in its statement of financial position, for example, as a loaned asset or repurchase receivable.
- (b) *Repurchase agreements and securities lending—assets that are substantially the same.* If a financial asset is sold under an agreement to repurchase the same or substantially the same asset at a fixed price or at the sale price plus a lender's return or if a financial asset is borrowed or loaned under an agreement to return the same or substantially the same asset to the transferor, it is not derecognised because the transferor retains substantially all the risks and rewards of ownership.
- (c) *Repurchase agreements and securities lending—right of substitution.* If a repurchase agreement at a fixed repurchase price or a price equal to the sale price plus a lender's return, or a similar securities lending transaction, provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the asset sold or lent under a repurchase or securities lending transaction is not derecognised because the transferor retains substantially all the risks and rewards of ownership.
- (d) *Repurchase right of first refusal at fair value.* If an entity sells a financial asset and retains only a right of first refusal to repurchase the transferred asset at fair value if the transferee subsequently sells it, the entity derecognises the asset because it has transferred substantially all the risks and rewards of ownership.
- (e) *Wash sale transaction.* The repurchase of a financial asset shortly after it has been sold is sometimes referred to as a wash sale. Such a repurchase does not preclude derecognition provided that the original transaction met the derecognition requirements. However, if an agreement to sell a financial asset is entered into concurrently with an agreement to repurchase the same asset at a fixed price or the sale price plus a lender's return, then the asset is not derecognised.
- (f) *Put options and call options that are deeply in the money.* If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.

- (g) *Put options and call options that are deeply out of the money.* A financial asset that is transferred subject only to a deep out-of-the-money put option held by the transferee or a deep out-of-the-money call option held by the transferor is derecognised. This is because the transferor has transferred substantially all the risks and rewards of ownership.
- (h) *Readily obtainable assets subject to a call option that is neither deeply in the money nor deeply out of the money.* If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (i) has neither retained nor transferred substantially all the risks and rewards of ownership, and (ii) has not retained control. However, if the asset is not readily obtainable in the market, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.
- (i) *A not readily obtainable asset subject to a put option written by an entity that is neither deeply in the money nor deeply out of the money.* If an entity transfers a financial asset that is not readily obtainable in the market, and writes a put option that is not deeply out of the money, the entity neither retains nor transfers substantially all the risks and rewards of ownership because of the written put option. The entity retains control of the asset if the put option is sufficiently valuable to prevent the transferee from selling the asset, in which case the asset continues to be recognised to the extent of the transferor's continuing involvement (see paragraph B3.2.9). The entity transfers control of the asset if the put option is not sufficiently valuable to prevent the transferee from selling the asset, in which case the asset is derecognised.
- (j) *Assets subject to a fair value put or call option or a forward repurchase agreement.* A transfer of a financial asset that is subject only to a put or call option or a forward repurchase agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
- (k) *Cash-settled call or put options.* An entity evaluates the transfer of a financial asset that is subject to a put or call option or a forward repurchase agreement that will be settled net in cash to determine whether it has retained or transferred substantially all the risks and rewards of ownership. If the entity has not retained substantially all the risks and rewards of ownership of the transferred asset, it determines whether it has retained control of the transferred asset. That the put or the call or the forward repurchase agreement is settled net in cash does not automatically mean that the entity has transferred control (see paragraphs B3.2.9 and (g), (h) and (i) above).
- (l) *Removal of accounts provision.* A removal of accounts provision is an unconditional repurchase (call) option that gives an entity the right to reclaim assets transferred subject to some restrictions. Provided that such an option results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership, it precludes derecognition only to the extent of the amount subject to repurchase (assuming that the transferee cannot sell the assets). For example, if the carrying amount and proceeds from the transfer of loan assets are CU100,000 and any individual loan could be called back but the aggregate amount of loans that could be repurchased could not exceed CU10,000, CU90,000 of the loans would qualify for derecognition.

- (m) *Clean-up calls.* An entity, which may be a transferor, that services transferred assets may hold a clean-up call to purchase remaining transferred assets when the amount of outstanding assets falls to a specified level at which the cost of servicing those assets becomes burdensome in relation to the benefits of servicing. Provided that such a clean-up call results in the entity neither retaining nor transferring substantially all the risks and rewards of ownership and the transferee cannot sell the assets, it precludes derecognition only to the extent of the amount of the assets that is subject to the call option.
- (n) *Subordinated retained interests and credit guarantees.* An entity may provide the transferee with credit enhancement by subordinating some or all of its interest retained in the transferred asset. Alternatively, an entity may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. If the entity retains substantially all the risks and rewards of ownership of the transferred asset, the asset continues to be recognised in its entirety. If the entity retains some, but not substantially all, of the risks and rewards of ownership and has retained control, derecognition is precluded to the extent of the amount of cash or other assets that the entity could be required to pay.
- (o) *Total return swaps.* An entity may sell a financial asset to a transferee and enter into a total return swap with the transferee, whereby all of the interest payment cash flows from the underlying asset are remitted to the entity in exchange for a fixed payment or variable rate payment and any increases or declines in the fair value of the underlying asset are absorbed by the entity. In such a case, derecognition of all of the asset is prohibited.
- (p) *Interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset and enter into an interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount that is equal to the principal amount of the transferred financial asset. The interest rate swap does not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on payments being made on the transferred asset.
- (q) *Amortising interest rate swaps.* An entity may transfer to a transferee a fixed rate financial asset that is paid off over time, and enter into an amortising interest rate swap with the transferee to receive a fixed interest rate and pay a variable interest rate based on a notional amount. If the notional amount of the swap amortises so that it equals the principal amount of the transferred financial asset outstanding at any point in time, the swap would generally result in the entity retaining substantial prepayment risk, in which case the entity either continues to recognise all of the transferred asset or continues to recognise the transferred asset to the extent of its continuing involvement. Conversely, if the amortisation of the notional amount of the swap is not linked to the principal amount outstanding of the transferred asset, such a swap would not result in the entity retaining prepayment risk on the asset. Hence, it would not preclude derecognition of the transferred asset provided the payments on the swap are not conditional on interest payments being made on the transferred asset and the swap does not result in the entity retaining any other significant risks and rewards of ownership on the transferred asset.

B3.2.17 This paragraph illustrates the application of the continuing involvement approach when the entity's continuing involvement is in a part of a financial asset.

Assume an entity has a portfolio of prepayable loans whose coupon and effective interest rate is 10 per cent and whose principal amount and amortised cost is CU10,000. It enters into a transaction in which, in return for a payment of CU9,115, the transferee obtains the right to CU9,000 of any collections of principal plus interest thereon at 9.5 per cent. The entity retains rights to CU1,000 of any collections of principal plus interest thereon at 10 per cent, plus the excess spread of 0.5 per cent on the remaining CU9,000 of principal. Collections from prepayments are allocated between the entity and the transferee proportionately in the ratio of 1:9, but any defaults are deducted from the entity's interest of CU1,000 until that interest is exhausted. The fair value of the loans at the date of the transaction is CU10,100 and the estimated fair value of the excess spread of 0.5 per cent is CU40.

The entity determines that it has transferred some significant risks and rewards of ownership (for example, significant prepayment risk) but has also retained some significant risks and rewards of ownership (because of its subordinated retained interest) and has retained control. It therefore applies the continuing involvement approach.

To apply this HKFRS, the entity analyses the transaction as (a) a retention of a fully proportionate retained interest of CU1,000, plus (b) the subordination of that retained interest to provide credit enhancement to the transferee for credit losses.

The entity calculates that CU9,090 (90 per cent × CU10,100) of the consideration received of CU9,115 represents the consideration for a fully proportionate 90 per cent share. The remainder of the consideration received (CU25) represents consideration received for subordinating its retained interest to provide credit enhancement to the transferee for credit losses. In addition, the excess spread of 0.5 per cent represents consideration received for the credit enhancement. Accordingly, the total consideration received for the credit enhancement is CU65 (CU25 + CU40).

The entity calculates the gain or loss on the sale of the 90 per cent share of cash flows. Assuming that separate fair values of the 90 per cent part transferred and the 10 per cent part retained are not available at the date of the transfer, the entity allocates the carrying amount of the asset in accordance with paragraph 3.2.14 as follows:

	<i>Estimated fair value</i>	<i>Percentage</i>	<i>Allocated carrying amount</i>
Portion transferred	9,090	90%	9,000
Portion retained	1,010	10%	1,000
Total	10,100		10,000

The entity computes its gain or loss on the sale of the 90 per cent share of the cash flows by deducting the allocated carrying amount of the portion transferred from the consideration received, ie CU90 (CU9,090 – CU9,000). The carrying amount of the portion retained by the entity is CU1,000.

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In addition, the entity recognises the continuing involvement that results from the subordination of its retained interest for credit losses. Accordingly, it recognises an asset of CU1,000 (the maximum amount of the cash flows it would not receive under the subordination), and an associated liability of CU1,065 (which is the maximum amount of the cash flows it would not receive under the subordination, ie CU1,000 plus the fair value of the subordination of CU65).

The entity uses all of the above information to account for the transaction as follows:

	<i>Debit</i>	<i>Credit</i>
Original asset	–	9,000
Asset recognised for subordination or the residual interest	1,000	–
Asset for the consideration received in the form of excess spread	40	–
Profit or loss (gain on transfer)	–	90
Liability	–	1,065
Cash received	9,115	–
Total	10,155	10,155

Immediately following the transaction, the carrying amount of the asset is CU2,040 comprising CU1,000, representing the allocated cost of the portion retained, and CU1,040, representing the entity's additional continuing involvement from the subordination of its retained interest for credit losses (which includes the excess spread of CU40).

In subsequent periods, the entity recognises the consideration received for the credit enhancement (CU65) on a time proportion basis, accrues interest on the recognised asset using the effective interest method and recognises any credit impairment on the recognised assets. As an example of the latter, assume that in the following year there is a credit impairment loss on the underlying loans of CU300. The entity reduces its recognised asset by CU600 (CU300 relating to its retained interest and CU300 relating to the additional continuing involvement that arises from the subordination of its retained interest for credit losses), and reduces its recognised liability by CU300. The net result is a charge to profit or loss for credit impairment of CU300.

Derecognition of financial liabilities (section 3.3)

B3.3.1 A financial liability (or part of it) is extinguished when the debtor either:

- (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or
- (b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)

- B3.3.2 If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term.
- B3.3.3 Payment to a third party, including a trust (sometimes called 'insubstance defeasance'), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.
- B3.3.4 If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph B3.3.1(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.
- B3.3.5 Although legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 3.2.1–3.2.23 are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.
- B3.3.6 For the purpose of paragraph 3.3.2, the terms are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability. If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.
- B3.3.7 In some cases, a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility defaults. In these circumstances the debtor:
- (a) recognises a new financial liability based on the fair value of its obligation for the guarantee, and
 - (b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the original financial liability less the fair value of the new financial liability.

Classification (chapter 4)

Classification of financial assets (section 4.1)

The entity's business model for managing financial assets

- B4.1.1 Paragraph 4.1.1(a) requires an entity to classify financial assets as subsequently measured at amortised cost or fair value on the basis of the entity's business model for managing the financial assets. An entity assesses whether its financial assets meet this condition on the basis of the objective of the business model as determined by the entity's key management personnel (as defined in HKAS 24).

B4.1.2 The entity's business model does not depend on management's intentions for an individual instrument. Accordingly, this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation. However, a single entity may have more than one business model for managing its financial instruments. Therefore, classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages in order to trade to realise fair value changes.

B4.1.3 Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur. For example, the entity may sell a financial asset if:

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

However, if more than an infrequent number of sales are made out of a portfolio, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

B4.1.4 The following are examples of when the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows. This list of examples is not exhaustive.

Example	Analysis
<p>Example 1</p> <p>An entity holds investments to collect their contractual cash flows but would sell an investment in particular circumstances.</p>	<p>Although an entity may consider, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective.</p>
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Example	Analysis
<p>Example 2</p> <p>An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets with incurred credit losses. If payment on the loans is not made on a timely basis, the entity attempts to extract the contractual cash flows through various means—for example, by making contact with the debtor by mail, telephone or other methods.</p> <p>In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.</p>	<p>The objective of the entity's business model is to hold the financial assets and collect the contractual cash flows. The entity does not purchase the portfolio to make a profit by selling them.</p> <p>The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets have incurred credit losses).</p> <p>Moreover, the fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model. If the portfolio is not managed on a fair value basis, the objective of the business model could be to hold the assets to collect the contractual cash flows.</p>
<p>Example 3</p> <p>An entity has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors.</p> <p>The originating entity controls the securitisation vehicle and thus consolidates it.</p> <p>The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors.</p> <p>It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.</p>	<p>The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows.</p> <p>However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.</p>

- B4.1.5 One business model in which the objective is not to hold instruments to collect the contractual cash flows is if an entity manages the performance of a portfolio of financial assets with the objective of realising cash flows through the sale of the assets. For example, if an entity actively manages a portfolio of assets in order to realise fair value changes arising from changes in credit spreads and yield curves, its business model is not to hold those assets to collect the contractual cash flows. The entity's objective results in active buying and selling and the entity is managing the instruments to realise fair value gains rather than to collect the contractual cash flows.
- B4.1.6 A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis (as described in paragraph 4.2.2(b)) is not held to collect contractual cash flows. Also, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows. Such portfolios of instruments must be measured at fair value through profit or loss.

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding

- B4.1.7 Paragraph 4.1.1 requires an entity (unless paragraph 4.1.5 applies) to classify a financial asset as subsequently measured at amortised cost or fair value on the basis of the contractual cash flow characteristics of the financial asset that is in a group of financial assets managed for the collection of the contractual cash flows.
- B4.1.8 An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated (see also paragraph B5.7.2).
- B4.1.9 Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include leverage. Thus such contracts do not meet the condition in paragraph 4.1.2(b) and cannot be subsequently measured at amortised cost.
- B4.1.10 Contractual provisions that permit the issuer (ie the debtor) to prepay a debt instrument (eg a loan or a bond) or permit the holder (ie the creditor) to put a debt instrument back to the issuer before maturity result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding only if:
- (a) the provision is not contingent on future events, other than to protect:
 - (i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations), or a change in control of the issuer; or
 - (ii) the holder or issuer against changes in relevant taxation or law; and
 - (b) the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

B4.1.11 Contractual provisions that permit the issuer or holder to extend the contractual term of a debt instrument (ie an extension option) result in contractual cash flows that are solely payments of principal and interest on the principal amount outstanding only if:

- (a) the provision is not contingent on future events, other than to protect:
 - (i) the holder against the credit deterioration of the issuer (eg defaults, credit downgrades or loan covenant violations) or a change in control of the issuer; or
 - (ii) the holder or issuer against changes in relevant taxation or law; and
- (b) the terms of the extension option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding.

B4.1.12A contractual term that changes the timing or amount of payments of principal or interest does not result in contractual cash flows that are solely principal and interest on the principal amount outstanding unless it:

- (a) is a variable interest rate that is consideration for the time value of money and the credit risk (which may be determined at initial recognition only, and so may be fixed) associated with the principal amount outstanding; and
- (b) if the contractual term is a prepayment option, meets the conditions in paragraph B4.1.10; or
- (c) if the contractual term is an extension option, meets the conditions in paragraph B4.1.11.

B4.1.13 The following examples illustrate contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
<p>Instrument A</p> <p>Instrument A is a bond with a stated maturity date. Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued. The inflation link is not leveraged and the principal is protected.</p>	<p>The contractual cash flows are solely payments of principal and interest on the principal amount outstanding. Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects ‘real’ interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.</p> <p>However, if the interest payments were indexed to another variable such as the debtor’s performance (eg the debtor’s net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the interest payments are not consideration for the time value of money and for credit risk associated with the principal amount outstanding. There is variability in the contractual interest payments that is inconsistent with market interest rates.</p>
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Instrument	Analysis
<p>Instrument B</p> <p>Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis. For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.</p>	<p>The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money and for the credit risk associated with the instrument. The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument.</p> <p>However, if the borrower is able to choose to pay one-month LIBOR for three months and that one-month LIBOR is not reset each month, the contractual cash flows are not payments of principal and interest.</p> <p>The same analysis would apply if the borrower is able to choose between the lender's published one-month variable interest rate and the lender's published three-month variable interest rate.</p> <p>However, if the instrument has a contractual interest rate that is based on a term that exceeds the instrument's remaining life, its contractual cash flows are not payments of principal and interest on the principal amount outstanding. For example, a constant maturity bond with a five-year term that pays a variable rate that is reset periodically but always reflects a five-year maturity does not result in contractual cash flows that are payments of principal and interest on the principal amount outstanding. That is because the interest payable in each period is disconnected from the term of the instrument (except at origination).</p>
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Instrument	Analysis
<p>Instrument C</p> <p>Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.</p>	<p>The contractual cash flows of both:</p> <p>(b) an instrument that has a fixed interest rate and</p> <p>(f) an instrument that has a variable interest rate</p> <p>are payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money and for the credit risk associated with the instrument during the term of the instrument.</p> <p>Therefore, an instrument that is a combination of (a) and (b) (eg a bond with an interest rate cap) can have cash flows that are solely payments of principal and interest on the principal amount outstanding. Such a feature may reduce cash flow variability by setting a limit on a variable interest rate (eg an interest rate cap or floor) or increase the cash flow variability because a fixed rate becomes variable.</p>
<p>Instrument D</p> <p>Instrument D is a full recourse loan and is secured by collateral.</p>	<p>The fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.</p>

B4.1.14 The following examples illustrate contractual cash flows that are not payments of principal and interest on the principal amount outstanding. This list of examples is not exhaustive.

Instrument	Analysis
<p>Instrument E</p> <p>Instrument E is a bond that is convertible into equity instruments of the issuer.</p>	<p>The holder would analyse the convertible bond in its entirety. The contractual cash flows are not payments of principal and interest on the principal amount outstanding because the interest rate does not reflect only consideration for the time value of money and the credit risk. The return is also linked to the value of the equity of the issuer.</p>
<p>Instrument F</p> <p>Instrument F is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates).</p>	<p>The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding.</p> <p>The interest amounts are not consideration for the time value of money on the principal amount outstanding.</p>
<i>...continued</i>	

<i>...continued</i>	
Instrument	Analysis
<p>Instrument G</p> <p>Instrument G is a perpetual instrument but the issuer may call the instrument at any point and pay the holder the par amount plus accrued interest due.</p> <p>Instrument G pays a market interest rate but payment of interest cannot be made unless the issuer is able to remain solvent immediately afterwards.</p> <p>Deferred interest does not accrue additional interest.</p>	<p>The contractual cash flows are not payments of principal and interest on the principal amount outstanding. That is because the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts. As a result, interest amounts are not consideration for the time value of money on the principal amount outstanding.</p> <p>If interest accrued on the deferred amounts, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.</p> <p>The fact that Instrument G is perpetual does not in itself mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.</p> <p>Also, the fact that Instrument G is callable does not mean that the contractual cash flows are not payments of principal and interest on the principal amount outstanding unless it is callable at an amount that does not substantially reflect payment of outstanding principal and interest on that principal. Even if the callable amount includes an amount that compensates the holder for the early termination of the instrument, the contractual cash flows could be payments of principal and interest on the principal amount outstanding.</p>

B4.1.15 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 on the principal amount outstanding as described in paragraphs 4.1.2(b) and 4.1.3 of this HKFRS.

B4.1.16 This may be the case if the financial asset represents an investment in particular assets or cash flows and hence the contractual cash flows are not solely payments of principal and interest on the principal amount outstanding. For example, the contractual cash flows may include payment for factors other than consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. As a result, the instrument would not satisfy the condition in paragraph 4.1.2(b). This could be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset).

B4.1.17 However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraph 4.1.2(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the

financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraph 4.1.2(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

B4.1.18 If a contractual cash flow characteristic is not genuine, it does not affect the classification of a financial asset. A cash flow characteristic is 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.

B4.1.19 In almost every lending transaction the creditor's instrument is ranked relative to the instruments of the debtor's other creditors. An instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy. For example, a trade receivable that ranks its creditor as a general creditor would qualify as having payments of principal and interest on the principal amount outstanding. This is the case even if the debtor issued loans that are collateralised, which in the event of bankruptcy would give that loan holder priority over the claims of the general creditor in respect of the collateral but does not affect the contractual right of the general creditor to unpaid principal and other amounts due.

Contractually linked instruments

B4.1.20 In some types of transactions, an entity may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk (tranches). Each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches.

B4.1.21 In such transactions, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:

- (a) the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (eg the interest rate on the tranche is not linked to a commodity index);
- (b) the underlying pool of financial instruments has the cash flow characteristics set out in paragraphs B4.1.23 and B4.1.24; and
- (c) the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, this condition would be met if the underlying pool of instruments were to lose 50 per cent as a result of credit losses and under all circumstances the tranche would lose 50 per cent or less).

B4.1.22 An entity must look through until it can identify the underlying pool of instruments that are creating (rather than passing through) the cash flows. This is the underlying pool of financial instruments.

B4.1.23 The underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

B4.1.24 The underlying pool of instruments may also include instruments that:

- (a) reduce the cash flow variability of the instruments in paragraph B4.1.23 and, when combined with the instruments in paragraph B4.1.23, result in cash flows that are solely payments of principal and interest on the principal amount outstanding (eg an interest rate cap or floor or a contract that reduces the credit risk on some or all of the instruments in paragraph B4.1.23); or
- (b) align the cash flows of the tranches with the cash flows of the pool of underlying instruments in paragraph B4.1.23 to address differences in and only in:
 - (i) whether the interest rate is fixed or floating;
 - (ii) the currency in which the cash flows are denominated, including inflation in that currency; or
 - (iii) the timing of the cash flows.

B4.1.25 If any instrument in the pool does not meet the conditions in either paragraph B4.1.23 or paragraph B4.1.24, the condition in paragraph B4.1.21(b) is not met.

B4.1.26 If the holder cannot assess the conditions in paragraph B4.1.21 at initial recognition, the tranche must be measured at fair value. If the underlying pool of instruments can change after initial recognition in such a way that the pool may not meet the conditions in paragraphs B4.1.23 and B4.1.24, the tranche does not meet the conditions in paragraph B4.1.21 and must be measured at fair value.

Option to designate a financial asset or financial liability as at fair value through profit or loss (sections 4.1 and 4.2)

B4.1.27 Subject to the conditions in paragraphs 4.1.5 and 4.2.2, this HKFRS allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.

B4.1.28 The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of HKAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. For example, in the case of designation of a financial liability as at fair value through profit or loss, paragraph 4.2.2 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 4.2.2, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Designation eliminates or significantly reduces an accounting mismatch

B4.1.29 Measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as subsequently measured at fair value and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through profit or loss.

B4.1.30 The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 4.1.5 or 4.2.2(a).

- (a) An entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by HKFRS 4, paragraph 24), and financial assets it considers related that would otherwise be measured at amortised cost.
- (b) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (ie are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met, for example because the requirements for effectiveness in paragraph 88 of HKAS 39 are not met.
- (c) An entity has financial assets, financial liabilities or both that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and the entity does not qualify for hedge accounting because none of the instruments is a derivative. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of recognition of gains and losses that would otherwise result from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

B4.1.31 In cases such as those described in the preceding paragraph, to designate, at initial recognition, the financial assets and financial liabilities not otherwise so measured as at fair value through profit or loss may eliminate or significantly reduce the measurement or recognition inconsistency and produce more relevant information. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at fair value through profit or loss at its initial recognition and, at that time, any remaining transactions are expected to occur.

B4.1.32 It would not be acceptable to designate only some of the financial assets and financial liabilities giving rise to the inconsistency as at fair value through profit or loss if to do so would not eliminate or significantly reduce the inconsistency and would therefore not result in more relevant information. However, it would be acceptable to designate only some of a number of similar financial assets or similar financial liabilities if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. For example, assume an entity has a number of similar financial liabilities that sum to CU100 and a number of similar financial assets that sum to CU50 but are measured

on a different basis. The entity may significantly reduce the measurement inconsistency by designating at initial recognition all of the assets but only some of the liabilities (for example, individual liabilities with a combined total of CU45) as at fair value through profit or loss. However, because designation as at fair value through profit or loss can be applied only to the whole of a financial instrument, the entity in this example must designate one or more liabilities in their entirety. It could not designate either a component of a liability (eg changes in value attributable to only one risk, such as changes in a benchmark interest rate) or a proportion (ie percentage) of a liability.

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

B4.1.33 An entity may manage and evaluate the performance of a group of financial liabilities or financial assets and financial liabilities in such a way that measuring that group at fair value through profit or loss results in more relevant information. The focus in this instance is on the way the entity manages and evaluates performance, rather than on the nature of its financial instruments.

B4.1.34 For example, an entity may use this condition to designate financial liabilities as at fair value through profit or loss if it meets the principle in paragraph 4.2.2(b) and the entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented policy of asset and liability management. An example could be an entity that has issued ‘structured products’ containing multiple embedded derivatives and manages the resulting risks on a fair value basis using a mix of derivative and non-derivative financial instruments.

B4.1.35 As noted above, this condition relies on the way the entity manages and evaluates performance of the group of financial instruments under consideration. Accordingly, (subject to the requirement of designation at initial recognition) an entity that designates financial liabilities as at fair value through profit or loss on the basis of this condition shall so designate all eligible financial liabilities that are managed and evaluated together.

B4.1.36 Documentation of the entity’s strategy need not be extensive but should be sufficient to demonstrate compliance with paragraph 4.2.2(b). Such documentation is not required for each individual item, but may be on a portfolio basis. For example, if the performance management system for a department—as approved by the entity’s key management personnel—clearly demonstrates that its performance is evaluated on a total return basis, no further documentation is required to demonstrate compliance with paragraph 4.2.2(b).

Embedded derivatives (section 4.3)

B4.3.1 When an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this HKFRS, paragraph 4.3.3 requires the entity to identify any embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently.

B4.3.2 If a host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related. If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument.

- B4.3.3 An embedded non-option derivative (such as an embedded forward or swap) is separated from its host contract on the basis of its stated or implied substantive terms, so as to result in it having a fair value of zero at initial recognition. An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract on the basis of the stated terms of the option feature. The initial carrying amount of the host instrument is the residual amount after separating the embedded derivative.
- B4.3.4 Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative. However, embedded derivatives that are classified as equity (see HKAS 32) are accounted for separately from those classified as assets or liabilities. In addition, if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other.
- B4.3.5 The economic characteristics and risks of an embedded derivative are not closely related to the host contract (paragraph 4.3.3(a)) in the following examples. In these examples, assuming the conditions in paragraph 4.3.3(b) and (c) are met, an entity accounts for the embedded derivative separately from the host contract.
- (a) A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity or commodity price or index is not closely related to a host debt instrument.
 - (b) An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension. If an entity issues a debt instrument and the holder of that debt instrument writes a call option on the debt instrument to a third party, the issuer regards the call option as extending the term to maturity of the debt instrument provided the issuer can be required to participate in or facilitate the remarketing of the debt instrument as a result of the call option being exercised.
 - (c) Equity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the value of equity instruments—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
 - (d) Commodity-indexed interest or principal payments embedded in a host debt instrument or insurance contract—by which the amount of interest or principal is indexed to the price of a commodity (such as gold)—are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar.
 - (e) A call, put, or prepayment option embedded in a host debt contract or host insurance contract is not closely related to the host contract unless:
 - (i) the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument or the carrying amount of the host insurance contract; or
 - (ii) the exercise price of a prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity

would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with HKAS 32.

- (f) Credit derivatives that are embedded in a host debt instrument and allow one party (the 'beneficiary') to transfer the credit risk of a particular reference asset, which it may not own, to another party (the 'guarantor') are not closely related to the host debt instrument. Such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

B4.3.6 An example of a hybrid contract is a financial instrument that gives the holder a right to put the financial instrument back to the issuer in exchange for an amount of cash or other financial assets that varies on the basis of the change in an equity or commodity index that may increase or decrease (a 'puttable instrument'). Unless the issuer on initial recognition designates the puttable instrument as a financial liability at fair value through profit or loss, it is required to separate an embedded derivative (ie the indexed principal payment) under paragraph 4.3.3 because the host contract is a debt instrument under paragraph B4.3.2 and the indexed principal payment is not closely related to a host debt instrument under paragraph B4.3.5(a). Because the principal payment can increase and decrease, the embedded derivative is a non-option derivative whose value is indexed to the underlying variable.

B4.3.7 In the case of a puttable instrument that can be put back at any time for cash equal to a proportionate share of the net asset value of an entity (such as units of an open-ended mutual fund or some unit-linked investment products), the effect of separating an embedded derivative and accounting for each component is to measure the hybrid contract at the redemption amount that is payable at the end of the reporting period if the holder exercised its right to put the instrument back to the issuer.

B4.3.8 The economic characteristics and risks of an embedded derivative are closely related to the economic characteristics and risks of the host contract in the following examples. In these examples, an entity does not account for the embedded derivative separately from the host contract.

- (a) An embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract or insurance contract is closely related to the host contract unless the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment or the embedded derivative could at least double the holder's initial rate of return on the host contract and could result in a rate of return that is at least twice what the market return would be for a contract with the same terms as the host contract.
- (b) An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.
- (c) An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt

instrument (eg a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because HKAS 21 requires foreign currency gains and losses on monetary items to be recognised in profit or loss.

- (d) An embedded foreign currency derivative in a host contract that is an insurance contract or not a financial instrument (such as a contract for the purchase or sale of a non-financial item where the price is denominated in a foreign currency) is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
- (i) the functional currency of any substantial party to that contract;
 - (ii) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
 - (iii) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).
- (e) An embedded prepayment option in an interest-only or principal only strip is closely related to the host contract provided the host contract (i) initially resulted from separating the right to receive contractual cash flows of a financial instrument that, in and of itself, did not contain an embedded derivative, and (ii) does not contain any terms not present in the original host debt contract.
- (f) An embedded derivative in a host lease contract is closely related to the host contract if the embedded derivative is (i) an inflation-related index such as an index of lease payments to a consumer price index (provided that the lease is not leveraged and the index relates to inflation in the entity's own economic environment), (ii) contingent rentals based on related sales or (iii) contingent rentals based on variable interest rates.
- (g) A unit-linking feature embedded in a host financial instrument or host insurance contract is closely related to the host instrument or host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund. A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.
- (h) A derivative embedded in an insurance contract is closely related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (ie without considering the host contract).

Instruments containing embedded derivatives

B4.3.9 As noted in paragraph B4.3.1, when an entity becomes a party to a hybrid contract with a host that is not an asset within the scope of this HKFRS and with one or more embedded derivatives, paragraph 4.3.3 requires the entity to identify any such embedded derivative, assess whether it is required to be separated from the host contract and, for those that are required to be separated, measure the derivatives at fair value at initial recognition and subsequently. These requirements can be more complex, or result in less reliable measures, than measuring the entire instrument at fair value through profit or loss. For that reason this

HKFRS permits the entire hybrid contract to be designated as at fair value through profit or loss.

B4.3.10 Such designation may be used whether paragraph 4.3.3 requires the embedded derivatives to be separated from the host contract or prohibits such separation. However, paragraph 4.3.5 would not justify designating the hybrid contract as at fair value through profit or loss in the cases set out in paragraph 4.3.5(a) and (b) because doing so would not reduce complexity or increase reliability.

Reassessment of embedded derivatives

B4.3.11 In accordance with paragraph 4.3.3, an entity shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative when the entity first becomes a party to the contract. Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, in which case reassessment is required. An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

B4.3.12 Paragraph B4.3.11 does not apply to embedded derivatives in contracts acquired in:

- (a) a business combination (as defined in HKFRS 3 *Business Combinations*);
- (b) a combination of entities or businesses under common control as described in paragraphs B1–B4 of HKFRS 3; or
- (c) the formation of a joint venture as defined in HKAS 31 *Interests in Joint Ventures*

or their possible reassessment at the date of acquisition.*

Reclassification of financial assets (section 4.4)

B4.4.1 Paragraph 4.4.1 requires an entity to reclassify financial assets if the objective of the entity's business model for managing those financial assets changes. Such changes are expected to be very infrequent. Such changes must be determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Examples of a change in business model include the following:

- (a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
- (b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

* HKFRS 3 addresses the acquisition of contracts with embedded derivatives in a business combination.

B4.4.2 A change in the objective of the entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (ie the first day of the entity's next reporting period), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.

B4.4.3 The following are not changes in business model:

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

Measurement (chapter 5)

Initial measurement (section 5.1)

B5.1.1 The fair value of a financial instrument at initial recognition is normally the transaction price (ie the fair value of the consideration given or received, see also paragraph B5.4.8). However, if part of the consideration given or received is for something other than the financial instrument, the fair value of the financial instrument is estimated using a valuation technique (see paragraphs B5.4.6–B5.4.12). For example, the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating. Any additional amount lent is an expense or a reduction of income unless it qualifies for recognition as some other type of asset.

B5.1.2 If an entity originates a loan that bears an off-market interest rate (eg 5 per cent when the market rate for similar loans is 8 per cent), and receives an upfront fee as compensation, the entity recognises the loan at its fair value, ie net of the fee it receives.

Subsequent measurement of financial assets (section 5.2)

B5.2.1 If a financial instrument that was previously recognised as a financial asset is measured at fair value and its fair value decreases below zero, it is a financial liability measured in accordance with paragraph 4.2.1. However, hybrid contracts with hosts that are assets within the scope of this HKFRS are always measured in accordance with paragraph 4.3.2.

B5.2.2 The following example illustrates the accounting for transaction costs on the initial and subsequent measurement of a financial asset measured at fair value with changes through other comprehensive income in accordance with paragraph 5.7.5. An entity acquires an asset for CU100 plus a purchase commission of CU2. Initially, the entity recognises the asset at CU102. The reporting period ends one day later, when the quoted market price of the asset is CU100. If the asset were sold, a commission of CU3 would be paid. On that date, the entity measures the asset at CU100 (without regard to the possible commission on sale) and recognises a loss of CU2 in other comprehensive income.

Fair value measurement (section 5.4)

B5.4.1 Underlying the definition of fair value is a presumption that an entity is a going concern without any intention or need to liquidate, to curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale. However, fair value reflects the credit quality of the instrument.

B5.4.2 This HKFRS uses the terms 'bid price' and 'asking price' (sometimes referred to as 'current offer price') in the context of quoted market prices, and the term 'the bid-ask spread' to include only transaction costs. Other adjustments to arrive at fair value (eg for counterparty credit risk) are not included in the term 'bid-ask spread'.

Active market: quoted price

B5.4.3 A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency, and those prices represent actual and regularly occurring market transactions on an arm's length basis. Fair value is defined in terms of a price agreed by a willing buyer and a willing seller in an arm's length transaction. The objective of determining fair value for a financial instrument that is traded in an active market is to arrive at the price at which a transaction would occur at the end of the reporting period in that instrument (ie without modifying or repackaging the instrument) in the most advantageous active market to which the entity has immediate access. However, the entity adjusts the price in the more advantageous market to reflect any differences in counterparty credit risk between instruments traded in that market and the one being valued. The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability.

B5.4.4 The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price. When an entity has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. When current bid and asking prices are unavailable, the price of the most recent transaction provides evidence of the current fair value as long as there has not been a significant change in economic circumstances since the time of the transaction. If conditions have changed since the time of the transaction (eg a change in the risk-free interest rate following the most recent price quote for a corporate bond), the fair value reflects the change in conditions by reference to current prices or rates for similar financial instruments, as appropriate. Similarly, if the entity can demonstrate that the last transaction price is not fair value (eg because it reflected the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale), that price is adjusted. The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price. If a published price quotation in an active market does not exist for a financial instrument in its entirety, but active markets exist for its component parts, fair value is determined on the basis of the relevant market prices for the component parts.

B5.4.5 If a rate (rather than a price) is quoted in an active market, the entity uses that market-quoted rate as an input into a valuation technique to determine fair value. If the market-quoted rate does not include credit risk or other factors that market participants would include in valuing the instrument, the entity adjusts for those factors.

No active market: valuation technique

- B5.4.6 If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. Valuation techniques include using recent arm's length market transactions between knowledgeable, willing parties, if available, reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.
- B5.4.7 The objective of using a valuation technique is to establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. Fair value is estimated on the basis of the results of a valuation technique that makes maximum use of market inputs, and relies as little as possible on entity-specific inputs. A valuation technique would be expected to arrive at a realistic estimate of the fair value if (a) it reasonably reflects how the market could be expected to price the instrument and (b) the inputs to the valuation technique reasonably represent market expectations and measures of the risk-return factors inherent in the financial instrument.
- B5.4.8 Therefore, a valuation technique (a) incorporates all factors that market participants would consider in setting a price and (b) is consistent with accepted economic methodologies for pricing financial instruments. Periodically, an entity calibrates the valuation technique and tests it for validity using prices from any observable current market transactions in the same instrument (ie without modification or repackaging) or based on any available observable market data. An entity obtains market data consistently in the same market where the instrument was originated or purchased. The best evidence of the fair value of a financial instrument at initial recognition is the transaction price (ie the fair value of the consideration given or received) unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.
- B5.4.9 The subsequent measurement of the financial asset or financial liability and the subsequent recognition of gains and losses shall be consistent with the requirements of this HKFRS. The application of paragraph B5.4.8 may result in no gain or loss being recognised on the initial recognition of a financial asset or financial liability. In such a case, this HKFRS requires that a gain or loss shall be recognised after initial recognition only to the extent that it arises from a change in a factor (including time) that market participants would consider in setting a price.
- B5.4.10 The initial acquisition or origination of a financial asset or incurrence of a financial liability is a market transaction that provides a foundation for estimating the fair value of the financial instrument. In particular, if the financial instrument is a debt instrument (such as a loan), its fair value can be determined by reference to the market conditions that existed at its acquisition or origination date and current market conditions or interest rates currently charged by the entity or by others for similar debt instruments (ie similar remaining maturity, cash flow pattern, currency, credit risk, collateral and interest basis). Alternatively, provided there is no change in the credit risk of the debtor and applicable credit spreads after the origination of the debt instrument, an estimate of the current market interest rate may be derived by using a benchmark interest rate reflecting a better credit quality than the underlying debt instrument, holding the credit spread constant, and adjusting for the change in the benchmark interest rate from the origination date. If conditions have changed since the most recent market transaction, the corresponding change in the fair value of the financial instrument being valued is determined by reference to current prices or rates for similar financial instruments, adjusted as appropriate, for any differences from the instrument being valued.

B5.4.11 The same information may not be available at each measurement date. For example, at the date that an entity makes a loan or acquires a debt instrument that is not actively traded, the entity has a transaction price that is also a market price. However, no new transaction information may be available at the next measurement date and, although the entity can determine the general level of market interest rates, it may not know what level of credit or other risk market participants would consider in pricing the instrument on that date. An entity may not have information from recent transactions to determine the appropriate credit spread over the basic interest rate to use in determining a discount rate for a present value computation. It would be reasonable to assume, in the absence of evidence to the contrary, that no changes have taken place in the spread that existed at the date the loan was made. However, the entity would be expected to make reasonable efforts to determine whether there is evidence that there has been a change in such factors. When evidence of a change exists, the entity would consider the effects of the change in determining the fair value of the financial instrument.

B5.4.12 In applying discounted cash flow analysis, an entity uses one or more discount rates equal to the prevailing rates of return for financial instruments having substantially the same terms and characteristics, including the credit quality of the instrument, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made. Short-term receivables and payables with no stated interest rate may be measured at the original invoice amount if the effect of discounting is immaterial.

Inputs to valuation techniques

B5.4.13 An appropriate technique for estimating the fair value of a particular financial instrument would incorporate observable market data about the market conditions and other factors that are likely to affect the instrument's fair value. The fair value of a financial instrument will be based on one or more of the following factors (and perhaps others).

- (a) *The time value of money (ie interest at the basic or risk-free rate).* Basic interest rates can usually be derived from observable government bond prices and are often quoted in financial publications. These rates typically vary with the expected dates of the projected cash flows along a yield curve of interest rates for different time horizons. For practical reasons, an entity may use a well-accepted and readily observable general rate, such as LIBOR or a swap rate, as the benchmark rate. (Because a rate such as LIBOR is not the riskfree interest rate, the credit risk adjustment appropriate to the particular financial instrument is determined on the basis of its credit risk in relation to the credit risk in this benchmark rate.) In some countries, the central government's bonds may carry a significant credit risk and may not provide a stable benchmark basic interest rate for instruments denominated in that currency. Some entities in these countries may have a better credit standing and a lower borrowing rate than the central government. In such a case, basic interest rates may be more appropriately determined by reference to interest rates for the highest rated corporate bonds issued in the currency of that jurisdiction.
- (b) *Credit risk.* The effect on fair value of credit risk (ie the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings.
- (c) *Foreign currency exchange prices.* Active currency exchange markets exist for most major currencies, and prices are quoted daily in financial publications.
- (d) *Commodity prices.* There are observable market prices for many commodities.

- (e) *Equity prices.* Prices (and indexes of prices) of traded equity instruments are readily observable in some markets. Present value based techniques may be used to estimate the current market price of equity instruments for which there are no observable prices.
- (f) *Volatility (ie magnitude of future changes in price of the financial instrument or other item).* Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices.
- (g) *Prepayment risk and surrender risk.* Expected prepayment patterns for financial assets and expected surrender patterns for financial liabilities can be estimated on the basis of historical data. (The fair value of a financial liability that can be surrendered by the counterparty cannot be less than the present value of the surrender amount—see paragraph 5.4.3.)
- (h) *Servicing costs for a financial asset or a financial liability.* Costs of servicing can be estimated using comparisons with current fees charged by other market participants. If the costs of servicing a financial asset or financial liability are significant and other market participants would face comparable costs, the issuer would consider them in determining the fair value of that financial asset or financial liability. It is likely that the fair value at inception of a contractual right to future fees equals the origination costs paid for them, unless future fees and related costs are out of line with market comparables.

Investments in unquoted equity instruments (and contracts on those investments that must be settled by delivery of the unquoted equity instruments)

B5.4.14 All investments in equity instruments and contracts on those instruments must be measured at fair value. However, 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.

B5.4.15 Indicators that cost might not be representative of fair value include:

- (a) a significant change in the performance of the investee compared with budgets, plans or milestones.
- (b) changes in expectation that the investee's technical product milestones will be achieved.
- (c) a significant change in the market for the investee's equity or its products or potential products.
- (d) a significant change in the global economy or the economic environment in which the investee operates.
- (e) a significant change in the performance of comparable entities, or in the valuations implied by the overall market.
- (f) internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy.

- (g) evidence from external transactions in the investee's equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

B5.4.16 The list in paragraph B5.4.15 is not exhaustive. An entity shall use all information about the performance and operations of the investee that becomes available after the date of initial recognition. To the extent that any such relevant factors exist, they may indicate that cost might not be representative of fair value. In such cases, the entity must estimate fair value.

B5.4.17 Cost is never the best estimate of fair value for investments in quoted equity instruments (or contracts on quoted equity instruments).

Gains and losses (section 5.7)

B5.7.1 Paragraph 5.7.5 permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of an investment in an equity instrument that is not held for trading. This election is made on an instrument-by-instrument (ie share-by-share) basis. Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity. Dividends on such investments are recognised in profit or loss in accordance with HKAS 18 unless the dividend clearly represents a recovery of part of the cost of the investment.

B5.7.2 An entity applies HKAS 21 *The Effects of Changes in Foreign Exchange Rates* to financial assets and financial liabilities that are monetary items in accordance with HKAS 21 and denominated in a foreign currency. HKAS 21 requires any foreign exchange gains and losses on monetary assets and monetary liabilities to be recognised in profit or loss. An exception is a monetary item that is designated as a hedging instrument in either a cash flow hedge (see paragraphs 95–101 of HKAS 39) or a hedge of a net investment (see paragraph 102 of HKAS 39).

B5.7.3 Paragraph 5.7.5 permits an entity to make an irrevocable election to present in other comprehensive income changes in the fair value of an investment in an equity instrument that is not held for trading. Such an investment is not a monetary item. Accordingly, the gain or loss that is presented in other comprehensive income in accordance with paragraph 5.7.5 includes any related foreign exchange component.

B5.7.4 If there is a hedging relationship between a non-derivative monetary asset and a non-derivative monetary liability, changes in the foreign currency component of those financial instruments are presented in profit or loss.

Liabilities designated as at fair value through profit or loss

B5.7.5 When an entity designates a financial liability as at fair value through profit or loss, it must determine whether presenting in other comprehensive income the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss. An accounting mismatch would be created or enlarged if presenting the effects of changes in the liability's credit risk in other comprehensive income would result in a greater mismatch in profit or loss than if those amounts were presented in profit or loss.

B5.7.6 To make that determination, an entity must assess whether it expects that the effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument measured at fair value through profit or loss. Such an expectation must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument.

- B5.7.7 That determination is made at initial recognition and is not reassessed. For practical purposes the entity need not enter into all of the assets and liabilities giving rise to an accounting mismatch at exactly the same time. A reasonable delay is permitted provided that any remaining transactions are expected to occur. An entity must apply consistently its methodology for determining whether presenting in other comprehensive income the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss. However, an entity may use different methodologies when there are different economic relationships between the characteristics of the liabilities designated as at fair value through profit or loss and the characteristics of the other financial instruments. HKFRS 7 requires an entity to provide qualitative disclosures in the notes to the financial statements about its methodology for making that determination.
- B5.7.8 If such a mismatch would be created or enlarged, the entity is required to present all changes in fair value (including the effects of changes in the credit risk of the liability) in profit or loss. If such a mismatch would not be created or enlarged, the entity is required to present the effects of changes in the liability's credit risk in other comprehensive income.
- B5.7.9 Amounts presented in other comprehensive income shall not be subsequently transferred to profit or loss. However, the entity may transfer the cumulative gain or loss within equity.
- B5.7.10 The following example describes a situation in which an accounting mismatch would be created in profit or loss if the effects of changes in the credit risk of the liability were presented in other comprehensive income. A mortgage bank provides loans to customers and funds those loans by selling bonds with matching characteristics (eg amount outstanding, repayment profile, term and currency) in the market. The contractual terms of the loan permit the mortgage customer to prepay its loan (ie satisfy its obligation to the bank) by buying the corresponding bond at fair value in the market and delivering that bond to the mortgage bank. As a result of that contractual prepayment right, if the credit quality of the bond worsens (and, thus, the fair value of the mortgage bank's liability decreases), the fair value of the mortgage bank's loan asset also decreases. The change in the fair value of the asset reflects the mortgage customer's contractual right to prepay the mortgage loan by buying the underlying bond at fair value (which, in this example, has decreased) and delivering the bond to the mortgage bank. Therefore, the effects of changes in the credit risk of the liability (the bond) will be offset in profit or loss by a corresponding change in the fair value of a financial asset (the loan). If the effects of changes in the liability's credit risk were presented in other comprehensive income there would be an accounting mismatch in profit or loss. Therefore, the mortgage bank is required to present all changes in fair value of the liability (including the effects of changes in the liability's credit risk) in profit or loss.
- B5.7.11 In the example in paragraph B5.7.10, there is a contractual linkage between the effects of changes in the credit risk of the liability and changes in the fair value of the financial asset (ie as a result of the mortgage customer's contractual right to prepay the loan by buying the bond at fair value and delivering the bond to the mortgage bank). However, an accounting mismatch may also occur in the absence of a contractual linkage.
- B5.7.12 For the purposes of applying the requirements in paragraphs 5.7.7 and 5.7.8, an accounting mismatch is not caused solely by the measurement method that an entity uses to determine the effects of changes in a liability's credit risk. An accounting mismatch in profit or loss would arise only when the effects of changes in the liability's credit risk (as defined in HKFRS 7) are expected to be offset by changes in the fair value of another financial instrument. A mismatch that arises solely as a result of the measurement method (ie because an entity does not isolate changes in a liability's credit risk from some other changes in its fair value) does not affect the determination required by paragraphs 5.7.7 and 5.7.8. For example, an entity may not isolate changes in a liability's credit risk from changes in liquidity risk. If the entity presents the combined effect of both factors in other comprehensive income, a mismatch may occur because changes in liquidity risk may be included in the fair value measurement of the entity's financial assets and the entire fair value change of those assets is presented in profit or loss. However, such a mismatch is caused by measurement

imprecision, not the offsetting relationship described in paragraph B5.7.6 and, therefore, does not affect the determination required by paragraphs 5.7.7 and 5.7.8.

The meaning of 'credit risk'

B5.7.13 HKFRS 7 defines credit risk as 'the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation'. The requirement in paragraph 5.7.7(a) relates to the risk that the issuer will fail to perform on that particular liability. It does not necessarily relate to the creditworthiness of the issuer. For example, if an entity issues a collateralised liability and a non-collateralised liability that are otherwise identical, the credit risk of those two liabilities will be different, even though they are issued by the same entity. The credit risk on the collateralised liability will be less than the credit risk of the non-collateralised liability. The credit risk for a collateralised liability may be close to zero.

B5.7.14 For the purposes of applying the requirement in paragraph 5.7.7(a), credit risk is different from asset-specific performance risk. Asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation but rather it is related to the risk that a single asset or a group of assets will perform poorly (or not at all).

B5.7.15 The following are examples of asset-specific performance risk:

- (a) a liability with a unit-linking feature whereby the amount due to investors is contractually determined on the basis of the performance of specified assets. The effect of that unit-linking feature on the fair value of the liability is asset-specific performance risk, not credit risk.
- (b) a liability issued by a special purpose entity (SPE) with the following characteristics. The SPE is legally isolated so the assets in the SPE are ring-fenced solely for the benefit of its investors, even in the event of bankruptcy. The SPE enters into no other transactions and the assets in the SPE cannot be hypothecated. Amounts are due to the SPE's investors only if the ring-fenced assets generate cash flows. Thus, changes in the fair value of the liability primarily reflect changes in the fair value of the assets. The effect of the performance of the assets on the fair value of the liability is asset specific performance risk, not credit risk.

Determining the effects of changes in credit risk

B5.7.16 For the purposes of applying the requirement in paragraph 5.7.7(a), an entity shall determine the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability either:

- (a) as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk (see paragraphs B5.7.17 and B5.7.18); or
- (b) using an alternative method the entity believes more faithfully represents the amount of change in the liability's fair value that is attributable to changes in its credit risk.

B5.7.17 Changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates.

B5.7.18 If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, the amount in paragraph B5.7.16(a) can be estimated as follows:

- (a) First, the entity computes the liability's internal rate of return at the start of the period using the fair value of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.
- (b) Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in (a).
- (c) The difference between the fair value of the liability at the end of the period and the amount determined in (b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).

B5.7.19 The example in paragraph B5.7.18 assumes that changes in fair value arising from factors other than changes in the instrument's credit risk or changes in observed (benchmark) interest rates are not significant. This method would not be appropriate if changes in fair value arising from other factors are significant. In those cases, an entity is required to use an alternative method that more faithfully measures the effects of changes in the liability's credit risk (see paragraph B5.7.16(a)). For example, if the instrument in the example contains an embedded derivative, the change in fair value of the embedded derivative is excluded in determining the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).

B5.7.20 As with all estimates of fair value, an entity's measurement method for determining the portion of the change in the liability's fair value that is attributable to changes in its credit risk must make maximum use of market inputs.

Effective date and transition (chapter 7)

Transition (section 7.2)

Financial assets held for trading

B7.2.1 At the date of initial application of this HKFRS, an entity must determine whether the objective of the entity's business model for managing any of its financial assets meets the condition in paragraph 4.1.2(a) or if a financial asset is eligible for the election in paragraph 5.7.5. For that purpose, an entity shall determine whether financial assets meet the definition of held for trading as if the entity had acquired the assets at the date of initial application.

Definitions (Appendix A)

Derivatives

BA.1 Typical examples of derivatives are futures and forward, swap and option contracts. A derivative usually has a notional amount, which is an amount of currency, a number of shares, a

number of units of weight or volume or other units specified in the contract. However, a derivative instrument does not require the holder or writer to invest or receive the notional amount at the inception of the contract. Alternatively, a derivative could require a fixed payment or payment of an amount that can change (but not proportionally with a change in the underlying) as a result of some future event that is unrelated to a notional amount. For example, a contract may require a fixed payment of CU1,000 if six-month LIBOR increases by 100 basis points. Such a contract is a derivative even though a notional amount is not specified.

- BA.2 The definition of a derivative in this HKFRS includes contracts that are settled gross by delivery of the underlying item (eg a forward contract to purchase a fixed rate debt instrument). An entity may have a contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument or by exchanging financial instruments (eg a contract to buy or sell a commodity at a fixed price at a future date). Such a contract is within the scope of this HKFRS unless it was entered into and continues to be held for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (see paragraphs 5–7 of HKAS 39).
- BA.3 One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. An option contract meets that definition because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked. A currency swap that requires an initial exchange of different currencies of equal fair values meets the definition because it has a zero initial net investment.
- BA.4 A regular way purchase or sale gives rise to a fixed price commitment between trade date and settlement date that meets the definition of a derivative. However, because of the short duration of the commitment it is not recognised as a derivative financial instrument. Rather, this HKFRS provides for special accounting for such regular way contracts (see paragraphs 3.1.2 and B3.1.3-B3.1.6).
- BA.5 The definition of a derivative refers to non-financial variables that are not specific to a party to the contract. These include an index of earthquake losses in a particular region and an index of temperatures in a particular city. Non-financial variables specific to a party to the contract include the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract. A change in the fair value of a non-financial asset is specific to the owner if the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car's physical condition, the change in that residual value is specific to the owner of the car.

Financial assets and liabilities held for trading

- BA.6 Trading generally reflects active and frequent buying and selling, and financial instruments held for trading generally are used with the objective of generating a profit from short-term fluctuations in price or dealer's margin.
- BA.7 Financial liabilities held for trading include:
- (a) derivative liabilities that are not accounted for as hedging instruments;
 - (b) obligations to deliver financial assets borrowed by a short seller (ie an entity that sells financial assets it has borrowed and does not yet own);

- (c) financial liabilities that are incurred with an intention to repurchase them in the near term (eg a quoted debt instrument that the issuer may buy back in the near term depending on changes in its fair value); and
- (d) financial liabilities that are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking.

BA.8 The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading.

Appendix C

Amendments to other HKFRSs

Except where otherwise stated, an entity shall apply the amendments in this appendix when it applies HKFRS 9 issued in November 2010. These amendments incorporate with additions the amendments issued in Appendix C of HKFRS 9 in 2009.

HKFRS 1 *First-time Adoption of Hong Kong Financial Reporting Standards*

C1 Paragraph 29 is amended to read as follows, paragraph 39B is deleted and paragraphs 29A and 39G are added:

29 An entity is permitted to designate a previously recognised financial asset as a financial asset measured at fair value through profit or loss in accordance with paragraph D19A. The entity shall disclose the fair value of financial assets so designated at the date of designation and their classification and carrying amount in the previous financial statements.

29A An entity is permitted to designate a previously recognised financial liability as a financial liability at fair value through profit or loss in accordance with paragraph D19. The entity shall disclose the fair value of financial liabilities so designated at the date of designation and their classification and carrying amount in the previous financial statements.

39B [Deleted]

39G HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 29, B1–B5, D1(j), D14, D15, D19 and D20, added paragraphs 29A, B8, B9, D19A–D19D, E1 and E2 and deleted paragraph 39B. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

C2 In Appendix B, paragraphs B1–B5 are amended to read as follows, and a heading and paragraph B8, and a heading and paragraph B9 are added:

B1 An entity shall apply the following exceptions:

- (a) derecognition of financial assets and financial liabilities (paragraphs B2 and B3);
- (b) hedge accounting (paragraphs B4–B6);
- (c) non-controlling interests (paragraph B7);
- (d) classification and measurement of financial assets (paragraph B8); and
- (e) embedded derivatives (paragraph B9).

Derecognition of financial assets and financial liabilities

- B2 Except as permitted by paragraph B3, a first-time adopter shall apply the derecognition requirements in HKFRS 9 *Financial Instruments* prospectively for transactions occurring on or after 1 January 2004. In other words, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction that occurred before 1 January 2004, it shall not recognise those assets and liabilities in accordance with HKFRSs (unless they qualify for recognition as a result of a later transaction or event).
- B3 Despite paragraph B2, an entity may apply the derecognition requirements in HKFRS 9 retrospectively from a date of the entity's choosing, provided that the information needed to apply HKFRS 9 to financial assets and financial liabilities derecognised as a result of past transactions was obtained at the time of initially accounting for those transactions.

Hedge accounting

- B4 As required by HKFRS 9, at the date of transition to HKFRSs an entity shall:
- (a) measure all derivatives at fair value; and
 - (b) eliminate all deferred losses and gains arising on derivatives that were reported in accordance with previous GAAP as if they were assets or liabilities.
- B5 An entity shall not reflect in its opening HKFRS statement of financial position a hedging relationship of a type that does not qualify for hedge accounting in accordance with HKAS 39 (for example, many hedging relationships where the hedging instrument is a cash instrument or written option; or where the hedged item is a net position). However, if an entity designated a net position as a hedged item in accordance with previous GAAP, it may designate an individual item within that net position as a hedged item in accordance with HKFRSs, provided that it does so no later than the date of transition to HKFRSs.

Classification and measurement of financial assets

- B8 An entity shall assess whether a financial asset meets the conditions in paragraph 4.1.2 of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.

Embedded derivatives

- B9 A first-time adopter shall assess whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative on the basis of the conditions that existed at the later of the date it first became a party to the contract and the date a reassessment is required by paragraph B4.3.11 of HKFRS 9.
- C3 In Appendix D, paragraphs D1(j), D14, D15, D19 and D20 are amended to read as follows and paragraphs D19A–D19D are added:

- D1 An entity may elect to use one or more of the following exemptions:
- (a) ...

- (j) designation of previously recognised financial instruments (paragraphs D19–D19D)
 - (k) ...
- D14 When an entity prepares separate financial statements, HKAS 27 requires it to account for its investments in subsidiaries, jointly controlled entities and associates either:
- (a) at cost; or
 - (b) in accordance with HKFRS 9.
- D15 If a first-time adopter measures such an investment at cost in accordance with HKAS 27, it shall measure that investment at one of the following amounts in its separate opening HKFRS statement of financial position:
- (a) cost determined in accordance with HKAS 27; or
 - (b) deemed cost. The deemed cost of such an investment shall be its:
 - (i) fair value (determined in accordance with HKFRS 9) at the entity's date of transition to HKFRSs in its separate financial statements; or
 - (ii) previous GAAP carrying amount at that date.
- A first-time adopter may choose either (i) or (ii) above to measure its investment in each subsidiary, jointly controlled entity or associate that it elects to measure using a deemed cost.
- D19 HKFRS 9 permits a financial liability (provided it meets certain criteria) to be designated as a financial liability at fair value through profit or loss. Despite this requirement an entity is permitted to designate, at the date of transition to HKFRSs, any financial liability as at fair value through profit or loss provided the liability meets the criteria in paragraph 4.2.2 of HKFRS 9 at that date.
- D19A An entity may designate a financial asset as measured at fair value through profit or loss in accordance with paragraph 4.1.5 of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.
- D19B An entity may designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5 of HKFRS 9 on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.
- D19C If it is impracticable (as defined in HKAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements in paragraphs 58–65 and AG84–AG93 of HKAS 39, the fair value of the financial asset at the date of transition to HKFRSs shall be the new amortised cost of that financial asset at the date of transition to HKFRSs.
- D19D An entity shall determine whether the treatment in paragraph 5.7.7 of HKFRS 9 would create an accounting mismatch in profit or loss on the basis of the facts and circumstances that exist at the date of transition to HKFRSs.

Fair value measurement of financial assets or financial liabilities at initial recognition

D20 Despite the requirements of paragraphs 7 and 9, an entity may apply the requirements in the last sentence of paragraph B5.4.8 and in paragraph B5.4.9 of HKFRS 9, in either of the following ways:

- (a) prospectively to transactions entered into after 25 October 2002; or
- (b) prospectively to transactions entered into after 1 January 2004.

C4 In Appendix E, a heading and paragraphs E1 and E2 are added:

Exemption from the requirement to restate comparative information for HKFRS 9

E1 In its first HKFRS financial statements, an entity that (a) adopts HKFRSs for annual periods beginning before 1 January 2012 and (b) applies HKFRS 9 shall present at least one year of comparative information. However, this comparative information need not comply with HKFRS 7 *Financial Instruments: Disclosures* or HKFRS 9, to the extent that the disclosures required by HKFRS 7 relate to items within the scope of HKFRS 9. For such entities, references to the 'date of transition to HKFRSs' shall mean, in the case of HKFRS 7 and HKFRS 9 only, the beginning of the first HKFRS reporting period.

E2 An entity that chooses to present comparative information that does not comply with HKFRS 7 and HKFRS 9 in its first year of transition shall:

- (a) apply the recognition and measurement requirements of its previous GAAP in place of the requirements of HKFRS 9 to comparative information about items within the scope of HKFRS 9.
- (b) disclose this fact together with the basis used to prepare this information.
- (c) treat any adjustment between the statement of financial position at the comparative period's reporting date (ie the statement of financial position that includes comparative information under previous GAAP) and the statement of financial position at the start of the *first HKFRS reporting period* (ie the first period that includes information that complies with HKFRS 7 and HKFRS 9) as arising from a change in accounting policy and give the disclosures required by paragraph 28(a)–(e) and (f)(i) of HKAS 8. Paragraph 28(f)(i) applies only to amounts presented in the statement of financial position at the comparative period's reporting date.
- (d) apply paragraph 17(c) of HKAS 1 to provide additional disclosures when compliance with the specific requirements in HKFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

HKFRS 3 *Business Combinations*

C5 Paragraphs 16, 42, 53, 56 and 58(b) are amended to read as follows, paragraph 64A is deleted and paragraph 64D is added:

- 16 In some situations, HKFRSs provide for different accounting depending on how an entity classifies or designates a particular asset or liability. Examples of classifications or designations that the acquirer shall make on the basis of the pertinent conditions as they exist at the acquisition date include but are not limited to:
- (a) classification of particular financial assets and liabilities as measured at fair value or at amortised cost, in accordance with HKFRS 9 *Financial Instruments*;
 - (b) designation of a derivative instrument as a hedging instrument in accordance with HKAS 39; and
 - (c) assessment of whether an embedded derivative should be separated from a host contract in accordance with HKFRS 9 (which is a matter of 'classification' as this HKFRS uses that term).
- 42 In a business combination achieved in stages, the acquirer shall remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss or other comprehensive income, as appropriate. In prior reporting periods, the acquirer may have recognised changes in the value of its equity interest in the acquiree in other comprehensive income. If so, the amount that was recognised in other comprehensive income shall be recognised on the same basis as would be required if the acquirer had disposed directly of the previously held equity interest.
- 53 Acquisition-related costs are costs the acquirer incurs to effect a business combination. Those costs include finder's fees; advisory, legal, accounting, valuation and other professional or consulting fees; general administrative costs, including the costs of maintaining an internal acquisitions department; and costs of registering and issuing debt and equity securities. The acquirer shall account for acquisition-related costs as expenses in the periods in which the costs are incurred and the services are received, with one exception. The costs to issue debt or equity securities shall be recognised in accordance with HKAS 32 and HKFRS 9.
- 56 After initial recognition and until the liability is settled, cancelled or expires, the acquirer shall measure a contingent liability recognised in a business combination at the higher of:
- (a) the amount that would be recognised in accordance with HKAS 37; and
 - (b) the amount initially recognised less, if appropriate, cumulative amortisation recognised in accordance with HKAS 18 *Revenue*.

This requirement does not apply to contracts accounted for in accordance with HKFRS 9.

- 58 Some changes ...
- (b) Contingent consideration classified as an asset or a liability that:
 - (i) is a financial instrument and is within the scope of HKFRS 9 shall be measured at fair value, with any resulting gain or loss recognised either in profit or loss or in other comprehensive income in accordance with HKFRS 9.

- (ii) is not within the scope of HKFRS 9 shall be accounted for in accordance with HKAS 37 or other HKFRSs as appropriate.

64A [Deleted]

64D HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 16, 42, 53, 56 and 58(b) and deleted paragraph 64A. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKFRS 4 *Insurance Contracts*

C6 Paragraph IN3 is amended to read as follows:

IN3 The HKFRS applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other HKFRSs. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of HKFRS 9 *Financial Instruments*. Furthermore, it does not address accounting by policyholders.

C7 Paragraphs 3, 4(d), 7, 8, 12, 34(d), 35 and 45 are amended to read as follows, paragraph 41C is deleted and paragraph 41D is added:

3 This HKFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see HKAS 32 *Financial Instruments: Presentation*, HKAS 39 *Financial Instruments: Recognition and Measurement*, HKFRS 7 and HKFRS 9 *Financial Instruments*), except in the transitional provisions in paragraph 45.

4 An entity shall not apply this HKFRS to:

(a) ...

(d) financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, in which case the issuer may elect to apply either HKAS 32, HKFRS 7 and HKFRS 9 or this HKFRS to such financial guarantee contracts. The issuer may make that election contract by contract, but the election for each contract is irrevocable.

(e) ...

7 HKFRS 9 requires an entity to separate some embedded derivatives from their host contract, measure them at *fair value* and include changes in their fair value in profit or loss. HKFRS 9 applies to derivatives embedded in an insurance contract unless the embedded derivative is itself an insurance contract.

8 As an exception to the requirements in HKFRS 9, an insurer need not separate, and measure at fair value, a policyholder's option to surrender an insurance contract for a fixed amount (or for an amount based on a fixed amount and an interest rate), even if the exercise price differs from the carrying amount of the host *insurance liability*. However, the requirements in HKFRS 9 do apply to a put option or cash surrender option embedded in an insurance contract if the surrender value varies in response to the change in a financial variable (such as an equity or commodity price or index), or a

non-financial variable that is not specific to a party to the contract. Furthermore, those requirements also apply if the holder's ability to exercise a put option or cash surrender option is triggered by a change in such a variable (for example, a put option that can be exercised if a stock market index reaches a specified level).

- 12 To unbundle a contract, an insurer shall:
- (a) apply this HKFRS to the insurance component.
 - (b) apply HKFRS 9 to the deposit component.
- 34 Some insurance contracts contain a discretionary participation feature as well as a *guaranteed element*. The issuer of such a contract:
- (a) ...
 - (d) shall, if the contract contains an embedded derivative within the scope of HKFRS 9, apply HKFRS 9 to that embedded derivative.
 - (e) ...

Discretionary participation features in financial instruments

- 35 The requirements in paragraph 34 also apply to a financial instrument that contains a discretionary participation feature. In addition:
- (a) if the issuer classifies the entire discretionary participation feature as a liability, it shall apply the liability adequacy test in paragraphs 15–19 to the whole contract (ie both the guaranteed element and the discretionary participation feature). The issuer need not determine the amount that would result from applying HKFRS 9 to the guaranteed element.
 - (b) if the issuer classifies part or all of that feature as a separate component of equity, the liability recognised for the whole contract shall not be less than the amount that would result from applying HKFRS 9 to the guaranteed element. That amount shall include the intrinsic value of an option to surrender the contract, but need not include its time value if paragraph 9 exempts that option from measurement at fair value. The issuer need not disclose the amount that would result from applying HKFRS 9 to the guaranteed element, nor need it present that amount separately. Furthermore, the issuer need not determine that amount if the total liability recognised is clearly higher.
 - (c) ...

41C [Deleted]

41D HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 3, 4(d), 7, 8, 12, 34(d), 35, 45 and B18–B20 and Appendix A and deleted paragraph 41C. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

45 Despite paragraph 4.4.1 of HKFRS 9, when an insurer changes its accounting policies for insurance liabilities, it is permitted, but not required, to reclassify some or all of its

financial assets so that they are measured at fair value. This reclassification is permitted if an insurer changes accounting policies when it first applies this HKFRS and if it makes a subsequent policy change permitted by paragraph 22. The reclassification is a change in accounting policy and HKAS 8 applies.

C8 In Appendix A the defined term ‘deposit component’ is amended to read as follows:

deposit component A contractual component that is not accounted for as a derivative under HKFRS 9 and would be within the scope of HKFRS 9 if it were a separate instrument.

C9 In Appendix B, paragraphs B18–B20 are amended to read as follows:

B18 The following are examples of contracts that are insurance contracts, if the transfer of insurance risk is significant:

(a) ...

(g) credit insurance that provides for specified payments to be made to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due under the original or modified terms of a debt instrument. These contracts could have various legal forms, such as that of a guarantee, some types of letter of credit, a credit derivative default contract or an insurance contract. However, although these contracts meet the definition of an insurance contract, they also meet the definition of a financial guarantee contract in HKFRS 9 and are within the scope of HKAS 32 [footnote omitted] and HKFRS 9, not this HKFRS (see paragraph 4(d)). Nevertheless, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either HKAS 32 [footnote omitted] and HKFRS 9 or this HKFRS to such financial guarantee contracts.

(h) ...

B19 The following are examples of items that are not insurance contracts:

(a) ...

(e) derivatives that expose one party to financial risk but not insurance risk, because they require that party to make payment based solely on changes in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract (see HKFRS 9).

(f) a credit-related guarantee (or letter of credit, credit derivative default contract or credit insurance contract) that requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due (see HKFRS 9).

(g) ...

B20 If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of HKFRS 9. Among other things, this means ...

HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

C10 Paragraph 5 is amended to read as follows and paragraph 44F is added:

5 The measurement provisions of this HKFRS [footnote omitted] do not apply to the following assets, which are covered by the HKFRSs listed, either as individual assets or as part of a disposal group:

- (a) ...
- (c) financial assets within the scope of HKFRS 9 *Financial Instruments*.
- (d) ...

44F HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraph 5. An entity shall apply that amendment when it applies HKFRS 9 as issued in November 2010.

HKFRS 7 *Financial Instruments: Disclosures*

C11 In the rubric, the reference to 'Appendices A–D' is amended to 'Appendices A–C'. Paragraphs 2–5, 8–10, 11, 14, 20, 28 and 30 are amended to read as follows, paragraphs 12, 12A, 29(b) and 44H are deleted and a heading and paragraphs 10A, 11A, 11B, 12B–12D, 20A, 44I, 44J and 44N are added:

2 The principles in this HKFRS complement the principles for recognising, measuring and presenting financial assets and financial liabilities in HKAS 32 *Financial Instruments: Presentation* and HKFRS 9 *Financial Instruments*.

Scope

3 This HKFRS shall be applied by all entities to all types of financial instruments, except:

- (a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with HKAS 27 *Consolidated and Separate Financial Statements*, HKAS 28 *Investments in Associates* or HKAS 31 *Interests in Joint Ventures*. However, in some cases, HKAS 27, HKAS 28 or HKAS 31 permits an entity to account for an interest in a subsidiary, associate or joint venture using HKFRS 9; in those cases, entities shall apply the requirements of this HKFRS. Entities shall also apply this HKFRS to all derivatives linked to interests in subsidiaries, associates or joint ventures unless the derivative meets the definition of an equity instrument in HKAS 32.
- (b) ...
- (d) insurance contracts as defined in HKFRS 4 *Insurance Contracts*. However, this HKFRS applies to derivatives that are embedded in insurance contracts if HKFRS 9 requires the entity to account for them separately. Moreover, an issuer shall apply this HKFRS to *financial guarantee contracts* if the issuer applies HKFRS 9 in recognising and measuring the contracts, but shall apply HKFRS 4 if the issuer elects, in accordance with paragraph 4(d) of HKFRS 4, to apply HKFRS 4 in recognising and measuring them.

- (e) ...
- 4 This HKFRS applies to recognised and unrecognised financial instruments. Recognised financial instruments include financial assets and financial liabilities that are within the scope of HKFRS 9. Unrecognised financial instruments include some financial instruments that, although outside the scope of HKFRS 9, are within the scope of this HKFRS (such as some loan commitments).
- 5 This HKFRS applies to contracts to buy or sell a non-financial item that are within the scope of HKFRS 9.
- 8 The carrying amounts of each of the following categories, as specified in HKFRS 9, shall be disclosed either in the statement of financial position or in the notes:
- (a) financial assets measured at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those mandatorily measured at fair value in accordance with HKFRS 9.
- (b)–(d) [deleted]
- (e) financial liabilities at fair value through profit or loss, showing separately (i) those designated as such upon initial recognition and (ii) those that meet the definition of held for trading in HKFRS 9.
- (f) financial assets measured at amortised cost.
- (g) financial liabilities measured at amortised cost.
- (h) financial assets measured at fair value through other comprehensive income.

Financial assets or financial liabilities at fair value through profit or loss

- 9 If the entity has designated as measured at fair value a financial asset (or group of financial assets) that would otherwise be measured at amortised cost, it shall disclose:
- (a) the maximum exposure to *credit risk* (see paragraph 36(a)) of the financial asset (or group of financial assets) at the end of the reporting period.
- (b) the amount by which any related credit derivatives or similar instruments mitigate that maximum exposure to credit risk.
- (c) the amount of change, during the period and cumulatively, in the fair value of the financial asset (or group of financial assets) that is attributable to changes in the credit risk of the financial asset determined either:
- (i) ...
- (d) the amount of the change in the fair value of any related credit derivatives or similar instruments that has occurred during the period and cumulatively since the financial asset was designated.

- 10 If the entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 4.2.2 of HKFRS 9 and is required to present the effects of changes in that liability's credit risk in other comprehensive income (see paragraph 5.7.7 of HKFRS 9), it shall disclose:
- (a) the amount of change, cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability (see paragraphs B5.7.13–B5.7.20 of HKFRS 9 for guidance on determining the effects of changes in a liability's credit risk).
 - (b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
 - (c) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.
 - (d) if a liability is derecognised during the period, the amount (if any) presented in other comprehensive income that was realised at derecognition.
- 10A If an entity has designated a financial liability as at fair value through profit or loss in accordance with paragraph 4.2.2 of HKFRS 9 and is required to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in profit or loss (see paragraphs 5.7.7 and 5.7.8 of HKFRS 9), it shall disclose:
- (a) the amount of change, during the period and cumulatively, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability (see paragraphs B5.7.13–B5.7.20 of HKFRS 9 for guidance on determining the effects of changes in a liability's credit risk); and
 - (b) the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.
- 11 The entity shall also disclose:
- (a) a detailed description of the methods used to comply with the requirements in paragraphs 9(c), 10(a) and 10A(a) and paragraph 5.7.7(a) of HKFRS 9, including an explanation of why the method is appropriate.
 - (b) if the entity believes that the disclosure it has given, either in the statement of financial position or in the notes, to comply with the requirements in paragraph 9(c), 10(a) or 10A(a) or paragraph 5.7.7(a) of HKFRS 9 does not faithfully represent the change in the fair value of the financial asset or financial liability attributable to changes in its credit risk, the reasons for reaching this conclusion and the factors it believes are relevant.
 - (c) a detailed description of the methodology or methodologies used to determine whether presenting the effects of changes in a liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss (see paragraphs 5.7.7 and 5.7.8 of HKFRS 9). If an entity is required to present the effects of changes in a liability's credit risk in profit or loss (see paragraph 5.7.8 of HKFRS 9), the disclosure must include a detailed description of the economic relationship described in paragraph B5.7.6 of HKFRS 9.

Financial assets measured at fair value through other comprehensive income

- 11A If an entity has designated investments in equity instruments to be measured at fair value through other comprehensive income, as permitted by paragraph 5.7.5 of HKFRS 9, it shall disclose:
- (a) which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.
 - (b) the reasons for using this presentation alternative.
 - (c) the fair value of each such investment at the end of the reporting period.
 - (d) dividends recognised during the period, showing separately those related to investments derecognised during the reporting period and those related to investments held at the end of the reporting period.
 - (e) any transfers of the cumulative gain or loss within equity during the period including the reason for such transfers.
- 11B If an entity derecognised investments in equity instruments measured at fair value through other comprehensive income during the reporting period, it shall disclose:
- (a) the reasons for disposing of the investments.
 - (b) the fair value of the investments at the date of derecognition.
 - (c) the cumulative gain or loss on disposal.
- 12B An entity shall disclose if, in the current or previous reporting periods, it has reclassified any financial assets in accordance with paragraph 4.4.1 of HKFRS 9. For each such event, an entity shall disclose:
- (a) the date of reclassification.
 - (b) a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements.
 - (c) the amount reclassified into and out of each category.
- 12C For each reporting period following reclassification until derecognition, an entity shall disclose for assets reclassified so that they are measured at amortised cost in accordance with paragraph 4.4.1 of HKFRS 9:
- (a) the effective interest rate determined on the date of reclassification; and
 - (b) the interest income or expense recognised.
- 12D If an entity has reclassified financial assets so that they are measured at amortised cost since its last annual reporting date, it shall disclose:

- (a) the fair value of the financial assets at the end of the reporting period; and
- (b) 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.

14 An entity shall disclose:

- (a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraph 3.3.23(a) of HKFRS 9; and
- (b) the terms and conditions relating to its pledge.

20 An entity shall disclose the following items of income, expense, gains or losses either in the statement of comprehensive income or in the notes:

- (a) net gains or net losses on:
 - (i) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are mandatorily measured at fair value in accordance with HKFRS 9 (eg financial liabilities that meet the definition of held for trading in HKFRS 9). For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss.
 - (ii)-(iv)[deleted]
 - (v) financial liabilities measured at amortised cost.
 - (vi) financial assets measured at amortised cost.
 - (vii) financial assets measured at fair value through other comprehensive income.
- (b) total interest income and total interest expense (calculated using the effective interest method) for financial assets that are measured at amortised cost or financial liabilities not at fair value through profit or loss.
- (c) fee income and expense (other than amounts included in determining the effective interest rate) arising from:
 - (i) financial assets measured at amortised cost or financial liabilities that are not at fair value through profit or loss; and
 - (ii) trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.
- (d) interest income on impaired financial assets accrued in accordance with paragraph AG93 of HKAS 39.

(e) ...

20A An entity shall disclose an analysis of the gain or loss recognised in the statement of comprehensive income arising from the derecognition of financial assets measured at amortised cost, showing separately gains and losses arising from derecognition of those financial assets. This disclosure shall include the reasons for derecognising those financial assets.

28 If the market for a financial instrument is not active, an entity establishes its fair value using a valuation technique (see paragraphs B5.4.6–B5.4.12 of HKFRS 9). Nevertheless, the best evidence of fair value at initial recognition is the transaction price (ie the fair value of the consideration given or received), unless the conditions described in paragraph B5.4.8 of HKFRS 9 are met. It follows that there could be a difference between the fair value at initial recognition and the amount that would be determined at that date using the valuation technique. If such a difference exists, an entity shall disclose, by class of financial instrument:

- (a) its accounting policy for recognising that difference in profit or loss to reflect a change in factors (including time) that market participants would consider in setting a price (see paragraph B5.4.9 of HKFRS 9); and
- (b) the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period and a reconciliation of changes in the balance of this difference.

29 Disclosures of fair value are not required:

(a) ...

(b) [deleted]

(c) ...

30 In the case described in paragraph 29(c), an entity shall disclose information to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those contracts and their fair value, including:

(a) ...

44H [Deleted]

44I When an entity first applies HKFRS 9, it shall disclose for each class of financial assets at the date of initial application:

- (a) the original measurement category and carrying amount determined in accordance with HKAS 39;
- (b) the new measurement category and carrying amount determined in accordance with HKFRS 9;

- (c) the amount of any financial assets in the statement of financial position that were previously designated as measured at fair value through profit or loss but are no longer so designated, distinguishing between those that HKFRS 9 requires an entity to reclassify and those that an entity elects to reclassify.

An entity shall present these quantitative disclosures in tabular format unless another format is more appropriate.

44J When an entity first applies HKFRS 9, it shall disclose qualitative information to enable users to understand:

- (a) how it applied the classification requirements in HKFRS 9 to those financial assets whose classification has changed as a result of applying HKFRS 9.
- (b) the reasons for any designation or de-designation of financial assets or financial liabilities as measured at fair value through profit or loss.

44N HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 2–5, 8–10, 11, 14, 20, 28, 30, Appendix A, B1, B5, B10(a), B22 and B27, added paragraphs 10A, 11A, 11B, 12B–12D, 20A, 44I and 44J, and deleted paragraphs 12, 12A, 29(b), 44H, B4 and Appendix D. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

C12 In Appendix A, the last paragraph is amended to read as follows:

The following terms are defined in paragraph 11 of HKAS 32, paragraph 9 of HKAS 39 or Appendix A of HKFRS 9 and are used in the HKFRS with the meaning specified in HKAS 32, HKAS 39 and HKFRS 9.

- amortised cost of a financial asset or financial liability
- derecognition
- derivative
- effective interest method
- equity instrument
- fair value
- financial asset
- financial guarantee contract
- financial instrument
- financial liability
- financial liability at fair value through profit or loss

- forecast transaction
- hedging instrument
- held for trading
- reclassification date
- regular way purchase or sale.

C13 In Appendix B, paragraph B4 is deleted and paragraphs B1, B5, B10(a), B22 and B27 are amended to read as follows:

B1 Paragraph 6 requires an entity to group financial instruments into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments. The classes described in paragraph 6 are determined by the entity and are, thus, distinct from the categories of financial instruments specified in HKFRS 9 (which determine how financial instruments are measured and where changes in fair value are recognised).

B5 Paragraph 21 requires disclosure of the measurement basis (or bases) used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements. For financial instruments, such disclosure may include:

- (a) for financial liabilities designated as at fair value through profit or loss:
 - (i) the nature of the financial liabilities the entity has designated as at fair value through profit or loss;
 - (ii) the criteria for so designating such financial liabilities on initial recognition; and
 - (iii) how the entity has satisfied the conditions in paragraph 4.2.2 of HKFRS 9 for such designation.
- (aa) for financial assets designated as measured at fair value through profit or loss:
 - (i) the nature of the financial assets the entity has designated as measured at fair value through profit or loss; and
 - (ii) how the entity has satisfied the criteria in paragraph 4.1.5 of HKFRS 9 for such designation.
- (b) [deleted]
- (c) whether regular way purchases and sales of financial assets are accounted for at trade date or at settlement date (see paragraph 3.1.2 of HKFRS 9).
- (d) ...

B10 Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to:

- (a) granting loans to customers and placing deposits with other entities. In these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets.
- (b) ...

B22 *Interest rate risk* arises on interest-bearing financial instruments recognised in the statement of financial position (eg debt instruments acquired or issued) and on some financial instruments not recognised in the statement of financial position (eg some loan commitments).

B27 In accordance with paragraph 40(a), the sensitivity of profit or loss (that arises, for example, from instruments measured at fair value through profit or loss) is disclosed separately from the sensitivity of other comprehensive income (that arises, for example, from investments in equity instruments whose changes in fair value are presented in other comprehensive income).

C14 Appendix D is deleted.

HKAS 1 Presentation of Financial Statements

C15 In paragraph 7, the definition of 'other comprehensive income' and paragraphs 68, 71, 82, 93, 95 and 123 are amended to read as follows, paragraph 139E is deleted and paragraph 139G is added:

7 The following terms are used in this Standard with the meanings specified:

***Other comprehensive income* comprises items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other HKFRSs.**

The components of other comprehensive income include:

- (a) ...
- (d) gains and losses from investments in equity instruments measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of HKFRS 9 *Financial Instruments*;
- (e) the effective portion of gains and losses on hedging instruments in a cash flow hedge (see HKAS 39 *Financial Instruments: Recognition and Measurement*);
- (f) for particular liabilities designated as at fair value through profit or loss, the amount of the change in fair value that is attributable to changes in the liability's credit risk (see paragraph 5.7.7 of HKFRS 9).

...

- 68 The operating cycle of an entity ... Current assets also include assets held primarily for the purpose of trading (examples include some financial assets that meet the definition of held for trading in HKFRS 9) and the current portion of non-current financial assets.
- 71 Other current liabilities are not settled as part of the normal operating cycle, but are due for settlement within twelve months after the reporting period or held primarily for the purpose of trading. Examples are some financial liabilities that meet the definition of held for trading in HKFRS 9, bank overdrafts, and the current portion of non-current financial liabilities, dividends payable, income taxes and other non-trade payables. Financial liabilities that provide financing on a long-term basis (ie are not part of the working capital used in the entity's normal operating cycle) and are not due for settlement within twelve months after the reporting period are non-current liabilities, subject to paragraphs 74 and 75.
- 82 As a minimum, the statement of comprehensive income shall include line items that present the following amounts for the period:**
- (a) revenue;**
 - (aa) gains and losses arising from the derecognition of financial assets measured at amortised cost;**
 - (b) finance costs;**
 - (c) share of the profit or loss of associates and joint ventures accounted for using the equity method;**
 - (ca) if a financial asset is reclassified so that it is measured at fair value, any gain or loss arising from a difference between the previous carrying amount and its fair value at the reclassification date (as defined in HKFRS 9);**
 - (d) ...**
- 93 Other HKFRSs specify whether and when amounts previously recognised in other comprehensive income are reclassified to profit or loss. Such reclassifications are referred to in this Standard as reclassification adjustments. A reclassification adjustment is included with the related component of other comprehensive income in the period that the adjustment is reclassified to profit or loss. These amounts may have been recognised in other comprehensive income ...
- 95 Reclassification adjustments arise, for example, on disposal of a foreign operation (see HKAS 21) and when a hedged forecast transaction affects profit or loss (see paragraph 100 of HKAS 39 in relation to cash flow hedges).
- 123 In the process of applying the entity's accounting policies, management makes various judgements, apart from those involving estimations, that can significantly affect the amounts it recognises in the financial statements. For example, management makes judgements in determining:
- (a) [deleted]
 - (b) ...

139E [Deleted]

139G HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 7, 68, 71, 82, 93, 95 and 123 and deleted paragraph 139E. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 2 Inventories

C16 Paragraph 2(b) is amended to read as follows, paragraph 40A is deleted and paragraph 40B is added:

2 This Standard applies to all inventories, except:

- (a) ...
- (b) **financial instruments (see HKAS 32 *Financial Instruments: Presentation* and HKFRS 9 *Financial Instruments*); and**
- (c) ...

40A [Deleted]

40B HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraph 2(b) and deleted paragraph 40A. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

C17 Paragraph 53 is amended to read as follows, paragraph 54A is deleted and paragraph 54B is added:

53 Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period. For example, when an entity corrects a prior period error in calculating its liability for employees' accumulated sick leave in accordance with HKAS 19 *Employee Benefits*, it disregards information about an unusually severe influenza season during the next period that became available after the financial statements for the prior period were authorised for issue. The fact that significant estimates are frequently required when amending comparative information presented for prior periods does not prevent reliable adjustment or correction of the comparative information.

54A [Deleted]

54B HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraph 53 and deleted paragraph 54A. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 12 *Income Taxes*

C18 In the rubric 'paragraphs 1–95' is amended to 'paragraphs 1–97'. Paragraph 20 is amended to read as follows, paragraph 96 is deleted and paragraph 97 is added:

20 HKFRSs permit or require certain assets to be carried at fair value or to be revalued (see, for example, HKAS 16 *Property, Plant and Equipment*, HKAS 38 *Intangible Assets*, HKAS 40 *Investment Property* and HKFRS 9 *Financial Instruments*). In some jurisdictions, the revaluation or other restatement of an asset to fair value affects taxable profit (tax loss) for the current period. As a result, ...

96 [Deleted]

97 HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraph 20 and deleted paragraph 96. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 18 *Revenue*

C19 In the rubric the reference to 'paragraphs 1–38' is amended to 'paragraphs 1–40'. Paragraphs 6(d) and 11 are amended to read as follows, paragraph 39 is deleted and paragraph 40 is added:

6 This Standard does not deal with revenue arising from:

(a) ...

(d) changes in the fair value of financial assets and financial liabilities or their disposal (see HKFRS 9 *Financial Instruments*);

(e) ...

11 In most cases ... The difference between the fair value and the nominal amount of the consideration is recognised as interest revenue in accordance with paragraphs 29 and 30 and in accordance with HKFRS 9.

39 [Deleted]

40 HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 6(d) and 11 and deleted paragraph 39. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

C20 In the rubric 'paragraphs 1–43' is amended to 'paragraphs 1–44'. Paragraph 10A is amended to read as follows and paragraph 44 is added:

10A The benefit of a government loan at a below-market rate of interest is treated as a government grant. The loan shall be recognised and measured in accordance with HKFRS 9 *Financial Instruments*. The benefit of the below-market rate of interest shall

be measured as the difference between the initial carrying value of the loan determined in accordance with HKFRS 9 and the proceeds received. The benefit is accounted for in accordance with this Standard. The entity shall consider the conditions and obligations that have been, or must be, met when identifying the costs for which the benefit of the loan is intended to compensate.

- 44 HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraph 10A. An entity shall apply that amendment when it applies HKFRS 9 as issued in November 2010.

HKAS 21 *The Effects of Changes in Foreign Exchange Rates*

C21 Paragraph IN5 is amended to read as follows:

IN5 The Standard excludes from its scope foreign currency derivatives that are within the scope of HKFRS 9 *Financial Instruments*. Similarly, the material on hedge accounting has been moved to HKAS 39.

C22 Paragraphs 3(a), 4 and 52(a) are amended to read as follows, paragraph 60C is deleted and paragraph 60E is added:

3 This Standard shall be applied: [footnote omitted]

(a) in accounting for transactions and balances in foreign currencies, except for those derivative transactions and balances that are within the scope of HKFRS 9 *Financial Instruments*;

(b) ...

4 HKFRS 9 applies to many foreign currency derivatives and, accordingly, these are excluded from the scope of this Standard. However, those foreign currency derivatives that are not within the scope of HKFRS 9 (eg some foreign currency derivatives that are embedded in other contracts) are within the scope of this Standard. In addition, this Standard applies when an entity translates amounts relating to derivatives from its functional currency to its presentation currency.

52 An entity shall disclose:

(a) the amount of exchange differences recognised in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with HKFRS 9; and

(b) ...

60C [Deleted]

60E HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 3(a), 4 and 52(a) and deleted paragraph 60C. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 27 Consolidated and Separate Financial Statements

C23 Paragraph IN10 is amended to read as follows:

IN10 When an entity elects, or is required by local regulations, to present separate financial statements, investments in subsidiaries, jointly controlled entities and associates must be accounted for at cost or in accordance with HKFRS 9 *Financial Instruments*.

C24 Paragraphs 35, 37, 38 and 40 are amended to read as follows, paragraph 45D is deleted and paragraph 45E is added:

35 If a parent loses control of a subsidiary, ... For example, if a subsidiary has cumulative exchange differences relating to a foreign operation and the parent loses control of the subsidiary, the parent shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to the foreign operation. Similarly, ...

37 The fair value of any investment retained in the former subsidiary at the date when control is lost shall be regarded as the fair value on initial recognition of a financial asset in accordance with HKFRS 9 *Financial Instruments* or, when appropriate, the cost on initial recognition of an investment in an associate or jointly controlled entity.

Accounting for investments in subsidiaries, jointly controlled entities and associates in separate financial statements

38 When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly controlled entities and associates either:

- (a) at cost, or
- (b) in accordance with HKFRS 9.

The entity shall apply the same accounting for each category of investments. Investments accounted for at cost shall be accounted for in accordance with HKFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* when they are classified as held for sale (or included in a disposal group that is classified as held for sale). The accounting for investments in accordance with HKFRS 9 is not changed in such circumstances.

40 Investments in jointly controlled entities and associates that are accounted for in accordance with HKFRS 9 in the consolidated financial statements shall be accounted for in the same way in the investor's separate financial statements.

45D [Deleted]

45E HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 35, 37, 38 and 40 and deleted paragraph 45D. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 28 Investments in Associates

C25 Paragraph IN5 is amended to read as follows:

IN5 The Standard does not apply to investments that would otherwise be associates or interests of venturers in jointly controlled entities held by venture capital organisations, mutual funds, unit trusts and similar entities when those investments are accounted for at fair value through profit or loss in accordance with HKFRS 9 *Financial Instruments*. Those investments are measured at fair value with changes in fair value recognised in profit or loss in the period in which they occur.

C26 Paragraphs 1 and 18–19A are amended to read as follows, paragraph 41D is deleted and paragraph 41F is added:

1 This Standard shall be applied in accounting for investments in associates. However, it does not apply to investments in associates held by:

- (a) venture capital organisations, or**
- (b) mutual funds, unit trusts and similar entities including investment-linked insurance funds**

that are measured at fair value through profit or loss in accordance with HKFRS 9 *Financial Instruments*. An entity shall measure such investments at fair value through profit or loss in accordance with HKFRS 9. An entity holding such an investment shall make the disclosures required by paragraph 37(f).

18 An investor shall discontinue the use of the equity method from the date when it ceases to have significant influence over an associate and shall account for the investment in accordance with HKFRS 9 from that date, provided the associate does not become a subsidiary or a joint venture as defined in HKAS 31. On the loss of significant influence, ...

19 When an investment ceases to be an associate and is accounted for in accordance with HKFRS 9, the fair value of the investment at the date when it ceases to be an associate shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKFRS 9.

19A If an investor loses significant influence over an associate, ... For example, if an associate has cumulative exchange differences relating to a foreign operation and the investor loses significant influence over the associate, the investor shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to the foreign operation. If ...

41D [Deleted]

41F HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 1 and 18–19A and deleted paragraph 41D. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 31 *Interests in Joint Ventures*

C27 Paragraph IN5 is amended to read as follows:

IN5 The Standard does not apply to investments that would otherwise be interests of venturers in jointly controlled entities held by venture capital organisations, mutual funds, unit trusts and similar entities when those investments are accounted for at fair value through profit or loss in accordance with HKFRS 9 *Financial Instruments*. Those investments are measured at fair value, with changes in fair value recognised in profit or loss in the period in which they occur.

C28 Paragraphs 1, 45–45B and 51 are amended to read as follows, paragraph 58C is deleted and paragraph 58E is added:

1 This Standard shall be applied in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. However, it does not apply to venturers' interests in jointly controlled entities held by:

- (a) venture capital organisations, or
- (b) mutual funds, unit trusts and similar entities including investment-linked insurance funds

that are measured at fair value through profit or loss in accordance with HKFRS 9 *Financial Instruments*. An entity shall measure such investments at fair value through profit or loss in accordance with HKFRS 9. A venturer holding such an interest shall make the disclosures required by paragraphs 55 and 56.

45 When an investor ceases to have joint control over an entity, it shall account for any remaining investment in accordance with HKFRS 9 from that date, provided that the former jointly controlled entity does not become a subsidiary or an associate. From ...

45A When an investment ceases to be a jointly controlled entity and is accounted for in accordance with HKFRS 9, the fair value of the investment when it ceases to be a jointly controlled entity shall be regarded as its fair value on initial recognition as a financial asset in accordance with HKFRS 9.

45B If an investor loses joint control of an entity, ... For example, if a jointly controlled entity has cumulative exchange differences relating to a foreign operation and the investor loses joint control of the entity, the investor shall reclassify to profit or loss the gain or loss previously recognised in other comprehensive income in relation to the foreign operation. If ...

51 An investor in a joint venture that does not have joint control shall account for that investment in accordance with HKFRS 9 or, if it has significant influence in the joint venture, in accordance with HKAS 28.

58C [Deleted]

58E HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 1, 45–45B and 51 and deleted paragraph 58C. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 32 *Financial Instruments: Presentation*

C29 Paragraph IN13 is amended to read as follows:

IN13 The revisions eliminate the option previously in HKAS 32 to measure the liability component of a compound financial instrument on initial recognition either as a residual amount after separating the equity component, or by using a relative-fair-value method. Thus, any asset and liability components are separated first and the residual is the amount of any equity component. These requirements for separating the liability and equity components of a compound financial instrument are conformed to both the definition of an equity instrument as a residual and the measurement requirements in HKFRS 9.

C30 Paragraphs 3, 4, 12, 23, 31, 42 and 96C are amended to read as follows, paragraph 97F is deleted and paragraph 97H is added:

3 The principles in this Standard complement the principles for recognising and measuring financial assets and financial liabilities in HKFRS 9 *Financial Instruments*, and for disclosing information about them in HKFRS 7 *Financial Instruments: Disclosures*.

Scope

4 **This Standard shall be applied by all entities to all types of financial instruments except:**

- (a) those interests in subsidiaries, associates or joint ventures that are accounted for in accordance with HKAS 27 *Consolidated and Separate Financial Statements*, HKAS 28 *Investments in Associates* or HKAS 31 *Interests in Joint Ventures*. However, in some cases, HKAS 27, HKAS 28 or HKAS 31 permits an entity to account for an interest in a subsidiary, associate or joint venture using HKFRS 9; in those cases, entities shall apply the requirements of this Standard. Entities shall also apply this Standard to all derivatives linked to interests in subsidiaries, associates or joint ventures.
- (b) ...
- (d) insurance contracts as defined in HKFRS 4 *Insurance Contracts*. However, this Standard applies to derivatives that are embedded in insurance contracts if HKFRS 9 requires the entity to account for them separately. Moreover, an issuer shall apply this Standard to financial guarantee contracts if the issuer applies HKFRS 9 in recognising and measuring the contracts, but shall apply HKFRS 4 if the issuer elects, in accordance with paragraph 4(d) of HKFRS 4, to apply HKFRS 4 in recognising and measuring them.
- (e) financial instruments that are within the scope of HKFRS 4 because they contain a discretionary participation feature. The issuer of these instruments is exempt from applying to these features paragraphs 15–32 and AG25–AG35 of this Standard regarding the distinction between financial

liabilities and equity instruments. However, these instruments are subject to all other requirements of this Standard. Furthermore, this Standard applies to derivatives that are embedded in these instruments (see HKFRS 9).

- 12 The following terms are defined in Appendix A of HKFRS 9 or paragraph 9 of HKAS 39 and are used in this Standard with the meaning specified in HKAS 39 and HKFRS 9.
- amortised cost of a financial asset or financial liability
 - derecognition
 - derivative
 - effective interest method
 - financial guarantee contract
 - financial liability at fair value through profit or loss
 - firm commitment
 - forecast transaction
 - hedge effectiveness
 - hedged item
 - hedging instrument
 - held for trading
 - regular way purchase or sale
 - transaction costs.
- 23 With the exception of the circumstances described in paragraphs 16A and 16B or paragraphs 16C and 16D, a contract that contains an obligation for an entity to purchase its own equity instruments for cash or another financial asset gives rise to a financial liability for the present value of the redemption amount (for example, for the present value of the forward repurchase price, option exercise price or other redemption amount). This is the case even if the contract itself is an equity instrument. One example is an entity's obligation under a forward contract to purchase its own equity instruments for cash. When the financial liability is recognised initially under HKFRS 9, its fair value (the present value of the redemption amount) is reclassified from equity. Subsequently, the financial liability is measured in accordance with HKFRS 9. If the contract expires without delivery, the carrying amount of the financial liability is reclassified to equity. An entity's contractual obligation to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption amount even if the obligation to purchase is conditional on the counterparty exercising a right to redeem (eg a written put option that gives the counterparty the right to sell an entity's own equity instruments to the entity for a fixed price).

31 HKFRS 9 deals with the measurement of financial assets and financial liabilities. Equity instruments ...

42 ...

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see HKFRS 9, paragraph 3.2.22).

96C The classification of instruments under this exception shall be restricted to the accounting for such an instrument under HKAS 1, HKAS 32, HKAS 39, HKFRS 7 and HKFRS 9. The instrument shall not be considered an equity instrument under other guidance, for example HKFRS 2.

97F [Deleted]

97H HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 3, 4, 12, 23, 31, 42, 96C, AG2 and AG30 and deleted paragraph 97F. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

C31 In the Appendix, paragraphs AG2 and AG30 are amended to read as follows:

AG2 The Standard does not deal with the recognition or measurement of financial instruments. Requirements about the recognition and measurement of financial assets and financial liabilities are set out in HKFRS 9.

AG30 Paragraph 28 applies only to issuers of non-derivative compound financial instruments. Paragraph 28 does not deal with compound financial instruments from the perspective of holders. HKFRS 9 deals with the classification and measurement of financial assets that are compound financial instruments from the holder's perspective.

HKAS 36 Impairment of Assets

C32 Paragraphs 2(e) and 5 are amended to read as follows, paragraph 140F is deleted and paragraph 140G is added:

2 ...

(e) financial assets that are within the scope of HKFRS 9 *Financial Instruments*;

(f) ...

5 This Standard does not apply to financial assets within the scope of HKFRS 9, investment property measured at fair value in accordance with HKAS 40, or biological assets related to agricultural activity measured at fair value less costs to sell in accordance with HKAS 41. However, ...

140F [Deleted]

140G HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 2(e) and 5 and deleted paragraph 140F. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HKAS 37 Provisions, Contingent Liabilities and Contingent Assets

C33 In the rubric 'paragraphs 1–95' is amended to 'paragraphs 1–97'. Paragraph 2 is amended to read as follows and paragraph 97 is added:

2 This Standard does not apply to financial instruments (including guarantees) that are within the scope of HKFRS 9 *Financial Instruments*.

97 HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraph 2. An entity shall apply that amendment when it applies HKFRS 9 as issued in November 2010.

HKAS 39 Financial Instruments: Recognition and Measurement

C34 Paragraphs IN1–IN26 are deleted. A new Introduction is added as follows:

The International Accounting Standards Board has decided to replace HKAS 39 *Financial Instruments: Recognition and Measurement* over a period of time. The first instalment, dealing with classification and measurement of financial assets, was issued as HKFRS 9 *Financial Instruments* in November 2009. The requirements for classification and measurement of financial liabilities and derecognition of financial assets and liabilities were added to HKFRS 9 in November 2010. As a consequence, parts of HKAS 39 are being superseded and will become obsolete for annual periods beginning on or after 1 January 2013. Proposals to replace the requirements on impairment have been published and proposals on hedge accounting are expected to be published in 2010. The remaining requirements of HKAS 39 continue in effect until superseded by future instalments of HKFRS 9. The IASB expects to replace HKAS 39 in its entirety.

C35 Paragraph 1 is deleted.

C36 Paragraphs 2 and 4 are amended to read as follows:

2 This Standard shall be applied by all entities to all types of financial instruments except:

(a) ...

(b) **rights and obligations under leases to which HKAS 17 *Leases* applies. However:**

(i) **lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard;**

(ii) **finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard; and**

(iii) **derivatives that are embedded in leases are subject to the embedded derivatives provisions of this Standard.**

(c) ...

- (e) **rights and obligations arising under (i) an insurance contract as defined in HKFRS 4 *Insurance Contracts*, other than an issuer's rights and obligations arising under an insurance contract that meets the definition of a financial guarantee contract in Appendix A of HKFRS 9, or (ii) a contract that is within the scope of HKFRS 4 because it contains a discretionary participation feature. However, this Standard applies to a derivative that is embedded in a contract within the scope of HKFRS 4 if the derivative is not itself a contract within the scope of HKFRS 4. Moreover, if an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or HKFRS 4 to such financial guarantee contracts (see paragraphs AG4 and AG4A). The issuer may make that election contract by contract, but the election for each contract is irrevocable.**
- (f) ...
- (h) **loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply HKAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard.**
- (i) **financial instruments, contracts and obligations under sharebased payment transactions to which HKFRS 2 *Share-based Payment* applies, except for contracts within the scope of paragraphs 5–7 of this Standard, to which this Standard applies.**
- (j) ...

4 The following loan commitments are within the scope of this Standard:

- (a) **loan commitments that the entity designates as financial liabilities at fair value through profit or loss (see paragraph 4.2.2 of HKFRS 9). An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination shall apply this Standard to all its loan commitments in the same class.**
- (b) ...
- (c) **commitments to provide a loan at a below market interest rate (see paragraph 4.2.1 of HKFRS 9).**

C37 Paragraphs 8 and 9 are amended to read as follows:

- 8 The terms defined in HKFRS 9 and HKAS 32 are used in this Standard with the meanings specified in Appendix A of HKFRS 9 and paragraph 11 of HKAS 32. HKFRS 9 and HKAS 32 define the following terms:
 - derecognition
 - derivative

- equity instrument
- fair value
- financial asset
- financial guarantee contract
- financial instrument
- financial liability

and provide guidance on applying those definitions.

In paragraph 9, the 'Definition of a derivative', 'Definitions of four categories of financial instruments' and 'Definition of a financial guarantee contract' are deleted. In 'Definitions relating to recognition and measurement', the definitions 'derecognition', 'fair value' and 'regular way purchase or sale' are deleted.

C38 Paragraphs 10–57 are deleted.

C39 The heading 'Impairment and uncollectibility of financial assets' above paragraph 58 and paragraphs 58 and 63 are amended to read as follows and paragraphs 61 and 66–70 and the headings above paragraphs 63, 66 and 67 are deleted:

Impairment and uncollectibility of financial assets measured at amortised cost

58 An entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets measured at amortised cost is impaired. If any such evidence exists, the entity shall apply paragraph 63 to determine the amount of any impairment loss.

63 If there is objective evidence that an impairment loss on financial assets measured at amortised cost has been incurred, the amount of the loss is measured as ...

C40 Paragraph 79 is deleted and paragraphs 88(d), 89(b), 90 and 96(c) are amended to read as follows:

88 A hedging relationship qualifies for hedge accounting under paragraphs 89–102 if, and only if, all of the following conditions are met.

(a) ...

(d) **The effectiveness of the hedge can be reliably measured, ie the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.**

(e) ...

Fair value hedges

- 89** If a fair value hedge meets the conditions in paragraph 88 during the period, it shall be accounted for as follows:
- (a) ...
 - (b) **the gain or loss on the hedged item attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognised in profit or loss. This applies if the hedged item is otherwise measured at cost.**
- 90 If only particular risks attributable to a hedged item are hedged, recognised changes in the fair value of the hedged item unrelated to the hedged risk are recognised as set out in paragraph 5.7.1 of HKFRS 9.
- 96 More specifically, a cash flow hedge is accounted for as follows:
- (a) ...
 - (c) if an entity's documented risk management strategy for a particular hedging relationship excludes from the assessment of hedge effectiveness a specific component of the gain or loss or related cash flows on the hedging instrument (see paragraphs 74, 75 and 88(a)), that excluded component of gain or loss is recognised in accordance with paragraph 5.7.1 of HKFRS 9.
- C41 Paragraphs 103B, 103C, 103K, 104 and 108C are amended to read as follows, paragraphs 103H–103J, 103L, 103M and 105–107A are deleted and paragraph 103O is added:
- 103B *Financial Guarantee Contracts* (Amendments to HKAS 39 and HKFRS 4), issued in August 2005, amended paragraphs 2(e) and (h), 4 and AG4, added paragraph AG4A, added a new definition of financial guarantee contracts and deleted paragraph 3. An entity shall apply those amendments for annual periods beginning on or after 1 January 2006. Earlier application is encouraged. If an entity applies these changes for an earlier period, it shall disclose that fact and apply the related amendments to HKAS 32 [footnote omitted] and HKFRS 4 at the same time.
- 103C HKAS 1 (as revised in 2007) amended the terminology used throughout HKFRSs. In addition it amended paragraphs 95(a), 97, 98, 100, 102, 108 and AG99B. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. If an entity applies HKAS 1 (revised 2007) for an earlier period, the amendments shall be applied for that earlier period.
- 103K *Improvements to HKFRSs*, issued in May 2009, amended paragraphs 2(g), 97 and 100. An entity shall apply the amendments to those paragraphs prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendment for an earlier period it shall disclose that fact.
- 103L [Deleted]
- 103M [Deleted]

- 103O HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 2, 4, 8, 9, 58, 63, 88(d), 89(b), 90, 96(c), 103B, 103C, 103K, 104, 108C, AG3–AG4, AG8, AG84, AG95, AG114(a) and AG118(b) and deleted paragraphs 1, 10–57, 61, 66–70, 79, 103H–103J, 103L, 103M, 105–107A, AG4B–AG4K, AG9–AG12A, AG14–AG15, AG27–AG83 and AG96. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.
- 104 This Standard shall be applied retrospectively except as specified in paragraph 108. The opening balance of retained earnings for the earliest prior period presented and all other comparative amounts shall be adjusted as if this Standard had always been in use unless restating the information would be impracticable. If restatement is impracticable, the entity shall disclose that fact and indicate the extent to which the information was restated.
- 108C Paragraphs 73 and AG8 were amended by *Improvements to HKFRSs*, issued in October 2008. Paragraph 80 was amended by *Improvements to HKFRSs*, issued in May 2009. An entity shall apply those amendments for annual periods beginning on or after 1 January 2009. Earlier application of all the amendments is permitted. If an entity applies the amendments for an earlier period it shall disclose that fact.
- C42 In Appendix A, paragraphs AG3–AG4 are amended to read as follows:
- AG3 ... If neither the equity method nor proportionate consolidation is appropriate, the entity applies this Standard and HKFRS 9 to that strategic investment.
- AG3A This Standard and HKFRS 9 apply to the financial assets and financial liabilities of insurers, other than rights and obligations that paragraph 2(e) excludes because they arise under contracts within the scope of HKFRS 4.
- AG4 Financial guarantee contracts may have various legal forms, such as...
- (a) Although a financial guarantee contract meets the definition of an insurance contract in HKFRS 4 if the risk transferred is significant, the issuer applies this Standard and HKFRS 9. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard and HKFRS 9 or HKFRS 4 to such financial guarantee contracts. If this Standard and HKFRS 9 apply, paragraph 5.1.1 of HKFRS 9 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs 3.2.15–3.2.23 and B3.2.12–B3.2.17 of HKFRS 9 apply (when a transfer of a financial asset does not qualify for derecognition or the continuing involvement approach applies), the issuer measures it at the higher of:
- (i) the amount determined in accordance with HKAS 37; and
- (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with HKAS 18 (see paragraph 4.2.1(c) of HKFRS 9).

(b) Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. An example of such a guarantee is one that requires payments in response to changes in a specified credit rating or credit index. Such guarantees are not financial guarantee contracts as defined in HKFRS 9, and are not insurance contracts as defined in HKFRS 4. Such guarantees are derivatives and the issuer applies this Standard and HKFRS 9 to them.

(c) ...

C43 In Appendix A, paragraphs AG4B–AG4K, AG9–AG12A and AG14–AG15 are deleted and paragraph AG8 is amended to read as follows:

AG8 If an entity revises its estimates of payments or receipts, the entity shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows. The entity recalculates the carrying amount by computing the present value of estimated future cash flows at the financial instrument's original effective interest rate or, when applicable, the revised effective interest rate calculated in accordance with paragraph 92. The adjustment is recognised in profit or loss as income or expense.

C44 In Appendix A, paragraphs AG27–AG83 are deleted.

C45 In Appendix A, the heading 'Impairment and uncollectibility of financial assets (paragraphs 58–70)' above paragraph AG84 and paragraph AG84 are amended to read as follows:

Impairment and uncollectibility of financial assets measured at amortised cost (paragraphs 58–65)

AG84 Impairment of a financial asset measured at amortised cost is measured using the financial instrument's original effective interest rate because discounting at the current market rate of interest would, in effect, impose fair value measurement on financial assets that are otherwise measured at amortised cost. If the terms of a financial asset measured at amortised cost are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Cash flows relating to short-term receivables are not discounted if the effect of discounting is immaterial. If a financial asset measured at amortised cost has a variable interest rate, the discount rate for measuring any impairment loss under paragraph 63 is the current effective interest rate(s) determined under the contract. As a practical expedient, a creditor may measure impairment of a financial asset measured at amortised cost on the basis of an instrument's fair value using an observable market price. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

C46 In Appendix A, paragraph AG96 and the first footnote to paragraph AG118(b) are deleted and paragraphs AG95, AG114(a) and AG118(b) are amended to read as follows:

AG95 A financial asset measured at amortised cost may be designated as a hedging instrument in a hedge of foreign currency risk.

AG96 [Deleted]

AG114 For a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities, an entity would meet the requirements of this Standard if it complies with the procedures set out in (a)–(i) and paragraphs AG115–AG132 below.

(a) As part of its risk management process the entity identifies a portfolio of items whose interest rate risk it wishes to hedge. The portfolio may comprise only assets, only liabilities or both assets and liabilities. The entity may identify two or more portfolios, in which case it applies the guidance below to each portfolio separately.

(b) ...

AG118 As an example of the designation set out...

(a) ...

(b) items that could have qualified for fair value hedge accounting if they had been designated as hedged individually. In particular, because HKFRS 9 specifies that the fair value of a financial liability with a demand feature (such as...

C47 The heading 'Transition (paragraphs 103–108N)' above paragraph AG133 is amended to read as follows:

Transition (paragraphs 103–108C)

HK(IFRIC)-Int 2 Members' Shares in Co-operative Entities and Similar Instruments

C48 In the rubric 'paragraphs 1–14A' is amended to 'paragraphs 1–15'. Below the heading 'References', the reference to HKAS 39 is deleted and a reference to HKFRS 9 *Financial Instruments* is added. Paragraph 15 is added:

15 HKFRS 9, issued in November 2010, amended paragraphs A8 and A10. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

C49 In the Appendix, paragraphs A8 and A10 are amended to read as follows:

A8 Members' shares in excess of the prohibition against redemption are financial liabilities. The co-operative entity measures this financial liability at fair value at initial recognition. Because these shares are redeemable on demand, the co-operative entity determines the fair value of such financial liabilities as required by paragraph 5.4.3 of HKFRS 9, which states: 'The fair value of a financial liability with a demand feature (eg a demand deposit) is not less than the amount payable on demand ...' Accordingly, the cooperative entity classifies as financial liabilities the maximum amount payable on demand under the redemption provisions.

A10 Following the change in its governing charter the co-operative entity can now be required to redeem a maximum of 25 per cent of its outstanding shares or a maximum of 50,000 shares at CU20 each. Accordingly, on 1 January 20X3 the co-operative entity classifies as financial liabilities an amount of CU1,000,000 being the maximum amount payable on demand under the redemption provisions, as determined in accordance with paragraph 5.4.3 of HKFRS 9. It therefore transfers on 1 January 20X3 from equity to financial liabilities an amount of CU200,000, leaving CU2,000,000 classified as equity. In this example the entity does not recognise a gain or loss on the transfer.

HK(IFRIC)-Int 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

C50 Below the heading 'References', the reference to HKAS 39 is deleted and a reference to HKFRS 9 *Financial Instruments* is added. Paragraph 5 is amended to read as follows and paragraph 14A is added:

- 5 A residual interest in a fund that extends beyond a right to reimbursement, such as a contractual right to distributions once all the decommissioning has been completed or on winding up the fund, may be an equity instrument within the scope of HKFRS 9 and is not within the scope of this Interpretation.

14A HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraph 5. An entity shall apply that amendment when it applies HKFRS 9 as issued in November 2010.

HK(IFRIC)-Int 10 Interim Financial Reporting and Impairment

C51 In the rubric 'paragraphs 1–10' is amended to 'paragraphs 1–12'. Below the heading 'References', the reference to HKAS 39 is deleted and a reference to HKFRS 9 *Financial Instruments* is added. Paragraphs 5, 6 and 11 are deleted, paragraphs 1, 2, 7 and 8 are amended to read as follows and paragraph 12 is added:

- 1 An entity is required to assess goodwill for impairment at the end of each reporting period, and, if required, to recognise an impairment loss at that date in accordance with HKAS 36. However, ...
- 2 The Interpretation addresses the interaction between the requirements of HKAS 34 and the recognition of impairment losses on goodwill in HKAS 36, and the effect of that interaction on subsequent interim and annual financial statements.
- 7 The Interpretation addresses the following issue:

Should an entity reverse impairment losses recognised in an interim period on goodwill if a loss would not have been recognised, or a smaller loss would have been recognised, had an impairment assessment been made only at the end of a subsequent reporting period?

Conclusions

- 8 An entity shall not reverse an impairment loss recognised in a previous interim period in respect of goodwill.
- 11 [Deleted]
- 12 HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 1, 2, 7 and 8 and deleted paragraphs 5, 6 and 11. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HK(IFRIC)-Int 12 *Service Concession Arrangements*

C52 Below the heading 'References', the reference to HKAS 39 is deleted and a reference to HKFRS 9 *Financial Instruments* is added. Paragraphs 23–25 are amended to read as follows, paragraph 28A is deleted and paragraph 28B is added:

23 HKAS 32 and HKFRSs 7 and 9 apply to the financial asset recognised under paragraphs 16 and 18.

24 The amount due from or at the direction of the grantor is accounted for in accordance with HKFRS 9 as:

- (a) at amortised cost; or
- (b) measured at fair value through profit or loss.

25 If the amount due from the grantor is accounted for at amortised cost, HKFRS 9 requires interest calculated using the effective interest method to be recognised in profit or loss.

28A [Deleted]

28B HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 23–25 and deleted paragraph 28A. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

HK(IFRIC)-Int 19 *Extinguishing Financial Liabilities with Equity Instruments*

C53 In the rubric 'paragraphs 1–13' is amended to 'paragraphs 1–14'. Below the heading 'References', the reference to HKAS 39 is deleted and a reference to HKFRS 9 *Financial Instruments* is added. Paragraphs 4(a), 5, 7, 9 and 10 are amended to read as follows and paragraph 14 is added:

4 This Interpretation addresses the following issues:

- (a) Are an entity's equity instruments issued to extinguish all or part of a financial liability 'consideration paid' in accordance with paragraph 3.3.3 of HKFRS 9?
- (b) ...

Conclusions

5 The issue of an entity's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with paragraph 3.3.3 of HKFRS 9. An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished in accordance with paragraph 3.3.1 of HKFRS 9.

- 7 If the fair value of the equity instruments issued cannot be reliably measured then the equity instruments shall be measured to reflect the fair value of the financial liability extinguished. In measuring the fair value of a financial liability extinguished that includes a demand feature (eg a demand deposit), paragraph 5.4.3 of HKFRS 9 is not applied.
- 9 The difference between the carrying amount of the financial liability (or part of a financial liability) extinguished, and the consideration paid, shall be recognised in profit or loss, in accordance with paragraph 3.3.3 of HKFRS 9. The equity instruments issued shall be recognised initially and measured at the date the financial liability (or part of that liability) is extinguished.
- 10 When only part of the financial liability is extinguished, consideration shall be allocated in accordance with paragraph 8. The consideration allocated to the remaining liability shall form part of the assessment of whether the terms of that remaining liability have been substantially modified. If the remaining liability has been substantially modified, the entity shall account for the modification as the extinguishment of the original liability and the recognition of a new liability as required by paragraph 3.3.2 of HKFRS 9.
- 14 HKFRS 9 *Financial Instruments*, issued in November 2010, amended paragraphs 4(a), 5, 7, 9 and 10. An entity shall apply those amendments when it applies HKFRS 9 as issued in November 2010.

Hong Kong (SIC) Interpretation 27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease

- C54 Below the heading 'References', the reference to HKAS 39 is deleted and a reference to HKFRS 9 *Financial Instruments* is added. In the Consensus, paragraph 7 is amended to read as follows:
- 7 Other obligations of an arrangement, including any guarantees provided and obligations incurred upon early termination, shall be accounted for under HKAS 37, HKFRS 4 or HKFRS 9, depending on the terms.

Appendix D

Comparison with International Financial Reporting Standards

This comparison appendix, which was prepared as at November 2010 and deals only with significant differences in the standards extant, is produced for information only and does not form part of the standards in HKFRS 9. The International Financial Reporting Standard comparable with HKFRS 9 is IFRS 9 *Financial Instruments*.

There are no major textual differences between HKFRS 9 and IFRS 9.

HKFRS 9 BC
~~Issued November 2009~~ Revised November 2010

Effective for annual periods
beginning on or after 1 January 2013

*Basis for Conclusions on
Hong Kong Financial Reporting Standard 9*

Financial Instruments



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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Basis for Conclusions

HKFRS 9 *Financial Instruments*

HKFRS 9 is based on IFRS 9 *Financial Instruments*. In approving HKFRS 9, the Council of the Hong Kong Institute of Certified Public Accountants considered and agreed with the IASB's Basis for Conclusions on IFRS 9. Accordingly, there are no significant differences between HKFRS 9 and IFRS 9. The IASB's Basis for Conclusions is reproduced below. The paragraph numbers of IFRS 9 referred to below generally correspond with those in HKFRS 9.

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APPENDIX

Amendments to the Basis for Conclusions on other IFRSs

DISSENTING OPINIONS

Basis for Conclusions on IFRS 9 *Financial Instruments*

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

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

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

References to the Framework are to IASC's Framework for the Preparation and Presentation of Financial Statements, adopted by the IASB in 2001. In September 2010 the IASB replaced the Framework with the Conceptual Framework for Financial Reporting.

Introduction

- BCIN.1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in developing IFRS 9 *Financial Instruments*. Individual Board members gave greater weight to some factors than to others.
- BCIN.2 The Board has long acknowledged the need to improve the requirements for financial reporting of financial instruments to enhance the relevance and understandability of information about financial instruments for users of financial statements. To meet the urgency of that need in the light of the financial crisis, the Board decided to replace IAS 39 *Financial Instruments: Recognition and Measurement* in its entirety as expeditiously as possible. To make progress quickly the Board divided the project into several phases. In adopting this approach, the Board acknowledged the difficulties that might be created by differences in timing between this project and others, in particular phase II of the project on insurance contracts. (Paragraphs BC7.2(b), BC7.4 and BC7.30–BC7.34 discuss issues relating to insurance contracts.)
- BCIN.3 IFRS 9 is a new standard dealing with the accounting for financial instruments. In developing IFRS 9, the Board considered the responses to its exposure draft *Financial Instruments: Classification and Measurement*, published in July 2009.
- BCIN.4 That exposure draft contained proposals for all items within the scope of IAS 39. However, some respondents said that the Board should finalise its proposals on classification and measurement of financial assets while retaining the existing requirements for financial liabilities (including the requirements for embedded derivatives and the fair value option) until the Board had more fully considered and debated the issues relating to financial liabilities. Those respondents pointed out that the Board accelerated its project on financial instruments because of the global financial crisis, which placed more emphasis on issues in the accounting for financial assets than for financial liabilities. They suggested that the Board should consider issues related to financial liabilities more fully before finalising the requirements for classification and measurement of financial liabilities.

- BCIN.5 The Board noted those concerns and, as a result, in November 2009 it finalised the first chapters of IFRS 9, dealing with classification and measurement of financial assets. In the Board's view, requirements on classification and measurement are the foundation for a financial reporting standard on accounting for financial instruments, and requirements on associated matters (for example, on impairment and hedge accounting) have to reflect those requirements. In addition, the Board noted that many of the application issues that have arisen in the financial crisis are related to the classification and measurement of financial assets in accordance with IAS 39.
- BCIN.6 Thus, financial liabilities, including derivative liabilities, remained within the scope of IAS 39. Taking that course enabled the Board to obtain further feedback on the accounting for financial liabilities, including how best to address accounting for changes in own credit risk.
- BCIN.7 Immediately after issuing IFRS 9, the Board began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities. The Board obtained information and views from its Financial Instruments Working Group (FIWG) and from users, regulators, preparers, auditors and others from a range of industries across different geographical regions. The primary messages that the Board received were that the requirements in IAS 39 for classifying and measuring financial liabilities are generally working well but that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. As a result of the feedback received, the Board decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities and carry them forward to IFRS 9 (see paragraphs BC4.46–BC4.53).
- BCIN.8 By taking that course, the issue of credit risk does not arise for most liabilities and would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010 the Board published an exposure draft *Fair Value Option for Financial Liabilities*, which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The Board considered the responses to that exposure draft and finalised requirements that were added to IFRS 9 in October 2010.
- BCIN.9 The Board is committed to completing its project on financial instruments expeditiously. The Board is also committed to increasing comparability between IFRSs and US generally accepted accounting principles (GAAP) requirements for financial instruments.

Scope (chapter 2)

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

Recognition and derecognition (chapter 3)

Derecognition of a financial asset

The original IAS 39*

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

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

- BCZ3.2 As an example, the original IAS 39 was unclear about the extent to which risks and rewards of a transferred asset should be considered for the purpose of determining whether derecognition is appropriate and how risks and rewards should be assessed. In some cases (eg transfers with total returns swaps or unconditional written put options), the Standard specifically indicated whether derecognition was appropriate, whereas in others (eg credit guarantees) it was unclear. Also, some questioned whether the assessment should focus on risks and rewards or only risks and how different risks and rewards should be aggregated and weighed.
- BCZ3.3 To illustrate, assume an entity sells a portfolio of short-term receivables of CU100* and provides a guarantee to the buyer for credit losses up to a specified amount (say CU20) that is less than the total amount of the receivables, but higher than the amount of expected losses (say CU5). In this case, should (a) the entire portfolio continue to be recognised, (b) the portion that is guaranteed continue to be recognised or (c) the portfolio be derecognised in full and a guarantee be recognised as a financial liability? The original IAS 39 did not give a clear answer and the IAS 39 Implementation Guidance Committee—a group set up by the Board's predecessor body to resolve interpretative issues raised in practice—was unable to reach an agreement on how IAS 39 should be applied in this case. In developing proposals for improvements to IAS 39, the Board concluded that it was important that IAS 39 should provide clear and consistent guidance on how to account for such a transaction.

Exposure draft of proposed amendments to IAS 39 published in 2002

- BCZ3.4 To resolve the problems, the exposure draft published in 2002 proposed an approach to derecognition under which a transferor of a financial asset continues to recognise that asset to the extent the transferor has a continuing involvement in it. Continuing involvement could be established in two ways: (a) a reacquisition provision (such as a call option, put option or repurchase agreement) and (b) a provision to pay or receive compensation based on changes in value of the transferred asset (such as a credit guarantee or net cash-settled option).
- BCZ3.5 The purpose of the approach proposed in the exposure draft was to facilitate consistent implementation and application of IAS 39 by eliminating conflicting concepts and establishing an unambiguous, more internally consistent and workable approach to derecognition. The main benefits of the proposed approach were that it would greatly clarify IAS 39 and provide transparency on the balance sheet about any continuing involvement in a transferred asset.

Comments received

- BCZ3.6 Many respondents to the exposure draft agreed that there were inconsistencies in the existing derecognition requirements in IAS 39. However, there was limited support for the proposed continuing involvement approach. Respondents expressed conceptual and practical concerns, including:
- (a) any benefits of the proposed changes did not outweigh the burden of adopting a different approach that had its own set of (as yet unidentified and unsolved) problems;
 - (b) the proposed approach was a fundamental change from that in the original IAS 39;
 - (c) the proposal did not achieve convergence with US GAAP;
 - (d) the proposal was untested; and
 - (e) the proposal was not consistent with the *Framework for the Preparation and Presentation of Financial Statements*.

* In this Basis for Conclusions, monetary amounts are denominated in 'currency units (CU)'.

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

Revisions to IAS 39

BCZ3.8 In response to the comments received, the Board decided to revert to the derecognition concepts in the original IAS 39 and to clarify how and in what order the concepts should be applied. In particular, the Board decided that an evaluation of the transfer of risks and rewards should precede an evaluation of the transfer of control for all types of transactions.

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

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

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

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

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

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

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

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

- BCZ3.14 The original IAS 39 did not provide explicit guidance about the extent to which derecognition is appropriate for contractual arrangements in which an entity retains its contractual right to receive the cash flows from an asset, but assumes a contractual obligation to pay those cash flows to another entity (a 'pass-through arrangement'). Questions were raised in practice about the appropriate accounting treatment and divergent interpretations evolved for more complex structures.
- BCZ3.15 To illustrate the issue using a simple example, assume the following. Entity A makes a five-year interest-bearing loan (the 'original asset') of CU100 to Entity B. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU90, Entity A agrees to pass to Entity C 90 per cent of all principal and interest payments collected from Entity B (as, when and if collected). Entity A accepts no obligation to make any payments to Entity C other than 90 per cent of exactly what has been received from Entity B. Entity A provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90 per cent of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B. In the example above, does Entity A have a loan asset of CU100 and a liability of CU90 or does it have an asset of CU10? To make the example more complex, what if Entity A first transfers the loan to a consolidated special purpose entity (SPE), which in turn passes through to investors the cash flows from the asset? Does the accounting treatment change because Entity A first sold the asset to an SPE?
- BCZ3.16 To address these issues, the exposure draft of proposed amendments to IAS 39 in 2002 included guidance to clarify under which conditions pass-through arrangements could be treated as a transfer of the underlying financial asset. The Board concluded that an entity does not have an asset and a liability, as defined in the *Framework*, when it enters into an arrangement to pass through cash flows from an asset and that arrangement meets specified conditions. In these cases, the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset. Accordingly, to the extent that those conditions are met the arrangement is treated as a transfer and considered for derecognition even though the entity may continue to collect cash flows from the asset. Conversely, to the extent the conditions are not met, the entity acts more as an owner of the asset with the result that the asset should continue to be recognised.
- BCZ3.17 Respondents to the exposure draft (2002) were generally supportive of the proposed changes. Some respondents asked for further clarification of the requirements and the interaction with the requirements for consolidation of special purpose entities (in SIC-12 *Consolidation—Special Purpose Entities*). Respondents in the securitisation industry noted that under the proposed guidance many securitisation structures would not qualify for derecognition.

- BCZ3.18 Considering these and other comments, the Board decided to proceed with its proposals to issue guidance on pass-through arrangements and to clarify that guidance in finalising the revised IAS 39 (this guidance is now in IFRS 9).
- BCZ3.19 The Board concluded that the following three conditions must be met for treating a contractual arrangement to pass through cash flows from a financial asset as a transfer of that asset:
- (a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. However, the entity is allowed to make short-term advances to the eventual recipient so long as it has the right of full recovery of the amount lent plus accrued interest.
 - (b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
 - (c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, during the short settlement period, the entity is not entitled to reinvest such cash flows except for investments in cash or cash equivalents and where any interest earned from such investments is remitted to the eventual recipients.
- BCZ3.20 These conditions followed from the definitions of assets and liabilities in the *Framework*. Condition (a) indicates that the transferor has no liability (because there is no present obligation to pay cash), and conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset).
- BCZ3.21 The Board decided that the derecognition tests that apply to other transfers of financial assets (ie the tests of transferring substantially all the risks and rewards and control) should also apply to arrangements to pass through cash flows that meet the three conditions but do not involve a fully proportional share of all or specifically identified cash flows. Thus, if the three conditions are met and the entity passes on a fully proportional share, either of all cash flows (as in the example in paragraph BCZ3.15) or of specifically identified cash flows (eg 10 per cent of all interest cash flows), the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, in the example in paragraph BCZ3.15, Entity A would report a loan asset of CU10 and derecognise CU90. Similarly, if an entity enters into an arrangement that meets the three conditions above, but the arrangement is not on a fully proportionate basis, the contractual arrangement would have to meet the general derecognition conditions to qualify for derecognition. This ensures consistency in the application of the derecognition model, whether a transaction is structured as a transfer of the contractual right to receive the cash flows of a financial asset or as an arrangement to pass through cash flows.
- BCZ3.22 To illustrate a disproportionate arrangement using a simple example, assume the following. Entity A originates a portfolio of five-year interest-bearing loans of CU10,000. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU9,000, Entity A agrees to pay to Entity C the first CU9,000 (plus interest) of cash collected from the loan portfolio. Entity A retains rights to the last CU1,000 (plus interest), ie it retains a subordinated residual interest. If Entity A collects, say, only CU8,000 of its loans of CU10,000 because some debtors default, Entity A would pass on to Entity C all of the CU8,000 collected and Entity A keeps nothing of the CU8,000 collected. If Entity A collects CU9,500, it passes CU9,000 to Entity C and retains CU500. In this case, if Entity A retains substantially all the risks and rewards of ownership because the subordinated retained interest absorbs all of the likely variability in net cash flows, the loans continue to be recognised in their entirety even if the three pass-through conditions are met.
- BCZ3.23 The Board recognised that many securitisations might fail to qualify for derecognition either because one or more of the three conditions (now in paragraph 3.2.5 of IFRS 9) were not met or because the entity has retained substantially all the risks and rewards of ownership.

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

Transfers that do not qualify for derecognition

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

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

Continuing involvement in a transferred asset

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

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

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

Improved disclosure requirements issued in October 2010

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

BC3.31 However, in June 2010 the Board revised its strategy and work plan. The Board and the US Financial Accounting Standards Board (FASB) decided that their near-term priority should be to increase the transparency and comparability of their standards by improving and aligning US GAAP and IFRS disclosure requirements for financial assets transferred to another entity. The boards also decided to conduct additional research and analysis, including a post-implementation review of the FASB's recently amended requirements, as a basis for assessing the nature and direction of any

further efforts to improve or align IFRSs and US GAAP. As a result, the Board finalised the disclosure requirements that were included in the exposure draft with a view to aligning the disclosure requirements in IFRSs with US GAAP requirements for transfers of financial assets. Those disclosure requirements were issued in October 2010 as an amendment to IFRS 7. In October 2010 the requirements in IAS 39 for derecognition of financial assets and financial liabilities were carried forward unchanged to IFRS 9.

Classification (chapter 4)

Classification of financial assets

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

- (a) reducing the number of classification categories and providing a clearer rationale for measuring financial assets in a particular way that replaces the numerous categories in IAS 39, each of which has specific rules dictating how an asset can or must be classified;
- (b) applying a single impairment method to all financial assets not measured at fair value, which replaces the many different impairment methods that are associated with the numerous classification categories in IAS 39; and
- (c) aligning the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics, thus providing relevant and useful information to users for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

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

Measurement categories for financial assets

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

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

- BC4.5 Some, including some of those who generally support the broad application of fair value for financial assets, raise concerns about the use of fair value when fair value cannot be determined within a narrow range. Those views were consistent with the general concerns raised during the financial crisis. Many also believe that other issues, including financial statement presentation, need to be addressed before a comprehensive fair value measurement requirement would be feasible.
- BC4.6 In response to those views, the Board decided that measuring all financial assets at fair value is not the most appropriate approach to improving the financial reporting for financial instruments. Accordingly, the exposure draft published in 2009 proposed that entities should classify financial assets into two primary measurement categories: amortised cost and fair value (the 'mixed attribute approach'). The Board noted that both of those measurement methods can provide useful information to users of financial statements for particular types of financial assets in particular circumstances.
- BC4.7 Almost all respondents to the exposure draft published in 2009 supported the mixed attribute approach, stating that amortised cost provides relevant and useful information about particular financial assets in particular circumstances because it provides information about the entity's likely actual cash flows. Some respondents said that fair value does not provide such information because it assumes that the financial asset is sold or transferred on the measurement date.
- BC4.8 Accordingly, IFRS 9 requires some financial assets to be measured at amortised cost if particular conditions are met.

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

- BC4.9 Some respondents to the exposure draft published in 2009 proposed that fair value information should be presented in the statement of financial position for financial assets measured at amortised cost. Some of those supporting such presentation said that the information provided would be more reliable and timely if it were required to be presented in the statement of financial position rather than in the notes.
- BC4.10 The Board also considered whether the total gains and losses for the period related to fair value measurements in Level 3 of the fair value measurement hierarchy (paragraph 27A of IFRS 7 describes the levels in the fair value hierarchy) should be presented separately in the statement of comprehensive income. Those supporting such presentation said that its prominence would draw attention to how much of the total fair value gain or loss for the period was attributable to fair value measurements that are subject to more measurement uncertainty.
- BC4.11 The Board decided that it would reconsider both issues at a future date. The Board noted that the Level 3 gains or losses for the period are required to be disclosed in the notes to the financial statements in accordance with IFRS 7. The Board also noted that neither proposal had been exposed for public comment and further consultation was required. The Board decided that these two issues should form part of convergence discussions with the FASB.

Approach to classifying financial assets

- BC4.12 The exposure draft published in 2009 proposed that an entity should classify its financial assets into two primary measurement categories on the basis of the financial assets' characteristics and the entity's business model for managing them. Thus, a financial asset would be measured at amortised cost if two conditions were met:
- (a) the financial asset has only basic loan features; and
 - (b) the financial asset is managed on a contractual yield basis.

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

- BC4.13 Most respondents supported classification on the basis on the contractual terms of the financial asset and how an entity manages groups of financial assets. Although they agreed with the principles proposed in the exposure draft, some did not agree with the way the approach was described and said that more application guidance was needed, in particular to address the following issues:
- (a) the order in which the two conditions are considered;
 - (b) how the ‘managed on a contractual yield basis’ condition should be applied; and
 - (c) how the ‘basic loan features’ condition should be applied.
- BC4.14 Most respondents agreed that the two conditions for determining how financial assets are measured were necessary. However, many questioned the order in which the two conditions should be considered. The Board agreed with those who commented that it would be more efficient for an entity to consider the business model condition first. Therefore, the Board clarified that entities would consider the business model first. However, the Board noted that the contractual cash flow characteristics of any financial asset within a business model that has the objective of collecting contractual cash flows must also be assessed to ensure that amortised cost provides relevant information to users.

The entity’s business model

- BC4.15 The Board concluded that an entity’s business model affects the predictive quality of contractual cash flows—ie whether the likely actual cash flows will result primarily from the collection of contractual cash flows. Accordingly, the exposure draft published in 2009 proposed that a financial asset should be measured at amortised cost only if it is ‘managed on a contractual yield basis’. This condition was intended to ensure that the measurement of a financial asset provides information that is useful to users of financial statements in predicting likely actual cash flows.
- BC4.16 Almost all respondents to the exposure draft agreed that classification and measurement should reflect how an entity manages its financial assets. However, most expressed concern that the term ‘managed on a contractual yield basis’ would not adequately describe that principle and that more guidance was needed.
- BC4.17 In August 2009 the FASB posted on its website a description of its tentative approach to classification and measurement of financial instruments. That approach also considers the entity’s business model. Under that approach, financial instruments would be measured at fair value through profit or loss unless:

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

The FASB also provided explanatory text:

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

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

- BC4.19 Therefore, in response to the concerns noted in paragraph BC4.16, the Board clarified the condition by requiring an entity to measure a financial asset at amortised cost only if the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows. The Board also clarified in the application guidance that:
- (a) it is expected that an entity may sell some financial assets that it holds with an objective of collecting the contractual cash flows. Very few business models entail holding all instruments until maturity. However, frequent buying and selling of financial assets is not consistent with a business model of holding financial assets to collect contractual cash flows.
 - (b) an entity needs to use judgement to determine at what level this condition should be applied. That determination is made on the basis of how an entity manages its business. It is not made at the level of an individual financial asset.
- BC4.20 The Board noted that an entity's business model does not relate to a choice (ie it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management.
- BC4.21 For example, if an investment bank uses a trading business model, it could not easily become a savings bank that uses an 'originate and hold' business model. Therefore, a business model is very different from 'management intentions', which can relate to a single instrument. The Board concluded that sales or transfers of financial instruments before maturity would not be inconsistent with a business model with an objective of collecting contractual cash flows, as long as such transactions were consistent with that business model, rather than with a business model that has the objective of realising changes in fair values.

Contractual cash flow characteristics

- BC4.22 The exposure draft published in 2009 proposed that only financial instruments with basic loan features could be measured at amortised cost. It specified that a financial instrument has basic loan features if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. For the purposes of this condition, interest is consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk.
- BC4.23 The objective of the effective interest method for financial instruments measured at amortised cost is to allocate interest revenue or expense to the relevant period. Cash flows that are interest always have a close relation to the amount advanced to the debtor (the 'funded' amount) because interest is consideration for the time value of money and the credit risk associated with the issuer of the instrument and with the instrument itself. The Board noted that the effective interest method is not an appropriate method to allocate cash flows that are not principal or interest on the principal amount outstanding. The Board concluded that if a financial asset contains contractual cash flows that are not principal or interest on the principal amount outstanding then a valuation overlay to contractual cash flows (fair value) is required to ensure that the reported financial information provides useful information.
- BC4.24 Most respondents to the exposure draft agreed with the principle that classification should reflect the contractual terms of the financial asset. However, many objected to the label 'basic loan features' and requested more guidance to apply the principle to particular financial assets. Respondents were also concerned that the exposure draft did not discuss 'immaterial' or 'insignificant' features that they believed ought not to affect classification.
- BC4.25 The Board decided to clarify how contractual cash flow characteristics should affect classification and improve the examples that illustrate how the condition should be applied. It decided not to add application guidance clarifying that the notion of materiality applies to this condition, because that notion applies to every item in the financial statements. However, it did add application guidance that a contractual cash flow characteristic does not affect the classification of a financial asset if it is 'not genuine'.

Application of the two classification conditions to particular financial assets

Investments in contractually linked instruments (tranches)

- BC4.26 A structured investment vehicle may issue different tranches to create a 'waterfall' structure that prioritises the payments by the issuer to the holders of the different tranches. In typical waterfall structures, multiple contractually linked instruments effect concentrations of credit risk in which payments to holders are prioritised. Such structures specify the order in which any losses that the issuer incurs are allocated to the tranches. The exposure draft published in 2009 concluded that tranches providing credit protection (albeit on a contingent basis) to other tranches are leveraged because they expose themselves to higher credit risk by writing credit protection to other tranches. Hence their cash flows do not represent solely payments of principal and interest on the principal amount outstanding. Thus, only the most senior tranche could have basic loan features and might qualify for measurement at amortised cost, because only the most senior tranche would receive credit protection in all situations.
- BC4.27 The exposure draft proposed that the classification principle should be based on whether a tranche could provide credit protection to any other tranches in *any* possible scenario. In the Board's view, a contract that contains credit concentration features that create ongoing subordination (not only in a liquidation scenario) would include contractual cash flows that represent a premium for providing credit protection to other tranches. Only the most senior tranche does not receive such a premium.
- BC4.28 In proposing this approach, the Board concluded that subordination in itself should not preclude amortised cost measurement. The ranking of an entity's instruments is a common form of subordination that affects almost all lending transactions. Commercial law (including bankruptcy law) typically sets out a basic ranking for creditors. This is required because not all creditors' claims are contractual (eg claims regarding damages for unlawful behaviour and for tax liabilities or social insurance contributions). Although it is often difficult to determine exactly the degree of leverage resulting from this subordination, the Board believes that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for general creditors such as trade creditors. Thus, the Board believes that the credit risk associated with general creditors does not preclude the contractual cash flows representing the payments of principal and interest on the principal amount outstanding. Consequently, the credit risk associated with any secured or senior liabilities ranking above general creditors should also not preclude the contractual cash flows from representing payments of principal and interest on the principal amount outstanding.
- BC4.29 Almost all respondents disagreed with the approach in the exposure draft for investments in contractually linked instruments for the following reasons:
- (a) It focused on form and legal structure rather than the economic characteristics of the financial instruments.
 - (b) It would create structuring opportunities because of the focus on the existence of a waterfall structure, without consideration of the characteristics of the underlying instruments.
 - (c) It would be an exception to the overall classification model, driven by anti-abuse considerations.
- BC4.30 In particular, respondents argued that the proposals in the exposure draft would conclude that some tranches provide credit protection and therefore were ineligible for measurement at amortised cost, even though that tranche might have a lower credit risk than the underlying pool of instruments that would themselves be eligible for measurement at amortised cost.

BC4.31 The Board did not agree that the proposals in the exposure draft were an exception to the overall classification model. In the Board's view, those proposals were consistent with many respondents' view that any financial instrument that creates contractual subordination should be subject to the proposed classification criteria and no specific guidance should be required to apply the classification approach to these instruments. However, it noted that, for contractually linked instruments that effect concentrations of credit risk, many respondents did not agree that the contractual cash flow characteristics determined by the terms and conditions of the financial asset in isolation best reflected the economic characteristics of that financial asset.

BC4.32 Respondents proposed other approaches in which an investor 'looks through' to the underlying pool of instruments of a waterfall structure and measures the instruments at fair value if looking through is not possible. They made the following points:

- (a) *Practicability*: The securitisation transactions intended to be addressed were generally over-the-counter transactions in which the parties involved had sufficient information about the assets to perform an analysis of the underlying pool of instruments.
- (b) *Complexity*: Complex accounting judgement was appropriate to reflect the complex economic characteristics of the instrument. In particular, in order to obtain an understanding of the effects of the contractual terms and conditions, an investor would have to understand the underlying pool of instruments. Also, requiring fair value measurement if it were not practicable to look through to the underlying pool of instruments would allow an entity to avoid such complexity.
- (c) *Mechanics*: Amortised cost measurement should be available only if all of the instruments in the underlying pool of instruments had contractual cash flows that represented payments of principal and interest on the principal amount outstanding. Some also suggested that instruments that change the cash flow variability of the underlying pool of instruments in a way that is consistent with representing solely payments of principal and interest on the principal amount outstanding, or aligned currency/interest rates with the issued notes, should not preclude amortised cost measurement.
- (d) *Relative exposure to credit risk*: Many favoured use of a probability-weighted approach to assess whether an instrument has a lower or higher exposure to credit risk than the average credit risk of the underlying pool of instruments.

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

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

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

- (a) determine whether the contractual terms of the issued instrument (the financial asset being classified) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. The Board concluded that the issued instrument must have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.
- (b) look through to the underlying pool of instruments until it can identify the instruments that are creating (rather than simply passing through) the cash flows.
- (c) determine whether one or more of the instruments in the underlying pool has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. The Board concluded that the underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.
- (d) assess whether any other instruments in the underlying pool only:
 - (i) reduce the cash flow variability of the underlying pool of instruments in a way that is consistent with representing solely payments of principal and interest on the principal amount outstanding, or
 - (ii) align the cash flows of the issued financial assets with the underlying pool of financial instruments.

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

- (e) measure at fair value any issued instrument in which any of the financial instruments in the underlying pool:
 - (i) have cash flows that do not represent solely payments of principal and interest on the principal amount outstanding; or
 - (ii) could change so that cash flows may not represent solely payments of principal and interest on the principal amount outstanding at any point in the future.
- (f) measure at fair value any issued instrument whose exposure to credit risk in the underlying pool of financial instruments is greater than the exposure to credit risk of the underlying pool of financial instruments. The Board decided that if the range of expected losses on the issued instrument is greater than the weighted average range of expected losses on the underlying pool of financial instruments, then the issued instrument should be measured at fair value.

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

Financial assets acquired at a discount that reflects incurred credit losses

- BC4.37 The exposure draft published in 2009 proposed that if a financial asset is acquired at a discount that reflects incurred credit losses, it cannot be measured at amortised cost because:
- (a) the entity does not hold such financial assets to collect the cash flows arising from those assets' contractual terms; and
 - (b) an investor acquiring a financial asset at such a discount believes that the actual losses will be less than the losses that are reflected in the purchase price. Thus, that asset creates exposure to significant variability in actual cash flows and such variability is not interest.
- BC4.38 Almost all respondents disagreed with the Board's conclusion that these assets cannot be held to collect the contractual cash flows. They regarded that conclusion as an exception to a classification approach based on the entity's business model for managing the financial assets. In particular, they noted that entities could acquire and subsequently manage such assets as part of an otherwise performing asset portfolio for which the objective of the entity's business model is to hold the assets to collect contractual cash flows.
- BC4.39 Respondents also noted that an entity's expectations about actual future cash flows are not the same as the contractual cash flows of the financial asset. Those expectations are irrelevant to an assessment of the financial asset's contractual cash flow characteristics.
- BC4.40 The Board agreed that the general classification approach in IFRS 9 should apply to financial assets acquired at a discount that reflects incurred credit losses. Thus, when such assets meet the conditions in paragraph 4.1.2, they are measured at amortised cost.

Alternative approaches to classifying assets

- BC4.41 In its deliberations leading to the exposure draft published in 2009, the Board discussed alternative approaches to classification and measurement. In particular, it considered an approach in which financial assets that have basic loan features, are managed on a contractual yield basis and meet the definition of loans and receivables in IAS 39 would be measured at amortised cost. All other financial assets would be measured at fair value. The fair value changes for each period for those financial assets with basic loan features that are managed on a contractual yield basis would be disaggregated and presented as follows:
- (a) changes in recognised value determined on an amortised cost basis (including impairments determined using the incurred loss impairment requirements in IAS 39) would be presented in profit or loss; and
 - (b) any difference between the amortised cost measure in (a) and the fair value change for the period would be presented in other comprehensive income.
- BC4.42 The Board also considered variants in which all financial assets and financial liabilities would be measured at fair value. One variant would be to present both the amounts in paragraph BC4.41(a) and (b) in profit or loss, but separately. Another variant would be to measure all financial instruments (including financial assets that meet the two conditions specified in the exposure draft published in 2009 and meet the definition of loans and receivables in IAS 39) at fair value in the statement of financial position. All financial instruments (including financial liabilities) with basic loan features that are managed on a contractual yield basis would be disaggregated and presented as described in paragraph BC4.41(a) and (b).
- BC4.43 Respondents noted that the alternative approach described in paragraph BC4.41 and both variants described in paragraph BC4.42 would result in more financial assets and financial liabilities being measured at fair value. Respondents also noted that the alternative approach would apply only to financial assets. Lastly, almost all respondents noted that splitting gains and losses between profit or loss and other comprehensive income would increase complexity and reduce understandability.

The Board concluded that those approaches would not result in more useful information than the approach in IFRS 9 and did not consider them further.

BC4.44 The Board also considered and rejected the following approaches to classification:

- (a) *Classification based on the definition of held for trading:* A few respondents suggested that all financial assets and financial liabilities that are not 'held for trading' should be eligible for measurement at amortised cost. However, in the Board's view, the notion of 'held for trading' is too narrow and cannot appropriately reflect all situations in which amortised cost does not provide useful information.
- (b) *Three-category approach:* Some respondents suggested retaining a three-category approach, ie including a third category similar to the available-for-sale category in IAS 39. However, in the Board's view, such an approach would neither significantly improve nor reduce the complexity of the reporting for financial instruments.
- (c) *Classification based only on the business model:* A small number of respondents thought the contractual terms of the instrument condition was unnecessary and that classification should depend solely on the entity's business model for managing financial instruments. However, in the Board's view, determining classification solely on the basis of how an entity manages its financial instruments would result in misleading information that is not useful to a user in understanding the risks associated with complex or risky instruments. The Board concluded, as had almost all respondents, that the contractual cash flow characteristics condition is required to ensure that amortised cost is used only when it provides information that is useful in predicting the entity's future cash flows.
- (d) *Amortised cost as the default option:* The Board considered developing conditions that specified when a financial asset must be measured at fair value, with the requirement that all other financial instruments would be measured at amortised cost. The Board rejected that approach because it believes that new conditions would have to be developed in the future to address innovative financial products. In addition, the Board noted that such an approach would not be practical because an entity can apply amortised cost only to some types of financial instruments.
- (e) *Originated loan approach:* In developing an approach to distinguish between financial assets measured at fair value and amortised cost the Board considered a model in which only loans originated by the entity would qualify for amortised cost measurement. The Board acknowledged that for originated instruments the entity potentially has better information about the future contractual cash flows and credit risk than for purchased loans. However, the Board decided not to pursue that approach, mainly because some entities manage originated and purchased loans in the same portfolio. Distinguishing between originated and purchased loans, which would be done mainly for accounting purposes, would involve systems changes. In addition, the Board noted that 'originated loans' might easily be created by placing purchased loans into an investment vehicle. The Board also noted that the definition of loans and receivables in IAS 39 had created application problems in practice.

Tainting

BC4.45 The Board considered whether it should prohibit an entity from classifying a financial asset as measured at amortised cost if the entity had previously sold or reclassified financial assets rather than holding them to collect the contractual cash flows. A restriction of this kind is often called 'tainting'. However, the Board believes that classification based on the entity's business model for managing financial assets and the contractual cash flow characteristics of those financial assets provides a clear rationale for measurement. A tainting provision would increase the complexity of application, be unduly prohibitive in the context of that approach and could give rise to classification that is inconsistent with the classification approach in IFRS 9. However, in 2009 the Board amended IAS 1 *Presentation of Financial Statements* to require an entity to present separately in the statement of comprehensive income all gains and losses arising from the derecognition of financial assets measured at amortised cost. The Board also amended IFRS 7

in 2009 to require an entity to disclose an analysis of those gains and losses, including the reasons for derecognising those financial assets. Those requirements enable users of financial statements to understand the effects of derecognising before maturity instruments measured at amortised cost and also provides transparency in situations where an entity has measured financial assets at amortised cost on the basis of having an objective of managing those assets in order to collect the contractual cash flows but regularly sells them.

Classification of financial liabilities

- BC4.46 Immediately after issuing the first chapters of IFRS 9 in November 2009, the Board began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities, in particular how best to address the effects of changes in the fair value of a financial liability caused by changes in the risk that the issuer will fail to perform on that liability. The Board obtained information and views from its FIWG and from users, regulators, preparers, auditors and others from a range of industries across different geographical regions. The Board also developed a questionnaire to ask users of financial statements how they use information about the effects of changes in liabilities' credit risk (if at all) and what their preferred method of accounting is for selected financial liabilities. The Board received over 90 responses to that questionnaire.
- BC4.47 During the outreach programme, the Board explored several approaches for classification and subsequent measurement of financial liabilities that would exclude the effects of changes in a liability's credit risk from profit or loss, including:
- (a) measuring liabilities at fair value and presenting in other comprehensive income the portion of the change in fair value that is attributable to changes in the liability's credit risk. A variant of this alternative would be to present in other comprehensive income the entire change in fair value.
 - (b) measuring liabilities at an 'adjusted' fair value whereby the liability would be remeasured for all changes in fair value except for the effects of changes in its credit risk (ie 'the frozen credit spread method'). In other words, the effects of changes in its credit risk would be ignored in the primary financial statements.
 - (c) measuring liabilities at amortised cost. This would require estimating the cash flows over the life of the instrument, including those cash flows associated with any embedded derivative features.
 - (d) bifurcating liabilities into hosts and embedded features. The host contract would be measured at amortised cost and the embedded features (eg embedded derivatives) would be measured at fair value through profit or loss. The Board discussed either carrying forward the bifurcation requirements in IAS 39 for financial liabilities or developing new requirements.
- BC4.48 The primary message that the Board received from users of financial statements and others during its outreach programme was that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.
- BC4.49 In addition to that view, there were several other themes in the feedback that the Board received:
- (a) Symmetry between how an entity classifies and measures its financial assets and its financial liabilities is not necessary and often does not result in useful information. Most constituents said that in its deliberations on financial liabilities the Board should not be constrained or biased by the requirements in IFRS 9 for financial assets.

- (b) Amortised cost is the most appropriate measurement attribute for many financial liabilities because it reflects the issuer's legal obligation to pay the contractual amounts in the normal course of business (ie on a going concern basis) and in many cases, the issuer will hold liabilities to maturity and pay the contractual amounts. However, if a liability has structured features (eg embedded derivatives), amortised cost is difficult to apply and understand because the cash flows can be highly variable.
- (c) The bifurcation methodology in IAS 39 is generally working well and practice has developed since those requirements were issued. For many entities, bifurcation avoids the issue of own credit risk because the host is measured at amortised cost and only the derivative is measured at fair value through profit or loss. Many constituents, including users of financial statements, favoured retaining bifurcation for financial liabilities even though they supported eliminating it for financial assets. That was because bifurcation addresses the issue of own credit risk, which is only relevant for financial liabilities. Users preferred structured assets to be measured at fair value in their entirety. Many constituents were sceptical that a new bifurcation methodology could be developed that was less complex and provided more useful information than using the bifurcation methodology in IAS 39. Moreover, a new bifurcation methodology would be likely to have the same classification and measurement outcomes as the existing methodology in most cases.
- (d) The Board should not develop a new measurement attribute. The almost unanimous view was that a 'full' fair value amount is more understandable and useful than an 'adjusted' fair value amount that ignores the effects of changes in the liability's credit risk.
- (e) Even for preparers with sophisticated valuation expertise, it is difficult to determine the amount of change in the fair value of a liability that is attributable to changes in its credit risk. Under existing IFRSs only entities that elect to designate liabilities under the fair value option are required to determine that amount. If the Board were to extend that requirement to more entities and to more financial liabilities, many entities would have significant difficulty determining that amount and could incur significant costs in doing so.

- BC4.50 Although there were common themes in the feedback received, there was no consensus on which of the alternative approaches being explored by the Board was the best way to address the effects of changes in liabilities' credit risk. Many constituents said that none of the alternatives being discussed was less complex or would result in more useful information than the existing bifurcation requirements.
- BC4.51 As a result of the feedback received, the Board decided to retain almost all of the existing requirements for the classification and measurement of financial liabilities. The Board decided that the benefits of changing practice at this point do not outweigh the costs of the disruption that such a change would cause. Accordingly, in October 2010 the Board carried forward almost all of the requirements unchanged from IAS 39 to IFRS 9.
- BC4.52 By retaining almost all of the existing requirements, the issue of credit risk is addressed for most liabilities because they would continue to be subsequently measured at amortised cost or would be bifurcated into a host, which would be measured at amortised cost, and an embedded derivative, which would be measured at fair value. Liabilities that are held for trading (including all derivative liabilities) would continue to be subsequently measured at fair value through profit or loss, which is consistent with the widespread view that all fair value changes for those liabilities should affect profit or loss.
- BC4.53 The issue of credit risk would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010 the Board published an exposure draft *Fair Value Option for Financial Liabilities*, which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The Board considered the responses to that exposure draft and finalised amendments to IFRS 9 in October 2010 (see paragraphs BC5.35–BC5.64). Those amendments also eliminated the cost exception for particular derivative liabilities that will be settled by delivering unquoted equity instruments whose fair values cannot be reliably determined (see paragraph BC5.20).

Option to designate a financial asset or financial liability at fair value through profit or loss

Background to the fair value option in IAS 39

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

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

- (a) originated loans and receivables, including a debt instrument acquired directly from the issuer, unless they met the conditions for classification as held for trading (now in Appendix A of IFRS 9).
- (b) financial assets classified as available for sale, unless as an accounting policy choice gains and losses on all available-for-sale financial assets were recognised in profit or loss or they met the conditions for classification as held for trading (now in Appendix A of IFRS 9).
- (c) non-derivative financial liabilities, even if the entity had a policy and practice of actively repurchasing such liabilities or they formed part of an arbitrage/customer facilitation strategy or fund trading activities.

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

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

- (a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss.
- (b) the use of the option might increase, rather than decrease, volatility in profit or loss, for example if an entity applied the option to only one part of a matched position.
- (c) if an entity applied the fair value option to financial liabilities, it might result in an entity recognising gains or losses in profit or loss associated with changes in its own creditworthiness.

^{*} IFRS 9 eliminated the loans and receivables and available-for-sale categories.

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

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

- (a) when such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise (paragraphs BCZ4.61-BCZ4.63);
- (b) when a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy (paragraphs BCZ4.64-BCZ4.66); and
- (c) when an instrument contains an embedded derivative that meets particular conditions (paragraphs BCZ4.67-BCZ4.70).

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

- (a) it eliminates the need for hedge accounting for hedges of fair value exposures when there are natural offsets, and thereby eliminates the related burden of designating, tracking and analysing hedge effectiveness.
- (b) it eliminates the burden of separating embedded derivatives.
- (c) it eliminates problems arising from a mixed measurement model when financial assets are measured at fair value and related financial liabilities are measured at amortised cost. In particular, it eliminates volatility in profit or loss and equity that results when matched positions of financial assets and financial liabilities are not measured consistently.
- (d) the option to recognise unrealised gains and losses on available-for-sale financial assets in profit or loss is no longer necessary.
- (e) it de-emphasises interpretative issues around what constitutes trading.

Designation eliminates or significantly reduces an accounting mismatch

BCZ4.61 IAS 39, like comparable standards in some national jurisdictions, imposed (and IFRS 9 now imposes) a mixed attribute measurement model. It required some financial assets and liabilities to be measured at fair value, and others to be measured at amortised cost. It required some gains and losses to be recognised in profit or loss, and others to be recognised initially as a component of equity.^{*} This combination of measurement and recognition requirements could result in inconsistencies, which some refer to as 'accounting mismatches', between the accounting for an asset (or group of assets) and a liability (or group of liabilities). The notion of an accounting mismatch necessarily involves two propositions. First, an entity has particular assets and liabilities that are measured, or on which gains and losses are recognised, inconsistently; second, there is a perceived economic relationship between those assets and

^{*} As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 these other gains and losses are recognised in other comprehensive income.

liabilities. For example, a liability may be considered to be related to an asset when they share a risk that gives rise to opposite changes in fair value that tend to offset, or when the entity considers that the liability funds the asset.

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

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

- the criteria an entity uses for designating financial assets and financial liabilities as at fair value through profit or loss
- how the entity satisfies the conditions for such designation
- the nature of the assets and liabilities so designated
- the effect on the financial statement of using this designation, namely the carrying amounts and net gains and losses on assets and liabilities so designated, information about the effect of changes in a financial liability's credit quality on changes in its fair value, and information about the credit risk of loans or receivables and any related credit derivatives or similar instruments.

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

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

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

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

The instrument contains an embedded derivative that meets particular conditions

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

- (a) identify whether the instrument contains one or more embedded derivatives,
- (b) determine whether each embedded derivative is one that must be separated from the host instrument or one for which separation is prohibited, and
- (c) if the embedded derivative is one that must be separated, determine its fair value at initial recognition and subsequently.

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

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

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

The role of prudential supervisors

- BCZ4.71 The Board considered the circumstances of regulated financial institutions such as banks and insurers in determining the extent to which conditions should be placed on the use of the fair value option. The Board recognised that regulated financial institutions are extensive holders and issuers of financial instruments and so are likely to be among the largest potential users of the fair value option. However, the Board noted that some of the prudential supervisors that oversee these entities expressed concern that the fair value option might be used inappropriately.
- BCZ4.72 The Board noted that the primary objective of prudential supervisors is to maintain the financial soundness of individual financial institutions and the stability of the financial system as a whole. Prudential supervisors achieve this objective partly by assessing the risk profile of each regulated institution and imposing a risk-based capital requirement.
- BCZ4.73 The Board noted that these objectives of prudential supervision differ from the objectives of general purpose financial reporting. The latter is intended to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the Board acknowledged that for the purposes of determining what level of capital an institution should maintain, prudential supervisors may wish to understand the circumstances in which a regulated financial institution has chosen to apply the fair value option and evaluate the rigour of the institution's fair value measurement practices and the robustness of its underlying risk management strategies, policies and practices. Furthermore, the Board agreed that certain disclosures would assist both prudential supervisors in their evaluation of capital requirements and investors in making economic decisions. In particular, the Board decided to require an entity to disclose how it has satisfied the conditions for using the fair value option, including, for instruments that are now within paragraph 4.2.2(b) of IFRS 9, a narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

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

- BCZ4.74 Some comments received on the exposure draft of proposed amendments to IAS 39 published in June 2002 argued that the fair value option should be extended so that it could also be applied to a component of a financial asset or a financial liability (eg changes in fair value attributable to one risk such as changes in a benchmark interest rate). The arguments included (a) concerns regarding inclusion of own credit risk in the measurement of financial liabilities and (b) the prohibition on using non-derivatives as hedging instruments (cash instrument hedging).
- BCZ4.75 The Board concluded that IAS 39 should not extend the fair value option to components of financial assets or financial liabilities. It was concerned (a) about difficulties in measuring the change in value of the component because of ordering issues and joint effects (ie if the component is affected by more than one risk, it may be difficult to isolate accurately and measure the component); (b) that the amounts recognised in the balance sheet would be neither fair value nor cost; and (c) that a fair value adjustment for a component might move the carrying amount of an instrument away from its fair value. In finalising the 2003 amendments to IAS 39, the Board separately considered the issue of cash instrument hedging (see paragraphs BC144 and BC145 of the Basis for Conclusions on IAS 39).
- BCZ4.76 Other comments received on the April 2004 exposure draft of proposed restrictions on the fair value option contained in IAS 39 (as revised in 2003) suggested that the fair value option should be extended so that it could be applied to a proportion (ie a percentage) of a financial asset or financial liability. The Board was concerned that such an extension would require prescriptive guidance on how to determine a proportion. For example if an entity were to issue a bond totalling CU100 million in the form of 100 certificates each of CU1 million, would a proportion of 10 per cent be identified as 10 per cent of each certificate, CU10 million specified certificates, the first (or last) CU10 million certificates to be redeemed, or on some other basis? The Board

was also concerned that the remaining proportion, not being subject to the fair value option, could give rise to incentives for an entity to 'cherry pick' (ie to realise financial assets or financial liabilities selectively so as to achieve a desired accounting result). For these reasons, the Board decided not to allow the fair value option to be applied to a proportion of a single financial asset or financial liability (that restriction is now in IFRS 9). However, if an entity simultaneously issues two or more identical financial instruments, it is not precluded from designating only some of those instruments as being subject to the fair value option (for example, if doing so achieves a significant reduction in a recognition or measurement inconsistency). Thus, in the above example, the entity could designate CU10 million specified certificates if to do so would meet one of the three criteria in paragraph BCZ4.59.

Option to designate a financial asset at fair value

BC4.77 As noted above, IAS 39 allowed entities an option to designate on initial recognition any financial asset or financial liability as measured at fair value through profit or loss if one (or more) of the following three conditions is met:

- (a) Doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities on different bases or recognising the gains and losses on them on different bases.
- (b) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.
- (c) The financial asset or financial liability contains one or more embedded derivatives (and particular other conditions now described in paragraph 4.3.5 of IFRS 9 are met) and the entity elects to account for the hybrid contract in its entirety.

BC4.78 However, in contrast to IAS 39, IFRS 9 requires:

- (a) any financial asset that is not managed within a business model that has the objective of collecting contractual cash flows to be measured at fair value; and
- (b) hybrid contracts with financial asset hosts to be classified in their entirety, hence eliminating the requirement to identify and account for embedded derivatives separately.

Accordingly, the Board concluded that the conditions described in paragraph BC4.77(b) and (c) are unnecessary for financial assets.

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

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

Option to designate a financial liability at fair value

Eligibility conditions

- BC4.81 During its discussions about subsequent classification and measurement of financial liabilities in 2010 (see paragraphs BC4.46–BC4.53), the Board considered whether it was necessary to propose any changes to the eligibility conditions for designating financial liabilities under the fair value option. However, the Board decided that such changes were not necessary because the Board was not changing the underlying classification and measurement approach for financial liabilities. Therefore, the exposure draft published in May 2010 proposed to carry forward the three eligibility conditions.
- BC4.82 Most respondents agreed with that proposal in the exposure draft. The Board confirmed the proposal and decided to carry forward to IFRS 9 the three eligibility conditions in October 2010. Some would have preferred an unrestricted fair value option. However, they acknowledged that an unrestricted fair value option had been opposed by many in the past and it was not appropriate to pursue it now.

Embedded derivatives

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

- BC4.83 An embedded derivative is a derivative component of a hybrid contract that also includes a non-derivative host, with the effect that some of the cash flows of the combined contract vary like the cash flows of a stand-alone derivative contract. IAS 39 required an entity to assess all contracts to determine whether they contain one or more embedded derivatives that are required to be separated from the host and accounted for as stand-alone derivatives.
- BC4.84 Many respondents to the discussion paper *Reducing Complexity in Reporting Financial Instruments* commented that the requirements and guidance in IAS 39 were complex, rule-based and internally inconsistent. Respondents, and others, also noted the many application problems that arose from requirements to assess all non-derivative contracts for embedded derivatives and, if required, to account for and measure those embedded derivatives separately as stand-alone derivatives.
- BC4.85 In 2009 the Board discussed three approaches for accounting for embedded derivatives:
- (a) to maintain the requirements in IAS 39;
 - (b) to use 'closely related' (used in IAS 39 to determine whether an embedded derivative is required to be separated from the host) to determine the classification for the contract in its entirety; and
 - (c) to use the same classification approach for all financial assets (including hybrid contracts).
- BC4.86 The Board rejected the first two approaches. The Board noted that both would rely on the assessment of whether an embedded derivative is 'closely related' to the host. The 'closely related' assessment is based on a list of examples that are inconsistent and unclear. That assessment is also a significant source of complexity. Both approaches would result in hybrid contracts being classified using conditions different from those that would be applied to all non-hybrid financial instruments. Consequently, some hybrid contracts whose contractual cash flows do not solely represent payments of principal and interest on the principal amount outstanding might be measured at amortised cost. Similarly, some hybrid contracts whose contractual cash flows do meet the conditions for measurement at amortised cost might be measured at fair value. The Board also believes that neither approach would make it easier for users of financial statements to understand the information that financial statements present about financial instruments.

BC4.87 Therefore, the exposure draft published in 2009 proposed that entities should use the same classification approach for all financial instruments, including hybrid contracts with hosts within the scope of the proposed IFRS ('financial hosts'). The Board concluded that a single classification approach for all financial instruments and hybrid contracts with financial hosts was the only approach that responded adequately to the criticisms described above. The Board noted that using a single classification approach improves comparability by ensuring consistency in classification, and hence makes it easier for users to understand the information that financial statements present about financial instruments.

BC4.88 In the responses to the exposure draft, some respondents, mainly preparers, stated their preference for keeping or modifying the bifurcation model that was in IAS 39. They noted that:

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

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

- (a) The elimination of the embedded derivatives guidance for hybrid contracts with financial hosts reduces the complexity in financial reporting of financial assets by eliminating another classification approach and improves the reporting for financial instruments. Many constituents agreed with this conclusion.
- (b) In the Board's view, the underlying rationale for separate accounting for embedded derivatives is not to reflect risk management activities, but to avoid entities circumventing the recognition and measurement requirements for derivatives. Accordingly it is an exception to the definition of the unit of account (the contract) motivated by a wish to avoid abuse. It would reduce complexity to eliminate an anti-abuse exception.
- (c) The Board noted the concerns about structuring opportunities referred to in paragraph BC4.88(b). However, two contracts represent two units of account. Reconsideration of the unit of account forms part of a far broader issue for financial reporting that is outside the scope of the Board's considerations in IFRS 9. In addition, embedded derivative features often do not have contractual cash flows that represent payments of principal and interest on the principal amount outstanding and thus the entire hybrid contract would not be eligible to be measured at amortised cost. However, the Board noted that this would provide more relevant information because the embedded derivative feature affects the cash flows ultimately arising from the hybrid contract. Thus, applying the classification approach to the hybrid contract in its entirety would depict more faithfully the amount, timing and uncertainty of future cash flows.
- (d) In the Board's view, accounting for the hybrid contract as one unit of account is consistent with the project's objective—to improve the usefulness for users in their assessment of the timing, amount and uncertainty of future cash flows of financial instruments and to reduce the complexity in reporting financial instruments.

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

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

IFRS 9. The Board also noted the importance for many non-financial entities of hedge accounting for non-financial items, and the relationship to both scope and embedded derivative requirements. Therefore, the Board concluded that the requirements for hybrid contracts with non-financial hosts should be addressed in a later phase of the project to replace IAS 39.

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

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

Embedded foreign currency derivatives

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

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

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

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

Embedded prepayment penalties

- BCZ4.96 The Board identified an apparent inconsistency in the guidance in IAS 39 (as issued in 2003). The inconsistency related to embedded prepayment options in which the exercise price represented a penalty for early repayment (ie prepayment) of the loan. The inconsistency related to whether these are considered closely related to the loan.
- BCZ4.97 The Board decided to remove this inconsistency by amending paragraph AG30(g) in April 2009 (now paragraph B4.3.5(e) of IFRS 9). The amendment makes an exception to the examples in paragraph AG30(g) of embedded derivatives that are not closely related to the underlying. This exception is in respect of prepayment options, the exercise prices of which compensate the lender for the loss of interest income because the loan was prepaid. This exception is conditional on the exercise price compensating the lender for loss of interest by reducing the economic loss from reinvestment risk.

Reassessment of embedded derivatives

- BC4.98 In October 2010 the Board incorporated into IFRS 9 the consensus in IFRIC 9 *Reassessment of Embedded Derivatives*. This section summarises the considerations of the International Financial Reporting Interpretations Committee (IFRIC) in reaching that consensus, as approved by the Board, and the Board's consideration for amending IFRIC 9 in April 2009.
- BCZ4.99 When an entity first becomes a party to particular hybrid contracts it is required to assess whether any embedded derivative contained in the contract needs to be separated from the host contract and accounted for as a derivative. However, the issue arises whether an entity is required to continue to carry out this assessment after it first becomes a party to a contract, and if so, with what frequency.
- BCZ4.100 The question is relevant, for example, when the terms of the embedded derivative do not change but market conditions change and the market was the principal factor in determining whether the host contract and embedded derivative are closely related. Instances when this might arise are given in paragraph B4.3.8(d) of IFRS 9. Paragraph 4.3.8(d) states that an embedded foreign currency derivative is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:
- (a) the functional currency of any substantial party to that contract;
 - (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or
 - (c) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).
- BCZ4.101 Any of the currencies specified in (a)–(c) above may change. Assume that when an entity first became a party to a contract, it assessed the contract as containing an embedded derivative that was closely related and hence not accounted for separately. Assume that subsequently market conditions change and that if the entity were to reassess the contract under the changed circumstances it would conclude that the embedded derivative is not closely related and therefore requires separate accounting. (The converse could also arise.) The issue was whether the entity should make such a reassessment.
- BCZ4.102 When the IFRIC considered this issue in 2006, it noted that the rationale for the requirement to separate particular embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract (for example, by embedding a commodity forward in a debt instrument). Changes in external circumstances are not ways to circumvent the requirements. The IFRIC therefore concluded that reassessment was not appropriate for such changes.

BCZ4.103 The IFRIC noted that as a practical expedient IAS 39 did not require the separation of embedded derivatives that are closely related (that guidance is now in IFRS 9 for hybrid contracts with a host that is not an asset within the scope of that IFRS). Many financial instruments contain embedded derivatives. Separating all of these embedded derivatives would be burdensome for entities. The IFRIC noted that requiring entities to reassess embedded derivatives in all hybrid instruments could be onerous because frequent monitoring would be required. Market conditions and other factors affecting embedded derivatives would have to be monitored continuously to ensure timely identification of a change in circumstances and amendment of the accounting treatment accordingly. For example, if the functional currency of the counterparty changes during the reporting period so that the contract is no longer denominated in a currency of one of the parties to the contract, then a reassessment of the hybrid instrument would be required at the date of change to ensure the correct accounting treatment in future.

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

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

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

- (a) The entity could remove the derivative from its balance sheet and recognise in profit or loss a corresponding gain or loss. This would lead to recognition of a gain or loss even though there had been no transaction and no change in the value of the total contract or its components.
- (b) The entity could leave the derivative as a separate item in the balance sheet. The issue would then arise as to when the item was to be removed from the balance sheet. Should it be amortised (and, if so, how would the amortisation affect the effective interest rate of the asset), or should it be derecognised only when the asset is derecognised?
- (c) The entity could combine the derivative (which is recognised at fair value) with the asset (which is recognised at amortised cost). This would alter both the carrying amount of the asset and its effective interest rate even though there had been no change in the economics of the whole contract. In some cases, it could also result in a negative effective interest rate. The IFRIC noted that, under its view that subsequent reassessment is appropriate only when there has been a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required by the contract, the above issues do not arise.

* Hybrid contracts with a host that is an asset within the scope of IFRS 9 are now classified and measured in their entirety in accordance with section 4.1 of that IFRS.

BCZ4.106 The IFRIC noted that IAS 39 required (and now IFRS 9 requires) an entity to assess whether particular embedded derivatives need to be separated from particular host contracts and accounted for as a derivative when it first becomes a party to a contract. Consequently, if an entity purchases a contract that contains an embedded derivative it assesses whether the embedded derivative needs to be separated and accounted for as a derivative on the basis of conditions at that date.

Improvements to IFRSs issued in April 2009

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

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

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

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

Reclassification

Reclassification of financial assets

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

- (a) Requiring (or permitting) reclassifications would not make it easier for users of financial statements to understand the information that financial statements provide about financial instruments.
- (b) Requiring (or permitting) reclassifications would increase complexity because detailed guidance would be required to specify when reclassifications would be required (or permitted) and the subsequent accounting for reclassified financial instruments.
- (c) Reclassification should not be necessary because classification is based on the entity's business model and that business model is not expected to change.

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

- BC4.113 However, almost all respondents (including most users) argued that prohibiting reclassification is inconsistent with a classification approach based on how an entity manages its financial assets. They noted that in an approach based on an entity's business model for managing financial assets, reclassifications would provide useful, relevant and comparable information to users because it would ensure that financial statements faithfully represent how those financial assets are managed at the reporting date. In particular, most users stated that, conceptually, reclassifications should not be prohibited when the classification no longer reflects how the instruments would be classified if the items were newly acquired. If reclassification were prohibited, the reported information would not reflect the amounts, timing and uncertainty of future cash flows.
- BC4.114 The Board was persuaded by these arguments and decided that reclassification should not be prohibited. The Board noted that prohibiting reclassification decreases comparability for like instruments managed in the same way.
- BC4.115 Some respondents contended that reclassifications should be permitted, rather than required, but did not explain their justification. However, the Board noted that permitting reclassification would decrease comparability, both between different entities and for instruments held by a single entity, and would enable an entity to manage its profit or loss by selecting the timing of when future gains or losses are recognised. Therefore, the Board decided that reclassification should be required when the entity's business model for managing those financial assets changes.
- BC4.116 The Board noted that, as highlighted by many respondents, such changes in business model would be very infrequent, significant and demonstrable and determined by the entity's senior management as a result of external or internal change.
- BC4.117 The Board considered arguments that reclassification should also be permitted or required when contractual cash flow characteristics of a financial asset vary (or may vary) over that asset's life based on its original contractual terms. However, the Board noted that, unlike a change in business model, the contractual terms of a financial asset are known at initial recognition. An entity classifies the financial asset at initial recognition on the basis of the contractual terms over the life of the instrument. Therefore the Board decided that reclassification on the basis of a financial asset's contractual cash flows should not be permitted.
- BC4.118 The Board considered how reclassifications should be accounted for. Almost all respondents said that reclassifications should be accounted for prospectively and should be accompanied by robust disclosures. The Board reasoned that if classification and reclassification are based on the business model within which they are managed, classification should always reflect the business model within which the financial asset was managed at the reporting date. To apply the reclassification retrospectively would not reflect how the financial assets were managed at the prior reporting dates.
- BC4.119 The Board also considered the date at which reclassifications could take effect. Some respondents stated that reclassifications should be reflected in the entity's financial statements as soon as the entity's business model for the relevant instruments changes. To do otherwise would be contradictory to the objective of reclassification—ie to reflect how the instruments are managed. However, the Board decided that reclassifications should take effect from the beginning of the following reporting period. In the Board's view, entities should be prevented from choosing a reclassification date to achieve an accounting result. The Board also noted that a change in an entity's business model is a significant and demonstrable event; therefore, an entity will most likely disclose such an event in its financial statements in the reporting period in which the change in business model takes place.
- BC4.120 The Board also considered and rejected the following approaches:
- (a) *Disclosure approach:* Quantitative and qualitative disclosure (instead of reclassification) could be used to address when the classification no longer reflects how the financial assets would be classified if they were newly acquired. However, in the Board's view, disclosure is not an adequate substitute for recognition.

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

Reclassification of financial liabilities

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

Changes in circumstances that are not reclassifications

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

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

Measurement (chapter 5)

Fair value measurement considerations

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

Use of quoted prices in active markets

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

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

Entities that have access to more than one active market

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

Bid-ask spreads in active markets

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

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

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

No active market

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

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

- BCZ5.9 The Board decided to simplify the proposed fair value measurement hierarchy by requiring the fair value of financial instruments for which there is not an active market to be determined by using valuation techniques, including recent market transactions between knowledgeable, willing parties in an arm's length transaction.
- BCZ5.10 The Board also considered constituents' comments regarding whether an instrument should always be recognised on initial recognition at the transaction price or whether gains or losses may be recognised on initial recognition when an entity uses a valuation technique to estimate fair value. The Board concluded that an entity may recognise a gain or loss at inception only if fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or is based on a valuation technique incorporating only observable market data. The Board concluded that those conditions were necessary and sufficient to provide reasonable assurance that fair value was other than the transaction price for the purpose of recognising upfront gains or losses. The Board decided that in other cases, the transaction price gave the best evidence of fair value. The Board also noted that its decision achieved convergence with US GAAP.

Measurement of financial liabilities with a demand feature

- BCZ5.11 Some comments received on the exposure draft published in 2002 requested clarification of how to determine fair value for financial liabilities with a demand feature (eg demand deposits), when the fair value measurement option is applied or the liability is otherwise measured at fair value. In other words, could the fair value be less than the amount payable on demand, discounted from the first date that an amount could be required to be paid (the 'demand amount'), such as the amount of the deposit discounted for the period that the entity expects the deposit to be outstanding? Some commentators believe that the fair value of financial liabilities with a demand feature is less than the demand amount, for reasons that include the consistency of such measurement with how those financial liabilities are treated for risk management purposes.
- BCZ5.12 The Board agreed that this issue should be clarified. It confirmed that the fair value of a financial liability with a demand feature is not less than the amount payable on demand discounted from the first date that the amount could be required to be paid (this guidance is now in paragraph 5.4.3 of IFRS 9). This conclusion is the same as in the original IAS 32 (issued by the Board's predecessor body, IASC, in 1999 and revised in 2000). The Board noted that in many cases, the market price observed for such financial liabilities is the price at which they are originated between the customer and the deposit-taker—ie the demand amount. It also noted that recognising a financial liability with a demand feature at less than the demand amount would give rise to an immediate gain on the origination of such a deposit, which the Board believes is inappropriate.

Exception in IAS 39 from fair value measurement for some unquoted equity instruments (and some derivative assets linked to those instruments)

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

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

- (a) For investments in equity instruments and derivatives, fair value provides the most relevant information. Cost provides little, if any, information with predictive value about the timing, amount and uncertainty of the future cash flows arising from the instrument. In many cases, fair value will differ significantly from historical cost (this is particularly true for derivatives measured at cost under the exception).
- (b) To ensure that a financial asset accounted for under the cost exception is not carried above its recoverable amount, IAS 39 required an entity to monitor instruments measured at cost for any impairment. Calculating any impairment loss is similar to determining fair value (ie the estimated future cash flows are discounted using the current market rate of return for a similar financial asset and compared with the carrying amount).
- (c) Removing the exception would reduce complexity because the classification model for financial assets would not have a third measurement attribute and would not require an additional impairment methodology. Although there might be an increase in the complexity of determining fair values on a recurring basis that complexity would be offset (at least partially) by the fact that all equity instruments and derivatives have one common measurement attribute; thus the impairment requirements would be eliminated.

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

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

BC5.17 The Board considered those arguments as follows:

(a) *Reliability and usefulness of fair value measurement*

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

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

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

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

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

Elimination of the cost exception for particular derivative liabilities

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

Gains and losses

Investments in equity instruments

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

liquidation) is classified as equity. However, the Board noted that such instruments do not meet the definition of an equity instrument.

- BC5.22 In the Board's view, fair value provides the most useful information about investments in equity instruments to users of financial statements. However, the Board noted arguments that presenting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment. An example could be a requirement to hold such an investment if an entity sells its products in a particular country.
- BC5.23 The Board also noted that, in their valuation of an entity, users of financial statements often differentiate between fair value changes arising from equity investments held for purposes other than generating investment returns and equity investments held for trading. Thus, the Board believes that separate presentation in other comprehensive income of gains and losses for some investments could provide useful information to users of financial statements because it would allow them to identify easily, and value accordingly, the associated fair value changes.
- BC5.24 Almost all respondents to the exposure draft published in 2009 supported recognition of fair value gains and losses in other comprehensive income for particular equity investments. They agreed that an entity should make an irrevocable election to identify those equity instruments. However, some users did not support these proposals in the exposure draft.
- BC5.25 The concerns expressed in the comment letters were as follows:
- (a) *Dividends*: The exposure draft proposed that dividends on equity instruments measured at fair value with changes recognised in other comprehensive income would also be recognised in other comprehensive income. Nearly all respondents objected to that proposal. They argued that dividends are a form of income that should be presented in profit or loss in accordance with IAS 18 *Revenue* and noted that those equity investments are sometimes funded with debt instruments whose interest expense is recognised in profit or loss. As a result, presenting dividends in other comprehensive income would create a 'mismatch'. Some listed investment funds stated that without recognising dividend income in profit or loss their financial statements would become meaningless to their investors. The Board agreed with those arguments. The Board noted that structuring opportunities might remain because dividends could represent a return of investment, rather than a return on investment. Therefore, the Board decided that dividends that clearly represent a recovery of part of the cost of the investment are not recognised in profit or loss. However, in the Board's view, those structuring opportunities would be limited because an entity with the ability to control or significantly influence the dividend policy of the investment would not account for those investments in accordance with IFRS 9. Furthermore, the Board decided to require disclosures that would allow a user to compare easily the dividends recognised in profit or loss and the other fair value changes.
 - (b) *Recycling*: Many respondents, including many users, did not support the proposal to prohibit subsequent transfer ('recycling') of fair value changes to profit or loss (on derecognition of the investments in an equity instrument). Those respondents supported an approach that maintains a distinction between realised and unrealised gains and losses and said that an entity's performance should include all realised gains and losses. However, the Board concluded that a gain or loss on those investments should be recognised once only; therefore, recognising a gain or loss in other comprehensive income and subsequently transferring it to profit or loss is inappropriate. In addition, the Board noted that recycling of gains and losses to profit or loss would create something similar to the available-for-sale category in IAS 39 and would create the requirement to assess the equity instrument for impairment, which had created application problems. That would not significantly improve or reduce the complexity of the financial reporting for financial assets. Accordingly, the Board decided to prohibit recycling of gains and losses into profit or loss when an equity instrument is derecognised.

- (c) *Scope of exception:* Some respondents asked the Board to identify a principle that defined the equity instruments to which the exception should apply. However, they did not specify what that principle should be. The Board previously considered developing a principle to identify other equity investments whose fair value changes should be presented in profit or loss (or other comprehensive income), including a distinction based on whether the equity instruments represented a 'strategic investment'. However, the Board decided that it would be difficult, and perhaps impossible, to develop a clear and robust principle that would identify investments that are different enough to justify a different presentation requirement. The Board considered whether a list of indicators could be used to support the principle, but decided that such a list would inevitably be rule-based and could not be comprehensive enough to address all possible situations and factors. Moreover, the Board noted that such an approach would create complexity in application without necessarily increasing the usefulness of information to users of financial statements.
- (d) *Irrevocability of the exception:* A small number of respondents believed that an entity should be able to reclassify equity instruments into and out of the fair value through other comprehensive income category if an entity starts or ceases to hold the investments for trading purposes. However, the Board decided that the option must be irrevocable to provide discipline to its application. The Board also noted that the option to designate a financial asset as measured at fair value is also irrevocable.

BC5.26 An entity may transfer the cumulative gain or loss within equity. In the light of jurisdiction-specific restrictions on components of equity, the Board decided not to provide specific requirements related to that transfer.

BC5.27 IFRS 9 amended IFRS 7 in 2009 to require additional disclosures about investments in equity instruments that are measured at fair value through other comprehensive income. The Board believes those disclosures will provide useful information to users of financial statements about instruments presented in that manner and the effect of that presentation.

BC5.28 The Board noted that permitting an option for entities to present some gains and losses in other comprehensive income is an exception to the overall classification and measurement approach and adds complexity. However, the Board believes that the requirement that the election is irrevocable, together with the additional disclosures required, addresses many of those concerns.

Liabilities designated as at fair value through profit or loss

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

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

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

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

- (a) Entities realise changes in fair value, including fair value attributable to the liability's credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives.
- (b) Changes in credit risk affect the observed market price of a financial liability and hence its fair value.
- (c) It is difficult from a practical standpoint to exclude changes in credit risk from an observed market price.
- (d) The fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects its credit risk. The Board believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.

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

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

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

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

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

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

- BC5.37 However, in its deliberations leading to the exposure draft published in 2010, the Board discussed whether such treatment would create or enlarge an accounting mismatch in profit or loss in some limited cases. The Board acknowledged that this might be the case if an entity holds large portfolios of financial assets that are measured at fair value through profit or loss and there is an economic relationship between changes in the fair value of those assets and the effects of changes in the credit risk of the financial liabilities designated under the fair value option. A mismatch would arise because the entire change in the fair value of the assets would be presented in profit or loss but only a portion of the change in the fair value of the liabilities would be presented in profit or loss. The portion of the liabilities' fair value change attributable to changes in their credit risk would be presented in other comprehensive income. To address potential mismatches, the Board set out an alternative approach in the exposure draft whereby the effects of changes in the liabilities' credit risk would be presented in other comprehensive income unless such treatment would create or enlarge an accounting mismatch in profit or loss (in which case, the entire fair value change would be presented in profit or loss). The exposure draft stated that the determination about potential mismatches would be made when the liability is initially recognised and would not be reassessed. The Board asked respondents for feedback on the alternative approach.
- BC5.38 Many respondents preferred the alternative approach. They agreed that in almost all cases the effects of changes in credit risk ought not to be presented in profit or loss. However, those respondents said that if such treatment would create or enlarge an accounting mismatch in profit or loss, the entire fair value change should be presented in profit or loss. Respondents thought such cases would be rare and asked the Board to provide guidance on how to determine whether presenting the effects of changes in credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss.
- BC5.39 The Board agreed with the responses and finalised the alternative approach. Therefore entities are required to present the effects of changes in the liabilities' credit risk in other comprehensive income unless such treatment would create or enlarge an accounting mismatch in profit or loss (in which case, the entire fair value change is required to be presented in profit or loss). The Board acknowledged that that approach will introduce some additional complexity to financial reporting because not all liabilities designated under the fair value option will be treated the same. However, the Board decided that it was necessary to address circumstances in which the proposals would create or enlarge a mismatch in profit or loss. Although the Board expects those circumstances to be rare, they could be significant in some industries in some jurisdictions.
- BC5.40 The Board discussed how an entity should determine whether a mismatch would be created or enlarged. It decided that an entity has to assess whether it expects that changes in the credit risk of a liability will be offset by changes in the fair value of another financial instrument. The Board decided that such an assessment must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument. Such a relationship does not arise by coincidence.
- BC5.41 The Board believes that in many cases the relationship will be contractual (as described in paragraph B5.7.10 of IFRS 9) but decided that a contractual relationship is not required. Requiring a contractual relationship would have created a very high threshold for presenting the effects of changes in a liability's credit risk in profit or loss and the Board decided that such a high threshold was too strict to accommodate all of the possible scenarios in which a mismatch would be created or enlarged by presenting those amounts in other comprehensive income.
- BC5.42 However, to increase transparency about an entity's determination about potential mismatches, the Board decided to require disclosures about an entity's methodology for making that determination. Also, an entity is required to apply its methodology consistently. The determination must be made at initial recognition of the liability and is not reassessed, which is consistent with the entity's overall election to use the fair value option.

BC5.43 Some respondents to the exposure draft asked whether the Board intended that the proposals should apply to loan commitments and financial guarantee contracts that are designated under the fair value option. Those respondents suggested that the proposals should not apply to those items because the Board's intention seemingly had always been to address the issue of own credit risk for non-derivative liabilities. The respondents noted that loan commitments and financial guarantee contracts either meet the definition of a derivative or are very similar to a derivative from an economic perspective and therefore changes in their fair value should always be presented in profit or loss. The Board agreed with those respondents and decided that all changes in the fair value of loan commitments and financial guarantee contracts designated under the fair value option should be presented in profit or loss. In addition to the comments put forward by respondents, the Board also noted that phase II of the insurance project was discussing whether all financial guarantee contracts should be within the scope of that proposed IFRS.

Alternative approaches to address the issue of own credit risk

BC5.44 In 2010 the Board discussed and rejected the following approaches for addressing the issue of credit risk:

- (a) *Present the effects of changes in credit risk directly in equity:* Some believe that the effects of changes in credit risk should not affect the entity's performance; therefore they believe that those amounts should be presented directly in equity. The Board rejected this approach in the exposure draft because it believes that changes in the liability's credit risk ought to affect the entity's performance if the liability is measured at fair value. If those amounts were presented directly in equity, they would never be presented in the entity's statement of comprehensive income. The Board acknowledged that IFRSs do not provide a clear objective for when an item should be presented in other comprehensive income instead of in profit or loss or whether the amounts in other comprehensive income should be reclassified to profit or loss. However, the Board believes that presenting the effects of changes in credit risk in other comprehensive income is preferable to presenting them directly in equity because the latter would create a new problem by causing confusion or creating inconsistencies in what items are presented directly in equity. The Board noted that remeasurements of assets and liabilities should not be presented directly in equity because remeasurements are not transactions with equity holders. The Board asked respondents for feedback on presenting directly in equity the effects of changes in a liability's credit risk and almost all respondents, including users, did not support it. Accordingly the Board did not pursue this alternative.
- (b) *Present the entire change in the fair value of liabilities in other comprehensive income:* Some believe that the entire change in fair value (not just the portion attributable to changes in credit risk) should be presented in other comprehensive income. They argue that this approach would avoid the difficult question of how to measure the effects of changes in credit risk. The Board rejected this approach because it believes that at least some of the change in fair value should be presented in profit or loss. The Board's objective was to address issues related to the effects of changes in liabilities' credit risk; therefore, presenting the entire change in fair value in other comprehensive income is not appropriate. Also, this approach would result in mismatches in profit or loss because changes in the fair value of an entity's assets would be presented in profit or loss and changes in the fair value of its liabilities would be presented in other comprehensive income (see similar discussion in paragraph BC5.37). Moreover, this alternative would raise difficult questions about what (if any) amounts should be presented in profit or loss during the life of the liability (eg interest or other financing costs). The Board has discussed the topic of disaggregating finance costs from other fair value changes on numerous occasions without reaching any conclusions.

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

- BC5.45 The exposure draft published in 2010 proposed a ‘two-step approach’ for presenting a liability’s credit risk in the statement of comprehensive income, with the result that those changes would not affect profit or loss. In the first step, the entity would present the entire fair value change in profit or loss. In the second step, the entity would ‘back out’ from profit or loss the portion of the fair value change that is attributable to changes in the liability’s credit risk and present that amount in other comprehensive income.
- BC5.46 The exposure draft also set out a ‘one-step approach’, which would present the portion of the fair value change that is attributable to changes in the liability’s credit risk directly in other comprehensive income. All other portions of the fair value change would be presented in profit or loss.
- BC5.47 The Board acknowledged that the only difference between those two approaches is how the effects of changes in the liability’s credit risk are presented. The two-step approach would present those amounts first in profit or loss and then transfer them to other comprehensive income, whereas the one-step approach would present them directly in other comprehensive income.
- BC5.48 The Board proposed the two-step approach in the exposure draft because it thought that it would present more clearly all of the relevant information in the primary financial statements, but it decided to ask respondents which approach they supported.
- BC5.49 Almost all respondents, including users, supported the one-step approach. They said that the one-step approach is more efficient and less complicated than the two-step approach. They pointed out that both approaches have the same net result in profit or loss and other comprehensive income. Respondents said that there is little (if any) added benefit of the ‘gross’ presentation in the two-step approach and the extra line items on the face of the performance statement result in unnecessary clutter. Furthermore, respondents noted the Board’s exposure draft published in May 2010 on the presentation of items in other comprehensive income. That exposure draft proposes that the profit or loss section and other comprehensive income should be displayed as separate components within an overall statement of profit or loss and other comprehensive income. Respondents questioned whether the two-step approach would have any added benefit if the Board finalised the proposals in that exposure draft.
- BC5.50 Users told the Board that the two-step approach would not be more helpful to their analysis than the one-step approach. Some users noted that the effects of changes in a liability’s credit risk should not be presented in profit or loss, even if those effects were subsequently backed out.
- BC5.51 The Board was persuaded by respondents’ arguments and decided to require the one-step approach. The Board noted that no information is lost by using the one-step approach because IFRS 7 and IAS 1 *Presentation of Financial Statements* require entities to disclose (either on the financial statements or in the notes) all of the information required by the two-step approach.

Reclassifying amounts to profit or loss

- BC5.52 The exposure draft published in 2010 proposed to prohibit reclassification of gains or losses to profit or loss (on derecognition of the liability or otherwise)—sometimes called ‘recycling’. In the Basis for Conclusions on that exposure draft, the Board noted that the proposal was consistent with the requirements in IFRS 9 that prohibit recycling for investments in equity instruments that are measured at fair value with changes presented in other comprehensive income.
- BC5.53 Moreover, the Board noted that if the entity repays the contractual amount, the cumulative effect over the life of the instrument of any changes in the liability’s credit risk will net to zero because its fair value will equal the contractual amount. Therefore, for many liabilities, the issue of reclassification is irrelevant.

- BC5.54 Most respondents to the exposure draft disagreed with that proposal and urged the Board to require reclassification if the liability was derecognised and the effects of changes in its credit risk were realised. They acknowledged that there would not be any amount to reclassify if the entity repays the contractual amount. But they believe that if the entity repays an amount other than the contractual amount, the realised amounts in other comprehensive income should be reclassified. Those respondents view other comprehensive income as a ‘temporary holding place’ for unrealised gains and losses. They believe that unrealised and realised amounts are fundamentally different and thus should not be treated the same. The former are still uncertain and may never be crystallised. In contrast, the latter have crystallised and are backed by cash flows.
- BC5.55 However, the Board was not persuaded and confirmed the proposal to prohibit reclassification. The Board acknowledged that it needs to address the overall objective of other comprehensive income, including when an item should be presented in other comprehensive income instead of in profit or loss and whether amounts in other comprehensive income should be reclassified to profit or loss (and if so, when). However, in the absence of such an objective, the Board noted that its decision is consistent with the requirements in IFRS 9 that prohibit recycling for investments in equity instruments that are measured at fair value with changes presented in other comprehensive income.
- BC5.56 However, to provide users with information about how much of the accumulated other comprehensive income balance has been realised during the current reporting period (ie how much would have been reclassified if the Board had required reclassification upon derecognition), the Board decided to require entities to disclose that amount.
- BC5.57 Also, consistently with the requirements for equity investments measured at fair value with changes presented in other comprehensive income, the Board decided that an entity may transfer the cumulative gain or loss within equity.

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

- BC5.58 IFRS 7 required an entity, when designating a financial liability under the fair value option, to disclose the amount of the change in fair value that is attributable to changes in the liability’s credit risk. The application guidance in IFRS 7 provided a default method for determining that amount. If the only relevant changes in market conditions for the liability are changes in an observed (benchmark) interest rate, that method attributes all changes in fair value, other than changes in the benchmark interest rate, to changes in the credit risk of the liability. In the Basis for Conclusions on IFRS 7, the Board acknowledged that quantifying the change in a liability’s credit risk might be difficult in practice. It noted that it believes that the default method provides a reasonable proxy for changes in the liability’s credit risk, in particular when such changes are large, and would provide users with information with which to understand the effect on profit or loss of such a change in credit risk. However, IFRS 7 permitted entities to use a different method if it provides a more faithful representation of the changes in the liability’s credit risk.
- BC5.59 During the Board’s outreach programme preceding the publication of the exposure draft in 2010, preparers told the Board that the default method in IFRS 7 is appropriate in many circumstances but a more sophisticated method is sometimes needed to reflect faithfully the effects of changes in the liabilities’ credit risk (eg when the volume of liabilities outstanding significantly changed during the reporting period).
- BC5.60 In the user questionnaire conducted during that outreach programme, the Board asked users whether the default method in IFRS 7 was appropriate for determining the change in a liability’s credit risk. Most users said that it was an appropriate method. Many users noted the difficulty in determining that amount more precisely.
- BC5.61 Therefore, for the purposes of measuring the effects of changes in the credit risk of a liability, the exposure draft proposed to use the guidance in IFRS 7. Under the proposals, the default method would be carried forward but entities would continue to be permitted to use a different method if it provides a more faithful representation of the amount of the change in fair value that is attributable to changes in the liability’s credit risk.

- BC5.62 Most respondents agreed with the proposals in the exposure draft. Those respondents agreed that the guidance in IFRS 7 for measuring the effects of changes in a liability's credit risk is appropriate and operational. They noted that determining the effects of changes in a liability's credit risk can be complex, and therefore it was necessary to allow some flexibility in how it is measured. They acknowledged that the default method described in IFRS 7 is imprecise but said that it is a reasonable proxy in many cases. Moreover, although some respondents acknowledged that the default method does not isolate changes in a liability's credit risk from some other changes in fair value (eg general changes in the price of credit or changes in liquidity risk), those respondents said that it is often very difficult or impossible to separate those items. However, some respondents (including those who supported the Board's proposals in the exposure draft) asked for some clarification on particular aspects of the guidance in IFRS 7.
- BC5.63 Consistently with the majority of responses, the Board decided to confirm the proposals in the exposure draft to use the guidance in IFRS 7 related to determining the effects of changes in a liability's credit risk. Thus, that guidance was carried forward from IFRS 7 to IFRS 9. However, to respond to some of the questions raised in the comment letters, the Board decided to clarify the difference between the creditworthiness of the entity and the credit risk of a liability. Moreover, the Board addressed the difference between a liability's credit risk and asset-specific performance risk—and confirmed that a change in a liability's credit risk does not include changes in asset-specific performance risk. Furthermore, the Board noted that in some cases a liability might not have credit risk. Therefore, the Board included additional examples in the application guidance to clarify those points.
- BC5.64 Also, the Board clarified that the default method illustrated in IFRS 7 (and relocated to IFRS 9) is appropriate only if the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate. If that is not the case, an entity is required to use a more precise method. Moreover, an entity is always permitted to use a different method if that method more faithfully represents the effects of changes in a liability's credit risk.

Effective date and transition (chapter 7)

Effective date

- BC7.1 The Board recognises that many countries require time for translation and for introducing the mandatory requirements into law. In addition, entities require time to implement new standards. The Board usually sets an effective date of between six and eighteen months after issuing an IFRS. However, the Board has adopted a phased approach to publishing IFRS 9, so this is not possible.
- BC7.2 In the response to the exposure draft published in 2009, respondents urged that:
- (a) it would be helpful to preparers if the Board were to permit all phases of the project to replace IAS 39 to be adopted at the same time.
 - (b) it would be helpful to entities that issue insurance contracts if the effective date of IFRS 9 were aligned with the forthcoming IFRS on accounting for insurance contracts. Most of an insurer's assets are financial assets and most of its liabilities are insurance liabilities or financial liabilities. Thus, if an insurer applies IFRS 9 before it applies any new IFRS on insurance, it might face two rounds of major change in a short period. This would be disruptive for both users and preparers.
 - (c) because a number of countries will adopt IFRSs in the next few years, it would be helpful to entities in those countries if the Board did not require them to make two changes in a short period of time.
- BC7.3 With these factors in mind, the Board decided it should require entities to apply the requirements of IFRS 9 for annual periods beginning on or after 1 January 2013. The Board intends that this date will allow entities to adopt at the same time the guidance from all phases of the project to replace IAS 39.

- BC7.4 The Board will consider delaying the effective date of IFRS 9 if the impairment phase of the project to replace IAS 39 makes such a delay necessary, or if the new IFRS on insurance contracts has a mandatory effective date later than 2013, to avoid an insurer having to face two rounds of changes in a short period.
- BC7.5 The Board decided to permit earlier application of IFRS 9 to allow an entity to apply the new requirements on classification and measurement of financial assets. This enables entities to use IFRS 9 (as issued in November 2009) in their 2009 annual financial statements and meets one of the objectives of the phased approach, ie to have improved classification and measurement requirements for financial assets in place for 2009 year-ends.
- BC7.6 The effect of transition will be significant for some entities. As a result, there will be less comparability between entities that apply IFRS 9 and those that do not. Accordingly, IFRS 9 includes additional disclosures about the transition to IFRS 9.

Requirements added to IFRS 9 in October 2010

- BC7.7 The Board chose to complete the project to replace IAS 39 in phases to respond to requests that the accounting for financial instruments should be improved quickly. However, the Board is concerned that if an entity is permitted to adopt one phase early without also adopting early all of the preceding phases, there would be a period of significant incomparability among entities until all of the phases of the project are mandatorily effective. That is because there will be many possible combinations of which requirements are adopted early and which are not. Moreover, the period of incomparability would be significant because the phases will not be mandatorily effective before 1 January 2013.
- BC7.8 Therefore, in the exposure draft published in 2010 the Board proposed that if an entity elects to apply any finalised requirements early, the entity must also apply any preceding requirements in IFRS 9 that it does not already apply. Some respondents did not agree with this proposal and urged the Board to permit an entity to adopt the proposals in the exposure draft early without also adopting early the requirements in IFRS 9 for financial assets. As an alternative, some respondents asked the Board to finalise the proposals as an amendment to IAS 39, which could be applied immediately, rather than add the proposals to IFRS 9. Those respondents thought that the proposals in the exposure draft are unrelated to the requirements for financial assets and would be less complex to implement. However, the Board was not persuaded that the benefits of permitting an entity to adopt early only the proposals in the exposure draft exceeded the significant incomparability that would result. Moreover, the Board noted that the transition requirements in IFRS 9 for financial assets require an entity to reassess some financial liabilities designated under the fair value option. Therefore there is a linkage between the two phases and to permit entities to adopt early only the proposals in the exposure draft would be inappropriate and confusing. Moreover, the Board decided that it would be inappropriate to amend IAS 39 while it was in the process of replacing it. For those reasons, the Board decided to confirm the proposals in the exposure draft.
- BC7.9 However, if an entity chooses to adopt a phase early, the Board does not require the entity to adopt subsequent phases early. The Board decided that it would be unfair to require an entity to anticipate the outcomes of unfinished phases in order to make a decision about adopting a phase early. Moreover, the Board decided that an entity is permitted to adopt early the requirements in IFRS 9 issued in 2009 without adopting early the requirements that were added to IFRS 9 in 2010.

Transition related to IFRS 9 as issued in November 2009

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

- BC7.11 Most respondents agreed, in principle, with requiring retrospective application, but many questioned the practicability of the approach. In particular, many noted that the extensive exceptions to retrospective application that would be required to make such transition practicable significantly reduced (and possibly eliminated) any benefit that users might obtain from requiring comparative information to be restated.
- BC7.12 The Board considered whether to require prospective application, but noted that such an approach does not provide comparable information for users of financial statements. In addition, the Board noted that any transition approach (such as prospective application) that requires resetting the effective interest rate for financial assets measured at amortised cost reduces the usefulness of information about interest income.
- BC7.13 The Board decided to require retrospective application but provide transition relief to address particular difficulties that might arise from retrospective application. The Board also noted that IAS 8 sets out transition requirements that apply if retrospective application is impracticable and prohibits the use of hindsight when applying a new accounting policy to a prior period.

Transition relief

Impracticability exceptions

- BC7.14 The Board acknowledged that it may be impracticable for an entity to apply the effective interest method or impairment requirements in IAS 39 retrospectively in some situations. The process would be cumbersome, in particular for an entity with a large number of financial assets that were previously measured at fair value but are measured at amortised cost in accordance with the approach in IFRS 9. Several loss events and reversals might have occurred between the date when the asset was initially recognised and the date of initial application of the IFRS. IFRS 9 requires that if applying the impairment requirements is impracticable or requires the use of hindsight, an entity should use previously determined fair value information to determine whether a financial asset was impaired in comparative periods. IFRS 9 also requires that the fair value at the date of initial application of the new requirements should be treated as the new amortised cost carrying amount of that financial asset in that case. The Board rejected proposals that entities should be permitted, but not required, to treat the fair value at the date of initial application as amortised cost because it would impair comparability and require significant guidance about when such an option should be permitted.
- BC7.15 The Board noted that an entity would not have determined the fair value of an investment in an unquoted equity instrument (or a derivative on such an investment) that was previously accounted for in accordance with paragraphs 46(c) and 66 of IAS 39. Moreover, an entity will not have the necessary information to determine fair value retrospectively without using hindsight. Accordingly, IFRS 9 requires such instruments to be measured at fair value at the date of initial application.

Hybrid contracts

- BC7.16 An entity may not have previously determined the fair value of a hybrid contract in its entirety. Moreover, an entity will not have the necessary information to determine fair value retrospectively without using hindsight. However, an entity would have been required to measure both the embedded derivative and host separately at fair value to apply the disclosure requirements in IFRS 7. Therefore, in comparative periods, IFRS 9 requires the sum of the fair value of the embedded derivative and the host to be used as an approximation of the fair value of the entire hybrid contract.
- BC7.17 The proposals in the exposure draft published in 2009 would have resulted in fair value measurement for many hybrid contracts for which the embedded derivative was accounted for separately in accordance with IAS 39. Some respondents asked for such treatment under IAS 39 to be 'grandfathered'. The Board noted that many such requests had been related to the proposed treatment of hybrid contracts with financial liability hosts, which are not included in the IFRS. Therefore the Board decided not to permit an option to grandfather hybrid contracts with

financial asset hosts that were bifurcated in accordance with IAS 39 as an accounting policy choice because it would impair comparability, and because some such contracts may still have a significant remaining maturity.

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

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

Assessment of qualifying criteria for the fair value option

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

Comparative information

- BC7.20 As noted above, many respondents were concerned that the inevitable exceptions to full retrospective application would result in restated information that is incomplete. They proposed an approach similar to that used on first-time adoption of IFRSs and when entities adopted IAS 39 in 2005, in which the requirement to provide comparative information was waived. Some respondents believe that such an approach would address the concerns that, although IAS 1 requires only one year of comparative information, the legal and regulatory frameworks in many jurisdictions require further comparative periods to be presented. In those situations, the restatement of comparatives would be virtually impossible for an entity wishing to adopt IFRS 9 early.
- BC7.21 In the Board's view, waiving the requirement to restate comparatives strikes a balance between the conceptually preferable method of full retrospective application (as stated in IAS 8) and the practicability of adopting the new classification model within a short time frame. Accordingly, the Board decided that it would permit, but not require, restatement of comparative periods by entities that implement IFRS 9 for reporting periods beginning before 1 January 2012. However, those considerations would be less applicable for entities that adopted outside a short time frame. Therefore, restated comparative information is required if an entity adopts IFRS 9 for reporting periods beginning after 1 January 2012.

Date of initial application

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

Hedge accounting

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

Transitional disclosures

- BC7.24 The exposure draft published in July 2009 proposed disclosures for entities that apply the new IFRS 9 early. However, many noted that such disclosures would be useful for all entities applying IFRS 9 for the first time, and not only early adopters. The Board noted that the information necessary to make those disclosures would be readily available to the entity to make the necessary journal entries on transition and to account for the financial assets in the future. Accordingly, IFRS 9 requires all entities to supply additional disclosures on transition.
- BC7.25 The Board rejected a proposal in the comment letters that entities should apply disclosures similar to those based on IFRS 1 *First-time Adoption of International Financial Reporting Standards* explaining the transition to the new IFRS. The Board noted that the disclosures in IFRS 1 relate to first-time adoption and not to changes in accounting policies. Disclosures about changes in an accounting policy are required by IAS 8.

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

- BC7.26 As noted above, IAS 8 states that retrospective application results in the most useful information to users because the information presented for all periods is comparable. The Board noted that IFRS 7 already requires disclosure of the amount of the change in fair value that is attributable to changes in the credit risk of the liability. Therefore, entities are already calculating the information necessary to present the effects of changes in liabilities' credit risk in other comprehensive income. Thus, the exposure draft published in 2010 proposed retrospective application and almost all respondents agreed. The Board confirmed that proposal.
- BC7.27 The Board did not change the classification and measurement approach for financial liabilities, including the eligibility conditions for the fair value option for financial liabilities. Therefore, the proposals in the exposure draft did not permit entities to make new designations or revoke its previous designations as a result of the proposals. Some respondents believed that the Board should permit entities to reassess their designations in the light of the new requirements related to own credit risk.
- BC7.28 However, the Board was not persuaded that there is a compelling reason to permit entities to reassess their elections, especially because the underlying classification and measurement approach has not changed. As noted in paragraph BC7.19, when an entity initially applies IFRS 9 to assets, it is required to reassess particular liabilities designated under the fair value option. That was necessary because IFRS 9 (issued in 2009) introduced a new classification and measurement approach for financial assets, which would change the classification of some (and perhaps many) financial assets. Those changes require an entity to reassess liabilities designated under the fair value option to the extent that designation was originally elected to address an accounting mismatch. However, the Board believed that a similar case could not be made for the requirements added to IFRS 9 in 2010. And because IFRS 9 (issued in 2009) already requires reassessment of particular liabilities, the Board believes that a second reassessment would make transition unnecessarily complex. Therefore, the Board decided to confirm the proposal in the exposure draft.

Transition relief

- BC7.29 When the Board issued the new requirements for financial assets in November 2009, it granted some transition relief from full retrospective transition. To be consistent with the transition requirements for assets, the Board decided to grant similar transition relief for the requirements added to IFRS 9 in October 2010:
- (a) The requirements are not applied to liabilities that have been derecognised at the date of initial application. The Board concluded that applying the requirements in IFRS 9 to some derecognised items but not others would be confusing and unnecessarily complex.
 - (b) An entity is required to assess whether presenting the effects of changes in a liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss on the basis of facts and circumstances that exist at the date of initial application. This is consistent with the other transition requirements in IFRS 9 related to the fair value option. Moreover, the Board noted that the conclusion will most likely be the same regardless of whether it is made on the basis of facts and circumstances that existed at initial recognition of the liability or at the date of initial application.
 - (c) Derivative liabilities that were previously accounted for at cost are measured at fair value at the date of initial application. Consistently with the requirements for financial assets, an entity will not have the necessary information to determine fair value retrospectively without using hindsight.
 - (d) An entity is not required to restate prior periods if the requirements are adopted for reporting periods beginning before 1 January 2012. The Board decided that it would be inappropriate and confusing to require an entity to restate prior periods for some of the requirements in IFRS 9 but not others. However, the Board decided that if the entity elects to restate prior periods to reflect the requirements added to IFRS 9 in October 2010, it must also restate prior periods to reflect the other requirements in IFRS 9. That conclusion is consistent with the Board's decision that if an entity elects to adopt the requirements early, it must at the same time adopt early all of the requirements in IFRS 9 that it does not already apply.

Transitional insurance issues

- BC7.30 The Board noted that insurers may face particular problems if they apply IFRS 9 before they apply the phase II standard on insurance contracts (the new IFRS 4). To avoid accounting mismatches in profit or loss, many insurers classify many of their financial assets as available for sale. If those insurers apply IFRS 9 before the new IFRS 4, they might decide to classify many of their financial assets at amortised cost (assuming they meet the relevant conditions in IFRS 9). When those insurers later apply the new IFRS 4, they may wish to reclassify those assets from amortised cost to fair value through profit or loss, but that may not generally be possible in accordance with IFRS 9. Thus, those insurers might have either to classify those assets at fair value through profit or loss during the intervening period or to continue to classify them at amortised cost when they apply the new IFRS 4. Either choice might lead to an accounting mismatch.
- BC7.31 The Board considered whether it could reduce such mismatches by maintaining the available-for-sale category for insurers until they can apply the new IFRS 4. However, if the Board did so, it would have to create detailed and arbitrary descriptions of the entities and instruments to which that approach would apply. The Board concluded that permitting the continuation of that category would not provide more useful information for users.
- BC7.32 The Board will consider in developing the new IFRS 4 whether to provide an option for insurers to reclassify some or all financial assets when they first apply the new IFRS 4. This would be similar to the option in paragraph 45 of IFRS 4 *Insurance Contracts* and paragraph D4 of IFRS 1. The Board included such an option in IFRS 4 for reasons that may be equally valid for phase II.

Shadow accounting for participating contracts

- BC7.33 Some insurers expressed concerns that an accounting mismatch will arise if the assets backing participating insurance liabilities include equity investments and the insurer elects to present gains and losses on those investments in other comprehensive income. That accounting mismatch would arise because paragraph 30 of IFRS 4 does not give explicit authority to apply 'shadow accounting' in such cases.
- BC7.34 The Board acknowledges that this accounting mismatch is undesirable. However, for the following reasons, the Board did not amend paragraph 30 of IFRS 4:
- (a) This accounting mismatch will arise only if an insurer elects to present gains and losses on equity investments in other comprehensive income.
 - (b) As described in paragraph BC5.23, in creating the option to present gains and losses on equity investments in other comprehensive income, the Board's intention was to provide a presentation alternative for some equity investments in which presenting fair value gains and losses in profit or loss may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily to generate increases in the value of the investment. The Board did not intend to provide an alternative for investments in any other circumstances, including if an entity intends to hold an equity investment over a long time frame. In the Board's view, if an insurer holds investments with the primary objective of realising a profit from increases in their value, for the benefit of either the insurer itself or its policyholders, the most transparent place to present those value changes is in profit or loss.

General

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

- BCG.1 The main changes made by IFRS 9 issued in 2009 from the exposure draft published in 2009 were:
- (a) IFRS 9 dealt with the classification and measurement of financial assets only, rather than financial assets and financial liabilities as proposed in the exposure draft.
 - (b) IFRS 9 requires entities to classify financial assets on the basis of the objective of the entity's business model for managing the financial assets and the characteristics of the contractual cash flows. It points out that the entity's business model should be considered first, and that the contractual cash flow characteristics should be considered only for financial assets that are eligible to be measured at amortised cost because of the business model. It states that both classification conditions are essential to ensure that amortised cost provides useful information.
 - (c) Additional application guidance was added on how to apply the conditions necessary for amortised cost measurement.
 - (d) IFRS 9 requires a 'look through' approach for investments in contractually linked instruments that effect concentrations of credit risk. The exposure draft had proposed that only the most senior tranche could have cash flows that represented payments of principal and interest on the principal amount outstanding.
 - (e) IFRS 9 requires (unless the fair value option is elected) financial assets purchased in the secondary market to be recognised at amortised cost if the instruments are managed within a business model that has an objective of collecting contractual cash flows and the financial asset has only contractual cash flows representing principal and interest on the

principal amount outstanding even if such assets were acquired at a discount that reflects incurred credit losses.

- (f) IFRS 9 requires that when an entity elects to present gains and losses on equity instruments measured at fair value in other comprehensive income, dividends are to be recognised in profit or loss. The exposure draft had proposed that those dividends would be recognised in other comprehensive income.
- (g) IFRS 9 requires reclassifications between amortised cost and fair value classifications when the entity's business model changes. The exposure draft had proposed prohibiting reclassification.
- (h) For entities that adopt IFRS 9 for reporting periods before 1 January 2012, IFRS 9 provides transition relief from restating comparative information.
- (i) IFRS 9 requires additional disclosures for all entities when they first apply the IFRS.

Summary of main changes from the exposure draft *Fair Value Option for Financial Liabilities*

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

- (a) For liabilities designated under the fair value option, IFRS 9 requires an entity to present the effects of changes in the liability's credit risk in other comprehensive income unless that treatment would create or enlarge an accounting mismatch in profit or loss. If that treatment would create or enlarge an accounting mismatch in profit or loss, the entire fair value change is presented in profit or loss. That was the alternative approach set out in the exposure draft. The proposed approach in the exposure draft had treated all liabilities designated under the fair value option in the same way and had not addressed cases in which the proposed treatment would create or enlarge an accounting mismatch in profit or loss.
- (b) IFRS 9 requires a 'one-step' approach for presenting the effects of changes in a liability's credit risk in the performance statement. That approach requires the effects of changes in a liability's credit risk to be presented directly in other comprehensive income, with the remaining amount of fair value change presented in profit or loss. The exposure draft had proposed a 'two-step' approach, which would have required the total fair value change to be presented in profit or loss. The effects of changes in a liability's credit risk would have been backed out and presented in other comprehensive income.

Cost-benefit considerations

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

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

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

- (c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information;
- (d) the benefit of better economic decision-making as a result of improved financial reporting; and
- (e) the costs of transition for users, preparers and others.

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

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

- (a) reducing the number of classification categories. All financial assets will be subsequently measured at either amortised cost or fair value. Hybrid contracts with financial asset hosts will be classified and measured in their entirety thereby eliminating the complex and rule-based requirements in IAS 39.
- (b) having a single impairment methodology that is applied to all financial assets that are not measured at fair value. Many constituents criticised the multitude of impairment methodologies in IAS 39.
- (c) providing a clear rationale for why financial assets are measured in a particular way, which aligns the measurement attribute to the way that an entity manages its financial assets and their contractual cash flow characteristics.

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

Appendix

Amendments to the Basis for Conclusions on other IFRSs

This appendix contains amendments to the Basis for Conclusions on other IFRSs that are necessary in order to ensure consistency with IFRS 9 and the related amendments to other IFRSs.

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

BCA1 The footnotes to the reference to 'IAS 39' in paragraphs BC58A, BC63A, BC65, BC66, BC74, BC89 and BC89A and to the heading 'Available-for-sale financial assets' above paragraph BC81 are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC17(a), and the first references to 'IAS 39' in paragraphs BC20–BC23, BC58A, BC63A, BC74, BC81, BC89 and BC89A are footnoted appropriately as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The first references to 'IAS 39' in paragraphs BC65 and BC66 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

The term 'available for sale' in paragraph BC63A, the term 'available-for-sale financial assets' in paragraph BC74(b) and the heading 'Available-for-sale financial assets' above paragraph BC81 are footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009, with requirements added in October 2010, eliminated the category of available-for-sale financial assets.

IFRS 2 *Share-based Payment*

BCA2 The footnote to the reference to 'IAS 39' in the heading above paragraph BC25 is deleted.

The heading above paragraph BC25 is footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. Paragraphs BC25–BC28 refer to matters relevant when IFRS 2 was issued.

IFRS 3 *Business Combinations*

BCA3 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC185 and the first references to 'IAS 39' in paragraphs BC244, BC256 and BC437(c) are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC185 and the first references to 'IAS 39' in paragraphs BC246–BC251, BC256, BC354, BC434A and BC437(c) are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The reference to 'IAS 39' in paragraph BC244 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, relocated to IFRS 9 the requirements on the accounting for financial guarantees and commitments to provide loans at below-market interest rates.

The first reference to 'available-for-sale securities' in paragraph BC389 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

IFRS 4 *Insurance Contracts*

BCA4 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC11(a), the first references to 'IAS 39' in paragraphs BC22(c), BC28(b), BC41(b), BC47, BC55, BC73(d), BC82, BC161, the reference to 'available for sale' in paragraph BC145(b) and the heading above paragraph BC166 are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC11(a), the first references to 'IAS 39' in paragraphs BC21, BC22(c), BC28(b), BC40–BC54, BC55–BC60, BC62, BC73(d), BC82, BC117, BC146 and BC154–BC165 and the heading 'Issues related to IAS 39' above paragraph BC166 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The references to 'IAS 39' in paragraphs BC47 and BC161 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended the requirements in IAS 39 to identify and separately account for embedded derivatives and relocated them to IFRS 9 *Financial Instruments*. This Basis for Conclusions has not been updated for changes in requirements since IFRIC 9 *Reassessment of Embedded Derivatives* was issued in March 2006.

The term 'available for sale' in paragraph BC145(b) and the heading 'Issues related to IAS 39' above paragraph BC166 are footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

BCA5 The footnotes to the headings above paragraphs DO7, DO9 and DO18 are deleted and replaced as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

BCA6 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC8(b), the first references to 'IAS 39' in paragraphs BC13(a) and BC54(b) and the reference to 'available-for-sale assets' in paragraph BC58 are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC8(b) and the reference to 'IAS 39' in paragraphs BC13(a), BC54(a) and BC81 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 5 was issued.

The term 'held-for-trading financial asset' in paragraph BC54(b) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of held-for-trading financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

The term 'available-for-sale assets' in paragraph BC58 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IFRS 5 was issued.

IFRS 7 Financial Instruments: Disclosures

BCA7 In the rubric below the title a paragraph is added as follows:

In November 2009 and October 2010 the requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments, and IFRS 7 was amended accordingly. The text of this Basis for Conclusions has been amended for consistency with those changes.

Paragraphs BC14–BC16 are amended to read as follows:

BC14 Paragraph 8 requires entities to disclose financial assets and financial liabilities by the measurement categories in IFRS 9 *Financial Instruments*. The Board concluded that disclosures for each measurement category would assist users in understanding the extent to which accounting policies affect the amounts at which financial assets and financial liabilities are recognised.

BC15 The Board also concluded that separate disclosure of the carrying amounts of financial assets and financial liabilities that are designated upon initial recognition as financial assets and financial liabilities at fair value through profit or loss and those mandatorily measured at fair value is useful because such designation is at the discretion of the entity.

Financial assets or financial liabilities at fair value through profit or loss (paragraphs 9–11, B4 and B5)

BC16 IFRS 9 permits entities to designate a non-derivative financial liability as at fair value through profit or loss, if specified conditions are met. If entities do so, they are required to provide the disclosures in paragraphs 10 and 11. The Board's reasons for these disclosures are set out in the Basis for Conclusions on IFRS 9, paragraphs BCZ5.29–BCZ5.34.

The heading above paragraph BC23 is amended to read as follows and paragraph BC23B is added:

Reclassification (paragraphs 12B–12D)

BC23B In November 2009 the Board issued the requirements relating to the reclassification of financial assets in IFRS 9 *Financial Instruments* and revised accordingly the disclosure requirements relating to the reclassification of financial assets.

Paragraphs BC33 and BC34 are amended to read as follows:

BC33 Paragraph 20(a) requires disclosure of income statement gains and losses by the measurement classifications in IFRS 9 (which complement the balance sheet disclosure requirement described in paragraph BC14). The Board concluded that the disclosure is needed for users to understand the financial performance of an entity's financial instruments, given the different measurement bases in IFRS 9.

BC34 Some entities include interest and dividend income in gains and losses on financial assets and financial liabilities measured at fair value through profit or loss and others do not. To assist users in comparing income arising from financial instruments across different entities, the Board decided that an entity should disclose how the income statement amounts are determined. For example, an entity should disclose whether net gains and losses on financial assets or financial liabilities measured at fair value through profit or loss include interest and dividend income (see Appendix B, paragraph B5(e)).

Paragraphs BC39 and BC39B–BC39E are amended to read as follows:

BC39 Paragraph 28 requires disclosure about the difference that arises if the transaction price differs from the fair value of a financial instrument that is determined in accordance with paragraph B5.4.8 of IFRS 9. Those disclosures relate to matters addressed in the December 2004 amendment to IAS 39 *Transition and Initial Recognition of Financial Assets and Financial Liabilities*. That amendment does not specify how entities should account for those initial differences in subsequent periods. The disclosures required by paragraph 28 inform users about the amount of gain or loss that will be recognised in profit or loss in future periods. The Board noted that the information required to provide these disclosures would be readily available to the entities affected.

BC39B Because its own fair value measurement project was not yet completed, the Board decided not to propose a fair value hierarchy for measurement, but only for disclosures. The fair value hierarchy for disclosures is the same as that in SFAS 157 but uses IFRS language pending completion of the fair value measurement project. Although the implicit fair value hierarchy for measurement in IFRS 9 is different from the fair value hierarchy in SFAS 157, the Board recognised the importance of using a three-level hierarchy for disclosures that is the same as that in SFAS 157.

BC39C The Board noted the following three-level measurement hierarchy implicit in IFRS 9:

...

BC39D For example, the Board acknowledged that some financial instruments that for measurement purposes are considered to have an active market in accordance with paragraphs B5.4.3–B5.4.5 of IFRS 9 might be in Level 2 for disclosure purposes. Also, the application of paragraph B5.4.9 of IFRS 9 might result in no gain or loss being recognised on the initial recognition of a financial instrument that is in Level 2 for disclosure purposes.

BC39E The introduction of the fair value disclosure hierarchy does not affect any measurement or recognition requirements of other standards. In particular, the Board noted that the recognition of gains or losses at inception of a financial instrument (as required by paragraph B5.4.8 of IFRS 9) would not change as a result of the fair value disclosure hierarchy.

Paragraph BC73(b) is amended to read as follows:

BC73 The main changes to the proposals in ED 7 are:

- (a) ...
- (b) a requirement has been added for disclosures about the difference between the transaction price at initial recognition (used as fair value in accordance with paragraph B5.4.8 of IFRS 9) and the results of a valuation technique that will be used for subsequent measurement.
- (c) ...

BCA8 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC17 and the reference to 'IAS 39' in paragraph BC23A are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IFRS 7 was issued.

IAS 1 *Presentation of Financial Statements*

BCA9 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC38A, to the reference to 'IAS 39' in paragraph BC38B and to the references to 'available-for-sale' in paragraphs BC49 and BC69 are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC38A and the reference to 'IAS 39' in paragraph BC38B are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 1 was issued.

The term 'available-for-sale financial assets' in paragraphs BC49 and BC69 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

The term 'held-to-maturity investments' in paragraph BC77 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of held-to-maturity financial assets. This paragraph refers to matters relevant when IAS 1 was issued.

IAS 17 Leases

BCA10 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC21 is deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC21 is footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 17 was issued.

IAS 19 Employee Benefits

BCA11 The rubric below the title is amended to read as follows:

The original text has been marked up to reflect the revision of IAS 39 Financial Instruments: Recognition and Measurement in 2003 and the issue of IFRS 2 Share-based Payment in 2004, Improvements to IFRSs in May 2008 and IFRS 9 Financial Instruments in October 2010; new text is underlined and deleted text is struck through. The terminology ...

Paragraph BC68D(b) is amended and footnoted to read as follows:

BC68D Supporters of ...

- (b) if offsetting is allowed when condition (c) is not met, this would seem to be equivalent to permitting a net presentation for 'in-substance defeasance' and other analogous cases where IAS 32 indicates explicitly that offsetting is inappropriate. The Board has rejected 'in-substance defeasance' for financial instruments (see ~~IAS 39 Application Guidance paragraph AG59~~ IFRS 9 paragraph AG3.3.3)* and there is no obvious reason to permit it in accounting for defined benefit plans. In these cases the entity retains an obligation that should be recognised as a liability and the entity's right to reimbursement from the plan is a source of economic benefits that should be recognised as an asset. Offsetting would be permitted if the conditions in paragraph ~~3342~~ of IAS 32 are satisfied;

...

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

BCA12 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC75A, to the references to 'IAS 39' in paragraphs BC68H and BC68I, to the reference to 'available-for-sale financial assets' in paragraph BC48W and to the references to 'IAS 25 *Accounting for Investments*' in paragraphs BC69 and BC73 are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC75A and the reference to 'IAS 39' in paragraph BC68H are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items

within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.

The term 'available-for-sale financial assets' in paragraph BC48W is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets. This paragraph refers to matters relevant when IAS 19 was issued.

The references to 'IAS 25 *Accounting for Investments*' in paragraphs BC69 and BC73 are footnoted as follows:

* superseded by IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 40 *Investment Property*. In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 19 was issued.

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

BCA13 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the first reference to 'IAS 39' in paragraph BC3 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 20 was amended in 2008.

IAS 27 Consolidated and Separate Financial Statements

BCA14 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and to the references to 'IAS 39' in paragraphs BC65–BC66C are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and the first references to 'IAS 39' in paragraphs BC65–BC66C are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The first references to the term 'available-for-sale' in paragraphs BC54, BC56 and BC65 are footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009, and amended in October 2010, eliminated the category of available-for-sale financial assets.

BCA15 In the dissenting opinions on the amendments to IFRS 1 and IAS 27 issued in May 2008 the footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph DO3 is deleted and replaced by the following footnote:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 28 *Investments in Associates*

BCA16 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC7 and the references to 'IAS 39' in paragraphs BC9, BC22 and BC26 are deleted.

The reference to 'IAS 39' in the heading above paragraph BC7 and the first references to 'IAS 39' in paragraphs BC22 and BC26 are footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The first reference to 'IAS 39' in paragraph BC9 is footnoted as follows:

† In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. IFRS 9 eliminated the category of available-for-sale financial assets and permits entities to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not held for trading.

The term 'available-for-sale equity instrument' in paragraph BC26 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

IAS 31 *Investments in Joint Ventures*

BCA17 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC7 and to the references to 'IAS 39' in paragraphs BC9 and BC17 are deleted.

The heading above paragraph BC7 and the first references to 'IAS 39' in paragraphs BC9 and BC17 are footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 32 *Financial Instruments: Presentation*

BCA18 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and to the references to 'IAS 39' in paragraphs BC25, BC26 and BC53(a) are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the first references to 'IAS 39' in paragraphs BC26 and BC53(a) are footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The first reference to 'IAS 39' in paragraph BC25 is footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. The requirements of paragraph 43 of IAS 39 relating to the initial measurement of financial assets were relocated to paragraph 5.1.1 of IFRS 9.

BCA19 In the dissenting opinion on the issue of IAS 32 in December 2003, the reference to 'IAS 39' in paragraph DO2 is footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 36 Impairment of Assets

BCA20 The footnote to the reference to 'IAS 39' in paragraph BCZ15(d) is deleted.

The reference to 'IAS 39' in paragraph BCZ15(d) is footnoted as follows:

* The IASB's project to revise IAS 32 and IAS 39 in 2003 resulted in the relocation of the requirements on fair value measurement from IAS 32 to IAS 39. In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IAS 39 Financial Instruments: Recognition and Measurement

BCA21 The following paragraphs are added to the rubric:

In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of financial assets within the scope of IAS 39 and relocated them to IFRS 9 Financial Instruments. Accordingly, the following were deleted: paragraphs BC13 and BC14, the heading above paragraph BC25 and paragraphs BC25–BC29, paragraph BC70, the heading above paragraph BC104A and paragraphs BC104A–BC104E, the headings above paragraphs BC125, BC127 and BC129 and paragraphs BC125–BC130, the heading above paragraph BC221 and that paragraph and the heading above paragraph BC222 and that paragraph.

In October 2010 the Board relocated to IFRS 9 the requirements of IAS 39 relating to classification and measurement of financial liabilities and derecognition of financial assets and financial liabilities. The Board did not reconsider most of those requirements. Accordingly the following were relocated to IFRS 9: paragraphs BC11C, BC37–BC79A and BC85–BC104.

Paragraphs BC11C, BC11E, BC11F, BC13 and BC14, BC25–BC29, BC37–BC104E, BC105–BC107, BC125–BC130, BC221 and BC222 and the headings above BC25, BC37, BC104A, BC105 ('Impairment of investments in equity instruments (paragraph 61)' only), BC221 and BC222 are deleted.

Paragraph BC20A is amended to read as follows:

BC20A As discussed in paragraphs BC21–BC23E, the Board amended IAS 39 in 2005 to address financial guarantee contracts. In making those amendments, the Board moved the material on loan commitments from the scope section of the Standard to the section on subsequent measurement. The purpose of this change was to rationalise the presentation of this material without making substantive changes.

The headings above paragraphs BC15, BC21 and BC24 are amended to read as follows:

Loan commitments

Financial guarantee contracts

Contracts to buy or sell a non-financial item

BCA22 The footnotes to the references to 'IAS 39' in paragraphs BC185(d), BC186 and BC189(a) are deleted. The following footnotes are amended to read as follows and added:

To the reference to 'IAS 39' in paragraph BC12	In November 2009 the Board amended the requirements of IAS 39 relating to classification and measurement of assets within the scope of IAS 39 and relocated them to IFRS 9 <i>Financial Instruments</i> . In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
To the heading above paragraph BC15	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
At the end of paragraph BC16	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of loans and receivables.
To the heading above paragraphs BC21, BC24, BC40B, BC41 and BC70A	In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.
To the reference to 'held-to-maturity' in paragraph BC80A	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of held-to-maturity.
To the reference to 'loans and receivables' in paragraph BC111	IFRS 9 <i>Financial Instruments</i> , issued in November 2009, eliminated the category of loans and receivables.

At the end of paragraph BC185(d) and to the references to 'required to be paid' in paragraphs BC186 and BC189(a)

In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

To the reference to 'held-to-maturity' in paragraph BC201(f)

IFRS 9 *Financial Instruments*, issued in November 2009, eliminated the category of held-to-maturity.

At the end of paragraph BC203(b)

In October 2010 the Board amended IFRS 9 to add the requirements for classifying and measuring financial liabilities and derecognising financial assets and financial liabilities. Those requirements were relocated from IAS 39.

BCA23 The dissenting opinions from the issue of IAS 39 in December 2003, *The Fair Value Option* in June 2005 and *Reclassification of Financial Assets* in October 2008 are deleted.

IAS 40 Investment Property

BCA24 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC8, to the references to 'IAS 39' in paragraphs B35 and B67(a)(i) and to the reference to 'available-for-sale investments' in paragraph B63(a) are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC8 is footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. Paragraph BC8 refers to matters relevant when IAS 40 was issued.

BCA25 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph B2 and the references to 'IAS 39' in paragraphs B46(b), B54 and B63(d) are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39. This paragraph refers to matters relevant when IAS 40 was issued.

The reference to 'IAS 39' in paragraph B35 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the held-to-maturity category. This paragraph discusses matters relevant when IAS 40 was issued.

The reference to 'IAS 39' in paragraph B63(a) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

In paragraph B67(a)(i) the footnote to 'IAS 39' is amended to read as follows:

* Paragraph 69 was replaced by paragraph 46 when the IASB revised IAS 39 in 2003. In 2009 paragraph 46 of IAS 39 was deleted by IFRS 9 *Financial Instruments*.

IAS 41 Agriculture

BCA26 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph B48 and to the reference to 'IAS 39' in paragraph B54 are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph B48 and the first reference to 'IAS 39' in paragraph B54 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments

BCA27 In paragraph BC18 the reference to 'IAS 39' is footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. Paragraph 49 of IAS 39 was relocated to paragraph 5.4.3 of IFRS 9. Paragraph BC18 refers to matters relevant when IFRIC 2 was issued.

IFRIC 4 Determining whether an Arrangement contains a Lease

BCA28 The footnote to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC14 is deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC14 is footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 5 Rights to Interests arising from Decommissioning, Restoration and Environmental Rehabilitation Funds

BCA29 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC6 and to the references to 'IAS 39' in paragraphs BC11(a), BC12, BC20 and BC24 are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC6, the first references to 'IAS 39' in paragraphs BC8(c), BC20, BC24 and BC27 and the heading above paragraph BC11 are footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The term 'available-for-sale financial asset' in paragraph BC11 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the categories of available-for-sale and held-to-maturity financial assets.

IFRIC 10 *Interim Financial Reporting and Impairment*

BCA30 The footnotes to the references to 'IAS 39' in paragraphs BC2 and BC9 are deleted.

The first references to 'IAS 39' in paragraphs BC2 and BC9 are footnoted as follows:

* In November 2009 and October 2010 the Board amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 12 *Service Concession Arrangements*

BCA31 The footnotes to the reference to 'IAS 39' in paragraph BC59 and to the heading above paragraph BC60 are deleted.

The references to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC43(a) and to 'IAS 39' in paragraph BC59 and the heading above paragraph BC60 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

IFRIC 17 *Distributions of Non-cash Assets to Owners*

BCA32 The footnotes to the reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22, to the last sentence of paragraph BC28(a), to the reference to 'AG81' in paragraph BC29, to the reference to 'IAS 39' in paragraph BC32 and to the reference to 'available-for-sale' in paragraph BC47(e) are deleted.

The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC22 and the references to 'IAS 39' in paragraphs BC37 and BC50 are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

The reference to 'IAS 39' in paragraph BC28(a) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, requires all investments in equity instruments to be measured at fair value.

The reference to 'AG81' in paragraph BC29 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009, amended paragraphs AG80 and AG81 of IAS 39 so that they apply only to derivatives on unquoted equity instruments. IFRS 9, issued in October 2010, deleted paragraphs AG80 and AG81 of IAS 39.

The reference to 'IAS 39' in paragraph BC32 is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the requirement in IAS 39 for some assets to be measured using a historical cost basis.

The term 'available-for-sale investment' in paragraph BC47(e) is footnoted as follows:

* IFRS 9 *Financial Instruments*, issued in November 2009 and amended in October 2010, eliminated the category of available-for-sale financial assets.

IFRIC 19 Extinguishing Financial Liabilities with Equity Instruments

BCA33 The reference to 'IAS 39 *Financial Instruments: Recognition and Measurement*' in paragraph BC2 and the references to 'IAS 39' in paragraphs BC10, BC20, BC24, BC31 and BC34(c) are footnoted as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

SIC Interpretation 27 Evaluating the Substance of Transactions Involving the Legal Form of a Lease

BCA34 The rubric '*[The original text ... struck through]*' is deleted and replaced with the following rubric:

[In November 2009 and October 2010 the requirements of IAS 39 relating to classification and measurement of items within the scope of IAS 39 were relocated to IFRS 9 Financial Instruments. To avoid confusion with earlier amendments marked up on the original text to reflect the revision of IAS 39 in 2003 and the subsequent issue of IFRS 4, paragraphs 14 and 15 have been amended for consistency with IFRS 9 as issued in 2010.]

Paragraph 14 is amended to read as follows:

- 14 When an Entity ... A financial asset and a financial liability, or a portion of either, are derecognised only when the requirements of paragraphs 3.2.1–3.2.23, 3.3.1–3.3.4, B3.2.1–B3.2.17 and B3.3.1–B3.3.7 of IFRS 9 are met.
- 15 IFRS 4 provides guidance for recognising and measuring financial guarantees and similar instruments that provide for payments to be made if the debtor fails to make payments when due, if that contract transfers significant insurance risk to the issuer. Financial guarantee contracts that provide for payments to be made in response to changes in relation to a variable (sometimes referred to as an 'underlying') are subject to IAS 39.*

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all items within the scope of IAS 39.

Dissenting opinions

Dissent of James J Leisenring from IFRS 9 *Financial Instruments* (issued 2009)

- DO1 Mr Leisenring supports efforts to reduce the complexity of accounting for financial instruments. In that regard, he supports requiring all financial instruments to be measured at fair value, with that measurement being recognised in profit or loss. He finds no compelling reason related to improving financial reporting to reject that approach. It is an approach that maximises comparability and minimises complexity.
- DO2 It maximises comparability because all financial instruments would be measured at one attribute within an entity and across entities. No measurement or presentation would change to reflect either arbitrary distinctions or management behaviour or intentions. IFRS 9 emphasises management intentions and behaviour, which substantially undermines comparability.
- DO3 Complexity of accounting would be drastically reduced if all financial instruments were measured at fair value. The approach favoured by Mr Leisenring provides at least the following simplifications:
- (a) no impairment model is necessary.
 - (b) criteria for when a given instrument must or can be measured with a given attribute are unnecessary.
 - (c) there is no need to bifurcate embedded derivatives or to identify financial derivatives.
 - (d) it eliminates the need for fair value hedge accounting for financial instruments.
 - (e) it eliminates the disparity in the measurement of derivatives within and outside the scope of IAS 39.
 - (f) it minimises the incentives for structuring transactions to achieve a particular accounting outcome.
 - (g) no fair value option would be needed to eliminate accounting mismatches.
 - (h) it provides a superior foundation for developing a comprehensive standard for the derecognition of financial instruments that is not present in a mixed attribute model.
- DO4 Mr Leisenring accepts that measuring more instruments at fair value increases measurement complexity, but this increase is minimal compared with the reductions in complexity that would be otherwise achieved. There is no disagreement that derivatives must be measured at fair value. Those instruments raise the most difficult measurement issues, as cash instruments have many fewer problems. Indeed, some suggestions for an impairment model would measure at fair value the credit loss component of cash instruments. If that were to be the conclusion on impairment (an expected loss approach), it would minimise the incremental fair value measurement complexity of recording at fair value instruments now at amortised cost.
- DO5 Mr Leisenring recognises that measuring all instruments at fair value through profit or loss raises presentation issues about disaggregation of fair value changes. However, he does not believe that these issues are insurmountable.
- DO6 Investors have often told both the IASB and the FASB that fair value of financial instruments recognised in profit or loss provides the most useful information for their purposes. There is a worldwide demand for an improved and common solution to the accounting for financial instruments. Investors are disappointed that the Board will not take this opportunity to make, with other standard-setters, truly substantive changes rather than these minimal changes that perpetuate all the legitimate concerns that have been expressed about the mixed attribute model.

- DO7 IFRS 9 does to some extent reduce complexity but that reduction is minimal. Certain measurement classifications are eliminated but others have been added. Mr Leisenring does not think that, on balance, this is an improvement over IAS 39.
- DO8 Fundamental to IFRS 9 is the distinction between financial instruments measured at amortised cost and those at fair value. Mr Leisenring is concerned that neither of the two conditions necessary for that determination is operational. Paragraph BC4.86 criticises IAS 39 because the embedded derivative requirement of that Standard is based on a list of examples. However, the basic classification model of IFRS 9 is based on lists of examples in paragraphs B4.1.4, B4.1.13 and B4.1.14. The examples are helpful but are far from exhaustive of the issues that will be problematic in applying the two criteria for classification at amortised cost.
- DO9 Mr Leisenring also thinks that the two criteria are inconsistently applied. When the objective of the entity's business model is to hold the assets to collect the contracted cash flows of an instrument there is no requirement that the entity must actually do so. The cash flow characteristics of the instrument are also ignored when the guidance is applied to investments in contractually linked instruments (tranches). In those circumstances the contractual cash flows of the instrument are ignored and one is required to look through to the composition of assets and liabilities of the issuing entity. This 'look through' requirement is also potentially complex and in Mr Leisenring's opinion is likely to be not very operational. Mr Leisenring also objects to eliminating the requirement to bifurcate derivatives embedded in cash instruments. This objection is primarily because of concern that the two criteria to qualify for amortised cost will not be operational. The pressure on those two conditions will be enormous because there will be an incentive to embed derivatives in a cash instrument in anticipation that the instrument might qualify for amortised cost. Derivatives should be at fair value whether embedded or standing alone and a bifurcation requirement would achieve that accounting. If Mr Leisenring were confident that the criteria for amortised cost could be applied as intended he would not be as concerned because instruments with embedded derivatives would be at fair value in their entirety.
- DO10 Mr Leisenring is concerned that, in the current crisis, instruments that have provided some of the most significant losses when measured at fair value would be eligible for amortised cost. That conclusion is not responsive to the present environment. The approach also allows actively traded debt instruments, including treasury securities, to be at amortised cost. These results are unacceptable and reduce the usefulness of reported information for investors.
- DO11 The Board is required by its *Framework* to be neutral in its decision-making and to strive to produce neutral information to maximise the usefulness of financial information. IFRS 9 fails in that regard because it produces information based on free choice, management intention and management behaviour. Reporting that will result from this approach will not produce neutral information and diminishes the usefulness of financial reporting.
- DO12 The Board is insistent in paragraph BC4.20 that accounting based on a business model is not free choice but never explains why selection of a business model is not a management choice. The existence of a trading account, a fair value option and the objective of a business model are all free choices.
- DO13 The classification of selected equity instruments at fair value with the result of the remeasurement reported outside profit or loss is also a free choice. The Board concludes that reporting fair value changes in profit or loss may not reflect the operating performance of an entity. Mr Leisenring could accept accounting for changes in fair value of some instruments outside profit or loss in other comprehensive income. That accounting, however, should not be a free choice and why that presentation is superior in defined circumstances should be developed. In addition, when these securities are sold any realised gains and losses are not 'recycled' to profit or loss. That conclusion is inconsistent with the Board's conclusion that dividends received on these instruments should be reported in profit or loss. Such dividends would represent a return on investment or a form of 'recycling' of changes in the value of the instruments.

- DO14 Mr Leisenring believes that a business model is rarely relevant in writing accounting standards. Identical transactions, rights and obligations should be accounted for in the same way if comparability of financial information is to be achieved. The result of applying IFRS 9 ignores any concern for comparability of financial information.
- DO15 The credit crisis has provided confirmation that a drastic change in accounting for financial instruments is desirable. However, many have said that while they agree that the approach suggested by Mr Leisenring would be superior, and a significant improvement, the world is not ready to embrace such change. It is unclear to Mr Leisenring what factors need to be present for the optimal solution to be acceptable. He has concluded that it is hard to envisage circumstances that would make the case any more compelling for fundamental change and improvement than the present circumstances. Therefore, IFRS 9 will inevitably preserve a mixed attribute model and the resulting complexity for a significant period of time.
- DO16 An objective of replacing IAS 39 was to provide a basis for convergence with accounting standards issued by the FASB. Mr Leisenring is concerned that IFRS 9 does not provide such a basis. As a consequence, allowing early adoption of the IFRS is undesirable. For convergence to be achieved significant changes in the IFRS are inevitable. Early adoption of the IFRS will therefore necessitate another costly accounting change when convergence is achieved. Permitting early adoption of this IFRS is also undesirable as it permits a lack of comparability in accounting for many years due to the deferred required effective date.
- DO17 Mr Leisenring would accept that if, for reasons other than the desire to provide useful information to investors, his approach is politically unattainable, an alternative could be developed that would be operational. That approach would require all financial assets and financial liabilities to be recorded at fair value through profit or loss except originated loans retained by the originator, trade receivables and accounts payable. If certain derivatives were embedded in an instrument to be accounted for at amortised cost the derivative would be either bifurcated and accounted for at fair value or the entire instrument would be measured at fair value. Either approach would be acceptable.

Dissent of Patricia McConnell from IFRS 9 *Financial Instruments* (2009)

- DO18 Ms McConnell believes that fair value is the most relevant and useful measurement attribute for financial assets. However, she acknowledges that many investors prefer not to measure all financial assets at fair value. Those investors believe that both amortised cost and fair value can provide useful information for particular kinds of financial assets in particular circumstances. Therefore, in order to meet the objective of developing high quality, global accounting standards that serve the interests of all investors, Ms McConnell believes that no single measurement attribute should have primacy over another. Thus any new IFRS setting classification and measurement principles for financial assets should require disclosure of sufficient information in the primary financial statements to permit determination of profit or loss and financial position using both amortised cost and fair value. For example, when a measurement attribute other than fair value is used for financial assets, information about fair value should be displayed prominently in the statement of financial position. The Board did not adopt such disclosure in IFRS 9, as discussed in paragraphs BC4.9–BC4.11 of the Board's Basis for Conclusions.
- DO19 As stated in paragraph BC4.1, an objective of the Board in developing IFRS 9 was to reduce the number of classification categories for financial instruments. However, Ms McConnell believes that IFRS 9 has not accomplished that objective. IFRS 9 would permit or require the following categories: (1) amortised cost, (2) a fair value option through profit or loss for financial assets that qualify for amortised cost but for which amortised cost would create an accounting mismatch, (3) fair value through profit or loss for debt instruments that fail to qualify for amortised cost, (4) fair value through profit or loss for trading securities, (5) fair value through profit or loss for equity securities not held for trading and (6) fair value through other comprehensive income for equity investments not held for trading. Ms McConnell does not view those six categories as a significant improvement over the six categories in IAS 39; like the categories in IAS 39, they will hinder investors' understanding of an already complex area of financial reporting.

- DO20 IFRS 9 sets out two criteria for measuring financial assets at amortised cost: (1) the way the entity manages its financial assets ('business model') and (2) the contractual cash flow characteristics of its financial assets. On the surface, this appears to be an improvement over IAS 39's criterion that was based on management's intention to trade, hold available for sale, hold to maturity, or hold for the foreseeable future. However, Ms McConnell finds it difficult to see how IFRS 9's criterion based on the objective of the entity's business model differs significantly from management's intention. In her opinion selection of a business model is a management choice, as is the decision to have a trading account, use the fair value option for debt instruments or the fair value option for equity instruments with gains and losses reported in other comprehensive income. In paragraphs BC4.20 and BC4.21 the Board argues that selection of a measurement method based on an entity's business model is not a free choice. Ms McConnell does not find the arguments persuasive.
- DO21 IFRS 9 permits an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading. Ms McConnell could accept accounting for changes in fair value of some instruments outside profit or loss in other comprehensive income. However, that treatment should not be a free choice; criteria for that presentation should be developed. In addition, the Board decided that when those securities are sold any realised gains and losses are not 'reclassified' to profit or loss. That conclusion is inconsistent with the Board's decision to report dividends received on these investments in profit or loss. Such dividends represent a return on investment or a form of 'reclassifying' changes in the value of the instruments.
- DO22 In addition, Ms McConnell believes the 'look through' guidance for contractually linked investments (tranches) is an exception to one of the criteria necessary for applying amortised cost, namely the contractual cash flow characteristics of the instrument. In those circumstances the contractual cash flows of the instrument are ignored. Instead an entity is required to 'look through' to the underlying pool of instruments and assess their cash flow characteristics and credit risk relative to a direct investment in the underlying instruments. Ms McConnell believes that this provision adds complexity to the IFRS and reduces the usefulness of the reporting for financial assets. Moreover, since an entity is required to 'look through' only upon initial recognition of the financial asset, subsequent changes in the relative exposure to credit risk over the life of a structured investment vehicle would be ignored. Consequently, Ms McConnell believes it is possible that highly volatile investments, such as those owning sub-prime residential mortgage loans, would be reported at amortised cost.

HKFRS 9 IG
Issued November 2010

Effective for annual periods
beginning on or after 1 January 2013

Implementation Guidance
Hong Kong Financial Reporting Standard 9

Financial Instruments



Hong Kong Institute of
Certified Public Accountants
香港會計師公會

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IFRS 9 *Financial Instruments* Illustrative example

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

Financial liabilities at fair value through profit or loss

- IE1 The following example illustrates the calculation that an entity might perform in accordance with paragraph B5.7.18 of IFRS 9.
- IE2 On 1 January 20X1 an entity issues a 10-year bond with a par value of CU150,000* and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.
- IE3 The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:
- (a) LIBOR has decreased to 4.75 per cent.
- (b) the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.†
- IE4 The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.
- IE5 The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

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

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

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

<i>...continued</i>	
<p>[paragraph B5.7.18(b)]</p> <p>Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph B5.7.18(a).</p>	<p>The contractual cash flows of the instrument at the end of the period are:</p> <ul style="list-style-type: none"> • interest: CU12,000^(a) per year for each of years 2–10. • principal: CU150,000 in year 10. <p>The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is 4.75 per cent end of period LIBOR rate, plus the 3 per cent instrument-specific component.</p> <p>This gives a present value of CU152,367.^(b)</p>
<p>[paragraph B5.7.18(c)]</p> <p>The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph B5.7.18(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).</p>	<p>The market price of the liability at the end of the period is CU153,811.^(c)</p> <p>Thus, the entity presents CU1,444 in other comprehensive income, which is CU153,811 - CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.</p>
<p>(a) $CU150,000 \times 8\% = CU12,000$</p> <p>(b) $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$</p> <p>(c) $market\ price = [CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}$</p>	

QUESTIONS AND ANSWERS ON IMPLEMENTING IFRS 9 *FINANCIAL INSTRUMENTS*

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Guidance on implementing IFRS 9 *Financial Instruments*

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

Section B Definitions

B.1 Definition of a financial instrument: gold bullion

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

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

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

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

IFRS 9 defines a derivative as follows:

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

- (a) **its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’);**
- (b) **it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and**
- (c) **it is settled at a future date.**

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

continued...

...continued

Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity of another entity)

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

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

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

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

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

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.

B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)

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

Yes.

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

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

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

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

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

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

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' criterion of a derivative.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap's notional amount, ie CU10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be

expected to have a similar response to changes in market factors' criterion of IFRS 9. Therefore, the contract is not accounted for as a derivative under IFRS 9. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.6 Definition of a derivative: offsetting loans

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

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

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

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

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

The definition of a derivative in IFRS 9 requires that the instrument 'is settled at a future date'. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

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

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

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

B.9 Definition of a derivative: prepaid forward

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

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

To illustrate: Entity XYZ enters into a forward contract to purchase one million T ordinary shares in one year. The current market price of T is CU50 per share; the one-year forward price of T is CU55 per share. XYZ is required to prepay the forward contract at inception with a CU50 million payment. The initial investment in the forward contract of CU50 million is less than the notional amount applied to the underlying, one million shares at the forward price of CU55 per share, ie CU55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T's shares could be purchased at inception for the same price of CU50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.10 Definition of a derivative: initial net investment

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

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit-taking

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

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

B.28 Regular way contracts: no established market

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

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

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

B.29 Regular way contracts: forward contract

Entity ABC enters into a forward contract to purchase one million of M's ordinary shares in two months for CU10 per share. The contract is with an individual and is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty CU10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

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

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

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

The provisions that apply are those in the market in which the purchase actually takes place.

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

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

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

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of CU100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

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

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

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

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

Section C Embedded derivatives

C.1 Embedded derivatives: separation of host debt instrument

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

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

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

C.2 Embedded derivatives: separation of embedded option

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

No. The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid contract, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caplet, floorlet or swaption feature in a hybrid contract) should be based on the stated terms of the option feature documented in the hybrid contract. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid contract being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid contract to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid contract. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be

consistent with the likely economic behaviour of the hybrid contract, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid contract.

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

C.4 Embedded derivatives: equity kicker

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

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

C.6 Embedded derivatives: synthetic instruments

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

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

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

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

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

C.8 Embedded foreign currency derivatives: unrelated foreign currency provision

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

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

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

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

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

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

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment

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

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

Section D Recognition and derecognition

D.1 Initial recognition

D.1.1 Recognition: cash collateral

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

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

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

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

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

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

FINANCIAL INSTRUMENTS

Settlement date accounting			
Balances	Financial assets measured at amortised cost	Financial assets measured at fair value with changes presented in other comprehensive income	Financial assets measured at fair value through profit or loss
29 December 20X1			
Financial asset	–	–	–
Financial liability	–	–	–
31 December 20X1			
Receivable	–	2	2
Financial asset	–	–	–
Financial liability	–	–	–
Other comprehensive income (fair value adjustment)	–	(2)	–
Retained earnings (through profit or loss)	–	–	(2)
4 January 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Other comprehensive income (fair value adjustment)	–	(3)	–
Retained earnings (through profit or loss)	–	–	(3)

FINANCIAL INSTRUMENTS

Trade date accounting			
Balances	Financial assets measured at amortised cost	Financial assets measured at fair value with changes presented in other comprehensive income	Financial assets measured at fair value through profit or loss
29 December 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
31 December 20X1			
Receivable	–	–	–
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Other comprehensive income (fair value adjustment)	–	(2)	–
Retained earnings (through profit or loss)	–	–	(2)
4 January 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Other comprehensive income (fair value adjustment)	–	(3)	–
Retained earnings (through profit or loss)	–	–	(3)

D.2.2 Trade date vs settlement date: amounts to be recorded for a sale

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

The following example illustrates the application of the trade date and settlement date accounting principles in IFRS 9 for a sale of a financial asset. On 29 December 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its amortised cost is CU1,000. On 31 December 20X2 (financial year-end), the fair value of the asset is CU1,012. On 4 January 20X3 (settlement date), the fair value is CU1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any interest that might have accrued on the asset is disregarded).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

Settlement date accounting		
Balances	Financial assets measured at amortised cost	Financial assets measured at fair value through profit or loss
29 December 20X2		
Receivable	–	–
Financial asset	1,000	1,010
Other comprehensive income (fair value adjustment)	–	–
Retained earnings (through profit or loss)	–	10
31 December 20X2		
Receivable	–	–
Financial asset	1,000	1,000
Other comprehensive income (fair value adjustment)	–	–
Retained earnings (through profit or loss)	–	10
4 January 20X3		
Other comprehensive income (fair value adjustment)	–	–
Retained earnings (through profit or loss)	10	10

Trade date accounting		
Balances	Financial assets measured at amortised cost	Financial assets measured at fair value through profit or loss
29 December 20X2		
Receivable	1,010	1,010
Financial asset	–	–
Other comprehensive income (fair value adjustment)	–	–
Retained earnings (through profit or loss)	10	10
31 December 20X2		
Receivable	1,010	1,010
Financial asset	–	–
Other comprehensive income (fair value adjustment)	–	–
Retained earnings (through profit or loss)	10	10
4 January 20X3		
Other comprehensive income (fair value adjustment)	–	–
Retained earnings (through profit or loss)	10	10

D.2.3 Settlement date accounting: exchange of non-cash financial assets

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

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

To illustrate: on 29 December 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is measured at amortised cost, in exchange for Bond B, which meets the definition of held for trading and is measured at fair value. Both assets have a fair value of CU1,010 on 29 December, while the amortised cost of Note Receivable A is CU1,000. Entity A uses settlement date accounting for financial assets measured at amortised cost and trade date accounting for assets that meet the definition of held for trading. On 31 December 20X2 (financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009. On 4 January 20X3, the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007. The following entries are made:

FINANCIAL INSTRUMENTS

29 December 20X2

Dr	Bond B	CU1,010	
	Cr Payable		CU1,010

31 December 20X2

Dr	Trading loss	CU1	
	Cr Bond B		CU1

4 January 20X3

Dr	Payable	CU1,010	
Dr	Trading loss	CU2	
	Cr Note Receivable A		CU1,000
	Cr Bond B		CU2
	Cr Realisation gain		CU10

Section E Measurement

E.1 Initial measurement of financial assets and financial liabilities

E.1.1 Initial measurement: transaction costs

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

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

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

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

E.3 Gains and losses

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

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

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

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

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

In B's financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 (= LCY100 × 2.00) in the consolidated financial statements.

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

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

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

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

Statement of financial position

Generally, the measurement of a financial asset or financial liability at fair value or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with IFRS 9. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IAS 21 (paragraph B5.7.2 of IFRS 9). For example, if a monetary financial asset (such as a debt instrument) is measured at amortised cost in accordance with IFRS 9, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity's financial statements (IAS 21.23). That applies regardless of whether a monetary item is measured at amortised cost or fair value in the foreign currency (IAS 21.24). A non-monetary financial asset (such as an investment in an equity instrument) is translated using the closing rate if it is measured at fair value in the foreign currency (IAS 21.23(c)).

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

Profit or loss

The recognition of a change in the carrying amount of a financial asset or financial liability in profit or loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognising changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.3).

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

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

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

Appendix

Amendments to guidance on other IFRSs

The following amendments to guidance on IFRSs are necessary in order to ensure consistency with IFRS 9 Financial Instruments and the related amendments to other IFRSs.

IFRS 1 *First-time Adoption of International Financial Reporting Standards*

IGA1 The heading above paragraph IG52 and paragraphs IG52–IG58A and IG59 are amended to read as follows:

IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 *Financial Instruments*

IG52 An entity recognises and measures all financial assets and financial liabilities in its opening IFRS statement of financial position in accordance with IFRS 9, except as specified in paragraphs B2–B6 of the IFRS, which address derecognition and hedge accounting.

Recognition

IG53 An entity recognises all financial assets and financial liabilities (including all derivatives) that qualify for recognition in accordance with IFRS 9 and have not yet qualified for derecognition in accordance with IFRS 9, except non-derivative financial assets and non-derivative financial liabilities derecognised in accordance with previous GAAP before 1 January 2004, to which the entity does not choose to apply paragraph B3 (see paragraphs B2 and B3 of the IFRS). For example, an entity that does not apply paragraph B3 does not recognise assets transferred in a securitisation, transfer or other derecognition transaction that occurred before 1 January 2004 if those transactions qualified for derecognition in accordance with previous GAAP. However, if the entity uses the same securitisation arrangement or other derecognition arrangement for further transfers after 1 January 2004, those further transfers qualify for derecognition only if they meet the derecognition criteria of IFRS 9.

IG54 An entity does not recognise financial assets and financial liabilities that do not qualify for recognition in accordance with IFRS 9, or have already qualified for derecognition in accordance with IFRS 9.

Embedded derivatives

IG55 When IFRS 9 requires an entity to separate an embedded derivative from a host contract, the initial carrying amounts of the components at the date when the instrument first satisfies the recognition criteria in IFRS 9 reflect circumstances at that date (IFRS 9 paragraph 4.3.3). If the entity cannot determine the initial carrying amounts of the embedded derivative and host contract reliably, it measures the entire combined contract as at fair value through profit or loss (IFRS 9 paragraph 4.3.6).

Measurement

IG56 In preparing its opening IFRS statement of financial position, an entity applies the criteria in IFRS 9 to identify on the basis of the facts and circumstances that exist at the date of transition to IFRSs those financial assets and financial liabilities that are measured at fair value and those that are measured at amortised cost. The resulting classifications are applied retrospectively.

IG57 ... first satisfied the recognition criteria in IFRS 9. However, ...

IG58 An entity's estimates of impairments of financial assets measured at amortised cost at the date of transition to IFRSs are consistent with estimates made for the same date ...

Transition adjustments

IG58A An entity shall treat an adjustment to the carrying amount of a financial asset or financial liability as a transition adjustment to be recognised in the opening balance of retained earnings at the date of transition to IFRSs only to the extent that it results from adopting IAS 39 and IFRS 9. Because all derivatives, other than those that are financial guarantee contracts or are designated and effective hedging instruments, are measured at fair value through profit or loss, the differences between the previous carrying amount (which may have been zero) and the fair value of the derivatives are recognised as an adjustment of the balance of retained earnings at the beginning of the financial year in which IAS 39 and IFRS 9 are initially applied (other than for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

IG59 An entity may, in accordance with its previous GAAP, have measured investments at fair value and recognised the revaluation gain outside profit or loss. If an investment is classified as at fair value through profit or loss, the pre-IFRS 9 revaluation gain that had been recognised outside profit or loss is reclassified into retained earnings on initial application of IFRS 9. If, on initial application of IFRS 9, an investment in an equity instrument is classified as at fair value through other comprehensive income, then the pre-IFRS 9 revaluation gain is recognised in a separate component of equity. Subsequently, the entity recognises gains and losses on the financial asset in other comprehensive income (except dividends, which are recognised in profit or loss) and accumulates the cumulative gains and losses in that separate component of equity. On subsequent derecognition, the entity may transfer that separate component of equity within equity.

IGA2 IG Example 11, paragraph IG63 is amended to read as follows:

The table 'Reconciliation of equity at 1 January 20X4 (date of transition to IFRSs)' is amended to read as follows:

Reconciliation of equity at 1 January 20X4 (date of transition to IFRSs)				
Note		<i>Previous GAAP</i> <i>CU</i>	<i>Effect of transition</i> <i>to IFRSs</i> <i>CU</i>	<i>IFRSs</i> <i>CU</i>
1	Property, plant and equipment	8,299	100	8,399
2	Goodwill	1,220	150	1,370
2	Intangible assets	208	(150)	58
3	Financial assets	3,471	420	3,891
	Total non-current assets	13,198	520	13,718
	Trade and other receivables	3,710	0	3,710
				<i>continued...</i>

FINANCIAL INSTRUMENTS

continued...

4	Inventories	2,962	400	3,362
5	Other receivables	333	431	764
	Cash and cash equivalents	748	0	748
	Total current assets	7,753	831	8,584
	Total assets	20,951	1,351	22,302
	Interest-bearing loans	9,396	0	9,396
	Trade and other payables	4,124	0	4,124
6	Employee benefits	0	66	66
7	Restructuring provision	250	(250)	0
	Current tax liability	42	0	42
8	Deferred tax liability	579	460	1,039
	Total liabilities	14,391	276	14,667
	Total assets less total liabilities	6,560	1,075	7,635
	Issued capital	1,500	0	1,500
5	Hedging reserve	0	302	302
9	Retained earnings	5,060	773	5,833
	Total equity	6,560	1,075	7,635

Note 3 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

3 Financial assets are all classified at fair value through profit or loss in accordance with IFRSs and are carried at their fair value of CU3,891. They were carried at cost of CU3,471 in accordance with previous GAAP. The resulting gains of CU294 (CU420, less related deferred tax of CU126) are included in retained earnings.

Note 8 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

8	The above changes increased the deferred tax liability as follows:	
		CU
	Hedging reserve (note 5)	129
	Retained earnings	331
	Increase in deferred tax liability	<u>460</u>

Because the tax base at 1 January 20X4 of the items reclassified from intangible assets to goodwill (note 2) equalled their carrying amount at that date, the reclassification did not affect deferred tax liabilities.

Note 9 to the reconciliation of equity at 1 January 20X4 is amended to read as follows:

9	The adjustments to retained earnings are as follows:	
		CU
	Depreciation (note 1)	100
	Financial assets (note 3)	420
	Production overhead (note 4)	400
	Pension liability (note 6)	(66)
	Restructuring provision (note 7)	250
	Tax effect of the above	<u>(331)</u>
	Total adjustment to retained earnings	<u>773</u>

The reconciliation of total comprehensive income for 20X4 is amended to read as follows:

Reconciliation of total comprehensive income for 20X4				
Note		<i>Previous GAAP CU</i>	<i>Effect of transition to IFRSs CU</i>	<i>IFRSs CU</i>
	Revenue	20,910	0	20,910
1, 2, 3	Cost of sales	(15,283)	(97)	(15,380)
	Gross profit	5,627	(97)	5,530
6	Other income	0	180	180
1	Distribution costs	(1,907)	(30)	(1,937)
1, 4	Administrative expenses	(2,842)	(300)	(3,142)
	Finance income	1,446	0	1,446
	Finance costs	(1,902)	0	(1,902)
	Profit before tax	422	(247)	175
5	Tax expense	(158)	74	(84)
	Profit (loss) for the year	264	(173)	91
7	Cash flow hedges	0	(40)	(40)
8	Tax relating to other comprehensive income	0	(29)	(29)
	Other comprehensive income	0	(69)	(69)
	Total comprehensive income	264	(242)	22

Note 6 to the reconciliation of total comprehensive income for 20X4 is amended to read as follows:

6	Financial assets at fair value through profit or loss increased in value by CU180 during 20X4. They were carried at cost in accordance with previous GAAP. Fair value changes have been included in 'Other income'.
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IFRS 4 Insurance Contracts

IGA3 In the table in IG Example 1, the 'Treatment in Phase I' column of contract types 1.7–1.12, 1.15, 1.18, 1.19 and 1.20(a) are amended to read as follows:

1.7	<p>Not an insurance contract at inception, if the insurer can reprice the mortality risk without constraints. Within the scope of IFRS 9 <i>Financial Instruments</i> unless the contract contains a discretionary participation feature.</p> <p>Will become an insurance contract when the annuity rate is fixed (unless the contingent amount is insignificant in all scenarios that have commercial substance).</p>
1.8	Within the scope of IFRS 9.
1.9	Paragraph 35 of the IFRS sets out requirements for these contracts, which are excluded from the scope of IFRS 9.
1.10	Within the scope of IFRS 9. Payments denominated in unit values representing the fair value of the specified assets are measured at current unit value (see paragraph B4.3.8(g) of IFRS 9).
1.11	<p>Insurance contract, but within the scope of IFRS 9, not IFRS 4. However, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 9 and IAS 32^(b) or IFRS 4 to such financial guarantee contracts.</p> <p>The legal form of the contract does not affect its recognition and measurement.</p> <p>Accounting by the holder of such a contract is excluded from the scope of IFRS 9 and IFRS 4 (unless the contract is a reinsurance contract). Therefore, paragraphs 10–12 of IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i> apply. Those paragraphs specify criteria to use in developing an accounting policy if no IFRS applies specifically to an item.</p>
1.12	Not an insurance contract. A derivative within the scope of IFRS 9.
1.15	<p>Insurance contract within the scope of the IFRS (unless changes in the condition of the asset have an insignificant effect). The risk of changes in the fair value of the non-financial asset is not a financial risk because the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific asset held (a non-financial variable).</p> <p>However, if the contract compensates the beneficiary only for changes in market prices and not for changes in the condition of the beneficiary's asset, the contract is a derivative and within the scope of IFRS 9.</p> <p>Residual value guarantees given by a lessee under a finance lease are within the scope of IAS 17 <i>Leases</i>.</p>
1.18	Insurance risk is insignificant. Therefore, the contract is a financial asset within the scope of IFRS 9. Servicing fees are within the scope of IAS 18 (recognise as services are provided, subject to various conditions).
1.19	Financial instrument with embedded derivative within the scope of IFRS 9.
1.20	<p>The contract is an insurance contract, and contains an insurance component (with the issuer as policyholder and the holder as the insurer) and a deposit component.</p> <p>(a) If specified conditions are met, paragraph 10 of the IFRS requires the holder to unbundle the deposit component and apply IFRS 9 to it.</p> <p>(b) ...</p>

IGA4 Paragraph IG3 is amended to read as follows:

IG3 IFRS 9 requires an entity to separate embedded derivatives that meet specified conditions from the host instrument that contains them, measure the embedded derivatives at fair value and recognise changes in their fair value in profit or loss. However, an insurer need not separate an embedded derivative that itself meets the definition of an insurance contract (paragraph 7 of the IFRS). Nevertheless, separation and fair value measurement of such an embedded derivative are not prohibited if the insurer's existing accounting policies require such separation, or if an insurer changes its accounting policies and that change meets the criteria in paragraph 22 of the IFRS.

IGA5 In the table in IG Example 2, the 'Treatment if embedded in a host insurance contract' and 'Treatment if embedded in a host investment contract' columns of embedded derivative types 2.4, 2.5, 2.6(b), 2.12 and 2.14–2.17 are amended to read as follows:

Type	Treatment if embedded in a host insurance contract	Treatment if embedded in a host investment contract
2.4	<p>The embedded guarantee is not an insurance contract (unless significant payments are life-contingent^(a)). However, it is closely related to the host contract (paragraph B4.3.8(b) of IFRS 9). Fair value measurement is not required (but not prohibited).</p> <p>If significant payments are life-contingent, the contract is an insurance contract and contains a deposit component (the guaranteed minimum). However, an insurer is not required to unbundle the contract if it recognises all obligations arising from the deposit component (paragraph 10 of the IFRS).</p> <p>If cancelling the deposit component requires the policyholder to cancel the insurance component, the two cancellation options may be interdependent; if the option to cancel the deposit component cannot be measured separately (ie without considering the other option), both options are regarded as part of the insurance component (paragraph B4.3.8(h) of IFRS 9).</p>	Fair value measurement is not permitted (paragraph B4.3.8(b) of IFRS 9).
2.5	<p>The embedded guarantee is not an insurance contract (unless the embedded guarantee is life-contingent to a significant extent). Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9).</p>	Fair value measurement is required (paragraph B4.3.8(b) of IFRS 9).
2.6(b)	<p>The embedded derivative is not an insurance contract. Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an un-leveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9).</p>	Fair value measurement is required (unless the guarantee is regarded as closely related to the host contract because the guarantee is an un-leveraged interest floor that is at or out of the money at inception, see paragraph B4.3.8(b) of IFRS 9).
<i>continued...</i>		

<i>continued...</i>		
Type	<i>Treatment if embedded in a host insurance contract</i>	<i>Treatment if embedded in a host investment contract</i>
2.12	<p>Fair value measurement is not required (but not prohibited: paragraph 8 of the IFRS).</p> <p>The surrender value may be viewed as a deposit component, but the IFRS does not require an insurer to unbundle a contract if it recognises all its obligations arising under the deposit component (paragraph 10).</p>	<p>The surrender option is closely related to the host contract if the surrender value is approximately equal to the amortised cost at each exercise date (paragraph B4.3.5(e) of IFRS 9). Otherwise, the surrender option is measured at fair value.</p>
2.14	<p>The option is not closely related to the host contract (unless the option is life-contingent to a significant extent). Fair value measurement is required (paragraphs 8 of the IFRS and B4.3.5 (c) and (d) of IFRS 9).</p>	<p>Fair value measurement is required (paragraph B4.3.5 (c) and (d) of IFRS 9).</p>
2.15	<p>If the insurer measures that portion of its obligation at account value, no further adjustment is needed for the option (unless the surrender value differs significantly from account value) (see paragraph B4.3.8(g) of IFRS 9). Otherwise, fair value measurement is required.</p>	<p>If the insurer regards the account value as the amortised cost or fair value of that portion of its obligation, no further adjustment is needed for the option (unless the surrender value differs significantly from account value). Otherwise, fair value measurement is required.</p>
2.16	<p>The embedded derivative is not an insurance contract and is not closely related to the contract (paragraph B4.3.5(f) of IFRS 9). Fair value measurement is required.</p>	<p>Fair value measurement is required.</p>
2.17	<p>The embedded derivative (option to receive the persistency bonus) is not an insurance contract (unless the persistency bonus is life-contingent to a significant extent). Insurance risk does not include lapse or persistency risk (paragraph B15 of the IFRS). Fair value measurement is required.</p>	<p>An option or automatic provision to extend the remaining term to maturity of a debt instrument is not closely related to the host debt instrument unless there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension (paragraph B4.3.5(b) of IFRS 9). If the option or provision is not closely related to the host instrument, fair value measurement is required.</p>

IGA6 IG Example 3 is amended to read as follows:

IG Example 3: Unbundling a deposit component of a reinsurance contract

Application of requirements: case 1—no claims

...

If the reinsurer is required, or elects, to unbundle the contract, it does so as follows. Each payment by the cedant has two components: a loan advance (deposit component) and a payment for insurance cover (insurance component). Applying IFRS 9 to the deposit component, the reinsurer is required to measure it initially at fair value. Fair value could be determined by discounting the future cash flows from the deposit component. Assume that an appropriate discount rate is 10 per cent and that the insurance cover is equal in each year, so that the payment for insurance cover is the same in every year. Each payment of CU10 by the cedant is then made up of a loan advance of CU6.7 and an insurance premium of CU3.3.

...

Incremental cash flows because of the claim in year 1

...

The incremental cash flows have a present value, in year 1, of CU35 (assuming a discount rate of 10 per cent is appropriate). Applying paragraphs 10–12 of the IFRS, the cedant unbundles the contract and applies IFRS 9 to this deposit component (unless the cedant already recognises its contractual obligation to repay the deposit component to the reinsurer). If this were not done, the cedant might recognise the CU150 received in year 1 as income, and the incremental payments in years 2–5 as expenses. However, in substance, the reinsurer has paid a claim of CU35 and made a loan of CU115 (CU150 less CU35) that will be repaid in instalments.

...

IGA7 IG Example 4 is amended to read as follows:

IG Example 4: Shadow accounting

Background

...

At the inception of a contract, insurer A has DAC of CU20 relating to that contract and the present value, at inception, of EGP is CU100. In other words, DAC is 20 per cent of EGP at inception. Thus, for each CU1 of realised gross profits, insurer A amortises DAC by CU0.20. For example, if insurer A sells assets and recognises a gain of CU10, insurer A amortises DAC by CU2 (20 per cent of CU10).

Before adopting IFRSs for the first time in 20X5, insurer A measured financial assets on a cost basis. (Therefore, EGP under those national requirements considers only realised gains and losses.) However, under IFRSs, it classifies its financial assets as measured at fair value through profit or loss.

In 20X5, insurer A recognises unrealised gains of CU10 on the assets backing the contract and in 20X6 it sells the assets for an amount equal to their fair value at the end of 20X5.

Application of paragraph 30 of the IFRS

Paragraph 30 of the IFRS permits, but does not require, insurer A to adopt shadow accounting. If insurer A adopts shadow accounting, it amortises DAC in 20X5 by an additional CU2 (20 per cent of CU10) as a result of the change in the fair value of the assets. Insurer A recognises the additional amortisation of CU2 in profit or loss.

When insurer A sells the assets in 20X6, it makes no further adjustment to DAC.

In summary, shadow accounting treats an unrealised gain in the same way as a realised gain. If insurer A does not adopt shadow accounting, unrealised gains on assets do not affect the amortisation of DAC.

IGA8 Paragraph IG65A is amended to read as follows:

IG65A The issuer of a financial guarantee contract provides disclosures complying with IFRS 7 if it applies IFRS 9 in recognising and measuring the contract. If the issuer elects, when permitted by paragraph 4(d) of IFRS 4, to apply IFRS 4 in recognising and measuring the contract, it provides disclosures complying with IFRS 4. The main implications are as follows:

- (a) IFRS 4 requires disclosure about actual claims compared with previous estimates (claims development), but does not require disclosure of the fair value of the contract.
- (b) IFRS 7 requires disclosure of the fair value of the contract, but does not require disclosure of claims development.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

IGA9 The tables in Example 10 are amended to read as follows:

	Carrying amount at the end of the reporting period before classification as held for sale	Carrying amount as remeasured immediately before classification as held for sale
	CU*	CU
Goodwill	1,500	1,500
Property, plant and equipment (carried at revalued amounts)	4,600	4,000
Property, plant and equipment (carried at cost)	5,700	5,700
Inventory	2,400	2,200
Investments in equity instruments	1,800	1,500
Total	16,000	14,900

* In this guidance, monetary amounts are denominated in 'currency units (CU)'.

...

The impairment loss is allocated to non-current assets to which the measurement requirements of the IFRS are applicable. Therefore, no impairment loss is allocated to inventory and investments in equity instruments. The loss is allocated to the other assets in the order of allocation set out in paragraphs 104 and 122 of IAS 36 (as revised in 2004).

...

	Carrying amount as remeasured immediately before classification as held for sale	Allocated impairment loss	Carrying amount after allocation of impairment loss
	CU	CU	CU
Goodwill	1,500	(1,500)	0
Property, plant and equipment (carried at revalued amounts)	4,000	(165)	3,835
Property, plant and equipment (carried at cost)	5,700	(235)	5,465
Inventory	2,200	–	2,200
Investments in equity instruments	1,500	–	1,500
Total	14,900	(1,900)	13,000

IGA10 The table in Example 12 is amended to read as follows:

	Carrying amount after classification as held for sale	
	Disposal group I: CU	Disposal group II: CU
Property, plant and equipment	4,900	1,700
Investments in equity instruments	1,400 ^(a)	–
Liabilities	(2,400)	(900)
Net carrying amount of disposal group	3,900	800
(a) An amount of CU400 relating to these assets has been recognised in other comprehensive income and accumulated in equity.		

IFRS 7 Financial Instruments: Disclosures

IGA11 The heading above paragraph IG7 and paragraphs IG7–IG11 are deleted.

IGA12 The table in paragraph IG13A is amended to read as follows:

Assets measured at fair value				
Description	31 Dec 20X2	Fair value measurement at end of the reporting period using:		
		Level 1 CU million	Level 2 CU million	Level 3 CU million
Financial assets at fair value through profit or loss				
Trading securities	100	40	55	5
Trading derivatives	39	17	20	2
Financial assets at fair value through other comprehensive income				
Equity investments	75	30	40	5
Total	214	87	115	12

(Note: For liabilities, a similar table might be presented.)

IGA13 The table in paragraph IG13B is amended to read as follows:

Assets measured at fair value based on Level 3				
Fair value measurement at the end of the reporting period				
	Financial assets at fair value			Total
	Trading securities	Trading derivatives	Equity investments	
	CU million	CU million	CU million	CU million
Opening balance	6	5	3	14
Total gains or losses				
in profit or loss	(2)	(2)	–	(4)
in other comprehensive income	–	–	1	1
Purchases	1	2	1	4
Issues	–	–	–	–
Settlements	–	(1)	–	(1)
Transfers out of Level 3	–	(2)	–	(2)
Closing balance	<u>5</u>	<u>2</u>	<u>5</u>	<u>12</u>
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period	<u>(1)</u>	<u>(1)</u>	<u>–</u>	<u>(2)</u>
Gains or losses included in profit or loss for the period (above) are presented in trading income and in other income as follows:				
			Trading Income	
Total gains or losses included in profit or loss for the period			<u>(4)</u>	
Total gains or losses for the period included in profit or loss for assets held at the end of the reporting period			<u>(2)</u>	
(Note: For liabilities, a similar table might be presented.)				

IGA14 Paragraph IG14 and the illustrative disclosure following paragraph IG14 are amended to read as follows:

IG14 The fair value at initial recognition of financial instruments that are not traded in active markets is determined in accordance with paragraph B5.4.8 of IFRS 9. However, when, after initial recognition, an entity will use a valuation technique that incorporates data not obtained from observable markets, there may be a difference between the transaction price at initial recognition and the amount determined at initial recognition using that valuation technique. In these circumstances, the difference will be recognised in profit or loss in subsequent periods in accordance with IFRS 9 and the entity's accounting policy. Such recognition reflects changes in factors (including time) that market participants would consider in setting a price (see paragraph B5.4.9 of IFRS 9). Paragraph 28 requires disclosures in these circumstances. An entity might disclose the following to comply with paragraph 28:

...

Accounting policies

The entity uses the following valuation technique to determine the fair value of financial instruments that are not traded in an active market: [description of technique, not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with IFRS 9, is generally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].

In the notes to the financial statements

As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with IFRS 9, the fair value of an instrument at inception is generally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].

IGA15 Paragraph IG36 is amended to read as follows:

IG36 The following example illustrates the application of the disclosure requirement in paragraph 40(a):

Interest rate risk

At 31 December 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, post-tax profit for the year would have been CU1.7 million (20X1—CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings. If interest rates had been 10 basis points higher, with all other variables held constant, post-tax profit would have been CU1.5 million (20X1—CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings. Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X). [footnote omitted] ...

IAS 1 Presentation of Financial Statements

IGA16 The heading above paragraph IG7 and paragraphs IG7–IG9 are deleted. Paragraph IG2 is amended to read as follows:

IG2 The guidance is in two sections. Paragraphs IG3–IG6 provide examples of the presentation of financial statements. Paragraphs IG7–IG9 have been deleted. Paragraphs IG10 and IG11 provide examples of capital disclosures.

IGA17 In the illustrative financial statements, references to 'Available-for-sale financial assets' are replaced by 'Investments in equity instruments'. In the single statement of comprehensive income the reference to footnote (b) against the deleted line item 'Available-for-sale financial assets' is deleted. The heading and table 'Disclosure of components of other comprehensive income' are amended to read as follows:

Part I: Illustrative presentation of financial statements			
Disclosure of components of other comprehensive income [footnote omitted]			
Notes			
Year ended 31 December 20X7			
(in thousands of currency units)			
		20X7	20X6
Other comprehensive income:			
Exchange differences on translating foreign operations [footnote omitted]		5,334	10,667
Investments in equity instruments		(24,000)	26,667
Cash flow hedges:			
Gains (losses) arising during the year	(4,667)		(4,000)
Less: Reclassification adjustments for gains (losses) included in profit or loss	3,333		–
Less: Adjustments for amounts transferred to initial carrying amount of hedged items	667	(667)	–
Gains on property revaluation		933	3,367
Actuarial gains (losses) on defined benefit pension plans		(667)	1,333
Share of other comprehensive income of associates		400	(700)
Other comprehensive income		(18,667)	37,334
Income tax relating to components of other comprehensive income [footnote omitted]		4,667	(9,334)
Other comprehensive income for the year		(14,000)	28,000

IGA18 The second paragraph in footnote (k) to the illustrative financial statements is amended to read as follows:

- (k) The amount included in the translation, investments in equity instruments and cash flow hedge reserves represents other comprehensive income for each component, net of tax and non-controlling interests, eg other comprehensive income related to investments in equity instruments for 20X6 of 16,000 is 26,667, less tax 6,667, less non-controlling interests 4,000.

IGA19 The second paragraph in footnote (l) to the illustrative financial statements is amended to read as follows:

- (l) The amount included in the translation, investments in equity instruments and cash flow hedge reserves represents other comprehensive income for each component, net of tax and non-controlling interests, eg other comprehensive income related to the translation of foreign operations for 20X7 of 3,200 is 5,334, less tax 1,334, less non-controlling interests 800.

IAS 18 Revenue

IGA20 In the illustrative examples, paragraphs 5 and 14 are amended to read as follows:

5 ...

For a sale and repurchase agreement on an asset other than a financial asset, the terms of the agreement need to be analysed to ascertain whether, in substance, the seller has transferred the risks and rewards of ownership to the buyer and hence revenue is recognised. When the seller has retained the risks and rewards of ownership, even though legal title has been transferred, the transaction is a financing arrangement and does not give rise to revenue. For a sale and repurchase agreement on a financial asset, IFRS 9 *Financial Instruments* applies.

14 *Financial service fees*

...

- (a) *Fees that are an integral part of the effective interest rate of a financial instrument.*

...

- (i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IFRS 9 is measured at fair value through profit or loss.*

Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related transaction costs [footnote omitted] (as defined in IAS 39), are deferred and recognised as an adjustment to the effective interest rate.

- (ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of IFRS 9.*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of IFRS 9, the commitment fee received is regarded as compensation for an ongoing involvement with

the acquisition of a financial instrument and, together with the related transaction costs (as defined in IAS 39), is deferred and recognised as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. Loan commitments that are within the scope of IFRS 9 are accounted for as derivatives and measured at fair value.

- (iii) *Origination fees received on issuing financial liabilities measured at amortised cost.*

These fees are an integral part of generating an involvement with a financial liability. When a financial liability is not classified as at fair value through profit or loss, the origination fees received are included, with the related transaction costs (as defined in IAS 39) incurred, in the initial carrying amount of the financial liability and recognised as an adjustment to the effective interest rate. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

- (b) *Fees earned as services are provided.*

(i) ...

- (ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of IFRS 9.*

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of IFRS 9, the commitment fee is recognised as revenue on a time proportion basis over the commitment period. Loan commitments that are within the scope of IFRS 9 are accounted for as derivatives and measured at fair value.

(iii) ...

IAS 27 Consolidated and Separate Financial Statements

IGA21 Paragraph IG7 is amended to read as follows:

IG7 IFRS 9 *Financial Instruments* does not apply to interests in subsidiaries, associates and jointly controlled entities that are consolidated, accounted for using the equity method or proportionately consolidated in accordance with IAS 27, IAS 28 and IAS 31 respectively. When instruments containing potential voting rights in substance currently give access to the economic benefits associated with an ownership interest, and the investment is accounted for in one of the above ways, the instruments are not subject to the requirements of IFRS 9. In all other cases, instruments containing potential voting rights are accounted for in accordance with IFRS 9.

IGA22 A footnote is added to 'IAS 39' after the Table of Concordance as follows:

* In November 2009 and October 2010 the IASB amended some of the requirements of IAS 39 and relocated them to IFRS 9 *Financial Instruments*. IFRS 9 applies to all financial items within the scope of IAS 39. This section refers to matters relevant when IAS 27 was issued.

IAS 32 *Financial Instruments: Presentation*

IGA23 Paragraph IE1 is amended to read as follows:

IE1 The following examples [footnote omitted] illustrate the application of paragraphs 15–27 and IFRS 9 to the accounting for contracts on an entity's own equity instruments (other than the financial instruments specified in paragraphs 16A and 16B or paragraphs 16C and 16D).

IGA24 In the example in paragraph IE5, the caption below the first journal entry is amended to read as follows:

To record the obligation to deliver CU104,000 in one year at its present value of CU100,000 discounted using an appropriate interest rate (see IFRS 9, paragraph B5.1.1).

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

IGA25 Example 9 is amended to read as follows:

On 31 December 20X0, Entity A gives a guarantee of certain borrowings of Entity B, whose financial condition at that time is sound. During 20X1, the financial condition of Entity B deteriorates and at 30 June 20X1 Entity B files for protection from its creditors.

This contract meets the definition of an insurance contract in IFRS 4 *Insurance Contracts*, but is within the scope of IFRS 9 *Financial Instruments*, because it also meets the definition of a financial guarantee contract in IFRS 9. If an issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IFRS 4 or IFRS 9 to such financial guarantee contracts. IFRS 4 permits the issuer to continue its existing accounting policies for insurance contracts if specified minimum requirements are satisfied. IFRS 4 also permits changes in accounting policies that meet specified criteria. The following is an example of an accounting policy that IFRS 4 permits and that also complies with the requirements in IFRS 9 for financial guarantee contracts within the scope of IFRS 9.

IAS 39 *Financial Instruments: Recognition and Measurement*

IGA26 Section C and Section D are deleted.

IGA27 The following Questions and Answers (Q&A) are deleted:

- Section B Definitions: B.1–B.23, B.28–B.32
- Section E Measurement: E.1, E.3, E.4.9, E.4.10
- Section F Hedged items: F.1.1, F.1.10, F.2.9–F.2.11, F.2.19, F.2.20

IGA28 In the answer to Question A.1, 'IAS 39' is amended to 'IFRS 9'.

IGA29 In the answer to Question A.2, 'exemption from IAS 39' is amended to 'exemption from paragraph 5 of IAS 39'.

IGA30 Question B.26 is amended to read as follows:

How is amortised cost calculated for financial assets measured at amortised cost in accordance with IFRS 9?

IGA31 In the answer to Question E.2.1, 'IAS 39.AG72' is amended to 'paragraph B5.4.4 of IFRS 9'.

IGA32 In the answer to Question E.2.2, 'IAS 39.AG71' is amended to 'paragraph B5.4.3 of IFRS 9'.

IGA33 The answer to Question E.4.2 is amended to read as follows:

No. Paragraph 5.1.1 of IFRS 9 requires a financial asset to be initially measured at fair value. For a loan asset, the fair value is the amount of cash lent adjusted for any fees and costs (unless a portion of the amount lent is compensation for other stated or implied rights or privileges). In addition, paragraph 5.2.2 of IFRS 9 requires an entity to apply the impairment requirements in IAS 39. IAS 39.58 requires that an impairment loss is recognised only if there is objective evidence of impairment as a result of a past event that occurred after initial recognition. Accordingly, it is inconsistent with paragraph 5.1.1 of IFRS 9 and IAS 39.58 to reduce the carrying amount of a loan asset on initial recognition through the recognition of an immediate impairment loss.

IGA34 Question E.4.5 is amended to read as follows:

A financial institution calculates impairment in the unsecured portion of financial assets measured at amortised cost on the basis of a provision matrix that specifies fixed provision rates for the number of days a financial asset has been classified as non-performing (zero per cent if less than 90 days, 20 per cent if 90–180 days, 50 per cent if 181–365 days and 100 per cent if more than 365 days). Can the results be considered to be appropriate for the purpose of calculating the impairment loss on the financial assets measured at amortised cost under IAS 39.63?

IGA35 The last sentence of the answer to Question F.1.2 is amended to read as follows:

However, if the foreign currency component of the sales commitment is required to be separated as an embedded derivative under paragraph 4.3.3 and paragraph B4.3.8(d) of IFRS 9, it could be designated as a hedging instrument in a hedge of the exposure to changes in the fair value of the maturity amount of the debt attributable to foreign currency risk.

IGA36 The last sentence of the answer to Question F.1.4 is deleted.

IGA37 The answer to Question F.2.1 is amended to read as follows:

No. Derivative instruments always meet the definition of held for trading and are measured at fair value with gains and losses recognised in profit or loss unless they are designated and effective hedging instruments (IAS 39.9 and IFRS 9 paragraphs 4.1.1–4.1.5, 5.7.1 and 5.7.3). As an exception, IAS 39.AG94 permits the designation of a purchased option as the hedged item in a fair value hedge.

IGA38 The answer to Question F.2.5 is amended to read as follows:

Yes. A derivative instrument that will be settled gross can be designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the future transaction that will occur on gross settlement of the derivative contract itself because there would be an exposure to variability in the purchase or sale price without the derivative. This applies to all fixed price contracts that are accounted for as derivatives under IFRS 9.

For example, if an entity enters into a fixed price contract to sell a commodity and that contract is accounted for as a derivative under IAS 39 and IFRS 9 (for example, because the entity has a practice of settling such contracts net in cash or of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin), the entity may designate the fixed price contract as a

cash flow hedge of the variability of the consideration to be received on the sale of the asset (a future transaction) even though the fixed price contract is the contract under which the asset will be sold. Also, ...

IGA39 Q&A F.2.13 is amended to read as follows:

Is fair value hedge accounting permitted for exposure to interest rate risk in fixed rate loans that are measured at amortised cost?

Yes. Under IFRS 9, some fixed rate loans are measured at amortised cost. Banking institutions in many countries hold the bulk of their fixed rate loans to collect their contractual cash flows. Thus, changes in the fair value of such fixed rate loans that are due to changes in market interest rates will not affect profit or loss. IAS 39.86 specifies that a fair value hedge is a hedge of the exposure to changes in fair value that is attributable to a particular risk and that can affect profit or loss. Therefore, IAS 39.86 may appear to preclude fair value hedge accounting for fixed rate loans. However, the entity could sell them and the change in fair values would affect profit or loss. Thus, fair value hedge accounting is permitted for fixed rate loans.

IGA40 The last paragraph of the answer to Question F.2.17 is amended to read as follows:

To illustrate: Entity A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as measured at amortised cost. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap. ...

IGA41 In the answer to Question F.5.6, references to 'IAS 39.43' are replaced with 'paragraph 5.1.1 of IFRS 9' and 'IAS 39.55' are replaced with 'paragraph 5.7.1 of IFRS 9'.

IGA42 In the answer to Question F.6.4, 'IAS 39' in the second sentence is amended to 'IFRS 9'.

IGA43 Q&A G.1 is amended to read as follows:

IFRS 9 requires remeasurement of financial assets and financial liabilities measured at fair value. Unless a financial asset or a financial liability is designated as a cash flow hedging instrument, fair value changes for financial assets and financial liabilities at fair value through profit or loss are recognised in profit or loss, and fair value changes for financial assets designated at fair value through other comprehensive income are recognised in other comprehensive income. What disclosures are required regarding the amounts of the fair value changes during a reporting period?

IFRS 7.20 requires items of income, expense and gains and losses to be disclosed. This disclosure requirement encompasses items of income, expense and gains and losses that arise on remeasurement to fair value. Therefore, an entity provides disclosures of fair value changes, distinguishing between changes that are recognised in profit or loss and changes that are recognised in other comprehensive income. Further breakdown is provided of changes that relate to:

- (a) financial assets or financial liabilities measured at fair value through profit or loss, showing separately those on financial assets or financial liabilities designated as such upon initial recognition, and those on financial assets or financial liabilities that are mandatorily measured at fair value in accordance with IFRS 9. For financial liabilities designated as at fair value through profit or loss, an entity shall show separately the amount of gain or loss recognised in other comprehensive income and the amount recognised in profit or loss;
- (b) financial assets measured at fair value through other comprehensive income; and
- (c) hedging instruments.

In addition, IFRS 7.11A and IFRS 7.11B require an entity to disclose the amount of gain or loss recognised in other comprehensive income for financial assets measured at fair value through other comprehensive income, including any amount transferred within equity.

IFRS 7 neither requires nor prohibits disclosure of components of the change in fair value by the way items are classified for internal purposes. For example, an entity may choose to disclose separately the change in fair value of those derivatives that meet the definition of held for trading in IFRS 9, but the entity classifies as part of risk management activities outside the trading portfolio.

In addition, IFRS 7.8 requires disclosure of the carrying amounts of financial assets or financial liabilities at fair value through profit or loss, showing separately: (i) those designated as such upon initial recognition; (ii) financial assets mandatorily classified as such in accordance with IFRS 9; (iii) financial liabilities that meet the definition of held for trading in IFRS 9; and (iv) disclosures of financial assets measured at fair value through other comprehensive income.

IFRIC 12 Service Concession Arrangements

IGA44 Paragraphs IE7 and IE28 are amended to read as follows:

- IE7 IFRS 9 *Financial Instruments* may require the entity to measure the amounts due from the grantor at amortised cost, unless the entity designates those amounts as measured at fair value through profit or loss. If the receivable is measured at amortised cost in accordance with IFRS 9, it is measured initially at fair value and subsequently at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount calculated using the effective interest method minus repayments.
- IE28 IFRS 9 *Financial Instruments* may require the entity to measure the amount due from or at the direction of the grantor in exchange for the construction services at amortised cost. If the receivable is measured at amortised cost in accordance with IFRS 9, it is measured initially at fair value and subsequently at amortised cost, ie the amount initially recognised plus the cumulative interest on that amount minus repayments.

Tables of Concordance

This table shows how the contents of IAS 39 and IFRS 9 correspond. In transferring the material from IAS 39 to IFRS 9 some minor editorial changes have been necessary.

Paragraph in IAS 39 (as amended by IFRS 9 in 2009)	Paragraphs in IFRS 9 (October 2010)	Paragraph in IAS 39 (as amended by IFRS 9 in 2009)	Paragraphs in IFRS 9 (October 2010)	
1—deleted		103–103G—not moved		
2–8—not moved		103H–103J—deleted		
9—the following definitions are moved to IFRS 9:	The definitions noted were added to Appendix A	103M	7.2.9	
• derecognition		105–107A—deleted		
• derivative		108–108C—not moved		
• fair value		109–110—not moved		
• financial guarantee contract		AG1–AG4A—not moved		
• financial liability at fair value through profit or loss		AG4B–AG4K	B4.1.27–B4.1.36	
• holding for trading		AG5–AG8—not moved		
• regular way purchase or sale		AG9–AG12A	BA.1–BA.5	
10		4.3.1	AG13—not moved	
11–13		4.3.3–4.3.7	AG14–AG15	BA.6–BA.8
14	3.1.1	AG27–AG33B	B4.3.1–B4.3.10	
15–37	3.2.1–3.2.23	AG34, AG35	B3.1.1, B3.1.2	
38	3.1.2	AG36–AG52	B3.2.1–B3.2.17	
39–42	3.3.1–3.3.4	AG53–AG56	B3.1.3–B3.1.6	
43, 44	5.1.1, 5.1.2	AG57–AG63	B3.3.1–B3.3.7	
47	4.2.1	AG64	B5.1.1	
48–49	5.4.1–5.4.3	AG69–AG79	B5.4.1–B5.4.12	
50, 50A	4.4.2, 4.4.3	AG80, AG81—deleted		
53 and 54—deleted		AG82	B5.4.13	
55	5.7.1	AG83	B5.7.2, B5.7.4	
56	5.7.2, 5.7.3	AG84–AG93—not moved		
57	5.7.4	AG94–AG95—not moved		
58–65—not moved		AG96—deleted		
71–102—not moved		AG97–AG133—not moved		

FINANCIAL INSTRUMENTS

This table shows how the contents of IFRS 9 (issued in November 2009) and IFRS 9 (issued in October 2010) correspond.

Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)	Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)
1.1	1.1	8.2.4	7.2.4
2.1	2.1	8.2.5	7.2.5
3.1.1	3.1.1	8.2.6	7.2.6
3.1.2	Replaced by amended 3.1.2	8.2.7	7.2.7
4.1	4.1.1	8.2.8	7.2.8
4.2	4.1.2	8.2.9	Replaced by 7.2.9
4.3	4.1.3	8.2.10	7.2.10
4.4	4.1.4	8.2.11	7.2.11
4.5	4.1.5	8.2.12	7.2.14
4.6	4.3.1	8.2.13	7.2.15
4.7	4.3.2	B4.1	B4.1.1
4.8	Replaced by 4.3.3–4.3.7	B4.2	B4.1.2
4.9	4.4.1	B4.3	B4.1.3
5.1.1	5.1.1	B4.4	B4.1.4
5.2.1	5.2.1	B4.5	B4.1.5
5.2.2	5.2.2	B4.6	B4.1.6
5.2.3	5.2.3	B4.7	B4.1.7
5.3.1	5.6.1	B4.8	B4.1.8
5.3.2	5.6.2	B4.9	B4.1.9
5.3.3	5.6.3	B4.10	B4.1.10
5.4.1	Replaced by 5.7.1	B4.11	B4.1.11
5.4.2	5.7.2	B4.12	B4.1.12
5.4.3	Replaced by 5.7.3	B4.13	B4.1.13
5.4.4	5.7.5	B4.14	B4.1.14
5.4.5	5.7.6	B4.15	B4.1.15
8.1.1	Replaced by 7.1.1	B4.16	B4.1.16
8.2.1	7.2.1	B4.17	B4.1.17
8.2.2	7.2.2	B4.18	B4.1.18
8.2.3	7.2.3	B4.19	B4.1.19
		B4.20	B4.1.20
		B4.21	B4.1.21

FINANCIAL INSTRUMENTS

Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)	Paragraph in IFRS 9 (November 2009)	Paragraphs in IFRS 9 (October 2010)
B4.22	B4.1.22	B5.7	B5.4.16
B4.23	B4.1.23	B5.8	B5.4.17
B4.24	B4.1.24	B5.9	B4.4.1
B4.25	B4.1.25	B5.10	B4.4.2
B4.26	B4.1.26	B5.11	B4.4.3
B5.1	B5.1.1	B5.12	B5.7.1
B5.2	B5.1.2	B5.13	B5.7.2
B5.3	B5.2.1	B5.14	B5.7.3
B5.4	B5.2.2	B5.15	B5.7.4
B5.5	B5.4.14	B8.1	B7.2.1
B5.6	B5.4.15		