to be designated at FVTPL. However, if all of the loan were designated at FVTPL, Entity A would create an accounting mismatch in profit or loss related to the portion of the bank loan (CU500,000) not matched by the financial assets measured at FVTPL. This accounting mismatch is comparable to the mismatch that would have arisen if the fair value option were not applied in the first place. Therefore, Entity A cannot apply the fair value option to the loan because it would not significantly reduce the accounting mismatch between the financial assets and the financial liability.

6 Reclassification

6.1 Reclassification required

An entity is required to reclassify financial assets when it changes its business model for managing financial assets. [IFRS 9:4.4.1]

Reclassifications 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. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line. [IFRS 9:B4.4.1]

Example 6.1A

Portfolio of commercial loans resulting in a change in business model

[IFRS 9:B4.4.1(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.

Example 6.1B

Closure of retail mortgage business resulting in a change in business model

[IFRS 9:B4.4.1(b)]

A financial services firm decides to shut down its retail mortgage business. The retail mortgage business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

The following are not considered to be changes in business model: [IFRS 9:B4.4.3]

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

6.2 Reclassification not permitted

If there has been no change in the business model for managing financial assets and if the terms of a financial asset remain unchanged, or the terms of a financial asset change but the asset is not derecognised, reclassification is not permitted.

6.2-1

Reclassification of assets: terms of instrument unchanged

In cases where terms inherent in the instrument expire or take effect during the instrument's life, and the asset continues to be recognised, the changing terms would not change the classification assessment made at initial recognition.

The following example illustrates this issue further.

Example

Entity D lends CU10 million to Entity E; the loan is repayable in five years. The contractual return on the loan for the first three years is derived from movements in a specified equity price index. In Years 4 and 5, the contractual return is 5 per cent of par.

At initial recognition, Entity D classifies the loan as a financial asset measured as at FVTPL because the loan does not pass the contractual cash flow characteristics test (see 5.2). The contractual return is linked to equity prices and, therefore, is not consistent with a basic lending arrangement.

Entity D is not permitted to reclassify the financial asset after Year 3, the point at which the contractual linkage to equity prices ceases, because the terms of the instrument have not changed since initial recognition and the original asset continues to be recognised.

It is not permitted for an entity to revoke its election to measure an asset at FVTPL. This is because the fair value election made on initial recognition is irrevocable. [IFRS 9:4.1.5]

6.2-2

Reclassification of asset designated at FVTPL at initial recognition out of FVTPL when business model change

The guidance appears less clear as to whether an entity is required to de-designate out of FVTPL, if previously designated as at FVTPL at initial recognition, when there is a change in the business model that would result in the instrument no longer meeting the business model qualification criteria. IFRS 9:4.4.1 requires reclassification in the case of a change in business model (see **6.1**) and does not specifically distinguish between assets that are *classified by default* at FVTPL and those that met at initial recognition the amortised cost criteria in IFRS 9:4.1.2 or FVTOCI criteria in IFRS 9:4.1.2A but were instead *designated* as at FVTPL.

Because IFRS 9:BC5.25(d) refers to the option to designate a financial asset at fair value as irrevocable, it is appropriate to conclude that the requirements to reassess classification due to changes in business model for assets described in IFRS 9:4.4.1 do not apply for assets designated as at FVTPL. Consequently, if the financial asset was designated as at FVTPL at initial recognition, an entity is not permitted to reclassify out of FVTPL to amortised cost or FVTOCI should the business model change and thereby require other non-designated at FVTPL assets included in the same business to be reclassified from FVTPL to amortised cost or FVTOCI.

Similarly, investments in equity instruments that are designated as at FVTOCI at initial recognition cannot be reclassified because IFRS 9:5.7.5 and BC5.25(d) are clear that the election to designate as at FVTOCI is irrevocable.

6.3 Reclassification versus initial recognition

If the terms of an instrument change sufficiently to warrant derecognition, this would not be a reclassification; instead, the old asset is derecognised and a new asset is recognised, i.e. a classification assessment is required on initial recognition of the new asset.

6.3-1

Reclassification: assets converts into a different asset during its life

When an asset converts into a different asset during the instrument's life, the entity must consider whether the original asset should continue to be recognised or whether, on conversion, the old instrument is derecognised and a new one is recognised.

The following example explores this issue further.

Example

Entity X invests in a convertible bond issued by Entity Y. Upon conversion, Entity X will receive a predetermined number of Entity Y's non-derivative equity instruments in exchange for giving up its right to receive the principal on the bond. On conversion, the convertible bond is derecognised and ceases to be measured at FVTPL. The equity instruments recognised may be classified as at FVTPL or designated as at FVTOCI at their initial recognition. The conversion does not give rise to a reclassification because the original instrument is derecognised.

6.4 The date of reclassification

If an entity reclassifies financial assets, it is required to apply the reclassification prospectively from the reclassification date, defined as the first day of the first reporting period following the change in business model that results in the entity reclassifying financial assets. [IFRS 9:Appendix A] The reclassification applies prospectively from the reclassification date and therefore previously recognised gains, losses (including impairment gains or losses) or interest are not restated. [IFRS 9:5.6.1]

A change in the objective of the entity's business model must be effected before the reclassification date. [IFRS 9:B4.4.2]

Example 6.4

Date of reclassification

[IFRS 9:B4.4.2]

A financial services firm decides on 15 February to shut down its retail mortgage business and thus must reclassify all affected financial assets on 1 April (i.e. 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.

6.4-1

Date of reclassification for interim and annual financial statements

IFRS 9 is not explicit as to how to interpret the 'first day of the first reporting period following the change in business model' in the context of interim financial statements. Specifically, it is not clear whether the 'first reporting period following the change in business model' is the next interim financial reporting period or the next annual financial reporting period.

6.5-1

Measurement at date of reclassification: reclassification out of amortised cost into FVTPL – example

At initial recognition, Entity H classifies a portfolio of loans at amortised cost. At initial recognition, the amortised cost is equal to fair value, CU10 million. The effective interest rate on the loans is 10 per cent.

After initial recognition, the portfolio of loans is reclassified to FVTPL. At the date of reclassification, being the start of the reporting period immediately following the period when there was the change in the objective of the business model, the amortised cost was CU10 million. The fair value at that date was CU11 million.

At the date of reclassification, Entity H recognises a gain of CU1 million, and discloses this as a separate line item in its statement of comprehensive income.

6.5-2

Measurement at date of reclassification: reclassification out of FVTPL into amortised cost – example

At initial recognition, Entity M classifies a portfolio of loans as at FVTPL; the loans do not qualify for amortised cost measurement because they fail the business model test. The beginning of Entity M's reporting period is 1 January 20X1. Subsequent to initial recognition, in November 20X1, the business model changes and the loans are required to be reclassified to amortised cost.

At 1 January 20X2, Entity M reclassifies the loans that were previously classified as at FVTPL to amortised cost. The fair value at 1 January 20X2 becomes the new opening gross carrying amount at amortised cost and, therefore, no gain or loss is recognised at that date. Entity M estimates the remaining contractual cash flows of the reclassified loans and determines the effective interest rate which will be applied in measuring the assets at amortised cost in future period(s).

When a financial asset is reclassified from amortised cost to FVTOCI (or vice versa) the measurement of expected credit losses will not change as both classification categories apply the same impairment approach. However, the presentation and disclosure of the impairment allowance will differ. If a financial asset is reclassified out of FVTOCI to amortised cost measurement, for presentation purposes, a loss allowance would be recognised as an adjustment to the gross carrying amount of the financial asset from the reclassification date. If a financial asset is reclassified out of amortised cost to FVTOCI measurement, for presentation purposes,

a loss allowance would be derecognised (and thus would no longer be recognised as an adjustment to the gross carrying amount) but instead would be recognised as an accumulated impairment amount (of an equal amount) in other comprehensive income and would be disclosed from the reclassification date. [IFRS 9:B5.6.1(b)]

6.6 Reclassification: disclosure requirements

If an entity reclassifies a financial asset from amortised cost to FVTPL, it must disclose as a separate line item in its statement of comprehensive income any gain or loss arising from a difference between the previous carrying amount and its fair value on reclassification in accordance with IAS 1:82(ca). Similarly, if an entity reclassifies a financial asset from FVTOCI to FVTPL, it must disclose as a separate line in its statement of comprehensive income any gain or loss arising from reclassifying the previously recognised amount in other comprehensive income to profit or loss in accordance with IAS 1:82(cb).

Example 6.6

Reclassification of financial assets

[IFRS 9:IE104 - IE114]

An entity purchases a portfolio of bonds for its fair value (gross carrying amount) of CU500,000.

The entity changes the business model for managing the bonds in accordance with IFRS 9:4.4.1. The fair value of the portfolio of bonds at the reclassification date is CU490,000.

If the portfolio was measured at amortised cost or at fair value through other comprehensive income immediately prior to reclassification, the loss allowance recognised at the date of reclassification would be CU6,000 (reflecting a significant increase in credit risk since initial recognition and thus the measurement of lifetime expected credit losses).

The 12-month expected credit losses at the reclassification date are CU4,000.

For simplicity, journal entries for the recognition of interest revenue are not provided.

Scenario 1: Reclassification out of the amortised cost measurement category and into the fair value through profit or loss measurement category

Bank A reclassifies the portfolio of bonds out of the amortised cost measurement category and into the fair value through profit or loss measurement category. At the reclassification date, the portfolio of bonds is measured at fair value. Any gain or loss arising from a difference between the previous amortised cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognised in profit or loss on reclassification.

	Debit CU	Credit CU
Bonds (FVTPL assets)	490,000	
Bonds (gross carrying amount of the amortised cost assets)		500,000
Loss allowance	6,000	
Reclassification loss (profit or loss)	4,000	

To recognise the reclassification of bonds from amortised cost to fair value through profit or loss and to derecognise the loss allowance.

Scenario 2: Reclassification out of the fair value through profit or loss measurement category and into the amortised cost measurement category

Bank A reclassifies the portfolio of bonds out of the fair value through profit or loss measurement category and into the amortised cost measurement category. At the reclassification date, the fair value of the portfolio of bonds becomes the new gross carrying amount and the effective interest rate is determined based on that gross carrying amount. The impairment requirements apply to the bond from the reclassification date. For the purposes of recognising expected credit losses, the credit risk of the portfolio of bonds at the reclassification date becomes the credit risk against which future changes in credit risk shall be compared.

	Debit CU	Credit CU
Bonds (gross carrying amount of the amortised cost assets)	490,000	
Bonds (FVTPL assets)		490,000
Impairment loss (profit or loss)	4,000	
Loss allowance		4,000

To recognise reclassification of bonds from fair value through profit or loss to amortised cost including commencing accounting for impairment.

Scenario 3: Reclassification out of the amortised cost measurement category and into the fair value through other comprehensive income measurement category

Bank A reclassifies the portfolio of bonds out of the amortised cost measurement category and into the fair value through other comprehensive income measurement category. At the reclassification date, the portfolio of bonds is measured at fair value. Any gain or loss arising from a difference between the previous amortised cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognised in other comprehensive income. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. The credit risk at initial recognition continues to be used to assess changes in credit risk. From the reclassification date the loss allowance ceases to be recognised as an adjustment to the gross carrying amount of the bond and is recognised as an accumulated impairment amount, which would be disclosed.

	Debit CU	Credit CU
Bonds (FVTOCI)	490,000	
Bonds (gross carrying amount of amortised cost assets)		500,000
Loss allowance	6,000	
Other comprehensive income*	4,000	

To recognise the reclassification from amortised cost to fair value through other comprehensive income. The measurement of expected credit losses is however unchanged.

* For simplicity, the amount related to impairment is not shown separately. If it had been, this journal entry (i.e. Dr CU4,000) would be split into the following two entries:

- Dr Other comprehensive income CU10,000 (fair value changes); and
- Cr Other comprehensive income CU6,000 (accumulated impairment amount).

Scenario 4: Reclassification out of the fair value through other comprehensive income measurement category and into the amortised cost measurement category

Bank A reclassifies the portfolio of bonds out of the fair value through other comprehensive income measurement category and into the amortised cost measurement category. The portfolio of bonds is reclassified at fair value. However, at the reclassification date, the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the portfolio of bonds. As a result, the portfolio of bonds is measured at the reclassification date as if it had always been measured at amortised cost. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. The credit risk at initial recognition continues to be used to assess changes in the credit risk on the bonds. The loss allowance is recognised as an adjustment to the gross carrying amount of the bond (to reflect the amortised cost amount) from the reclassification date.

	Debit CU	Credit CU
Bonds (gross carrying value of the amortised cost assets)	490,000	
Bonds (FVTOCI assets)		490,000
Bonds (gross carrying value of the amortised cost assets)	10,000	
Loss allowance		6,000
Other comprehensive income*		4,000

To recognise the reclassification from fair value through other comprehensive income to amortised cost including the recognition of the loss allowance deducted to determine the amortised cost amount. The measurement of expected credit losses is however unchanged.

The fact that the contractual put right in a puttable instrument is conditional upon the holder exercising its right to require redemption does not negate the existence of a financial liability, because the issuer does not have the unconditional right to avoid delivering cash or another financial asset. [IAS 32:19(b)] An obligation is not negated if the instrument gives the holder the right to a residual interest in the assets of the issuer as is the case, for example, for a unit in a mutual fund. [IAS 32:18(b)]

2.1.2.2-1

Classification of preference shares puttable at par – example

An entity issues preference shares that are puttable at par for cash at the option of the holder at a particular date.

The preference shares contain a financial liability element which should be measured at the present value of the obligation to redeem the preference shares for par in cash.

The fact that the contractual put right in a puttable instrument is conditional upon the holder exercising its right to require redemption does not negate the existence of a financial liability element, because the issuer does not have the unconditional right to avoid delivering cash or another financial asset. Further, the instrument does not meet the exception to the definition of a financial liability in IAS 32:16A and 16B to be presented as equity.

2.1.2.2-2

Classification of an instrument puttable at net asset value – example

Entity A issues Class B shares which allow the holder to put the shares back to Entity A at any time at a price equal to the holder's proportional share of the net assets of Entity A. This price is calculated as the number of Class B shares owned, divided by the total number of Class B shares outstanding, multiplied by the net assets of Entity A (excluding the Class B shares from the net asset calculation).

The Class B shares do not entitle the holder to a pro rata share of Entity A's net assets in the event of liquidation and are not the most subordinate class of shares. As such, the criteria of IAS 32:16A are not met.

Although Class B shareholders might receive returns that would typically be associated with equity holders in that they participate in the performance of the net assets of Entity A, the fact that Entity A has a contractual obligation to pay the holder of the Class B shares cash if the holder chooses to put the instrument back to Entity A, and the fact that the terms of the Class B shares do not meet the criteria to be classified as equity in IAS 32:16A, mean that Entity A should classify the Class B shares as financial liabilities.

2.1.2.2-3

Classification of an instrument when issuer has discretion to refuse redemption – example

Entity A has instruments in issue that allow the holders to request redemption of their instrument at specified dates and amounts. Entity A's governing charter states that the entity has a choice whether or not to accept the holder's request. There are no other conditions on the level of redemptions or any limitations on the entity's discretion to redeem or make payments to holders. In its history, Entity A has never refused to redeem the instruments when requested to do so by a holder.

All other characteristics of the instrument are equity.

Because Entity A has no obligation to transfer cash or another financial asset, the instrument should be classified as equity. A history of, or intention to make, discretionary payments does not trigger liability classification. [IAS 32:AG26]

Under IAS 32, interests in many open-ended mutual funds, unit trusts, partnerships and some co-operative entities, which embody the right of the holder to require the issuer to redeem the interests for a cash amount equivalent to their share of net assets, but which do not meet the narrow criteria for equity classification described at **2.1.2.1**, should be classified as financial liabilities. This may lead to a situation where some entities have no equity capital in their financial statements. IAS 32 permits the use of an appropriate description of the line item relating to puttable instruments and provides an illustrative example of such presentation, which is reproduced as **example 2.1.2.2**.

2.1.2.2-4

Classification of shares in a co-operative where a partial prohibition against redemption exists – example

Local laws governing the operation of co-operatives prohibit co-operative entities from redeeming members' shares if, by such redemption, an entity would reduce paid-in capital from members' shares below 90 per cent of the highest amount of paid-in capital from members' shares.

The highest amount for a particular co-operative is CU1,000,000, meaning that local law prohibits a redemption that would reduce paid-in capital below CU900,000.

With the exception of the 90 per cent restriction, the paid-in capital for this co-operative is redeemable at the option of the member.

At 31 December 20X0 the balance of paid-in capital represented by the issued shares is CU900,000; at 31 December 20X1, the balance has increased to CU950,000.

At 31 December 20X0, the entire balance of CU900,000 is classified as equity.

At 31 December 20X1, CU900,000 is classified as equity and CU50,000 as a financial liability.

In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change over time. If this is the case, such a change may lead to a transfer between financial liabilities and equity. [IFRIC 2:9]

2.1.2.2-5

Reclassification due to change in local law – example

The background facts are the same as at **2.1.2.2-4**. Assume that, at 31 December 20X2, the local law governing the operation of co-operatives is amended so that redemption of members' shares is permitted up to 20 per cent of the highest amount of members' shares, rather than 10 per cent.

If, at that date, the entire balance of paid-in capital remained unchanged from 31 December 20X1 at CU950,000, the entity would reclassify an additional CU100,000 from equity to financial liabilities so that CU800,000 is classified as equity and CU150,000 is classified as a financial liability, with no gain or loss resulting at the date the transfer is made. The entity should disclose separately the amount, timing and reason for the transfer.

Consistent with the requirements of IFRS 9, demand deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers, are financial liabilities of the entity. [IFRIC 2:6]

2.1.3 *Instruments containing an obligation to deliver a pro rata share of the net assets of the entity only on liquidation*

When liquidation of an entity is certain to occur and is outside the control of the entity (e.g. an entity with a limited life) or is not certain to occur but is at the option of the holder of an instrument issued by the entity (e.g. in some partnership interests), the entity has a contractual obligation to pay cash or another financial asset that the entity cannot avoid. Therefore, such entities will generally recognise a financial liability with respect to the amounts payable by the entity on liquidation. However, IAS 32 has an exception for certain instruments, or components of instruments, when the issuer has an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation. This limited scope exception was introduced at the same time as the equivalent limited scope exception for puttable instruments described at **2.1.2.1**.

The criteria for equity classification are similar to, but not the same as, the criteria described in IAS 32:16A and 16B for puttable instruments. The instrument must meet all of the following criteria to be presented as equity: [IAS 32:16C]

(a) it entitles the holder to a pro rata share of the entity's net assets in the event of the entity's liquidation;

(b) it is in the class of instruments that is subordinate to all other classes of instruments; and

(c) all financial instruments in the class of instruments that is subordinate to all other classes of instruments must have an identical contractual obligation for the issuing entity to deliver a pro rata share of its net assets on liquidation.

The three criteria in IAS 32:16C are equivalent to the criteria in IAS 32:16A(a) - (c) for puttable instruments. The shaded boxes that accompany the criteria described at **2.1.2.1** apply equally to the criteria in IAS 32:16C.

For an instrument, or component of a financial instrument, containing an obligation to deliver a pro rata share of the net assets of the entity only on liquidation, to be classified as equity, in addition to meeting the criteria in IAS 32:16C, the issuer must have no other financial instrument or contract that has: [IAS 32:16D]

- A financial instrument may contain a non-financial obligation that must be settled if, and only if, the entity fails to make distributions or to redeem the instrument. If the entity can avoid a transfer of cash or another financial asset only by settling the non-financial obligation, the financial instrument is a financial liability. [IAS 32:20(a)]
- A financial instrument is a financial liability if it provides that, on settlement, the entity will deliver either cash or another financial asset, or its own shares whose value is determined to exceed substantially the value of the cash or other financial asset. Although the entity does not have an explicit obligation to deliver cash or another financial asset, the holder of the asset has in substance been guaranteed a minimum amount equal to at least the cash/other financial asset settlement option amount. [IAS 32:20(b)]

In March 2006, the IFRIC (now the IFRS Interpretations Committee) discussed the role of contractual and economic obligations in the classification of two different financial instruments under IAS 32. The first instrument was an irredeemable, callable financial instrument with dividends payable only if dividends are paid on the ordinary shares of the issuer which included a 'step-up' dividend clause that would increase the dividend at a pre-determined date in the future unless the instrument had previously been called by the issuer. The second instrument was an irredeemable, callable financial instrument with dividends that must be paid if interest is paid on another, linked, instrument.

The IFRIC agreed that IAS 32 is clear that a contractual financial obligation was necessary in order that a financial instrument be classified as a liability (ignoring the classification of financial instruments that may or will be settled in the issuer's own equity instruments). Such a contractual obligation could be established explicitly or indirectly. However, the obligation must be established through the *terms and conditions* of the financial instrument. IFRIC also noted that IAS 32 is clear that an economic obligation (commonly known as *economic compulsion*), by itself, would not result in a financial instrument being classified as a liability. The IFRIC also discussed the role of 'substance' in the classification of financial instruments. It noted that IAS 32 restricted the role of 'substance' to consideration of the contractual terms of an instrument, and that anything outside the contractual terms was not considered for the purpose of assessing whether an instrument should be classified as a liability under IAS 32. These points were subsequently confirmed by the Board through their discussions in June 2006.

In September 2013 the IFRS Interpretations Committee dealt with a request to clarify how an issuer would classify three financial instruments in accordance with IAS 32. None of the financial

instruments had a maturity date but each gave the holder the contractual right to redeem at any time. The holder's redemption right was described differently for each of the three financial instruments; however in each case the issuer had the contractual right to choose to settle the instrument in cash or a fixed number of its own equity instruments if the holder exercised its redemption right. The issuer was not required to pay dividends on the three instruments but could choose to do so at its discretion.

The Committee noted that IAS 32:15 requires the issuer of a financial instrument to classify the instrument in accordance with the substance of the contractual arrangement. Consequently, the issuer cannot achieve different classification results for financial instruments with the same contractual substance simply by describing the contractual arrangements differently.

IAS 32:11 sets out the definitions of both a financial liability and an equity instrument. IAS 32:16 describes in more detail the circumstances in which a financial instrument meets the definition of an equity instrument.

The Committee noted that a non-derivative financial instrument that gives the issuer the contractual right to choose to settle in cash or a fixed number of its own equity instruments meets the definition of an equity instrument in IAS 32 as long as the instrument does not establish an obligation to deliver cash (or another financial asset) indirectly through its terms and conditions. IAS 32:20(b) provides the example that an indirect contractual obligation would be established if a financial instrument provides that on settlement the entity will deliver either cash or its own equity instruments whose value is determined to exceed substantially the value of the cash.

The Committee also acknowledged that financial instruments, in particular those that are more structured or complex, require careful analysis to determine whether they contain equity and non-equity components that must be accounted for separately in accordance with IAS 32.

The Committee noted that if the issuer has a contractual obligation to deliver cash, that obligation meets the definition of a financial liability.

The Committee considered that in the light of its analysis of the existing IFRS requirements, an interpretation was not necessary and consequently decided not to add the issue to its agenda.

In January 2014 the IFRS Interpretations Committee dealt with a request to clarify how an issuer would classify in accordance with IAS 32 a financial instrument that is mandatorily convertible into a

2.1.7-4

Classification of an instrument with contingent settlement provisions: change of control – example

Entity D issues preference shares for CU1 million. Entity D is obliged to redeem the preference shares at par in the event that control of Entity D changes. A change in control is defined in the terms of the preference shares as a change in ownership of at least 51 per cent of the ordinary shares of Entity D.

Given that the contingent event (the sale of ordinary shares in Entity D by one set of shareholders to another) is not in the control of the Entity D, it is a contingent settlement provision. Because Entity D cannot avoid redeeming the preference shares for cash, the instrument contains an obligation to pay cash that creates a financial liability.

2.1.7-5

Contingent settlement provisions: change of control (classification in consolidated financial statements of issuer's parent entity) – example

Entity P is the parent and majority owner of the ordinary shares of Entity D which has issued preference shares to a party external to the group. The terms of the preference shares require that they be redeemed in the event of a change of control of Entity D.

The preference shares have no other redemption, conversion or dividend rights. As discussed at **2.1.7-4** the preference shares are classified as financial liabilities in the financial statements of Entity D.

The classification in the consolidated financial statements of Entity P requires further consideration.

If redemption of the preference shares is required only in the event of a change in Entity D's *direct* controlling party and Entity P can avoid redemption by not entering into a transaction (or permitting Entity D to enter into a transaction) that would result in Entity P losing control over Entity D, the preference shares should be classified as equity (a non-controlling interest) in the consolidated financial statements of Entity P.

If, however, redemption is also required in the event of a change in Entity D's *ultimate* controlling party (i.e. by a sale of shares in Entity P from one set of shareholders to another), Entity P cannot avoid redemption by Entity D of the preference shares because it cannot prevent its own shareholders from deciding to sell their shareholdings to a third party. In this case, the redemption clause is also a contingent settlement provision from Entity P's perspective, resulting in classification of the preference shares as a financial liability in Entity P's consolidated financial statements.

Care should be taken to assess the precise nature of events that would result in redemption of such instruments in order to determine whether those events are within the control of the entity.

2.2 Equity instruments

In classifying a financial instrument as a liability or equity, equity classification is appropriate only if the instrument fails the definition of a financial liability as detailed in **section 2**.

The key requirement in determining whether an instrument is equity is the issuer's unconditional ability to avoid delivery of cash or another financial asset. That ability is not affected by:

- the history of making distributions;
- an intention to make distributions in the future;
- a possible negative impact on the price of ordinary shares of the issuer if the distributions are not made on the instrument concerned;
- the amount of the issuer's reserves;
- an issuer's expectations of a profit or loss for the period; or
- an ability or inability of the issuer to influence the amount of its profit or loss for the period.

Provided that dividends are at the discretion of the issuer, it is irrelevant whether dividends are cumulative or non-cumulative. [IAS 32:AG26]

Once a dividend is properly declared and the issuer is legally required to pay it, a contractual obligation to deliver cash comes into existence and a financial liability for the amount of the declared dividend should be recognised. Similarly, a liability arises upon liquidation to distribute to the shareholders the residual assets in the issuer, i.e. any remaining assets after satisfying all of its liabilities.

The existence of an option whereby the issuer can redeem equity shares for cash does not trigger liability classification because the issuer retains an unconditional right to avoid delivering cash or another financial asset. A contractual obligation would only arise at the point when the issuer exercised its right to redeem. This principle applies to all instruments that are not derivatives over own equity.

Consequently, the IFRIC recommended that the Board address this issue as part of the current project on *Financial Instruments with Characteristics of Equity* (FICE). At that time, the Board's project was expected to address the distinction between equity and non-equity instruments in a shorter period than the IFRIC would require to complete its due process. The IFRIC therefore decided not to add this issue to its agenda.

Since the IFRIC reached the agenda decision the FICE project has been deferred and has been included in the Board's research programme. See future developments in **section 9**.

3 Compound instruments

The terms of a financial instrument may be structured such that it contains both equity and liability components (i.e. the instrument is neither entirely a liability nor entirely an equity instrument). Such instruments are defined in IAS 32 as compound instruments. An example of a compound instrument is a bond that is convertible, either mandatorily or at the option of the holder, into a fixed number of equity shares of the issuer. Compound instruments come in many forms and are not restricted solely to convertible instruments. The liability and equity components of a compound instrument are required to be accounted for separately. [IAS 32:28]

The requirement to separate out the equity and financial liability components of a compound instrument is consistent with the principle that a financial instrument must be classified in accordance with its substance, rather than its legal form. A compound instrument takes the legal form of a single instrument, while the substance is that both a liability and an equity instrument exist.

For example, a convertible bond that pays fixed coupons and is convertible by the holder into a fixed number of ordinary shares of the issuer has the legal form of a debt contract; however, its substance is that of two instruments:

- a financial liability to deliver cash (by making scheduled payments of coupon and principal) which exists as long as the bond is not converted; and
- a written call option granting the holder the right to convert the bond into a fixed number of ordinary shares of the entity.

The economic effect of the instrument is substantially the same as issuing simultaneously (i) a debt instrument with an early settlement provision and (ii) warrants to issue ordinary shares. [IAS 32:29]

3-1

Classification of a bond convertible into shares of another group entity – bond is denominated in the functional currency of the issuer and the other group entity – example

Entity P issues to independent investors zero coupon guaranteed exchangeable bonds for cash of CU2 billion. The bonds are exchangeable into the existing ordinary shares of a subsidiary of Entity P, Entity S, at a fixed conversion price of CU25 per share (80 million shares). The functional currency of both Entity P and Entity S is currency units (CU).

At maturity, the bondholders will choose to either (1) redeem the bonds in cash at 109.10 per cent of their issued amount, or (2) convert the bonds into equity shares of Entity S at the fixed exercise price. If the bond holders choose to convert the bonds into equity, Entity P will deliver existing ordinary shares of Entity S, reducing Entity P's interest in Entity S from 100 per cent to a minimum of 90 per cent.

The conversion option is classified as equity in Entity P's consolidated financial statements because it provides for the exchange of a fixed amount of cash for a fixed number of Entity S's shares. IAS 32:22 states that "a contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument". In consolidated financial statements, this applies to equity instruments of a subsidiary as well as of the parent entity.

Assuming that Entity P does not lose control of Entity S, any transfer of Entity S's shares on conversion of bonds will be accounted for as an equity transaction in accordance with IFRS 10:23.

The treatment of a convertible bond denominated in a currency that is not the functional currency of the entity that issued the instrument and/or the entity whose shares will be delivered on conversion is discussed at **3.8.1**.

3.1 Separating the liability and equity components

Separation of the instrument into its liability and equity components is made upon initial recognition of the instrument and is not subsequently revised. The method used is as follows:

- firstly, the fair value of the liability component is calculated, and this fair value establishes the initial carrying amount of the liability component; and

The preference share is a compound financial instrument that contains both liability and equity components. The liability is the contractual obligation by the issuer to deliver cash (CU424 per year), while the equity component is represented by the holder's right to receive an equity return in the form of additional dividends, if declared.

The fair value of the liability will be calculated as the present value of the mandatory dividend of CU424 per share per year in perpetuity discounted at the market interest rate for a similar instrument that does not entitle the holder to additional discretionary dividends. The equity component is calculated as the residual amount after deducting from the fair value of the instrument as a whole the amount separately determined for the liability component.

3.2 Separating the liability and equity components when the instrument has embedded derivatives

In addition to the financial liability and equity components, a compound instrument may also have embedded derivatives (see **chapter B5**). For example, the instrument may contain a call option exercisable by the issuer. The value of any such embedded derivative features must be allocated to the liability component. [IAS 32:31] Thus, the carrying amount of the liability component is established by measuring the fair value of a similar liability (with similar terms, credit status and embedded non-equity derivative features) but without an associated equity component. The carrying amount of the equity component is then determined by deducting the fair value of the liability component from the fair value of the compound instrument as a whole.

A further assessment is required to establish whether the embedded derivative is closely related to the liability component (see **chapter B5**). This assessment is made before separating the equity component. No gain or loss arises from initially recognising the components of the instrument separately.

3.2-1

Convertible debt with issuer call – example

A CU functional currency entity issues a bond with a principal amount of CU60 million carrying a coupon of 5 per cent payable annually in arrears. The instrument is issued for proceeds of CU60 million. The instrument is convertible into a fixed number of equity shares of the issuer after a specified date. The instrument has no fixed maturity. However, it contains an issuer call option that allows the issuer to redeem the bond at par at any point in time.

It is established that the value of a similar bond (of similar credit status with similar features except that it does not contain a call or equity conversion option) at current market rates would be CU57 million. Based on an option pricing model, it is further determined that the value of the issuer purchased call option on a similar bond without a conversion option is an asset of CU2 million.

The value allocated to the liability and equity components should be as follows.

Liability component: CU55 million (CU57 million – CU2 million)

This reflects the inclusion of the value of the additional embedded derivative feature (asset) in the liability component.

Equity component: CU5 million (CU60 million – CU55 million)

This represents the equity residual arrived at by subtracting from the fair value of the whole instrument the fair value of the liability component (which includes the value of the embedded derivative feature in the form of the purchased call feature).

The guidance in IFRS 9:B4.3.1 to B4.3.8 will need to be considered in assessing whether the embedded derivative is closely related to the host contract or whether, subsequent to issuance of the bond, it will be accounted for separately at fair value through profit or loss.

In the example at **3.2-1**, the initial amortised cost of the financial liability is established as the fair value of issued callable debt. Assuming the call feature over the debt instrument is not separated, the effective interest rate applied at inception and throughout the life of the instrument is the same rate of interest that would apply to plain callable debt. To the extent that interest rates change subsequent to issue, this will impact the likelihood that the callable debt will be called by the issuer and, therefore, the carrying amount will be updated (see **4.1** in **chapter B6**).

3.2-2

Accounting for convertible bond with embedded put/call option – example

Entity X issued a convertible debt instrument in May 20X1 with a contractual maturity of eight years. One bond allows the holder to obtain, at any time, one share of the issuer (the conversion option). The coupon is 2 per cent payable annually. The issue price is 100 per cent and the redemption price is 140 per cent.

The instrument is puttable by the holders on three different dates during the life of the instrument (May 20X3, May 20X5 and May 20X7).

3.3-1

Conversion of a compound instrument: issue of new shares – example

Assume the facts are as at **3.1-1**, but the date now is 31 December 20X6 (i.e. the end of Year 2 of the instrument's life). Due to a rapid rise of Entity A's share price, all holders of the bonds exercise their right to convert their holdings into a fixed number of equity instruments of Entity A at 31 December 20X6.

The liability has been accounted for at amortised cost using the effective interest method (see **4.1** in **chapter B6**).

At 31 December 20X6, the following applies:

- the amortised cost carrying amount of the liability (determined using the effective interest method) immediately prior to conversion is CU1,944,954 (being interest of CU120,000 and principal of CU2 million due on 31 December 20X7 discounted at the original effective interest rate of 9 per cent);
- the original equity component immediately prior to conversion still stands at the original CU151,878; and
- upon conversion, 500,000 equity shares will be issued (250 equity shares for each the 2,000 bonds issued) with each equity share having a nominal value of CU1.

If the entity satisfies the conversion option by issuing new shares, the accounting entries on conversion are as follows.

		CU	CU
Dr	Bond liability	1,944,954	
Cr	Equity		1,944,954

To remove the liability from the statement of financial position and recognise the issue of shares as a result of conversion.

The original component of equity, CU151,878, may be reclassified to another line item within equity.

3.3-2

Conversion of a compound instrument: issue of treasury shares – example

Assume the facts are as at **3.1-1** except that, instead of issuing new shares upon conversion, Entity A satisfies the conversion option by delivering to holders 500,000 of its own shares which it had previously repurchased and held as treasury shares.

The accounting entries in these circumstances would be as follows.

		CU	CU
Dr	Bond liability	1,944,954	
Cr	Equity		1,944,954

To remove the liability from the statement of financial position as a result of conversion and remove the treasury shares from equity.

The original component of equity (CU151,878) and the amount deducted from equity (as required by IAS 32:33) on acquisition of the treasury shares may be reclassified to another line item within equity upon conversion.

3.4 Early redemption of a compound instrument

When an entity redeems or repurchases a convertible instrument before its maturity through a tender offer (without altering the conversion feature), the consideration paid (including any transaction costs) is allocated to the liability and equity components at the date of the early redemption/early repurchase. The method used to make this allocation is the same as that used to make the original allocation of the proceeds of the issue of the instrument between the liability and equity components upon initial recognition. [IAS 32:AG33]

To the extent that the amount of the consideration allocated to the liability component exceeds the carrying amount of the liability component at that time, a loss is recognised in profit or loss. Conversely, to the extent that the consideration allocated to the liability component is smaller than its carrying amount, a gain is recognised in profit or loss. [IAS 32:AG34]

The amount of consideration allocated to equity is recognised in equity with no gain or loss being recognised (the equity component that is not eliminated may be reclassified to another line item within equity). [IAS 32:AG34]

3.4-1

Convertible debt: repurchase – example

Assume the facts are as at **3.1-1** and that one year has elapsed since the convertible bonds were issued and it is now 31 December 20X5.

In respect of the first year (year ended 31 December 20X5), the following accounting entries will have been recorded.

		CU	CU
Dr	Interest expense	166,331	
Cr	Bond liability		166,331

To recognise the interest expense and amortised cost of the bond using an effective interest rate of 9 per cent.

liability. That assumed transaction establishes a basis for estimating the price to sell the asset or to transfer the liability (see **3.3.3**).

In such circumstances, the entity is not required to identify specific market participants. Instead, the entity should consider the characteristics of potential market participants who would purchase the asset or accept a transfer of the liability being measured. In addition, the entity should identify the assumptions that such market participants would make in a transaction that maximises the amount received to sell an asset or minimises the amount paid to transfer a liability.

Potential market participants for financial instruments include counterparties to a derivative instrument, investors maximising return, investors trying to establish a strategic relationship with an investee, or a range of other participants with a specific objective.

When identifying a potential market participant, care should be taken to ensure that the unit of account from the perspective of the market participant is consistent with the unit of account of the item being measured.

3.4.3-2

Developing market participant assumptions when no apparent exit market exists

When developing assumptions that market participants would use in such a hypothetical transaction, an entity may start with its own assumptions and make adjustments for factors specific to the asset or liability being measured, including (the list is not exhaustive):

- growth rates and risk adjustments to reflect market participant assumptions; and
- performance and risk indicators (e.g. delinquencies, defaults, prepayment speeds and interest rates).

Market participant assumptions that are developed when no apparent market exists may be based on unobservable inputs or adjustments. An entity needs to evaluate the significance of these inputs or adjustments when determining the appropriate level in the fair value hierarchy within which the measurement should be categorised. [IFRS 13:73] See **10.3.3.2** for additional guidance regarding such evaluations.

3.5 The price at which a transaction is assumed to occur

3.5.1 Characteristics of the price at which a transaction is assumed to occur

The price at which a transaction is assumed to occur in the principal or most advantageous market is the price: [IFRS 13:24]

- in an 'orderly' transaction (see **3.5.2**); and
- under current market conditions at the measurement date.

The price may be directly observable or estimated using another valuation technique (see **section 8**). [IFRS 13:24]

The price should not be adjusted for 'transaction costs', but it should be adjusted for 'transport costs' in specified circumstances (see **3.5.3**). [IFRS 13:25 & 26]

3.5.2 An 'orderly' transaction

A fair value measurement assumes that the asset or liability is exchanged in an 'orderly' transaction in the principal (or most advantageous) market. An orderly transaction is defined as "[a] transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (e.g. a forced liquidation or distress sale)". [IFRS 13:Appendix A]

Appendix B to the Standard provides additional guidance regarding the identification of orderly transactions (see **9.6**).

3.5.3 Transaction costs and transport costs

Transaction costs are defined as "[t]he costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and that meet both of the following criteria. [IFRS 13:Appendix A]

- They result directly from and are essential to that transaction.
- They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made (similar to costs to sell, as defined in IFRS 5)".

Transaction costs do not include transport costs. [IFRS 13:26] Transport costs are defined as "[t]he costs that would be incurred to transport an asset from its current location to its principal (or most advantageous) market". [IFRS 13:Appendix A]

IFRS 13 specifies that, when measuring fair value, the relevant market price should *not* be adjusted for transaction costs. Because such costs are specific to a transaction and will differ depending on how an entity enters into a transaction for an asset or a liability, they are not considered to be a characteristic of the asset or liability. [IFRS 13:25]

Note, however, that transaction costs are considered when identifying the most advantageous market for an asset or a liability (see **3.3.1** and **example 3.5.3**).

The appropriate treatment for transaction costs should be determined in accordance with other relevant IFRS Standards. [IFRS 13:25] For financial instruments, transaction costs are accounted for in accordance with the requirements in IAS 32 and IFRS 9 (see **2.1** in **chapter B6**). [IFRS 13:24 & 25]

In contrast, the price in the principal (or most advantageous) market used to measure the fair value of the asset or liability *is* adjusted for costs that would be incurred to transport the asset from its current location to that market *if* location is a characteristic of the asset. [IFRS 13:26]

Transport costs are relevant in determining the fair value of non-financial items. Because certain contracts that include the delivery or receipt of non-financial items are scoped into IAS 32, IFRS 9 and IFRS 7 (see **2.5** in **chapter B1**), transport costs may be relevant in determining the fair value of a contract that is in the scope of the financial instruments Standards. This may be the case in determining the fair value of a commodity for delivery to a particular location where location is an attribute of the contract.

The appropriate treatments for transaction and transport costs are illustrated in the following example.

Example 3.5.3

Level 1 principal (or most advantageous) market

[IFRS 13:IE19 - IE22, Example 6]

An asset is sold in two different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date. In Market A, the price that would be received is CU26, transaction costs in that market are CU3 and the costs to transport the asset to that market are CU2 (i.e. the net amount that would be received is CU21). In Market B, the price that would be received is CU25, transaction costs in that market are CU1 and the costs to transport the asset to that market are CU2 (i.e. the net amount that would be received in Market B is CU22).

If Market A is the principal market for the asset (i.e. the market with the greatest volume and level of activity for the asset), the fair value of the asset would be measured using the price that would be received in that market, after taking into account transport costs (CU24).

If neither market is the principal market for the asset, the fair value of the asset would be measured using the price in the most advantageous market. The most advantageous market is the market that maximises the amount that would be received to sell the asset, after taking into account transaction costs and transport costs (i.e. the net amount that would be received in the respective markets).

Because the entity would maximise the net amount that would be received for the asset in Market B (CU22), the fair value of the asset would be measured using the price in that market (CU25), less transport costs (CU2), resulting in a fair value measurement of CU23. Although transaction costs are taken into account when determining which market is the most advantageous market, the price used to measure the fair value of the asset is not adjusted for those costs (although it is adjusted for transport costs).

4 Measuring the fair value of non-financial assets – highest and best use

The application of IFRS 13's requirements under this heading is limited to non-financial assets. This concept is not relevant for financial assets, liabilities or an entity's own equity instruments because those items do not have alternative uses as contemplated in IFRS 13. [IFRS 13:BC63] Consequently, this topic is not dealt with in this chapter but is discussed in **section 4** of **chapter A6** of this manual.

5 Measuring the fair value of financial liabilities and an entity's own equity instruments

5.1 Measuring the fair value of liabilities and an entity's own equity instruments – general

5.1.1 General principles

Except when indicated otherwise, the guidance in this section regarding liabilities applies equally to financial and non-financial liabilities.

The fair value of a financial liability or an entity's own equity instruments (e.g. an equity share issued as part of the consideration in a business combination) is measured based on the assumption that the liability or equity instrument is transferred to a market participant at the measurement date. [IFRS 13:34]

For a financial liability, it is assumed that the liability would remain outstanding and the market participant transferee would be required to fulfil the obligation. It would not be settled with the counterparty or otherwise extinguished on the measurement date. [IFRS 13:34(a)]

IFRS 13 is clear that the fair value of a liability is based on a transfer amount, i.e. the amount the reporting entity would need to pay a third party to take on the obligation, and that obligation remains outstanding and contractually unaltered before and after transfer. Fair value is therefore *not* based on the premise of settling the liability with the counterparty at the measurement date.

For an entity's own equity instrument, it is assumed that the equity instrument would remain outstanding and the market participant transferee would take on the rights and responsibilities associated with the instrument. The instrument would not be cancelled or otherwise extinguished on the measurement date. [IFRS 13:34(b)]

IFRS 13 requires that the fair value measurement should be based on an assumed transfer to a market participant even if an entity does not intend to transfer its liability or own equity instrument to a third party (e.g. because the entity has advantages relative to the market that make it more beneficial for the entity to fulfil the liability using its own internal resources) or it is unable to do so (e.g. because the counterparty would not permit the liability to be transferred to another party). [IFRS 13:BC81 & BC82]

Even when there is no observable market to provide pricing information about the transfer of a liability or an entity's own equity instruments (e.g. because contractual or other legal restrictions prevent the transfer of such items), there might be an observable market for such items if they are held by other parties as assets (see **5.1.2**). [IFRS 13:35]

Consistent with the objective of fair value measurement and the prioritisation in the fair value hierarchy (see **section 10**), when measuring the fair value of a liability or an entity's own equity instrument at fair value, the entity should maximise the use of relevant observable inputs and minimise the use of unobservable inputs. [IFRS 13:36]

5.1.2 Liabilities and equity instruments held by other parties as assets

When a quoted price for the transfer of an identical or a similar financial liability or an entity's own equity instruments is not available, and the identical item is held by another party as an asset, an entity is required to measure the fair value of the financial liability or equity instrument from the perspective of a market participant that holds the identical item as an asset at the measurement date. [IFRS 13:37] This requirement could be relevant, for example, when measuring the fair value of corporate bonds or a call option on an entity's shares. [IFRS 13:35]

Determining the fair value of a financial liability or an entity's own equity instrument from the perspective of the counterparty holding the same instrument as an asset reinforces the notion that the fair value ascribed to the contract is the same irrespective of whether the entity is the issuer or the holder. This is based on the theory that fair value is based on a transaction in which the contract is transferred, as opposed to being settled or extinguished with the holder. In all cases the fair value is based on the premise that the instrument remains outstanding and therefore is a theoretical transfer value.

In the circumstances described above, the appropriate bases for measuring the fair value of the liability or the entity's own equity instrument are listed below, in descending order of preference: [IFRS 13:38]

(a) using the quoted price in an active market (see below) for the identical item held by another party as an asset, if that price is available;

(b) if that price is not available, using other observable inputs, such as the quoted price in a market that is not active for the identical item held by another party as an asset; and

(c) if the observable prices in (a) and (b) above are not available, using another valuation technique, such as:

   (i) an income approach (e.g. a present value technique that takes into account the future cash flows that a market participant would expect to receive from holding the liability or equity instrument as an asset; see **8.6**); or

   (ii) a market approach (e.g. using quoted prices for similar liabilities or equity instruments held by other parties as assets; see **8.4**).

An active market is defined as "[a] market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis". [IFRS 13:Appendix A]

A quoted price of a liability or an entity's own equity instrument held by another party as an asset should be adjusted only if there are factors specific to the asset that are not applicable to the fair value measurement of the liability or equity instrument. An entity should ensure that the price of

(b) **Subordination**: the level of subordination of an instrument is critical to assessing the risk of non-payment of an instrument. If other more senior instruments have higher claims over the cash flows and assets that support the instrument, this increases the risk of the instrument. The lower the claim on the cash flows and assets, the more risky an instrument is and the higher the return the market will demand on the instrument.

(c) **Non-payment protection**: many instruments contain some form of protection to reduce the risk of non-payment to the holder. In measuring fair value, both the issuer and the holder of the instrument consider the effect of the protection on the fair value of the instrument, unless the entity accounts for the protection as a separate instrument. Protection might take the form of a guarantee or a similar undertaking (e.g. when a parent guarantees the debt of a subsidiary), an insurance contract, a credit default swap or simply the fact that more assets support the instrument than are needed to make the payments (this is commonly referred to as over-collateralisation). The risk of non-payment is also reduced by the existence of more subordinated tranches of instruments that take the first losses on the underlying assets and therefore reduce the risk of more senior tranches absorbing losses. When protection is in the form of a guarantee, an insurance contract or a credit default swap, it is necessary to identify the party providing the protection and assess that party's creditworthiness (to the extent that the protection is not accounted for separately). The protection will be more valuable if the credit risk of the protection provider is low. This analysis involves considering not only the current position of the protection provider but also the effect of other guarantees or insurance contracts that it might have written. For example, if the provider has guaranteed many correlated debt securities, the risk of its non-performance might increase significantly with increases in defaults on those securities. In addition, the credit risk of some protection providers moves as market conditions change. Thus, an entity evaluates the credit risk of each protection provider at each measurement date."

Although paragraph 35 of the Expert Advisory Panel report refers to the valuation of a 'debt instrument', the factors listed above would also be relevant in determining the non-performance risk for a derivative.

5.2.1-3

Impact of a guarantee by an acquirer on the fair value of an acquiree's loan – example

Entity A acquires 100 per cent of Entity B from Entity C in a business combination. One of the identifiable liabilities of Entity B is a loan owed to a third party. The loan was originally guaranteed by Entity C as part of the loan terms. However, as a result of the business combination, the terms of the loan are revised so that Entity A becomes the guarantor of the loan (i.e. the guarantee by Entity A becomes part of the revised loan terms).

IFRS 3 *Business Combinations* requires that the third-party loan is measured at fair value at the date of acquisition. The measurement requirements of IFRS 13 apply.

There are no quoted prices available for the transfer of an identical or a similar liability.

When measuring the fair value of the loan at the date of acquisition for the purpose of preparing consolidated financial statements, Entity A should take into account the effect of its own guarantee of the loan because the guarantee is part of the loan terms.

As discussed at **5.1.2**, IFRS 13:37 requires that when a quoted price for the transfer of an identical or a similar liability is not available, and the identical item is held by another party as an asset, an entity should measure the fair value of the liability from the perspective of a market participant that holds the identical item as an asset at the measurement date.

In the circumstances described, the loan is guaranteed by Entity A from the date of acquisition. From the perspective of a market participant holding the loan as an asset, the fact that the loan is guaranteed by Entity A would be taken into account when measuring the fair value of the loan receivable because the market participant would expect to recover the loan from Entity A if Entity B defaulted on the loan. Consequently, when measuring the fair value of the loan, a market participant would take into account (1) the credit standing of Entity B, and (2) the guarantee provided by Entity A.

This is also consistent with the requirement in IFRS 13:43 (see below) that an entity should take into account the effect of its own credit risk (credit standing) and any other factors that might influence the likelihood that the obligation will or will not be fulfilled.

The effect of an entity's credit standing and any other factors that might influence the likelihood that the obligation will or will not be fulfilled may differ depending on the nature of the liability (e.g. whether it is a financial or a non-financial liability, or whether any credit enhancements are attached). [IFRS 13:43]

To understand non-performance risk, consideration has to be given to the specific terms of the instrument rather than simply looking at the overall credit rating or quality of the entity in its entirety. Looking at the latter will generally obscure the particular credit characteristics of the instrument itself, like credit enhancements, or fail to reflect the relative seniority or subordination of the liability relative to the liabilities of the entity.

5.4 Financial liability with a demand feature

The fair value of a financial liability with a demand feature (e.g. 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. [IFRS 13:47]

6 Measuring the fair value of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk

An entity that holds a group of financial assets and financial liabilities is exposed to market risks (as defined in IFRS 7) and to the credit risk (as defined in IFRS 7) of each of the counterparties. If the entity manages that group of financial assets and financial liabilities on the basis of its net exposure to either market risks or credit risk, the entity is permitted to apply an exception to the general requirements of IFRS 13 for measuring fair value.

The exception permits an entity to measure the fair value of a group of financial assets and financial liabilities on the basis of the price that would be received to sell a net long position (i.e. an asset) for a particular risk exposure or to transfer a net short position (i.e. a liability) for a particular risk exposure in an orderly transaction between market participants at the measurement date under current market conditions. This fair value measure for the group of financial assets and financial liabilities should be consistent with how market participants would price the net risk exposure at the measurement date. [IFRS 13:48] This exception only applies to financial assets, financial liabilities and other contracts within the scope of IFRS 9. [IFRS 13:52]

In December 2013, the Board issued *Annual Improvements to IFRSs 2011 - 2013 Cycle* that amended IFRS 13:52 to clarify that the portfolio exception applies to all contracts within the scope of IFRS 9 regardless of whether they meet the definitions of financial assets or financial liabilities as defined in IAS 32. The clarification was in response to questions raised about whether the scope included contracts that are accounted for as if they were financial instruments, but that do not meet the definitions of financial assets or financial liabilities in IAS 32, such as contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments.

6-1

Measuring the fair value of portfolios with offsetting risk positions – application to portfolio of assets

An entity is permitted to apply the measurement exception in IFRS 13:48 to a portfolio that contains *only* financial assets (as opposed to a group of financial assets and financial liabilities) provided that the financial instruments have offsetting positions in market risks or counterparty credit risk and that the detailed conditions in IFRS 13:49 (see below) are met.

An example of a portfolio containing only financial assets is a portfolio of bonds measured at fair value and purchased credit default swaps also measured at fair value. The credit default swaps may provide an offset to the credit risk associated with the specific bonds.

An entity is permitted to use this exception only if the entity does all of the following: [IFRS 13:49]

- it manages the group of financial assets and financial liabilities on the basis of the entity's net exposure to a particular market risk (or risks) or to the credit risk of a particular counterparty in accordance with the entity's documented risk management or investment strategy;
- it provides information on that basis about the group of financial assets and financial liabilities to the entity's key management personnel, as defined in IAS 24 *Related Party Disclosures*; and
- it is required or has elected to measure those financial assets and financial liabilities at fair value in the statement of financial position at the end of each reporting period.

This exception does not apply for financial statement presentation. When the basis for the presentation of financial instruments in the statement of financial position differs from the group basis for the measurement of financial instruments (e.g. if IAS 32 does not require or permit the group of financial instruments to be presented on a net basis) an entity may need to allocate the portfolio-level adjustments to the individual instruments that make up the group. That allocation should be performed on a reasonable and consistent basis using a methodology appropriate in the circumstances. [IFRS 13:50] market risks or credit risk arising from a group of financial assets and financial liabilities in specified circumstances. The portfolio exception was intended to align the valuation of financial instruments for financial reporting with an entity's internal risk management practices. In particular, the issue that was discussed by the Committee was whether an entity is:

(a) permitted to apply the portfolio exception in IFRS 13 to measure the resulting net risk exposure of a portfolio made up solely with identical Level 1 instruments; or

(b) required to measure the financial assets and the financial liabilities of such a portfolio on an individual basis, using the corresponding Level 1 prices for each financial instrument.

In its discussions, the Committee observed that, in relation to (a) above, the main question that needs to be addressed is whether an entity:

(a) would be required to measure such a net risk exposure on the basis of the Level 1 prices for the individual instruments that comprise that net risk exposure; or

(b) would be allowed to consider the net risk exposure as a whole and, consequently, consider adjusting it with any appropriate premiums or discounts.

The Committee noted that there was insufficient guidance in the Standard for it to be able to answer this question and so it decided that this issue needs to be considered by the Board. Accordingly it asked the staff to present the Interpretations Committee's concerns to the Board.

The Board also noted that this issue has similarities with the issue of the interaction between the use of Level 1 inputs and the unit of account that arises when measuring the fair value of investments in subsidiaries, joint ventures and associates (discussed above). Consequently, the Board included this issue in exposure draft ED/2014/4 *Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value* issued in September 2014. In the ED the Board included an illustrative example to illustrate the application of IFRS 13:48 to a group of financial assets and financial liabilities whose market risks are substantially the same and whose fair value measurement is categorised within Level 1 of the fair value hierarchy.

As part of the Board's redeliberations following the publication of the ED, the illustrative example was discussed by the Board in April 2015 when it decided that the example appropriately illustrates the application of IFRS 13:48. That is, if an entity elects to use the exception in IFRS 13:48, the appropriate fair value measurement

of the net risk exposure arising from a group of financial assets and financial liabilities whose market risks are substantially the same, and whose fair value measurement is categorised within Level 1 of the fair value hierarchy, would be determined by multiplying the financial instruments included in the resulting net position by the corresponding unadjusted Level 1 price.

The Board noted that the proposed illustrative example to IFRS 13 is non-authoritative, and the comments received did not reveal significant diversity in practice. Accordingly, the Board concluded that it was unnecessary to publish the proposed illustrative example in IFRS 13 as a separate document. Therefore the illustrative example is not due to be published by the Board.

The example below is taken from the staff paper that was discussed by the Board in April 2015 (agenda reference 6). It is based on the illustrative example from the ED but also includes some of the changes proposed by the staff following feedback received on the ED.

6.3

Measuring the fair value of a portfolio of Level 1 financial assets and financial liabilities with offsetting risk positions – example

Entity A holds a group of financial assets and financial liabilities consisting of a long position of 10,000 financial assets and a short position of 9,500 financial liabilities whose market risks are substantially the same. Entity A manages that group of financial assets and financial liabilities on the basis of its net exposure to market risks. The fair value measurement of all financial instruments in the group is categorised within Level 1 of the fair value hierarchy.

The bid-ask spread is CU98 to CU102, with the mid-price being CU100. The most representative bid price is CU99 and the most representative ask price is CU101.

Entity A applies the exception in IFRS 13:48 that permits Entity A to measure the fair value of the group of financial assets and financial liabilities on the basis of the price that would be received to sell, in this particular case, a net long position (i.e. an asset) for the exposure to market risks in an orderly transaction between market participants at the measurement date under current market conditions.

Since the market risks arising from the financial instruments are substantially the same, the measurement of the net exposure to market risks arising from the group of financial assets and financial liabilities coincides with the measurement of the net long position (500 financial assets). Consequently, Entity A measures the group of financial assets

7 Fair value measurement at initial recognition

7.1 Potential for difference between the transaction price and fair value at initial recognition

IFRS 9:5.1.1 requires that all financial assets and financial liabilities, except certain trade receivables, should be recognised initially on the basis of 'fair value'. The exception applies to trade receivables that do not have a significant financing component (determined in accordance with IFRS 15) that are not initially measured at fair value, rather they are initially measured at their transaction price as defined under IFRS 15.

If the asset has been acquired, or the liability assumed, in a market transaction, it might be assumed that the transaction price (i.e. the price paid to acquire an asset or received to assume a liability) can be taken to be the fair value of the asset or the liability. However, if the fair value of the financial asset or financial liability at initial recognition differs from the transaction price, an entity shall apply the day 1 P&L requirements of IFRS 9 (see **7.3**). [IFRS 9:5.1.1A & B5.1.2A]

Furthermore, the price paid to acquire an asset, or received to assume a liability, is an *entry* price and, consequently, it is not necessarily the same as the fair value of the asset or liability for IFRS 13 purposes (which is an *exit* price – see **section 3**). The Standard notes that entities do not necessarily sell assets at the prices paid to acquire them; nor do they necessarily transfer liabilities at the prices received to assume them. [IFRS 13:57]

7.2 Indicators that the transaction price differs from fair value at initial recognition

When determining whether the fair value at initial recognition equals the transaction price, an entity should take into account factors specific to the transaction and to the asset and liability. [IFRS 13:59]

In many cases the transaction price and the fair value will be equal (e.g. when the transaction date is the same as the measurement date and the asset is acquired in the market in which the asset would be sold). [IFRS 13:58] However, when the amounts are not equal, the asset or liability should be measured at fair value and the difference between the transaction price and fair value (generally referred to as a 'day 1 gain or loss', 'day 1 profit or loss' or as 'day 1 P&L') is required to be recognised as a gain or loss in profit or loss unless the relevant IFRS specifies otherwise. [IFRS 13:60] See **7.3** for the appropriate treatment of 'day 1 P&L' under IFRS 9.

IFRS 13:B4 lists a number of factors which may suggest that the transaction price is not the fair value of the asset or liability at initial recognition.

7.2-1

Indicators that the transaction price is not representative of fair value at initial recognition – examples

The following table repeats the factors listed in IFRS 13:B4 and provides examples for each. Note that this list of indicators is not exhaustive, and other factors may exist that should be considered in evaluating whether a transaction price represents fair value (see IFRS 13:BC133).

Factor (IFRS 13:B4)	Example
The transaction is between related parties, although the price in a related party transaction may be used as an input into a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms.	An entity purchases a portfolio of troubled loans from an unconsolidated investee. The parties meet the definition of related parties under IAS 24 *Related Party Disclosures*. The fact that the parties are related may indicate that the transaction price does not reflect fair value. However, this alone would not be determinative. Evidence that the transaction was entered into at market terms may include: • the appointment of third parties to negotiate or measure fair value; or • the terms of the transaction are consistent with available market data for similar transactions between unrelated parties; or • there is no evidence that one of the parties to the transaction is under duress (see the next factor).
The transaction takes place under duress or the seller is forced to accept the price in the transaction (e.g. if the seller is experiencing financial difficulty).	A hedge fund must sell all of its non-marketable assets in response to a spike in redemptions that may lead to a liquidity crisis. A liquidity crisis may be an indicator of financial difficulty. The factors in IFRS 13:B43 indicating that a transaction is not orderly (see **9.6**) may also indicate that the transaction price does not represent fair value.

An entity is required to disclose any changes in the qualitative information from the previous period. Such changes may result from changes in the entity's exposure to risk or from changes in the way in which the exposures are managed. [IFRS 7:IG17] This information is important because users of the financial statements need to understand the effect that such changes have on the nature, timing and uncertainty of future cash flows.

One of the objectives of the disclosure requirements is to enable users to evaluate an entity's ability to generate returns, and to appreciate the risks and uncertainties of those expected returns. This evaluation can only be meaningful if it is carried out in the context of the entity's risk management policies.

5.2 Quantitative disclosures

For each type of risk arising from financial instruments, IFRS 7 requires an entity to provide quantitative information about exposure to that risk at the end of the reporting period, based on information reported internally to key management personnel. [IFRS 7:34(a)] If more than one method is used to manage and report information about risk exposures, then the method that provides the most relevant and reliable information should be disclosed. [IFRS 7:B7] The advantages of basing disclosures on management information are that such disclosures: [IFRS 7:BC47]

- provide a useful insight into how risk is viewed and managed by the entity;
- are based on information that has a more predictive value than information based on assumptions and methods that management does not use; and
- adapt to changes in the manner in which risk is measured and managed and allows users to use the same data that management uses to measure and manage risk.

Key management personnel are defined as "those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity". [IAS 24:9]

5.2-1

Definition of 'key management personnel'

Following the definition, any director, whether executive or non-executive, will be considered to be key management personnel. The definition of key management personnel is, however, wider than just directors of an entity. Key management personnel might, in some instances, include directors of subsidiaries who are not directors of the parent entity and senior managers who are not directors. Other managers may be included as key management personnel in some circumstances, and not in others. Consideration needs to be given to the relative autonomy of management and whether their decisions are subject to the approval of the board of directors. For example, a Treasury Manager in an organisation may unilaterally review exposures and act independently following only guidelines and objectives established by the board of directors. In such circumstances, the Treasury Manager may be considered to be part of the key management personnel of that entity. In contrast, if the Treasury Manager operates purely in accordance with detailed treasury risk policies set out and approved by the board of directors, then that person is more likely to be excluded from the definition of key management personnel. In order to arrive at an appropriate determination, it is always necessary to obtain a thorough understanding of the manager's role within the organisation and the extent of his or her authority.

In addition to the disclosures under IFRS 7:34(a) (see above), which are based on information provided to key management personnel, IFRS 7:34(b) requires disclosures regarding credit, liquidity and market risk to the extent that these are not covered by the disclosures under IFRS 7:34(a) (see **5.2.1** to **5.2.3**).

Disclosures regarding concentrations of risk are also required to be provided if not apparent from the disclosures provided in accordance with IFRS 7:34(a) and (b). [IFRS 7:34(c)] Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgement and must take into account the specific circumstances of the entity. Disclosures may include: [IFRS 7:B8]

- a description of how management determines concentrations;
- a description of the shared characteristic that identifies each concentration (e.g. counterparty credit rating, geographical distribution, industry sector and other risks such as liquidity and market risks); and
- the amount of the risk exposure associated with all financial instruments that share that risk characteristic.

In all circumstances, the quantitative information should be provided for the risk exposures that exist at the end of the reporting period. When such information is unrepresentative of the exposure to financial risk during the period, an entity should provide additional information, which may include, but not be limited to, disclosure of the highest, lowest and average amount of risk the entity was exposed to during the period. For example, if an entity typically has a large exposure to a particular currency, but at year-end unwinds the position, the entity might disclose a graph that shows the exposure at various times during the period, or disclose the highest, lowest and average exposures. [IFRS 7:IG20]

5.2.1 Credit risk

Credit risk is defined 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". [IFRS 7:Appendix A] IFRS 7 disclosure requirements regarding credit risk are substantial and are discussed in detail below.

When applying the IFRS 9 impairment model there are many judgements for management to take. For example, a key judgement is how to determine when there has been a significant increase in credit risk. This is an important judgement because it determines when an allowance for lifetime expected losses should be recognised instead of 12-month expected losses. Other judgements include an entity's definition of default and determination of low credit risk; both of which can have a significant effect on the recognition and measurement of expected losses. Furthermore, any measurement of expected losses is inherently subjective because it uses forward-looking information, management assumptions and estimates and entity specific inputs, all of which can give rise to measurement uncertainty. The methods and approaches used to determine expected losses will also vary amongst entities depending, in part, on their approach to risk management but also due to availability of information without undue cost and effort (see **5.3.5** in **chapter B6**).

Given all of these factors influencing the application of the IFRS 9 impairment model, it is no surprise that IFRS 7 requires in-depth disclosures about *how* an entity has applied the model, *what* the results of applying the model have been for each class of financial instrument, and the reasons *why* for any changes in expected losses.

5.2.1.1 Scope and objective

The IFRS 7 credit risk disclosures are designed to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. This is achieved by requiring disclosures in the following three areas for financial instruments to which the IFRS 9 impairment requirements are applied (see **5.1** in **chapter B6**): [IFRS 7:35B]

- **credit risk management practices** – requiring information on some of the key judgements, inputs, assumptions and estimation techniques used to apply the IFRS 9 impairment model and in essence explains *how* the entity has applied the model (see **5.2.1.2**);
- **quantitative and qualitative information about amounts arising from expected credit losses** – requiring a detailed reconciliation of changes in the loss allowance by class, with a number of specific requirements, in essence explaining *what* the results of applying the model were, supplemented by narrative explaining *why* the results were as they were (i.e. giving cause and effect analysis) (see **5.2.1.3**); and

- **credit risk exposures** – requiring information about the entity's exposure to credit risk and significant credit risk concentrations (see **5.2.1.4**).

Those disclosures are required for all financial instruments to which the impairment requirements in IFRS 9 are applied. However: [IFRS 7:35A]

- IFRS 7:35J(a) applies for trade receivables, contract assets and lease receivables on which lifetime expected credit losses are recognised in accordance with IFRS 9:5.5.15, if those financial assets are modified while more than 30 days past due; and
- IFRS 7:35K(b) does not apply to lease receivables.

When providing the above disclosures consideration should be given as to: [IFRS 7:35D]

- how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements;
- the appropriate level of aggregation or disaggregation; and
- whether users of financial statements need additional explanations to evaluate the quantitative information disclosed.

If the specific credit risk disclosures required by IFRS 7 (see **5.2.1.2** to **5.2.1.7**) are insufficient to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows, an entity is required to disclose additional information as necessary. [IFRS 7:35E]

As with other IFRS 7 disclosures, credit risk information may be disclosed outside the notes to the financial statements as long as there is cross-reference from the financial statements to other statements, such as a management commentary or risk report that are available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete. [IFRS 7:35C]

IFRS 7 also requires some disclosures about credit exposures not in scope of the IFRS 9 impairment requirements, see **5.2.1.5** and **5.2.1.6**.

5.2.1.2 Credit risk management practices

An explanation of an entity's credit risk management practices, including how they relate to the recognition and measurement of expected credit losses, is a key component of the credit risk disclosures. IFRS 7 specifically requires the disclosure of information that enables users of financial statements to understand and evaluate: [IFRS 7:35F]

(a) how an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how:

(c) changes in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

An entity's assumptions and inputs used to measure expected credit losses or determine the extent of increases in credit risk since initial recognition may include information obtained from internal historical information or rating reports and assumptions about the expected life of financial instruments and the timing of the sale of collateral. [IFRS 7:B8C]

5.2.1.3 *Quantitative and qualitative information about amounts arising from expected credit losses*

From period to period the amount of the loss allowance could vary for a variety of reasons. For example, it could go up because of an increase in lending activity or because of an increase in credit risk on existing lending; or they could go down because of write-offs or sales, or a reduction in credit risk on existing lending. Each of these different reasons has important information value and therefore IFRS 7 requires an explanation of the changes in the loss allowance and the reasons for those changes. In particular it requires a reconciliation from the opening balance to the closing balance of the loss allowance, by class of financial instrument in a table, showing separately the changes during the period for: [IFRS 7:35H]

(a) the loss allowance measured at an amount equal to 12-month expected credit losses;

(b) the loss allowance measured at an amount equal to lifetime expected credit losses for:

  (i) financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;

  (ii) financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and

  (iii) trade receivables, contract assets or lease receivables for which the loss allowance is measured at an amount equal to lifetime expected losses using the simplified approach (see **5.2.5.2** in **chapter B6**);

5.2.1.3-1

Assessing for significant increases in credit risk for financial assets with a maturity of less than 12 months

IFRS 9 requires an assessment of significant increases in credit risk for financial instruments irrespective of whether the maturity is 12 months or less. Even though in some cases the measurement

of expected credit losses may be the same whether credit risk has increased significantly or not, the assessment of significant increase in credit risk is distinct from the measurement of expected credit losses. Knowing whether a financial instrument's credit risk has significantly increased is relevant information given assessing changes in credit risk would generally be consistent with risk management practices and the expected life of a financial instrument may change if it has suffered a significant increase in credit risk.

Furthermore, IFRS 7:35H and 35M require disclosures that distinguish between assets for which the loss allowance is equal to 12-month expected credit losses and assets for which the loss allowance is equal to lifetime expected credit losses. Therefore, it is necessary for disclosure purposes that an entity assesses significant increases in credit risk on its loan assets.

The disclosures in IFRS 7 are required to provide users with information about the credit quality of loan assets held and subject to the IFRS 9 impairment requirements. The separate disclosure is relevant because it distinguishes between those assets on which there has been a significant increase in credit risk and those on which there has not. Credit risk information assists users to understand an entity's exposure to credit risk, regardless of whether the asset matures in more or less than 12 months. Because of the credit deterioration, the measurement of expected credit losses for assets with a significant increase in credit risk would be expected to be higher than the measurement of expected credit losses before a significant increase in credit risk. Consequently, identifying assets that have exhibited a significant increase in credit risk separately provides relevant credit risk information.

Note that for some financial assets (i.e. purchased or originated credit-impaired financial assets (see IFRS 9:5.5.13 and 5.5.14) and financial assets for which the simplified approach is applied (see IFRS 9:5.5.15 and 5.5.16)), it is not required to track significant increases in credit risk to meet the disclosure requirements of IFRS 7. The simplified approach is not applicable for short-term loans.

The following example illustrates this issue.

Example

Entity A originates loan assets with terms of less than 12 months. The assets are not originated credit-impaired.

In accordance with IFRS 9:5.5.3, if, at the reporting date, the credit risk on a loan asset has increased significantly since initial

Mortgage loans – loss allowance	12-month expected credit losses	Lifetime expected credit losses (collectively assessed)	Lifetime expected credit losses (individually assessed)	Credit-impaired financial assets (lifetime expected credit losses)
New financial assets originated or purchased	X	–	–	–
Write-offs	–	–	(X)	(X)
Changes in models/ risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31 December	**X**	**X**	**X**	**X**

Significant changes in the gross carrying amount of mortgage loans that contributed to changes in the loss allowance were:

- The acquisition of the ABC prime mortgage portfolio increased the residential mortgage book by x per cent, with a corresponding increase in the loss allowance measured on a 12-month basis.
- The write-off of the CUXX DEF portfolio following the collapse of the local market reduced the loss allowance for financial assets with objective evidence of impairment by CUX.
- The expected increase in unemployment in the Region X caused a net increase in financial assets whose loss allowance is equal to lifetime expected credit losses and drove a net increase of CUX in the lifetime expected credit losses allowance.

To supplement the reconciliation of the loss allowance, IFRS 7 requires an explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance. The information, both qualitative and quantitative, should be provided separately for financial instruments that represent the loss allowance listed in IFRS 7:35H(a) to (c) (see above).

Examples of changes in the gross carrying amount of financial instruments that contributed to the changes in the loss allowance may include: [IFRS 7:35I]

(a) changes because of financial instruments originated or acquired during the reporting period;

(b) the modification of contractual cash flows on financial assets that do not result in a derecognition of those financial assets in accordance with IFRS 9;

(c) changes because of financial instruments that were derecognised or written-off during the reporting period; and

(d) changes arising from whether the loss allowance is measured at an amount equal to 12-month or lifetime expected credit losses.

IFRS 7:35I(d) refers to changes arising from whether the loss allowance is measured at an amount equal to 12-month or lifetime expected losses. It should be noted that moving between 12-month and lifetime expected losses does not give rise to a change in the gross carrying amount for the particular asset (i.e. the gross amount of the asset remains the same and only the loss allowance changes). However, moving between 12-month and lifetime expected losses changes the proportion of the gross amounts that are subject to 12-month or lifetime expected losses.

5.2.1.3-2 Disclosure of the gross carrying amount for financial assets measured at fair value through other comprehensive income under IFRS 9:4.1.2A

The disclosures provided regarding the gross carrying amount of financial assets should include financial assets measured at fair value through other comprehensive income (FVTOCI) under IFRS 9:4.1.2A (i.e. debt instruments measured at FVTOCI). As explained at **4.1.8-1**, the disclosures required under IFRS 7:35F to 35N apply equally to financial assets measured at FVTOCI in accordance with IFRS 9:4.1.2A. Information regarding gross carrying amount is equally relevant for financial assets in the scope of the impairment requirements irrespective of whether they are classified as at amortised cost or FVTOCI.

Example 5.2.1.3B

Changes in gross carrying amount

[Extract from IFRS 7:IG20B]

The following example illustrates one way of providing information about the significant changes in the gross carrying amount of financial assets during the period that contributed to changes in the loss allowance. This example does not illustrate the requirements for financial assets that are purchased or originated credit-impaired.

Mortgage loans – gross carrying amount	12-month expected credit losses	Lifetime expected credit losses (collectively assessed)	Lifetime expected credit losses (individually assessed)	Credit-impaired financial assets (lifetime expected credit losses)
CU'000				
Gross carrying amount as at 1 January	X	X	X	X
Individual financial assets transferred to lifetime expected credit losses	(X)	–	X	–
Individual financial assets transferred to credit-impaired financial assets	(X)	–	(X)	X
Individual financial assets transferred from credit-impaired financial assets	X	–	X	(X)
Financial assets assessed on collective basis	(X)	X	–	–
New financial assets originated or purchased	X	–	–	–
Write-offs	–	–	(X)	(X)
Financial assets that have been derecognised	(X)	(X)	(X)	(X)
Changes due to modifications that did not result in derecognition	(X)	–	(X)	(X)
Other changes	X	X	X	X
Gross carrying amount as at 31 December	X	X	X	X

Because the allowance for expected losses is derived from the difference between all the contractual cash flows that are due and the contractual cash flows expected to be received, a modification of a financial asset which

does not result in derecognition can give rise to a change in the amount of the loss allowance. Furthermore, a modification could change the credit risk of a financial asset such that the loss allowance is measured on a different basis (e.g. moving from lifetime to 12-month expected losses). Consequently, IFRS 7 requires disclosures on the nature and effect of modifications and how they affect the measurement of expected credit losses. These disclosures cover all modifications that have not resulted in derecognition of the financial asset and not only those that arise from financial difficulty of the borrower. The following disclosures are required: [IFRS 7:35J]

(a) the amortised cost before the modification and the net modification gain or loss recognised for financial assets for which the contractual cash flows have been modified during the reporting period while they had a loss allowance measured at an amount equal to lifetime expected credit losses; and

(b) the gross carrying amount at the end of the reporting period of financial assets that have been modified since initial recognition at a time when the loss allowance was measured at an amount equal to lifetime expected credit losses and for which the loss allowance has changed during the reporting period to an amount equal to 12-month expected credit losses.

When lifetime expected credit losses are recognised for trade receivables, contract assets (under IFRS 15) and lease receivables using the simplified approach (see **5.2.5.2** in **chapter B6**) and those assets are modified while more than 30 days past due, the disclosures in paragraph (a) immediately above applies to those assets. [IFRS 7:35A(a)]

5.2.1.3-3

Lifetime expected loss disclosures for modified financial assets

The disclosures in IFRS 7:35J specifically apply to assets which had a lifetime expected loss allowance when they were modified. This would appear to exclude purchase or originated credit-impaired financial assets which have a loss allowance measured at an amount equal to the *change* in lifetime expected losses since initial recognition (see **5.2.5.3** in **chapter B6**). This is reasonable given IFRS 7:35J(b) refers to a 12-month expected loss provision which is not relevant for purchased credit-impaired financial assets. However, the information required by IFRS 7:35J(a) would appear to be equally relevant for purchased or originated credit-impaired financial assets. Consequently, an entity should consider whether this information should be provided for purchased or originated credit-impaired financial assets in order to meet the credit risk disclosure objectives (see **5.2.1.1**).

For a financial asset measured at FVTOCI, the loan loss allowance is the same as if the asset was measured at amortised cost, except