IFRS 9: Classification of Financial Assets

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The Group considered the following fact patterns related to classification and measurement of financial assets under IFRS 9 *Financial Instruments*.

Fact Pattern 1

Entity A has already adopted IFRS 9 (2014) to account for its financial instruments. Entity A acquires an investment in a financial asset whose contractual cash flows are considered to be solely payments of principal and interest as set out in IFRS 9 on initial recognition of the instrument. The instrument is held in a business model that is either "held to collect contractual cash flows" or "held to collect and sell" under IFRS 9. On initial recognition, the instrument qualifies to be recognized at amortized cost or at fair value through other comprehensive income (FVOCI).

After initial recognition, some of the terms of the financial asset are changed. There are no changes in the business model.

Issue 1: What are some approaches that an entity can use to determine whether a modification of a financial asset giving rise to a new instrument has occurred?

It is important to determine whether a modification has occurred because it can have implications on the classification and measurement of the new instrument, and the recognition of the related impairment. Paragraphs B5.5.25 and B5.5.26 of IFRS 9 provides guidance related to modifications in the context of impairment.

View 1A – An entity could perform a quantitative assessment.

Analogizing to the guidance on derecognition of financial liabilities, an entity could perform a quantitative analysis similar to the 10 per cent test described in paragraph B3.3.6 of IFRS 9.

A modification of a financial asset that breached the 10 per cent test should always result in the recognition of a new financial asset.

View 1B – An entity could develop an accounting policy that considers both quantitative and qualitative factors in the assessment.

An entity should consider the nature of any quantitative and qualitative factors that could have given rise to the new financial asset.

The Group's Discussion

The Group members agreed that both the quantitative and qualitative factors should be considered. In completing the assessment, Group members noted that in the absence of guidance, analogizing to the most relevant piece of accounting literature might be appropriate. One Group member commented that consideration would need to be given to the full model and not only components of the model when analogizing to other guidance. In this circumstance, that literature would be relating to financial liabilities and the 10 per cent test in paragraph B3.3.6 of IFRS 9. Within that guidance, there is a requirement to look at qualitative factors in addition the quantitative factors. One Group member commented that an entity cannot qualitatively overcome a breach of the 10 per cent test but the entity would also need to consider all qualitative factors (e.g., due to a change in currency, addition of new security). Some of these factors might signify a modification.

Another Group member noted that an entity that has a large amount of small retail loans, for example, might perform the qualitative test prior to the quantitative test for practical reasons.

Fact Pattern 2

An entity has a loan receivable outstanding as at January 1, 2018. The terms of the loan receivable were modified in 2016. Under its previous accounting policies applying IAS 39 *Financial Instruments: Recognition and Measurement*, the entity did not derecognize the modified loan receivable and recognize a new financial asset. However, under its accounting policy for assessing modifications of financial assets applying IFRS 9, the 2016 modification of the loan receivable would result in the conclusion that the original loan receivable should be derecognized and a new loan receivable recognized.

Issue 2: Is consideration of modifications of financial assets before the date of initial application of IFRS 9 relevant at the entity's transition to IFRS 9?

View 2A – Yes.

IFRS 9 is to be applied retrospectively, although prior periods need not be restated. As a result, the entity's new IFRS 9 accounting policies should be applied to the 2016 modification of the loan receivable.

Therefore, the 2016 modification date will be considered to be the inception of the instrument for purposes of assessing whether the loan's cash flows are solely payments of principal and interest. The 2016 modification date will also be considered as the inception date of the instrument for assessing whether the increase in the loan's credit risk is significant as at the date of initial application of IFRS 9.

View 2B – No.

IAS 39 did not deal explicitly with modifications of financial assets and the entity's prior policies were appropriate under that standard. The entity should rely on its prior assessment that the 2016 modification did not give rise to a new financial asset.

View 2C – Either Yes or No.

The transitional requirements of IFRS 9 are not clear on this point and either View 2A or View 2B would be acceptable, as long as the approach selected is applied consistently to all previously modified financial assets outstanding at January 1, 2018.

The Group's Discussion

Group members agreed that conceptually IFRS 9 requires full retrospective application for assessing whether a financial asset meets the solely payments of principal and interest condition. In this scenario, an entity would need to apply its new policy retrospectively to assess whether a financial asset modification results in derecognition of the original financial asset and the recognition of a new financial asset that has been modified before the date of initial application of IFRS 9. However, in many circumstances, retrospective application for large pools of financial assets might be impracticable and require the use of hindsight, which is not permitted in retrospective applications.

Fact Pattern 3

Paragraph B4.1.20 of IFRS 9 presents the concept of a "contractually linked" instrument as follows:

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

When a financial asset is contractually linked under IFRS 9, there are criteria that need to be met in order for the financial asset to be considered to have contractual cash flows that are solely payments of principal and interest. For example, Entity A holds a loan receivable from Entity B and this financial asset is considered to be a contractually linked instrument under IFRS 9. In order for Entity A to consider the loan receivable to have contractual cash flows that are solely payments of principal and interest, Entity B would have to hold only financial assets that themselves give rise to contractual cash flows that are solely payments of principal and interest.

Issue 3: Presume Entity B has issued senior debt and that the loan receivable held by Entity A is the most subordinate of Entity B's debt. Does the contractually linked guidance in IFRS 9 apply to the subordinated loan receivable held by Entity A?

View 3A– Yes.

The subordination of Entity A's loan receivable specifies the order of allocation of cash flows to Entity A and the other lenders as contemplated by paragraph B4.1.20 of IFRS 9.

View 3B – No.

Entity A has the legal right to be paid interest and principal on the loan receivable. Entity A's claim related to its loan receivable may be limited to specified assets of Entity B. This may be considered to be a "non-recourse" financial asset in IFRS 9. Paragraph B4.1.17 provides the following guidance:

> "However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the condition in paragraphs 4.1.2(b) and

4.1.2A(b). In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b). Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment."

This guidance is not as restrictive as that for contractually linked instruments because the non-recourse guidance does not specify that the assets of Entity B would need to be financial assets whose cash flows are solely payments of principal and interest.

The Group's Discussion

Group members observed that the single fact that subordination exists within a normal lending relationship between an operating entity and a lender does not cause an entity to have to consider the contractually linked guidance. The entity should also consider the non-recourse guidance.

Group members noted that careful consideration of the terms and conditions, in particular for subordinated financings, how cash flows would work and whether there is leverage, is needed.

One Group member also pointed out that the guidance within IFRS 9 on contractually linked instruments deals with fenced in pools of assets, which are typically in more structured entities, not in lending arrangements with operating entities. The guidance in IFRS 9 draws the distinction that if the borrower is an operating entity, it is most likely not within the contractually linked guidance. However, if the borrower is a structured entity, it needs to think about the contractually linked guidance when there is more than one tranche. In an operating entity, there might be commercial reasons why the entity has subordination or senior tranches.

Another Group member cautioned that subordination can exist in complex instruments and arrangements. All relevant facts and circumstances need to be considered before determining that the contractually linked guidance does not apply.

A Group member noted another factor to consider is the right to sue for failure to pay the amounts otherwise due, which can include more than the cash in the entity.

Fact Pattern 4

Entity C holds an investment in shares of Entity D. Holders of these shares can put them back to Entity D and receive a cash payment equal to the net asset value per share of Entity D, which is determined based on the fair value of the net assets of Entity D.

Entity D classifies these shares as equity. The notes to Entity D's financial statements explain that the shares are classified as equity because they met the special conditions for equity classification set out in paragraphs 16A and 16B of IAS 32 *Financial Instruments: Presentation*, which relate to puttable instruments.

Issue 4: How should Entity C classify its investment in Entity D's shares under IFRS 9?

View 4A – Classify at fair value through profit or loss (FVTPL) with the option to irrevocably elect to classify at FVOCI.

Entity D's shares are legal form equity instruments classified as equity in Entity D's financial statements. Therefore, Entity C's investment is an investment in an equity instrument that would be recorded at FVTPL under IFRS 9. However, Entity C could make an irrevocable election under IFRS 9 to classify the investment in Entity D's shares at FVOCI, presuming that this investment is not held for trading by Entity C.

View 4B – Classify at FVTPL only.

Paragraph BC5.21 in the Basis for Conclusions of IFRS 9 is relevant to this issue.

> "IFRS 9 permits an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading. The term 'equity instrument' is defined in IAS 32 *Financial Instruments: Presentation*. The IASB noted that in particular circumstances a puttable instrument (or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) is classified as equity. However, the IASB noted that such instruments do not meet the definition of an equity instrument."

The IFRS Interpretations Committee reinforced this guidance in its agenda decision on this topic released in September 2017.

As a result, Entity C would not be able to classify its investment in Entity D's shares at FVOCI. If Entity C puts the shares to Entity D, Entity D must redeem them for an amount based on the fair value per share of its assets. Entity C would conclude that this settlement amount is not consistent with a normal lending arrangement and causes the instrument to fail the "solely payments of principal and interest" conditions in IFRS 9. As a result, the investment in Entity D's puttable shares would be recorded at FVTPL.

The Group's Discussion

Group members observed that the classification exception does not override the conclusion that a puttable equity instrument is a financial liability and is not eligible for the FVOCI election that is available for investments in equity instruments.

Overall, the Group's discussion of these four fact patterns raises awareness in applying some of the principles related to classification and measurement of financial assets in IFRS 9. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).