
In depth

A look at current financial reporting issues

IFRS 9: What's new in financial instruments accounting for asset management

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At a glance

On 24 July 2014 the IASB published the complete version of IFRS 9, 'Financial Instruments', which replaces most of the guidance in IAS 39. IFRS 9 addresses all of the relevant aspects of the accounting for financial instruments, including classification and measurement, impairment of financial assets and general hedge accounting.

IFRS 9 includes amended guidance for the classification and measurement of financial assets, sets out a new impairment model (which will result in earlier recognition of losses), and aligns hedge accounting more closely with risk management. No changes were introduced to the scope of the standard and for the classification and measurement of financial liabilities, except for the recognition of changes in own credit risk in other comprehensive income for liabilities designated at fair value through profit or loss.

IFRS 9 will be effective for annual periods beginning on or after 1 January 2018, subject to endorsement in certain territories.

This publication focuses on the new guidance in IFRS 9 and the questions that might arise when applying it to financial instruments held by investment funds, private equity funds and real estate funds, as well as to investments in an investment fund held by an investor. The main areas covered in this publication relate to the classification and measurement of financial assets. Further guidance on the new impairment model is included in our publication 'In depth – IFRS 9: Expected credit losses'. The general hedging model is covered in the 'General hedge accounting Practical guide' and explained in more detail in the publication 'IFRS 9: Hedging in practice – Frequently asked questions'. See page 32 for further useful publications.

This document is not meant to be prescriptive, but is aimed at providing guidance on how the requirements of IFRS 9 could be applied under different scenarios. This publication is not a substitute for reading the standards and interpretations themselves or for professional judgement as to fairness of presentation. It does not cover all possible requirements and issues arising while applying the new provisions, nor does it take account of any specific legal framework. Further specific information might be required in order to ensure fair presentation under IFRS.

Background

On 24 July 2014 a complete version of IFRS 9, 'Financial Instruments', was issued. IFRS 9 will replace IAS 39 in its entirety. The new standard is applicable for annual periods beginning on or after 1 January 2018. Earlier application is permitted.

The objective of IFRS 9, 'Financial Instruments'

IFRS 9 sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy and sell non-financial items. The objective of the standard is to establish principles for the financial reporting of financial assets and financial liabilities that provide users of financial statements with relevant and useful information for their assessment of the amounts, timing and uncertainty of an entity's future cash flows. [IFRS 9 para 1.1].

Reflecting the IASB's view that the requirements for classification and measurement are the foundation of a standard on accounting for financial instruments, IFRS 9 builds on a principle-based classification model, which considers the business model for managing the financial assets and the financial asset's contractual cash flow characteristics. [IFRS 9 paras IN6(a) and IN7].

The impairment requirements under IFRS 9 are based on a forward-looking model that is applied to all financial instruments that are subject to impairment accounting. Under this approach, it is no longer necessary for a credit event to have occurred before credit losses are recognised, because it requires an entity to recognise expected credit losses and changes in those expected credit losses on its financial assets and commitments to extend credit. [IFRS 9 paras IN6(b) and IN9]. Specifically, IFRS 9 requires an entity to base the measurement of expected credit losses on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information. Hence, entities are required to consider broader information when determining expectations of credit losses. [IFRS 9 para 5.5.17].

The treatment of financial liabilities is carried forward essentially unchanged from IAS 39 to IFRS 9. Consequently, most financial liabilities will continue to be measured at amortised cost. However, IFRS 9 also includes the fair value option known from IAS 39, which permits entities to elect to measure financial liabilities at fair value through profit or loss if particular criteria are met. To address the so-called 'own credit issue' – which leads to counterintuitive effects where an entity's own credit risk changes – IFRS 9 requires changes in the fair value of an entity's own credit risk to be considered in other comprehensive income. [IFRS 9 para 5.7.7].

This publication focuses on questions and answers relating to the application of IFRS 9 for investment funds, private equity funds and real estate funds, as well as for asset managers and investors in investment fund structures.

Where to look for additional information

There are several publications available that cover the provisions of IFRS 9. Please refer to page 29 for a list of available publications or visit the website: <https://inform.pwc.com/>.

PwC's IFRS Manual of accounting provides expert interpretation and practical guidance on the IFRSs issued by the International Accounting Standards Board (IASB).

Scope of IFRS 9

IFRS 9 applies to all entities and to all types of financial instruments, and thus to investment funds as well. However, paragraph 2.1 of IFRS 9 outlines some exceptions to the general principle. Overall, there are no changes to the principles already applicable under IAS 39.

Q.A1 Interest in an investment fund that is controlled by another entity

Company A has determined that it controls Fund B in accordance with IFRS 10.

Does IFRS 9 apply to an interest in an investment fund that is controlled by the entity in accordance with IFRS 10?

It depends. If company A (parent company) meets the definition of an investment entity, investments in an investment fund are accounted for in accordance with IFRS 9. However, if company A does not meet the definition of an investment entity, the interest in a subsidiary is exempt from applying IFRS 9 in its separate financial statements. [IFRS 9 para 2.1(a)].

Q.A2 Amounts attributable to investors puttable at the discretion of the investor – fund's perspective

Fund B issues redeemable participating units that are redeemable at the investor's discretion at any time.

Should an investment fund with puttable instruments apply IFRS 9 to the amounts attributable to investors?

It depends. If the puttable instruments issued by the investment fund meet the requirements in paragraphs 16A to 16B of IAS 32, the amounts attributable to investors are equity. However, if the puttable instruments do not meet the requirements in paragraphs 16A to 16B of IAS 32, the amounts attributable to investors are presented as financial liability, and thus IFRS 9 applies. [IFRS 9 para 2.1(d)].

Note that the same applies to closed-ended funds that meet the requirements in paragraphs 16C to 16D of IAS 32.

Where to look for additional information

The publication 'A practical guide for investment funds on IAS 32 amendments' addresses the questions that arise in applying the amendments to IAS 32 and IAS 1, 'Puttable financial instruments and obligations arising on liquidation'.

A practical guide for investment funds on IAS 32 amendments (issued December 2013)

(<https://inform.pwc.com/inform2/show?action=informContent&id=0901184602191771>)

Q.A3 Investor in an investment fund with instruments that are puttable at the discretion of the investor – investor's perspective

Company A holds an investment in fund B. Fund B issues redeemable participating units that are redeemable at the investors' discretion at any time. However, the

amounts attributable to investors are presented as equity in fund B's financial statements, because the puttable instruments issued by the fund meet the requirements in paragraphs 16A to 16B of IAS 32.

Should an investor in an investment fund with puttable instruments, which meet the requirements in paragraphs 16A to 16B of IAS 32 to be presented as equity in the investment fund's financial statements and thus would be exempt from IFRS 9, apply IFRS 9 to its investment in the fund?

Yes. The holder of such an investment in a fund is required to apply IFRS 9 in its entirety to the investment, unless the investment fund is a subsidiary, associate or joint venture. [IFRS 9 para 2.1(d)].

Note that the same applies to closed-ended funds that meet the requirements in paragraphs 16C to 16D of IAS 32.

Q.A Accounting for uncalled 'capital' commitments – investor's perspective

Asset manager M is in the process of launching fund B, which has a maturity of 10 years. The legal form of fund B is that of a limited partnership. The partnership's 'capital', paid in by the limited partners after inception of the fund, will be accounted for as a financial liability in accordance with paragraph 18(b) of IAS 32.

During the commitment period, the limited partners commit themselves to invest into the fund. The commitments are signed on the following terms:

'At inception of the fund, the investor has to pay 0.02% of the total commitment as a first instalment. After that, asset manager M has the right to call the moneys at any time at its own discretion, if a new investment in line with the investment objectives has been identified. Asset manager M is not required to call the entire commitment during the life of the fund, and can therefore release some commitments at an early stage ...'

Should an investor into fund B account for the undrawn 'capital' commitments as a financial liability?

Because asset manager M has not identified an investment which is in line with the investment objectives of the fund, no financial liability exists.

If asset manager M were to call the moneys before having identified an eligible investment, the investor could refuse to pay the moneys in, so that, at inception, the fund would not have an enforceable right to receive cash and no financial liability should be recognised by the investor. The investor should start to recognise a financial liability from the date when the fund has the right to call the money (for example, an investment is identified) and the amounts are called.

The uncalled capital commitments are to be accounted for as a loan commitment. Loan commitments are, in general, not to be accounted for as a financial liability, unless they are loan commitments specifically within the scope of IFRS 9. [IFRS 9 paras 2.1(g) and 2.3]. This might be the case if the commitment to provide capital to the fund is designated as at FVTPL in accordance with paragraph 4.2.2 of IFRS 9. However, the investor applies the impairment rules of IFRS 9 to the capital commitment. [IFRS 9 para 2.1(g)].

Loan commitments within the scope of IFRS 9

The following loan commitments are within the scope of IFRS 9:

- *Loan commitments that the entity designates as financial liabilities at fair value through profit or loss in accordance with paragraph 4.2.2 of IFRS 9. An entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination should apply IFRS 9 to all of its loan commitments in the same class.*
- *Loan commitments that can be settled net in cash or by delivering or issuing another financial instrument. These loan commitments are derivatives. A loan commitment is not regarded as settled net merely because the loan is paid out in instalments.*
- *Commitments to provide a loan at a below-market rate. [IFRS 9 para 2.3].*

Q.A5 Accounting for uncalled 'capital' commitments where fund issues debt instruments – fund's perspective

Same fact pattern as Q.A4, with the following addition: the fund classifies the amounts attributable to investors as other liabilities.

Should the fund account for the undrawn 'capital' commitments as amounts attributable to investors, with a corresponding financial asset?

No. Uncalled capital commitments are not recognised as a financial asset unless the fund would have an unconditional right to receive cash or another financial asset from the investors. Although there is a past event which gives the fund the right to make a future call which the fund controls, there is no financial asset, because the contractual right does not give rise to a financial liability of the other party (that is, the investor – see Q.A4 for further details).

The fund accounts for the capital commitments as loan commitments.

Q.A6 Asset management fees that can be paid in units of a fund

Asset manager M provides asset management services to fund B under an investment management agreement with the fund. Asset manager M is entitled to a performance fee, comprising 15% of the amount by which the fund's benchmark is exceeded. Fund B issues non-puttable units that are traded on an exchange and which contain no obligation for fund B to pay cash or transfer other financial assets to the unit holders. Accordingly, fund B units in issue are equity instruments in accordance with paragraph 11 of IAS 32.

At year end, the fund's net asset value exceeds the benchmark. The agreement allows fund B to choose between a cash settlement and a settlement in the fund's own units that equals the cash value. The decision to pay cash or to settle in equity instruments is in the sole discretion of fund B.

Is the arrangement with asset manager M within the scope of IFRS 9 from the fund's perspective?

No. The fund has entered into a share-based payment. Fund B is receiving investment management services, in return for which asset manager M is entitled to equity instrument of fund B. [IFRS 2 App A].

Share-based payment arrangements are exempt from the scope of IFRS 9. [IFRS 9 para 2.1(h)].

Q.A Asset management fees that can be paid in units of a fund when units in issue are presented as equity instruments

Same fact pattern as Q.A6, with the exception that the fund units in issue are presented as equity instruments in accordance with paragraphs 16A to 16B of IAS 32.

Is the arrangement with asset manager M exempt from the scope of IFRS 9, due to the share-based payment exception?

No. The fund has entered into an agreement that is not exempt from IFRS 9. Arrangements that are presented as equity (but are not equity within the meaning of para 11 of IAS 32) are not subject to the share-based payment provisions of IFRS 2, because the fund units are not considered equity for the purpose of IFRS 2. [IAS 32 para 96C].

PwC Observation

For an arrangement to be within the scope of IFRS 2, the fund units need to be equity instruments in accordance with paragraph 11 of IAS 32. Thus, fund units that are presented as equity instruments in accordance with paragraphs 16A to 16D of IAS 32 are not equity instruments in accordance with IFRS 2. [IAS 32 para 96C]. Therefore an agreement that gives an asset manager the right to receive units of the fund in return for the investment service provided is not outside the scope of IFRS 9.

Classification of financial instruments and subsequent measurement

The principle

Financial instruments are **recognised initially** at fair value, including transaction costs in the case of a financial asset or financial liability not at fair value through profit or loss. [IFRS 9 para 5.1.1].

After initial recognition, an entity measures a financial asset either at amortised cost or at its fair value. [IFRS 9 para 5.2.1]. A financial asset is measured at fair value through profit or loss (FVTPL), unless it is measured at amortised cost or at fair value through other comprehensive income (FVOCI). [IFRS 9 para 4.1.4].

An entity classifies financial assets as subsequently measured at amortised cost, FVOCI or FVTPL on the basis of both:

- (a) the entity's business model for managing the financial assets; and
- (b) the contractual cash flow characteristics of the financial asset. [IFRS 9 para 4.1.1].

(a) Business model test

Financial assets are classified based on the objective of the business model as determined by the entity's key management personnel for the respective portfolio [IFRS 9 para B4.1.1].

The entity's business model does not depend on management's intention for an individual financial asset. Accordingly, this is not an instrument-by-instrument approach and thus the business model needs to be determined on a higher level of aggregation, which however, does not have to be the reporting entity level [IFRS 9 para B4.1.2].

Thus, IFRS 9 para B4.1.1(b) requires an entity to classify its financial asset on the basis of its contractual cash flow characteristics if the financial assets are held within the business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, unless the option in IFRS 9 para 4.1.5 applies [IFRS 9 para B4.1.7].

(b) SPPI test

The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding. For this purpose, interest is the consideration of:

- the time value of money;
- the credit risk associated with the principal amount outstanding during a particular period of time;
- other basic lending risks and costs; and
- profit margin.

[IFRS 9 para 4.1.3(b)].

Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are those consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of

money and credit risk are typically the most significant elements of interest. [IFRS 9 para B4.1.7A].

A financial asset is measured at **amortised cost** if both of the following conditions are met:

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

[IFRS 9 para 4.1.2].

If the financial asset is held within a business model whose objective is achieved by collecting the contractual cash flows as well as selling financial assets ('hold to collect and sell' business model) and the SPPI test is passed, it is measured at **FVOCI**. [IFRS 9 para 4.1.2A].

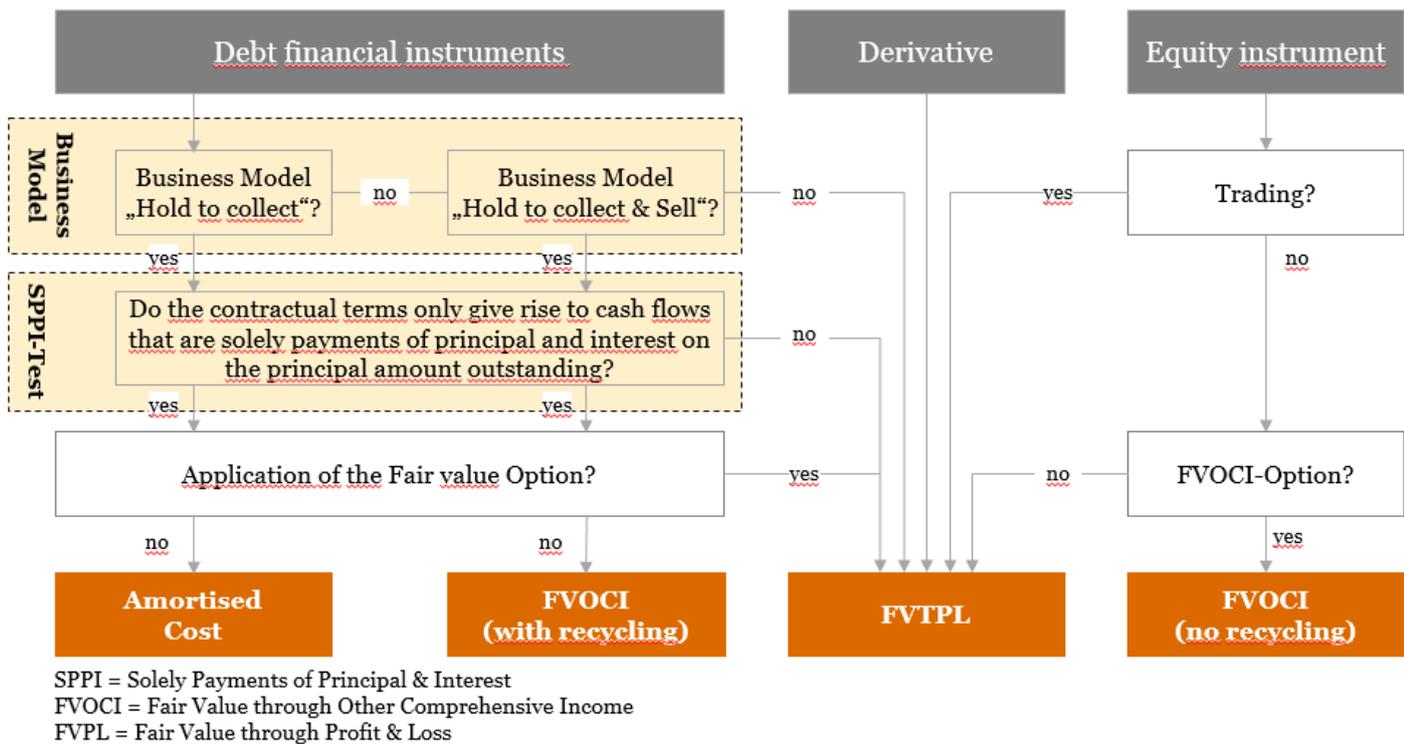
In all other cases, if the business model is not that of 'hold to collect' or 'hold to collect and sell' or the SPPI test is not passed, the financial asset is accounted for at **FVTPL**. In addition, a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. The entity is primarily focused on fair value information, and it uses that information to assess the assets' performance and to make decisions. Such portfolios must be measured at FVTPL. [IFRS 9 para B4.1.6].

If an entity changes its business model for managing financial assets, it reclassifies all financial assets in the portfolio affected. [IFRS 9 para 4.4.1]. The reclassification is applied prospectively from the first day of the first reporting period following the **change in the business model** (the reclassification date). [IFRS 9 para 5.6.1, App A]. In all other circumstances, reclassification is not permissible.

At initial recognition, an entity can **irrevocably designate** a financial asset as measured at FVTPL if this eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch). [IFRS 9 para 4.1.5]. The fair value option can be applied on an instrument-by-instrument basis.

An entity can make an irrevocable election at initial recognition, for particular **investments in equity instruments** that would otherwise be measured at FVTPL, to present subsequent changes in fair value in other comprehensive income ('OCI option'). [IFRS 9 para 4.1.4]. The term 'equity instrument' is defined in IAS 32 as any contract that evidences a residual interest in the assets of an entity after deducting its liabilities. [IAS 32 para 11].

In particular circumstances, IAS 32 allows for 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 on liquidation, to be classified as equity. [IAS 32 paras 16A and 16B or paras 16C and 16D]. Such instruments do not meet the definition of an equity instrument for the purpose of applying the OCI option. [IFRS 9 para BC5.21].



Financial assets are **measured subsequently** in accordance with the above described classification [IFRS 9 paras 4.1.1 to 4.1.5] at either:

- amortised cost;
- fair value through other comprehensive income (FVOCI); or
- fair value through profit or loss (FVTPL).

[IFRS 9 para 5.2.1].

Financial assets measured at amortised cost or at FVOCI are accounted for using the **effective interest rate method**. The interest revenue is generally calculated by applying the effective interest rate to the gross carrying amount of a financial asset. A different approach, of applying the effective interest rate to the amortised cost of the financial asset, has to be used:

- for purchased or originated credit-impaired financial assets, which are credit impaired on initial recognition and require the use of a credit-adjusted effective interest rate; and
- for financial assets that have become credit-impaired.

[IFRS 9 para 5.4.1].

If an entity has no reasonable expectation of recovering the financial asset (partly or entirely), a write-off is recognised and reduces the gross carrying amount. [IFRS 9 para 5.4.4].

Gains or losses on financial instruments measured at FVOCI are recognised in other comprehensive income, and they are reclassified to profit and loss when the financial asset is derecognised. Interest income calculated using the effective interest rate method has to be considered directly in profit or loss. [IFRS 9 para 5.7.10].

Gains and losses on financial instruments measured at FVTPL are recognised directly in profit or loss. There is no requirement to recognise interest income separately nor to recognise an impairment loss. However, if interest income is calculated, it has to be done by using the effective interest rate method.

At initial recognition, an entity has the irrevocable option to present the subsequent changes of investments in equity instruments, which are not held for trading, in other comprehensive income (FVOCI option). [IFRS 9 para 5.7.5]. The amounts presented in other comprehensive income are not reclassified to profit or loss. [IFRS 9 para B5.7.5]. However, any dividends from those instruments are to be disclosed in profit and loss. [IFRS 9 para 5.7.6]. Dividends are recognised in profit or loss only when:

- (a) the entity's right to receive payment of the dividend is established;
 - (b) it is probable that the economic benefits associated with the dividend will flow to the entity; and
 - (c) the amount of the dividend can be measured reliably.
- [IFRS 9 para 5.7.1A].

A **financial liability** is initially measured at fair value and subsequently at amortised cost, unless it is either held for trading or designated as at FVTPL. [IFRS 9 para 4.2.1]. The classification of a financial liability is irrevocable. [IFRS 9 para 4.4.2].

For a financial liability to be designated as at fair value through profit or loss, it is either managed on a portfolio basis and its performance is evaluated on a fair value basis, or its designation would eliminate or reduce an accounting mismatch, or it is a hybrid instrument that contains one or more embedded derivatives. [IFRS 9 paras 4.2.2(b) and 4.3.5].

Financial liabilities are measured subsequently in accordance with their classification either at amortised cost or at fair value through profit or loss. [IFRS 9 para 5.3.1]. Hence, any gains and losses on a financial liability measured at fair value through profit or loss are recognised in profit or loss, unless they relate to changes in the entity's own credit risk for financial liability designated as at fair value through profit or loss. [IFRS 9 para 5.7.1(c)]. The effect of changes in the entity's own credit risk in the fair value of the financial liabilities should be presented in other comprehensive income. [IFRS 9 para 5.7.7(a)].

Classification of investments in an investment fund held by an investor

For the purposes of measuring an investment in an investment fund subsequent to initial recognition, the investment in the fund is classified into one of three categories:

- (a) amortised cost;
 - (b) fair value through other comprehensive income; and
 - (c) fair value through profit or loss.
- [IFRS 9 paras 4.1.2, 4.1.2A and 4.1.4].

In principle, it is expected that an investment in an investment fund is categorised in FVTPL, requiring an investor to measure its investment in the fund at fair value, with fair value changes recognised in profit or loss.

The SPPI test

In order to be able to classify an investment in an investment fund into amortised cost or FVOCI, the investment in the fund would not only be held in a portfolio that either meets the 'hold to collect' business model or the 'hold to collect and sell'

business model, but it would also have to **pass the SPPI test**. Questions Q.B1 to Q.B4 deal with investments held in investment funds meeting the SPPI test.

Q.B Classification of an investment in an open-ended investment fund with debt investments

Company A invests in an open-ended investment fund, fund B. Fund B itself is invested in debt instruments (such as government bonds), which are quoted in an active market. Company A owns 4% of the outstanding units of fund B. Fund B has issued two classes of redeemable units, which it presents in its financial statements as financial liabilities. The redeemable units are not quoted in an active market, and they pay the net asset value at the redemption date.

Is it possible to classify an investment in an open-ended investment fund that invests in debt instruments at amortised cost or at FVOCI?

No. The investment in the fund meets the definition of puttable instruments in accordance with paragraph 18(b) of IAS 32. Investments in puttable instruments are required to be measured at FVTPL in accordance with IFRS 9, because the units give rise to cash flows that are not solely payments of principal and interest.

Irrespective of the investments in which the fund is invested, the open-ended investment fund pays dividends at its discretion during the life of the fund and, at redemption, a pro rata share of the net asset value of the fund that reflects the fair value changes of the underlying investments rather than an interest payment and a principal payment that equal those of a basic lending arrangement.

Q.B2 Classification of an investment in an investment fund with a fixed maturity

Company A owns 4% of the outstanding units of fund C. Fund C invests its entire capital in a pool of mortgages that are not publicly traded. The other outstanding units are held by three other investors. The fund has a fixed maturity and will be terminated in October 20X7.

Is it possible to classify as amortised cost or FVOCI an investment in an investment fund with a fixed maturity?

No. The units represent a residual interest in the net assets of the fund and not in a pool of mortgages itself. The units do not give rise solely to payments of principal and interest, and thus they do not meet the SPPI criterion. Therefore, the investments in the fund units should be measured at FVTPL in accordance with paragraph 4.1.4 of IFRS 9.

Q.B Applying the look-through approach to an investment in an investment fund

Company A holds a 4% investment in fund D that manages its portfolio of debt investments on a hold to collect and sell basis. Fund D usually passes the interest received on the investments through to the investors; however, the ability to access liquidity (for example, from the sale or the repayment of an underlying investment) is at the discretion of the fund.

Is it appropriate to apply the look-through approach in paragraph B4.1.21 of IFRS 9 when assessing whether the fund's units meet the SPPI criterion?

No. Whether the units of a fund meet the SPPI criterion is not to be assessed by looking through to the underlying investments of the fund. The look-through

approach in paragraph B4.1.21 of IFRS 9 is applicable to instruments that are contractually linked to an underlying pool of assets and which are part of a waterfall structure.

Even though the net asset value of the fund might vary, depending on the performance of the underlying pool of assets, and the investor determines that the underlying pool of assets meets the SPPI criterion [IFRS 9 para B4.1.21(b)], the fund units are not to be assessed by applying the look-through approach. This is because the fund is not a waterfall structure and does not have interest payments on a principal amount outstanding, but pays a dividend that is at the discretion of the fund. However, both would be required for a contractually linked instrument to meet the SPPI test in accordance with paragraph B4.1.21 of IFRS 9. This applies irrespective of whether the fund units might bear the same credit risk as the underlying portfolio, and not a higher one. [IFRS 9 para B4.1.21(c)].

PwC Observation

Open-ended funds with redeemable units are typically set up in a way that the fund units usually do not meet the SPPI criterion.

In very exceptional circumstances, a closed-ended fund might be set up in a way that the units in substance meet the SPPI criterion. This might be the case if:

- the investment fund has a limited life, without any option to extend the life of the fund or any early redemption option;
- the investment fund invests only once, at inception, in instruments that have the same maturity as the fund itself, and the investments are held until maturity;
- the investments of the fund, all of which meet the SPPI criterion, are not sold or transferred in any other way during the life of the fund to realise fair value gains or losses; and
- the fund distributes all of its free liquidity during the life of the fund and at maturity, and no reinvestments are made of any kind.

In that case, even though the fund still legally pays back the next asset value at wind up, the economic substance of the fund is that of a debt instrument that meets the SPPI criterion.

Q.B Classification of an investment in a hedge fund mainly invested in derivatives

Company A invests in a hedge fund, fund F. The majority of fund F is invested in different types of derivative.

Is it admissible to treat the investment in a hedge fund that is mainly invested in derivatives as a derivative?

No. The investment in fund F is not a derivative. The unit represents a residual interest in the net assets of the fund and not in the derivatives themselves. The investment itself does not meet the definition of a derivative. There is typically a significant initial net investment required.

However, since the fund units do not give rise solely to payments of principal and interest and thus they do not meet the SPPI criterion, the investment should be measured at FVTPL in accordance with paragraph 4.1.4 of IFRS 9, which is equal to the accounting of a derivative in accordance with IFRS 9.

Definition of a derivative:

A derivative is a financial instrument with all three of the following characteristics:

- a) its value changes in response to the change in a specified interest

rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided that (in the case of a non-financial variable) the variable is not specific to a party to the contract (sometimes called the ‘underlying’);

- b) it requires no initial net investment, or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors; and*
- c) it is settled at a future date.*

[IFRS 9 App A].

FVOCI option for equity instruments

At initial recognition, an investor might want to make an **irrevocable election**, for its equity investment in an investment fund that would otherwise be measured at fair value through profit or loss, to present subsequent changes in fair value in other comprehensive income (OCI option). [IFRS 9 para 4.1.4]. Questions Q.B5 to Q.B7 deal with investment funds meeting the term ‘equity instrument’ as defined in paragraph 11 of IAS 32.

Q.B5 Classification of an investment in an equity-based mutual fund with a fixed maturity

Company A owns 4% of the outstanding units in issue of fund G. Fund G has a fixed maturity and will be terminated in October 20X8. Company A has the right to redeem the units at any time in accordance with the fund’s prospectus. However, it does not intend to do so before maturity. Company A will receive cash on redemption equivalent to the net asset value of the fund at the termination of fund G.

Fund G’s outstanding units are classified as equity in accordance with paragraphs 16C to 16D of IAS 32 in the fund’s financial statement.

How should an investment in a mutual fund be classified in the holder’s financial statement where the units are classified as equity in accordance with paragraphs 16C to 16D of IAS 32?

The investment in fund G meets the definition of puttable instruments in accordance with paragraphs 16A to 16B of IAS 32; however, such instruments do not meet the definition of an equity instrument in accordance with paragraph 11 of IAS 32, and thus are not eligible for the OCI option for equity instruments. [IFRS 9 para BC5.21].

Although company A’s business model might be to hold the fund units to maturity, fund G should be classified and measured at fair value through profit or loss, because it fails the contractual cash flow characteristics criterion. This is because the cash flows received from the fund are not solely payments of principal and interest on the principal amount outstanding.

Company A should account for fund G’s units at fair value, with fair value changes recognised in profit or loss for the period. Since the fund units are classified as equity in accordance with the exceptions in paragraphs 16C to 16D of IAS 32, an irrevocable election to present the fair value changes in other comprehensive income is not permissible. [IFRS 9 para BC5.21].

Q.B6 Classification of an investment in an investment fund which issues redeemable participating units

Company A invests in an open-ended investment fund, fund H. Company A owns 4% of the outstanding units of fund H. The fund units are not held for trading. Fund H has issued one class of redeemable units, which it presents in its financial statements as equity.

Is it possible to irrevocably elect that the investment in the open-ended investment fund is accounted for as at FVOCI (FVOCI option)?

No. The investment in fund H meets the definition of puttable instruments in accordance with paragraphs 16A to 16B of IAS 32; however, such instruments do not meet the definition of an equity instrument in accordance with paragraph 11 of IAS 32, and thus are not eligible for the OCI option for equity instruments. [IFRS 9 para BC5.21].

Investments in puttable shares are required to be measured at FVTPL in accordance with IFRS 9, because the units give rise to cash flows that are not solely payments of principal and interest.

Q.B Classification of an investment in an investment fund which is able to suspend redemption

Same fact pattern as Q.B6, with the exception that the fund is fully invested in instruments that cannot be liquidated at short notice, and thus the fund might be required to suspend redemptions.

Is it possible to irrevocably elect that the investment in the open-ended investment fund is accounted for as at FVOCI (FVOCI option)?

No. The investment in fund H meets the definition of puttable instruments in accordance with paragraphs 16A to 16B of IAS 32, irrespective of whether the redemption request might be suspended. This is because the fund will be required to liquidate its investments after receiving the redemption request, and so eventually it will be able to fulfil the request. Thus, the suspension is not suspended indefinitely in such cases. Therefore, the instruments are puttable at the request of the investors, and the instruments do not meet the definition of an equity instrument in accordance with paragraph 11 of IAS 32 and are not eligible for the OCI option for equity instruments. [IFRS 9 para BC5.21].

Investments in puttable shares are required to be measured at FVTPL in accordance with IFRS 9, because the units give rise to cash flows that are not solely payments of principal and interest.

PwC Observation

A puttable instrument still exists, even though the fund might – at its own discretion – suspend the redemption for a certain period of time. This is irrespective of the reason for the suspension or the amount of time that might pass until the redemption requests are fulfilled, or whether they are fulfilled in instalments.

There might be one exception to the rule, if the fund has the right to suspend redemption indefinitely (although this would be the case only in extremely rare circumstances). In that case, the instrument might not be considered puttable. However, it needs to be carefully

assessed whether any other provision in the fund's set-up will result in a fund that will be liquidated at a future date and thus provides the investors with a right to receive cash on liquidation in accordance with paragraphs 16C to 16D of IAS 32, which will also result in fund units not being eligible for the FVOCI option for equity instruments.

Classification of financial instruments held by an investment fund

For the purposes of measuring a financial asset subsequent to initial recognition, paragraph 4.1.1 of IFRS 9 classifies financial assets into categories based on:

- a) the entity's business model for managing the fund's investment in financial assets; and
- b) the contractual cash flow characteristics of these financial assets.

Thus, for an investment fund to determine how to account for the financial assets that it holds, it must first determine whether the fund has one or more portfolios. Questions Q.C1 to Q.C4 deal with the portfolio definition. More detailed guidance on how to determine the business model of a fund can be found in Questions Q.C5 to Q.C12. The application of the SPPI test with respect to the investments of the fund is dealt with in Questions Q.C13 to Q.C14.

Considerations to determine the business model of a fund

Investment funds manage their investments in different ways and with different objectives, so there is no straightforward answer to the question of whether a fund measures its financial assets at amortised cost or at fair value through other comprehensive income or at fair value through profit or loss.

To determine the business model of a fund, the following areas should be considered:

- *How does the fund manage its financial assets?*
- *How is the performance of the fund measured?*
- *What does the fund's prospectus say about the management strategy and the risk factors to be considered when investing into the fund?*
- *How does management communicate the achievements of the fund to investors?*
- *What is the measurement basis for the fund units at sale or redemption?*
- *How does the fund meet the redemption requests?*
- *How are the assets currently reported under IAS 39?*

Analysis of the criteria to be considered**A) How does the fund manage its financial assets?**

Determining how the fund is managed requires, as a first step, assessment of whether a fund is managed in segregated groups of financial assets (portfolios) or as a whole. Paragraph B4.1.2 of IFRS 9 acknowledges that an entity might have more than one business model for managing its financial assets, so a fund might have one portfolio of financial assets that it manages on a fair value basis or to meet the redemption requests, and another portfolio that is managed in order to collect contractual cash flows. However, such portfolios might only exist if they are held in separate portfolios and managed separately, which requires (among other things) that the performance of each portfolio is assessed separately.

The assessment of the business model of an investment fund is based on how the fund is managed. For example, a fund that is actively managed in order to follow a price index, or to exceed a benchmark that is based on a fair value notion, is not managed in order to receive interest and to realise the residual amount on maturity. Such a fund will be required to sell financial assets before maturity on a regular basis in order to track the index.

Funds that draw benefits from market opportunities by selling financial assets are not managed on a 'hold to collect' business model. However, IFRS 9 does not prohibit sales, and so management needs to assess the reasons for such sales. If the sales occur in order to realise gains or to minimise losses (other than sales close to maturity of the investments), the fund does not manage its financial assets in order

to receive solely payments of principal and interest. However, those sales might still be in line with the business model that considers both collecting contractual cash flows and selling financial assets.

Furthermore, if funds are required, either contractually or due to regulatory provisions, to sell their financial assets in order to prove the liquidity of the fund's asset, they might not manage the respective portfolio in order to solely collect the contractual cash flows.

Funds might use derivative financial instruments for different purposes (such as hedging or to create a synthetic position). Whereas hedging of a portfolio of debt instruments might still be considered as being managed to collect contractual cash flows, funds that use derivatives to build synthetic positions are typically managed on a fair value basis. The same applies to mixed portfolios that include a **substantial** amount of equity instruments.

B) How is the performance of the fund measured?

The performance of the fund might be measured against a benchmark that is based on fair value, such as an index provided from a stock exchange. However, even if no benchmark is applied, the fund might be managed on a fair value basis. This might be evident through the information provided to investors or the key management personnel apart from the financial statements. If such information includes a comparison of fair value from year to year, it is likely that the fund is managed on a fair value basis.

C) What does the fund's prospectus say about the management strategy and the risk factors to be considered when investing into the fund?

An indication of when a fund is managed on a fair value basis rather than on a 'hold to collect' business model might also be drawn from the management strategy described in the fund's prospectus. In addition to that, if a fund highlights market risk as one of the significant risks that an investor in the fund would need to consider, it might be questioned whether the fund is managed on a business model that results in the collection of contractual cash flows.

D) How does management communicate the achievements of the fund to investors?

If the fund management does not provide investors with fair value information and the respective fair value benchmark information, either as part of the information issued together with the financial statements or apart from that (for example, on the fund manager's internet platform), it is unlikely that the fund is managed on a fair value basis. Thus, to assess the business model of the fund, it might be necessary to assess the information provided to investors in addition to the financial statements; such information might include the publication of the net asset value (NAV) applicable for issuance and redemption of fund units. However, the disclosure of fair value information alone does not mean that the fund is managed on a fair value basis.

E) What is the measurement basis for the fund units at sale or redemption?

Where, in accordance with the governing documents, the investments of a fund are fair valued, the NAV applicable for issuance and redemption of fund units is also measured at fair value.

F) How does the fund meet the redemption requests?

An investment fund that issues redeemable participating shares needs to consider, in addition to the above, whether it can meet the expected and unexpected redemption request by flow of cash. If this is not the case, a fund would need to have a sufficient liquidity buffer in order to be able to apply the 'hold to collect' business

model to a portion of the fund.

Management would need to assess the expected and unexpected redemption requests that might occur over time, and whether the fund is able to meet these requests through the contractually received cash flows.

If sales occur in order to meet the expected or unexpected redemption requests, the fund does not manage its financial assets in order to collect contractual cash flows. However, sales to meet exceptional liquidity Constraints such as in a financial crisis, might be acceptable. [IFRS 9 para B4.1.3].

If the sales are used to meet the day-to-day liquidity needs rather than day-to-day trading, management might consider the sales to be integral to achieving the objective of the business model of the fund. In that case, the fund might be managed based on a business model that includes both collecting contractual cash flows and selling financial assets.

G) How are the assets currently measured under IAS 39?

If the assets in the fund are currently measured at FVTPL because, under IAS 39, they were designated as such because they are managed (and performance is measured) on a fair value basis in accordance with a documented risk management or investment strategy, and information about that portfolio is provided internally on that basis to the entity's key management personnel, then absent a change in business model, those assets would remain FVTPL under IFRS 9. [IFRS 9 para BC4.78].

Determining whether the fund has one or more portfolios

A fund might have one single portfolio that is managed together or more than one separate managed portfolio. Whether there is one or more portfolio to be considered for classification purposes is a matter of judgement.

Q.C1 Two people managing the fund – performance reported to the key management personnel on an aggregated basis

Fund A is investing in equity securities (75% of the NAV) and debt securities (25% of the NAV). The fund is managed by two fund managers, one responsible for the equity securities portfolio and one for the debt securities portfolio. The equity securities are purchased and sold based on the individual performance of the instrument, but the fund does not trade its equity securities on a short-term basis. The debt securities are purchased mostly on a 'buy and hold' strategy.

The evaluation of the performance of the fund is done for the entire portfolio on a fair value basis, as is the reporting to the key management personnel and to the investors.

Are the assets of the fund part of the same group of assets that should be assessed for classification together?

Yes. In this case, both the equity and debt investments form part of the same portfolio for which the performance is evaluated on a fair value basis together and reported to the key management personnel in its entirety. This is irrespective of the fact that two managers are managing the portfolio. Therefore, the equity and debt investments should be measured at FVTPL.

Q.C2 Fund with different sub-portfolios managed on different investment strategies

Fund B is investing in equity securities (75% of the NAV) and debt securities (25% of the NAV). The entire fund is managed by one fund manager, who chooses, based on the requirements of the prospectus, two different investment strategies for the equity and the debt portfolio. The equity securities are purchased and sold based on the individual performance of the instrument, and the debt securities are purchased on a 'buy and hold' strategy.

The performance of the portfolios is measured separately (two different comparative performance indices). The internal reporting to the key management personnel is reflecting the two separate portfolios. The financial statements, which are prepared in accordance with regulatory requirements, present only one investment portfolio.

Are the assets of the fund part of the same group of assets that should be assessed for classification together?

No. In this particular case, the fund's investments are managed in two separate portfolios – demonstrated through the different investment strategies and the separate reporting to key management personnel – for which the classification criteria of IFRS 9 are applied separately. Accordingly, equity and debt instruments should be considered two separate groups of assets.

Paragraph 4.1.4 of IFRS 9 establishes that equity instruments should be measured at fair value through profit or loss, unless the entity takes the irrevocable option at inception to present changes in fair value in OCI. [IFRS 9 para 5.7.5].

However, for the investments in debt securities, the fund needs to perform the business model assessment on the portfolio, which requires, among other things, an assessment of whether the liquidity requirements could be met through investments in the equity portfolio.

In this particular case, equity investments are measured at FVTPL, unless the FVOCI option mentioned above is taken and assuming that they are not trading. The debt investments could be measured at amortised cost if they are 'hold to collect' contractual cash flows, or at FVOCI if the portfolio is managed on a 'hold to collect and sell' business model, provided that they meet the solely payments of principal and interest criterion in paragraph 4.1.2(b) of IFRS 9.

Q.C3 Multiple business models

A global bond fund, fund C, has a diverse range of bond instruments. The bonds can be split between short-term and long-term maturity bonds. The short-term maturity bonds are primarily money market instruments that are generally held to maturity. The positions are held for the receipt of interest and principal, and not for fair value appreciation.

The longer-term bonds are generally held for speculative purposes, by taking short-term views on yield and credit curve movements. The individual investment manager does not manage these positions for the contractual cash flows, but instead hopes to generate gains from anticipated movements in yield, credit or liquidity spreads.

Both the long- and short-term portfolios are managed by the same individual investment manager, rather than by separate investment houses or separate personnel within the same house.

Is it possible that the fund has more than one business model?

Yes. While fund C might be a single reporting entity, with all bonds managed by the same investment manager, this does not preclude the existence of more than one business model. Provided that the short- and long-term bonds are segregated and, in effect, managed as two separate portfolios, then viewing both long- and short-term bond positions as separate business models would be deemed acceptable under IFRS 9.

Q.C4 Reporting to key management personnel

Fund D is a closed-ended fund. The fund manager is managing the fund with the objective of realising cash flows through the sale of the assets. The fund is managed on a portfolio basis, with investment decisions to be made on a daily basis, and the performance of the fund is measured on a fair value basis.

The internal reporting to the board of directors of the fund (which does not include the fund manager) is prepared on fair value basis. The internal reporting is only prepared twice a year, because the board does not meet more often than that to discuss the investment strategy.

How should the investment be treated and measured under IFRS 9?

It should be treated as one portfolio that should be measured at FVTPL, because the assets are managed with the objective of realising cash flows through the sale of the assets. [IFRS 9 para B4.1.5].

The business model test does not require information to be sent frequently to the key management personnel; however, an internal reporting which is only sent to the key management twice a year is a sufficient document that the fund is managed on a fair value basis and its performance is measured on a fair value basis, provided that the investment strategy is not changed on a daily basis and the fund manager receives appropriate and timely information, necessary to execute the investment strategy.

Determining the business model of a fund

Determining the business model of an investment fund requires the assessment of how the fund manages its financial assets.

Q.C5 Investment fund managing funds on a 'hold to collect and sell' business model

Fund F manages its investments in debt financial instruments to receive interest payments and to provide an investor with a constant distribution. However, to meet the liquidity requirements, the fund needs to sell individual debt investments on a regular basis.

Can fund F classify its investments as fair value through OCI?

It depends. IFRS 9 requires fund F to classify its investment as FVOCI if the classification criteria are met. However, the fund might, at inception, irrevocably designate its portfolio as at fair value through profit or loss if this reduces an accounting mismatch. Given that investors are able to redeem their holdings at NAV, it is likely that the business model would be FVTPL, depending on how disposals of investments happen.

Q C6 Open-ended investment fund with redeemable participating units

Fund G is an open-ended investment fund that issues redeemable participating shares. The debt investments in the fund, that have an average duration of five years, are held on a 'buy and hold' strategy. However, because the fund only keeps a minimum liquidity in the fund, the fund might sell its investments once in a while.

What indicators need to be considered when determining the business model of the fund?

Even though the fund might be managed on a 'buy and hold' strategy, the fund needs to sell its investments if investors redeem their units. Thus, the business model of the fund is most likely that of 'hold to collect and sell'; however, if redemptions occur on a frequent basis, the fund might even be managed on another business model, which requires that the fund measures its investments at FVTPL.

PwC Observation

Due to the liquidity constraints that an open-ended investment fund might face when dealing with the redemption requests of the investors, it is highly unlikely that an open-ended investment fund held by various investors with different investment strategies will be able to meet the 'hold to collect' business model.

However, such a fund might still meet the 'hold to collect and sell' business model if it manages its investments on a business model that is considering sales as part of the management strategy to accommodate the redemption requests.

Q C7 Money market fund generating an attractive yield

A money market fund, fund H, with a unitary NAV invests in an array of short-term money market instruments. The objective of the fund is to generate an attractive yield while attempting to maintain capital preservation. Fund H has not, since inception, sold any positions prior to maturity. The yield earned by the fund on the

underlying positions is solely compensation for the time value of money and credit risk.

Is it possible that the fund is managed with a 'hold to collect' business model?

Since the objective of fund H is to generate an attractive yield that represents principal and interest, the fund's performance is not managed on a fair value basis. Therefore the fund might manage its investments on a business model that is to collect the contractual cash flows. However, management will need to assess whether the fund is able to meet its expected and unexpected redemption requests through the cash inflows received from its short-term money market investments, or through the cash held at bank, in order to meet the 'hold to collect' business model. Such a fund might still meet the 'hold to collect and sell' business model.

Q.C8 Money market fund with a NAV measured at amortised cost

A short-term bond fund, fund I, invests in an array of floating- and fixed-rate instruments that comprise money market instruments, corporate debt and government debt.

Fund I is an open-ended investment fund managing the debt instruments for the receipt of the contractual cash flows that represent the payment of interest and principal. The fund has a dealing NAV that is based on amortised cost.

Does a fund have to employ amortised cost where the criterion in paragraph 4.1.2 of IFRS 9 indicates that the fund's business model is to manage the debt instruments for the receipt of the contractual cash flows?

Since the fund's business model is to collect the cash flows on the underlying debt instruments, the instruments should be valued by the fund using amortised cost, provided that, for example, the instruments were not being fair valued for dealing purposes. However, fund I, which is an open-ended investment fund, needs to carefully assess whether it can meet the redemption requests with the cash received from the repayment of the short-term debt. If fund I cannot satisfy this criterion, it will not meet the 'hold to collect' business model.

Q.C9 Money market fund with a NAV measured at fair value

Same fact pattern as Q.C8, with the exception that the dealing NAV is measured based on fair value. The redeemable shares of the fund are not presented as equity in accordance with paragraphs 16A and 16B of IAS 32.

Is the fund required to measure its investments at amortised cost, if the 'hold to collect' business model is met (it is assumed that all criteria are met, including the SPPI test)?

No. There might be an accounting mismatch if the debt instruments were valued using amortised cost and the related financial liability at fair value. In this scenario, it is appropriate for the fund to designate the assets at fair value under paragraph 4.1.5 of IFRS 9, because it would significantly eliminate a measurement inconsistency.

Q.C10 Money market fund and a ‘hold to collect’ business model with some sales

A money market fund, fund J, with a unitary NAV invests in an array of short-term securities that comprise corporate bonds, commercial paper, repurchase agreements, time deposits and certificates of deposit. The objective of fund J is to generate an attractive yield while attempting to maintain capital preservation. The yield earned by fund J on the underlying positions is solely compensation for the time value of money and credit risk.

The securities purchased are generally held to maturity; however, there have been instances where instruments have been disposed of prematurely. The sale of these positions has been for concerns surrounding underlying credit quality.

Could a money market fund continue to measure a portfolio of short-term instruments at amortised cost, even where there are some sales occurring?

Yes. The fact that some positions might be sold early does not, in itself, preclude the use of amortised cost. Provided that the instances of selling are infrequent, this generally need not lead to a re-examination of the fund’s business model. However, it needs to be ensured that the sales did not occur to meet the liquidity requirements drawn from the expected and unexpected redemptions.

Q.C11 The classification of distressed debt – portfolio held to realise gains from successful restructuring

A distressed debt fund, fund L, holds a portfolio of distressed instruments that are managed as a single portfolio. The fund holds these positions, because they offer attractive yields, which reflect the increased credit risk inherent in the positions.

The debt instruments are trading at relatively low levels, reflecting the incurred losses to date and the uncertainty surrounding the issuers’ prospects.

Fund L intends to hold the positions in order to speculate on the prospects of the underlying issuers, in order to realise gains, for example, from the ability of the issuers to successfully restructure or to sell the loans.

Could a distressed debt fund measure its distressed debt instruments at amortised cost?

No. It would not be appropriate to hold the debt instruments at amortised cost, because the business model is based on fair value, with the instruments being effectively held for trading.

Distressed debt

Distressed debt describes securities that might include significant risk resulting, for example, from financial or operational distress, default or similar issues, and thus resulting in partial or total loss.

Q.C12 Classifying debt instruments in a private equity fund

A private equity fund, fund N, with a finite life has a portfolio which comprises both private equity investments and loan instruments. Holders cannot ask to redeem their holdings before maturity of the fund.

The loan instruments are managed separately by fund N, and they are due to mature prior to the termination of fund N. The loans are managed in order to

receive cash flows over the period of the loans that solely represent principal and interest.

Can fund N, with a finite life, classify loan instruments under amortised cost?

Yes. This is because they are held solely for the purposes of generating principal and interest.

Determining whether the investments held in a 'hold to collect and sell' business model meet the SPPI criterion

Where the fund has a 'hold to collect' or 'hold to collect and sell' business model, the next step is to determine whether the investments held by the fund meet the contractual cash flows test.

Q.C13 Asset-backed securities positions in a money market fund that manages its portfolio on a 'hold to collect' basis

A money market fund, fund K, with a unitary NAV invests in an array of short-term securities that include asset-backed securities (ABS). The objective of the fund is to generate an attractive yield while attempting to maintain capital preservation. The yield earned by the fund on the ABS positions is solely compensation for the time value of money and credit risk. The fund has not, however, assessed the underlying pool of assets, nor compared the credit quality of the ABS with the credit quality of the underlying pool of assets.

Is it appropriate for fund K to value all ABS positions held at amortised cost, solely on the basis that the positions offer cash flows that are solely payments of principal and interest?

No. Fund K must determine the underlying characteristics of the pool of assets. The fact that the business model is to hold assets for the contractual cash flows, and the ABS positions pay amounts which solely represent principal and interest, is not in itself sufficient to categorise them at amortised cost in the case of contractually linked instruments.

For fund K to value the ABS positions (such as mortgage-backed securities, residential mortgage-backed securities and similar instruments) at amortised cost, it is necessary for the fund to look through to the underlying pool of assets to determine the characteristics of the pool. Fund K will also need to compare the credit quality of the ABS against that of the underlying pool of assets (see also paras B4.22 to B4.25 of IFRS 9).

It is necessary for fund K to satisfy the three requirements outlined under paragraph B4.1.21 in order to use amortised cost. Where it is not possible to perform any of the steps, it will be necessary for fund K to value the positions using fair value.

PwC Observation

Under paragraph B4.1.21 of IFRS 9, a tranche has cash flow characteristics that are payments of principal and interest on the principal amount outstanding only if:

- a. the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (for example, the interest rate on the tranche is not linked to a commodity index);*
- b. the underlying pool of financial instruments has the cash flow characteristics set out in paragraphs B4.1.23 and B4.1.24; and*
- c. the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (for example, the credit rating of the tranche being assessed for classification is equal to or higher than the credit rating that would apply to a single tranche that funded the underlying pool of financial instruments).*

Under paragraph B4.1.23 of IFRS 9, the underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

Under paragraph B4.1.24 of IFRS 9, the underlying pool of instruments could also include instruments that:

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

Q.C14 Classification of preference shares in the fund's financial statements

Fund B purchases EUR 10 million (nominal value) of unquoted perpetual preference shares issued by company X, a company incorporated in Europe with no definite life. The shares have a fixed non-discretionary dividend of 5% per annum. If there are inadequate distributable profits to pay the dividend in one year, the dividend will roll forward and become payable in future, if and when sufficient distributable profits exist. Interest is accrued on the deferred amounts.

Can fund B, the holder of unquoted perpetual preference shares, measure the shares at amortised cost?

It depends. In this case, the perpetual preference shares do not meet the definition of equity in IAS 32, because the instrument includes a contractual obligation to deliver cash to the holder. [IAS 32 para 16]. The contractual terms of the instruments are likely to give rise to cash flows that are solely payments of principal and interest if the dividend rate per annum approximates the market interest rate for perpetual instruments and the instrument accrues interest on the deferred amounts. [IFRS 9 para B4.1.14 – Instrument H]. In such a case, if the SPPI test is passed and the business model applied is to 'hold and collect', the unquoted preferred shares could be measured at amortised cost.

Impairment requirements

The recognition of impairment losses under IFRS 9 is based on the expected credit loss model, which has to be applied to financial assets that passed SSPI testing and are measured at amortised cost or at fair value through other comprehensive income, lease receivables, contract assets, as well as for loan commitments and financial guarantees not measured at fair value. [IFRS 9 para 5.5.1].

The general approach for the consideration of expected credit losses requires an entity to recognise expected credit losses at each reporting date. The calculation of loss allowances is based on a three-stage model. At initial recognition, financial instruments are considered in stage one, and the calculated loss allowances should reflect an amount equal to the 12-month expected credit losses. [IFRS 9 para 5.5.5]. This is the portion of lifetime expected credit losses that result from default events on financial instruments within 12 months after the reporting date. [IFRS 9 App A].

For those financial instruments which are not determined to have a low credit risk [IFRS 9 para 5.5.10], an entity has to analyse at each reporting date whether the credit risk has increased significantly since initial recognition. [IFRS 9 para 5.5.9]. This assessment can be done on an individual or a collective basis, and it should consider reasonable and supportable information (including forward-looking information) that is available without undue cost or effort. [IFRS 9 para 5.5.4]. If the credit risk for a financial instrument has increased significantly since initial recognition, it is allocated to stage two of the general impairment model, and the loss allowance to be recognised is equal to the lifetime expected credit losses. [IFRS 9 para 5.5.3].

If there is evidence that an asset is credit-impaired at the relevant reporting date (see App A of IFRS 9), it is allocated to stage three of the general impairment model. The loss allowance reflects, as in stage two, the expected lifetime credit losses. In addition, the effective interest rate on credit-impaired financial assets has to be calculated based on the amortised cost of the financial asset instead of the gross carrying amount for assets in stages one and two. [IFRS 9 para 5.4.1(b)].

Expected credit losses are a probability-weighted estimate of credit losses – in other words, the difference between present value of the contractual cash flows and the present value of the cash flows that an entity expects to receive. [IFRS 9 para B5.5.28]. Hence, the measurement of expected credit losses reflects a range of at least two [IFRS 9 para B5.5.42] possible outcomes, which are discounted to the reporting date [IFRS 9 para B5.5.44] and which consider reasonable information that is available without undue cost or effort and also covers forecasts of future economic conditions. [IFRS 9 para B5.5.17(c)]. The impairment gains or losses resulting from changes in the amount of expected credit losses have to be considered in profit or loss. [IFRS 9 para 5.5.8]. Any loss allowances for financial assets measured at fair value through other comprehensive income do not reduce the carrying amount of the asset, but they are considered in other comprehensive income. [IFRS 9 para 5.5.2].

A simplified approach is used for trade receivables and contract assets that result from transactions that are within the scope of IFRS 15 without significant financing component, and it can be used for trade receivables and contract assets with significant financing component as well as for lease receivables. Under this approach, the entity always measures the loss allowance at the amount equal to the lifetime expected credit losses, and it does not need to consider changes between the stages. [IFRS 9 para 5.5.15].

In the case of purchased or originated credit-impaired financial assets, the cumulated changes in lifetime expected credit losses since initial recognition are recognised as an impairment gain or loss. [IFRS 9 paras 5.5.13 to 5.5.14].

Q.D1 Investment in equity securities

Fund A is a mutual fund investing in equity instruments issued by major European telecoms. The fund designated some of the investments to be measured at fair value through OCI in accordance with paragraph 4.1.4 of IFRS 9. Due to a significant downturn in the European telecoms market, fund B recognises a valuation loss on its investments in OCI.

Should fund A recognise an impairment loss in profit or loss?

No. Fund A classifies its investments in fair value through OCI, and thus it does not recognise an impairment loss, or gains and losses from its investment in the equity instruments, in profit or loss (that is, no recycling). However, dividends could be recognised in profit or loss if the provisions in paragraph 5.7.1A of IFRS 9 are met.

Q.D2 Investment in debt securities

Fund B is a mutual fund investing in debt instruments. The fund is managed in accordance with the 'hold to collect and sell' business model, and thus it classifies its investments in fair value through OCI. The risk rating of the investments is wide spread and ranks from AAA to CCC.

Can fund B make use of the exception for low credit risk investments in paragraph 5.5.10 of IFRS 9 and defer from monitoring the changes in credit risk on an instrument-by-instrument basis?

No. Fund B classifies its investments in fair value through OCI, and thus it has to apply the impairment provisions in IFRS 9. However, where the fund's investments are considered low credit risk investments, the fund could apply the exception in paragraph 5.5.10 of IFRS 9 which allows it to assume that the fund's investments have not significantly increased in credit risk since initial recognition.

In the above scenario, the fund's investments have an external ranking that provides evidence that not all of the fund's investments are of low credit risk, so the relief from monitoring the credit risk provided by paragraph 5.5.10 of IFRS 9 is not admissible for the fund as a whole. However, if the fund investments were held in two separate portfolios (one holding all investment grade investments, and the other holding the higher-risk investments), the answer might be different.

Q.D3 Investment in debt securities

Fund C is a mutual fund investing in debt instruments. The fund is managed in accordance with the 'hold to collect and sell' business model, and thus it classifies its investments in fair value through OCI. The risk rating of all of the investments held by the fund is AAA and AA.

Can fund C make use of the exception for low credit risk investments in paragraph 5.5.10 of IFRS 9 and defer from monitoring the changes in credit risk on an instrument-by-instrument basis?

It depends. For the fund to consider all of its investments to have low credit risk, the investments need to have a low risk of default. In addition to that, it needs to be assessed, from a market participant view, whether the issuer of the debt

instrument has a strong capability to meet the contractual cash flow obligations in the short term as well as in the long term, irrespective of adverse changes in the economic and business conditions.

Based on paragraph B5.5.23 of IFRS 9, an investment grade rating might be an indicator that the debt instrument has a low credit risk.

Q.D4 Investment in debt securities

Fund D classifies its portfolio of non-investment grade debt instruments as at fair value through OCI, and thus it is required to monitor whether the debt instruments' credit risk significantly decreased compared to the previous period. Fund D purchased some of the debt securities in tranches.

Can fund D monitor the changes in credit risk for all tranches together?

It depends. If, since the fund purchased the first tranche, the credit risk of the debt instrument did not change (for example, similar rating), it might be appropriate to monitor the changes in credit risk for all tranches as if they were purchased at the same time. However, if the credit risk is different for the tranches purchased at different times (for example, tranche 1 has a rating AAA and tranche 2 has a rating AA), a combined approach (such as assessing that the risk rating for both tranches is AA) might not be justifiable, because this might change the assessment of whether the credit risk increased significantly for one of the tranches (in this case, tranche 1).

Hedge accounting

An entity can choose to apply either the hedge accounting requirements of IFRS 9 or to continue to apply the existing requirements of IAS 39 for all of its hedge accounting. [IFRS 9 para IN10].

Generally, the objective of hedge accounting is to represent the effect of an entity's risk management activities using financial instruments to manage exposures arising from certain risks that could affect profit or loss. The IFRS 9 hedge accounting requirements continue to distinguish between three types of hedging relationships: fair value hedges; cash flow hedges; and hedges of a net investment in a foreign operation. [IFRS 9 para 6.5.2].

However, IFRS 9 also introduces some changes to hedge accounting, with the intention of aligning the accounting more closely with risk management. This is reflected in a wider range of possible hedged items, which includes groups of items, components of an item, or a group of items that is a nil net position. [IFRS 9 paras 6.6.1 to 6.6.6]. Furthermore, it is also possible, under the hedge accounting requirements of IFRS 9, to designate non-derivative financial instruments as hedging instruments. [IFRS 9 para 6.2.2]. In addition, IFRS 9 offers an entity the possibility to designate credit exposures under certain conditions as measured at fair value through profit or loss, if the credit risk is managed with credit derivatives. [IFRS 9 para 6.7.1].

The qualifying criteria for hedge accounting under IFRS 9 do not require the proof of an effectiveness within a fixed range, but there has to be an economic relationship between hedged item and hedging instrument. [IFRS 9 para 6.4.1(c)]. Retrospective effectiveness testing is no longer required. Any discontinuation of hedge accounting applies prospectively from the date on which the qualifying criteria are no longer met. This implies that an entity should not de-designate any hedging relationships that still meet the qualifying criteria. [IFRS 9 paras B6.5.22 to B6.5.23].

Transitional requirements

IFRS 9 is applicable for annual periods beginning on or after 1 January 2018, and it generally has to be applied retrospectively in accordance with IAS 8. [IFRS 9 para 7.2.1]. At the date of initial application, an entity performs the classification, based on the facts and circumstances that existed at that date, and applies it retrospectively, irrespective of the entity's business model in prior periods. [IFRS 9 para 7.2.3].

The contractual cash flow conditions have to be assessed on the basis of the facts and circumstances that existed at the initial recognition of the financial asset. [IFRS 9 paras 7.2.4 to 7.2.5]. Furthermore, an entity has to revise the designation of financial instruments to categories on the basis of facts and circumstances that exist at the date of initial application of the standard. This might lead to adjustments of the former designation under IAS 39. [IFRS 9 paras 7.2.8 to 7.2.14]. Despite the requirement of retrospective application, an entity should provide the disclosures set out in paragraphs 42L-42O of IFRS 7, but it is not required to restate prior periods. Generally, a restatement is only allowed if it is possible without the use of hindsight. If prior periods are not restated, the entity recognises any difference between the previous carrying amount and the carrying amount at the beginning of the period of initial application in the opening retained earnings. [IFRS 9 para 7.2.15].

With respect to the initial application of impairment requirements, an entity uses reasonable and supportable information, that is available without undue cost or effort, to determine the credit risk at the date that a financial instrument was initially recognised, and it compares that to the credit risk at the date of the initial application of IFRS 9. [IFRS 9 para 7.2.18]. If it is not possible to determine, without undue cost or effort, whether the credit risk has increased significantly since the initial recognition, the entity has to recognise a loss allowance corresponding to the lifetime expected losses, unless the financial instrument is low credit risk at the reporting date. [IFRS 9 paras 7.2.19 to 7.2.20]. The requirements of paragraph 7.2.15 of IFRS 9 might also be applied to impairment disclosures.

Where to look for additional information

Additional information on IFRS 9

Publications on classification:

Retail banking: practical implications of IFRS 9 classification and measurement (In depth INT2018-03; issued January 2018)

(https://inform.pwc.com/s/Retail_banking_practical_implications_of_IFRS_9_classification_and_measurement_PwC_In_depth_INT2018_03/informContent/1829101501155772#ic_1829101501155772)

Corporate banking: practical implications of IFRS 9 classification and measurement (In depth INT2018-02; issued January 2018)

(https://inform.pwc.com/s/Corporate_banking_practical_implications_of_IFRS_9_classification_and_measurement_PwC_In_depth_INT2018_02/informContent/1857105701149014#ic_1857105701149014)

Treasury and securities portfolios: practical implications of IFRS 9 classification and measurement (In depth INT2018-01; issued January 2018)

(https://inform.pwc.com/s/Treasury_and_securities_portfolios_practical_implications_of_IFRS_9_classification_and_measurement_PwC_In_depth_INT2018_01/informContent/1859103301132157#ic_1859103301132157)

IFRS 9: Classification and measurement (In depth INT2014-05; issued August 2014)

(https://inform.pwc.com/inform2/s/INT2014_05_IFRS_9_Classification_and_measurement/informContent/1432051608151978#ic_1432051608151978)

Publications on impairment:

IFRS 9 impairment: significant increase in credit risk (In depth INT2018-04; issued January 2018)

(https://inform.pwc.com/s/IFRS_9_impairment_significant_increase_in_credit_risk_PwC_In_depth_INT2018_04/informContent/1834102601150563#ic_1834102601150563)

IFRS 9 impairment: revolving credit facilities and expected credit losses (In depth INT2017-08; issued November 2017)

(https://inform.pwc.com/s/IFRS_9_impairment_Revolving_credit_facilities_and_expected_credit_losses_PwC_In_depth_INT2017_08/informContent/172528271113344#ic_172528271113344)

IFRS 9 impairment: how to include multiple forward-looking scenarios (In depth INT2017-05; issued August 2017)

(https://inform.pwc.com/s/IFRS_9_impairment_how_to_include_multiple_forward_looking_scenarios_PwC_In_depth_INT2017_05/informContent/1717022708150826#ic_1717022708150826)

Basel Committee guidance on accounting for IFRS 9 expected credit losses for banks (In depth INT2016-02; issued March 2016)

(https://inform.pwc.com/s/Basel_Committee_guidance_on_accounting_for_IFRS_9_expected_credit_losses_for_banks_PwC_In_depth_INT2016_02/informContent/1648184003126267#ic_1648184003126267)

Getting governance right on IFRS 9 expected credit loss: accounting policy and implementation decisions (In depth INT2015-16; issued November 2015)

(https://inform.pwc.com/s/Getting_governance_right_on_IFRS_9_Expected_Credit_Loss_accounting_policy_and_implementation_decisions_PwC_In_depth_INT2015_16/informContent/155420031108359#ic_155420031108359)

IFRS 9: Impairment of financial assets – Questions and answers (In depth INT2015-13; issued March 2015)

(https://inform.pwc.com/inform2/s/INT2015_13_IFRS_9_Impairment_of_financial_assets_Questions_and_answers/informContent/1543264003107782#ic_1543264003107782)

IFRS 9: Expected credit losses (In depth INT2014-06; issued November 2014)

(https://inform.pwc.com/inform2/s/INT2014_06_IFRS_9_Expected_credit_losses/informContent/1415113308150843#ic_1415113308150843)

Publications on hedge accounting:

Achieving hedge accounting in practice under IFRS 9 (In depth INT2017-09; issued December 2017)

(https://inform.pwc.com/s/Achieving_hedge_accounting_in_practice_under_IFRS_9_PwC_In_depth_INT2017_09/informContent/1701045512146487#ic_1701045512146487)

IFRS 9: Hedging in practice – frequently asked questions (In depth INT2015-05; issued January 2015)

(https://inform.pwc.com/inform2/s/INT2015_05_IFRS_9_Hedging_in_practice_Frequently_asked_questions/informContent/1524305001096041#ic_1524305001096041)

General hedge accounting (Practical Guide No 48; issued January 2014)

(https://inform.pwc.com/inform2/s/48_General_hedge_accounting/informContent/1456074901128251#ic_1456074901128251)

Disclosures on IFRS 9, ‘Financial Instruments’

IFRS 9 for banks: illustrative disclosures (issued February 2017)

(https://inform.pwc.com/s/IFRS_9_for_banks_Illustrative_disclosures/informContent/1758231802155468#ic_1758231802155468)

IFRS 9 disclosures by banks in 2018 interim reporting and transition documents (In depth INT2017-07; issued December 2017)

(https://inform.pwc.com/s/IFRS_9_disclosures_by_banks_in_2018_interim_reporting_and_transition_documents_PwC_In_depth_INT2017_07/informContent/173821581108521#ic_173821581108521)

IFRS 9 disclosures for corporates (In depth INT2017-06; issued September 2017)

(https://inform.pwc.com/s/IFRS_9_disclosures_for_corporates_PwC_In_depth_INT2017_06/informContent/1755045909146362#ic_1755045909146362)

IFRS 9: Expected credit loss disclosures for banking (In depth INT2015-02; issued January 2015)

(https://inform.pwc.com/inform2/s/INT2015_02_IFRS_9_Expected_credit_loss_disclosures_for_banking/informContent/1522235301123500#ic_1522235301123500)

For a comprehensive look at the disclosure requirements for investment funds, private equity funds and real estate entities, please refer to our Illustrative Financial Statements series. The industry-specific illustrative financial statements attempt to create a realistic set of financial statements. However, by necessity the illustrative disclosures illustrate disclosures that might be immaterial to some entities but material to others. Determining the level of disclosure is a matter of judgement and, naturally, disclosure of immaterial items is not required.

Illustrative IFRS Financial Statements 2017 – Investment funds

(https://inform.pwc.com/s/Illustrative_IFRS_financial_statements_Investment_funds_2017/informContent/1705260210118843#ic_1705260210118843)

Illustrative IFRS Financial Statements 2017 – Private equity funds

(https://inform.pwc.com/s/Illustrative_IFRS_financial_statements_2017_Private_equity_funds/informContent/1854314201113354#ic_1854314201113354)

Illustrative Financial Statements of Private Equity Fund holding an Investment Entity subsidiary 2016

(https://inform.pwc.com/s/Illustrative_Financial_Statements_of_Private_Equity_Fund_holding_a_n_Investment_Entity_subsidary/informContent/1721092301150052#ic_1721092301150052#ic_1721092301150052)

Illustrative IFRS Financial Statements 2017 – Investment property

(https://inform.pwc.com/s/Illustrative_IFRS_consolidated_financial_statements_Investment_property_2017/informContent/1812221701157410/Y/sec#ic_1812221701157410)

Publications on other issues concerning financial instruments

Disclosures on IFRS 7 and IFRS 13 for financial instruments:

*With respect to the disclosure requirements in IFRS 7, 'Financial Instruments: Disclosures', the In depth '**IFRS 7 and IFRS 13 disclosures**' provides information on how to apply the disclosure requirements to investment funds, private equity funds, real estate funds and investment managers investing into financial instruments.*

IFRS 7 and IFRS 13 disclosures (In depth INT2014-01; issued February 2014)

(https://inform.pwc.com/inform2/s/INT2014_01_IFRS_7_and_IFRS_13_disclosures/informContent/1401222605104101#ic_1401222605104101)

Offsetting financial instruments:

*The IAS 32 and IFRS 7 offsetting amendments require investment funds (i) to re-assess when they offset financial instruments for accounting purposes, and (ii) to analyse what additional financial statement disclosures in relation to offsetting might be required. The In depth '**Offsetting financial instruments for investment funds**' provides answers to frequently asked questions.*

Frequently asked questions – Offsetting financial instruments for investment funds (In depth INT2014-11; issued December 2014)

(https://inform.pwc.com/inform2/s/INT2014_11_Frequently_asked_questions_Offsetting_financial_instruments_for_investment_funds/informContent/1446110212147393#ic_1446110212147393)

*The bank's perspective on the offsetting requirements is covered in the In depth '**Offsetting financial instruments for financial institutions**'.*

Offsetting financial instruments for financial institutions (In depth INT2014-05; issued July 2014)

(https://inform.pwc.com/inform2/s/Offsetting_financial_instruments_for_financial_institutions_PwC_In_depth_INT2014_03/informContent/1455101707161091#ic_1455101707161091)

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Publications

Over the past few years, the Global AWM IAG has been responsible for developing the firm's global position on the application of IFRS to the asset and wealth management industry by publishing various publications.

The image displays a grid of nine publication covers from PwC. The covers are arranged in three rows and three columns. The top row features three covers: 'Illustrative IFRS consolidated financial statements 2017 Investment funds', 'Illustrative IFRS consolidated financial statements Investment property - 2017 update', and 'VALUE IFRS Plc Illustrative IFRS consolidated financial statements December 2017'. The middle row contains three covers: 'Illustrative IFRS consolidated financial statements 2017 Private Equity Funds', 'Illustrative Financial Statements of Private Equity Fund holding an Investment Entity subsidiary', and 'In depth IFRS 7 and IFRS 13 disclosures'. The bottom row includes three covers: 'A practical guide to IAS 32 for investment funds', 'Practical guide to IFRS 10 IFRS 10 for asset managers', and 'Practical guide to IFRS 10 Investment entities: Exception to consolidation'. Each cover includes the PwC logo and a small image related to the publication's theme.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner. Engagement teams that have questions should contact members of the Revenue team in Accounting Consulting Services.

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