An Overview of the New Financial Asset Classification and Measurement Requirements of IFRS 9 *Financial Instruments*

January 2016

Scope and Purpose of the Guide

The International Accounting Standards Board (IASB) published the final version of IFRS 9 *Financial Instruments* in July 2014. IFRS 9 replaces IAS 39 *Financial Instruments: Recognition and Measurement*, and is effective for annual periods beginning on or after January 1, 2018. Earlier application is permitted.

The new standard aims to simplify the accounting for financial instruments and address perceived deficiencies which were highlighted by the recent financial crisis.

The purpose of this guide is to highlight relevant IFRS 9 classification and measurement requirements and provide application guidance, including examples, to ensure appropriate classification of financial instruments under IFRS 9. The guide focuses on key issues that may affect MNP's clients, including Credit Unions which will be significantly impacted.

This guide does not discuss the classification and measurement of financial liabilities. Please refer to MNP guide *An Overview of IFRS 9 Financial Instruments vs. IAS 39 Financial Instruments: Recognition and Measurement* for highlights of the significant differences between IFRS 9 and IAS 39, including those relating to financial liabilities.

Overview of Classification of Financial Assets

IFRS 9 classifies financial assets into the following measurement categories:

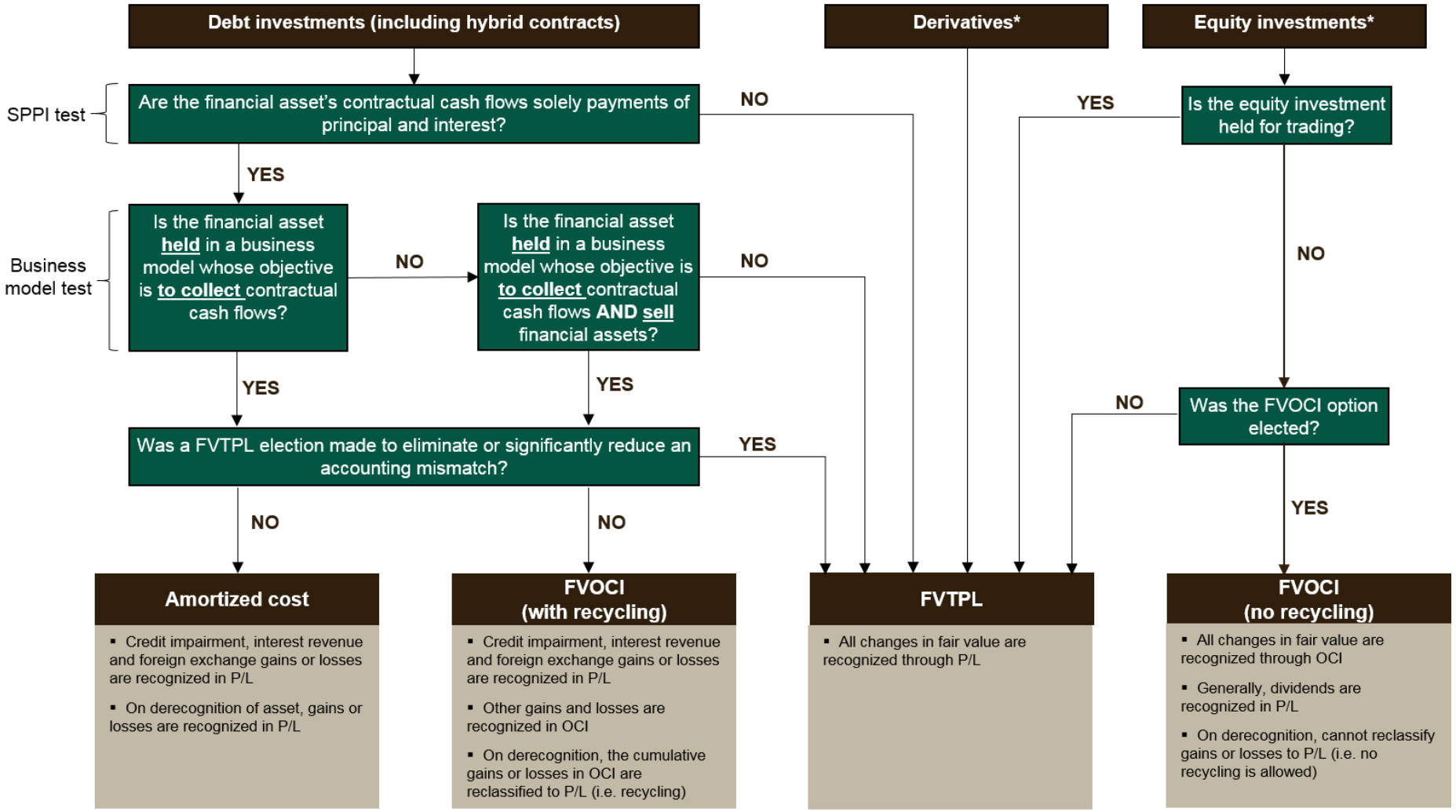
- Amortized cost
- Fair value through other comprehensive income (FVOCI)
- Fair value through profit or loss (FVTPL)

The classification of financial assets is based on both of the following:

- The entity's business model for managing the financial assets (i.e., the "business model test").
- The contractual cash flow characteristics of the financial assets (i.e., whether contractual cash flows are solely payments of principal and interest – the "SPPI test").

Certain designations are also allowed as presented in the decision tree below.

The following decision tree may be used to determine the appropriate classification of a financial asset:



** Assuming the contractual terms of the financial asset do not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. This is generally the case for equity investments and derivatives; hence we recommend this simplified approach to the classification of these instruments.*

For the purposes of this guide, we have separated the classification of financial assets into:

- Debt investments (i.e., trade receivables, bonds, debentures, loans, mortgages) including hybrid contracts
- Equity investments (i.e., shares)
- Derivatives

Generally, equity investments and derivatives do not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (i.e., the SPPI test). As such we have simplified the approach to classifying these instruments by assuming equity investments and derivatives will not meet the SPPI test.

Hybrid contracts have been grouped with debt investments for classification purposes because IFRS 9 requires hybrid contracts with a host that is a financial asset to be assessed for classification as a whole.

This guide first discusses the classification of debt investments followed by equity investments. Derivatives are always measured at fair value and hence are not discussed further in this guide.

Classification and Measurement of Debt Investments (Including Hybrid Contracts)

A four step process is provided below to assist in determining the appropriate classification of debt investments (including hybrid contracts). Please note that debt investments and hybrid contracts are collectively referred to as financial assets for the remainder of the guide with the exception of those instances where guidance applies to only one of these types of financial assets.

Step 1: SPPI Test

The first step in determining the appropriate classification of a financial asset is to assess its contractual cash flow characteristics. Specifically, an entity will need to assess whether the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest. If so, the SPPI test is met. This is consistent with a basic lending arrangement.

Although the standard first discusses the business model test, the decision tree and this guide first addresses the SPPI test. This is because the business model assessment is only needed for instruments that meet the SPPI criterion. Therefore, in practice, some efficiencies may be realized by first performing the SPPI step as it may eliminate the need for a business model test for some instruments.

a) What is the principal?

Per IFRS 9, principal is the fair value of the financial asset at initial recognition though it may change over the life of the financial asset (e.g. if there are repayments of principal).

Example of Principal

Company A borrows $100,000 from Company B on December 31, 2014. During the 2015 fiscal year, Company A makes a loan payment to Company B of $8,000 ($3,000 of which is interest). What is the principal balance at the end of 2015?

Assessment: The principal balance at the end of the first year is $95,000. Interest payments do not reduce the principal balance, as such the principal balance is reduced by $5,000 ($8,000 - $3,000) when the $8,000 payment is made.

b) What are the significant elements of interest?

Interest is paid to the lender as consideration for the risks it takes on as a result of the lending arrangement.

The following are significant elements of interest:

- Time value of money
- Credit risk of the borrower
- Specific lending risks (e.g. liquidity risk)
- Administrative costs
- A profit margin consistent with a basic lending arrangement

Consideration for the time value of money and credit risk are usually the most significant elements of interest. However, the other bullets mentioned above are not inconsistent with a basic lending arrangement.

c) What currency should an entity use to assess whether contractual cash flows of an instrument meet the SPPI test?

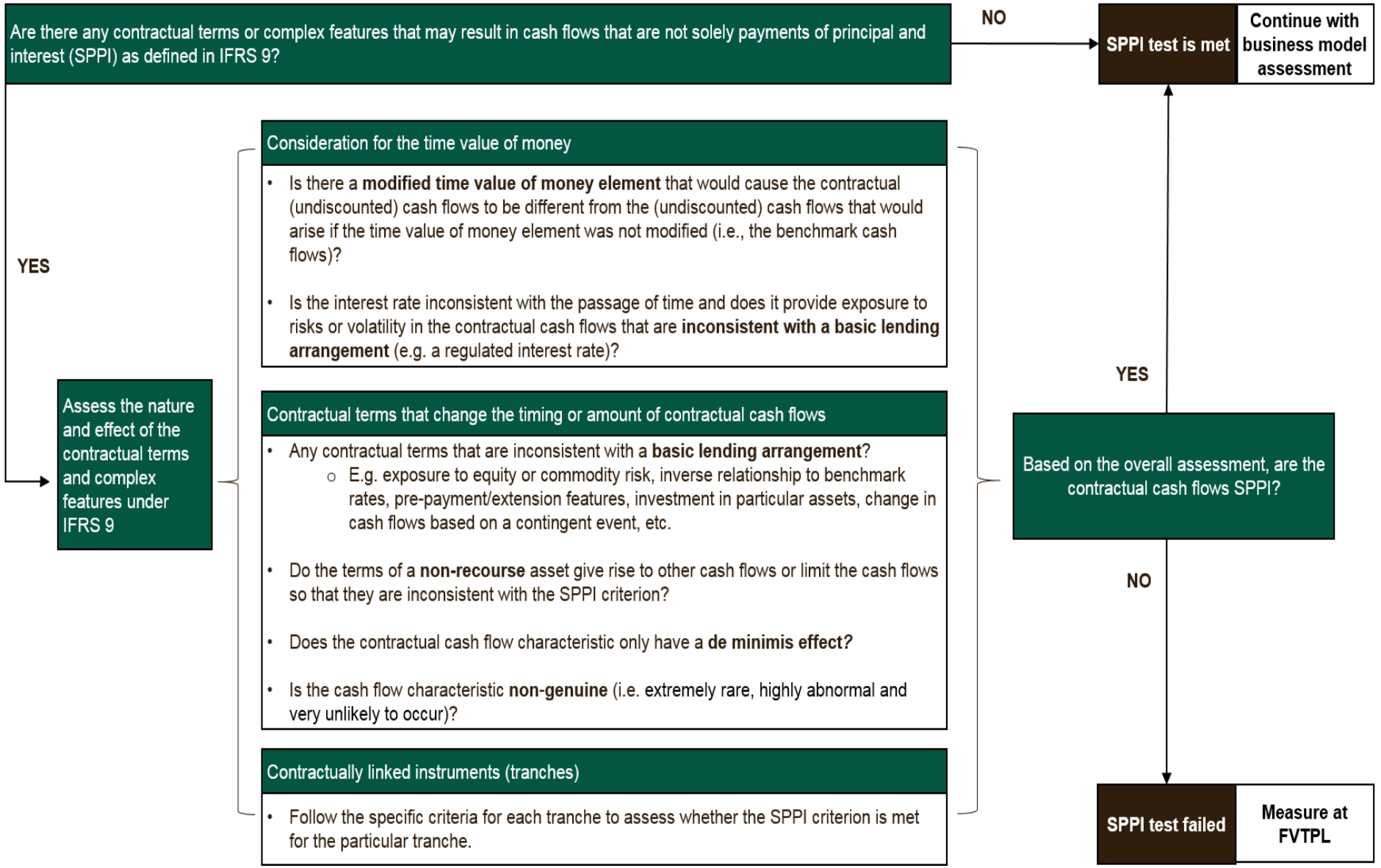
An entity must assess whether the SPPI test is met for the currency in which the financial asset is denominated.

d) Does a financial asset need to be a loan in its legal form in order to be considered a basic lending arrangement?

The substance rather than the legal form of the financial asset is most relevant. An originated or purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form. As a result, an analysis of agreements with cash flows that have characteristics of principal and interest needs to be performed to determine the appropriate accounting treatment.

Note! For “plain vanilla” debt investments, the SPPI test will be straightforward. This is because it is typically clear with little or no analysis to see why these investments are basic lending arrangements. In others words, it is apparent that the contractual cash flows are repayments of principal or payments of interest on the principal amount outstanding (i.e., the SPPI test is met).

Thus far, this guide discussed the basic characteristics of principal and interest. As indicated in the decision tree on the next page, a deeper analysis is needed whenever there are contractual terms or complex features that may indicate the SPPI criterion is not met.



Consideration for the Time Value of Money

Time value of money is the element of interest that provides consideration for only the passage of time and does not provide consideration for other costs or risks associated with holding the financial asset. An entity applies judgement and considers relevant factors, such as the currency in which the financial asset is denominated and the period for which the interest rate is set, in assessing whether more than just the passage of time has been reflected in the time value of money element.

Modified Time Value of Money

In some cases, the time value of money may be modified (i.e., imperfect). IFRS 9 provides the following examples of such situations:

- A financial asset's interest rate periodically resets but the frequency of the reset does not match the tenor of the interest rate (e.g., the interest rate resets every month to a one-year rate); or
- A financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates.

In these situations, the entity needs to assess the modification to determine if the SPPI criterion is met.

a) How does an entity assess if the SPPI criterion is met given a time value of money modification?

An entity must determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows of the instrument if the time value of money was not modified (i.e., the benchmark cash flows). If it could be significantly different, the SPPI criterion is not met.

In some circumstances, the entity may be able to make the above determination by only performing a qualitative assessment while in other circumstances, it may be necessary to perform a quantitative assessment. Furthermore, the determination must consider not only the effect of the modification in each reporting period but also cumulatively over the life of the financial asset.

Example of SPPI Assessment ***(IFRS 9.B4.1.9D)***

An entity is assessing a five-year bond with a variable interest rate that resets semi-annually to a five-year rate.

The entity cannot conclude that the SPPI criterion is met simply because the interest rate curve at the time of the assessment is such that the difference between a five-year and a six-month interest rate is not significant. Rather, the entity must assess the relationship between the two rates over the life of the instrument and its impact on the contractual undiscounted cash flows.

An entity must consider only reasonably possible scenarios instead of every possible scenario. The reason for the interest rate being set in this manner is not relevant to the analysis. If an entity concludes that the contractual undiscounted cash flows (i.e., cash flows based on the interest rate reset at the five-year rate) could be significantly different from the undiscounted benchmark cash flows (i.e., cash flows for an identical instrument but resets semi-annually based on a six-month rate), the financial asset does not meet the SPPI criterion and therefore, is measured at FVTPL.

b) Is a detailed assessment necessary if it is clear, with little or no analysis, whether the contractual (undiscounted) cash flows on the financial asset under assessment could (or could not) be significantly different from the undiscounted (benchmark) cash flows?

No.

Note! IFRS 9 does not contain any additional guidance on what is "significant" when considering a modified time value of money. The assessment will likely involve significant judgement and depend on the specific facts and circumstances taking into account the factors mentioned above.

Contractual Terms that Change the Timing or Amount of Contractual Cash Flows

A financial asset may contain a contractual term that could change the timing or amount of contractual cash flows (e.g. prepayment or extension features). In such a situation, the entity must determine whether the contractual cash flows that could arise over the life of the instrument, due to the contractual term, meet the SPPI criterion. This is accomplished by comparing the contractual cash flows that could arise before and after the change in contractual cash flows.

The following examples were adapted from IFRS 9.B4.1.11.

Examples of Contractual Terms that Change the Timing or Amount of Contractual Cash Flows

Example 1. Variable rate mortgage

ABC Credit Union offers variable interest rate mortgages to members at a rate of Prime + 1%. The interest rate reflects consideration for:

- The time value of money;
- The credit risk associated with the principal amount outstanding during a particular period of time (which in this situation is fixed at initial recognition);
- Other basic lending risks and costs; and
- Profit margin.

Assessment: Despite the potential change in the amount of cash flows in the event that the prime rate changes, the contractual cash flows of the variable interest rate mortgages remain solely payments of principal and interest on the principal amount outstanding. This is because the rate reflects only the significant elements of interest consistent with a basic lending arrangement. Therefore, the SPPI test is met.

Example 2. Loan with term extension feature

XYZ Credit Union offers its lending clients a term extension feature allowing these members to extend the repayment of the loan for one extra year. Upon extension, the member pays a reasonable amount of additional compensation to extend the loan. In addition, the interest rate is reset to current market interest rates for the extended term.

Assessment: The SPPI test is met since the contractual cash flows during the extension period are solely payments of principal and interest on the principal amount outstanding. Payment of reasonable additional compensation for extension of the loan does not violate the SPPI criterion.

Example 3. Loan with prepayment feature

ABC Credit Union offers its lending clients a prepayment feature allowing these members to pay off the loan prior to maturity. On prepayment, the member repays any outstanding principal and unpaid accrued interest. In addition, when the member exercises the option, they pay additional compensation for early termination of the contract. If the current market interest rate is higher than the loan interest rate, the compensation is based on the difference between the current market interest rate and the loan interest rate over the original term of the loan. If the current market interest rate is lower than the loan interest rate, a fixed amount is payable.

Examples of Contractual Terms that Change the Timing or Amount of Contractual Cash Flows
(Continued from previous page)

Assessment: The SPPI test is met since the amount prepaid substantially represents unpaid amounts of principal and interest on the principal amount outstanding. The prepayment amount may include reasonable additional compensation for early termination of the contract which does not violate the SPPI criterion.

Note! IFRS 9 does not provide examples of what is considered "reasonable compensation". This will likely include compensation for administration costs and/or any changes in interest rates which may benefit or disadvantage any of the parties. It will typically be apparent when compensation is unreasonable and there may be special circumstances that caused the parties to agree to such compensation. Examining compensation terms which are prevalent in practice and within the industry may be useful when completing this analysis.

Contingent Events

The nature of any contingent event (i.e., the trigger) that would change the timing or amount of contractual cash flows may need to be assessed. While the nature of the contingent event in itself is not a determinative factor in assessing whether the SPPI criterion is met, it may be an indicator.

Example of a Contingent Event

Consider two financial instruments with the following contractual terms that could trigger a change in the amount of contractual cash flows:

- Financial Instrument 'A': Interest rate resets to a higher rate if the debtor misses a certain number of payments.
- Financial Instrument 'B': Interest rate resets to a higher rate if a specific equity index reaches a particular level.

Assessment: Financial Instrument A is more likely to meet the SPPI criterion because of the relationship between missed payments and an increase in credit risk, resulting in an increased interest rate. As a result, the contingent events in this example provide an indication of whether the SPPI criterion is met. An entity would still need to consider if the new interest rate for Financial Instrument A is consistent with the elements of interest and reasonably compensates the lender for the change in credit risk. However, for Financial Instrument B the level of interest depends on a level of an equity index which indicates the lender has exposure to equity risk which likely means the SPPI criterion is violated. Again, additional analysis may be needed to understand why Financial Instrument B was structured in this manner.

Exception for Certain Prepayment Features

IFRS 9 contains an exception relating to financial assets with prepayment features which were acquired or originated at a premium or discount to the contractual par amount (i.e., its face value).

The *Basis for Conclusions on IFRS 9*, paragraphs BC4.193-195, provides the following examples of where the exception will apply:

- Credit-impaired financial assets purchased at a deep discount.

  The SPPI test would not be met if the asset could be repaid immediately at the par amount. However, the prepayment feature would have an insignificant fair value if it is very unlikely that prepayment will occur because the borrower is having financial difficulty. Consequently, the prepayment amount does not introduce variability that is inconsistent with a basic lending arrangement (i.e., reflects both the credit risk element as more cash flows are received and the time value of money element as the cash flows are received immediately).

- Financial assets originated at below-market interest rates.

  In such a situation, the fair value at initial recognition would be at a discount to the par amount. If the financial assets can be repaid at the par amount at any point before maturity, then the SPPI test would not be met. Again, the prepayment feature likely would have an insignificant fair value because it is unlikely that the counterparty will choose to prepay because the interest rate is below-market and, thus, the financing is advantageous. Similar to the above example, the prepayment amount does not introduce variability that is inconsistent with a basic lending arrangement.

The exception allows these types of financial assets to still be measured at amortized cost or FVOCI, as if the SPPI criterion is met, as long as all of the following conditions are met:

- The financial asset is held in a business model whose objective is either to (1) hold the financial asset to collect contractual cash flows or (2) to collect contractual cash flows by holding the financial asset and through sale.
- The financial asset was acquired or originated at a premium or discount to the contractual par amount.
- The prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable compensation for early termination of the contract.
- When the financial asset is initially recognized, the fair value of the prepayment feature is insignificant.

Note! Prepayments or extension features are common derivatives embedded in debt investments. Provided any additional compensation payable is reasonable or the criteria for the prepayment features exception are met, these contracts will typically not result in measurement at FVTPL for the contract as a whole.

Other Contractual Features that may Affect the Classification of a Financial Asset

In some cases, a financial asset's contractual cash flows may be described as principal and interest but they do not represent the payment of principal and interest on the principal amount outstanding. This may be the case if the financial asset represents an investment in particular assets or cash flows.

Tip! To appropriately perform the SPPI assessment, the contractual terms of the instrument should be analyzed based on the legal agreement to identify clauses that indicate that cash flows may vary based on an underlying asset which may be inconsistent with a basic lending arrangement.

Consider the contractual cash flows of the following instruments:

Instrument	Is the SPPI Criterion Met?
A loan agreement charges "interest" which is based on a percentage of the borrower's revenue.	The contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the SPPI criterion.
The contractual terms stipulate that the financial asset's cash flows increase as more customers use a specific type of credit card.	The contractual cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the SPPI criterion.
A lender's claim is limited to specified assets of the borrower or the cash flows from specified assets (e.g. a "non-recourse" financial asset).	The fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the SPPI criterion. Refer to the guidance below for the additional analysis needed.

a) How does the SPPI criterion apply to an asset that is non-recourse?

A 'non-recourse' financial asset is secured by collateral, which is usually property. If the borrower defaults, the issuer can seize the collateral, but cannot seek out the borrower for any further compensation, even if the collateral does not cover the full value of the defaulted amount. This is in contrast to other secured loans where the lender can seek further compensation if the collateral is not sufficient to cover the debt. Therefore, in the case of non-recourse loans the cash flows may be impacted by the value/characteristics of the collateral which could impact the SPPI criterion.

When a financial asset is non-recourse, the creditor performs its SPPI assessment by evaluating the underlying assets or cash flows. 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 SPPI criterion. Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.

Example of Commonly Encountered Non-Recourse Loans

Non-recourse loans that are issued by mortgage companies and Credit Unions are often secured by property collateral. The amount of loan granted also depends on the value of the property and the loan granted is usually less than the property value (e.g. 80%). As a result, the contractual cash flows are usually not limited by the fact that the loan is non-recourse and the SPPI criterion is met.

This consideration should also not be a concern for loans with guarantees or collateralized loans with recourse. Situations that require additional analysis arise when the collateral does not cover the outstanding amount or the interest or repayments are limited by actual profits.

b) What if a particular cash flow characteristic could have only a de minimis effect on the contractual cash flows of the financial asset?

The classification of the financial asset is not affected if the contractual cash flow characteristic could have only a de minimis effect on the contractual cash flows of the financial asset. An entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument in completing this assessment.

Note! IFRS 9 does not have any further guidance on what is meant by a de minimis effect. However, this Latin expression refers to effects that are trivial or minimal and therefore, of no concern.

The determination of whether a contractual cash flow characteristic has a de minimis effect on the cash flows may involve significant judgement. If a contractual term is included in a contract it is likely because it was expected to have an effect that is not clearly trivial. Therefore, we recommend consulting with your MNP representative before concluding that a contractual term has a de minimis effect.

c) What is a particular contractual cash flow characteristic that only affects the instrument's cash flows on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur?

A cash flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

The classification of a financial asset is not affected if a contractual cash flow characteristic could have an effect on the contractual cash flows that is more than de minimis (either in a single reporting period or cumulatively) but that cash flow characteristic is not genuine.

Note! IFRS 9 does not provide further guidance or examples of events that are extremely rare, highly abnormal and very unlikely to occur.

This assessment may involve significant judgement and will raise the question of why it was included in the agreement in the first place. Therefore, we recommend consulting with your MNP representative before concluding that a contractual cash flow characteristic is non-genuine.

d) Is the SPPI criterion impacted by an instrument being subordinated to other instruments?

No. Generally, a creditor's instrument is ranked relative to the instruments of the debtor's other creditors in a lending transaction. Although an instrument is subordinated to other instruments, it may have contractual cash flows that are payments of principal and interest on the principal amount outstanding. This is the case if:

- The debtor's non-payment is a breach of contract; and
- The holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor's bankruptcy.

For example, a general creditor (e.g. a trade receivable creditor) would qualify as having payments of principal and interest on the principal amount outstanding regardless whether the debtor issued loans that are collateralized. In the event of bankruptcy, the loan holder has priority over the claims of the general creditor in respect of the collateral but it does not affect the contractual right of the general creditor to unpaid principal and other amounts due.

e) Does a perpetual instrument meet the SPPI criterion?

The fact that an instrument is perpetual does not in itself mean that the SPPI test failed. In effect, a perpetual instrument has continuous (multiple) extension options. Such options may meet the SPPI test if interest payments are mandatory and must be paid in perpetuity.

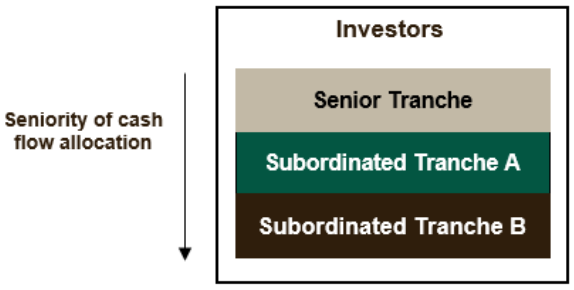
f) Does a callable instrument meet the SPPI criterion?

The fact that an instrument is callable does not mean that the SPPI test failed. If the callable amount does not substantially reflect payment of outstanding principal and interest on the principal amount outstanding, the SPPI criterion is not met. Even if the callable amount includes reasonable compensation for the holder for the early termination of the instrument, the contractual cash flows could meet the SPPI criterion. Refer to the note under the "Contractual Terms that Change the Timing or Amount of Contractual Cash Flows" section of this guide for guidance on determining what "reasonable compensation" is.

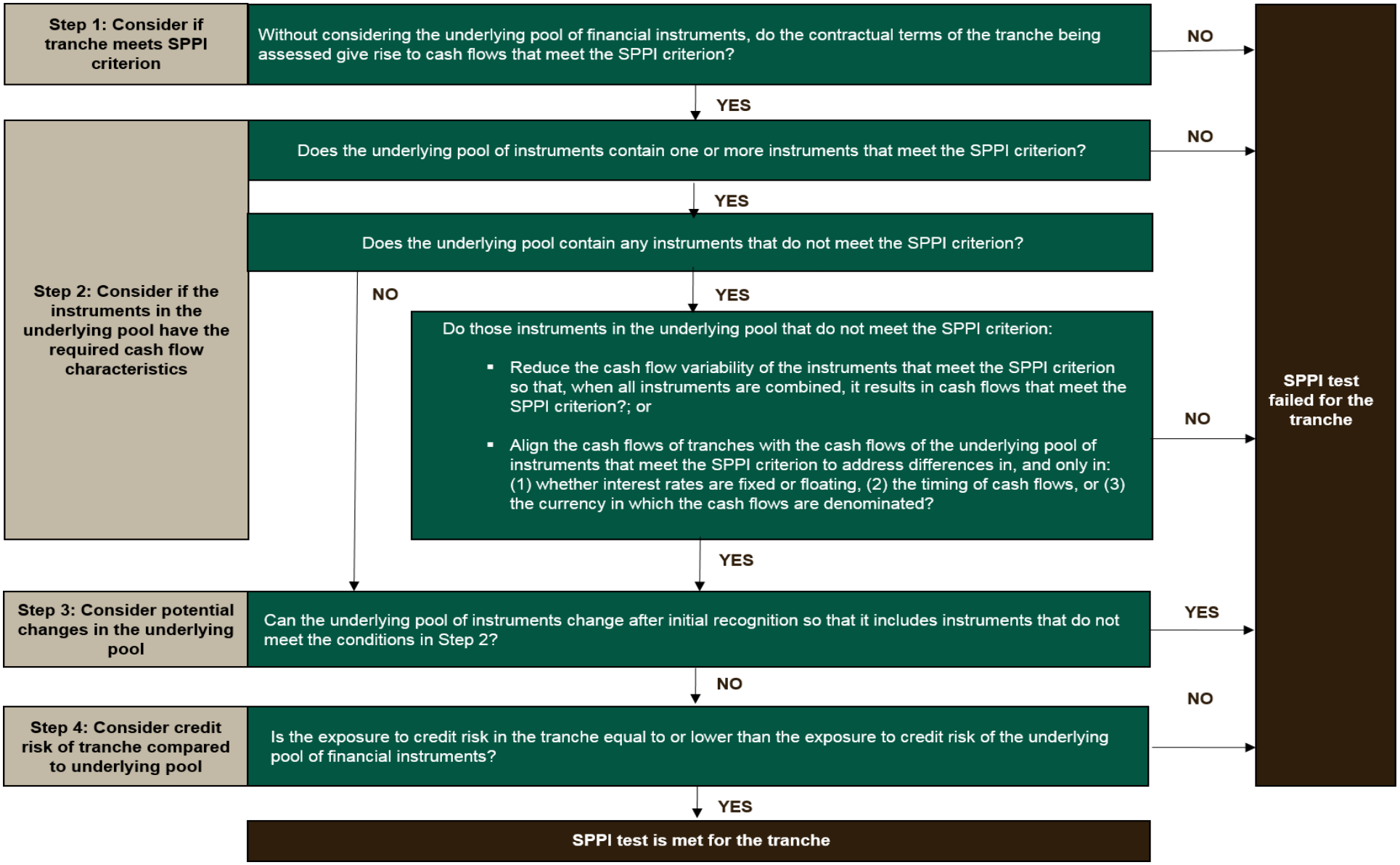
Examples of Contractual Cash Flows that do not Meet the SPPI Criterion	
Instrument	**Analysis**
A bond that is convertible into a fixed number of equity instruments of the issuer.	The contractual cash flows reflect a return that is inconsistent with a basic lending arrangement (i.e., return is linked to the value of the issuer's equity). Therefore, they are not solely payments of principal and interest on the principal amount outstanding.
A loan with an interest rate that has an inverse relationship to market interest rates (i.e., the loan's interest rate rises as the market rate falls).	The interest amounts are not consideration for the time value of money on the principal amount outstanding. Therefore, the SPPI test failed.
A perpetual instrument (e.g. a bond with no maturity) that the issuer may call at any point and pay the holder the par amount plus accrued interest due. The instrument pays a market interest rate but payment of interest is dependent on the issuer remaining solvent immediately afterward. Deferred interest does not accrue additional interest.	The interest amounts are not consideration for the time value of money on the principal amount outstanding. This is because interest payments may be deferred depending on the issuer's solvency and additional interest does not accrue on those deferred amounts. If interest accrued on the deferred amounts, the contractual cash flows could be solely payments of principal and interest on the principal amount outstanding.

Contractually Linked Instruments

An issuer may contractually link financial instruments to prioritize the contractual cash flows paid to their holders. This creates concentrations of credit risk (i.e., tranches) with each tranche subordinated to the tranche(s) above it. The subordination ranking specifies the order in which any cash flows generated by the issuer are allocated.



In these cases, the holders of the instruments have the right to payments of principal and interest on the principal amount outstanding only if the issuer has sufficient cash flows to satisfy the financial instruments in higher ranked tranches. To determine if the SPPI criterion has been met for each tranche the following decision tree may be used.



The following examples demonstrate how the above decision tree can be used to perform the assessment for each tranche.

Example of Contractually Linked Instruments

Company ABC issues two tranches (A and B) of contractually linked debt instruments which pay interest on the principal amount outstanding. Tranche B is subordinate to Tranche A and therefore only receives distributions after the tranche A holders have been paid. The underlying instruments are a fixed pool of loans, which all meet the SPPI criterion.

	Tranche A	Tranche B
Step 1	Without looking through to the underlying pool of instruments (i.e., the pool of loans), the contractual terms of each tranche give rise only to payments of principal and interest.	
Step 2	Since the underlying pool of instruments are a fixed pool of loans, it contains at least one instrument with cash flows that are solely payments of principal and interest. Company ABC has no other financial instruments that would prohibit the tranche from meeting the SPPI criterion.	
Step 3	The underlying pool of instruments cannot change in a way that the pool would not meet the conditions in Step 2.	
Step 4	Since Tranche A is the most senior tranche, its credit risk is lower than the underlying pool as it may receive some cash flows even if the underlying assets default. As such, tranche A meets the SPPI criterion.	Tranche B is the most junior tranche; therefore, the credit risk of Tranche B is higher than the underlying pool. Consequently, it does not meet the last criterion dealing with the credit risk of the tranche compared to the underlying pool. The SPPI criterion has not been met and investments in Tranche B must be measured at FVTPL.

The following table provides examples of instruments that may be included in the underlying pool and their impact on the SPPI assessment.

Example of Underlying Pool Instruments	Impact on SPPI test
Derivative instruments that act like an interest rate cap or floor	These instruments reduce the overall variability of cash flows of the loans in the underlying pool. Therefore, these are instruments that IFRS 9 allows to be included in the underlying pool without violating the SPPI criterion.
Financial guarantee contract	
Currency derivative that converts the cash flows in the underlying pool to the currency that the tranches are denominated in.	This instrument addresses differences in currency between the cash flows of the underlying pool and the tranches. Therefore, it is one of the instruments that IFRS 9 allows to be included in the underlying pool without violating the SPPI criterion.
Equity instruments or commodity derivatives	These instruments do not meet the criteria in Step 2 and therefore the SPPI test would fail for all tranches.

a) What if the underlying pool includes instruments that are collateralized by assets that do not meet the conditions in Step 2 (e.g. real estate or equity investments)?

In assessing whether a tranche meets the SPPI criterion, the ability to take possession of such assets shall be disregarded unless the entity acquired the tranche with the intention of controlling the collateral.

b) How detailed should the analysis in Step 2 be?

Sufficient analysis will need to be performed to determine whether the instruments in the underlying pool meet the conditions in Step 2. This may, or may not, require a detailed instrument-by-instrument analysis; however, significant judgement will be involved. An entity should also consider the guidance on de minimis or non-genuine features in this analysis.

c) How do I identify the underlying pool of instruments?

The underlying pool of instruments are those that are creating (instead of passing through) the cash flows.*)*

d) What if the holder cannot assess the conditions under Steps 1 through Step 4 at initial recognition?

If the holder cannot assess the conditions under Steps 1 through 4 at initial recognition, the tranche must be measured at FVTPL.

Step 2: Business Model Test

The next step in determining the classification of a financial asset within the scope of IFRS 9 is to assess the objective of the business model the financial asset is held within. The business model refers to how an entity manages the assets in order to generate cash flows (i.e., either as collecting cash flows, selling the financial assets or both). The business model test is only applicable to financial assets that meet the SPPI criterion to determine if they will be measured at amortized cost or FVOCI. All financial assets that do not meet the SPPI criterion are measured at FVTPL.

The following table summarizes the three types of business models used to determine the classification of financial assets:

	Held to Collect	Both Held to Collect and for Sale	Other
Objective of Business Model	Hold financial assets to collect contractual cash flows. *Note: Selling financial assets is incidental.*	Both hold financial assets to collect contractual cash flows and sell the financial assets.	Examples: ▪ Realizing cash flows through sale. ▪ A portfolio is managed, and its performance is evaluated, on a fair value basis. ▪ A portfolio that meets the definition of held for trading. *Note: Collecting contractual cash flows is incidental.*

When assessing the objective of the business model, the entity must ensure that the assessment is completed at the appropriate level within the entity and that the assessment is based on what the entity reasonably expects to occur with the financial assets. Relevant evidence must support the assessment.

a) Who performs the business model assessment?

The business model assessment is determined by the entity's key management personnel[1].

b) At what level (e.g. individual instrument, portfolio or entity level) is the business model assessment performed?

The assessment is performed at the group of financial assets level based on which financial assets are managed together to achieve a particular business objective. Accordingly, this condition is not dependent on management's intentions for an individual instrument and, thus, is not an instrument-by-instrument approach to classification.

Since it is possible for a single entity to have more than one business model for managing its financial instruments, it may not be appropriate to determine the classification at the reporting entity level. Similarly, in some circumstances, it may be appropriate to separate a portfolio of financial assets into sub-portfolios in order to reflect the level at which an entity manages those financial assets.

Examples of Level of Assessment *(IFRS 9.B4.1.2)*

Example 1. Portfolios of assets

An entity holds two portfolios of investments – one that it manages to collect contractual cash flows and the other that it manages to trade to realize fair value changes.

Assessment: The business objective differs for each individual portfolio. Thus, in this example, the assessment is made at a portfolio level.

Example 2. Sub-portfolios of assets

An entity manages some of the loans within its mortgage loan portfolio with the objective of collecting contractual cash flows and other loans with the objective of selling them.

Assessment: The entity would separate the portfolio of mortgage loans into sub-portfolios to reflect the level at which it manages the financial assets. Thus, in this example, the assessment is made at a sub-portfolio level.

c) To what extent should an entity consider 'worst case' or 'stress case' scenarios when performing the business model assessment?

The business model assessment is based on what the entity reasonably expects to occur with regard to the financial assets, rather than a 'worst case' or 'stress case' scenario. For example, if an entity expects to sell a portfolio of financial assets only if it were close to bankruptcy (i.e., in a worst case scenario), that scenario would have no effect on the business model assessment.

[1] IAS 24 *Related Party Disclosures* defines key management personnel as "those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity".

d) If cash flows are subsequently realized in a way that is different from the entity expectations at the business model assessment date (e.g. entity sells more/fewer financial assets than expected when classification determined), does this result in a prior period error?

No. Such scenarios will not give rise to a prior period error, or a change in classification of the remaining financial assets that are still held in that business model (i.e., those assets that the entity recognized in prior periods and still holds), as long as the entity considered all available and relevant information when it made the business model assessment.

A change in business model for existing financial assets is expected to be very rare. Refer to the "Reclassifications" section of this guide for guidance on what constitutes a change in business model.

e) What type of information should be considered when performing the business model assessment?

An entity's business model for managing assets is based on factual evidence and not merely an assertion. It is typically observable through the activities that the entity undertakes to achieve the business model objective. However, judgement is still needed because, in practice, the situations are rarely black and white.

All relevant and available evidence (i.e., not just a single factor or activity) must be used to support the business model assessment. The following are examples of relevant evidence:

- How the entity's key management evaluates the performance of the business model and the financial assets held within that business model and how that information is reported to them.
- The risks that affect the performance of the business model, and the financial assets held within that business model, and how those risks are managed.
- The compensation base for managers of the business (e.g. whether compensation is based on the fair value of the assets managed, the overall return of the portfolio or on the contractual cash flows collected).
- How cash flows were realized in the past for similar instruments compared to their assigned business model.

Each type of business model is discussed in further detail below.

Tips for performing the business model assessment:

- Assess whether the sale of financial assets and/or collection of contractual cash flows are incidental or integral to the objective of the business model.
- Familiarize yourself with the examples provided below.
- Consult with your MNP representative if you are unsure what type of business model a financial asset is held within.

Held to Collect Business Model

Financial assets that are held within this business model are managed to generate cash flows by collecting contractual payments over the life of the instrument. This is contrary to the held to collect and for sale business model which involves managing the overall return on the portfolio by both holding and selling assets. To determine whether instruments are in a held to collect business model, consider:

- The frequency, value and timing of prior period sales;
- The reasons for prior period sales; and
- Expectations regarding future sales activity.

However, the above-noted sales information should not be considered in insolation when determining the business model. Rather, this information should be used as evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realized. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions.

It is important to note that all financial assets do not need to be held until maturity in order to be in the held to collect business model. Sales with the following characteristics, or for the following reasons, may still be consistent with a held to collect business model:

- Asset no longer meets the entity's documented investment policy.
- Minimizing potential credit losses due to credit deterioration.
- Reducing or managing the entity's credit risk concentration even if there is no increase in the asset's credit risk.
- Sales made close to the maturity of the financial asset where proceeds approximate the collection of the remaining contractual cash flows.
- Infrequent sales even if significant in value (both individually and in aggregate).
- Sales insignificant in value (both individually and in aggregate) even if frequent.
- Sales due to urgent unexpected liquidity needs.
- A change in business goals so that certain cash flows are no longer needed.

Note! The held to maturity classification category under IAS 39 has strict "tainting provisions" which has reduced the use of the held to maturity category in practice. IFRS 9 does away with these strict tainting provisions. As shown above, some sales of financial assets can take place without being inconsistent with a held to collect business model. If an entity's intention is to hold the financial assets to collect contractual cash flows and sales remain incidental or unexpected, use of the held to collect business model is appropriate.

Judgement may be required to determine whether sales are incidental to an entity's business model and there is no additional guidance on the terms "significant", "infrequent", "close to maturity" or "approximate". The assessment will depend on specific circumstances and consultation with your MNP representative may be warranted to ensure that financial assets are classified appropriately.

a) Is whether sales are imposed by a third party or at entity's discretion relevant to this assessment?

No. Who imposes the sales is irrelevant to the assessment; however, the facts around the condition for the sales may be relevant. For example, assume that the Credit Union Deposit Guarantee Corporation imposed a requirement on Credit Unions to regularly sell a significant portion of their financial assets from a portfolio to demonstrate that the assets are highly liquid. In this instance, the Credit Unions' business model could not be held to collect.

b) Does an increase in frequency or value of sales in a specific period indicate an inconsistency with the objective of a held to collect business model?

Not necessarily. If an entity can explain the reasons for the increase and provide factual evidence for why those sales don't reflect a change in business model, then a held to collect business model remains appropriate.

The following examples are adapted from IFRS 9 where the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows. This list of examples is not exhaustive. Furthermore, the examples are not intended to discuss all factors that may be relevant to the assessment of the entity's business model nor specify the relative importance of the factors.

Examples of Held to Collect Business Models *(IFRS 9.B4.1.4)*

Example 1. Liquidity needs in stress case scenario

ABC Credit Union maintains a portfolio of debt investments which will only be sold in a 'stress case' scenario (e.g. a financial crisis due to a run on the bank's deposits). ABC does not otherwise anticipate selling these assets. Further:

- In accordance with its internal policies, ABC monitors the credit quality of the debt investments as part of its business objective which is to collect contractual cash flows.
- ABC evaluates the performance of the portfolio with reference to interest revenue earned and credit losses realized.
- The fair value of the debt investments are also monitored to ensure that the cash realized in the unlikely event of sale would be sufficient to meet the credit union's liquidity needs. Sales of an insignificant value are occasionally made to demonstrate liquidity.

Assessment: ABC's objective is to hold the portfolio of debt investments to collect the contractual cash flows. There would be no change in this analysis even if:

- During a previous stress case scenario, ABC had sales that were significant in value in order to meet its liquidity needs.
- ABC had recurring sales activity of insignificant value.

Example 2. Credit management

As AAA Company's funding needs are predictable, the entity is able to purchase debt investments with the same maturity as the entity's estimated funding needs. AAA monitors credit risk very carefully in order to minimize credit losses. Therefore, sales have typically occurred when the assets' credit risk increased above the entity's tolerance level per its investment and risk management strategies or as a result of unanticipated funding needs. Reporting provided to key management personnel includes the credit quality of the assets, the contractual return and the fair value of the assets from a liquidity perspective.

Assessment: Although AAA considers, among other information, the fair value of the financial assets from a liquidity perspective (i.e., the amount that would be realized if the entity needs to sell assets), the entity's objective is to hold to collect contractual cash flows. AAA's business model is to hold the investments up to maturity in order to match the timing of the payment of the principal with the entity's expecting funding needs. Sales would not contradict that objective (even if significant in value) if they were in response to:

- An increase in the assets' credit risk (e.g. asset no longer meets the credit criteria specified in the entity's documented investment policy).
- Unanticipated funding needs resulting in infrequent sales (e.g. in a stress case scenario).

Examples of Held to Collect Business Models *(Continued from previous page)*

Example 3. Purchases of portfolios

ZZZ Company purchases portfolios of loans which may, or may not, include credit-impaired financial assets. If loan payments are past due, ZZZ will contact the debtor in an attempt to realize the contractual cash flows. ZZZ does not plan to sell the loans. ZZZ occasionally enters into receive-fixed pay-variable interest rate swaps to reduce the cash flow variability of a particular financial asset.

Assessment: ZZZ's objective is to hold the portfolios of loans to collect their contractual cash flows. The same analysis applies for the credit-impaired loans (i.e., it is irrelevant that ZZZ does not expect to receive all of the contractual cash flows on these loans). The fact that ZZZ enters into swaps to change the cash flow variability of the portfolios doesn't change the entity's business model.

Example 4. Securitization vehicle

DDD Credit Union issues residential mortgages and subsequently sells the mortgages to a securitization vehicle which it controls and, thus, consolidates. The securitization entity collects the contractual cash flows and distributes them to its investors. The mortgages continue to be recognized in DDD's consolidated financial statements.

Assessment: At the consolidated group level, the mortgages are originated with the objective of holding to collect contractual cash flows. However, at an individual entity level, DDD has the objective of realizing cash flows on the mortgage portfolio by selling the mortgages to the securitization vehicle. Therefore, for purposes of DDD's separate financial statements, it would not be considered to be managing this portfolio in order to collect contractual cash flows.

Example 5. Term deposits

XYZ Credit Union holds term deposits with its provincial Central (central bank facility, trade association and service bureau owned by Credit Unions). XYZ's objective is to earn interest revenue from the deposits. If XYZ wishes to access its money before the term deposit matures it would face an interest adjustment that would significantly reduce the interest revenue earned. In the past XYZ has held term deposits until maturity.

Assessment: XYZ is holding the term deposits to earn interest revenue and doesn't anticipate selling the investments as this would result in an interest adjustment. Moreover, in the past, term deposits have been held until maturity. Therefore, XYZ is holding the financial assets to collect the contractual cash flows.

Example 6. Planned capital expenditure

ABC Ltd. anticipates a cash outflow in two years to fund a capital expenditure and invests its excess cash in a two-year bond. ABC collects interest on the bond during the two-year period. When the investments mature, the entity uses the proceeds to fund the capital expenditure.

Assessment: This entity's business model is to hold financial assets to collect contractual cash flows as it plans to hold the bonds until maturity.

Both Held to Collect and for Sale Business Model

The second type of business model that an entity's key management may utilize in managing its financial assets is the held to collect and for sale business model. In this type of model, both collecting contractual cash flows and selling financial assets are integral to achieving the business model objective.

Examples of the objective of this type of business model may include:

- Managing everyday liquidity needs.
- Maintaining particular interest yield profile.
- Matching the duration of the financial assets to the duration of the liabilities those assets are funding.

Generally, a greater frequency and value of sales of financial assets occur under the held to collect and for sale business model than under the held to collect business model. This is because selling financial assets is integral to achieving the objective of the collect and for sale business model objective while it is only incidental to achieving the objective of the held to collect business model. However, no threshold for the frequency or value of the sales exists.

The following examples are adapted from IFRS 9 where the objective of the entity's business model may be achieved by both collecting contractual cash flows and selling financial assets. This list of examples is not exhaustive. Furthermore, the examples are not intended to describe all the factors that may be relevant to the assessment of the entity's business model nor specify the relative importance of the factors.

Examples of Both Held to Collect and for Sale Business Models *(IFRS 9.B4.1.4C)*

Example 1. Daily liquidity needs

XYZ Credit Union invests in bonds for its short term liquidity needs. Sales occur because XYZ invests in assets with higher returns or to better match the duration of its liabilities. This strategy usually results in frequent and significant sales activity. The return on this portfolio:

- Is actively managed to minimize the cost of the credit union meeting its daily liquidity.
- Consists of contractual cash flows and gains and losses from the sale of these investments

Assessment: The objective of XYZ's business model is to maximize the return on the portfolio to meet its every day liquidity needs. This is achieved by both collecting contractual cash flows and selling financial assets, which are both integral to the business model's objective.

Example 2. Anticipated capital expenditure

AAA Company anticipates a large cash outflow in five years related to a significant capital expenditure. In order to help fund the expenditure, AAA has started to invest any excess cash into short- and long-term bonds. Many of the financial assets mature after five years. AAA collects interest on the bonds during the term; however, to maximize its cash inflow for the expected capital expenditure, it may also sell the bonds to re-invest in higher yielding assets. Portfolio managers are compensated based on the portfolio's overall return.

Assessment: AAA's objective is both collecting contractual cash flows and selling financial assets depending on what will maximize the return on the portfolio.

If the managers were compensated based on the fair value of the portfolio, additional analysis or judgement may be needed to conclude as the compensation would appear to be inconsistent with the other facts of the situation.

Examples of Both Held to Collect and for Sale Business Models *(Continued from previous page)*

Example 3. Insurance contract liabilities

ZZZ Insurance has a portfolio of financial assets which it uses the contractual cash flows from to fund its insurance contract liabilities as they become due. ZZZ frequently buys and sells significant amounts of financial assets to rebalance the portfolio and meet its cash flow needs to settle those liabilities.

Assessment: ZZZ's objective is to fund its insurance contract liabilities and it achieves this by collecting contractual cash flows on the financial assets as they mature and selling financial assets to maintain the desired profile of the asset portfolio. As such, both collecting contractual cash flows and selling financial assets are integral to the business model's objective.

Example 4. Regulator required sales

ABC Credit Union holds financial assets to meet its daily liquidity needs. ABC is required by its Credit Union Deposit Guarantee Corporation to regularly sell a significant portion of its financial assets to demonstrate that the assets are highly liquid. The return on the portfolio consists of both contractual cash flows and gains and losses from the sale of financial assets.

Assessment: Because ABC's regulator requires it to sell a significant portion of its financial assets to demonstrate their liquidity, its business model objective is both collecting contractual cash flows and selling financial assets.

Other Business Models

Financial assets that are not held within either a:

- Held to collect business model; or
- Both held to collect and for sale business model

are measured at FVTPL.

The following are examples from IFRS 9 of business models that result in this measurement.

Examples of Business Models that are Neither Held to Collect or Held to Collect and Sell

Example 1. Financial assets managed with the objective of realizing cash flows through sale

In such a situation, the fair value of the financial assets is the key factor in the entity's decisions on how to manage the assets as they want to realize those fair values. In this case, the entity's objective will typically result in active buying and selling.

The objective of such a business model is achieved by selling the financial assets in order to realize the fair value gains. Although contractual cash flows will be received while the financial assets are held, the collection of contractual cash flows is incidental to achieving the business model's objective.

Examples of Business Models that are Neither Held to Collect or Held to Collect and Sell *(Continued from previous page)*

Example 2. A portfolio that is managed, and whose performance is evaluated, on a fair value basis

An entity has financial assets and financial liabilities that share one or more risks and those risks are managed and evaluated on a fair value basis in accordance with a documented risk management policy. Often, the goal may be for the fair value changes in the assets and liabilities to offset each other.

In such a situation, the primary focus is on fair value information to assess the assets' performance and to make decisions. Collecting cash flows is an incidental part of this business model.

Example 3. A portfolio that meets the definition of held for trading

In this context, a held for trading investment includes a financial asset that meets one of the following criteria:

- Is acquired, or incurred, principally for the purpose of selling or repurchasing it in the near term; or
- On initial recognition, is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

In held for trading portfolios, the collection of contractual cash flows is only incidental to achieving the business model's objective of selling the financial assets. Consequently, such portfolios of financial assets must be measured at FVTPL.

Step 3: Election to Eliminate or Reduce an Accounting Mismatch

Despite the SPPI and business model tests, an entity may, at initial recognition, irrevocably designate a financial asset as measured at FVTPL. This is only allowed if doing so eliminates, or significantly reduces, a measurement or recognition inconsistency (sometimes referred to as an accounting mismatch) that would otherwise arise from measuring assets or liabilities, or recognizing the gains and losses on them, on different bases.

a) When may an accounting mismatch arise?

An accounting mismatch may arise in the absence of designation as at FVTPL. For example, Credit Union A has a loan receivable that meets the SPPI and business model tests and is, therefore, classified and measured at amortized cost (with changes in fair value not recognized). The credit union holds a related interest rate swap derivative liability that is classified and measured at FVTPL, which the entity considers to be related. In such a situation, there is an accounting mismatch and the credit union may conclude that its financial statements would provide more relevant information if both the asset and liability were measured at FVTPL.

b) Is this designation required to be applied consistently to all similar transactions?

No. The decision to designate a financial asset at FVTPL is similar to an accounting policy choice; however, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions.

IFRS 9.B4.1.30–32 contains additional examples and application guidance which should be consulted if an entity is considering making this designation. This designation was also available under IAS 39; therefore, this guide does not discuss it in further detail.

Step 4: Determine Measurement Basis

The outcome of the previous steps determine the classification and the related measurement. The table below provides a high-level overview of the IFRS 9 measurement requirements for financial assets.

Measurement Category	Accounting Treatment
Amortized Cost	▪ Recognize through profit or loss: • Credit impairment • Interest revenue • Foreign exchange gains or losses ▪ On derecognition, gains or losses are recognized in profit or loss.*
FVOCI (With Recycling)	▪ Recognize through profit or loss: • Credit impairment • Interest revenue • Foreign exchange gains or losses The amounts recognized in profit or loss would be the same as under the amortized cost treatment above. ▪ Gains or losses to recognize the financial asset at fair value instead of amortized cost are recognized in OCI. ▪ On derecognition, the cumulative gains or losses in OCI are reclassified (i.e., recycled) to profit or loss.
FVTPL	▪ All changes in fair value are recognized in profit or loss.**

** Fair value changes are not recognized until the investment is sold. Given, that this measurement applies to the hold to collect business model it is not expected that significant fair value changes relating to these financial assets will be recognized.*
*** An entity does not distinguish between changes resulting from interest, foreign exchange rates or impairment.*

Hybrid Contracts

Hybrid contracts refer to contracts with a non-derivative host and embedded derivatives[2]. The host contract can be a financial asset in the scope of IFRS 9 or another type of contract (e.g. financial assets not in the scope of IFRS 9, financial liabilities, leases, insurance contracts, etc.).

The following table contrasts these two types of hybrid contracts:

	Hybrid Contracts with Host Contracts that are Financial Assets in the Scope of IFRS 9	Other Hybrid Contracts
Examples	▪ Loans issued with prepayment and extension features. ▪ Investments in convertible debt.	▪ Embedded derivatives embedded in leases or insurance contracts. ▪ Loans payable with embedded derivative features. ▪ Convertible debt payable.
IAS 39 Treatment	Determine if the embedded derivative should be bifurcated from the host contract or not based on a few criteria including consideration of whether the embedded derivative is closely related to the host contract.	
IFRS 9 Treatment	The embedded derivative is <u>not</u> separated from the financial asset. Rather, the hybrid instrument is assessed for classification and measurement using the process previously described for debt investments. In other words, the SPPI and business model assessment are performed for the hybrid instrument.	Same as under IAS 39.

[2] A derivative is "a financial instrument or other contract within the scope of this standard with all three of the following characteristics.

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
(c) It is settled at a future date."

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

Note! IFRS 9 removes the complex IAS 39 bifurcation assessment for embedded derivatives attached to host contracts that are financial assets in the scope of IFRS 9. However, under IFRS 9, the bifurcation requirements from IAS 39 still apply to other hybrid contracts. In addition, the definition of derivatives and embedded derivatives have not changed from IAS 39 to IFRS 9.

The rest of this section briefly explains how the new classification requirements may apply to commonly encountered embedded derivatives in financial asset host contracts.

Examples of Commonly Encountered Hybrid Contracts

Example 1. Loans issued with prepayment or extension features

The "Step 1: SPPI Test" section above explains the considerations relevant to prepayment and extension features which should be applied to these instruments as a whole. Given the specific IFRS 9 guidance on assessing the SPPI criterion for prepayment and extension features, and the limited exception for certain prepayment features as discussed in the "Step 1: SPPI Test" section of this guide, the business model assessment will likely be performed to conclude on the measurement as either FVOCI or amortized cost.

Example 2. Investments in convertible debt

The contractual cash flows from convertible debt include exposure to equity risk which will usually result in the hybrid contract failing the SPPI criterion because the contractual cash flows are not solely payments of principal and interest. Hence, convertible debt will likely be measured at FVTPL in its entirety.
If a business model test is required, the "Step 2: Business Model Test" section of this guide contains relevant guidance that will also be applied to the instrument as a whole.

Classification and Measurement of Equity Investments

As discussed above, equity investments (including preference shares) and derivatives generally do not give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. As such, we have simplified the approach for classifying these instruments by assuming they will not meet the SPPI test.

Step 1: Equity Investment is Held for Trading

The first step in determining the appropriate classification of a financial asset that is an equity investment is to assess whether the investment is held for trading. In this context, the equity investment is held for trading if one of the following criteria applies:

- It is acquired or incurred principally for the purpose of selling or repurchasing in the near term.
- On initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking.

If the financial asset meets either of the above criteria, it must be measured at FVTPL.

Step 2: Irrevocable Election Made to Measure the Equity Investment at FVOCI

IFRS 9 allows an entity to make an irrevocable election, on initial recognition, to present subsequent changes in the fair value of an equity investment through OCI, permitted that the investment is neither:

- Held for trading
- Contingent consideration recognized by an acquirer in a business combination

If the equity investment is not eligible for the irrevocable FVOCI election, or the entity chooses not to make the election, the equity investment must be measured at FVTPL. This election is made on an instrument-by-instrument basis.

Step 3: Determine Measurement Basis

The outcome of the previous steps determine the classification and the related measurement. All equity investments are measured at fair value, but changes in fair value are either recognized in profit or loss, or OCI.

The table below provides a high-level overview of the IFRS 9 measurement requirements for equity instruments.

Measurement Category	Accounting Treatment
FVOCI (Without Recycling)	▪ All changes in fair value of the instrument go through OCI. ▪ Dividends are usually accounted for in profit or loss. ▪ On derecognition, cumulative amounts previously recognized in OCI are not subsequently transferred to profit or loss (i.e., recycled). However, they may be transferred within equity (i.e., moved from comprehensive income to retained earnings).
FVTPL	▪ All changes in fair value are recognized in profit or loss.

Note! The accounting for equity investments measured at FVOCI differs from debt investments measured at FVOCI. Specifically, no impairment testing is performed for equity investments measured at FVOCI while the impairment requirements apply to debt investments measured at FVOCI. Further, the impact on profit or loss for debt investments measured at FVOCI is the same as under the amortized cost treatment. On the other hand, equity investments measured at FVOCI have no impact on profit or loss as all changes in fair value are recognized in OCI and are not transferred from OCI to profit or loss on derecognition.

The fact that the impairment requirements of IFRS 9 do not apply to equity investments is also different from IAS 39 where equity investments classified as available-for-sale are subject to impairment testing.

Example of Common Equity Instruments Held by Credit Unions

ABC Credit Union holds shares in its provincial Central (central banking facility, trade association and service bureau owned by Credit Unions). ABC holds the shares with Central to maintain required liquidity levels and the shares are currently classified as available-for-sale under IAS 39.

Assessment: As the shares are currently classified as available-for-sale, and as such are not held for trading, to the Credit Union can make an irrevocable election to measure at FVOCI. As a result, the Credit Union has a choice of how to classify these types of investments – i.e., at FVTPL or at FVOCI.

Note! IAS 39 is more lenient in allowing equity investments to be measured at cost in certain circumstances, whereas IFRS 9 requires all such investments to be measured at fair value but provides some guidance on when cost may approximate fair value.

As such, Credit Unions holding Central shares (or other similar unquoted shares) will need to proactively consider how fair value will be determined under IFRS 9. This may include obtaining information from the entity/Central on recent transactions or other information to determine fair value and provide the IFRS 13 *Fair Value Measurement* disclosures at each reporting period. Consultation with valuation experts is recommended.

Reclassifications

a) When is reclassification required for financial assets?[3]

Under IFRS 9, an entity is required to reclassify all affected financial assets when, and only when, the business model for managing those financial assets changes. It is not merely because the cash flows are realized in a way that differs from the entity's expectations when initially classifying the financial assets.

b) What constitutes a change in business model?

Changes in an entity's business model for managing the financial assets are expected to be very infrequent and are:

- Determined by the entity's senior management;
- A result of external or internal changes;
- Significant to the entity's operations; and
- Demonstrable to external parties.

Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations (e.g. when the entity has acquired, disposed of or terminated a business line).

[3] Financial liabilities are not reclassified.

Reclassification Scenarios *(IFRS 9.B4.4.1 & 3)*	Change in Business Model?
ABC Financial Group decides to close its retail mortgage department. No new retail mortgage loans are accepted and the firm is actively trying to sell the related portfolio.	Yes
Canada Credit Union manages its commercial loan portfolio for the purpose of selling it within the next year. During the year, Canada Credit Union acquires World Credit Union that manages commercial loans to collect the contractual cash flows. Therefore, its portfolio is now managed together with World Credit Union's commercial loan portfolio in order to collect contractual cash flows.	Yes
A change in intention* related to certain financial assets (even in circumstances of significant changes in market conditions).	No
The temporary disappearance of a particular market for financial assets.	No
A transfer of financial assets between parts of the entity with different business models.	No

** A change in intention with respect to a particular financial asset should be distinguished from a change in business model that affects many financial assets. Only the latter will result in reclassification.*

c) When should the reclassification be performed relative to the change in business model?

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

A change in the objective of the entity's business model must occur before the reclassification date.

Example of Timing of Reclassification

An entity with a December year-end has a change in business model on July 17, 2019 because that was the date that it decided to shut down its retail mortgage business.

Assessment: All affected financial assets will be reclassified prospectively on January 1, 2020 (i.e., the first day of the new reporting period). The entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after July 17, 2019.

d) How is the reclassification performed?

Reclassification is done prospectively with no restatement of any previously recognized gains, losses (including impairment gains or losses) or interest.

IFRS 9.5.6.2-7 details the reclassification measurement requirements depending on which category the financial assets are classified from and into. Because reclassifications are expected to be very rare, they are not discussed further in this guide.

Further Resources

External Resources

- IFRS 9 can be found in Part I of the CPA Canada Handbook.
- More information about IFRS 9 and background to the updates can be found in the press release for the standard.
- The IASB's Project Summary providing an overview of the standard.

Other MNP Technical Guidance

- IFRS 9 *Financial Instruments* Snapshot
- An Overview of IFRS 9 *Financial Instruments* versus IAS 39 *Financial Instruments: Recognition and Measurement*
- An Overview of the Impairment Requirements of IFRS 9 *Financial Instruments (coming soon)*
- An Overview of the Transition Requirements of IFRS 9 *Financial Instruments (coming soon)*

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