

Get ready for FRS 109: Classifying and measuring financial instruments

July 2018



Contents

	Preface	03
1	Overview of classification and measurement requirements	04
2	The business model test	06
2.1	Determining the business model	08
2.1.1	Level of determination	08
2.1.2	Management of business unit versus management of assets within the business unit	09
2.1.3	Outcome differs from expectations	09
2.2	Hold to collect business model	10
2.2.1	Sales that may be consistent with a business model of holding assets to collect cash flows	11
2.3	Hold to collect and sell business model	12
2.4	Other business models	12
2.5	Reassessment of business models	13
2.6	Reclassification of financial assets on change in business model	13
2.6.1	Date of reclassification	15
3	Contractual cash flows characteristics test	16
3.1	Principal	17
3.2	Interest	17
3.2.1	Consideration for the time value of money	17
3.3	Leverage	18
3.4	Terms that change the contractual cash flows	19
3.4.1	Prepayment or extension options	20
3.4.2	De minimis and non-genuine contractual terms	20
3.5	Impact of collateral or subordination	21
3.6	Non-contractual terms	21
3.7	Non-recourse and limited recourse assets	21
3.8	Contractually linked instruments	22
4	Classification and measurement	24
4.1	Financial assets measured at amortised cost	25
4.2	Financial assets measured at fair value through other comprehensive income	26
4.2.1	Option to designate equity investments at fair value through other comprehensive income	26
4.3	Financial assets measured at fair value through profit or loss	27
4.3.1	Designation as at fair value through profit or loss	27
5	Classification of financial liabilities	28
5.1	Basic principles	29
5.2	Amortised cost measurement	29
5.3	Financial liabilities at fair value through profit or loss	29
5.3.1	Financial liabilities held for trading	30
5.3.2	Option to designate as at fair value through profit or loss	30
5.3.3	Changes in fair value attributable to own credit risk	31
5.4	Reclassification	31
	Practical insight – next steps	32
	How we can help	33

Preface

FRS 109 'Financial Instruments' fundamentally rewrites the accounting rules for financial instruments. It introduces a new approach for financial asset classification; a more forward-looking expected loss model; and major new requirements on hedge accounting.

With FRS 109 becoming effective in Singapore from 1 January 2018, companies now really need to start evaluating the impact of the new Standard now. As well as the impact on reported results, many businesses will need to collect and analyse additional data and implement changes to systems.

This is the first in a series of publications designed to get you ready for FRS 109. In this issue, we bring you up to speed on the Standard's new classification and measurement requirements.



1. Overview of classification and measurement requirements

FRS 109 classifies financial assets into three main measurement categories:

- amortised cost
- fair value through other comprehensive income
- fair value through profit or loss.

Classification is determined by both:

- the entity's business model
- the contractual cash flow characteristics of the asset.

The classification and measurement of financial assets was one of the areas of IAS 39 that received the most criticism during the financial crisis.

Under FRS 109 each financial asset is classified into one of three main classification categories:

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

The classification is determined by both:

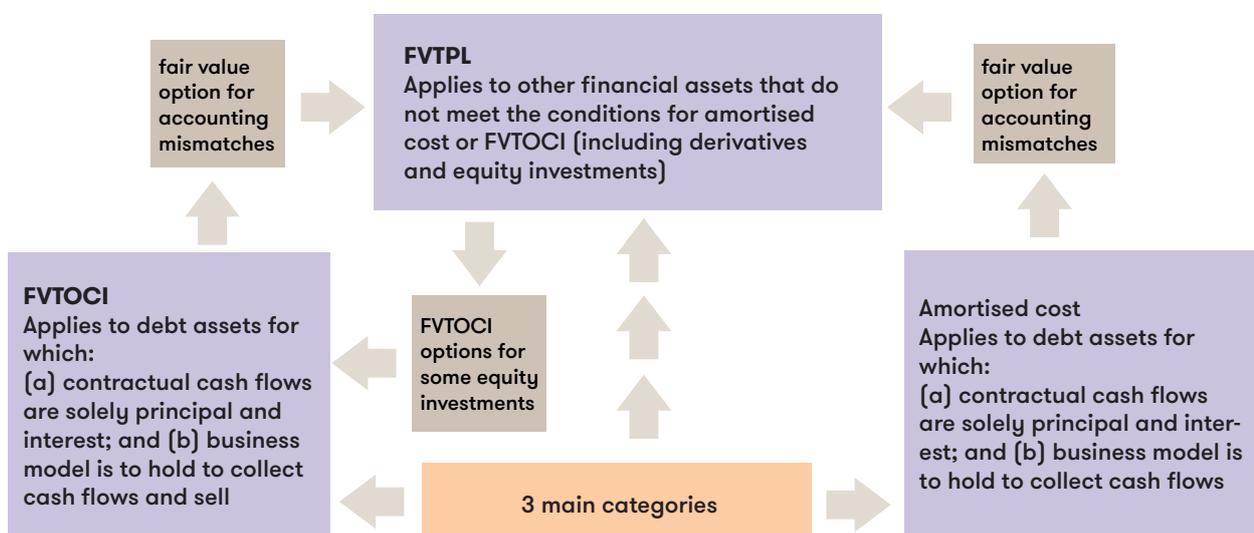
- the entity's business model for managing the financial asset ('business model test'); and
- the contractual cash flow characteristics of the financial asset ('cash flow characteristics test').

The diagramme below summarises the three main categories and how the business model and cash flow characteristics tests determine the applicable category.

In addition, FRS 109 provides options allowing an entity to, on initial recognition only, irrevocably designate:

- financial assets that would otherwise be measured at amortised cost or fair value through other comprehensive income FRS 109's general principles at fair value through profit or loss, if this designation would reduce or eliminate a so-called 'accounting mismatch'
- equity instruments, which will otherwise need to be measured at fair value through profit or loss, in a special 'equity – fair value through other comprehensive income' category. This is available for any investment in equities within the scope of FRS 109 apart from investments held for trading and contingent consideration receivable resulting from a business combination to which FRS 103 'Business Combinations' applies.

This publication explores the different classification categories and the criteria that accompany them.



2. The business model test

The business model test is the first of the two tests that determine the classification of a financial asset.

FRS 109 uses the term in relation to how financial assets are managed and the extent to which cash flows will result from collecting contractual cash flows, selling financial assets or both.

Two business models are positively defined:

- a 'hold to collect' business model
- a 'hold to collect and sell' business model.

Debt-type financial assets that are not managed under either of these models will need to be measured at fair value through profit or loss.

As discussed above, the classification of financial assets under FRS 109 is determined by both the entity's business model for managing the financial asset and the contractual cash flow characteristics of the financial asset.

In practice, the 'business model test' is relevant only for debt-type financial assets such as receivables, originated and purchased loans and debt securities. This is because derivative financial assets and investments in equities will be classified at fair value through profit or loss as a result of the 'cash flow characteristics test' (see Section 3 below). This is subject to the option to designate on initial recognition as measured at 'equity - fair value through other comprehensive income' referred to in Section 1 above.

Looking at the first of the two classification criteria, FRS 109 uses the term 'business model' in terms of how financial assets are managed and the extent to which cash flows will result from collecting contractual cash flows, selling financial assets or both. The Standard positively defines two such 'business models':

Model	Possible Examples
Hold to collect contractual cash flows	<ul style="list-style-type: none"> • trade Receivables • originated loans and debt securities held to maturity
Hold to collect contractual cash flows and to sell	<ul style="list-style-type: none"> • liquidity portfolio • assets held by an insurer to back insurance liabilities
Other (not defined)	<ul style="list-style-type: none"> • trading portfolios • assets managed on a fair value basis

- a business model whose objective is to hold the financial asset in order to collect contractual cash flows ('hold to collect')
- a business model in which assets are managed to achieve a particular objective by both collecting contractual cash flows and selling financial assets ('hold to collect and sell').

If debt-type financial assets are not managed under either of these two models, they will need to be measured at fair value through profit or loss.

In practice, the 'business model test' is relevant only for debt-type financial assets such as receivables, originated and purchased loans and debt securities.

2.1 Determining the business model

An entity's business model refers to how an entity manages its financial assets in order to generate cash flows.

The business model is determined by the entity's key management personnel. The Standard guides that the determination will be a matter of fact which is typically observable through the activities the entity undertakes to achieve the objectives of the business model. The business model should be determined by considering all relevant and objective evidence, which might include:

- how performance is evaluated and reported to the entity's key management personnel
- the risks affecting performance of the business model and how those risks are managed
- how managers of the business are compensated (eg whether compensation is based on fair value of assets managed or on contractual cash flows collected).

Determining the model involves expectations about the future actions of the entity but should not be based on scenarios that the entity does not reasonably expect to occur ('worst case' or 'stress test' scenarios for example are excluded when determining the model).

2.1.1 Level of determination

An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. Accordingly, the assessment does not depend on management's intentions for individual instruments.

Also, for FRS 109 purposes, an entity can have more than one business model. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages by actively trading them to realise fair value changes. Similarly it may be necessary to separate a portfolio into sub-portfolios in some situations in order to reflect the level at which an entity manages those financial assets.

Example

An entity holding a portfolio of mortgage loans may manage some of the loans to collect contractual cash flows while having an objective of selling other loans within the portfolio in the near term. The portfolio would be sub-divided, with part of it being accounted for under a hold to collect business model while the other loans are accounted for at fair value through profit or loss.

FRS 109 uses the term 'business model' in terms of how financial assets are managed and the extent to which cash flows will result from collecting contractual cash flows, selling financial assets or both.

2.1.2 Management of business unit versus management of assets within the business unit

When assessing business models, it is important to distinguish between the management of a portfolio within a business unit and management of the overall business unit. The fact that an entity may be planning to dispose of a business unit does not preclude portfolios within the business unit from being classified as 'hold to collect' or 'hold to collect and sell'.

2.1.3 Outcome differs from expectations

The business model assessment is forward-looking, so cash flows may sometimes be realised in a way that differs from the entity's expectations at the time of the original assessment. For example, the entity might sell more assets from the portfolio than had been anticipated at the time of making the original assessment for various reasons.

This does not result in a prior period error if the original assessment considered all the relevant information that was available at the time. Neither does it change the classification of the remaining assets that continue to be held within the business model (unless the entity changes its business model in a manner that meets FRS 109's requirements on reclassification – see 2.6 below). However in such an example the increased level of sales and the reasons for them may be relevant in terms of assessing the business model for new financial assets that have been acquired or originated.

Example

Entity Y has operated a hold to collect business model for many years. Its portfolio of assets has for many years consisted of investment grade bonds issued by utility companies. Entity Y's investment policies attach importance to both the yield and the stability afforded by such investments, and result in sales only in response to significant deteriorations in the credit risk of individual assets within the portfolio. Recently however there has been a wave of takeovers in the utility sector fuelled by overseas interest in the sector. As a result, Entity Y has sold a number of the bonds within its portfolio in response to unsolicited offers that have been made to it. Continuing interest in this sector means that such sales are likely to continue in the future.

Can Entity A's portfolio continue to be accounted for under a held to collect business model?

Changes in the way that assets are managed within the business model (such as the increased frequency of sales that has taken place) do not result in the reclassification of existing assets, but may result in new assets being classified differently. As a result the portfolio may need to be sub-divided going forward, with the existing bonds continuing to be accounted for within a hold to collect business model at amortised cost and the new bonds accounted for either at fair value through profit or loss or under a 'hold to collect and sell' business model at fair value through other comprehensive income.

An entity's business model for managing financial assets:

- reflects how financial assets are managed to generate cash flows
- is determined by the entity's key management personnel
- doesn't depend on management's intentions for individual instruments but is based on a higher level of aggregation that reflects how groups of financial assets are managed together to achieve a particular business objective.

2.2 Hold to collect business model

A 'hold to collect' business model is one in which assets are managed to realise cash flows by collecting contractual payments over the instruments' lives.

In determining whether cash flows are going to be realised by collecting the financial assets' contractual payments, it is necessary to consider:

- the frequency, value and timing of sales in prior periods
- the reasons for those sales and
- expectations about future sales activity

Objective

- collect contractual payments over life of the instrument
- entity manages the assets held within the portfolio to collect **those particular** contractual cash flows

Factors to consider



1. Frequency of sales in prior periods



2. Value of sales in prior periods



3. Timing of sales in prior periods



4. Reason for such sales



5. Expectations about future

Sales in themselves however do not determine the business model and should not be considered in isolation. It is not necessary then for an entity to hold all of the instruments until maturity. Rather, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised.

When assessing past sales, an entity considers the reasons for those sales, their timing, frequency and value. The entity also considers how the conditions that existed at that time compare to current conditions.

2.2.1 Sales that may be consistent with a business model of holding assets to collect cash flows

An entity's business model can be hold to collect' even when some sales occur or are expected to occur in the future. This section looks at some examples:

2.2.1.1 Sales due to an increase in the assets' credit risk

Sales due to an increase in the assets' credit risk are not inconsistent with a hold to collect business model because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows.

It will be easiest to demonstrate this when there is a documented investment policy that is aimed at minimising potential credit losses due to credit deterioration. However where such a policy does not exist, it may still be possible to show in other ways that a sale has occurred due to an increase in credit risk and is therefore consistent with the hold to collect business model.

Example

Entity A holds investments to collect their contractual cash flows but will sell investments with the objective of minimising credit losses. A formal policy documents Entity A's credit risk requirements and when sales are to be made. Provided that sales are made in response to conditions that are set out in the documented policy, they will be consistent with the hold to sell business model.

2.2.1.2 Sales for other reasons

Other sales which are not due to an increase in credit risk may still be consistent with a hold to collect business model. This is the case if those sales are incidental to the overall business model. Examples of such sales could include:

- sales that are insignificant in value both individually and in aggregate, even when such sales are frequent.
- sales that are infrequent, even when the sales are significant in value
- sales made close to the maturity of the financial assets when the proceeds from the sales approximate the collection of the remaining contractual cash flows.

Where sales occur that are more than infrequent and they are more than insignificant in value, an entity will need to assess whether and how those sales are consistent with the objective of a hold to collect business model. An increase in the frequency or value of sales in a particular period is not in itself necessarily inconsistent with a hold to collect business model, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model. For example an entity may sell some assets whose credit risk has not deteriorated in order to manage credit concentration risk. In such a situation, judgement will need to be applied in determining whether the sales are consistent with the hold to collect business model. No 'bright-lines' are given in the Standard to help entities in making this assessment.

Where sales occur that are more than infrequent and they are more than insignificant in value, an entity will need to assess whether and how those sales are consistent with the objective of a hold to collect business model.

2.3 Hold to collect and sell business model

The second defined business model in FRS 109 is often referred to as ‘hold to collect and sell’. This applies when key management personnel have made a decision that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the business model.

In determining whether this is so, entities will need to exercise an element of judgement. This is because there is no threshold for the frequency or value of sales that must occur in this business model. However, this business model will typically involve greater frequency and value of sales than a hold to collect model. This is because selling financial assets is integral to achieving the business model’s objective instead of being only incidental to it.

There are various objectives that may be consistent with this type of business model. For example, the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding.

Example

Entity Z operates in the entertainment industry. Its operations include a sports stadium. Entity Z has a long-term plan for renovating the stadium involving significant investment at set points three, seven and ten years in the future. In anticipation of this expenditure, Entity Z invests surplus cash in bond assets. Many of the bonds have maturity dates that substantially exceed the points at which the stadium expenditure is expected to take place.

Entity Z holds these bonds to collect the contractual cash flows until it needs the cash to invest in the stadium. It may also make opportunistic sales if management considers that market prices rise to levels that significantly exceed their own assessment of the bonds’ fundamental valuation. Accordingly the bonds held by Entity Z would be accounted for under a hold to collect and sell business model.

2.4 Other business models

If a debt-type financial asset is not held within either a hold to collect business model or a hold to collect and sell business model, then it will be measured at fair value through profit or loss. FRS 109 gives a number of examples of models which will result in fair value through profit or loss measurement, including business models in which:

- an entity manages the financial assets with the objective of realising cash flows through the sale of the assets
- an entity manages and evaluates a portfolio of financial assets on a fair value basis
- a portfolio of financial assets that meets the definition of held for trading and is not either held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets.

This business model will typically involve greater frequency and value of sales than a hold to collect model.

2.5 Reassessment of business models

An entity should reassess its business models at each reporting period in order to determine whether they have changed since the preceding period. For example an increased level of sales of assets within a portfolio that was assessed as ‘hold to collect’ may indicate that the business model has evolved and that it would be inappropriate to classify future additions to the portfolio in the same way. As discussed above, this does not however mean that the remaining assets within the portfolio need to be reclassified. Reclassification would be required only if the original business model assessment was made in error, or FRS 109’s strict conditions for reclassification of financial assets on change in business model are met (see below).

Examples of scenarios leading to reclassification

Model	Change of business model?
Entity A holds a group of debt assets originally intending to collect all the contractual cash flows. As a result of a cash shortage management decides to sell half the assets	
Entity B holds a portfolio of debt assets for trading and classifies them at FVTPL. Due to a severe financial crisis the market in these assets disappears.	
Entity C is a financial services firm with a large retail domestic mortgage business. As a result of a strategic review management decides to close this business and commences a programme to sell the loans	

2.6 Reclassification of financial assets on change in business model

Reclassification of financial assets is required when, and only when, an entity changes its business model for managing the assets. In such cases, the entity is required to reclassify all affected financial assets.

FRS 109 makes it clear that such changes are expected to be very infrequent and will be determined by senior management as a result of external or internal changes. The Standard further guides that the changes must be significant to the entity’s operations and demonstrable to external parties. In order for this to be the case, an entity will need to either begin or terminate an activity that is significant to its operations.

Changes in business model are expected to be very infrequent.

The Standard clarifies that the following are not changes in business model:

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

Even when there is a change in business model, it would still be inappropriate to reclassify financial assets that have been designated at fair value through profit or loss, or equity instruments that have been designated as at fair value through other comprehensive income. Such designations are irrevocable.

Practical insight – reclassification of financial assets on change in business model

FRS 109 discusses business models in the context of initial classification to describe how different groups of assets are managed and, in turn, how this is expected to affect future levels of cash collections and asset sales. This of course is not how senior management would typically describe their entity's business model from a commercial or strategic perspective.

By contrast, FRS 109 uses the term 'business model' differently in the context of reclassification of financial assets on a change in business model. In this context 'business model' is used with a more normal, strategic meaning. For this reason, entities might well change how they manage groups of financial assets in a way that affects the classification of newly-acquired assets going forward but does not trigger a reclassification of existing assets.



2.6.1 Date of reclassification

FRS 109 states that when an entity reclassifies financial assets, the reclassification is to be prospective from the reclassification date.

The reclassification date is the first day of the first reporting period following the applicable change in business model.

Previously recognised gains or losses (including ones relating to impairment) and interest are not to be restated.

FRS 109 contains detailed requirements on how to measure a financial asset when it is reclassified from one measurement category to another as a result of a change in business model. The table below provides a high level summary of these requirements. Reference should be made to the Standard itself for a proper understanding of the requirements.

Practical insight – effect of contractual cash flows test on reclassification

Reassessment of whether an instrument meets the contractual cash flows test following a modification to its terms is not relevant to reclassification of the financial asset. Rather the entity should consider the modification in terms of whether or not it leads to derecognition of the original asset. A change that affects whether the contractual cash flows test is met or not may be one of the factors to consider in determining whether there is a derecognition event.

Where a modification does not result in derecognition of the asset, reclassification will not be permitted unless there has also been a change in the business model for managing financial assets. Where the modification does result in derecognition, this does not result in reclassification but rather recognition of a new instrument which will then be classified in accordance with the Standard's usual requirements.

Practical insight – effect of interim periods

While FRS 109 defines the term 'reclassification date' by referring to the reporting period that follows a change in business model, it does not define the term 'reporting period' itself. We consider that an interim reporting period should be treated as a reporting period for the purpose of interpreting the reclassification date.

For example, consider an entity which has a 31 December year end and which prepares interim reports on a half yearly basis. If a change in business model occurs in April, then our view is that the reclassification date will be treated as 1 July for the purposes of both the interim financial statements for the period ending 30 June and the financial statements for the year ending 31 December.

Original Category	New category	Balance sheet impact	P&L impact	OCI impact
Amortised cost	FVTPL	FV is measured at RD*	Gain/loss = difference between previous amortised cost and FV	None
FVTPL	Amortised cost	FV at RD becomes new gross carrying amount	None	None
Amortised cost	FVTOCI	FV is measured at RD*	None	Gain/loss = difference between previous amortised cost and FV
FVTOCI	Amortised cost	FV at RD becomes new gross carrying amount	None	Gain/loss previously in OCI reclassified as an adjustment to FV at RD
FVTPL	FVTOCI	None	None	None
FVTOCI	FVTPL	None	Gain/loss previously recognised in OCI is reclassified from equity to profit or loss	

*RD = Reclassification Date

3. Contractual cash flows characteristics test

The contractual cash flow characteristics test is the second of the two tests that determine the classification of a financial asset.

For the test to be met, the contractual terms of the financial asset must give rise on specified dates to cash flows that are solely payments of principal and interest.

It is only possible to classify a financial asset in the amortised cost or fair value through other comprehensive income category where the test is met.

The second condition for classification in the amortised cost or fair value through other comprehensive income category can be labelled the ‘solely payments of principal and interest’ test. The requirement is that 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

The second condition for classification in the amortised cost or fair value through other comprehensive income category can be labelled the ‘solely payments of principal and interest’ test. The requirement is that 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.

3.1 Principal

For the purpose of applying this test, ‘principal’ is the fair value of the financial asset at initial recognition. The Standard acknowledges however that the principal amount may change over the life of the financial asset, for example as a result of repayments of principal.

3.2 Interest

Interest’ consists of consideration for:

- 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
- a profit margin.

3.2.1 Consideration for the time value of money

The time value of money represents the element of interest that provides consideration for the passage of time (ie it does not provide consideration for any other risks or costs associated with the asset).

In order to assess whether an element of interest provides consideration for only the passage of time, an entity applies judgement and considers relevant factors such as the currency in which the financial asset is denominated (see 3.2.1.3) and the period for which the interest rate is set.

A non-prepayable fixed rate bond or loan would for instance clearly provide the holder with consideration for the time value of money. It is equally clear that an equity investment does not, as the cash flows are not usually specified.

3.2.1.1 Modified time value of money element

In some cases, however, the analysis may be more complicated. One such case is when the time value of money element has been ‘modified’ such that it does not reflect a normal relationship between the time value element and the time period (or maturity) of the instrument. One example of a modified time value element is a loan or bond in which the interest rate resets periodically but based on a market rate that reflects a longer or shorter time period (eg a monthly reset based on a benchmark interest rate for a 12 month loan).

The requirement is that 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.

In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. In doing this the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). In some cases it will be possible to do this by performing a qualitative assessment but in more complicated cases, a quantitative assessment may be necessary.

The Standard notes that in extreme economic circumstances, interest can be negative. This is an important clarification as negative interest rates have been a real phenomenon in some jurisdictions in recent years. They have resulted in a number of application issues.

A floating contractual interest rate would not represent consideration for the time value of money and credit risk if the formula results in a decrease in the contractual rate when the applicable interest rate index increases, or vice versa. An example is an instrument with a rate formula such as 10% minus LIBOR (an 'inverse floating rate').

3.2.1.2 Regulated interest rates

In some jurisdictions, the government or a regulatory authority sets interest rates on some types of loans. This can raise questions over whether the regulated rate includes the necessary elements to meet FRS 109's definition of interest. FRS 109 aims to address this by stating that, for the purpose of the 'solely payments of principal and interest' test, a regulated interest rate is considered a proxy for the time value of money element. This applies if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

3.2.1.3 Foreign currency

In considering whether an instrument provides consideration for only the passage of time, FRS 109 guides that factors such as the currency in which the financial asset is denominated should be considered. For example, if the principal amount of an instrument was denominated in one currency but interest payments were made in another currency (a 'dual currency' bond), this would be inconsistent with the solely payments of principal and interest test. This is because the relationship between principal and interest would be affected by foreign exchange rates.

3.3 Leverage

Contractual cash flows that are solely payments of principal and interest are consistent with a basic lending arrangement.

Contractual terms that introduce exposures to risks or volatility in the contractual cash flows that are unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, fail the solely payments of principal and interest test.

Example

Entity X issues a bond which is repayable after ten years. Under the terms of the bond, interest resets periodically to an amount determined as a fixed margin plus twice the published rate of LIBOR.

The bond would fail the solely payments of principal and interest test as the interest rate is leveraged.

Similarly contracts that increase leverage fail the test as they increase the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest.

Stand-alone option, forward and swap contracts are other examples of financial assets that include such leverage. As a result, derivatives always 'fail' the solely payments of principal and interest test and must be classified in the fair value through profit or loss category.

3.4 Terms that change the contractual cash flows

Some financial assets contain terms that may change their contractual cash flows over time, such as a prepayment or extension option. In such cases the entity must assess the contractual cash flows that could arise both before and after the change in contractual cash flows.

The holder of the asset should also consider the nature of any contingent event that would change the contractual cash flows. FRS 109 guides here that while the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are solely payments of principal and interest, they may be an indicator. For example, an instrument with an interest rate that increases if the borrower misses a repayment is more likely to pass the solely payments of principal and interest test than another instrument with a rate that changes if an equity index falls below a stated level.

The sub-sections below discuss some other common terms that change the contractual cash flows of an asset, and the matters to consider.

Example

On 1 January 20X0, Entity M issues a financial instrument which matures in three years' time and pays interest at a rate of 10% per annum. Under the terms of the instrument, Entity M must pay an increased rate of 20% if it fails to make any of the annual interest payments which are scheduled to be made on 31 December each year.

In order to determine whether the solely payments of principal and interest test is met, Entity M needs to consider the nature of the contingent event itself that causes the payments to change and assess the contractual cash flows that could arise both before and after the change in contractual cash flows.

The contingent event that causes the payments to change is Entity M's failure to make a contractual interest payment. This feature is consistent with a deterioration in the credit risk of the instrument. As credit risk associated with the principal amount outstanding during a particular period of time is one of the components of interest (see section 3.2), the nature of the contingent event is consistent with the solely payments of principal and interest test.

In terms of the contractual cash flows that could arise both before and after the term that changes the contractual cash flows is triggered, there is no evidence of leverage or another feature that would cause the instrument to fail the solely payments of principal and interest test.

3.4.1 Prepayment or extension options

When a financial asset contains a prepayment or extension option, the holder must determine whether the contractual cash flows that could arise over the life of the instrument are solely payments of principal and interest whether or not the option is exercised. This means assessing the contractual cash flows that could arise assuming the option is exercised, and assuming it is not exercised.

FRS 109 also clarifies that a debt instrument which would meet the solely payments of principal and interest test but for the effect of a prepayment or extension option still meets the test (and is therefore eligible to be measured at amortised cost or fair value through other comprehensive income) if all of the following are met:

- the financial asset is 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 additional compensation for the early termination of the contract
- when the entity initially recognises the financial asset, the fair value of the prepayment feature is insignificant.

Example

Entity A holds a financial asset which pays a fixed rate of interest and is repayable on 31 December 20X2. In addition the terms of the instrument allow the holder to prepay the instrument before maturity. The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, plus a penalty calculated to provide the lender with reasonable compensation for the early termination of the contract.

The prepayment option is designed to merely accelerate the repayment of principal and the interest that would otherwise be charged on the instrument during its life, and would therefore meet the solely payments of principal and interest test.

3.4.2 De minimis and non-genuine contractual terms

Contractual cash flow terms that have only a 'de minimis' effect on the contractual cash flows of a financial asset do not affect classification. FRS 109 does not expand on the meaning of de minimis but does make it clear that, in the case of contingent cash flows, this relates to the amount of the cash flows not the probability that they will occur.

Where a contractual cash flow term could have an effect on the contractual cash flows that is more than de minimis but the characteristic is 'not genuine', it does not affect the classification of the asset.

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

In our view it will be rare for a contractual term to be 'not genuine'. An assertion that a term is not genuine raises a question as to why the contracting parties took the decision to include the term in the contract.

In such cases the entity must assess the contractual cash flows that could arise both before and after the change in contractual cash flows.

3.5 Impact of collateral or subordination

The fact that an instrument is collateralised in some way, or subordinated to other instruments, does not in itself prevent the instrument from passing the solely payments of principal and interest test.

In finalising FRS 109, the IASB noted that almost all forms of lending are affected by some degree of subordination. This is because instruments are commonly ranked in terms of seniority for repayment in the event of insolvency or similar financial distress situations. Even in the absence of contractual subordination, commercial law in many jurisdictions sets out a basic ranking for creditors.

The IASB concluded that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for general creditors such as trade creditors. Accordingly an instrument that is subordinated to other instruments may pass the solely payments of principal and interest test 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 even in the event of the debtor's bankruptcy.

This can still be the case even if loans are collateralised. For example in the event of bankruptcy a loan holder may have priority over a general creditor in relation to specific collateral. This does not affect the contractual right of the general creditor however to unpaid principal and other amounts due.

3.6 Non-contractual terms

In assessing whether the solely payments of principal and interest test is met, the asset holder should only consider the contractual terms of the instrument.

Example

Entity A issues an instrument which pays 5% interest and is repayable at par in seven years' time. Legislation in the country in which Entity A is based, states that Entity A is subject to regulation by the country's Central Bank and that the Central Bank can impose losses on the holders of the instruments issued by Entity A should it determine that Entity A is in severe financial difficulties.

The instrument would meet the solely payments of principal and interest test as the ability for the Central Bank to inflict losses on the holder of the instrument is not part of the instrument's contractual terms.

3.7 Non-recourse and limited recourse assets

Some assets may have contractual cash flows that are described as principal and interest but those cash flows do not represent the payment of principal and interest. This may be the case if the financial asset creates an exposure to particular assets or cash flows of the borrower (instead of an exposure to the borrower's overall credit risk). This may be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets.

A 'non-recourse' financial asset may be an example of such a situation. Entities will need therefore to consider such assets carefully. However, the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the solely payments of principal and interest test. In such situations, the holder should 'look through to' the particular underlying assets or cash flows to determine whether the contractual cash flows of the assets are payments of principal and interest on the principal amount outstanding.

The fact that an investment is collateralised in some way, does not in itself prevent the instrument from passing the solely payments of principle and interest test.

Example

Entity C issues a 25 year loan which is secured by a property that it is constructing. If Entity C defaults on the loan, the holder can seize the property but cannot seek out any further compensation. This is the case even if the proceeds from the collateral are insufficient to cover the outstanding borrowings. The loan pays interest at 5% per annum. Entity's C long-term prospects and therefore the viability of the interest payments will be affected by Entity C's development of the property among other things.

Entity C is a well-established property developer with several ongoing projects and revenue sources. Entity C has historically met its liabilities (including non-recourse liabilities secured over properties whose value has declined to less than the amount borrowed). Entity C's reputation and credit-worthiness would be severely affected if it failed to repay the loan in question.

Can the loan meet the solely payments of principal and interest test from the perspective of the holder?

The fact that the loan is non-recourse does not in itself prohibit it from passing the solely payments of principal and interest test. Instead the holder should 'look through to' the underlying assets or cash flows to assess the nature of the contractual cash flows. In this case, Entity C could in theory choose not to repay the loan and surrender the property to the lender. However, the overall facts and circumstances indicate that the lender is exposed to Entity C's business as a whole and not only or mainly to the single property to which it has recourse.

In this example the terms of the loan in combination with other relevant facts and circumstances suggest nothing that is inconsistent with payments representing principal and interest. If however the loan was structured such that proceeds from the property are the only source of cash flows to repay the principal and interest, it is likely that the solely principal and interest test would be failed.

3.8 Contractually linked instruments

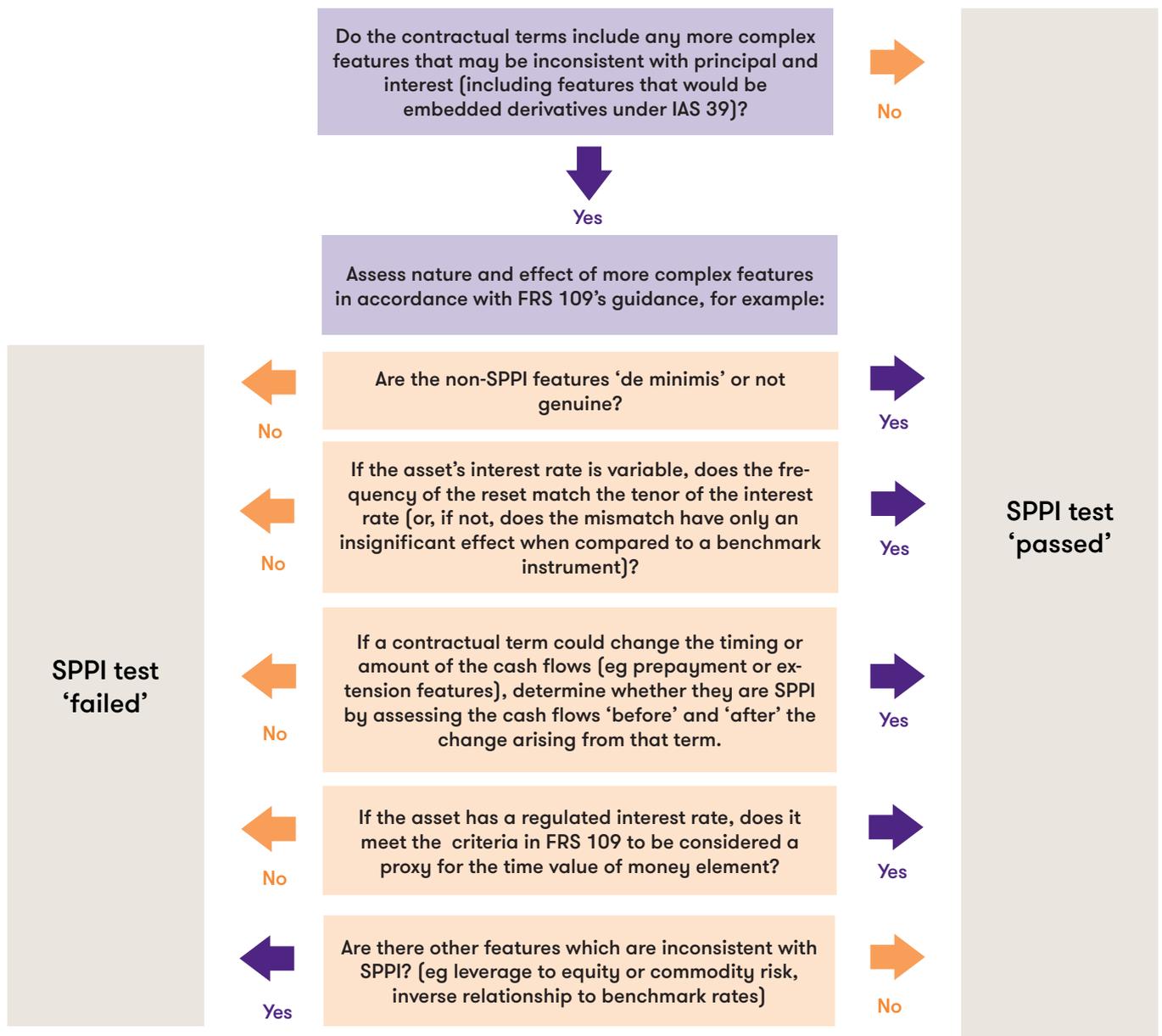
FRS 109 contains specific guidance on contractually linked instruments. Such transactions are commonly seen in securitisations, where an issuer may prioritise payments to the holders of financial assets using multiple contractually linked instruments that create concentrations of credit risk, sometimes referred to as 'tranches'.

A detailed discussion of the requirements in this area is beyond the scope of this publication. However at a highly summarised level, a tranche can only meet the solely payments of principal and interest test if all of the following conditions are met:

- the contractual terms of the tranche being assessed for classification (without looking through to the underlying pool of financial instruments) give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding (eg the interest rate on the tranche is not linked to a commodity index);
- the underlying pool of financial instruments must have certain cash flow characteristics (in assessing this an entity must 'look through' the terms of the tranche until it can identify the underlying pool of instruments that are creating the cash flows); and
- 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.

Applying the 'solely payments of principal and interest' test

As discussed in the sections above, FRS 109 provides extensive guidance on the solely payments of principal and interest (SPPI) test. The following diagramme visually summarises some of the matters to consider when evaluating whether an asset meets the solely payments of principal and interest test



4. Classification and measurement

The interaction of the business model and the cash flow characteristics tests discussed in previous sections, determine the classification of a financial asset.

The basic classifications for a financial asset are:

- amortised cost
- fair value through other comprehensive income
- fair value through profit or loss.

In addition, FRS 109 contains options to designate:

- equity investments at fair value through other comprehensive income
- a financial asset at fair value through profit or loss in some circumstances.

Both of these options are only available on the initial recognition of a financial asset.

As discussed in section 1 of this publication, classification of a financial asset is determined by both the business model test (covered in section 2) and the contractual cash flow characteristics test (covered in section 3).

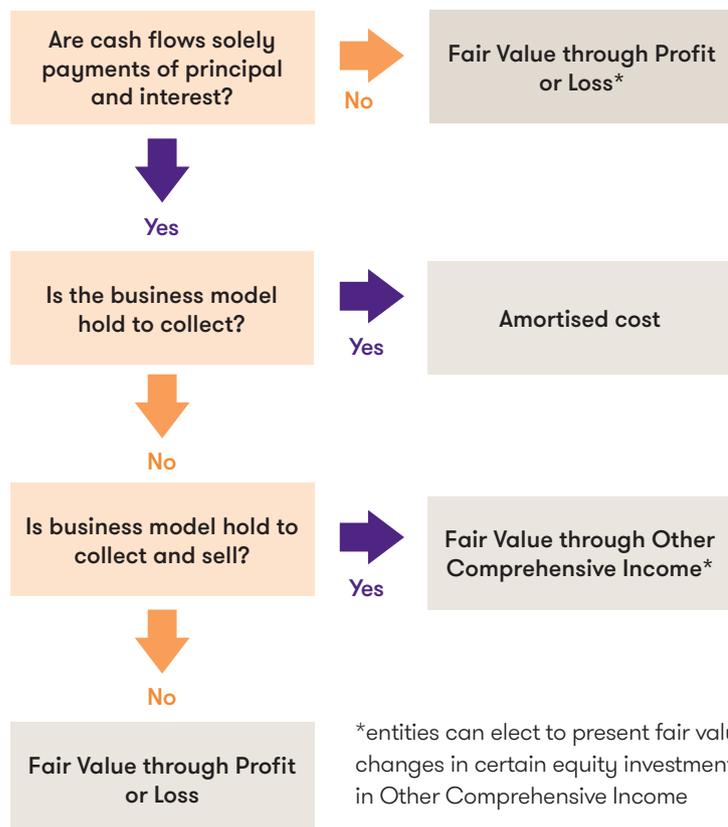
The interaction of these two tests, and the resulting classification outcomes, are illustrated in the diagramme opposite. We discuss the specific requirements of the different classifications in the following sections.

4.1 Financial assets measured at amortised cost

Financial assets are measured at amortised cost only where both of the following conditions are met:

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

Summary of FRS 109's classification model for financial assets



Investments in equity instruments fail the sole payments of principal and interest test, meaning that they need to be measured at fair value through profit and loss. FRS 109 however contains an exception to this rule (see 4.2.1)

4.2 Financial assets measured at fair value through other comprehensive income

A debt instrument is measured at fair value through other comprehensive income where both of the following conditions are met:

- the asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (a 'hold to collect and sell' business model)
- the asset's contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

4.2.1 Option to designate equity investments at fair value through other comprehensive income

Investments in equity instruments fail the solely payments of principal and interest test, meaning that they need to be measured at fair value through profit or loss. FRS 109 however contains the following exception to this rule.

An entity may on initial recognition make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not held for trading and is not contingent consideration of an acquirer in a business combination.

Furthermore, in contrast to the fair value through other comprehensive income category for debt instruments:

- gains and losses recognised in other comprehensive income are not subsequently transferred to profit or loss (sometimes referred to as 'recycling'), although the cumulative gain or loss may be transferred within equity
- equity fair value through other comprehensive income instruments are not subject to any impairment accounting.

Where this election is made, dividends are still recognised in profit or loss unless they clearly represent a recovery of part of the cost of the investment.

Financial assets that do not meet the criteria for classification for being measured at either amortised cost or fair value through other comprehensive income are measured at fair value through profit or loss.

4.3 Financial assets measured at fair value through profit or loss

Financial assets that do not meet the criteria for classification for being measured at either amortised cost or fair value through other comprehensive income are measured at fair value through profit or loss.

In addition it is possible to designate a financial asset at fair value through profit or loss in some circumstances (see section 4.3.1).

4.3.1 Designation as at fair value through profit or loss

FRS 109 contains a modified version of FRS 39's 'fair value option' – the option to designate a financial asset at fair value through profit or loss in some circumstances.

At initial recognition, an entity may designate a financial asset as measured at fair value through profit or loss that would otherwise be measured subsequently at amortised cost or at fair value through other comprehensive income. Such a designation can only be made, however, if it eliminates or significantly reduces an 'accounting mismatch' that would otherwise arise.

There is no requirement to apply the choice consistently to all similar transactions, instead an entity is free to choose when to use the option provided it results in more relevant information.

Practical insight – effect of contractual cash flows test on reclassification

Unlike FRS 39, it is not possible under FRS 109 to measure investments in equity instruments at cost where they do not have a quoted market price and their fair value cannot be reliably measured.

Although FRS 109 requires such investments to be measured at fair value, it notes that, in limited circumstances, cost may be an appropriate estimate of fair value. FRS 109 provides a list of indicators that cost might not be representative of fair value.

Summary of effect of different asset classifications

Category	Balance sheet	Statement of comprehensive income
Amortised cost	amortised cost less impairment allowance	<ul style="list-style-type: none"> presented in P&L: <ul style="list-style-type: none"> interest calculated using the effective interest method initial impairment allowance and subsequent changes
FVTOCI	fair value	<ul style="list-style-type: none"> changes in fair value presented in OCI presented in P&L: <ul style="list-style-type: none"> interest calculated using the effective interest method initial impairment allowance and subsequent changes (with offsetting entry presented in OCI) foreign exchange gains and losses cumulative FV gains/losses reclassified to P&L on derecognition or reclassification
FVPL	fair value	<ul style="list-style-type: none"> changes in fair value presented in P&L
Equity FVTOCI	fair value	<ul style="list-style-type: none"> changes in fair value presented in OCI no reclassification to P&L on disposal dividends recognised in P&L (unless they clearly represent a part-recovery of cost)

5. Classification of financial liabilities

The basic classifications for a financial liability are:

- amortised cost
- fair value through profit or loss.

Financial liabilities accounted for at fair value through profit or loss fall into two categories:

- financial liabilities held for trading
- financial liabilities designated at fair value through profit or loss on inception.

The option to, on inception, designate financial liabilities at fair value through profit or loss is limited to situations:

- involving embedded derivatives
- where it provides more relevant information.

5.1 Basic principles

Under FRS 109, most financial liabilities are accounted for at amortised cost (see section 5.2 below) or bifurcated into a host instrument measured at amortised cost and an embedded derivative, measured at fair value.

Exceptions to these general principles are set out in the table below.

5.2 Amortised cost measurement

In the same way as for financial assets, financial liabilities are accounted for at amortised cost using the effective interest rate method.

The effective interest rate method is designed to allocate and recognise interest revenue or expense in profit or loss over the relevant period. When applying it, an entity generally amortises any fees, points paid or received, transaction costs and other premiums or discounts that are included in the calculation of the effective interest rate over the expected life of the financial instrument.

5.3 Financial liabilities at fair value through profit or loss

Financial liabilities that are accounted for at fair value through profit or loss fall into two categories:

- financial liabilities held for trading
- financial liabilities designated at fair value through profit or loss on inception.

We discuss these two categories in more detail below. Note that not all changes in the fair value of a financial liability accounted for at fair value through profit or loss actually go through profit or loss – changes attributable to own credit risk are accounted for through other comprehensive income (see section 5.3.3).

Exceptions	Treatment
Financial liabilities at fair value through profit or loss	• see section 5.3 below
Contingent consideration recognised by an acquirer in a business combination to which FRS 103 applies.	• measured at fair value with changes recognised in profit or loss
Financial guarantee contracts	• measured after initial recognition at the higher of: <ul style="list-style-type: none">– the amount of the loss allowance– the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of FRS 115
Commitments to provide a loan at below-market interest rate	• measured after initial recognition at the higher of: <ul style="list-style-type: none">– the amount of the loss allowance– the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of FRS 115
Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies.	covered by detailed guidance in the Standard dealing with derecognition (beyond the scope of this guide)

5.3.1 Financial liabilities held for trading

Financial liabilities that meet the definition of held for trading must be classified at fair value through profit or loss. A financial liability is held for trading if it:

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

5.3.2 Option to designate as at fair value through profit or loss

FRS 109 provides entities with an option to designate a financial liability at initial recognition as at fair value through profit or loss. The ability to use this option, which is irrevocable, is limited to situations in which:

- an embedded derivative would otherwise need to be split from the liability; or
- fair value through profit or loss results in more relevant information being provided.

Practical insight: Elimination of the exception from fair value measurement for certain derivative liabilities

FRS 109 eliminates the exception from fair value measurement that existed in its predecessor standard, FRS 39, for derivative liabilities that are linked to and must be settled by delivery of an unquoted equity instrument. Under FRS 39, if those derivatives were not reliably measurable, they were required to be measured at cost. FRS 109 requires them to be measured at fair value.

5.3.2.1 Application of the option in situations involving embedded derivatives

Where a financial liability contains an embedded derivative (a 'hybrid' instrument), an entity may designate the entire contract as at fair value through profit or loss unless either:

- the embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or
- it is clear when a similar hybrid instrument is first considered that separation of the embedded derivative is prohibited by the Standard.

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

5.3.2.2 Application of the option in situations where it provides more relevant information

The second situation where the option to designate a financial liability at initial recognition as at fair value through profit or loss can be used is where it provides more relevant information. The Standard sets out the two circumstances when this will be the case as follows:

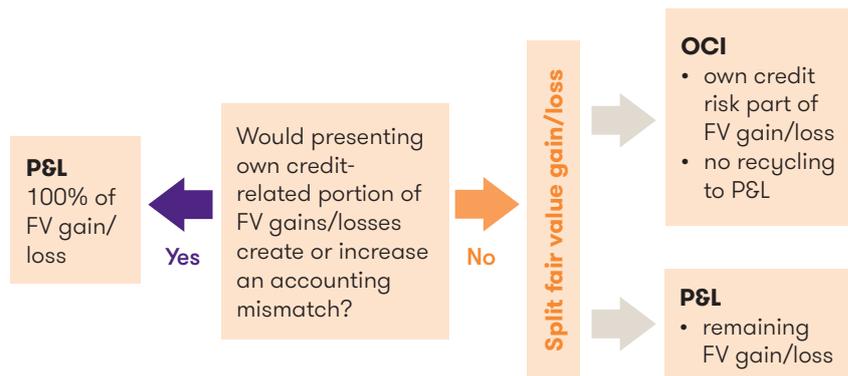
- it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases
- a group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about such group is provided internally on that basis to the entity's key management personnel.

In order to apply the option to designate a financial liability at initial recognition as at fair value through profit or loss, an entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Example

Entity C holds bonds issued by third parties that bear interest at a fixed rate. These bonds are accounted for at fair value through profit or loss as they are managed on a fair value basis. Entity C has also issued bonds. The bonds issued are in the same currency as the bonds held and also pay interest at a fixed rate. The issued bonds are not held for trading and would normally be accounted for at amortised cost. Management considers the issued bonds to provide a natural hedge of Entity C's exposure to changes in the fair value of the bonds held.

In this situation Entity C may opt to designate the issued bonds as at fair value through profit or loss in order to reduce the accounting mismatch that would otherwise arise from the different measurement bases of the bonds.



5.3.3 Changes in fair value attributable to own credit risk

Where an entity chooses to measure its own debt at fair value, FRS 109 requires the amount of the change in fair value due to changes in the entity's own credit risk to be presented in other comprehensive income. This change addresses the counterintuitive way in which companies in financial trouble were under the previous Standard, FRS 39, able to recognise a gain based on its theoretical ability to buy back its own debt at a reduced cost.

The only exception to the new requirement is where the effects of changes in the liability's credit risk would create or enlarge an accounting mismatch in profit or loss, in which case all gains or losses on that liability are to be presented in profit or loss.

The cumulative change in fair value attributable to own credit risk and presented in other comprehensive income is not reclassified to profit or loss on derecognition. However, this amount will reduce to nil if the liability is ultimately settled at maturity on its original terms.

5.4 Reclassification of financial liabilities

FRS 109 prohibits an entity from reclassifying any financial liability.

Not all changes in the fair value of a financial liability accounted for at fair value through profit or loss actually go through profit or loss – changes attributable to own credit risk are accounted for through other comprehensive income.

Practical insight – next steps

As FRS 109 is effective for accounting periods beginning on or after 1 January 2018, there are a number of actions you should consider taking now in order to implement the requirements for the current financial year. In particular, we suggest you:

- study the classification and measurement requirements and evaluate how the information will be accumulated
- engage with your auditors and business advisers now
- create and maintain buy-in from senior management within your organisation for the project
- compile information about existing instruments in order to gauge the Standard's impact
- consider whether to adopt any of the classification options available on initial recognition of the Standard
- review loan covenants and other agreements that incorporate financial ratios and metrics, such as compensation arrangements, that could be affected by the new Standard
- communicate what is happening and how it affects the entity
- monitor progress towards interim and final milestones and intervene where required.

Above all be clear on the impact of the Standard and be sure to tailor disclosures to your entity's specific circumstances.

How we can help

Grant Thornton's Financial Reporting Advisory Services team comprises financial reporting, and industry experts, each having several years of hands-on practical experience across GAAPs and sectors. Our professionals uniquely combine their technical expertise with the intuition, insight and confidence gained from their extensive practical experience to develop a systematic, reliable, efficient and scalable reporting framework for converging to the new standard.

This entails a careful and well-documented evaluation (and suitable modifications) of the financial reporting process, in order to achieve an optimal balance between transparency, consistency, accuracy, reliability and speed, while also controlling costs.

Diagnostic review

- Contract reviews under FRS 109.
- Identify areas of impact under FRS 109 and documentation of such impact assessment.
- Analyse and report on expected impact on processes, systems, controls, taxes, and KPIs.

Reporting

- Prepare computation of adjustments as of transition date to FRS 109
- Conduct a series of workshops and trainings for supporting the implementation
- Draft the additional disclosures required under FRS 109.
- Provide input on changes to systems and processes to generate information for sustainable financial reporting.

Implementation

- Draft accounting position papers for all identified differences under FRS 109
- Design templates and working notes for mathematical computations of transition adjustments.
- Update business process and policy manuals.

Support Services

- Provide regular updates on evolving changes in the accounting literature that are likely to have an effect on an ongoing basis

About Financial Reporting Advisory Services

In today's competitive business environment and fast changing regulatory & reporting landscape, dynamic organisations face several challenges with respect to financial reporting which could potentially impact the value of the businesses.

There is a greater need for accurate and timely financial information now. As a part of our Audit and Assurance practice, Financial Reporting Advisory Services (FRAS) has developed innovative solutions to make financial reporting process smooth, time-bound and auditable.

The FRAS team at Grant Thornton is a multi-disciplinary team that designs and implements creative solutions to address these complexities. Most of our team members are former auditors and assist companies design 'auditor ready' solutions such as whitepaper, reporting packages, reconciliations supporting financial report disclosures.

What differentiates us

- We pre-empt problems and draft solutions to them
- Our professionals have auditing experience, which helps them appreciate practical complexities in financial reporting
- Our team combines accounting knowledge with technological skills to deliver efficient and sustainable financial reporting solutions
- Our senior professionals are chosen experts with deep technical accounting knowledge and vast experience of advising clients on accounting matters
- Our size and structure create advantages for you. We adapt a flatter structure, with shorter decision making chains, empowered teams and no complex chains of command. Our teams are more responsive.

Contact us

To know more, please visit www.grantthornton.sg or contact any of our offices as mentioned below:



Timothy Braun
Partner
Grant Thornton Singapore
T +65 6805 4130
E Timothy.Braun@sg.gt.com



Chetan Hans
Director
Grant Thornton Singapore
T +65 6805 4110
E Chetan.hans@sg.gt.com

GRANT THORNTON SINGAPORE PTE LTD

39 Robinson Road
#14-01 Robinson Point
Singapore 068911

+65 6805 4110
enquiries@sg.gt.com

For more information or for any queries, write to us at enquiries@sg.gt.com

© 2018 Grant Thornton Singapore Pte Ltd. All rights reserved.

'Grant Thornton' refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. Grant Thornton Singapore Pte Ltd is a member firm of Grant Thornton International Ltd (GTIL). GTIL and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions. This publication has been prepared only as a guide. No responsibility can be accepted by us for loss occasioned to any person acting or refraining from acting as a result of any material in this publication.