IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IFRS 9 –– Classification of a particular type of dual currency bond**		
Paper topic	Initial consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a request about how a holder would classify a particular financial asset applying IFRS 9 *Financial Instruments*. Specifically, the request described a 'dual currency bond' with a par amount denominated in one currency and fixed interest coupon payments denominated in another currency. The submitter asked whether such an instrument has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding applying paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9.

2. The objective of this paper is to:

    (a) provide the Committee with a summary of the matter;

    (b) present our analysis; and

    (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:

   (a) background information;

   (b) staff analysis and assessment against the Committee’s agenda criteria; and

   (c) staff recommendation.

4. There are two appendices to this paper:

   (a) Appendix A — Proposed wording of the tentative agenda decision; and

   (b) Appendix B —Submission.

Background information

5. Unless an entity elects the fair value option applying paragraph 4.1.5 of IFRS 9, paragraph 4.1.1 of that Standard requires the entity to classify a financial asset as subsequently measured at amortised cost, fair value through other comprehensive income (FVOCI) or fair value through profit or loss on the basis of both:

   (a) the entity’s business model for managing the financial assets, and

   (b) the contractual cash flow characteristics of the asset.

6. Applying paragraphs 4.1.2 and 4.1.2A of IFRS 9, a financial asset is eligible to be measured at amortised cost or at FVOCI, subject to the business model in which it is held, only if 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 (SPPI condition).[1] Paragraph 4.1.3 describes the meaning of ‘principal’ and ‘interest’ and paragraphs B4.1.7-B4.1.26 provide application guidance related to the SPPI condition.

[1] The request asked only about the assessment of the contractual cash flow characteristics of the financial asset. Accordingly, this paper does not discuss the assessment of the business model for managing financial assets but instead assumes that the financial asset is held in the relevant business model.

7. The submitter asked whether a dual currency bond would meet the SPPI condition if the bond has the following features:

   (a) the contractual par amount is denominated in one currency (eg Japanese Yen) and fixed interest coupon payments are denominated in another currency (eg US Dollars);

   (b) the fixed interest coupon payments are paid annually; and

   (c) the par amount is repaid at a fixed maturity date (eg the contractual maturity date is in five years).

8. The submitter said there were different views on whether the dual currency bond described in paragraph 7 meets the SPPI condition.

Staff analysis and assessment against the Committee's agenda criteria

Outreach

9. In order to gather information about the instrument described in the submission, we sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators and the large accounting firms.

10. The request asked those participating to provide information, based on their experience, on:

    (a) whether the particular dual currency bond described in the submission is common, and

    (b) if it is common, whether entities hold such instruments within a business model whose objective is to collect the contractual cash flows (or whose objective is achieved by both collecting the contractual cash flows and selling) and whether there is any concentration in particular jurisdictions, industries or types of entities.

11. We received twelve responses—six from large accounting firms, three from national standard-setters, one from an organisation representing groups of regulators, one from a regulator and one from a Committee member. The views

received represent informal opinions and do not reflect the official views of those respondents or their organisations.

12. Almost all respondents said the dual currency bond described in the submission is not common. A few of those respondents also explained that the instrument was common in the past in particular jurisdictions (and some such instruments may remain outstanding), but it is no longer common.

13. One respondent said that dual currency bonds are common in the banking industry. This respondent said that there are many different variations of dual currency bonds and the particular instrument described in the submission is the simplest one. This respondent said that dual currency bonds are held in different business models such as ‘hold to maturity’, ‘hold or sell’ and ‘trading’.

Staff analysis

14. As explained above, the responses to our outreach request indicate that the financial instrument described in the submission is not common.

15. In addition, the instrument described in the submission is very specific. We are aware that there are many different variations of dual currency bonds in practice and we think differences in contractual terms could affect the analysis and classification conclusion.

16. We note that entities are required to apply IFRS 9 for annual periods beginning on or after 1 January 2018. We are unaware that dual currency bonds are causing problems in the implementation of IFRS 9. Furthermore, the Board has received a clear message from many stakeholders that discussions on IFRS 9 so close to its effective date has the potential to be disruptive, rather than helpful, to entities’ implementation activities. Entities have already used judgement to apply the SPPI condition in good faith to a large number, and wide variety, of financial assets. Stakeholders have told us that discussions on a specific matter, even if narrow in scope, can have unintended consequences on the accounting for other assets.

17. For these reasons, we recommend not analysing the accounting for the instrument described in the submission applying IFRS 9.

Should the Committee add this matter to its standard setting agenda?

Is the matter widespread and expected to have a material effect on those affected?[2]

18. As previously explained in this paper, the outreach responses indicate that the financial instrument described in the submission is not common. Therefore, we have not obtained evidence that the matter is widespread or is expected to have a material effect on those affected.

Staff recommendation

19. Based on our assessment of the Committee's agenda criteria in paragraphs 5.16 and 5.17 of the *Due Process Handbook*, we recommend that the Committee does not add this matter to its standard-setting agenda. Appendix A to this paper outlines the proposed wording of the tentative agenda decision.

Questions 1 and 2 for the Committee
1. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 2. Does the Committee have any comments on the proposed wording of the tentative agenda decision outlined in Appendix A to this paper?

[2] Paragraph 5.16(a) of the *Due Process Handbook*.

Appendix A –– Proposed wording of the tentative agenda decision

IFRS 9 *Financial Instruments* — Classification of a particular type of dual currency bond

The Committee received a request about how a holder would classify a particular financial asset applying IFRS 9. The submitter described a ‘dual currency bond’ with a par amount denominated in one currency and fixed interest coupon payments denominated in another currency. The fixed interest payments are paid annually and the par amount is repaid at a stated maturity date. The submitter asked whether such a financial instrument has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding applying paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9.

On the basis of the responses to outreach performed on the request, the Committee observed that the financial instrument described in the request is not common. Therefore, the Committee has not obtained evidence that the matter has widespread effect or is expected to have a material effect on those affected.

Consequently, the Committee [decided] not to add this matter to its standard-setting agenda.

Appendix B –– Submission

We have reproduced the submission below. We have deleted details that would identify the submitter of this request

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Potential Interpretations Committee Agenda Item Request

This letter describes an issue that we believe should be added to the agenda of the IFRS Interpretations Committee. We have included a summary of the issue, alternative views, and an assessment of the issue against the Interpretations Committee criteria.

The issue

Does a dual currency bond meet the solely payments of principal and interest on the principal amount outstanding (the 'SPPI') criterion in IFRS 9?

IFRS 9.4.1.1 requires that, unless the financial asset is designated as measured at fair value through profit or loss ('FVTPL') under IFRS 9.4.1.5, an entity shall classify a financial asset as subsequently measured at amortised cost or fair value through other comprehensive income ('FVOCI') on the basis of:

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

IFRS 9.4.1.2 and IFRS 9.4.1.2A require that, for a financial asset to be measured at amortised cost or FVOCI, the contractual terms of the financial asset should give rise on specified dates to cash flows that are SPPI.

IFRS 9.B4.1.8 states: 'An entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding for the currency in which the financial asset is denominated'.

For the purposes of this submission, consider a dual currency bond to be a debt instrument with a par amount denominated in one currency and coupons denominated in another currency. For example:

- The contractual par amount of the bond is denominated in Japanese Yen ('JPY') and fixed interest coupon payments are denominated in US Dollars ('USD')

- The par amount of the bond is JPY 10 million and its stated maturity is five years.
- The fixed interest coupon payments are USD 2 thousand a year.
- On redemption of the bond, the JPY 10 million par amount will be repaid.

Current practice

We believe that there are currently different views on applying the SPPI criterion and IFRS 9.B.4.1.8 to dual currency bonds. We believe that the Interpretations Committee should consider the issue because the potential outcomes (amortised cost measurement or measurement at FVOCI vs measurement at FVTPL) could have a significant effect on financial statements of affected entities, and consistency in this area is desirable.

Below are two views on how to analyse dual currency bonds.

View 1: When analysing the SPPI criterion, the analysis should be performed for the bond as a whole based on the currency in which the par amount is denominated

A dual currency bond is a single instrument and cannot be split into components for purposes of assessing the SPPI criterion. This is consistent with the discussion in IFRS.9.BC4.196-204, which suggests that the IASB discussed potential approaches to bifurcation of financial assets and confirmed 'the requirements in IFRS 9 that hybrid contracts with financial asset hosts should not be bifurcated but should instead be classified and measured in their entirety'.

Therefore, the requirement of IFRS 9.B4.1.8 needs to be applied to the bond as a single instrument and, in order for the SPPI criterion to be met, all of the contractual cash flows must be in the same currency as the denomination of the asset's par amount.

Under this view, the very reason that the phrase 'the currency in which the financial asset is denominated' was included in paragraph B4.1.8 is to address the treatment of dual currency bonds which have specified cash flows that do not correspond to the currency in which the bond's par amount is denominated.

In the example scenario, the bond is denominated in JPY currency, i.e. the currency in which its par (or notional) amount is denominated. Therefore, for the dual currency bond to meet the SPPI criterion and to be consistent with a basic lending arrangement, its contractual cash flows should consist only of JPY cash flows. However, this is not the case, and therefore foreign exchange rate (ie. JPY/USD) variations would create exposure unrelated to a basic lending arrangement and the bond would fail the SPPI test.

View 2: When analysing the SPPI criterion, the dual currency bond can be considered as having two components with each having cash flows in the same currency

The dual currency bond in the example – because the coupon rate is fixed - can be seen as the composite of:

- a zero-coupon bond denominated in JPY; and
- an amortising loan denominated in USD.

Under this view, if it can be demonstrated that both of these components, on their own, meet the SPPI criterion, then the dual currency bond (which is a sum of the two) would also meet this criterion.

IFRS 9.B.4.1.8 requires that the assessment of whether the contractual cash flows are SPPI is made in the currency in which the financial asset is denominated. However, when the instrument has cash flows in two currencies and is analysed as separate components, then the assessment of each component is made in the currency of denomination of that component.

The separation into components for purposes of performing the SPPI analysis is consistent with the Instrument C example in IFRS 9.B4.1.13, which provides a similar rationale for a variable rate instrument with an embedded cap meeting the SPPI criterion:

> *Instrument C is a bond with a stated maturity date and pays a variable market interest rate. That variable interest rate is capped.*
>
> *Analysis:*
>
> *The contractual cash flows of both:*
>
> *(a) an instrument that has a fixed interest rate and*
>
> *(b) an instrument that has a variable interest rate*
>
> *are payments of principal and interest on the principal amount outstanding as long as the interest reflects consideration for the time value of money, for the credit risk associated with the instrument during the term of the instrument and*

for other basic lending risks and costs, as well as a profit margin. (See paragraph B4.1.7A)

Consequently, an instrument that is a combination of (a) and (b) (eg a bond with an interest rate cap) can have cash flows that are solely payments of principal and interest on the principal amount outstanding. Such a contractual term may reduce cash flow variability by setting a limit on a variable interest rate (eg an interest rate cap or floor) or increase the cash flow variability because a fixed rate becomes variable.

Under this view, the discussion in BC4.196-204 that is referenced in View 1 merely suggests that there should not be separate accounting for multiple components, but instead there should be a single unit of account for an entire financial instrument. It does not discuss how the SPPI test is performed for that unit of account. Therefore, if both of the components meet the SPPI criterion, then the entire instrument meets the SPPI criterion. Otherwise, the entire instrument needs to be classified as measured at FVTPL.

When performing its assessment of a dual currency bond, the entity will need to consider the impact of contractual terms that change the timing or amount of contractual cash flows. In particular:

- a variable interest rate denominated in one currency based on a par amount in another currency could not be consistent with IFRS 9.B4.1.8; and
- a contractual term that may permit or require prepayment before maturity (eg. a lender’s option to demand immediate repayment in the event of default) would have to be assessed in accordance with IFRS 9.B4.1.11 and, if necessary, B4.1.12. A feature allowing or requiring prepayment at the contractual par amount (plus accrued contractual interest) would not be consistent with the SPPI criterion as contemplated by IFRS 9.B4.1.11 because the prepayment amount may not approximate to the sum of the two components identified in the assessment and the difference will vary with changes in the foreign exchange rate.

<u>Reasons for the Interpretations Committee to address the issue</u>

(a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

Yes. The market of dual currency bonds and similar instruments is significant. The classification of dual currency bonds could have a significant effect on an entity's financial statements, accounting systems and valuation processes when IFRS 9 becomes mandatory in 2018.

(b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes. In IAS 39, the Board provided specific guidance for applying the embedded derivative guidance to a dual currency bond (IAS 39.AG33(c), which also has been carried forward into IFRS 9 for financial liabilities). The comparability of financial statements would be improved if there was clarity about applying the SPPI criterion to these instruments under IFRS 9.

(c) Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

Yes. The issue addresses the interpretation of specific paragraphs in IFRS 9, most particularly IFRS 9.B.4.1.8.

(d) Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs?

Yes. It is concerned with specific concepts in IFRS 9, and involves a selection between two relatively straightforward alternatives.

(e) Will the solution developed by the Interpretations Committee be effective for a reasonable time period?

Yes. The issue does not relate to a current or planned IASB project. The issue is relevant for IFRS 9…