IFRS 9 for corporates

Are you good to go?

Application guidance

September 2017
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Pur pose of this document

What is Good to go?

IFRS 9 *Financial Instruments*, effective for annual periods beginning on or after 1 January 2018, will change the way corporates – i.e. non-financial sector companies – account for their financial instruments.

In the past, when major IFRS change has led to large-scale implementation projects, management at companies – usually group financial controllers – have asked us ‘How will I know when we’re done?’

The *Good to go?* series helps to answer that question. We’ve created a [SlideShare](#) that lists the key considerations that all companies need to focus on to get to the finish line. This document follows that list so that you can discuss the issues and understand the implications for your company.

Each section in this guide deals with a different issue and considers:
- the new requirements;
- how they differ from existing requirements; and
- application of the new requirements.

This publication is not intended for banks and other financial institutions.

More information

Please see the back of this publication for further resources to help you apply the new standard’s requirements.
On initial recognition, a financial asset is classified into one of the three primary measurement categories:

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

When classifying each financial asset, entities need to assess both the business model in which the financial asset is managed and whether the cash flows from the financial asset represent, on specified dates, solely payments of principal and interest (SPPI) on the principal amount outstanding.
1 Business model criterion

1.1 Assessing the business model

Requirements of the new standard

The business model is assessed to determine whether a financial asset with SPPI cash flows should be classified as measured at amortised cost or FVOCI.

The term ‘business model’ refers to the way an entity manages its financial assets in order to generate cash flows. That is, the entity’s business model determines whether cash flows result from collecting contractual cash flows, selling the financial assets or both.

The new standard provides detailed guidance on how to assess the business model; the key features of each type of business model and the resultant measurement category are summarised in the table below.

<table>
<thead>
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<th>Business model</th>
<th>Key features</th>
<th>Measurement category</th>
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<td><strong>Held-to-collect</strong></td>
<td>- The objective is to hold financial assets to collect contractual cash flows</td>
<td>Amortised cost*</td>
</tr>
<tr>
<td></td>
<td>- Sales of financial assets are incidental to the model’s objective. Typically, sales of financial assets are low (in frequency and volume)</td>
<td></td>
</tr>
<tr>
<td><strong>Both held-to-collect and for sale</strong></td>
<td>- Both collecting contractual cash flows from and sales of financial assets are integral to achieving the business model’s objective. Typically, more sales occur (in frequency and volume) than in the held-to-collect business model</td>
<td>FVOCI*</td>
</tr>
</tbody>
</table>
### Purpose of this document

**CLASSIFICATION AND MEASUREMENT**

**Impairment**

**Hedge accounting**

**Other requirements**

**Further resources**

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### Business model | Key features | Measurement category
--- | --- | ---
**Other business models, including:** | | **FVTPL**
– trading | Business model is neither held-to-collect nor held-to-collect and for sale |  
– managing assets on a fair value basis | Collection of contractual cash flows is incidental to the objective of the model |  
– maximising cash flows through sale |  |  

* Subject to meeting the SPPI criterion and electing the fair value option. The fair value option is available on initial recognition to irrevocably designate a financial asset as at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or recognising gains and losses on them on a different basis.

**SPPI criterion is irrelevant – all financial assets in all these business models are measured at FVTPL.**

Entities consider the frequency, volume and timing of sales in prior periods, the reasons for these sales and their expectations about future sales activity. However, information about sales activity is not considered in isolation, but as part of a holistic assessment of how the entity’s stated objective for managing the financial assets is achieved and how the cash flows are realised.

The new standard gives the following examples of sales that may be consistent with the held-to-collect business model.

– The sales are due to an increase in the credit risk of a financial asset.
– The sales are infrequent (even if they are significant) or are insignificant individually and in aggregate (even if they are frequent).
– The sales take place close to the maturity of the financial asset and the proceeds from the sales approximate the collection of the remaining contractual cash flows.

These requirements are discussed further in 7A.4.70 of our publication *Insights into IFRS*, 14th Edition 2017–18.

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### How does this approach differ from existing requirements?

**New assessment of how financial assets are managed**

Under IAS 39 *Financial Instruments: Recognition and Measurement*, an entity considers the business model for managing financial assets in a more limited way and the impact of the measurement may be different. For example, it requires an entity to assess whether a financial asset is held for trading and may allow amortised cost accounting for quoted bonds only if they are held-to-maturity. IAS 39 does not generally require an assessment of past levels of sales.
IAS 39 has a ‘tainting’ notion for the held-to-maturity measurement category. There is no similar notion under the new standard – i.e. subsequent sales do not result in the reclassification of existing financial assets measured at amortised cost, as long as an entity considered all relevant and objective information that was available when it assessed the business model. Reclassification of assets takes place under the new standard only when the business model has changed.

Application of the new requirements

Entities identify and evaluate all available evidence when assigning a business model to financial assets

The business model is determined at a level that reflects the way groups of financial assets are managed together to achieve a particular business objective. An entity’s business model does not depend on management’s intentions for an individual instrument. The assessment is not performed at the entity level and an entity may have more than one business model for managing financial assets.

Although the new standard states that an entity’s business model for managing financial assets is a matter of fact, it also acknowledges that judgement is needed to assess the business model for managing particular financial assets.

All relevant and objective evidence available at the date of the assessment should be used to determine the business model for particular financial assets. The new standard lists the following examples of relevant and objective evidence:

- how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity’s key management personnel;
- the risks that affect the performance of the business model (and the financial assets held within that business model) and the way those risks are managed; and
- how managers of the business are compensated – e.g. whether the compensation is based on the fair value of the assets managed or the contractual cash flows collected.

The new standard does not include ‘bright lines’ for assessing the impact of sales activity, but instead requires an entity to consider:

- the significance and frequency of sales activity; and
- whether sales activity and the collection of contractual cash flows are each integral or incidental to the business model.
To fund its future capital expenditure, Entity C invests its excess cash in short- and long-term investments. Many of the investments have contractual maturities that exceed C’s anticipated investment period.

Investments are held to collect the contractual cash flows but, when an opportunity arises, investments are sold to re-invest the cash in investments with a higher return. The managers responsible for the portfolio are remunerated based on the overall return generated by the portfolio.

Therefore, C’s objective for managing the financial assets is achieved by both collecting contractual cash flows and selling financial assets. C will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

1.2 Securitisation and factoring arrangements

Securitisations and factoring arrangements commonly involve transferring financial assets or the rights to collect their cash flows between different entities. Therefore, the business model assessment may not be straightforward and will require judgement.

Securitisations and factoring arrangements typically comprise loans and trade receivables. As discussed in Section 1.1, assigning a financial asset to a business model is a new requirement under the new standard that did not exist under IAS 39. Under IAS 39, many loans and trade receivables were classified as ‘loans and receivables’ and measured at amortised cost. However, financial assets that the entity intends to sell immediately or in the near term were required to be classified as held-for-trading.
## Application of the new requirements

### Whether a financial asset is derecognised may influence business model determination

A portfolio of financial assets acquired with the objective of selling to a securitisation vehicle may be consistent with a held-to-collect business model, depending on the circumstances. If selling the assets would result in their derecognition, then the objective would be inconsistent with the held-to-collect business model. However, if selling the assets would not result in derecognition, then further analysis may be required.

An entity may hold a portfolio of financial assets with the objective of selling some of the financial assets to third parties in factoring transactions. If the assets that are sold do not qualify for derecognition, then this might be considered consistent with a held-to-collect business model, depending on the circumstances.

### Example – Impact of securitisation on the business model assessment

Securitisation vehicle Z issues notes to investors. Z is consolidated by Entity Y, which issues the loans. Z receives the contractual cash flows on the loans from Y (its parent) and passes them on to investors in the notes.

Under the new standard, from the consolidated group’s perspective, the loans are originated with the objective of holding them to collect contractual cash flows. The fact that the consolidated group entered into an arrangement to pass cash flows to external investors, and so does not retain cash flows from the loans, does not preclude a conclusion that the loans are held in a held-to-collect business model.

Further, Y’s objective is to realise cash flows on the loan portfolio by selling the loans to Z, so for its separate financial statements, it is not considered to be managing this portfolio in order to collect the contractual cash flows.

### Example – Financial assets sold under factoring agreements

Company R sells its trade receivables to a factor, Company P. P obtains outright legal ownership of the receivables and the debtors are required to remit funds directly to P. However, under the factoring agreement R retains substantially all of the credit risk of the receivables through a guarantee given to P. Because of the guarantee, R continues to recognise the trade receivables in its statement of financial position.

In this case, in our view R should choose an accounting policy, to be applied consistently, on whether these receivables are held within a held-to-collect business model. R may conclude that a held-to-collect business model applies as it continues to recognise the receivables. Alternatively, it may conclude that the held-to-collect criterion is not met, because:

- it sells the receivables to P immediately; and
- it has no right to collect any of the contractual cash flows.
2 Assessing the SPPI criterion

2.1 Basic lending arrangement

Requirements of the new standard

If an asset is in a hold-to-collect or hold-to-collect or sell business model, an entity assesses whether the cash flows from the financial asset meet the ‘solely payments of principal and interest’ (SPPI) criterion – i.e. whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest.

– ‘Principal’ is the fair value of the financial asset on initial recognition. The principal may change over time – e.g. if there are repayments of principal.

– ‘Interest’ is consideration for the time value of money and credit risk. Interest can also include consideration for other basic lending risks and costs, and a profit margin.

A financial asset that does not meet the SPPI criterion is always measured at FVTPL, unless it is a non-trading equity instrument and the entity makes an irrevocable election to measure it at FVOCI.

Contractual cash flows that meet the SPPI criterion are consistent with a basic lending arrangement. The SPPI assessment is made with reference to the currency in which the financial asset is denominated, and therefore multi-currency features may cause failure of the SPPI criterion. Fixed and floating rates are generally consistent with SPPI as long as they meet the definition of interest. Leverage increases the variability of the contractual cash flows such that they do not have the economic characteristics of interest – e.g. standalone options, forward contracts and swap contracts.

Contractual features that introduce exposure to risks or volatility unrelated to a basic lending arrangement do not meet the SPPI criterion. The following features should be disregarded for the purposes of the SPPI analysis:

– de minimis – i.e. too trivial or minor to merit consideration;

– non-genuine features – i.e. those that affect the financial asset’s contractual cash flows only on the occurrence of an extremely rare, highly abnormal and very unlikely event; and

– statutory or regulatory terms that are not part of the financial asset’s contractual terms.

Under the new standard, embedded derivatives in a hybrid contract with a host that is a financial asset are not separated from the host contract, but are included in the classification assessment – i.e. assessing whether the cash flows of the hybrid contract meet the SPPI criterion.

These requirements are discussed further in 7A.4.150 of our publication Insights into IFRS, 14th Edition 2017–18.
How does this approach differ from existing requirements?

Criteria for classification of financial assets are different

The new standard contains three principal classification categories for financial assets – i.e. measured at: amortised cost, FVOCI and FVTPL. The existing IAS 39 categories of held-to-maturity, loans and receivables and available-for-sale (AFS) are removed. Although the permissible measurement categories for financial assets are similar to IAS 39, the criteria for classification into the appropriate measurement category are significantly different.

Unlike IAS 39, derivatives embedded in financial assets that are in the scope of IFRS 9 are never separated. Instead, the whole hybrid instrument is assessed for classification.

Application of the new requirements

Assessment is performed on the overall instrument

Assessing the SPPI criterion may require judgement to ensure that financial assets are classified into the appropriate measurement category. Entities may need to undertake a comprehensive review of loan documentation and the terms of securities.

The new standard’s approach to assessing SPPI focuses on an overall assessment of what the entity is being compensated for and whether there is a basic lending arrangement, rather than on how much the entity receives for a particular element. In addition, the concept of a *de minimis* contractual feature is introduced under the new standard.

Under IAS 39, an embedded derivative is always separated from a host debt instrument if its economic characteristics are not closely related to those of the host. In many of these cases, the embedded derivative, and therefore the hybrid contract in its entirety, is likely to contain cash flows that are not payments of principal and interest, and so would not meet the SPPI criterion. Accordingly, although the separated host contract in these cases may have been eligible for measurement at amortised cost under IAS 39, under the new standard the entire hybrid contract is measured at FVTPL.
Example – Investment in a convertible bond

Company B has an investment in a convertible bond. Under the terms of the bond, the holder has the option to convert it into a fixed number of equity shares of the issuer. The convertible bond is analysed for classification in its entirety.

The conversion option causes the instrument to fail the SPPI criterion. This is because the embedded feature cannot be separated and the contractual terms of the convertible bond as a whole do not give rise solely to payments of principal and interest on the principal amount outstanding on the bond. The return on the bond is not just consideration for the time value of money and credit risk, but also reflects the value of the issuer’s equity.

Therefore, the convertible bond in its entirety is classified as at FVTPL.

2.2 Prepayment features

Requirements of the new standard

The contractual cash flows of some financial assets may change over the life of the asset – e.g. in many cases an asset can be prepaid. A prepayment feature meets the SPPI criterion if:

- it permits the issuer (i.e. the debtor) to prepay a debt instrument or permits the holder (i.e. the creditor) to put the debt instrument back to the issuer before maturity; and
- the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding – which may include reasonable compensation1 for the early termination of the contract.

If a financial asset would otherwise meet the SPPI criterion, but fails to do so only as a result of the prepayment feature, then it may still be eligible for measurement at amortised cost or FVOCI (depending on its business model) if the exception applies.

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1. IFRS 9 (as issued in 2014) refers to ‘reasonable additional compensation’. Some prepayment options could result in the party that triggers the early termination of the contract receiving compensation from the other party (negative compensation) – e.g. the lender receives an amount less than the unpaid amounts of principal and interest even though the borrower chooses to prepay. In other cases, an event outside the control of both parties may cause the early termination. Under IFRS 9 (as issued in 2014), these prepayment features would probably fail the SPPI criterion. The IASB intends to issue amendments to IFRS 9 that clarify that negative compensation may be regarded as ‘reasonable compensation’ irrespective of the event or circumstance that causes the early termination of the contract. Financial assets with such prepayment features could therefore be measured at amortised cost or at FVOCI if they meet the other relevant requirements of IFRS 9. These amendments are expected to be effective for annual periods beginning on or after 1 January 2019 with early adoption permitted. Retrospective application is expected to be required subject to relevant transitional reliefs. See our July 2017 IFRS Newsletter: Financial Instruments for more information on the IASB’s discussions.
Exception applies if all of these conditions are met:

1. Asset is originated or acquired at a discount or premium to contractual par amount.
   - Discount or premium

2. Prepayment amount = contractual par + accrued interest, which may include reasonable compensation for early termination.
   - Prepayment at par + interest

3. When the financial asset is originally recognised, the fair value of the prepayment feature is insignificant.
   - FV prepayment feature insignificant

These requirements are discussed further in 7A.4.210 and 220 of our publication Insights into IFRS, 14th Edition 2017–18.

**Application of the new requirements**

**Judgement applies when analysing prepayment features**

An entity needs to evaluate the nature of the prepayment feature. It also needs to consider what the prepayment amount would be at each date on which the prepayment feature is exercisable, to determine for all cases whether the prepayment amount substantially represents ‘unpaid amounts of principal and interest’. This requires an entity to consider the economic characteristics of the contract and may require judgement.

Further, the new standard does not define ‘reasonable compensation’ and an entity will need to apply judgement when determining whether any penalty for early termination is reasonable compensation.

As shown above, an exception for prepayment features at par is available, allowing measurement at amortised cost or FVOCI. This might apply to:

- purchased, credit-impaired assets acquired at a deep discount to par; and
- financial assets issued at below-market rates – e.g. a loan provided to a customer as a marketing incentive such that the loan’s fair value on initial recognition is significantly below its contractual par amount.

In these cases, the borrower may have the contractual ability to prepay at par, but the contractual prepayment feature would have an insignificant fair value as it is very unlikely that prepayment will occur.

- In the first example, prepayment is very unlikely because the financial asset is impaired and so the borrower is unlikely to have funds to prepay the asset.
In the second example, it is very unlikely that the customer will choose to prepay, because the interest rate is below-market and the financing is advantageous. Consequently, the amount at which the loan can be prepaid does not introduce variability that is inconsistent with a basic lending arrangement.

The above examples deal with circumstances in which a financial asset is originated or purchased at a discount to the par amount. However, the exception is equally relevant for assets that are issued or purchased at a premium. Possible examples might include:

- a fixed-rate bond that is acquired at a substantial premium to par, but is redeemable at par only at the option of the holder; or
- a bond that is acquired at a substantial premium to par but is prepayable at par at the option of the issuer only in the event of a specified change in tax law, which is considered very unlikely to occur.

**Example – Investment in a corporate bond prepayable at par**

Company B invests in a corporate bond with a par value of 100. It acquires the bond at a premium – for 115 – due to a decline in market interest rates since its original issue. The corporate bond is prepayable at the option of the issuer only in the event of a specified change in tax law. It can be prepaid at the contractual par amount plus accrued but unpaid interest.

B considers the fair value of the prepayment feature to be insignificant because it is unlikely that the specified change in tax law will occur. To support this, B determines the fair value of the prepayment option by comparing the fair value of an otherwise identical bond without the prepayment option with the fair value of the corporate bond.

### 2.3 Other contractual features

#### Requirements of the new standard

There are various other contractual provisions that could change the contractual cash flows. An SPPI assessment considers all contractual features of the financial asset.

In some cases, a financial asset may have contractual cash flows that are described as principal and interest, but are not payments of principal and interest. This may be the case in the following circumstances.

- A creditor’s claim is limited only to specified assets of the debtor or to the cash flows from specified assets – e.g. non-recourse loans.
- Contractually linked instruments that create concentrations of credit risk – e.g. asset-backed securities.
- The relationship between the passage of time and interest rate is imperfect – i.e. ‘modified time value of money’.
- The financial asset contains term extension features.
- The financial asset contains other contingent or discretionary features.
The fact that a financial asset is non-recourse does not in itself mean that the SPPI criterion is not met. In this case, the holder of the asset has to assess (‘look through to’) the underlying assets or cash flows to determine whether the terms of the asset give rise to other cash flows or limit the cash flows so that they are not consistent with the SPPI criterion.

The new standard introduces the concept of the ‘modified time value of money’. It gives the following examples:

- if the asset’s interest rate is periodically reset but the frequency of that reset does not match the term of the interest rate – e.g. the interest rate resets every month to a one-year rate; or
- if the asset’s interest rate is periodically reset to an average of particular short-term and long-term rates.

When assessing whether a modified time value of money feature meets the SPPI criterion, an entity determines how the undiscounted contractual cash flows could differ from the undiscounted cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). If the difference could be significant, then the SPPI criterion is not met. An entity considers the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial asset. However, an entity considers only reasonably possible scenarios, instead of every possible scenario.

For assets with extension options – i.e. an option that permits the issuer or the holder to extend the contractual term of a debt instrument – an entity determines whether the contractual cash flows that could arise over the life of the asset meet the SPPI criterion. A term extension feature meets the SPPI criterion if the contractual cash flows during the extension period are solely payments of principal and interest on the principal amount outstanding. The contractual cash flows may include reasonable compensation for the extension of the contract.

These requirements are discussed further in 7A.4.180, 210 and 320 of our publication Insights into IFRS, 14th Edition 2017–18.

### Application of the new requirements

#### Non-recourse assets

Judgement is required when assessing whether a non-recourse asset meets the SPPI criterion. In our view, the underlying purpose of the assessment is to identify cases in which the financial asset is intended to provide the holder with a return based on the performance of specific assets or another variable that does not represent exposure to, and compensation for, a basic lending arrangement. These cases fail the SPPI criteria. In other cases, the borrower’s obligation to pay cash represents specified amounts of principal and interest but the obligation in default is limited in a way that is in substance consistent with the exposure to credit risk of a basic lending arrangement.
Modified time value of money
Assessing the modified time value of money requires judgement to:
– identify the characteristics of a benchmark instrument;
– identify reasonably possible scenarios; and
– determine whether the undiscounted contractual cash flows on the financial asset could (or could not) be significantly different from the undiscounted benchmark cash flows.

Extension features
Assessing extension features requires an entity to assess the contractual cash flows that could arise both before and after the change in contractual cash flows.

Example – Non-recourse loan
Company C finances a non-consolidated structured entity holding an aircraft that is leased to an airline with a strong credit rating. The contractual payments on the loan include only stated principal and interest. In the case of default, C’s recourse is limited to cash flows from the aircraft lease and the aircraft. Receipt of the minimum lease payments would be adequate to enable the structured entity to make all payments of principal and interest on the loan.

Looking through to the underlying assets, C concludes that the cash flows are consistent with payments representing principal and interest on the principal amount outstanding.

If the minimum lease payments were not adequate to service the loan or if the lease were to another structured entity, then further analysis would be required.

Example – Extension features
Company D places an extendable deposit with Bank B by paying the principal amount to B. B is required to repay this principal amount at maturity. The terms of the extendable deposit include an initial five-year term and a fixed coupon rate, agreed at inception. At the end of five years, B has the unconditional option to extend the deposit at the same fixed coupon rate for an additional five years. B is likely to choose to exercise the extension option only if the then-current market interest rate for five-year deposits is greater than the rate fixed in the contract.

In this example, D concludes that the contractual cash flows during the extension period are solely payments of principal and interest on the principal amount outstanding. This is because the coupon rate is fixed at inception of the deposit and is not leveraged. Furthermore, the contractual terms require payment at inception and repayment at maturity of the principal amount; they contain no other cash flow requirements or contingent features.
Investments in equity instruments

Requirements of the new standard

Under the new standard, investments in equity instruments are generally measured at FVTPL. However, on initial recognition an entity may make an irrevocable election to present in other comprehensive income (OCI) subsequent changes in the fair value of an investment in an equity instrument that is neither held-for-trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 Business Combinations applies. Equity instruments are defined in accordance with IAS 32 Financial Instruments: Presentation.

This election is irrevocable and can be made on an instrument-by-instrument (e.g. individual share) basis on initial recognition.

Dividends are generally recognised in profit or loss unless they clearly represent a recovery of part of the cost of the investment.

![Investment in equity instruments diagram]

These requirements are discussed further in 7A.4.420 of our publication Insights into IFRS, 14th Edition 2017–18.
How does this approach differ from existing requirements?

**Different accounting for equity investments**

Under IAS 39, equity instruments are generally classified as available-for-sale (AFS) financial assets and measured at fair value. However, an exemption for AFS financial assets whose fair value cannot be measured reliably is available so that they can be measured at cost.

This exemption applies only to unquoted equity instruments when:

- there is significant variability in the range of reasonable fair value estimates; and
- the probabilities of the various estimates within the range cannot be assessed reasonably.

Under IAS 39, fair value changes of AFS assets are recognised in OCI. When the asset is derecognised, on either sale or other disposal, or is impaired, the cumulative fair value changes recognised in OCI are reclassified from equity to profit or loss as a reclassification adjustment.

Under the new standard, measurement at cost is no longer permitted and FVTPL accounting applies unless the FVOCI election is made. The accounting for equity instruments under the new FVOCI election differs from that under IAS 39 because:

- the impairment requirements do not apply; and
- fair value gains and losses are recognised in OCI and never reclassified to profit or loss.

**Application of the new requirements**

**FVOCI option is permitted only for instruments that meet the equity instrument definition under IAS 32**

The FVOCI election is generally available for all investments in equity instruments in the scope of the new standard that are not held for trading. However, it is not available under the new standard for:

- investments in subsidiaries held by investment entities that are accounted for at FVTPL; and
- investments in associates and joint ventures held by venture capital organisations or mutual funds that are measured at FVTPL.
Under the new standard, equity instruments are defined in the same way as in IAS 32. This means that a holder of an investment assesses whether the instrument meets the definition of equity from the perspective of the issuer. IAS 32 both defines an equity instrument and provides guidance on what other instruments are classified as equity. However, the FVOCI option refers only to equity instruments defined as such by IAS 32; it does not apply to instruments defined as financial liabilities but classified as equity by the issuer – e.g. puttable instruments classified as equity by the issuer.
4

Financial liabilities

4.1

Financial liabilities designated at FVTPL

Requirements of the new standard

The new standard retains the option in IAS 39 to designate, irrevocably on initial recognition, a financial liability at FVTPL, subject to the following eligibility criteria.

- The designation should eliminate or significantly reduce a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities, or from recognising the gains and losses on them, using different bases.

- A group of financial liabilities, or a group of financial assets and financial liabilities, has to be managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy. Information about the group is provided internally on that basis to the entity’s key management personnel.

- If a contract contains one or more embedded derivatives and the host is not a financial asset in the scope of IFRS 9, then an entity may designate the entire hybrid (combined) contract at FVTPL. However, this does not apply if the embedded derivative is insignificant, or if it is obvious that separation of the embedded derivative would be prohibited.

Under the new standard, fair value changes are generally presented as follows:

- the change in fair value that is attributable to changes in the credit risk of the liability is presented in OCI; and

- the remaining change in fair value is presented in profit or loss.

Amounts presented in OCI are never reclassified to profit or loss. This prohibition applies even if such a gain or loss is realised by settling or repurchasing the liability at fair value.

These requirements are discussed further in 7A.5.40 and 7A.7.180 of our publication Insights into IFRS, 14th Edition 2017–18.
How does this approach differ from existing requirements?

New rules for presenting gains or losses attributable to own credit risk

Under IAS 39, all fair value changes on liabilities designated under the fair value option are recognised in profit or loss.

Since the fair value option for financial liabilities was introduced by IAS 39, many observers have expressed concern about an entity applying the fair value option and, as a result, recognising gains in profit or loss when its credit standing deteriorates (or losses when it improves). This result is widely seen as counter-intuitive. The new standard addresses this issue by generally requiring those changes to be recognised in OCI.

Application of the new requirements

Exceptions to split presentation exist and should be evaluated

There are two exceptions to the split presentation between profit or loss and OCI for financial liabilities designated as at FVTPL:

- if split presentation would create or enlarge an accounting mismatch in profit or loss; or
- if the financial liability is a loan commitment or a financial guarantee contract.

In these cases, all gains and losses are presented in profit or loss.

To determine whether split presentation would create or enlarge an accounting mismatch in profit or loss, an entity assesses whether it expects the changes in the financial liability’s credit risk to be offset in profit or loss by a change in the fair value of another financial instrument measured at FVTPL. The determination is based on an economic relationship between the characteristics of the financial liability and the characteristics of the other financial instrument.

The entity makes this determination on initial recognition and does not reassess it.

Example – Split presentation

Company Y has issued financial liabilities whose cash flows are linked to both:

- the cash flows received from investment property measured at fair value under IAS 40 *Investment Property*; and
- the fair value of that property.

Y determines that the contractual linkage does not constitute an embedded derivative and, without designation, the financial liabilities would be accounted for at amortised cost.
Y concludes that an accounting mismatch arises and that these financial liabilities qualify for designation at FVTPL. Changes in the fair value from own credit risk are presented in OCI and all other changes in fair value are presented in the statement of profit and loss. This is because the split presentation does not create or enlarge an accounting mismatch in profit or loss.

4.2 Modification or exchange of financial liabilities

Requirements of the new standard

In practice, modifications or exchanges of financial liabilities that do not result in derecognition are common. Under the new standard, the entity recalculates the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate (EIR). It then recognises any adjustment to the amortised cost of the financial liability in profit or loss.

When an instrument is modified but not derecognised, any fees and costs incurred are recognised as an adjustment to the carrying amount of the instrument and are amortised over the remaining term of the modified instrument.

If the entity has to change its accounting policy for these modifications or exchanges as a result of the initial application of the new standard, then it applies the new standard’s transition requirements, which require retrospective application, subject to particular reliefs as specified in Section 7.2 of IFRS 9.

For a discussion of modifications or exchanges of financial assets that do not result in derecognition, see Chapter 14 and 7A.11.200 of our publication Insights into IFRS, 14th Edition 2017–18.

How does this approach differ from existing requirements?

Recognising a gain or loss at date of modification

Entities that have modified fixed-rate financial instruments face a significant change in the accounting for a non-substantial modification. Common practice under IAS 39 when accounting for a modification of a liability that does not result in derecognition is to recalculate the EIR at the date of the modification to reflect the revised contractual cash flows, without recognising a gain or loss at the date of the modification.

2. The IASB and the IFRS Interpretations Committee discussed the accounting for modifications of financial liabilities that do not result in derecognition under IFRS 9 as issued in 2014 because IFRS 9 only explicitly specifies the accounting for modifications of financial assets that do not result in derecognition. This section reflects the outcome of these discussions, which is expected to be included in the basis for conclusions that will accompany the forthcoming amendments to IFRS 9 for prepayment features with negative compensation. See our July 2017 IFRS Newsletter: Financial Instruments for more information on these discussions.
Under the new standard, there is no change to the accounting for costs and fees when a modification occurs. When an instrument has been modified (but not substantially), any fees and costs incurred are recognised as an adjustment to the carrying amount of the liability and are amortised over the remaining term of the modified liability.

**Application of the new requirements**

**Modifications of floating-rate instruments**

Entities should consider how to apply the guidance in the new standard to a modification of a floating-rate instrument. Paragraph B5.4.5 of IFRS 9 applies to floating-rate instruments and requires changing the EIR to reflect re-estimation of cash flows due to changes in market interest rates.
5

Scope of impairment requirements

Requirements of the new standard

The following table sets out which instruments are in and which are outside the scope of the new standard’s impairment requirements.

<table>
<thead>
<tr>
<th>In scope</th>
<th>Out of scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Financial assets that are debt instruments measured at amortised cost or at FVOCI – these may include loans, trade receivables and debt securities</td>
<td>- Equity investments</td>
</tr>
<tr>
<td>- Loan commitments issued that are not measured at FVTPL</td>
<td>- Loan commitments issued that are measured at FVTPL</td>
</tr>
<tr>
<td>- Financial guarantee contracts issued that are in the scope of IFRS 9 and are not measured at FVTPL</td>
<td>- Other financial instruments measured at FVTPL</td>
</tr>
<tr>
<td>- Lease receivables in the scope of IAS 17/IFRS 16 Leases</td>
<td></td>
</tr>
<tr>
<td>- Contract assets in the scope of IFRS 15 Revenue from Contracts with Customers</td>
<td></td>
</tr>
</tbody>
</table>

The new standard has a single expected credit loss (ECL) impairment model that applies to all financial instruments in its scope. However, it does include simplifications for trade receivables, contract assets3 and lease receivables. These requirements are discussed further in 7A.8.10 of our publication Insights into IFRS, 14th Edition 2017–18.

3. IFRS 15 defines a "contract asset" as an entity’s right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time – e.g. the entity’s future performance.
How does this approach differ from existing requirements?

**Different scope**

The population of financial instruments in the scope of the new standard’s impairment requirements differs from that under IAS 39.

Equity investments are no longer tested for impairment. Contract assets in the scope of IFRS 15 are now subject to impairment. The new impairment model may also affect corporates that apply IFRS 9 to issued financial guarantee contracts or loan commitments.
6 Application of impairment requirements

6.1 Simplified approach

Requirements of the new standard

Under the new standard, an ECL model applies. The ECL model differs from the IAS 39 incurred loss model in that a loss event need not occur before an impairment loss is recognised. Consequently, all financial assets in the scope of the impairment model generally carry a loss allowance – even those that are newly originated or acquired.

The new standard establishes a general approach for measuring impairment and a simplified approach for certain financial assets. Under the general approach, impairment is generally measured as either:

- 12-month ECLs – defined as the ‘portion of lifetime expected credit losses that represents the expected credit losses that result from default events on the financial instrument that are possible within the 12 months after the reporting date’; or

- lifetime ECLs – defined as the ‘expected credit losses that result from all possible default events over the expected life of the financial instrument’.

Under the general approach, the measurement basis depends on whether there has been a significant increase in credit risk since initial recognition. ECLs are measured as lifetime ECLs if, at the reporting date, the credit risk on the financial instrument has increased significantly since its initial recognition.

However, the new standard allows a simplified approach for trade receivables or contract assets that result from transactions in the scope of IFRS 15, and lease receivables that result from transactions in the scope of IAS 17/IFRS 16. Under the simplified approach, the loss allowance is always equal to lifetime ECLs. The diagram below explains when the simplified approach may be or has to be applied.
The estimate of ECLs has to reflect the time value of money – i.e. ECLs are discounted to the reporting date.

These requirements are discussed further in 7A.8.30 and 390 in our publication *Insights into IFRS*, 14th Edition 2017–18.

**How does this approach differ from existing requirements?**

**Expected loss model**

IAS 39’s incurred loss model is replaced by an ECL approach under the new standard, based on a probability-weighted estimate of credit losses. A simplified approach is allowed for certain trade and lease receivables and contract assets.

Under IAS 39, an entity might estimate an impairment loss as either a single amount or a range of possible amounts. In the latter case, an entity recognised an impairment loss equal to the best estimate within the range. Under the ECL approach, corporates are likely to have larger and more volatile bad debt provisions.

**Application of the new requirements**

**Simplified approach**

The simplified approach for trade receivables may not be applied to receivables purchased from third parties. It applies only to trade receivables that result from transactions that are in the scope of IFRS 15 from the perspective of the reporting entity.

**Day one loss on initial recognition**

Applying the new ECL model will effectively result in a day one loss on initial recognition of a financial asset, including:

- trade receivables or contract assets; and
- lease receivables.
This day one loss equals the loss allowance recognised at the reporting date. Although corporates with significant amounts of trade receivables will be affected by the new impairment requirements, the impact may be limited because their trade receivables are usually short-term – e.g. 90 days or less.

**Trade receivables without a significant financing component**

Trade receivables without a significant financing component are measured on initial recognition at the transaction price determined in accordance with IFRS 15, and do not have a contractual interest rate. This implies that the EIR for those receivables would be zero. Accordingly, the discounting of cash shortfalls to reflect the time value of money when measuring ECLs would generally not be required. However, further analysis and judgement may be required if a trade receivable is not paid when it is due and is rescheduled so as to effectively incorporate a significant financing component. In this case, using an EIR of zero may no longer be appropriate. Additionally, trade receivables that do not contain a significant financing component have a short duration – typically less than 12 months – which means that measuring the loss allowance as lifetime ECLs does not generally differ from measuring it as 12-month ECLs.

**Practical expedient**

The new standard allows the use of practical expedients when measuring ECLs and provides an example of a provision matrix for trade receivables. An entity that applies a provision matrix might, for example:

- consider whether it is appropriate to segment trade receivables; and/or
- use historical loss experience on its trade receivables and adjust historical loss rates to reflect information about current conditions, and reasonable and supportable forecasts of future economic conditions.

Remember, all receivables balances need an ECL provision, including those in the current column.

**Example – Using a provision matrix for short-term trade receivables**

Company T has a portfolio of trade receivables of 30,000 at the reporting date. None of the receivables includes a significant financing component and T applies the simplified approach. T operates in only one geographic region and has a large number of small clients.

T uses a provision matrix to determine the lifetime ECLs for the portfolio. It is based on T’s historical, observed default rates, and is adjusted by a forward-looking estimate that includes the probability of a worsening economic environment within the next year. At each reporting date, T updates the observed default history and forward-looking estimates.
On this basis, T uses the following provision matrix.

<table>
<thead>
<tr>
<th></th>
<th>ECL rate</th>
<th>Trade receivables</th>
<th>Impairment allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>0.3%</td>
<td>15,000</td>
<td>45</td>
</tr>
<tr>
<td>1–30 days past due</td>
<td>1.6%</td>
<td>7,500</td>
<td>120</td>
</tr>
<tr>
<td>31–60 days past due</td>
<td>3.6%</td>
<td>4,000</td>
<td>144</td>
</tr>
<tr>
<td>61–90 days past due</td>
<td>6.6%</td>
<td>2,500</td>
<td>165</td>
</tr>
<tr>
<td>Over 90 days past due</td>
<td>10.6%</td>
<td>1,000</td>
<td>106</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>30,000</td>
<td>580</td>
</tr>
</tbody>
</table>

### 6.2 Assessing significant increase in credit risk

#### Requirements of the new standard

Under the new standard’s general approach, at each reporting date an entity assesses whether the credit risk on a financial instrument has increased significantly since initial recognition.

The new standard’s impairment model is symmetrical and assets can move into and out of the lifetime ECLs category, as illustrated below.

When assessing whether there is a significant increase in credit risk (SICR), an entity uses the change in the risk of default occurring over the expected life of the financial instrument, rather than changes in the size of the loss if the default were to occur.

Therefore, changes in loss given default (LGD) are not considered when assessing whether there is a SICR, although they are incorporated into the resulting measurement of ECLs.

To determine whether the risk of default of a financial instrument has increased significantly since initial recognition, an entity compares the current risk of default at the reporting date with the risk of default on initial recognition. The new standard allows an entity to apply various approaches when assessing whether there has been a SICR – including using different approaches for different financial instruments.
Any approach used considers:

- the change in the risk of default occurring since initial recognition;
- the expected life of the financial instrument; and
- reasonable and supportable information that is available without undue cost or effort that may affect credit risk.

In some cases, the qualitative and non-statistical quantitative information available may be sufficient for the assessment. In other cases, a statistical model or credit ratings process may be used. Alternatively, an entity may base the assessment on both of the following types of information, if both are relevant:

- a specific internal-rating category; and
- qualitative factors that are not captured through the internal credit ratings process.

For some instruments, a significant increase in credit risk may not be evident on an individual instrument basis before the financial instrument becomes past due. For example, this could be the case when there is little or no updated information that is routinely obtained and monitored on an individual instrument until a customer breaches the contractual terms. In these cases, if more forward-looking information is available on a collective basis, then an entity makes the assessment on a collective basis.

As an exception to the general requirements, an entity may assume that the criterion for recognising lifetime ECLs is not met if the credit risk on the financial instrument is low at the reporting date. An entity can choose to apply this simplification on an instrument-by-instrument basis.

The new standard states that the credit risk is low if:

- the instrument has a low risk of default;
- the borrower has a strong capacity to meet its contractual cash flow obligations in the near term; and
- adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the borrower’s ability to fulfil its obligations.

The new standard contains a rebuttable presumption that the condition for recognising lifetime ECLs is met when payments are more than 30 days past due. However, it also clarifies that delinquency is a lagging indicator, and that a significant increase in credit risk typically occurs before an asset is past due. Therefore, when more forward-looking information (compared with that about past-due payments) is available without undue cost or effort, it is considered when determining whether there has been a SICR. An entity cannot rely solely on past-due data. For example, this information could be available at a portfolio level.
This rebuttable presumption is not an absolute indicator but is presumed to be the latest point at which lifetime ECLs should be recognised, even when using forward-looking information.

These requirements are discussed further in 7A.8.60,120 and 150 in our publication Insights into IFRS, 14th Edition 2017–18.

**How does this approach differ from existing requirements?**

**SICR concept not in IAS 39**

There is no requirement under IAS 39 to assess for a SICR since initial recognition because an incurred loss model applies. An entity’s approach under the new standard will depend on the criteria that it uses to identify a SICR, which may include quantitative and qualitative factors.

**Application of the new requirements**

**Determining whether a SICR has occurred is a critical and difficult judgement**

The new standard does not define the term ‘significant increase’. Entities need to decide how to define this key term for their instruments.

Assessing SICR requires an entity to identify the date on which it initially recognised a financial instrument. This is because any increase in credit risk is measured from that date at each reporting date. This assessment is made relative to expectations on initial recognition, irrespective of whether the financial instrument has been repriced to reflect an increase in credit risk after initial recognition. For loan commitments and financial guarantee contracts, the date of initial recognition is considered to be the date on which the entity becomes a party to the irrevocable commitment.

To be ‘significant’, a larger absolute increase in the risk of default is required for an asset with a higher risk of default on initial recognition than for an asset with a low risk of default on initial recognition. For example, an absolute change of 2 percent in the probability of default occurring (PD) is more significant for an asset with an initial PD of 5 percent than for an asset with an initial PD of 20 percent. A larger absolute increase in the risk of default is also required for a longer-term financial asset than for a shorter-term financial asset.

The method that an entity employs considers the characteristics of the financial instrument and the historical default patterns for comparable financial instruments. When information is available, without undue cost or effort, that is more forward-looking than data about past-due payments, it is considered when determining whether there has been a SICR.

If there is evidence that there is no longer a SICR since initial recognition, then the loss allowance on the instrument returns to being measured as 12-month ECLs.
Example – SICR: A relative concept

Company W uses an internal credit rating system of 1 to 10, with 1 denoting the lowest credit risk and 10 denoting the highest credit risk.

W considers an increase of two rating grades to represent a significant increase in credit risk. It considers Grades 3 and lower to be a “low credit risk”.

At the reporting date, W has two loans to Company X outstanding, as follows.

<table>
<thead>
<tr>
<th>Grade on initial recognition</th>
<th>Grade at reporting date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan A</td>
<td>2</td>
</tr>
<tr>
<td>Loan B</td>
<td>4</td>
</tr>
</tbody>
</table>

W assesses whether there has been a SICR for each of the loans and reaches the following conclusions.

<table>
<thead>
<tr>
<th>SICR?</th>
<th>Recognise allowance equal to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Lifetime ECLs</td>
</tr>
<tr>
<td>No</td>
<td>12-month ECLs</td>
</tr>
</tbody>
</table>

The loss allowance for each loan is measured on a different basis because only the credit risk of Loan A has increased significantly since initial recognition. The measurement basis for the loss allowance is different irrespective of the fact that both loans have the same grade at the reporting date.

6.3 Definition of default

Requirements of the new standard

The new standard does not define the term ‘default’, but instead requires each entity to do so. The definition should be consistent with that used for internal credit risk management purposes for the relevant financial instrument, and should consider qualitative indicators – e.g. breaches of covenants – when appropriate.

The new standard contains a rebuttable presumption that default does not occur later than 90 days past due, unless an entity has reasonable and supportable information to corroborate a more lagging default criterion. The definition of default is applied consistently in the context of specific types of assets, unless information that becomes available indicates that another default definition is more appropriate for a particular financial instrument.
These requirements are discussed further in 7A.8.50 of our publication *Insights into IFRS*, 14th Edition 2017–18.

**How does this approach differ from existing requirements?**

**IAS 39 does not require entities to define default**

IAS 39 does not require entities to define default for the purpose of assessing and measuring impairment. However, it does include indicators of objective evidence of impairment, which also refer to default. This includes the unlikelihood of payment by the debtor.

Under the new standard, the objective of the definition of default is similar. This means an entity might define default using indicators that are similar to the indicators of objective evidence of impairment in IAS 39.

**Application of the new requirements**

**Default includes qualitative and quantitative factors**

Entities will need to define the term ‘default’ for each of their specific types of assets, and in a way that is consistent with their credit risk management practices.
Measuring impairment

Requirements of the new standard

ECLs are a probability-weighted estimate of credit losses over the expected life of the financial instrument. ‘Credit losses’ are the present value of expected cash shortfalls.

An estimate of ECLs is determined by evaluating a range of possible outcomes, rather than being based on a best- or worst-case scenario. The measurement of ECLs reflects:

- an unbiased and probability-weighted amount;
- the time value of money; and
- reasonable and supportable information that is available without undue cost or effort at the reporting date.

The new standard does not prescribe a single method to measure ECLs. Rather, it acknowledges that the methods used to measure them may vary based on the type of financial instrument and the information available. The estimate of ECLs includes information about past events and current conditions, and forecasts of future economic conditions. An entity uses an approach that is consistent with the measurement objective, and that can evolve over time as it obtains more experience in applying the new standard. This does not imply that a full review of the financial instrument has to be performed, as long as procedures, processes and systems are in place to provide relevant information for the ECL assessment for financial reporting purposes.

When assessing ECLs, an entity is not required to identify every possible scenario, but the estimate always reflects at least two scenarios:

- the probability that a credit loss will occur, even if this probability is very low; and
- the probability that no credit loss will occur.

The impairment loss (or reversal) recognised in profit or loss is the amount required to adjust the loss allowance at the reporting date to the amount that is required to be recognised under the new standard.
For detailed discussion of the requirements, see 7A.8.160 in our publication *Insights into IFRS*, 14th Edition 2017–18.

### How does this approach differ from existing requirements?

**Judgements required under IFRS 9 may be wider and significantly more complex**

The new standard does not retain the practical expedient available in IAS 39 to measure impairment on the basis of an instrument’s fair value using an observable market price. However, it does require that, as part of considering all reasonable and supportable information when measuring ECLs, an entity also considers observable market information about credit risk.

Under IAS 39’s incurred loss model, the expected cash flows from an asset are estimated only once an impairment trigger has been reached. At this point, the borrower is often in financial difficulties, so the analysis focuses on the amount that can be recovered from any available assets that the borrower may have.

Under the new standard’s ECL model, ECLs are needed for all financial assets in its scope. For assets maturing in the medium and longer term, these estimates may involve making assumptions about changes in economic conditions relatively far into the future. At any given time, there may be a number of conflicting and equally credible views about future economic conditions. Therefore, entities will need to develop robust methodologies to ensure that their conclusions are reasonable and supportable, and that judgement is applied consistently.

### Application of the new requirements

**Information used to measure ECLs is likely to be specific to each instrument**

The new standard acknowledges that the degree of judgement required to estimate cash shortfalls depends on the availability of detailed information. As the forecast horizon increases – i.e. as the period for which an entity needs to make its estimate becomes longer – the availability of detailed information decreases, and the judgement required to estimate ECLs increases.

An entity is not required to forecast future conditions over the entire expected life of the instrument. For periods far in the future, it could develop projections by extrapolating the information that is available for earlier periods. The maximum period over which ECLs are measured is the contractual period – including any extension options held by the borrower – over which there is exposure to credit risk on the financial instrument. This maximum contractual period is determined in accordance with substantive contractual terms. The new standard requires ECL estimates to reflect reasonable and supportable information that is available without undue cost or effort – including information about past events and current conditions, and forecasts of future economic conditions.
Historical information is an important base from which to measure ECLs. This base is adjusted for current observable data reflecting current conditions and an entity’s forecast of future conditions during the life of the instrument. However, in some cases the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of this information and when it was calculated, when compared with circumstances at the reporting date.

ECLs reflect an entity’s own expectations of credit losses. Entities that have no, or insufficient, sources of entity-specific data are permitted to use peer group experience for comparable financial instruments (or groups of financial instruments).

The estimate of ECLs reflects the cash flows expected from collateral and other credit enhancements that are part of the instrument’s contractual terms. These collateral and other credit enhancements are not recognised separately from the financial instrument being assessed for impairment.

The estimate of ECLs has to reflect the time value of money. ECLs are discounted to the reporting date, not to the expected default date or another date. For financial assets other than lease receivables, the discount rate used to reflect the time value of money is generally the EIR determined at the date of initial recognition or an approximation thereof (the current EIR for floating-rate financial assets). For lease receivables, the discount rate is the discount rate used in measuring the lease receivable under IAS 17/IFRS 16.

**Example – Measurement of ECLs**

**Fact pattern**

Company X invests in a corporate bond with a 10-year term for $1,000,000. The interest is paid annually. The bond’s coupon and EIR are 5%.

**Scenario 1 – Assume recognition of 12-month ECLs**

Using the most relevant information available, X makes the following estimates:

- the bond has a 12-month PD of 0.5%; and
- the LGD – which is an estimate of the amount of loss if the bond were to default – is 25%, and would occur in 12 months’ time if the bond were to default.

The 12-month ECL allowance is 1,250 – i.e. the amount of cash flows receivable ($1,050,000) multiplied by the PD (0.5%) and by the LGD (25%), and discounting the resulting amount using the EIR for one year (5%).
Scenario 2 – Assume recognition of lifetime ECLs

Using the most relevant information available, X makes the following estimates:

– the bond has a lifetime PD of 20%; and
– the LGD is 25% and would occur on average in 24 months’ time if the bond were to default.

The lifetime ECL allowance is 47,619 – i.e. \((1,050,000 / 1.05^2)\times 20\% \times 25\%\).

Summary

The difference between calculating 12-month ECLs and lifetime ECLs in this example comprises:

– the different PD applied – either the 12-month PD or the lifetime PD; and
– the timing of the losses occurring.

Other potential sources of differences include:

– different LGDs; and
– different exposures at default (EADs).

Notes

a. Includes the amount of principal and interest receivable in 12 months’ time.
b. Includes the amount of principal and interest receivable in 24 months’ time, assuming that the interest for Year 1 is paid in full.
Accounting policy for hedge accounting

Requirements of the new standard

When an entity adopts the new standard, it may choose as its accounting policy to defer applying the IFRS 9 general hedging model until the standard resulting from the IASB’s project on accounting for dynamic risk management is completed. Entities making this accounting policy choice continue to apply IAS 39’s hedge accounting requirements in their entirety to all of their hedging relationships.

In addition, if an entity chooses as its accounting policy to apply the new IFRS 9 general hedging model, then it may also continue to apply IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk.

These requirements are discussed further in 7A.9.80 of our publication Insights into IFRS, 14th Edition 2017–18.

Application of the new requirements

An entity that chooses to continue to apply IAS 39’s hedge accounting requirements in their entirety until the IASB’s project on accounting for dynamic risk management is completed also applies IFRIC 16 Hedges of a Net Investment in a Foreign Operation, without IFRS 9’s consequential amendments. Regardless of whether an entity applies the IAS 39 or IFRS 9 hedge model, the new hedge accounting disclosure requirements in IFRS 7 Financial Instruments: Disclosures may not be deferred.
Aligning hedge accounting with risk management

Requirements of the new standard

The new standard requires an entity’s hedge accounting to be more closely aligned with its actual risk management objectives. It also needs to be consistent with IFRS 9’s new hedge accounting objective – i.e. to reflect the effect of an entity’s risk management activities in the financial statements. To qualify for hedge accounting, an entity is required to document its risk management objective and strategy for undertaking the hedge. Hedge documentation needs to demonstrate how the hedge relationship is aligned with the actual risk management objective, and include an analysis of the sources of ineffectiveness and how it determines the hedge ratio.

These requirements are discussed further in 7A.9.20 of our publication Insights into IFRS, 14th Edition 2017–18.

How does this approach differ from existing requirements?

IAS 39 does not establish an explicit principle for the application of hedge accounting. Instead, hedge accounting is an exception to the normal recognition, measurement and presentation requirements of IAS 39. The new standard enhances documentation requirements to support alignment with risk management objectives and effectiveness measurement.

Application of the new requirements

Entities will need to revisit and amend hedge documentation. The new standard requires an entity’s hedge accounting to be more closely aligned with its actual risk management objectives. The new standard goes beyond IAS 39’s requirement to formally document ‘the entity’s risk management objective and strategy for undertaking the hedge’ to qualify for hedge accounting. An entity’s application of hedge accounting will now also have to be consistent with the new objective of hedge accounting – i.e. to reflect the effect of an entity’s risk management activities in the financial statements.

In instances where designations do not exactly represent the actual risk management approach, ‘proxy hedging’ may be applied. Examples of proxy hedging include using a designation of the gross amount of an exposure when risks are actually managed on a net position basis.

Judgement is required to assess how closely a hedge accounting designation needs to align with an entity’s risk management objectives to be able to qualify for hedge accounting.
In addition, an entity may need to rebalance its hedging relationships to maintain alignment with risk management, and is prohibited from voluntarily de-designating a hedge accounting relationship that remains consistent with its risk management objectives.
10 Costs of hedging

Requirements of the new standard

The new standard contains new requirements for accounting for certain ‘costs of hedging’ – i.e. the time value of purchased options, the forward element of forward contracts and foreign currency basis spreads.

An entity may separate the intrinsic value and the time value of a purchased option (including a zero-cost collar) contract and designate as the hedging instrument only the change in intrinsic value. The accounting for the undesignated time value of a purchased option depends on whether the hedging instrument hedges a transaction-related or a time period-related hedged item based on the nature of the hedged item. For a time period-related hedged item, an entity is required to account for the cost of hedging under an amortisation approach over the period during which the hedge adjustment for the option’s intrinsic value could affect profit or loss. For transaction-related hedged items, the cost of hedging is deferred until the hedged transaction impacts profit or loss.

An entity may also separate the forward element and the spot element of a forward contract and designate as the hedging instrument only the change in the value of the spot element. Similarly, foreign currency basis spreads may be separated and excluded from the designation of a financial instrument as the hedging instrument. In these situations, an entity may (but is not required to) account for the undesignated forward element or foreign currency basis spread under an amortisation or a deferral approach, similar to the approaches used for purchased options.

These requirements are discussed further in 7A.9.650 and 690 of our publication Insights into IFRS, 14th Edition 2017–18.
How does this approach differ from existing requirements?

The costs of hedging concept is not included in IAS 39.

Under IAS 39, changes in the time value of an option are often excluded from hedging relationships but are then required to be measured at FVTPL, giving rise to volatility, which does not reflect their nature as a cost of the hedge.

IAS 39 also permits an entity to separate the interest element and the spot element of a forward contract and designate only the change in the spot element as the hedging instrument. The interest element is excluded from the hedging relationship and is measured at FVTPL.

For foreign currency basis spreads, common practice under IAS 39 is to include them as part of the ‘hypothetical derivative’ when measuring ineffectiveness under cash flow hedges.

Application of the new requirements

Although accounting for a purchased option’s time value as a cost of hedging is required if the time value is excluded from the hedging instrument, it is optional for the forward element of a forward contract and the foreign currency basis spread of a financial instrument, if those elements are excluded from the hedging instrument.

Therefore, for purchased options there is only one decision to make – i.e. whether to exclude the time value from the designation of the hedging instrument and account for it separately as a cost of hedging.

However, for forward contracts and financial instruments with foreign currency basis spreads, there are two decisions to make – namely:

- whether to exclude the forward element or foreign currency basis spread from the designation of the hedging instrument; and
- whether to account for any excluded element at FVTPL or to account for it as a cost of hedging.

The accounting for the time value of purchased options, the excluded forward element of forward contracts and the excluded foreign currency basis spread of financial instruments also depends on whether the hedged item is transaction-related or time period-related.

An example of a transaction-related hedged item arises when an entity hedges an inventory purchase denominated in a foreign currency against foreign currency risk.

An example of a time period-related hedged item is an entity hedging its commodity inventory against fair value changes for six months using a commodity forward contract with a corresponding life.
Example – Time value of a purchased option that hedges a time period-related hedged item

Company E buys a three-year interest rate option (a cap) to protect against increases in the interest expense on a five-year floating-rate bond. The time value paid for the cap is amortised to profit or loss over the same period over which any intrinsic value of the cap would affect profit or loss – i.e. the hedged period.

The cap begins on the day the bond is issued, and expires in three years; it therefore hedges against increases in interest rates for the first three years of a five-year, floating-rate bond.

In this case, the time value paid for that cap is amortised over the first three years because that is the period over which any intrinsic value of the cap would affect profit or loss.
11 Risk components

Requirements of the new standard

Under the new standard, separately identifiable and reliably measurable components of both financial and non-financial items may be hedged items.

A ‘separately identifiable risk component’ could be contractually specified (i.e. the risk component is explicit in the contract) or non-contractually specified (i.e. the risk component is determined in the context of the particular market structure). A non-contractually specified inflation component may qualify as a hedged item. However, the standard contains a rebuttable presumption that unless inflation is contractually specified it is not separately identifiable and reliably measurable.

Whether sufficient observable forward transactions for the component exist may be a factor to consider when concluding whether a component is reliably measurable.

Evaluating whether a risk is separately identifiable

Is there a contract?

- Yes
- No

Does the contract specify how the risk is priced into the contract?

- Yes
- No

Is the risk separately considered in pricing the hedged item based on an analysis of the related market structure?

- Yes
- No

Risk is separately identifiable (permitted hedged risk if also ‘reliably measurable’)

Evaluating whether a risk is reliably measurable

Are the inputs to measuring the effect of the risk observable?

- Yes
- No

Are the unobservable inputs insignificant to the measurement?

- Yes
- No

Risk is reliably measurable (permitted hedged risk)
These requirements are discussed further in 7A.9.310 of our publication *Insights into IFRS*, 14th Edition 2017–18.

**How does this approach differ from existing requirements?**

IAS 39 treats financial and non-financial items differently for risk components that may be designated as hedged items. Financial items may be hedged for risks that are separately identifiable and reliably measurable. Non-financial items may only be hedged in their entirety for all risks or for foreign exchange risk.

There is no requirement for the hedged risk component to be the main or largest component, or for the fair value movement in the hedged risk component to be in the same direction as that for the value of the entire item.

**Application of the new requirements**

The evaluation of whether a risk component is separately identifiable and reliably measurable may require judgement. If a component is explicitly specified in a contract – e.g. a pricing formula that uses a reference to a benchmark commodity price – then concluding that it is separately identifiable may be straightforward.

If the component is not contractually specified, then the entity will need to consider factors such as whether it is a price component of the entire item – e.g. crude oil prices may be a price component of jet fuel prices.

**Example – Contractually specified risk components**

Company B has a long-term supply contract to buy natural gas. The contract is priced using a contractually specified formula that references gas oil, fuel oil and transportation charges. B’s risk management strategy is to hedge 100% of its exposure to gas oil price risk, and B enters into a gas oil forward contract to hedge that price risk.

The contract explicitly specifies how the gas oil component is determined. In addition, there is a market for gas oil forward instruments that extends to the maturity of the supply contract. Therefore, B determines that the gas oil price exposure is separately identifiable and reliably measurable. Therefore, the gas oil price exposure is an eligible risk component for designation as a hedged item.
Example – Non-contractually specified risk components

Company C has a long-term supply contract to buy jet fuel. C’s risk management strategy is to hedge a portion of its exposure to jet fuel price risk based on expected consumption up to 24 months before delivery. C then increases the coverage volume as delivery gets nearer. C uses the following derivatives as hedging instruments based on the liquidity of the respective derivative markets and the time remaining until the forecast purchase:

- 12 months to 24 months: crude oil contracts;
- six months to 12 months: gas oil contracts; and
- under six months: jet fuel contracts.

Crude oil and gas oil are not contractually specified components of jet fuel prices. Therefore, C has to determine whether crude oil and gas oil are separately considered in pricing jet fuel. C analyses the market structure for oil and oil products and determines that there is a relationship between crude oil and gas oil prices, and jet fuel prices. C determines that the relationship results from different refining margins (also known as ‘cracking spreads’) that allow the price of jet fuel to be made up of building blocks. Therefore, C is exposed to these two risk components, even though they are not specified contractually: crude oil and gas oil prices. If C determines that the two risk components are separately identifiable and reliably measurable, then it may designate crude oil or gas oil as risk components of the forecast jet fuel purchases.
12 Hedged items

Requirements of the new standard

Under the new standard, there are a number of other additional exposures that may qualify as hedged items. These include aggregated exposures, groups of items (including net positions), components of nominal amounts and equity instruments at FVOCI.

**Aggregated exposures**: Combinations of derivative and non-derivative exposures that are managed together for risk management purposes may be designated as the hedged item in a hedging relationship. The components that make up the aggregated exposure do not need to be designated in a separate hedging relationship. Instead, entities are allowed to hedge these exposures as one, even though they include a derivative.

![Diagram of Aggregated exposure = non-derivative exposure + derivative]

**Groups of items (including net positions)**: For groups of items, including net positions, to be an eligible hedged item for fair value and cash flow hedges, the position would need to consist of items (including components of items) that would individually be eligible hedged items, and the items in the group are managed together on a group basis for risk management purposes. Furthermore, in the case of a cash flow hedge of a group of items that represent an offsetting risk position, the net position is an eligible hedged item only if it is a hedge of foreign currency risk and the designation specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

**Components of nominal amounts**: There are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item or a layer component. An example of a component that is a proportion of an entire item...
is designating 50 percent of the interest payments of a fixed-rate bond as the hedged item in a fair value hedging relationship. A layer component may be specified from a defined, but open, population, or from a defined nominal amount, such as part of a physical volume – e.g. the bottom layer component, measuring 5 million cubic metres of the natural gas stored in a certain location.

**Equity investments at FVOCI:** Under the new standard, an entity may, on initial recognition, make an irrevocable election to present subsequent changes in the fair value of an investment in equity instruments in OCI if the investment is not held for trading (see Section 3). An entity can designate such an investment as a hedged item in a fair value hedge.

These requirements are discussed further in 7A.9.280 of our publication *Insights into IFRS*, 14th Edition 2017–18.

**How does this approach differ from existing requirements?**

### Aggregated exposures

Under IAS 39, in almost all cases derivatives can be designated only as hedging instruments and not as hedged items. Consequently, aggregated exposures also do not qualify as the hedged item.

In addition, an entity cannot add another derivative as a joint designation after inception of the hedging relationship without first discontinuing that hedging relationship and re-designating a new one.

### Groups of items (including net positions)

IAS 39 requires additional criteria to be met for a group of items to qualify for hedge accounting. In particular:

- the individual items within the group are required to have similar risk characteristics; and

- the changes in the fair value attributable to the hedged risk for each individual item in the group need to be approximately proportional to the overall change in the fair value of the group for the hedged risk.

Net positions are prohibited from being designated as the hedged item under IAS 39. Instead, a gross position approach is generally applied. For example, an entity may identify the excess of financial assets over financial liabilities and designate the excess gross position as the hedged item.

### Components of nominal amounts

Under IAS 39’s general approach, entities cannot designate a layer component, which is specified from a defined nominal amount, as the hedged item in a fair value hedging relationship.

**Equity investments at FVOCI**

IAS 39 describes a hedging relationship as one where the hedged exposure to changes in fair value attributable to a particular risk could affect profit or loss. As a result, hedge accounting cannot be applied to instruments where the hedged exposure is presented in OCI without reclassification to profit or loss.
Application of the new requirements – Aggregated exposures

If the components that make up these aggregated exposures are already designated in a hedging relationship, then an entity will account for the second hedging relationship without having to terminate and restart the initial hedging relationship. This avoids complexity and increased ineffectiveness, because the derivative in the first hedge would probably have a fair value other than zero at that time. Furthermore, if an entity fails to achieve hedge accounting for a first-level hedge, or chooses not to apply hedge accounting, then the second-level hedge may still qualify for hedge accounting.

Example – Aggregated exposures

Company X has the euro as its functional currency. It hedges its US dollar-denominated 1,000 tonne forecast purchase of steel using a US dollar-denominated steel forward contract. The forward contract has a delivery date that matches the expected delivery of the forecast purchase. X documents this as a cash flow hedge and designates:

- the forecast steel purchase as the hedged item;
- the variability in US dollar cash flows from the forecast purchase due to steel prices as the hedged risk; and
- the forward steel contract as the hedging instrument.

One month later, X enters into a foreign currency forward contract to hedge the foreign exchange risk between the euro and the US dollar arising from both the US dollar-denominated forecast steel purchase and the US dollar-denominated forward contract. This is because it views the two collectively as a US dollar aggregated exposure.

X may document this second-level hedge as a cash flow hedge, in which it would designate:

- the aggregated US dollar fixed-price exposure as the hedged item;
- the variability in euro cash flows relating to the euro/US dollar foreign exchange risk as the hedged risk; and
- the foreign currency forward contract as the hedging instrument.
Application of the new requirements – Groups of items including net positions

Foreign exchange risk is the only risk permitted to be designated in a cash flow hedge of a group of items that contains offsetting risk positions. An entity may manage the effect of other risks – e.g. commodity price risk – but it will not be able to achieve cash flow hedge accounting based on those groups. However, alternative hedge accounting strategies may be available – e.g. designating separate cash flow hedges of the gross positions of forecast sales and forecast purchases.

In contrast, there is no additional limitation on the hedged risk for fair value hedges of a group of items – i.e. fair value hedges of groups may be designated for any otherwise eligible risk, as long as the position consists of items that would individually be an eligible hedged item and the items are managed together on a group basis for risk management purposes.

Example – Net positions

Company S has a group of firm foreign currency-denominated sale commitments in nine months’ time for 100. It also has a group of firm foreign currency-denominated purchase commitments in 18 months’ time for 120.

When S designates the group that constitutes a net position as the hedged item, it cannot designate an abstract amount of a net position up to 20 – i.e. an over-hang position. Instead, it designates a gross amount of purchases and a gross amount of sales that together give rise to the hedged net position in a cash flow hedge.

Application of the new requirements – Components of nominal amounts

Designating a proportion component or layer component of a nominal amount as the hedged item can give rise to different accounting outcomes. Consider the following examples.

Example – Proportion component

A five-year, 100 debt instrument repays 20 per year. If the hedged component is designated as 20% of the debt instrument – i.e. a proportion component – then when determining the gain or loss on the hedged component due to the hedged risk, the entity would include 20% of all of the cash flows of the instrument over its entire life.

Example – Layer component

Continuing the above example, if the hedged component were the last 20 of principal of the debt instrument – i.e. a bottom layer component – then when determining the gain or loss on the hedged component, the entity would consider only the last payment of 20. This may result in a more effective hedging relationship.
Application of the new requirements – Equity investments at FVOCI

For equity investments at FVOCI designated in a fair value hedging relationship, changes in the fair value of the derivatives and hedged items are reflected in OCI. Therefore, any hedge ineffectiveness is recognised in OCI and these changes are never reclassified from accumulated OCI to profit or loss.
13

Hedge effectiveness assessment

Requirements of the new standard

Under the new standard, when designating a hedging relationship, and on an ongoing basis, entities analyse the sources of ineffectiveness that are expected to affect the hedging relationship during its term.

A hedging relationship meets the effectiveness requirements if:

- there is an economic relationship between the hedged item and the hedging instrument;
- the effect of credit risk does not dominate the value changes that result from that economic relationship; and
- the hedge ratio is the same as that resulting from actual quantities of hedged items and hedging instruments used for risk management.

An entity assesses hedge effectiveness at inception of the hedging relationship and on an ongoing basis – at a minimum, at each reporting date or on a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. The assessment relates to expectations about hedge effectiveness; therefore, the test is only forward-looking or prospective.

The new standard also includes additional guidance on measuring hedge ineffectiveness.

These requirements are discussed further in 7A.9.780 of our publication Insights into IFRS, 14th Edition 2017–18.

How does this approach differ from existing requirements?

Hedge accounting under IAS 39 requires prospective and retrospective hedge effectiveness assessments to demonstrate that a hedge is highly effective. For a hedge to be regarded as highly effective retrospectively, there is a ‘bright line’ requirement that the actual results of the hedge should be within the range of 80–125 percent.
Application of the new requirements

Hedge effectiveness requirements

Having an ‘economic relationship’ means that the hedging instrument and the hedged item have values that generally move in opposite directions to one another when they are exposed to the same risk – i.e. the hedged risk. The mere existence of a statistical correlation between two variables does not, by itself, demonstrate that an economic relationship exists.

When assessing credit risk, entities should consider the effect of both changes in counterparty credit risk and own credit risk on the assessment of hedge effectiveness, and the measurement of hedge ineffectiveness. If there is credit risk, then this means that even if there is an economic relationship between the hedging instrument and the hedged item, the level of offset might become erratic.

For the hedge ratio, if, for example, an entity hedges 85 percent of the exposure on an item, then it designates the hedging relationship using a hedge ratio that is the same as that resulting from 85 percent of the exposure and the quantity of the hedging instrument that the entity actually uses to hedge that 85 percent. In addition, entities are not permitted to use a hedge ratio that results in a deliberate mismatch that creates ineffectiveness to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting.

Assessing hedge effectiveness

Hedge qualification is based on qualitative, forward-looking hedge effectiveness assessments rather than arbitrary bright lines. A quantitative or qualitative method may be used to assess hedge effectiveness, which is applied consistently for similar types of hedges, unless different methods are justified. Entities also need to consider whether their IT systems need re-engineering to meet the new hedge effectiveness requirements.

Measuring ineffectiveness

Except for hedges of FVOCI equity investments (see Chapter 12), like IAS 39 the new standard requires actual ineffectiveness to be recognised in profit or loss. IFRS 9 is clear that the measurement of ineffectiveness should consider the time value of money – i.e. the change in value of the hedged item is determined on a present value basis.

The new standard allows a ‘hypothetical derivative’ method to assess effectiveness and measure ineffectiveness – however, it cannot be applied in a way that imputes a feature into the value of the hedged item that may be present in the value of an actual similar derivative (or the hedging instrument) but is not actually present in the hedged item (e.g. a foreign currency basis spread). Chapter 10 discusses how the IFRS 9 ‘costs of hedging’ concept allows an entity to reduce ineffectiveness that might otherwise arise from this spread in the value of the hedging instrument.
14

Transition requirements

Requirements of the new standard

The general principle in the new standard is for retrospective application in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. The transition requirements refer to the date of initial application (DIA), which is the beginning of the reporting period in which an entity first applies IFRS 9.

The new standard contains certain exemptions from full retrospective application, including an exemption from the requirement to restate comparative information about classification and measurement, including impairment. If an entity does not restate prior periods, then opening retained earnings (or other components of equity, as appropriate) for the annual reporting period that includes the DIA is adjusted for any difference between the carrying amount before adoption of IFRS 9 and the new carrying amount. Entities are allowed to restate comparatives if, and only if, this is possible without the use of hindsight. If an entity restates prior periods, then the restated financial information reflects all of the new standard’s requirements.

IFRS 9’s hedge accounting requirements are generally applied prospectively, with limited exceptions. In particular, comparative information may need to be restated for cost of hedging accounting that is applied retrospectively.

The new standard is not applied to items that have already been derecognised at the DIA.

Specific transition requirements include the following.

Business model assessment

On adopting the new standard, an entity assesses the nature of the business models in which its financial assets are held. As an exception to retrospective application, the assessment is based on facts and circumstances at the DIA. An entity is not required to consider business models that may have applied in previous periods. The resulting classification is applied retrospectively, irrespective of the entity’s business model in prior reporting periods.

Fair value option designations

The fair value option for financial assets and financial liabilities is re-opened, based on facts and circumstances at the DIA. The following tables show the transition requirements for the fair value option for financial assets and financial liabilities at the DIA.
### Financial assets

<table>
<thead>
<tr>
<th>Fair value option under IAS 39</th>
<th>Is met at the DIA</th>
<th>Is not met at the DIA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not designated</td>
<td>Designation is permitted</td>
<td>Designation is not possible</td>
</tr>
<tr>
<td>Designation based on reducing an accounting mismatch</td>
<td>Previous designation may be revoked</td>
<td>Previous designation has to be revoked</td>
</tr>
<tr>
<td>Designation based on the criterion that a group of financial assets were managed on a fair value basis</td>
<td>Previous designation has to be revoked</td>
<td>New designation is permitted</td>
</tr>
<tr>
<td>Designation based on the criterion that a financial asset contained an embedded derivative</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Financial liabilities

<table>
<thead>
<tr>
<th>Fair value option under IAS 39</th>
<th>Is met at the DIA</th>
<th>Is not met at the DIA</th>
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<td>Designation based on reducing an accounting mismatch</td>
<td>Previous designation may be revoked</td>
<td>Previous designation has to be revoked</td>
</tr>
<tr>
<td>Designation based on the criterion that a group of financial liabilities were managed on a fair value basis</td>
<td></td>
<td>Not permitted to revoke previous designation</td>
</tr>
<tr>
<td>Designation based on the criterion that a financial liability contained an embedded derivative</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Effective interest method

It may be impracticable to apply the effective interest method retrospectively to certain financial instruments. In these cases, the fair value of a financial instrument at the DIA is treated as its new gross carrying amount (if it is an asset) or amortised cost (if it is a liability) at that date. If an entity has restated comparative periods under IFRS 9, then the fair value at the end of each comparative period is similarly treated as the gross carrying amount or amortised cost at those dates.

Impairment

When determining whether there has been a significant increase in credit risk since initial recognition, an entity may apply:

- the low credit risk exception; and
- the rebuttable presumption for contractual payments that are more than 30 days past due if the entity identifies a SICR based on past-due information.

If, at the DIA, determining whether there has been a SICR since initial recognition of a financial instrument would require undue cost or effort, then the loss allowance or provision is measured as lifetime ECL at each reporting date until that financial instrument is derecognised, unless the credit risk of the financial instrument is low. If the credit risk of a financial instrument is low, then an entity may assume that the credit risk on that asset has not increased significantly since initial recognition, and may recognise a loss allowance equal to 12 months’ ECL.

Hedge accounting

Hedging relationships that qualify for hedge accounting in accordance with IAS 39 that also qualify under the new standard (after taking into account any rebalancing on transition) will be regarded as continuing hedging relationships. When applicable, an entity is required to use the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedge relationship.

All hedge accounting requirements will be applied prospectively, with the following limited exceptions.

- Retrospective application of the accounting for the time value of purchased options as a cost of hedging is required for all hedging relationships in which the hedging instrument is designated under IAS 39 as the intrinsic value of an option.

- Retrospective application of the accounting for the forward element of forward contracts as a cost of hedging is permitted for hedging relationships in which the hedging instrument is designated under IAS 39 as the spot element of a forward contract, provided that this election is applied consistently. Further, if an entity elects to apply this retrospective application, then it is required to apply it to all hedging relationships that qualify for this election.

- Retrospective application of the accounting for foreign currency basis spreads as a cost of hedging is permitted.

For further information on the transition requirements, see Chapter 7A.11 in our publication Insights into IFRS, 14th Edition 2017–18.
Application of the new requirements

Entities will need to be ready to adopt the standard at their DIA. This includes making relevant accounting assessments and elections.

Classification and measurement

To comply with the new standard’s classification and measurement requirements, entities need to, based on facts and circumstances at the DIA:

- assess the objective of the business model within which financial assets are held;
- make any election to designate an investment in an equity instrument that is not held for trading as at FVOCI;
- designate, or revoke designations of, financial assets or financial liabilities as at FVTPL; and
- assess whether presenting the effects of changes in a financial liability’s credit risk in OCI would create or enlarge an accounting mismatch in profit or loss for the purposes of applying the fair value option.

Modification of financial assets

IFRS 9 introduces new guidance on measuring financial assets that are renegotiated or otherwise modified and the renegotiation or modification does not result in derecognition. Under this guidance, the gross carrying amount of the financial asset is recalculated as the present value of the renegotiated or modified contractual cash flows discounted at the financial asset’s original effective interest rate. The difference between this recalculated amount and the existing gross carrying amount is recognised as a modification gain or loss in profit or loss.

Except for modifications because of financial difficulties of the borrower, IAS 39 was silent on how to account for modifications of financial assets that do not result in derecognition. In our experience, the common approach adopted when impairment was not applicable was to recognise the difference in contractual cash flows arising from the modification over the remaining life of the financial asset by adjusting the effective interest rate prospectively, rather than adjusting the carrying amount and recognising the difference immediately in profit or loss.

Because IFRS 9 requires retrospective application, it appears that entities that previously adjusted the effective interest rate prospectively should assess what the gross carrying amount would have been had the modification been accounted for in accordance with the IFRS 9 requirements. If comparative information for prior periods is not restated, then we believe that the difference in the gross carrying amount at the date of initial application should be taken to opening retained earnings of the annual period that includes the date of initial application.

Section 4.2 discusses similar forthcoming changes regarding accounting for modifications of financial liabilities.
Hedge accounting

Entities need to choose whether to defer application of the new general hedging model. If the new model is applied, then all qualifying criteria for hedge accounting need to be met at the DIA in order to apply hedge accounting from that date, including updating hedge documentation to comply with the new standard. Hedge relationships may need to be rebalanced on transition to the new standard. Further, an entity needs to determine if ‘costs of hedging’ accounting will be applied retrospectively.

Example – Modifications of financial assets

On 1 January 2016, Company D agreed to modify the terms of a loan to a borrower, whose credit quality has improved, by reducing the interest rate charged. Under IAS 39 and IFRS 9, the modification does not result in derecognition of the original loan, which is measured at amortised cost. Under IAS 39, D recognised the difference in contractual cash flows arising from the modification over the remaining life of the loan by adjusting the effective interest rate prospectively.

D initially applies IFRS 9 on 1 January 2018. D assesses what the gross carrying amount would have been had the modification been accounted for in accordance with IFRS 9. D recognises the difference in the gross carrying amount at 1 January 2018 in opening retained earnings at 1 January 2018.
15 Disclosure requirements

Requirements of the new standard

The objective of the disclosure requirements is for an entity to disclose information to enable users of financial statements to evaluate:

- the significance of financial instruments for the entity’s financial position and performance;
- the nature and extent of risks arising from those financial instruments, both during the period and at the reporting date; and
- how the entity manages those risks.

To meet the disclosure objective, the new standard introduces additional disclosure requirements in the following areas:

- investments in equity instruments designated at FVOCI;
- impairment:
  - credit risk management practices;
  - quantitative and qualitative information about amounts arising from ECLs; and
  - credit risk exposure; and
- hedge accounting

For hedge accounting, the higher level of judgement required under the new standard is complemented by extensive new disclosure requirements.

The new standard requires an entity to explain its risk management strategy for each risk category of risk exposures that it decides to hedge – e.g. interest rate risk, foreign exchange risk, commodity price risk – and to which it applies hedge accounting.

On initial application

Specific disclosures are required on initial application of the new standard. This section highlights some of these key disclosures, but does not reproduce them all.

On adoption of the new standard, an entity discloses, in the reporting period that includes the DIA:

- the original measurement category and carrying amount determined under IAS 39; and
- the new measurement category and carrying amount determined under IFRS 9 for each class of financial assets and financial liabilities.

In addition, an entity explains how it has applied the classification requirements of the new standard and the reasons for any designations or de-designations of financial assets and financial liabilities at FVTPL. The entity also discloses the amount of any financial assets and financial liabilities that were previously designated at FVTPL but are no longer so designated, distinguishing between mandatory and elective de-designations.
An entity discloses the changes in the classifications of financial assets and financial liabilities at the DIA, showing separately:

- the changes in the carrying amounts on the basis of their measurement categories under IAS 39; and
- the changes in the carrying amounts arising from a change in measurement attribute on transition to the new standard.

On the DIA of IFRS 9’s impairment requirements, an entity discloses reconciliations between:

- the closing balances for impairment allowances under IAS 39 and provisions under IAS 37; and
- the opening balances for loss allowances under IFRS 9.

For financial assets, an entity provides this disclosure by measurement category in accordance with IAS 39 and IFRS 9, showing separately the effect of changes in measurement category on the loss allowance as at the DIA.

For further information on the disclosure requirements, see Chapter 7A.10 in our publication *Insights into IFRS*, 14th Edition 2017–18.

### How does this approach differ from existing requirements?

**Disclosures are significantly expanded under the new standard**

Existing standards include fewer specific disclosure requirements for credit risk exposures and hedge accounting. In comparison, the new standard has extensive disclosure requirements that are intended to help users better understand the effect of credit risk on the amount, timing and uncertainty of future cash flows, as well as the entity’s risk management strategy and the effect that hedge accounting has had on the entity’s financial statements.

The new standard introduces disclosure requirements for investments in equity instruments designated at FVOCI, with specific disclosures required for those investments derecognised during the reporting period.

### Application of the new requirements

**Significant changes to data-gathering processes may be necessary**

All entities are affected by the new disclosure requirements to some extent. However, the additional information needed will vary depending on the relevance of the different requirements to the entity. It is important to assess the additional disclosure requirements fully.

Entities should assess whether their current systems and processes are capable of capturing, tracking, aggregating and reporting information to meet the new disclosure requirements. For many entities, this may require significant changes to existing data-gathering processes, IT systems and internal controls.
## Further resources for IFRS 9

### High-level and practical guidance

| Web article | Financial instruments – Introducing IFRS 9 | First Impressions | IFRS 9 Financial Instruments |
| Briefing | IFRS 9 for corporates – What’s the impact on your business? | First Impressions | IFRS 9 (2013) – Hedge accounting and transition |
| IFRS blog | New standards – Taking investors by the hand | IFRS blog | New standards – Coordinating group and local numbers |
| IFRS blog | New standards – Good and bad news on IT implementation | IFRS blog | New standards – Setting the tone at the top |
| IFRS blog | Regulators call for action on new accounting standards |  |

### In-depth analysis

| Insights into IFRS | 7A Financial instruments: IFRS 9 | Guides to financial statements |
| IFRS newsletter | Financial Instruments | IFRS newsletter | IFRS 9 Impairment |

### Sector-specific material

| Briefing | IFRS 9 for banks – What’s the impact on your business? | Banks – Auditing IFRS 9’s ECL requirements |
| IFRS newsletter | The Bank Statement | Briefing | IFRS 9 for insurers |
| Guide to annual financial statements | Banks | Guide to annual financial statements | Investment funds |
Keeping in touch

Follow ‘KPMG IFRS’ on LinkedIn or visit kpmg.com/ifrs for the latest on IFRS.

Whether you are new to IFRS or a current user, you can find digestible summaries of recent developments, detailed guidance on complex requirements, and practical tools such as illustrative disclosures and checklists.

IFRS toolkit

**Insights into IFRS**
Helping you apply IFRS to real transactions and arrangements.

**Guides to financial statements**
Illustrative IFRS disclosures and checklists of currently effective requirements.

**Newly effective standards**

**IFRS compared to US GAAP**

**Q&A: Fair Value Measurement**

**Combined and/or carve-out financial statements**

Amendments to existing standards

**Business combinations and consolidation**

**Presentation and disclosures**
IFRS readiness for 2018...

It’s time for action
Practical guidance on the new standards

Are you good to go?
Sector-specific guidance

Revenue

Financial instruments

... and beyond

Leases

Insurance contracts

IFRS news

IFRS for banks

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