



cutting through complexity

IFRS

# First Impressions: IFRS 9 *Financial Instruments*

September 2014

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# Fundamental changes call for careful planning

On 24 July 2014, the IASB issued the fourth and final version of its new standard on financial instruments accounting – IFRS 9 *Financial Instruments*. This completes a project that was launched in 2008 in response to the financial crisis. After long debate about this complex area, the implementation effort can begin in earnest.

The new standard includes revised guidance on the classification and measurement of financial assets, including impairment, and supplements the new hedge accounting principles published in 2013.

In the past, concerns have been raised about ‘too little, too late’ provisioning for loan losses. The new expected credit loss model for the recognition and measurement of impairment aims to address these concerns, and accelerates the recognition of losses by requiring provisions to cover both already-incurred losses and some losses expected in the future.

The new standard will have a massive impact on how banks account for credit losses on their loan portfolios. Provisions for bad debts will be bigger and are likely to be more volatile, and adopting the new rules will require a lot of time, effort and money. A major issue for banks and investors in banks will be how adoption of the new standard will affect regulatory capital ratios. Banks will need to factor this into their capital planning, and users are likely to be looking for information on the expected capital impact.

Insurers will also be significantly impacted by IFRS 9. The industry has to plan for the adoption of new standards on both financial instruments and insurance contracts over the next few years. The overall effect cannot be assessed until the insurance standard is finalised over the next 12 months, but we can expect a sea-change in financial reporting for most insurers.

Other corporates should not automatically assume that the impact of the classification, measurement and impairment requirements of the new standard will be small, as this depends on the exposures they have and how they manage them. Planning for IFRS 9 adoption – including implementation of the new hedge accounting requirements published in 2013 – is likely to be an important issue for corporate treasurers and accountants generally.

The new standard has a mandatory effective date of 1 January 2018, but may be adopted early. As the standard has been completed in stages, the relatively few entities that have adopted a previously released version of IFRS 9 can continue to use it until then. In addition, entities can adopt in isolation the part of the standard that allows them to reflect the effects of changes in credit risk on certain marked-to-market liabilities outside of profit or loss.

Entities need to think about when they plan to adopt the new standard. Many banks may need the whole three and a half years up to 2018 to prepare for adoption of the expected credit loss requirements. However, the possibility of early adopting only the ‘own credit’ amendment would provide some welcome relief from profit or loss volatility caused by fluctuations in an entity’s own credit risk.

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# Setting the standard

## A phased approach to completing IFRS 9

Since November 2008, the IASB has been working to replace its standard on financial instruments, IAS 39 *Financial Instruments: Recognition and Measurement*. The IASB structured the project in three phases:

- Phase 1: Classification and measurement of financial assets and financial liabilities
- Phase 2: Impairment
- Phase 3: Hedge accounting.

The issuance in July 2014 of the complete version of IFRS 9: *Financial Instruments*, hereafter referred to as IFRS 9, marks the culmination of this project. However, the IASB has decided to separate the accounting for macro hedging from the accounting for general hedging. The Board is still working on developing a new model for macro hedge accounting, and in April 2014 it issued a discussion paper DP/2014/1 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*.<sup>1</sup>

This *First Impressions* focuses on the chapters of IFRS 9 dealing with Phases 1 and 2 of the project, and the changes that these chapters introduce relative to IAS 39. The new general hedge accounting model that is incorporated in IFRS 9 was originally included in IFRS 9 (2013), and is discussed in our [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), issued in December 2013.

IFRS 9 retains, largely unchanged, the requirements of IAS 39 relating to scope and the recognition and derecognition of financial instruments.

## The different versions of IFRS 9

IFRS 9 has been completed in stages, with the IASB's phased approach reflected in a number of versions of the standard being issued since 2009. Previous versions of IFRS 9 will be superseded by the version issued in July 2014 at its effective date of 1 January 2018. However, entities that have adopted (or will adopt) a previous version by 31 January 2015 may continue to apply that version until IFRS 9's mandatory effective date of 1 January 2018 (see 15.2.4.1).

The following versions of IFRS 9 have been issued.

Version	Summary of content
<b>IFRS 9 (2009)</b>	Includes guidance on the classification and measurement of financial assets.
<b>IFRS 9 (2010)</b>	Incorporates IFRS 9 (2009), and adds requirements for the classification and measurement of financial liabilities.
<b>IFRS 9 (2013)</b>	Incorporates IFRS 9 (2010), with amendments to its transition requirements, and adds guidance on general hedge accounting.
<b>IFRS 9 (2014)</b>	Incorporates IFRS 9 (2013), with amendments to the requirements for the classification and measurement of financial assets, and adds requirements for the new expected credit loss model for impairment.

## Amendments to other standards

IFRS 9 introduces consequential amendments to other standards. References to other standards (except for IAS 18 *Revenue* and IAS 39) in this publication are to the versions as amended by IFRS 9. References to IAS 18 and IAS 39 are to the standards that have been superseded by IFRS 15 *Revenue from Contracts with Customers* and IFRS 9 respectively.

<sup>1</sup> For detailed analysis of the discussion paper, see our [New on the Horizon: Accounting for dynamic risk management activities](#), issued in July 2014.

# 1 Key facts

<b>Scope</b>	<ul style="list-style-type: none"> <li>IFRS 9 carries forward the scope of IAS 39, and adds:             <ul style="list-style-type: none"> <li>– an option to include certain contracts that would otherwise be subject to the ‘own use’ exemption; and</li> <li>– certain loan commitments and contract assets (see 12.7.2) in respect of the impairment requirements.</li> </ul> </li> </ul>
<b>Recognition and derecognition</b>	<ul style="list-style-type: none"> <li>IFRS 9 carries forward from IAS 39 the requirements for recognition and derecognition of financial instruments, with only minor amendments.</li> </ul>
<b>Classification of financial assets and financial liabilities</b>	<ul style="list-style-type: none"> <li>IFRS 9 contains three principal classification categories for financial assets – i.e. measured at: amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit or loss (FVTPL). The existing IAS 39 categories of held-to-maturity, loans and receivables, and available-for-sale are removed.</li> <li>A financial asset is classified as being subsequently measured at amortised cost if the asset is held within a business model whose objective is to collect contractual cash flows, and the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest (the ‘SPPI criterion’).</li> <li>A financial asset is classified as being subsequently measured at FVOCI if it meets the SPPI criterion and is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.</li> <li>All other financial assets are classified as being subsequently measured at FVTPL. In addition, an entity may, at initial recognition, irrevocably designate a financial asset as at FVTPL if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise.</li> <li>At initial recognition of an equity investment that is not held for trading, an entity may irrevocably elect to present in other comprehensive income (OCI) subsequent changes in its fair value.</li> <li>IFRS 9 retains the existing requirements in IAS 39 for the classification of financial liabilities.</li> </ul>
<b>Embedded derivatives</b>	<ul style="list-style-type: none"> <li>IFRS 9 retains the existing requirements in IAS 39 for derivatives where the host is not a financial asset in the scope of IFRS 9 – e.g. a financial liability, a lease receivable or an insurance contract.</li> <li>However, 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.</li> </ul>
<b>Reclassification</b>	<ul style="list-style-type: none"> <li>Reclassification of financial assets is required if the objective of the business model in which they are held changes after initial recognition of the assets, and if the change is significant to the entity’s operations. Such changes are expected to be very infrequent. No other reclassifications are permitted.</li> <li>No reclassification of financial liabilities is permitted.</li> </ul>
<b>Measurement</b>	<p><b>Measurement at initial recognition</b></p> <ul style="list-style-type: none"> <li>IFRS 9 generally retains IAS 39’s requirements on measurement at initial recognition.</li> </ul> <p><b>Subsequent measurement – financial assets</b></p> <ul style="list-style-type: none"> <li>For assets classified as subsequently measured at amortised cost, interest revenue, expected credit losses and foreign exchange gains or losses are recognised in profit or loss. On derecognition, any gain or loss is recognised in profit or loss.</li> <li>For assets classified as subsequently measured at FVOCI, interest revenue, expected credit losses, and foreign exchange gains or losses are recognised in profit or loss. Other gains and losses on remeasurement to fair value are recognised in OCI. On derecognition, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss.</li> </ul>

<b>Measurement (continued)</b>	<ul style="list-style-type: none"> <li>For assets classified as subsequently measured at FVTPL, all gains and losses are recognised in profit or loss.</li> <li>For equity investments for which subsequent changes in fair value are presented in OCI, the amounts recognised in OCI are never reclassified to profit or loss. However, dividend income on these investments is generally recognised in profit or loss.</li> </ul> <p><b>Subsequent measurement – financial liabilities</b></p> <ul style="list-style-type: none"> <li>IFRS 9 retains almost all of the existing requirements in IAS 39 on the subsequent measurement of financial liabilities. However, the portion of the gain or loss on a financial liability designated as at FVTPL that is attributable to changes in its credit risk is generally presented in OCI, with the remaining amount of the change in fair value presented in profit or loss.</li> </ul>
<b>Amortised cost and recognition of interest</b>	<ul style="list-style-type: none"> <li>The definition of amortised cost is similar to that in IAS 39.</li> <li>Generally, interest revenue is calculated by applying the effective interest rate (EIR) to the gross carrying amount of a financial asset. The gross carrying amount of a financial asset is the asset's amortised cost gross of any impairment allowance. However, when an asset is credit-impaired, interest is calculated by applying the EIR to the amortised cost – i.e. net of impairment allowance.</li> <li>Interest expense is calculated by applying the EIR to the amortised cost of a financial liability.</li> </ul>
<b>Impairment</b>	<ul style="list-style-type: none"> <li>IFRS 9 replaces the 'incurred loss' model in IAS 39 with an 'expected credit loss' model. The new model applies to financial assets that are not measured at FVTPL, including loans, lease and trade receivables, debt securities, contract assets under IFRS 15 and specified financial guarantees and loan commitments issued. It does not apply to equity investments.</li> <li>The model uses a dual measurement approach, under which the loss allowance is measured as either: <ul style="list-style-type: none"> <li>12-month expected credit losses; or</li> <li>lifetime expected credit losses.</li> </ul> </li> <li>The measurement basis generally depends on whether there has been a significant increase in credit risk since initial recognition.</li> <li>A simplified approach is available for trade receivables, contract assets and lease receivables, allowing or requiring the recognition of lifetime expected credit losses at all times. Special rules apply to assets that are credit-impaired at initial recognition.</li> </ul>
<b>Hedge accounting</b>	<ul style="list-style-type: none"> <li>The new standard carries forward the general hedge accounting requirements originally published in 2013. The IASB is continuing to work on its macro hedge accounting project.</li> </ul>
<b>Presentation and disclosures</b>	<ul style="list-style-type: none"> <li>IFRS 9 introduces new presentation requirements and extensive new disclosure requirements.</li> </ul>
<b>Effective date and transition</b>	<ul style="list-style-type: none"> <li>The mandatory effective date is 1 January 2018. Early adoption is permitted.</li> <li>An entity may early adopt in isolation the new requirements for 'own credit' gains and losses on financial liabilities designated as at fair value.</li> <li>Generally, the standard is applied retrospectively. However, the hedge accounting requirements are generally applied prospectively.</li> <li>Apart from some aspects of hedge accounting, the restatement of comparative information for prior periods is not required and is permitted only if information is available without the use of hindsight.</li> </ul>
<b>Comparison to US GAAP</b>	<ul style="list-style-type: none"> <li>Convergence between the IASB and the FASB has not been achieved. The FASB is continuing to deliberate changes to the accounting for financial instruments under US GAAP.</li> </ul>

## 2 How this could impact you

	Judgements – new complexities and wider scope	New systems and processes
<b>Classification and measurement of financial assets</b>	<p>The implementation of a business model approach and the SPPI criterion may require judgement to ensure that financial assets are classified into the appropriate category. Deciding whether the SPPI criterion is met will require assessment of contractual provisions that do or may change the timing or amount of contractual cash flows – e.g. prepayment features.</p>	<p>New processes will be needed to allocate financial assets to the appropriate measurement category.</p> <p>In addition, entities that have already applied, or are planning to early apply, IFRS 9 (2009), IFRS 9 (2010) or IFRS 9 (2013) may have to re-engineer the conversion process to take into account the new requirements of the standard on the classification and measurement of financial assets.</p>
<b>Impairment</b>	<p>Estimating impairment is an art rather than a science. It involves difficult judgements about whether loans will be received as due – and, if not, how much will be recovered and when. The new model – which widens the scope of these judgements – relies on entities being able to make robust estimates of:</p> <ul style="list-style-type: none"> <li>• expected credit losses; and</li> <li>• the point at which there is a significant increase in credit risk.</li> </ul> <p>For this purpose, entities will need to decide how key terms such as ‘significant increase’ and ‘default’ will be defined in the context of the instruments they hold.</p> <p>Also, judgement will be needed to ensure that the measurement of expected credit losses reflects reasonable and supportable information that is available without undue cost or effort and that includes historical, current and forecast information.</p>	<p>The new model is likely to have a significant impact on the systems and processes of banks, insurers and other financial services entities, due to its extensive new requirements for data and calculations. In addition, all entities with trade receivables will be affected, but the impact is likely to be smaller, and certain simplifications are available.</p> <p>Expanded data and calculation requirements may include:</p> <ul style="list-style-type: none"> <li>• estimates of 12-month and lifetime expected credit losses;</li> <li>• information and data to determine whether a significant increase in credit risk has occurred or reversed; and</li> <li>• data for the extensive new disclosure requirements.</li> </ul>
<b>Next steps</b>	<p>Entities will need to develop appropriate methodologies and controls to ensure that judgement is exercised appropriately and consistently throughout the organisation, and supported by appropriate evidence.</p>	<p>Entities may have to design and implement new systems and databases and related internal controls. Banks that plan to use the expected credit loss data already captured for regulatory capital requirements calculations under the Basel framework will need to identify differences between the two sets of requirements.</p>



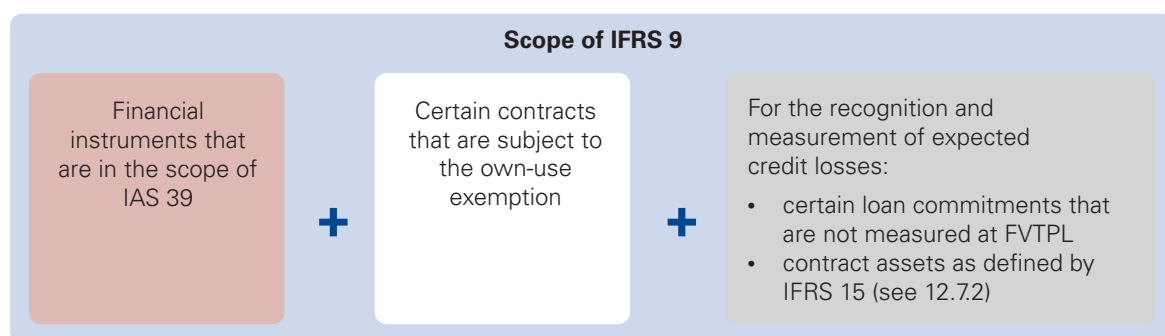
	Equity, regulatory capital and covenants may be affected	Impact on KPIs and volatility
<b>Classification and measurement of financial assets</b>	The way in which an entity classifies financial assets could affect the way its capital resources and capital requirements are calculated. This may affect banks and other financial services entities that have to comply with the Basel capital requirements or other national capital adequacy requirements.	The new standard may have a significant impact on the way financial assets are classified and measured, resulting in changes in volatility within profit or loss and equity, which in turn are likely to impact key performance indicators (KPIs).  However, the own credit requirements for financial liabilities will help to reduce profit or loss volatility, which may be an incentive to early adopt these requirements.
<b>Impairment</b>	The initial application of the new model may result in a large negative impact on equity for banks and, potentially, insurance and other financial services entities. It may also affect covenants. In addition, the regulatory capital of banks may be impacted. This is because equity will reflect not only incurred credit losses but also expected credit losses.  The impact on an entity may be substantially influenced by: <ul style="list-style-type: none"> <li>• the size and nature of its financial instrument holdings and their classification; and</li> <li>• the judgements it makes in applying the IAS 39 requirements and that it will make under the new model.</li> </ul>	Credit risk is at the heart of a bank's business, and is an important element of an insurer's business. Accordingly, the standard is likely to have a significant impact on the KPIs of banks, insurers and similar entities.  The new model is likely to introduce new volatility because: <ul style="list-style-type: none"> <li>• credit losses will be recognised for all financial assets in the scope of the new model – rather than only for those assets for which losses have been incurred;</li> <li>• external data used as inputs may be volatile – e.g. ratings, credit spreads and predictions about future conditions; and</li> <li>• any move from a 12-month to a lifetime expected credit loss measurement and vice versa may result in a big change in the loss allowance.</li> </ul>
<b>Next steps</b>	Entities should assess the impact and develop a plan to mitigate any negative consequences. The implementation plan should involve discussions with analysts, shareholders, regulators and providers of finance.	As well as understanding the impact and communicating it to key stakeholders, banks and other entities that are subject to stress testing should factor the new requirements into their tests, to ensure that the potential impact under adverse scenarios can be properly understood and addressed.

## 3 Scope

### 3.1 Overview

*IFRS 9.2, 5.5.1*

IFRS 9 largely carries forward the scope of IAS 39. Accordingly, financial instruments that are in the scope of IAS 39 are also in the scope of IFRS 9. In addition, certain other instruments are included in the scope of IFRS 9. This is illustrated by the diagram below.



### 3.2 Own-use exemption

*IFRS 9.2.4–5*

A contract to buy or sell a non-financial item that can be settled net in cash or in another financial instrument is excluded from the scope of IAS 39 if the contract was entered into, and continues to be held, for the purposes of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the 'own-use' exemption.

*IFRS 9.2.4–5*

Although IFRS 9 retains the exemption, it allows an entity to irrevocably designate such a contract, at inception, as at FVTPL. The designation can be made only if it eliminates or significantly reduces an accounting mismatch that would otherwise arise.<sup>2</sup>

### 3.3 Loan commitments and contract assets

IFRS 9 includes the following additional items in the scope of its impairment requirements (see 12.1):

- loan commitments issued that are not measured at FVTPL; and
- contract assets in the scope of IFRS 15.

<sup>2</sup> For further discussion on this issue, see our [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), issued in December 2013.

# 4 Recognition and derecognition

*IFRS 9.3* IFRS 9 incorporates without substantive amendments the requirements of IAS 39 for the recognition and derecognition of financial assets and financial liabilities.

*IFRS 9.5.4.4, B3.2.16(r)* However, IFRS 9 includes new guidance on write-offs of financial assets – clarifying that a write-off constitutes a derecognition event for a financial asset or a portion thereof, and explaining when an asset (or a portion) should be written off (see 12.5).

*IFRS 9.B5.5.25–26* In addition, IFRS 9 states that a modification of the terms of a financial asset may lead to its derecognition (see 11.5).

## Observation – Recognition of impairment losses between trade date and settlement date

*IFRS 9.3.1.2, B3.1.6*

IFRS 9 incorporates without substantive change the guidance in IAS 39 on applying trade-date or settlement-date accounting to regular-way purchases and sales of financial assets. Under settlement-date accounting:

- an asset is recognised on the date that it is received by the entity; and
- any change in fair value of the asset to be received during the period between the trade date and the settlement date is accounted for in the same way as for the acquired asset – i.e. the change in fair value is:
  - not recognised for assets measured at amortised cost;
  - recognised in profit or loss for assets measured at FVTPL; and
  - recognised in OCI for assets measured at FVOCI.

However, there is no guidance in the new standard stating that expected credit losses should be recognised in respect of an asset during the period between the trade date and the settlement date when settlement date accounting is applied.

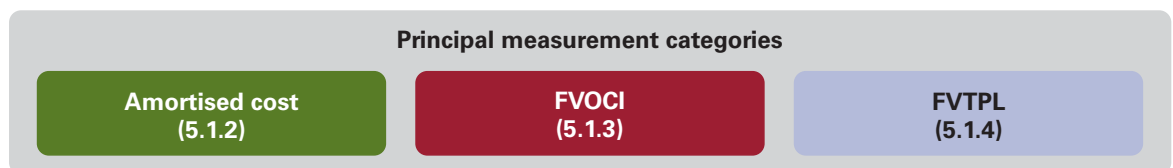
# 5 Classification of financial assets

## 5.1 Introduction

### 5.1.1 Overview of classification

*IFRS 9.4.1, 3.1.1*

IFRS 9 contains three principal measurement categories for financial assets, as illustrated below.



A financial asset is classified into a measurement category at inception and is reclassified only in rare circumstances (see 8.1).

The assessment as to how an asset should be classified is made on the basis of both the entity's business model for managing the financial asset and the contractual cash flow characteristics of the financial asset.

In addition, IFRS 9 provides presentation and designation options and other specific guidance for certain financial assets, as follows.

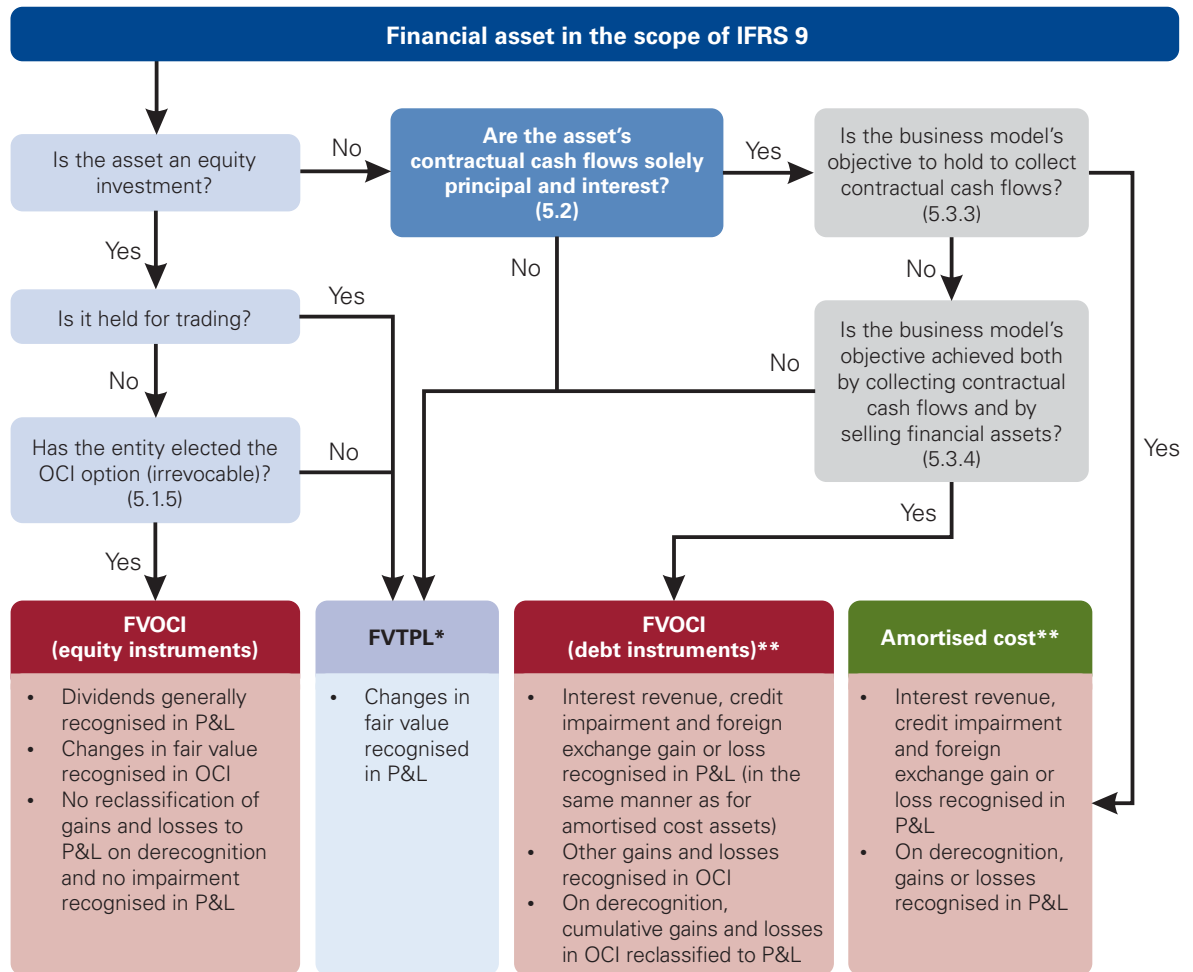
	Type of financial asset	Classification impact
a.	Financial assets for which designation as at FVTPL eliminates or significantly reduces an accounting mismatch (see 5.1.4)	May be designated as at FVTPL
b.	Investments in equity instruments that are not held for trading (see 5.1.5)	Option to present changes in fair value in OCI
c.	Certain credit exposures if a credit derivative that is measured at FVTPL is used to manage the credit risk of all, or a part, of the exposure	May be designated as at FVTPL <sup>3</sup>
d.	Financial assets that: <ul style="list-style-type: none"> <li>• continue to be recognised in their entirety when a transfer of the financial asset does not qualify for derecognition; or</li> <li>• continue to be recognised to the extent of their continuing involvement</li> </ul>	Specific guidance carried forward from IAS 39

*IFRS 9.BCZ 4.55, BC5.18*

IFRS 9 removes the existing categories of held-to-maturity, loans and receivables, and available-for-sale. It also removes the exception that allows certain equity investments, and derivatives linked to such investments, to be measured at cost (see 6.3).

The following diagram provides an overview of the classification of financial assets into the principal measurement categories, along with the presentation and designation options under IFRS 9.

<sup>3</sup> For further information, see Section 4.4 in our [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), issued in December 2013.



\* Certain credit exposures can also be designated as at FVTPL if a credit derivative that is measured at FVTPL is used to manage the credit risk of all, or a part, of the exposure.  
 \*\* Subject to an entity's irrevocable option to designate such a financial asset as at FVTPL on initial recognition if, and only if, such designation eliminates or significantly reduces a measurement or recognition inconsistency.

**Observation – Classification changes from IAS 39**

IFRS 9.BCE.10

Although the permissible measurement categories for financial assets – amortised cost, FVOCI and FVTPL – are similar to IAS 39, the criteria for classification into the appropriate measurement category are significantly different.

All financial assets will have to be assessed based on their cash flow characteristics and/or the business model in which they are held in order to determine their classification.

The overall impact of the new classification principles for financial assets will therefore vary from entity to entity based on these factors and what presentation and designation options an entity has elected under IAS 39 and will elect under IFRS 9.

For some entities, new processes will be needed to allocate financial assets to the appropriate measurement category.

In addition, entities that have already applied, or are planning to early apply, IFRS 9 (2009), IFRS 9 (2010) or IFRS 9 (2013) may have to re-engineer the conversion process to take into account the new requirements of the standard on the classification and measurement of financial assets.

**Observation – New classification and measurement model – judgements and complexities**

The implementation of a business model approach (see 5.3) and the SPPI criterion (see 5.2) may require judgement to ensure that financial assets are classified into the appropriate category. Deciding whether the SPPI criterion is met will require assessment of contractual provisions that do or may change the timing or amount of contractual cash flows – e.g. prepayment features.

**Observation – Classification of financial assets – order of application of criteria***IFRS 9.BC4.14*

While developing the classification and measurement model, the IASB discussed the order in which an entity would apply the business model assessment (see 5.3) and the SPPI criterion (see 5.2). It agreed that in many cases it would be more efficient to perform the business model assessment first – since this would generally be performed at a portfolio level. Therefore, it clarified that an entity would consider the business model first, and noted that an entity would also need to assess the contractual cash flow characteristics of any financial asset within a business model that has the objective of collecting contractual cash flows, to determine the appropriate classification.

However, the order in which the business model and SPPI assessments are performed does not impact the classification conclusion. In this publication, for ease of explanation, the discussion of the SPPI criterion is presented first.

**Observation – New classification and measurement model – business implications**

The new standard may have a significant impact on the way financial assets are classified and measured, resulting in changes in volatility within profit or loss and equity, which in turn is likely to impact key performance indicators.

Measuring assets at amortised cost generally leads to less volatility in profit or loss, OCI and equity than measuring assets at fair value. Under IFRS 9, although profit or loss volatility from some assets may be reduced, other assets previously measured under IAS 39 at amortised cost may need to be measured at FVTPL or FVOCI.

However, the own credit requirements for financial liabilities (see 6.2) will help to reduce profit or loss volatility, which may be an incentive to early adopt these requirements.

**Observation – Impact on capital of regulated institutions***IFRS 9.BCE.77*

Regulated institutions may be impacted by changes to the measurement bases introduced by IFRS 9 if regulators use the amounts reported under IFRS to calculate regulatory capital and other regulatory ratios.

For example, under the Basel III regulatory framework, changes from the amortised cost classification to classification as at FVOCI or FVTPL will have a direct effect on an entity's computed regulatory capital. This may also affect banks that are subject to different regulatory frameworks, and other financial institutions such as insurance companies and securities brokers that may operate under other regulatory frameworks that base regulatory ratios on accounting numbers.

Affected entities will need to assess, and if necessary consider options to mitigate, the potential impact of adopting IFRS 9 on their regulatory capital requirements.

## 5.1.2 Amortised cost measurement category

IFRS 9.4.1.1–2

A financial asset is classified as subsequently measured at amortised cost if it:

- meets the SPPI criterion (see 5.2); and
- is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows (see 5.3.3).

## 5.1.3 FVOCI measurement category

IFRS 9.4.1.2A

A financial asset is classified as subsequently measured at FVOCI if it:

- meets the SPPI criterion (see 5.2); and
- is held in a business model in which assets are managed both in order to collect contractual cash flows and for sale (see 5.3.4).

## 5.1.4 FVTPL measurement category

IFRS 9.4.1.4

All other financial assets – i.e. financial assets that do not meet the criteria for classification as subsequently measured at either amortised cost or FVOCI – are classified as subsequently measured at fair value, with changes in fair value recognised in profit or loss.

IFRS 9.4.1.5

In addition, similar to IAS 39, an entity has the option at initial recognition to irrevocably designate a financial asset as at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency – i.e. an ‘accounting mismatch’ – that would otherwise arise from measuring assets or liabilities, or recognising the gains and losses on them, on different bases.

### Observation – Changes in the fair value option compared to IAS 39

IFRS 9.BC 4.77–80

IAS 39 allows entities an option to designate, on initial recognition, any financial asset or financial liability as at FVTPL if one or more of the following conditions are met:

- doing so eliminates or significantly reduces an accounting mismatch;
- a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel, as defined in IAS 24 *Related Party Disclosures*; or
- the financial asset or financial liability is a hybrid contract that contains one or more embedded derivatives that might otherwise require separation (subject to certain conditions).

IFRS 9 retains only designation option (a) for financial assets. Options (b) and (c) have been removed for financial assets under IFRS 9, because:

- any financial asset that is managed on a fair value basis is mandatorily measured at FVTPL under IFRS 9 (see 5.3.5); and
- option (c) was intended to reduce the costs of complying with the requirements for the separation of embedded derivatives, whereas under IFRS 9 embedded derivatives are not separated from a hybrid financial asset (see 7.2).

IFRS 9 retains all three designation options for financial liabilities, because the other requirements for the classification of financial liabilities have not substantively changed from IAS 39 (see 6.1).

## 5.1.5 FVOCI election for equity instruments

*IFRS 9.5.75*

At initial recognition, an entity may make an irrevocable election to present in OCI subsequent changes in the fair value of an investment in an equity instrument<sup>4</sup> that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 *Business Combinations* applies.

### Observation – FVOCI election for equity instruments

*IFRS 9.2.1(a), B5.7.3, BC5.22–25, IFRS 10.31, IAS 28.18*

The accounting under this option is different to the accounting under the FVOCI category for debt instruments (see 5.1.3) because:

- the impairment requirements in IFRS 9 are not applicable;
- all foreign exchange differences are recognised in OCI; and
- amounts recognised in OCI are never reclassified to profit or loss.

Only dividend income is recognised in profit or loss.

The Board noted that presenting fair value gains and losses in profit or loss for some investments in equity instruments may not be indicative of the performance of the entity – in particular, if these equity instruments are held for non-contractual benefits rather than primarily for their increase in value.

However, the Board did not specify a principle that defined the equity investments to which the exception should apply. It had previously considered developing such a principle – including a distinction based on whether the equity instruments represented a ‘strategic investment’ – but concluded that it would be difficult, if at all possible, to develop a robust and clear principle. As a result, it made the FVOCI election generally available for all investments in equity instruments in the scope of IFRS 9 that are not held for trading. However, the election is not available for:

- investments in subsidiaries held by investment entities that are accounted for at FVTPL under IFRS 9; and
- investments in associates and joint ventures held by venture capital organisations or mutual funds that are measured at FVTPL under IFRS 9.

## 5.2 Contractual cash flows assessment – the SPPI criterion

*IFRS 9.4.1.2(b), 4.1.2A(b)*

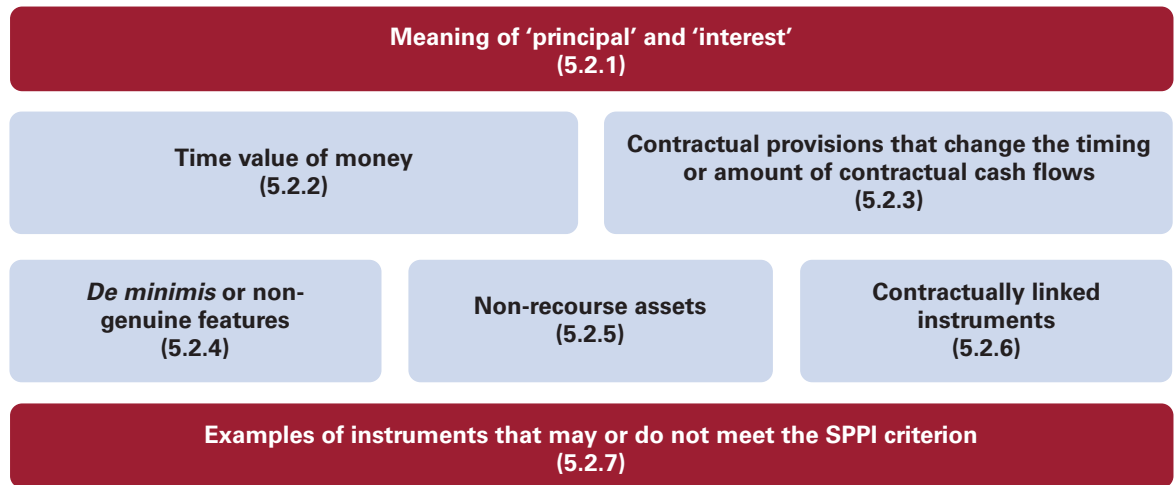
One of the criteria for determining whether a financial asset should be classified as measured at amortised cost (see 5.1.2) or FVOCI (see 5.1.3) is whether the cash flows from the financial asset meet the SPPI criterion – i.e. whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest.

A financial asset that does not meet the SPPI criterion is always measured at FVTPL, unless it is an equity instrument for which an entity applies the OCI election (see 5.1.1 and 5.1.5).

This section looks at the following aspects relating to the SPPI criterion assessment.

<sup>4</sup> The term ‘equity instrument’ is defined in IAS 32 *Financial Instruments: Presentation*.





## 5.2.1 Meaning of 'principal' and 'interest'

IFRS 9.B4.1.7A

Contractual cash flows that meet the SPPI criterion are consistent with a basic lending arrangement. In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest.

IFRS 9.4.1.3(a)–(b)

IFRS 9 defines the terms 'principal' and 'interest' as follows.

<b>Principal</b>	Principal is the fair value of the financial asset at initial recognition. However, principal may change over time – e.g. if there are repayments of principal.
<b>Interest</b>	<p>Interest is consideration for:</p> <ul style="list-style-type: none"> <li>the time value of money (see 5.2.2); and</li> <li>the credit risk associated with the principal amount outstanding during a particular period of time.</li> </ul> <p>Interest can also include:</p> <ul style="list-style-type: none"> <li>consideration for other basic lending risks (e.g. liquidity risk) and costs (e.g. administrative costs); and</li> <li>a profit margin.</li> </ul>

IFRS 9.B4.1.8

The assessment of whether the SPPI criterion is met is made for the currency in which the financial asset is denominated.

### Observation – Definition of 'principal'

IFRS 9.4.1.3(a), B4.1.12, BC4.182(a)

'Principal' is defined in a way that is not obvious. It is not the amount that is due under the contractual terms of an instrument, but rather the fair value of the financial asset at initial recognition.

Before concluding on this definition, the Board also considered whether principal should instead be defined as:

- the amount that is defined in the contract as 'principal'; or
- the amount that was advanced to the debtor when the debtor originally issued the instrument (less any repayments).

The Board decided to define principal as the fair value of the financial asset at initial recognition because it believes that this meaning reflects the economics of the financial asset from the perspective of the current holder. This means that an entity assesses the asset's contractual cash flow characteristics by comparing the contractual cash flows to the amount that it actually invested.

Were it not for an exception introduced in the new standard, this decision would have resulted in:

- the SPPI criterion generally not being met for assets with prepayment features, and that were acquired at a significant premium or discount to the contractual par amount; and consequently
- all such assets having to be classified as at FVTPL.

This is because, if such assets were prepaid early at the contractual par amount (plus accrued interest), the resulting cash flows would differ from the principal amount (plus accrued interest) as defined in IFRS 9. However, IFRS 9 provides an exception from this conclusion if the fair value of the prepayment feature is insignificant when the asset is initially recognised (see 5.2.3.1).

*IFRS 9.B4.1.7A, B4.1.9* The standard provides the following guidance on specific contractual features and types of financial assets.

<b>Contractual features that introduce exposure to risks or volatility unrelated to a basic lending arrangement</b>	Financial assets containing such features do not meet the SPPI criterion. Examples include exposure to changes in equity prices or commodity prices.
<b><i>De minimis</i> or non-genuine features</b>	Such contractual terms should be disregarded in the assessment (see 5.2.4).
<b>Leverage</b>	Leverage increases the variability of the contractual cash flows such that they do not have the economic characteristics of interest – e.g. stand-alone options, forward contracts and swap contracts. Financial assets containing such features do not meet the SPPI criterion.  However, as for all contractual terms, leverage is subject to the <i>de minimis</i> assessment.
<b>Negative interest</b>	IFRS 9 acknowledges that in extreme economic circumstances, interest can be negative. This might be the case if: <ul style="list-style-type: none"> <li>• the holder of a financial asset either implicitly or explicitly pays for the deposit of its money for a particular period of time; and</li> <li>• that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs.</li> </ul> Financial assets on which interest is negative may meet the SPPI criterion.

### Observation – SPPI criterion – changes to previous versions of IFRS 9

The complete version of IFRS 9 amends the previous versions of IFRS 9 to allow more scope for judgement in determining whether cash flows are solely payments of principal and interest – e.g. by including the concept of ‘modified time value of money’ (see 5.2.2.1). The complete version also introduces the concepts of a basic lending arrangement and a *de minimis* contractual feature (see 5.2.4). In addition, it clarifies that interest can include consideration for liquidity risk, administration costs and a profit margin.

As a result, it may be easier to demonstrate that loans made under customary lending arrangements (including loans where the interest rate is regulated – see 5.2.2.2) meet the SPPI criterion.

### Observation – Embedded derivatives and their impact on the SPPI assessment

IFRS 9.B4.3.1

Under IFRS 9, embedded derivatives in a hybrid contract with a host that is a financial asset in the scope of IFRS 9 are not separated from the host contract, but are included in assessing whether the cash flows of the hybrid contract meet the SPPI criterion.

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 such 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 such cases may have been eligible for measurement at amortised cost under IAS 39, under IFRS 9 the entire hybrid contract is measured at FVTPL.

## 5.2.2 Time value of money

IFRS 9.B4.1.9A

The time value of money is the element of interest that provides consideration only for the passage of time and not for other risks and costs associated with holding the financial asset.

To assess whether an element provides consideration only for the passage of time, an entity uses judgement and considers relevant factors – e.g. the currency in which the financial asset is denominated and the period for which the interest rate is set.

### 5.2.2.1 Modified time value of money

IFRS 9.B4.1.9B

The new standard introduces the concept of ‘modified time value of money’, explaining that the time value of money may be modified – i.e. the relationship between the passage of time and the interest rate may be imperfect. It gives the following examples:

- if the asset’s interest rate is periodically reset but the frequency of that reset does not match the tenor 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.

An entity assesses the modified time value of money feature to determine whether it meets the SPPI criterion.

IFRS 9.B4.1.9C–D

The objective of the assessment is to determine how different the undiscounted contractual cash flows could be from the undiscounted cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). If the difference could be significant, the SPPI criterion is not met. The entity considers the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial instrument.

In some cases, an entity may be able to make this determination by performing only a qualitative assessment. In other cases, it may be necessary to perform a quantitative assessment.

In making the assessment, an entity has to consider factors that could affect future contractual cash flows. For example, the relationship between the benchmark cash flows and the contractual cash flows could change over time. However, the entity only considers reasonably possible scenarios rather than every possible scenario. The reason for the interest rate being set in a particular way is irrelevant to the analysis.

The standard includes the following examples to illustrate the modified time value of money concept.

### Examples – Modified time value of money

*IFRS 9.B4.1.9C*

#### Interest rate resetting every month to a one-year rate

Company X holds an asset with a variable interest rate that is reset every month to a one-year rate.

To assess the modified time value of money feature, X compares the financial asset to a financial asset with identical contractual terms and identical credit risk – except that the variable interest rate is reset monthly to a one-month rate.

If the modified time value of money element could result in undiscounted contractual cash flows that are significantly different from the undiscounted benchmark cash flows, the SPPI criterion is not met.

*IFRS 9.B4.1.9D, B4.1.13*

#### Constant maturity bond

Company Y holds a constant-maturity bond with a five-year term and a variable interest rate that is reset semi-annually to a five-year rate. The interest rate curve at the time of initial recognition is such that the difference between a five-year rate and a semi-annual rate is insignificant.

The benchmark instrument would be the one that resets semi-annually to a semi-annual interest rate. The fact that the difference between a five-year rate and a semi-annual rate is insignificant at the time of initial recognition does not in itself enable Y to conclude that the modification of the time value of money results in contractual cash flows that are not significantly different from a benchmark instrument.

Y has to consider whether the relationship between the five-year interest rate and the semi-annual interest rate could change over the life of the instrument such that the undiscounted contractual cash flows over the life of the instrument could be significantly different from the undiscounted benchmark cash flows.

### Observation – Judgement needed in assessing modified time value of money

*IFRS 9.BC4.178*

The assessment of the modified time value of money element 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.

### Observation – Review of contractual terms

An entity will have to undertake a comprehensive review of its financial instruments – e.g. loan documentation – to identify contractual terms that modify the time value of money element.

As part of the review, it may consider changing its business practices by amending ‘problematic’ contractual terms’ to enable this type of financial asset to be measured at amortised cost in the future.

### 5.2.2.2 Regulated interest rates

*IFRS 9.B4.1.9E*

IFRS 9 recognises that in some jurisdictions, the government or a regulatory authority sets interest rates – e.g. as part of a broad macro-economic policy, or to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time.

In spite of the general requirements for the modified time value of money, a regulated interest rate is considered to be a proxy for the time value of money if it:

- provides consideration that is broadly consistent with the passage of time; and
- does not introduce exposure to risks or volatility in cash flows that are inconsistent with a basic lending arrangement.

#### Observation – Regulated interest rates

*IFRS 9 BC4.175, BC4.179–180*

The Board decided to include the specific guidance on regulated interest rates in the standard, as these regulated rates are set for public policy reasons and are therefore not subject to structuring in order to achieve a particular accounting result.

The Board gave an example of French retail banks collecting deposits on special ‘Livret A’ savings accounts. The interest rate is determined by the central bank and the government according to a formula that reflects protection against inflation and remuneration that incentivises entities to use these accounts. This is because legislation requires some of the amounts collected to be lent to a governmental agency, which uses the proceeds for social programmes. The Board noted that the time value element of interest on these accounts may not provide consideration only for the passage of time; however the Board believes that the amortised cost measurement category would provide relevant and useful information, as long as the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement.

### 5.2.3 Contractual provisions that change the timing or amount of contractual cash flows

*IFRS 9.B4.1.10, B4.1.12*

Contractual cash flows of some financial assets may change over their lives. For example, an asset may have a floating interest rate. Also, in many cases an asset can be prepaid or its term extended.

For such assets, an entity determines whether the contractual cash flows that could arise over the life of the instrument meet the SPPI criterion. It does so by assessing the contractual cash flows that could arise both before and after the change in contractual cash flows.

In some cases, contractual cash flows may change on the occurrence of a contingent event. In these cases, an entity assesses the nature of the contingent event. Although the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows meet the SPPI criterion, it may be an indicator.

The standard provides the following examples of contractual terms that change the timing or amount of contractual cash flows and meet the SPPI criterion.

### Examples – Contractual changes in timing or amount of cash flows that meet the SPPI criterion

IFRS 9.B4.1.11

<b>Variable interest rate</b>	<p>A variable interest rate that consists of consideration for:</p> <ul style="list-style-type: none"> <li>• the time value of money;</li> <li>• the credit risk associated with the principal amount outstanding during a particular period of time (the consideration for credit risk may be determined at initial recognition only, and so may be fixed);</li> <li>• other basic lending risks (e.g. liquidity risk) and costs (e.g. administrative costs); and</li> <li>• a profit margin.</li> </ul>
<b>Prepayment feature</b>	<p>A prepayment feature:</p> <ul style="list-style-type: none"> <li>• that 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</li> <li>• whose prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding – which may include reasonable additional compensation for the early termination of the contract.</li> </ul>
<b>Term extension feature</b>	<p>A term extension feature that:</p> <ul style="list-style-type: none"> <li>• permits the issuer or the holder to extend the contractual term of a debt instrument – i.e. an extension option; and</li> <li>• results in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding – which may include reasonable additional compensation for the extension of the contract.</li> </ul>

IFRS 9.B4.1.10

An instrument whose interest rate is reset to a higher rate if the debtor misses a particular payment may meet the SPPI criterion because of the relationship between missed payments and an increase in credit risk.

IFRS 9.B4.1.10, B4.1.13

This can be contrasted with contractual cash flows that are indexed to the debtor's performance – e.g. net income. In such cases, the contractual feature would generally reflect a return that is inconsistent with a basic lending arrangement and would not meet the SPPI criterion – unless the indexing results in an adjustment that only compensates the holder for changes in the credit risk of the instrument.

### Observation – Variable compensation for credit risk

IFRS 9.B4.1.11

In many cases, the component of a variable interest rate that represents compensation for credit risk is fixed at initial recognition. However, in some cases this may not be the case and the compensation for credit risk may vary in response to perceived changes in the creditworthiness of the borrower – e.g. if covenants are breached.

If there are variations in the contractual cash flows of an instrument related to credit risk, then an entity considers whether the variations can be regarded as compensation for credit risk, and therefore whether the instrument may meet the SPPI criterion.

### Observation – Prepayment at fair value with ‘make-whole’ clauses

A bond may contain a ‘make-whole’ clause – e.g. on early termination, the exercise price is based on the higher of:

- the fair value of future payments of principal and interest; and
- the principal amount plus accrued interest.

In this case, it appears that it is possible that the SPPI criterion may be met. This is because the additional amount payable under the make-whole clause if the fair value is higher may represent reasonable additional compensation for early termination.

### Observation – Mutual agreement to make changes to the contract

Sometimes, a contract may include a clause that provides for the parties to mutually agree to make specified changes to the terms of the contract at some point in the future. It appears that if a change of terms is subject to the future free and unconstrained mutual agreement of both parties, then it is not a cash flow characteristic that is included in the initial SPPI assessment. Such a clause would not preclude the contract from meeting the SPPI criterion.

#### 5.2.3.1

*IFRS 9.B4.1.12*

#### Exception for certain par prepayment features

If a financial asset would otherwise meet the SPPI criterion, but fails to do so only as a result of a contractual term that permits or requires prepayment before maturity, or permits or requires the holder to put the instrument back to the issuer, then the asset can be measured at amortised cost or FVOCI if:

- the relevant business model condition is satisfied (see 5.3);
- the entity acquired or originated the financial asset at a premium or discount to the contractual par amount;
- the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable compensation for early termination; and
- on initial recognition of the financial asset, the fair value of the prepayment feature is insignificant.

### Observation – Rationale behind the par prepayment exception

*IFRS 9.BC4.193–194*

The IASB decided to provide this narrow-scope exception because it was persuaded by the feedback that amortised cost would provide useful and relevant information for certain financial assets that would otherwise fail the SPPI criterion. The Board gives the following examples:

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

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 a prepayment will occur. In the first example, the prepayment is very unlikely because the financial asset is impaired and so the borrower is unlikely to have funds from which it could 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.

These examples discuss circumstances in which a financial asset is originated or purchased at a *discount* to the par amount. However, the IASB noted that its rationale for the exception is equally relevant for assets that are originated or purchased at a *premium*. Possible examples might include:

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

## 5.2.4 *De minimis* or non-genuine features

IFRS 9.B4.1.18

A contractual cash flow characteristic does not affect the classification of a financial asset if it could have only a *de minimis* effect on the contractual cash flows of the financial asset. To make this determination, an entity considers the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial asset.

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

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

## 5.2.5 Non-recourse assets

IFRS 9.B4.1.15–17

In some cases, a financial asset may have contractual cash flows that are described as principal and interest, but that do not represent the payment of principal and interest.

This may be the case if the financial asset represents an investment in *particular* assets or cash flows and, as a result, the contractual cash flows do not meet the SPPI criterion. For example, if the contractual terms stipulate that the financial asset's cash flows increase as more cars use a particular toll road, such terms are inconsistent with a basic lending arrangement.

This may also be the case when a creditor's claim is limited to specified assets of the debtor or to the cash flows from specified assets. However, 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 non-recourse asset give rise to other cash flows or limit the cash flows so that they are not consistent with the SPPI criterion. Whether the underlying assets are financial or non-financial assets does not in itself affect this assessment.

IFRS 9.B4.1.19

An instrument would not fail to meet the SPPI criterion simply because it is ranked as being subordinate to other instruments issued by the same entity. An instrument that is subordinated to other instruments may meet the SPPI criterion if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest, even in the event of the debtor's bankruptcy.

### Observation – Non-recourse assets meeting the SPPI criterion

It appears that, if the contractual payments due under a financial asset are contractually determined by the cash flows received on specified assets, then the financial asset generally cannot meet the SPPI criterion unless the criteria described in 5.2.6 are met.

For example, the SPPI criterion is not met for a loan to a property developer on which interest is payable only if specified rental income is received. However, it appears that a financial asset that represents a full or pro rata share in the contractual cash flows of an underlying financial asset that meets the SPPI criterion could itself meet the SPPI criterion.

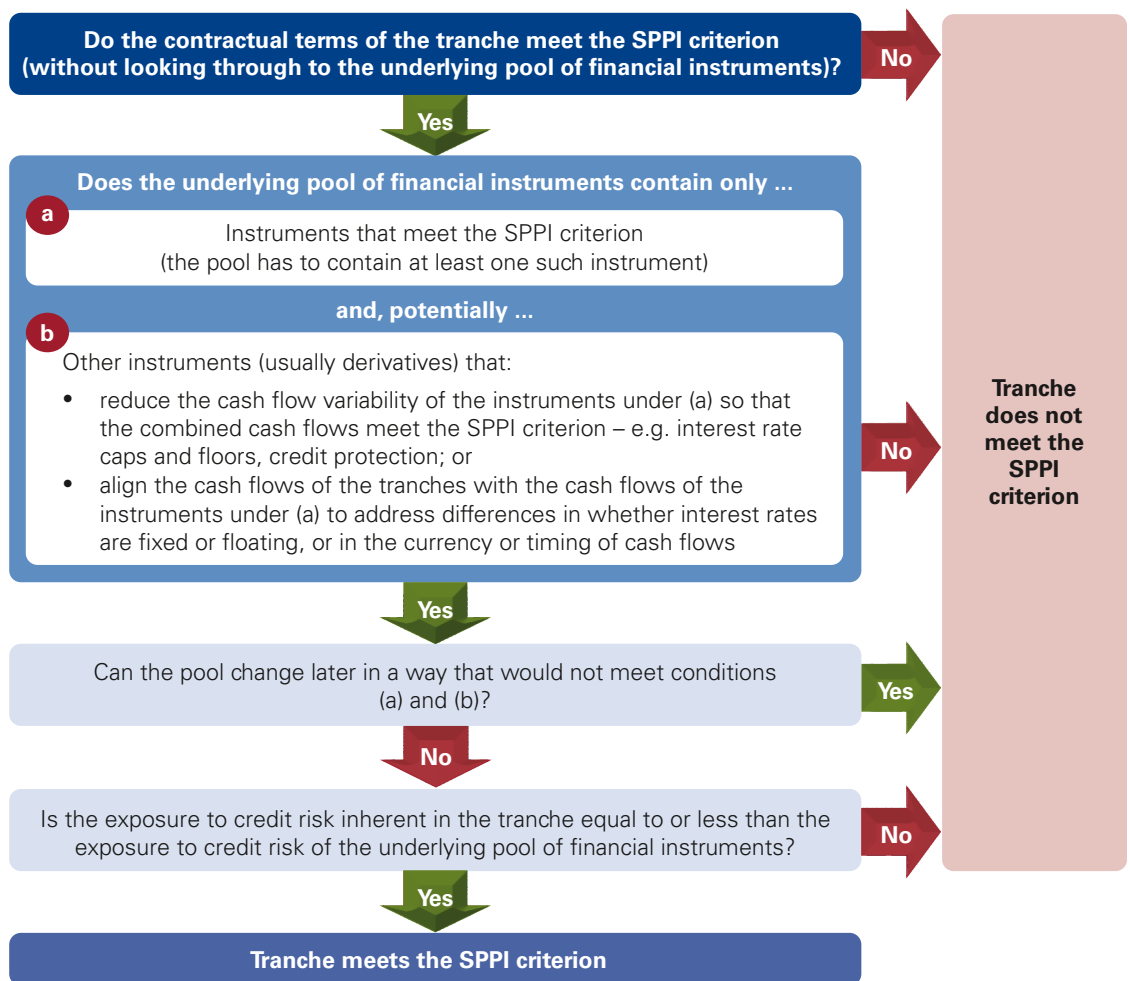


## 5.2.6 Contractually linked instruments

IFRS 9.B4.1.20–26

The standard provides specific guidance for circumstances in which an entity prioritises payments to the holders of multiple contractually linked instruments that create concentrations of credit risk – i.e. tranches. The right to payments on more junior tranches depends on the issuer generating sufficient cash flows to pay more senior tranches. The standard requires a look-through approach to determine whether the SPPI criterion is met.

IFRS 9.B4.21, B4.23–25 The following flow chart illustrates how an entity determines whether a tranche meets the SPPI criterion.



IFRS 9.B4.1.25

In performing the assessment of financial instruments in the underlying pool, a detailed instrument-by-instrument analysis of the pool may not be necessary. However, an entity has to use judgement and perform sufficient analysis to determine whether the SPPI criterion is met. In performing the analysis, an entity also considers IFRS 9's guidance on *de minimis* or non-genuine features (see 5.2.4).

IFRS 9.B4.1.22

The look-through approach is carried through to the underlying pool of instruments that create, rather than pass through, the cash flows. For example, if an entity invests in contractually linked notes issued by a special purpose entity SPE 1, whose only asset is an investment in contractually linked notes issued by SPE 2, then the entity looks through to the assets of SPE 2 in performing the assessment.

IFRS 9.B4.1.26

If an entity is not able to make an assessment based on the above criteria, then it measures its investment in the tranche at FVTPL.

### Example – Contractually linked instruments

Company W, a limited-purpose entity, has issued two tranches of debt that are contractually linked. The Class I tranche amounts to 15 and the Class II tranche amounts to 10. Class II is subordinate to Class I, and receives distributions only after payments have been made to the holders of Class I. W's assets are a fixed pool of loans of 25, all of which meet the SPPI criterion.

Investor X has invested in Class I. X determines that, without looking through the underlying pool, the contractual terms of the tranche give rise only to payments of principal and interest.

X then has to look through to the underlying pool of investments of W. Because W has invested in loans that meet the SPPI criterion, the pool contains at least one instrument with cash flows that are solely principal and interest. W has no other financial instruments, and is not permitted to acquire any other financial instruments. Therefore, the underlying pool of financial instruments held by W does not have features that would prohibit the tranche from meeting the SPPI criterion.

The last step in the analysis is for X to assess whether the exposure to credit risk inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments. Because the Class I notes are the most senior tranche, the credit rating of the tranche is higher than the weighted-average credit rating of the underlying pool of loans. Accordingly, X concludes that Class I meets the SPPI criterion.

Investor Y has invested in Class II. This tranche is the most junior tranche and does not meet the credit risk criterion. Therefore, Investor Y measures any investment in Class II at FVTPL.

#### IFRS 9.B4.1.26

In some cases, the financial assets in the pool may be collateralised by assets that would not themselves meet the SPPI criterion – e.g. loans secured against real estate or equity instruments – and, if the debtor defaults, then the issuer may take possession of that collateral. The new standard clarifies that this ability to take possession of such assets is disregarded when assessing whether the tranche satisfies the SPPI criterion, unless the entity acquired the tranche with the intention of controlling the collateral.

#### IFRS 9.B4.1.24(a)

The underlying pool may include derivative instruments that align the cash flows of a tranche with the cash flows of the underlying instruments, or that reduce cash flow variability. The allocation of gains and losses that arise from market risk on derivative instruments in the pool may be relevant in determining whether the contractual terms of a tranche itself give rise to cash flows that are solely payments of principal and interest. For example, if the cash flows from an interest rate swap included in the pool were allocated to a tranche to provide investors in the tranche with a return based on two-times LIBOR, then the tranche would not meet the SPPI criterion.

### Observation – Changes in the underlying pool

When a pool includes more than one derivative instrument, it appears that an entity is able to combine derivatives when performing the assessment described in condition (b) in the flowchart above if the combined derivative would give the same result as if a single derivative had been included in the portfolio.

### Example – Derivatives in the underlying pool

An SPE has a portfolio of variable interest rate financial assets denominated in euro. It issues tranches of fixed-rate contractually linked notes denominated in US dollars. The SPE enters into two derivatives:

- a pay-variable-euro, receive-variable-US-dollar swap; and
- a pay-variable-US-dollar, receive-fixed-US-dollar swap.

In this case, the combination of these two swaps is equivalent to one cross-currency interest rate swap to pay variable euro and receive fixed US dollars – i.e. the receive leg of the first swap offsets the pay leg of the second swap. In this scenario, the holder of an investment in the notes could combine the two derivatives and assess them in combination, rather than performing an individual assessment for each derivative.

### Observation – Derivatives in pools of assets

IFRS 9.B4.1.26

The pool of underlying instruments and their cash flows may change as a result of prepayments or credit losses, and by any permitted extinguishments or transfers. It appears that, for the SPPI criterion to be met, the terms of the contractually linked structure should include a mechanism designed to ensure that the amount of any derivatives is reduced in response to any such events, so that the derivatives do not fail to meet the cash flow variability or alignment tests. For example, an interest rate swap may contain a clause under which the notional amount is automatically reduced to match any declines in the principal amount of performing assets within an underlying pool.

## 5.2.7

### Examples of instruments that may or do not meet the SPPI criterion

#### Examples – Instruments for which the SPPI criterion may be met

IFRS 9.B4.1.13,  
 BC4.186, BC4.190

Example in IFRS 9	Analysis
A bond with a stated maturity and payments of principal and interest linked to an unleveraged inflation index of the currency in which the instrument is issued. The principal amount is protected. This linkage resets the time value of money to the current level.	Linking payments of principal and interest to an unleveraged inflation index resets the time value of money to a current level, so the interest rate on the instrument reflects 'real' interest. Therefore, the interest amounts are consideration for the time value of money on the principal amount outstanding.  It appears that the SPPI criterion would be met even when there is no principal protection clause – i.e. the principal amount repayable is reduced in line with any cumulative reduction in the inflation index – because this would merely indicate that a component of the time value of money associated with the period during which the instrument is outstanding could be negative.
An instrument with a stated maturity and variable interest for which the borrower can choose a market interest rate that corresponds to the reset period on an ongoing basis.	The fact that the interest rate is reset during the life of the instrument does not disqualify the instrument from meeting the SPPI criterion. However, if the borrower was able to choose to pay the one-month LIBOR rate for a three-month term without reset each month, then the time value of money element would be modified and an appropriate assessment would have to be made (see 5.2.2).
A bond with variable interest that is subject to an interest cap.	The instrument is a combination of a fixed- and floating-rate bond, as the cap reduces the variability of cash flows.

Example in IFRS 9	Analysis
A full-recourse loan secured by collateral.	The fact that a full-recourse loan is secured by collateral does not affect the analysis.
A fixed interest rate bond, all of whose contractual cash flows are non-discretionary, but whose issuer is subject to legislation that permits or requires a national resolving authority to impose losses on holders of particular instruments (including this instrument) in particular circumstances – e.g. if the issuer is having severe financial difficulties or additional regulatory capital is required.	<p>The holder analyses the contractual terms of the instrument to determine whether it meets the SPPI criterion. This analysis does not consider the payments that result from the national resolving authority's power to impose losses on the holders of the instrument, because these powers, and the resulting payments, are not contractual terms of the financial instrument. Accordingly, such powers do not impact the analysis of whether the asset meets the SPPI criterion.</p> <p>However, a contractual feature that specifies that all or some of the principal and interest should or may be written off if a specified event occurs – e.g. if the issuer has insufficient regulatory capital or is at a point of non-viability – would be relevant to the SPPI assessment; accordingly, a contractual bail-in feature could cause an instrument to fail to meet the SPPI criterion.</p>

#### Examples – Instruments for which the SPPI criterion is not met

IFRS 9.B4.1.9D, B4.1.14

Example in IFRS 9	Analysis
A bond that is convertible into a fixed number of equity instruments of the issuer.	The SPPI criterion is not met because 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.
An inverse floating interest rate loan – e.g. the interest rate on the loan increases if an interest rate index decreases.	The SPPI criterion is not met because interest has an inverse relationship to market rates and so does not represent consideration for the time value of money and credit risk.
A perpetual instrument that is callable at any time by the issuer at par plus accrued interest, but for which interest is only payable if the issuer remains solvent after payment and any deferred interest does not accrue additional interest.	The SPPI criterion is not met because the issuer may defer payments and additional interest does not accrue on the amounts deferred. As a result, the holder is not entitled to consideration for the time value of money and credit risk. However, the fact that an instrument is perpetual does not preclude it from meeting the SPPI criterion.

## 5.3 Business model assessment

### 5.3.1 Overview of the business models

IFRS 9.B4.1.1

A business model assessment is needed for financial assets that meet the SPPI criterion, to determine whether they meet the criteria for classification as subsequently measured at amortised cost or FVOCI (see 5.2).

IFRS 9.4.1.4, 5.75–6

Financial assets that do not meet the SPPI criterion are classified as at FVTPL irrespective of the business model in which they are held – except for investments in equity instruments, for which an entity may elect to present gains and losses in FVOCI (see 5.1.5).

IFRS 9.B4.1.2A

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 will result from collecting contractual cash flows, selling the financial assets or both. IFRS 9 provides detailed guidance on how to assess the business model (see 5.3.2).

The following table summarises the key features of each type of business model and the resultant measurement category.

Business model	Key features	Measurement category (see 5.1)
<b>Held-to-collect</b> (see 5.3.3)	<ul style="list-style-type: none"> <li>The objective of the business model is to hold assets to collect contractual cash flows</li> <li>Sales are incidental to the objective of the model</li> <li>Typically lowest sales (in frequency and volume)</li> </ul>	Amortised cost*
<b>Both held to collect and for sale</b> (see 5.3.4)	<ul style="list-style-type: none"> <li>Both collecting contractual cash flows and sales are integral to achieving the objective of the business model</li> <li>Typically more sales (in frequency and volume) than held-to-collect business model</li> </ul>	FVOCI*
<b>Other business models, including:</b> <ul style="list-style-type: none"> <li>trading</li> <li>managing assets on a fair value basis</li> <li>maximising cash flows through sale</li> </ul> (see 5.3.5)	<ul style="list-style-type: none"> <li>Business model is neither held-to-collect nor held to collect and for sale</li> <li>Collection of contractual cash flows is incidental to the objective of the model</li> </ul>	FVTPL**

\* Subject to meeting the SPPI criterion and the fair value option (see 5.1.4).

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

### 5.3.2 Assessing the business model

IFRS 9.B4.1.2

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. Accordingly, this condition is not an instrument-by-instrument approach to classification, but should be determined at a higher level of aggregation.

*IFRS 9.B4.1.2* However, the assessment is not performed at the entity level, and an entity may have more than one business model for managing financial instruments. Also, in some circumstances, it may be appropriate to separate a portfolio of financial assets into sub-portfolios – e.g. if an entity acquires a portfolio of loans and manages some of the loans to collect their contractual cash flows and manages others with the objective of selling them.

*IFRS 9.B4.1.2A* The assessment is not performed on the basis of scenarios that the entity does not reasonably expect to occur – e.g. 'worst case' scenarios. For example, if an entity expects that it will sell a particular portfolio of financial assets only in a stress case scenario, then that scenario will not affect the assessment of the business model for those assets if it is not reasonably expected that such a scenario will occur.

*IFRS 9.B4.1.2B* IFRS 9 states that an entity's business model for managing the financial assets is a matter of fact and is typically observable through particular activities that the entity undertakes to achieve the objectives of the business model.

### 5.3.2.1 Relevant and objective evidence

An entity assesses all relevant and objective evidence that is available at the date of the assessment to determine the business model for particular financial assets.

*IFRS 9.B4.1.2B* The 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.

*IFRS 9.B4.1.2C* In addition, an entity considers the frequency, volume and timing of sales in prior periods, the reasons for such sales, and its expectations about future sales activity. However, information about sales activity is not considered in isolation, but as part of an holistic assessment of how the entity's stated objective for managing the financial assets is achieved and how cash flows are realised. Therefore, an entity considers information about past sales in the context of the reasons for those sales, and the conditions that existed at that time as compared to current conditions.

#### Observation – Judgement needed for business model assessment

*IFRS 9.B4.1.2B* Although IFRS 9 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.

For example, the 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.

Examples of portfolios where judgement is likely to be required include:

- portfolios of instruments that are held for liquidity management; and
- those supporting a business model objective of providing insurance or pension benefits.

In preparing to apply the new standard, entities will have to identify and assess their business models for managing financial assets and document their conclusions. To do this, they may also need to:

- enhance their documentation of the relevant business objectives and operating policies; and
- establish processes and controls over gathering and assessing relevant and objective evidence, to support their assessments on an ongoing basis – e.g. reviewing actual and expected levels of sales activity.

### Observation – Data needed for business model assessment

Under IAS 39, an entity does not need to consider the business model for managing financial assets in a way that is similar to the new standard. IAS 39 requires an assessment of whether a financial asset is held for trading or whether the entity intends to hold a particular financial asset to maturity, but otherwise does not generally require an assessment of past levels of sales.

Accordingly, entities may not have readily available historic data on the frequency and significance of sales, and collecting it may require effort.

### Observation – Purpose of the business model assessment

*IFRS 9.1.1, BCE.53–56*

It appears that, in making the business model assessment, an entity should consider the stated objective of IFRS 9, which is to provide relevant and useful information to users of the financial statements for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

The more that a business model envisages holding financial assets for an extended period or until maturity to collect contractual cash flows, the more relevant and useful amortised cost information is. Conversely, the more that a business model envisages making sales of assets significantly before maturity, the more relevant and useful fair value information is.

#### 5.3.2.2

#### Cash flows that are realised in a way that is different from expectations

*IFRS 9.B4.1.2A*

If cash flows are realised in a way that is different from the expectations at the date on which the entity assessed the business model – e.g. if more or fewer financial assets are sold than was expected when the assets were classified – then this does not:

- give rise to a prior-period error in the entity's financial statements; or
- change the classification of the remaining financial assets held in that business model – i.e. those assets that the entity recognised in prior periods and still holds,

as long as the entity considered all relevant and objective information that was available when it made the business model assessment.

However, when an entity assesses the business model for newly acquired financial assets, it considers information about the way cash flows were realised in the past, along with other relevant information.

### Example – Change of management’s intention for a portfolio

Company K has a portfolio of financial assets that it has previously determined to be subject to a held-to-collect business model. Previously, there were insignificant sales of assets to manage concentrations of credit risk. However, the portfolio has grown much larger than was previously expected, and considerable merger and acquisition activity among issuers in the portfolio is now anticipated.

As a result, K now expects that there will be significant sales activity in the future to manage concentrations of credit risk, and concludes that its management of the portfolio is no longer consistent with a held-to-collect business model. K concludes that the reclassification criteria for existing assets (see Chapter 8) have not been met. However, when new financial assets are acquired for the portfolio after the change, these new financial assets will not meet the held-to-collect criterion. This may lead to the portfolio being sub-divided, with existing financial assets in the portfolio being measured at amortised cost, and others acquired after the change being measured at fair value.

### Observation – The ‘tainting’ notion

IFRS 9.4.4.1

IAS 39 has a ‘tainting’ notion for the held-to-maturity measurement category. There is no similar notion under IFRS 9 – i.e. subsequent sales do not result in the reclassification of existing assets measured at amortised cost, as long as an entity considered all relevant and objective information that was available when it made the business model assessment. The reclassification of assets takes place only when the business model has changed (see 8.2).

## 5.3.3 Held-to-collect business model

IFRS 9.B4.1.2C

Financial assets in a held-to-collect business model are managed to realise cash flows by collecting payments of principal and interest over the life of the instruments. That is, the assets held within the portfolio are managed to collect the contractual cash flows.

IFRS 9.B4.1.3

An entity need not hold all of these assets until maturity. Therefore, a business model’s objective can be to hold financial assets to collect contractual cash flows even when some sales of financial assets have occurred or are expected to occur.

IFRS 9.B4.1.3A–B

IFRS 9 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.*

Irrespective of their frequency and value, sales due to an increase in the assets’ credit risk are not inconsistent with a held-to-collect objective. This is because the credit quality of financial assets is relevant to the entity’s ability to collect contractual cash flows.

One example of such a sale is the sale of a financial asset because it no longer meets the credit criteria specified in the entity’s documented investment policy. However, in the absence of such a policy, the entity may demonstrate in other ways that the sale occurred due to an increase in credit risk.

- *The sales are infrequent (even if significant), or are insignificant individually and in aggregate (even if 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.*



An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with a held-to-collect business model if an entity can explain the reasons for those sales and why those sales do not reflect a change in the entity's objective for the business model.

Sales made in managing concentrations of credit risk (without an increase in the asset's credit risk) are assessed in the same way as any other sales made in the business model. Also, it is irrelevant to the assessment whether a third party imposes the requirement to sell the financial assets, or whether the sale is at the entity's discretion.

#### Example – Sales in a held-to-collect business model

IFRS 9 B4.1.4, BC4.145

Company L has a portfolio of financial assets that it has determined to be part of a held-to-collect business model. A change in the regulatory treatment of these assets has caused L to undertake a significant rebalancing of its portfolio in a particular period. However, L does not change its assessment of the business model, as the selling activity is considered an isolated – i.e. one-time – event.

By contrast, suppose that L were required by its regulator to routinely sell financial assets from a portfolio to demonstrate that the assets were liquid, and that the value of the assets sold was significant. In this case, L's business model for managing that portfolio would not be held-to-collect.

IFRS 9 includes examples of circumstances in which the objective of a business model may be to hold financial assets to collect the contractual cash flows. One of these examples can be summarised as follows.

#### Example – Held-to-collect business model – factors considered in the assessment

IFRS 9.B4.1.4  
 Example 1

Company J holds investments to collect their contractual cash flows. The maturities of the investments are matched to J's estimated, and generally predictable, funding needs.

In the past, sales of investments have typically occurred when the financial assets' credit risk has increased such that the assets no longer meet J's documented investment policy. In addition, infrequent sales have occurred as a result of unanticipated funding needs.

Reports to management focus on the credit quality of the instruments and contractual returns. However, management also considers the financial assets' fair values from a liquidity perspective.

The following factors are relevant to the assessment of J's business model.

- The stated objective of the business model is to hold assets to collect contractual cash flows. The fact that maturities of the investments match the generally predictable funding needs supports this objective.
- Sales in response to an increase in the investments' credit risk because the investments no longer meet the entity's documented investment policy, and infrequent sales resulting from unanticipated needs, are not inconsistent with the held-to-collect business model.
- Although management considers fair value information, it does so from a liquidity perspective, and the main focus of its review of financial information is on the credit quality and contractual returns, which is consistent with the held-to-collect business model.

IFRS 9.B4.1.4  
 Example 3

IFRS 9 also gives an example of a business model where the objective is to originate loans to customers and subsequently sell those loans to a securitisation vehicle.

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

A securitisation vehicle, which is consolidated by the entity originating the loans, issues notes to investors. The vehicle receives the contractual cash flows on the loans from the originating entity (its parent) and passes them on to investors in the notes.

IFRS 9 concludes that, 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.

The standard also concludes that the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of the separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.

### Example – Financial assets sold under sale and repurchase agreements

Company M holds financial assets to collect the contractual cash flows through to maturity; however, its objectives include selling some of those financial assets as part of sale and repurchase agreements (repos). Under these agreements, M agrees to repurchase the financial assets at a later date before their maturity. During the term of the repos, the transferee is required to remit immediately to M an amount equal to any payments the transferee receives from the transferred assets.

It appears that this scenario is consistent with a held-to-collect business model, based on:

- M's continuing recognition of the assets for accounting purposes; and
- the terms of the repo transactions in regard to remitting income payments and reconveying the transferred assets back to M before their maturity.

## 5.3.4 Both held to collect and for sale business model

### IFRS 9.B4.1.4A

An entity may hold financial assets in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. In this type of business model, the entity's key management personnel have made a decision that both of these activities are integral to achieving the objective of the business model.

### IFRS 9.B4.1.4A

Possible examples of such a business model, given by the new standard, include:

- a financial institution holding financial assets to meet its everyday liquidity needs; and
- an insurer holding financial assets to fund insurance contract liabilities.

### IFRS 9.B4.1.4B

A business model whose objective is achieved by both collecting contractual cash flows and selling financial assets will typically involve a greater frequency and value of sales than a held-to-collect business model. This is because selling financial assets is integral to achieving the business model's objective, rather than only incidental to it. However, there is no threshold for the frequency or amount of sales that have to occur in this business model, because both of these activities are integral to achieving its objective.

### Example – Holding investments in anticipation of capital expenditure

IFRS 9.B4.1.4C  
 Example 5

Company Z anticipates capital expenditure in five years. To be able to fund the expenditure, Z invests excess cash in short-term and long-term financial assets. Many of the financial assets have contractual lives that exceed Z's anticipated investment period.

Z intends to hold the financial assets, but when an opportunity arises, it will sell them to invest in assets with a higher return. The portfolio's managers are remunerated based on the overall return from the portfolio of assets.

Z's objective for managing the financial assets is therefore achieved by both collecting contractual cash flows and selling financial assets.

### Observation – Applying the business model criterion

IFRS 9.B4.1.4A–C

IFRS 9 clarifies that collecting contractual cash flows, or selling financial assets, or both, may not be the objective of the business model in itself. In particular, for the held to collect and for sale category, the business model is often to hold a portfolio of liquid assets in order to meet expected or unexpected commitments, or to fund anticipated acquisitions. The classification of those financial assets focuses not on the business model itself but rather on the way that the assets are managed in order to meet the objectives of the business model.

## 5.3.5 Other business models

IFRS 9.B4.1.5

Financial assets held in any other business model are measured at FVTPL (except when an entity elects to present in OCI subsequent changes in the fair value of an investment in an equity instrument – see 5.1.5).

IFRS 9.B4.1.5–6

Examples include:

- assets managed with the objective of realising cash flows through sale;
- a portfolio that is managed, and whose performance is evaluated, on a fair value basis; and
- a portfolio that meets the definition of 'held-for-trading'.<sup>5</sup>

<sup>5</sup> A financial asset or financial liability is held for trading if: it is acquired or incurred principally for the purpose of selling or repurchasing it in the near term; on initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or it is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

# 6 Classification of financial liabilities

## 6.1 Overview of classification

*IFRS 9.BCE.12*

IFRS 9 retains almost all of the existing requirements from IAS 39 on the classification of financial liabilities – including those relating to embedded derivatives – because the Board believes that the benefits of changing practice would not outweigh the costs of the disruption caused by such a change.

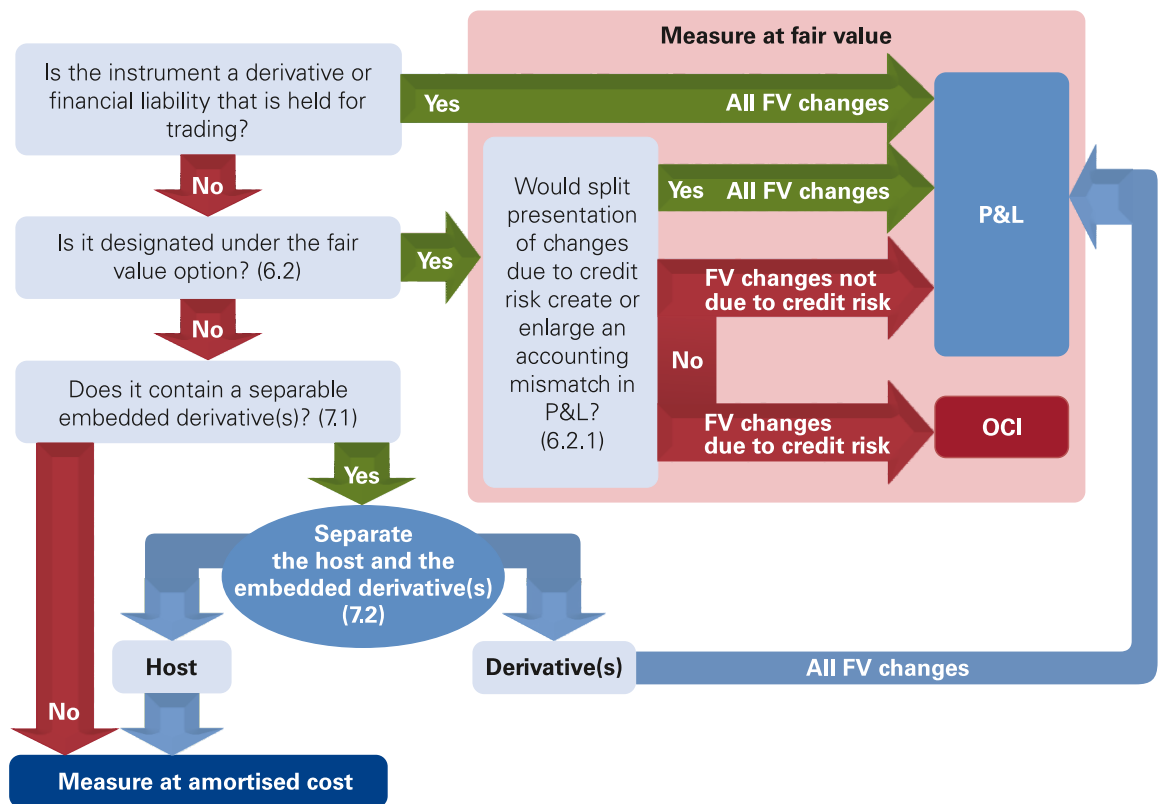
*IFRS 9.4.2.1–2*

Therefore under IFRS 9, financial liabilities are classified as subsequently measured at amortised cost, except for the following instruments.

	<b>Financial liabilities that are not measured at amortised cost</b>	<b>Measurement requirements</b>
a.	Financial liabilities that are held for trading – including derivatives	FVTPL
b.	Financial liabilities that are designated as at FVTPL on initial recognition	FVTPL
c.	Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies	Measured under specific guidance carried forward from IAS 39
d.	Financial guarantee contracts	See 12.4.9.1
e.	Commitments to provide a loan at a below-market interest rate	See 12.4.9.2
f.	Contingent consideration recognised by an acquirer in a business combination	FVTPL

*IFRS 9.5.71(c), 5.7.7*

The following diagram outlines the requirements for the classification and measurement of financial liabilities under IFRS 9. It does not cover financial liabilities under (c) to (f) above.



## 6.2 Fair value option for financial liabilities

IFRS 9.4.2.2, 4.3.5,  
IAS 39.9(b), 11A

IFRS 9 retains the option in IAS 39 to designate irrevocably on initial recognition a financial liability as at FVTPL. As under IAS 39, this ‘fair value option’ is subject to the following eligibility criteria.

- The designation has to 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 as 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.

IAS 39.9, 55,  
IFRS 9.5.71(c), 5.77

Under IAS 39, all fair value changes on liabilities designated under the fair value option are recognised in profit or loss. However, under IFRS 9, fair value changes are presented as follows:

- the amount of change in the fair value that is attributable to changes in the credit risk of the liability is presented in OCI (for the measurement of changes in credit risk, see 10.2); and
- the remaining amount of change in the fair value is presented in profit or loss.

IFRS 9.B5.79

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. However, an entity may transfer the cumulative gain or loss within equity.

*IFRS 9.5.77–9, B5.78* There are two exceptions to this split presentation:

- 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.

#### **Observation – Fair value changes due to changes in credit risk**

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 (and vice versa). This result is widely seen as counter-intuitive. IFRS 9 addresses this issue by generally requiring those changes to be recognised in OCI.

## **6.2.1 Would split presentation create or enlarge an accounting mismatch?**

*IFRS 9.B5.76*

To determine whether split presentation would create or enlarge an accounting mismatch in profit or loss, an entity assesses whether it expects that the changes in the financial liability's credit risk will 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.

*IFRS 9.B5.77*

The entity makes this determination at initial recognition, and does not reassess it. However, the entity need not enter into all of the financial instruments giving rise to an accounting mismatch at exactly the same time. A reasonable delay is allowed, provided that any remaining transactions are expected to occur.

#### **Observation – Application to components of financial liabilities**

Like IAS 39, IFRS 9 permits the fair value option to be applied only to whole financial liabilities and not to components or proportions. It appears that this indicates that the assessment of whether split presentation would create or enlarge an accounting mismatch in profit or loss should also be determined with reference to the entirety of the financial liability designated under the fair value option.

#### **Observation – Accounting mismatch that arises from another financial instrument**

IFRS 9 states that an accounting mismatch can relate to another financial instrument that is measured at FVTPL. Because the guidance refers to another financial instrument, it could mean a financial liability rather than only a financial asset. Therefore, for example, the mismatch could be between a credit derivative, which might be a financial asset or a financial liability, and a financial liability that has been designated as at FVTPL.

*IFRS 9.B5.712*

IFRS 9 explains that an accounting mismatch is not caused solely by the measurement method that an entity uses to determine the effects of changes in a liability's credit risk (see 10.2.2.2).

*IFRS 9.B5.710*

The new standard gives an example of when the exception from split presentation would apply. In this example, a financial asset held by an entity (lender) can be prepaid contractually by the debtor delivering a linked debt instrument issued by the lender to fund the origination of the asset. In this case, the change in fair value of the asset reflects the debtor's right to prepay by transferring the lender's liability to the lender; therefore, changes in the credit risk of the liability are offset in profit or loss by the change in the fair value of the financial asset.

#### Observation – Relationships that can give rise to an accounting mismatch

*IFRS 9.B5.711,  
BC5.39–40*

In the example described above, the economic relationship between the two instruments arises from a contractual linkage. The new standard indicates that an accounting mismatch may also occur in the absence of a contractual linkage, but it does not provide any such example. The IASB also states that it expects the circumstances in which the exception would apply to be rare, and notes that an economic relationship of the type contemplated does not arise by coincidence.

Sometimes, an entity may hold or have used a financial liability designated as at FVTPL to fund assets whose values also happen to be exposed to changes in the general price of credit. This fact alone does not seem to justify an argument that the exception should apply.

*IFRS 9.B5.77*

An entity's methodology for determining whether split presentation creates or enlarges an accounting mismatch in profit or loss should be applied consistently. However, if there are different economic relationships between the characteristics of liabilities designated under the fair value option and the characteristics of other financial instruments, different methodologies may be used.

#### Observation – Degree of offset

*IFRS 9.BCZ4.74,  
BCZ4.76*

The standard refers to an entity considering whether it expects that effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of another financial instrument.

However, although the IASB indicates that the exception would be applicable only in rare circumstances (as described above), IFRS 9 does not specify whether any particular level of probability or confidence should attach to the expectation of offset, or how precise the degree of offset should be – i.e. whether the effects of fair value changes should be expected to be (approximately) equal and opposite, or whether a wider range of expected offset ratios should lead to the exception being applied.

## 6.3 Deletion of the cost exception for derivative financial liabilities

*IFRS 9.4.2.1, BC4.53*

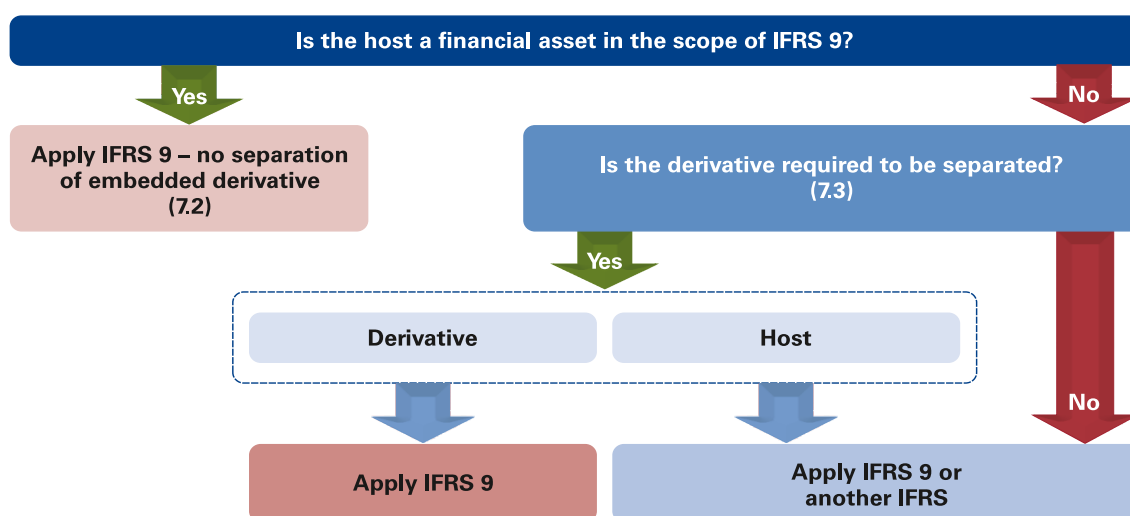
IFRS 9 removes the exception in IAS 39 that requires derivative financial liabilities that are linked to and settled by delivery of unquoted equity instruments, and whose fair value cannot be determined reliably, to be measured at cost. Instead, these liabilities are measured at FVTPL. This is consistent with the IFRS 9 guidance on the measurement of similar derivative financial assets (see 5.1.1).

# 7 Embedded derivatives

## 7.1 Overview

IFRS 9.4.3.1–7

IFRS 9 retains the IAS 39 definition of an embedded derivative and most of the associated guidance on separation. However, if the host contract is an asset in the scope of IFRS 9 then the embedded derivative is not separated but instead the whole hybrid instrument is assessed for classification. The following diagram illustrates the accounting under IFRS 9 for derivatives embedded in hybrid contracts.



## 7.2 Host contracts that are financial assets in the scope of IFRS 9

IFRS 9.4.3.2

When a hybrid contract contains a host that is a financial asset in the scope of IFRS 9, the entire hybrid contract, including all embedded features, is assessed for classification under IFRS 9 (see 5.2.1).

## 7.3 Host contracts that are not financial assets in the scope of IFRS 9

When a hybrid contract contains a host that is a financial asset outside the scope of IFRS 9 – e.g. a lease receivable in the scope of IAS 17 *Leases* or an insurance contract – then an entity assesses whether the embedded feature requires separation. The assessment is the same as that currently required under IAS 39.

IFRS 9.4.3.3–7

IFRS 9 also retains the IAS 39 requirements for accounting for embedded derivatives in hybrid contracts where the host is a financial liability or a contract that is not a financial instrument.

Examples of host instruments that have to be assessed for separation are as follows.

Type of host	Examples
Financial assets not in the scope of IFRS 9	Insurance contracts, lease receivables
Financial liabilities	Debt securities, loans
Non-financial items	Forward purchase contracts for goods and services



# 8 Reclassification

IFRS 9.4.4.2

This section looks at the circumstances in which financial assets are reclassified, and their measurement on reclassification. Financial liabilities cannot be reclassified.

## 8.1 Conditions for reclassification of financial assets

IFRS 9.4.4.1

Under IFRS 9, reclassification of financial assets is required if, and only if, the objective of the entity's business model for managing those financial assets changes.

IFRS 9.B.4.4.1

Such changes are expected to be very infrequent, and are determined by the entity's senior management as a result of external or internal changes. These changes have to be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in the objective of an entity's business model will occur only when an entity either begins or ceases to carry out an activity that is significant to its operations – e.g. when the entity has acquired, disposed of or terminated a business line.

### Example – Changes in business model

The standard provides the following examples of circumstances that are or are not changes in the business model.

IFRS 9.B4.4.1(a)

#### Change in business model

An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows.

The original portfolio of commercial loans is no longer for sale, and this portfolio is now managed together with the acquired commercial loans. All of the loans are held to collect the contractual cash flows.

IFRS 9.B4.4.1(b)

A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

IFRS 9.B4.4.3

#### Not a change in business model

An entity changes its intention for particular financial assets (even in circumstances of significant changes in market conditions).

A particular market for financial assets temporarily disappears.

Financial assets are transferred between parts of an entity with different business models.

### Observation – Changes in the way in which assets are managed

IFRS 9.B4.14A–C,  
B4.4.1, BC4.115–116,  
BCE70

As explained in 5.3, the classification of financial assets depends on the way in which they are managed within a business model, and not solely on the objective of the business model itself. Changes in the way that assets are managed within the business model – e.g. an increased frequency of sales – will not result in the reclassification of existing assets, but may result in newly acquired assets being classified differently. Such changes may occur more frequently than changes in the objective of the business model itself.

IFRS 9 does not contain any guidance requiring or allowing an entity to reclassify assets based on a reassessment of the SPPI criterion after initial recognition.

#### Example – Lapse of a contractual term

IFRS 9 does not provide guidance for circumstances in which:

- a feature that is significant in arriving at the conclusion that an asset does not meet the SPPI criterion expires before the maturity of the asset; and
- after the expiry of the feature the asset meets the SPPI criterion.

It appears that the entity should not reclassify the financial asset on expiration of the feature.

For example, assume that a bond is convertible into equity of the issuer and has a 10-year maturity, but the conversion feature is exercisable only for the first five years. If, at the end of five years, the conversion feature has not been exercised, then the bond should remain classified as at FVTPL until its maturity.

## 8.2 Timing of reclassification of financial assets

*IFRS 9.5.6.1*

If an entity determines that its business model has changed in a way that is significant to its operations, then it reclassifies all affected assets prospectively from the first day of the next reporting period (the reclassification date). Prior periods are not restated.

*IFRS 9.B4.4.2*

The change in business model has to be effected before the reclassification date. For reclassification to be appropriate, the entity cannot engage in activities that are consistent with its former business model after the date of change in business model.

#### Observation – No definition of ‘reporting period’

IFRS 9 does not define the term ‘reporting period’. It appears that the reclassification date depends on the frequency of the entity’s reporting – i.e. quarterly, semi-annually etc. For example, an entity with an annual reporting period ending 31 December that reports quarterly and determines that its business model has changed on 15 March would have a reclassification date of 1 April.

#### Observation – Long time period between business model change and reclassification

*IFRS 9.BC4.119*

In some cases, there may be a long time period between the change in an entity’s business model and the reclassification date. During this time period, the financial assets existing at the date of change in business model continue to be accounted for as if the business model has not changed – even though this no longer reflects the actual business model in operation. However, it appears that an entity should classify any new assets that were initially recognised after the date of change in business model based on the new business model in effect at the date of their initial recognition.

## 8.3 Measurement on reclassification of financial assets

IFRS 9.5.6, B5.6.1–2, IE104–114

The measurement requirements on the reclassification of financial assets are as follows.

		Reclassification to		
		FVTPL	FVOCI	Amortised cost
Reclassification from	FVTPL		Fair value on reclassification date = new gross carrying amount.  Calculate EIR based on new gross carrying amount.  Recognise subsequent changes in fair value in OCI.	Fair value on reclassification date = new gross carrying amount.  Calculate EIR based on new gross carrying amount.
	FVOCI	Reclassify accumulated OCI balance to profit or loss on reclassification date.		Reclassify financial asset at fair value. Remove cumulative balance from OCI and use it to adjust the reclassified fair value. Adjusted amount = amortised cost.  EIR determined at initial recognition and gross carrying amount are not adjusted as a result of reclassification.
	Amortised cost	Fair value on reclassification date = new carrying amount. Recognise difference between amortised cost and fair value in profit or loss.	Remeasure to fair value, with any difference recognised in OCI.  EIR determined at initial recognition is not adjusted as a result of reclassification.	

## 9 Measurement on initial recognition

*IFRS 9.5.1.1*

IFRS 9 retains the requirements under IAS 39 that, on initial recognition, financial assets and financial liabilities are measured at fair value plus, for financial instruments not at FVTPL, eligible transaction costs.

The fair value of financial instruments is determined in accordance with IFRS 13 *Fair Value Measurement*.

*IFRS 9.5.1.1A, B5.1.2A*

IFRS 9 also retains the guidance from IAS 39 that:

- the best evidence of fair value at initial recognition is normally the transaction price – i.e. the fair value of the consideration given or received for the financial instrument; and
- if there is a difference between the entity's estimate of fair value at initial recognition and the transaction price, then:
  - if the estimate of fair value uses only data from observable markets, then the difference is recognised in profit or loss; or
  - in all other cases, the difference is deferred as an adjustment to the carrying amount of the financial instrument.

*IFRS 9.5.1.3,  
IFRS 15.A, 60–65*

IFRS 9 requires trade receivables that do not have a significant financing component to be initially recognised at their transaction price (as defined in IFRS 15 – i.e. the amount of consideration to which the entity expects to be entitled), rather than at fair value.

*IFRS 15.60–62*

Whether a trade receivable has a 'significant financing component' is determined in accordance with the guidance in IFRS 15 on assessing whether a contract contains a significant financing component. IFRS 15 states that a contract contains a significant financing component if the timing of payments agreed to by the parties provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. IFRS 15 includes the following examples of factors to consider when assessing whether a contract contains a significant financing component:

- the difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and
- the combined effect of both:
  - the expected length of time between the entity transferring the promised goods or services to the customer and when the customer pays for those goods or services; and
  - the prevailing interest rates in the relevant market.

### Observations – Measuring trade receivables on initial recognition

*IFRS 13.BC138A*

#### Trade receivables without a significant financing component

In many cases, the measurement on initial recognition for trade receivables without a significant financing component based on the transaction price guidance in IFRS 15 is unlikely to be significantly different from that currently applied under IAS 39. This is because the IASB has indicated that an entity can measure short-term receivables and payables with no stated interest rate at their invoiced amounts without discounting when the effect of not discounting is immaterial.

*IFRS 15.108*

#### Trade receivables with a significant financing component

IFRS 9 does not exempt a trade receivable with a significant financing component from being measured at fair value on initial recognition. Therefore, differences may arise between the initial amount of revenue recognised in accordance with IFRS 15 – which is measured at the transaction price as defined in IFRS 15 – and the fair value of the trade receivable recognised at the date of initial recognition. Any difference between the measurement of the receivable in accordance with IFRS 9 and the corresponding amount of revenue recognised is presented as an expense.

*IFRS 15.63*  
*IFRS 9.BC235*

### **Impact of the practical expedient in IFRS 15**

As a practical expedient, IFRS 15 does not require an entity to adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between the entity transferring a promised good or service to the customer and the customer paying for that good or service is one year or less (see 12.72).

IFRS 9 does not state that a trade receivable with a significant financing component to which this practical expedient is applied may be initially measured at an amount equal to the undiscounted amount of consideration recognised as revenue under IFRS 15 (in the same way as a trade receivable without a significant financing component) rather than at fair value.

# 10 Subsequent measurement

## 10.1 Financial assets

IFRS 9.5.2.1–2,  
5.4, 5.7.5, 5.7.10–11

After initial recognition, a financial asset is subsequently measured at amortised cost, FVOCI or FVTPL (see Chapter 5). The recognition and presentation of gains and losses for each measurement category are as follows.

Measurement category	Recognition and presentation of gains and losses
<b>Amortised cost</b>	<p>The following items are recognised in profit or loss:</p> <ul style="list-style-type: none"> <li>• interest revenue using the effective interest method (see Chapter 11);</li> <li>• expected credit losses and reversals (see Chapter 12); and</li> <li>• foreign exchange gains and losses.</li> </ul> <p>When the financial asset is derecognised, the gain or loss is recognised in profit or loss.</p>
<b>FVOCI</b>	<p>Gains and losses are recognised in OCI, except for the following items, which are recognised in profit or loss in the same manner as for financial assets measured at amortised cost:</p> <ul style="list-style-type: none"> <li>• interest revenue using the effective interest method (see Chapter 11);</li> <li>• expected credit losses and reversals (see Chapter 12); and</li> <li>• foreign exchange gains and losses.</li> </ul> <p>When the financial asset is derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss.</p>
<b>Equity investments – presentation of gains or losses in OCI</b>	<p>Gains and losses are recognised in OCI.</p> <p>Dividends (as defined in IFRS 9) are recognised in profit or loss unless they clearly represent a repayment of part of the cost of the investment.</p> <p>The amounts recognised in OCI are not reclassified to profit or loss under any circumstances.</p>
<b>FVTPL</b>	<p>Gains and losses, both on subsequent measurement and derecognition, are recognised in profit or loss.</p>

### Observation – Transaction costs for equity investments on which gains and losses are presented in OCI

IFRS 9.5.1.1, IGE1.1,  
IAS 1.88

On initial recognition, financial assets and financial liabilities are measured at fair value plus, for instruments not subsequently measured at FVTPL, eligible transaction costs (see Chapter 9).

Transaction costs incurred on initial recognition of an equity investment classified as at FVOCI are effectively recognised in OCI. This is because the investment is initially measured at fair value plus those transaction costs but is subsequently remeasured at fair value.

However, it appears that transaction costs incurred on disposal of an equity investment classified as at FVOCI should be recognised in profit or loss, because presentation in OCI is not specifically permitted or required by the standard.

IFRS 9.B5.2.3–5,  
 BC5.18

IFRS 9 removes the exception for certain equity investments, and derivatives linked to such investments, to be measured at cost; these are required under IFRS 9 to be subsequently measured at fair value, like other investments in equity instruments and derivatives (see 10.1). However, the new standard states that, in limited circumstances, cost may be an appropriate estimate of fair value for such items – for example, if:

- the most recent available information is not sufficient to measure fair value; or
- there is a wide range of possible fair value measurements and cost represents the best estimate of value within that range.

The IASB notes that these circumstances never apply to equity investments held by entities such as financial institutions and investment funds.

IFRS 9.B5.2.6

In addition, cost is never the best estimate of fair value for quoted equity investments.

## 10.2 Financial liabilities

### 10.2.1 General principles

IFRS 9.4.2.1

IFRS 9 retains almost all of the existing requirements from IAS 39 on the subsequent measurement of financial liabilities. Accordingly, financial liabilities are generally subsequently measured at amortised cost (see Chapter 11), at FVTPL, or under specific measurement guidance carried forward from IAS 39 (see 6.1).

#### 10.2.1.1 Presentation of gains and losses on liabilities designated as at FVTPL

IAS 39.9, 55,  
 IFRS 9.5.7.7

IFRS 9 changes the principles for the presentation of gains and losses on financial liabilities that are designated as at FVTPL, resulting in a split presentation of such gains and losses (see 6.2).

### 10.2.2 Measurement of changes in credit risk

#### 10.2.2.1 Meaning of ‘credit risk’

IFRS 7.A,  
 IFRS 9.B5.7.13

IFRS 9 retains the existing definition of credit risk in IFRS 7 *Financial Instruments: Disclosures*, but expands the guidance on its application. ‘Credit risk’ is defined as: “the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation”. The standard explains that there is a difference between the risk that the issuer will fail to perform on the particular liability and the general creditworthiness of the issuer. For the purpose of applying the fair value option to financial liabilities, the standard focuses on the failure to perform on the particular liability. For example, the credit risk of a collateralised liability of an issuer will be less than the credit risk of an otherwise identical uncollateralised liability.

IFRS 7.A,  
 IFRS 9.B5.7.14–15

For the purpose of splitting gains and losses on liabilities designated under the fair value option, the standard differentiates between credit risk and asset-specific performance risk. Asset-specific performance risk is not related to the risk that the issuer of a liability will fail to perform, but rather it is related to the risk that one or more assets will perform poorly (or not at all).

IFRS 9.B5.7.14–15

IFRS 9 gives two examples of asset-specific performance risk. The first is a liability with a unit-linking feature. Under the contractual terms of the liability, the amount due to investors is determined on the basis of the performance of specified assets. The second example refers to a liability issued by an SPE with the following specified characteristics:

- the SPE is legally isolated such that its assets are ring-fenced solely for the benefit of investors, even in the event of bankruptcy;
- the SPE enters into no other transactions, and its assets cannot be hypothecated; and
- amounts are due to the SPE’s investors only if the ring-fenced assets generate cash flows.

The standard states that the effect of the assets on the fair value of the liability is asset-specific performance risk not credit risk. Therefore, in this example the credit risk of the liability issued by the

structured entity may be negligible. Fair value changes due to asset-specific performance risk are recognised in profit or loss (and not in OCI).

### 10.2.2.2 Measuring the effects of changes in credit risk

*IFRS 9.B5.7.16–17*

IFRS 9 largely carries forward existing guidance from IFRS 7 on determining the effects of changes in credit risk. Under IFRS 9 an entity determines the amount of the fair value change of a financial liability designated as at FVTPL that is attributable to changes in its credit risk either:

- as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; these conditions may include a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates; or
- using an alternative method that the entity believes more faithfully represents the required amount.

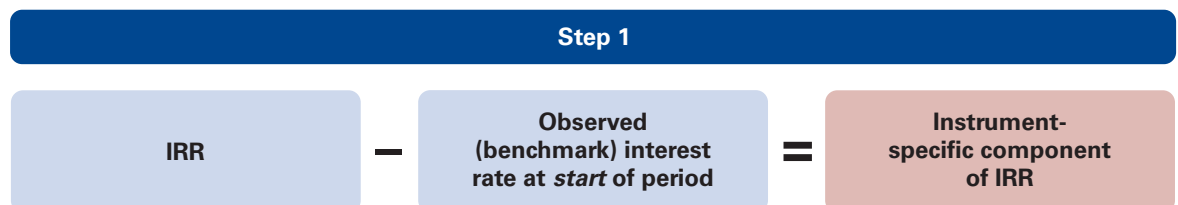
### 10.2.2.3 The default method for measuring the effects of changes in credit risk

*IFRS 9.B5.7.18*

If the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, then the amount of fair value changes that is attributable to changes in credit risk may be estimated using the so-called 'default method'.

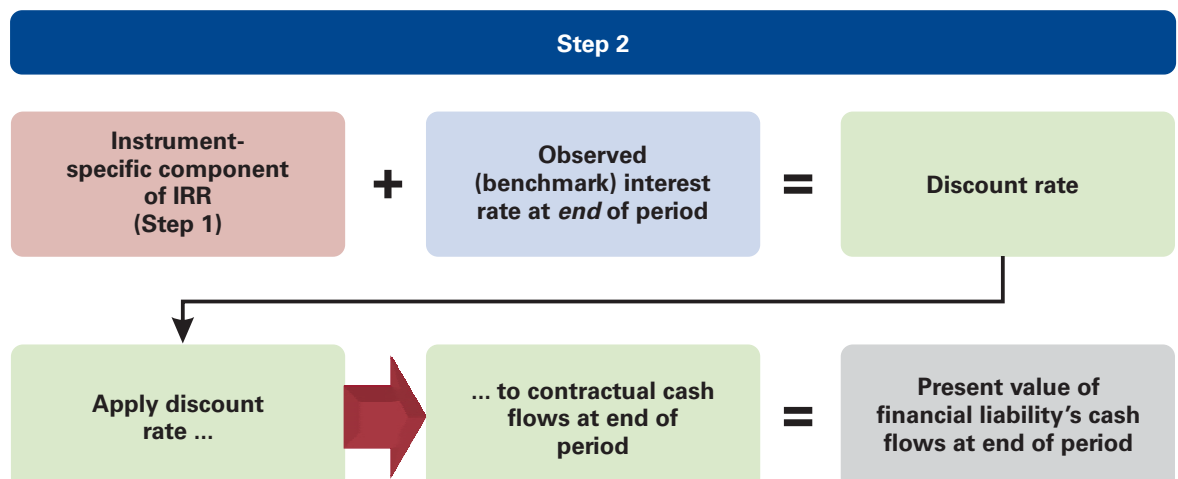
The first step is to calculate the instrument-specific component of the internal rate of return (IRR). This is done by:

- calculating the financial liability's IRR at the start of the period, using its fair value and contractual cash flows at that date; and then
- deducting from this IRR the observed (benchmark) interest rate at the start of the period.



The next step is to calculate, at the end of the period, the impact of changes in benchmark interest rates on the value of the liability. This is done by calculating the present value of the remaining contractual cash flows associated with the liability, using a discount rate that consists of:

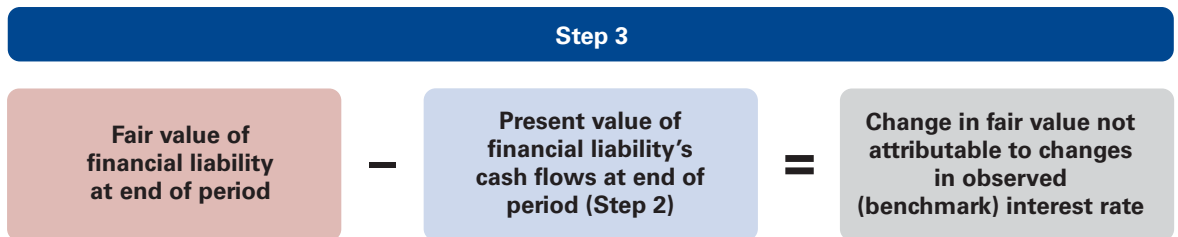
- the instrument-specific component calculated in Step 1; and
- the benchmark interest rate at the end of the period.





IFRS 9.B5.7.18, IE5

The final step is to calculate the change in fair value of the liability that is not attributable to changes in the benchmark interest rate. This is done by comparing the fair value of the financial liability at the end of the period with the present value amount calculated under Step 2. This is the amount presented in OCI.



#### Observation – No definition of ‘benchmark’ interest rate

IFRS 9 does not define the ‘benchmark’ interest rate in the context of the default method. In our experience, it is commonly understood to include inter-bank rates such as LIBOR for US dollar or sterling liabilities, or Euribor for euro liabilities. The default method treats a benchmark interest rate as being akin to a risk-free rate; it excludes all changes in the benchmark interest rate as being unrelated to, and not part of, changes in the financial liability's credit risk. However, many consider that inter-bank rates generally include a premium above the highest-quality government bond rates for the same term and currency, and that this premium may vary with market perceptions of changes in the credit risk of banks. The standard does not preclude either:

- using the risk-free rate as a benchmark interest rate; or
- using an alternative method that isolates a credit component of an inter-bank rate, and includes it in determining changes in credit risk if the entity believes that this is a more faithful representation.

IFRS 9.5.7.19, BC5.64

The IASB amended the guidance in IFRS 9 as compared to IFRS 7 by emphasising that the default method is appropriate only if the only significant relevant changes in market conditions for a financial liability are changes in an observed (benchmark) interest rate. When other factors are significant, an entity uses an alternative measure that more faithfully measures the effects of changes in the financial liability's credit risk.

IFRS 9.5.7.19

For example, if the financial liability contains an embedded derivative, then the change in fair value of the derivative that is not attributable to changes in credit risk is excluded when calculating the amount to be included in OCI.

#### Observation – Currently effective disclosures of the effects of changes in liability's credit risk

IFRS 9.BC5.58–64,  
IFRS 7.26

Currently effective IFRS 7 already requires an entity that has designated a financial liability under the fair value option to disclose the amount of the change in fair value recognised in profit or loss that is attributable to changes in the liability's credit risk.

However, on adoption of IFRS 9, entities may revisit the methodology used in identifying and measuring the effects of changes in the credit risk of such liabilities, because IFRS 9:

- clarifies that the credit risk of a liability is different from that of the issuer, and different from asset-specific performance risk;
- emphasises when the default method cannot be applied; and
- means that the calculation now has an impact on reported earnings.

IFRS 9.5.7.20

The method for measuring changes in credit risk has to make maximum use of relevant observable inputs and minimum use of unobservable inputs.

### Observation – Cumulative effect of applying the default method

IFRS 9.BC4.153(b)

The IASB notes that one of the primary reasons for the changes in the financial liability's credit risk accumulating in OCI, and not being reclassified to profit and loss, is that if the entity repays the contractual amount (which will often be the case), then the liability's fair value will ultimately equal the contractual amount due – and so the cumulative effect of those changes will net to zero.

However, if the guidance on the default method were applied literally to all periods in a scenario covering more than one period, then it would usually lead to a result in which the fair value changes accumulated in OCI do not accumulate to a net amount of zero on repayment of the financial liability at its contractual maturity. Under the default method, the calculation of the credit risk component of the change in fair value is performed separately for each period, and without reference to the cumulative position since inception. This is illustrated in the following example.

### Example – Determining the effects of changes in credit risk using the default method

Company K issues a financial liability for consideration of 100. It has an initial fair value and contractual repayment amount of 100, and a two-year maturity; it pays a coupon of 10% at the end of each year. The benchmark interest rate throughout the two years remains at 7%. K uses the default method to estimate the amount of fair value changes that is attributable to changes in credit risk.

As the first step, the instrument-specific component of the IRR is calculated as 3%. At the end of Year 1, K discounts the future cash flows at 10% – i.e. the unchanged benchmark interest rate of 7% plus the risk component of 3%.

#### At the end of Year 1:

Under Step 2 of the default method, the present value at the end of Year 1 after payment of the interest is therefore 100.

However, assume that the market spread on K's debt over the benchmark interest rate has increased, and that the fair value at the end of Year 1 has decreased to 98. Under Step 3 of the default method, K recognises a gain of 2 in OCI.

#### At the end of Year 2:

At the end of Year 2, both the present value of the cash flows calculated under Step 2 of the default method and the fair value of the financial liability are 110 immediately before repayment, and zero immediately after repayment.

Applying the guidance on the default method literally to the second year, the amount included in OCI for Year 2 would be calculated as zero. This would mean that there is no reversal of the gain of 2 recognised in OCI in Year 1.

The example is summarised in the following table.

Steps under the default method	Description	Inception	Year 1	Year 2	
				Before repayment	After repayment
Step 1	Instrument-specific component of IRR (being the financial liability's IRR minus the observed (benchmark) interest rate)	3%	3%	N/A	N/A
N/A	Fair value of financial liability	100	98	110	-
Step 2	Present value of cash flows discounted at current benchmark interest rate plus instrument-specific component	100	100	110	-
Step 3	Amount recognised in OCI for the period (being fair value minus present value)	N/A	2	-	N/A
N/A	Cumulative amount recognised in OCI	N/A	2	2	2

#### Observation – Modifying the default method to achieve a cumulative effect of zero

IFRS 9.B5.7.16

An entity is not required to apply the default method, and may use an alternative method that it believes more faithfully represents the change in the fair value of the liability that is attributable to its credit risk. Therefore, it may use a modified version of the default method, so as to:

- compute the cumulative change in fair value attributable to changes in credit risk since inception; and
- allow the amount recognised in OCI to revert to zero at maturity.

This modification of the default method can be applied by:

- replacing 'at the start of the period' in Step 1 of the default method with 'at inception'; and
- treating the difference derived in Step 3 of the default method as the cumulative amount of fair value changes attributable to changes in credit risk to be presented in OCI for the whole life to date of the financial liability – rather than as the amount to be presented in OCI for the current period.

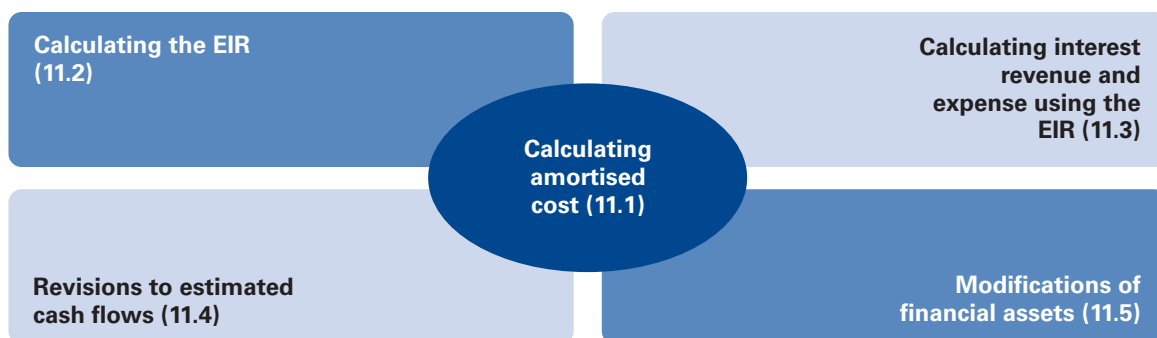
Under this modified approach, the amount presented in OCI for the current period is the difference between:

- the cumulative amount calculated under Step 3 at the end of the *current* period; and
- the cumulative amount calculated under Step 3 at the end of the *previous* period.

# 11 Amortised cost and the effective interest method

The guidance on amortised cost and the effective interest method in IFRS 9 is similar to that in IAS 39.

This chapter looks at the factors that an entity needs to consider in calculating the amortised cost of a financial asset or financial liability and recognising interest revenue and expense based on the EIR.



## 11.1 Calculating amortised cost

*IFRS 9 Appendix A*

The amortised cost of a financial asset or financial liability is calculated in the same way as under IAS 39, although IFRS 9 introduces the concept of ‘gross carrying amount’ for financial assets. The gross carrying amount is the amortised cost grossed up for the impairment allowance. The elements of amortised cost are illustrated below.

	Financial assets	Financial liabilities
	Amount initially recognised (see Chapter 9)	
minus	Principal repayments	
plus or minus	Cumulative amortisation, using the EIR (see 11.2), of any difference between the initial amount and the maturity amount	
equals	Gross carrying amount	
minus	Loss allowance (see Chapter 12)	
equals	<b>Amortised cost</b>	<b>Amortised cost (no adjustment for loss allowance)</b>

### Observation – Calculation of ‘amortised cost’

IAS 39.9

The definition of ‘amortised cost’ is unchanged from IAS 39. However, the amortised cost of a financial asset is likely to be different under IFRS 9 compared to IAS 39. This is because amortised cost is net of a loss allowance for impairment and the impairment requirements of IFRS 9 and IAS 39 are different (see 12.3.1).

## 11.2 Calculating the EIR

### 11.2.1 General approach

IFRS 9 Appendix A

The EIR is calculated at initial recognition of a financial asset or a financial liability. It is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to:

- the gross carrying amount of the financial asset; or
- the amortised cost of the financial liability.

At initial recognition, the gross carrying amount of a financial asset, or the amortised cost of a financial liability, is generally equal to the fair value of the instrument, adjusted for transaction costs (see Chapter 9).

IFRS 9 Appendix A

The estimate of expected cash flows considers all contractual terms (e.g. prepayment, call and similar options) but does not consider expected credit losses (i.e. the contractual cash flows are not reduced by expected credit losses).

#### 11.2.1.1 Floating-rate financial instruments

IFRS 9.B5.4.5

For floating-rate financial instruments, the EIR is altered by periodic re-estimations of cash flows to reflect movements in market rates of interest.

### Observation – Calculating the EIR for floating-rate financial instruments

Similar to IAS 39, IFRS 9 does not specify how to calculate the EIR for floating-rate financial instruments. Therefore, it appears that applying the new standard will not change current practice under IAS 39, which seems to allow two approaches for calculating the EIR.

- **Approach 1:** Based on the actual benchmark interest rate that was set for the relevant period.
- **Approach 2:** Taking into account expectations of future interest rates, and changes in these expectations.

This is illustrated by the following example.

### Example – Calculating the EIR for floating-rate financial instruments

Company X issues at par a financial liability with:

- principal of 100;
- a contractual interest rate of 12-month LIBOR plus 2% (payable annually); and
- a maturity of three years.

12-month LIBOR at initial recognition of the liability is 2% and is used to set the first annual coupon. 12-month LIBOR is expected to be 3% in Year 2 and 4% in Year 3.

Approach	Calculation of initial EIR
1	The initial EIR is calculated as 4% per annum – i.e. 12-month LIBOR at initial recognition plus the margin of 2%.
2	The initial EIR is calculated as approximately 5% per annum – i.e. the IRR of the following cash flows: <ul style="list-style-type: none"> <li>• expected coupons of 4, 5 and 6; and</li> <li>• principal repayable at maturity of 100.</li> </ul>

### 11.2.1.2

*IFRS 9.B5.4.1–3,  
IAS 18.IE14*

#### Fees that are an integral part of the EIR

IFRS 9 incorporates the guidance on financial service fees (both received and paid) that are an integral part of the EIR of a financial instrument. The guidance on fees received was previously included in the illustrative examples to IAS 18. IFRS 9 also includes examples of fees that are not an integral part of the EIR, which are accounted for under IFRS 15.

#### Observation – Fees that are an integral part of the EIR

*IAS 18.IE14*

The guidance in IAS 18 on financial service fees referred only to fees received as part of providing financial services. However, the guidance as incorporated into IFRS 9 also applies to fees paid by the issuer of a financial liability.

### 11.2.2

*IFRS 9 Appendix A,  
B5.4.7*

#### Credit-adjusted EIR

The EIR for purchased or originated credit-impaired financial assets ('POCI' assets) is calculated slightly differently than under the general approach (see 12.6.2). For POCI assets, the EIR is calculated using expected cash flows inclusive of future lifetime expected credit losses – i.e. the estimated contractual cash flows are reduced by lifetime expected credit losses.

*IFRS 9 Appendix A*

The resulting EIR is defined as the credit-adjusted EIR. For the definition of a credit-impaired asset, see 12.6.1.

#### Observation – Calculation of EIR for POCI assets

*IAS 39.AG5*

The requirements of the new standard for calculating the credit-adjusted EIR are very similar to the requirements of IAS 39 for assets that are acquired at a deep discount that reflects incurred credit losses. However, under IAS 39 the EIR calculation for these assets includes only credit losses that have been incurred, while under IFRS 9 the EIR includes all expected future credit losses.

Although under IFRS 9 the calculation of EIR for POCI assets reflects all expected credit losses rather than just incurred credit losses, this may not in practice result in a big change in the EIR for these assets as compared with IAS 39. This is because once an asset is impaired, it may be difficult in practice to distinguish between incurred and expected credit losses.

## 11.3 Calculating interest revenue and expense using the EIR

### 11.3.1 General approach

*IFRS 9 Appendix A, B5.4.4*

Under IFRS 9, the EIR is used to allocate interest revenue or expense over the expected life of the financial instrument in a similar manner to that under IAS 39.

*IFRS 9.5.4.1, Appendix A*

Generally, interest revenue and expense are calculated as follows.

<b>Revenue</b>	Apply the EIR to the gross carrying amount of a financial asset.
<b>Expense</b>	Apply the EIR to the amortised cost of a financial liability.

### 11.3.2 Approach for credit-impaired financial assets

*IFRS 9.5.4.1(a)–(b)*

For credit-impaired financial assets (see 12.6.1), interest revenue is calculated by applying the EIR (or credit-adjusted EIR if the asset was credit-impaired at initial recognition) to the amortised cost of the asset. An asset could be credit-impaired if:

- it was credit-impaired on initial recognition (a POCL asset); or
- it became credit-impaired after initial recognition.

*IFRS 9.5.4.1(a), 5.4.2*

For an asset that became credit-impaired after initial recognition, the calculation of interest revenue reverts to the gross basis if the asset is no longer credit-impaired. However, for POCL assets, the calculation of interest revenue can never revert to a gross basis, even if the credit risk of the asset improves.

#### Observation – Applying the EIR to the gross carrying amount or amortised cost of a financial asset

*IAS 39.9*

The requirements of IFRS 9 to calculate interest revenue for credit-impaired assets by applying the EIR to the amortised cost of a financial asset are the same as the current IAS 39 requirements for all financial assets and financial liabilities.

However, for assets that are not credit-impaired an apparent difference arises between the requirements of IFRS 9 and IAS 39. This is because under IFRS 9, an asset attracts an impairment allowance even if it is not credit-impaired (see 12.3.1). Therefore, under IFRS 9 interest revenue on these assets is calculated by applying the EIR to the gross carrying amount – i.e. the amortised cost grossed up for the impairment allowance. By contrast, under IAS 39 interest revenue is always calculated by applying the EIR to amortised cost but no impairment allowance is recorded for assets that are not credit-impaired.

## 11.4 Revisions to estimated cash flows

*IFRS 9.B5.4.6*

When an entity revises its estimate of payments or receipts from a financial asset or financial liability, it recalculates the gross carrying amount of the financial asset or the amortised cost of the financial liability to reflect the revision. The revised gross carrying amount of the asset (or amortised cost of the liability) is equal to the present value of the revised estimate of cash flows, discounted at the asset's EIR. The adjustment is recognised in profit or loss as income or expense.

*IFRS 9.4.1.3, B4.1.7A,  
B5.4.5–6,  
IAS 39.AG7–AG8*

### Observation – No definition of ‘floating-rate financial instrument’

IFRS 9 retains the guidance in IAS 39 on accounting for revisions to estimated cash flows that are receivable or payable under financial assets and financial liabilities. IFRS 9 also retains the guidance in IAS 39 on amending the EIR of floating-rate financial instruments but, similar to IAS 39, does not define the term ‘floating-rate financial instrument’.

IAS 39’s lack of guidance in this area has led to a debate as to whether certain instruments with contractual reset features – e.g. indexation to inflation or an entity’s revenue – should be considered floating-rate financial instruments such that the EIR is subject to alteration for resets (see 11.2.1.1), or whether the entire effect of resets should instead be reflected by remeasuring the present value of contractual cash flows at the unchanged original EIR.

A submission on this matter was made to the IFRS Interpretations Committee in July 2008, and the IASB discussed the issue in its October 2009 meeting.

For financial assets, the classification and measurement requirements of IFRS 9 restrict amortised cost measurement to assets whose contractual terms give rise to cash flows that are ‘solely payments of principal and interest’, consistent with a basic lending arrangement (see 5.2). This means that assets containing certain features – e.g. indexation to revenue – do not qualify for amortised cost treatment, and so for these assets entities will not have to determine whether those features could be viewed as floating-rate interest. However, this determination may still be relevant for some types of reset feature – e.g. indexation to inflation – for financial assets that may satisfy the SPPI criterion (see 5.2.7) and for financial liabilities.

## 11.5 Modifications of financial assets

### 11.5.1 Overview

*IFRS 9.5.4.3*

IFRS 9 introduces new guidance on:

- measuring the amortised cost of financial assets that have been modified, when the modification does not result in derecognition; and
- recognising the resulting gains or losses.

This guidance applies to all modifications, irrespective of the reason for the modification.

### Observation – Derecognition of a modified financial asset

*IFRS 9.3.2.3(a)*

IFRS 9 retains the guidance in IAS 39 that a financial asset is derecognised when the contractual rights to its cash flows expire. However, there is no specific guidance in IAS 39 on how this criterion should apply for modifications of financial assets.

A submission on this matter was made to the IFRS Interpretations Committee. The Committee discussed this issue in September 2012 in the context of the narrow fact pattern included in the submission. In its agenda decision, the Committee noted that to assess whether a financial asset was extinguished, an entity needs to assess:

- the changes made to the terms of the asset; against
- the notion of ‘expiry’ of the rights to the cash flows.



IFRS 9.B3.3.6, B5.5.25–26, IE68–IE69

The Committee also noted that, in the absence of an explicit discussion in IAS 39 on when a modification of a financial asset results in derecognition, an analogy might be made to the guidance on modifications of financial liabilities in IAS 39, under which a substantial change of terms would result in derecognition. This guidance, which is also carried forward unchanged into IFRS 9, states that the terms are substantially different if the discounted present value of the cash flows under the new terms using the original EIR is at least 10 percent different from the discounted present value of the remaining cash flows of the original financial liability.

This agenda decision only referred to the specific fact pattern in the submission, and the Committee decided not to add the issue to its agenda.

IFRS 9 does not provide a comprehensive analysis of the matter, but does:

- state that, in some circumstances, the renegotiation or modification of the contractual cash flows of a financial asset can lead to the derecognition of the existing financial asset;
- refer to ‘a substantial modification’ of a distressed asset as an example of a modification that results in derecognition; and
- include an example for modification that does not result in derecognition, in which the gross carrying amount of the modified asset is 30 percent lower than the original loan.

#### Observation – Scope of the guidance on modification of financial assets

IFRS 9.BC5.231–232, IFRS 7.BC48Z

Some respondents to the 2013 impairment ED<sup>6</sup> suggested that the scope of the modifications guidance should be limited and aligned to the definition of forbearance proposed by the European Banking Authority (EBA).<sup>7</sup> The EBA’s final draft defines forbearance as measures that: “consist of concession towards a debtor facing or about to face difficulties in meeting its financial commitments.”<sup>8</sup>

However, the IASB decided not to limit the application of the guidance. One reason for this decision was because it may be operationally difficult to determine the purpose of the modification – i.e. whether it is performed for commercial or credit risk management reasons. Therefore, IFRS 9 does not define the term ‘modification’, but discusses it in the wider context of any changes to contractual terms.

## 11.5.2

### Gains or losses on modifications of financial assets

IFRS 9.5.4.3, Appendix A

For modifications that do not result in derecognition, the gross carrying amount of the asset is recalculated by discounting the modified contractual cash flows using the EIR before modification. Any difference between this recalculated amount and the existing gross carrying amount is recognised in profit or loss as a modification gain or loss. Any costs or fees incurred as part of the modification adjust the carrying amount of the modified financial asset, and are amortised over the remaining term of the modified financial asset.

<sup>6</sup> Exposure draft ED/2013/3 *Financial Instruments: Expected Credit Losses*.

<sup>7</sup> EBA Consultation Paper EBA/CP/2013/06 Draft Implementing Technical Standards: [On Supervisory reporting on forbearance and non-performing exposures under article 95 of the draft Capital Requirements Regulation](#), published in March 2013.

<sup>8</sup> EBA Final Draft Implementing Technical Standards: [On Supervisory reporting on forbearance and non-performing exposures under article 99\(4\) of Regulation \(EU\) No. 575/2013](#), published in February 2014.

### Examples – Gain or loss on modifications that do not result in derecognition

A bank may modify the terms of loans with good credit quality for business reasons. For example, a borrower whose credit quality has improved may approach the bank to reduce the margin, and the bank may agree in order to preserve the relationship and to reflect the improved credit risk. If the modification does not result in derecognition of the original loan, the new standard requires the bank to recognise an immediate loss on this transaction. This is because the recalculated carrying amount of the loan will be equal to the net present value of the modified – i.e. reduced – cash flows discounted at the original EIR.

In another example, a bank may extend the maturity of a loan of a good customer to meet the customer's business needs, and increase the interest rate to reflect market rates for the extended maturity. If the modification does not result in derecognition of the original loan, the new standard requires the bank to recognise an immediate gain on this transaction. This is despite the fact that there is no economic gain for the bank, because the increased interest reflects market rates for the extended period and is intended to compensate the bank for increased risk.

### Observations – Gain or loss on modifications that do not result in derecognition

#### Overall impact on profit or loss

Modifications of a financial asset that do not result in derecognition may impact profit or loss in two ways:

- by recognising the modification gain or loss that is equal to the change in the gross carrying amount of the modified financial asset; and
- by changing the amount of expected credit losses recognised as an impairment allowance (see 12.4). For example, if modification resulted in a reduction in contractual cash flows, then the expected cash shortfalls would also be likely to reduce.

In many cases, this impact may be offsetting – e.g. when a modification results in a reduction in the contractual amount of a debt that reflects the debtor's assessed inability to pay the previous full contractual amount. In such cases, an entity may also have to assess whether the gross carrying amount of the financial asset should be partially written off before the modification, thereby reducing the gross modification gain or loss at the time of modification (see 12.5).

#### Presentation of gain or loss on modifications that do not result in derecognition

There is no guidance in IFRS 9 on the line item in the statement of profit or loss and OCI in which gains or losses on the modification of financial assets should be presented.

A modification gain or loss may not necessarily relate to impairment (see Chapter 12), because not all modifications are performed for credit risk reasons. Accordingly, entities will have to exercise judgement to determine an appropriate presentation for the gain or loss.

#### Modifications that do not result in derecognition – costs or fees incurred

IFRS 9 states that costs or fees incurred as part of the modification are amortised over the remaining term of the modified financial asset. However, there is no specific guidance in the standard on the basis of this amortisation. Because these costs or fees adjust the carrying amount of the asset as part of the amortised cost remeasurement, it appears that the EIR will need to be adjusted following the modification for the purposes of amortisation.

*IFRS 9.B3.3.6, B5.4.6,  
BC5.233, IAS 39.AG8*

### **Modifications that do not result in derecognition – application to financial liabilities**

IFRS 9 does not amend the guidance on modifications of financial liabilities that do not result in derecognition. Accordingly, the new standard does not specify the accounting treatment for an increase or decrease in the present value of contractual cash flows arising from a modification of a liability that does not result in derecognition – i.e. whether a modification gain or loss should be calculated in a similar manner to that for financial assets.

However, the standard has amended the wording of the general guidance on revisions of estimates of cash flows (see 11.4) to state that modifications of financial assets are excluded from its scope. The basis for conclusions indicates that the Board may have intended that the guidance in 11.4 would apply to modifications of financial liabilities that do not result in their derecognition. If it were applied to these modifications, they would result in gains or losses being recognised in profit or loss, similar to modifications of financial assets.

*IFRS 9.B5.5.25*

If a modification results in derecognition, then the modified financial asset is recognised as a new financial asset.

### **Observation – Gain or loss on modifications that result in derecognition**

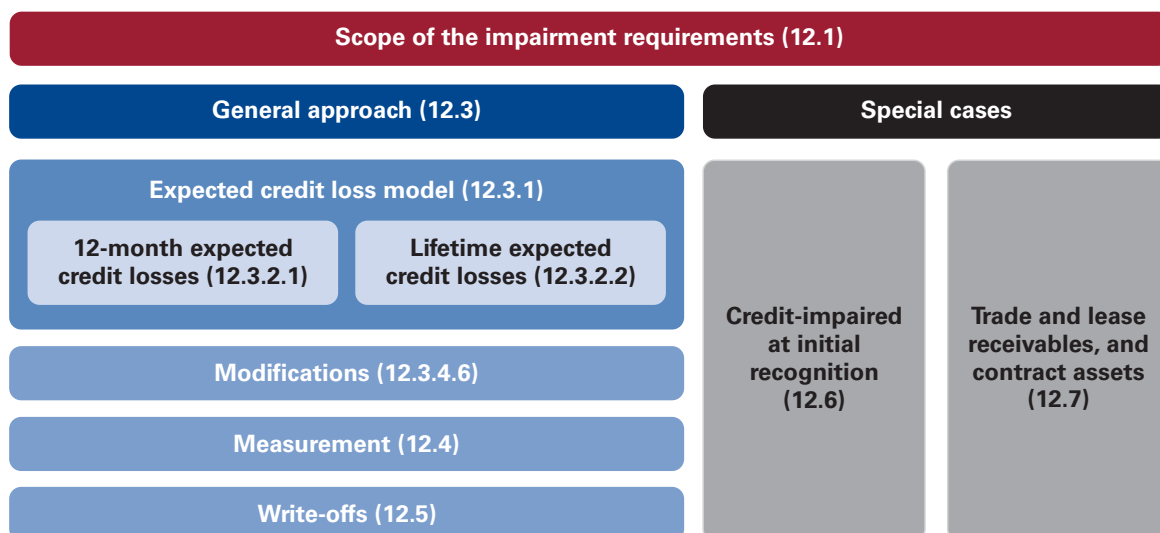
Because the modified asset is recognised as a new financial asset, this means that the new asset is initially measured at its fair value plus eligible transaction costs (see Chapter 9). The standard does not discuss to what extent costs and fees incurred may be eligible for capitalisation as transaction costs attributable to the origination of the new asset, as opposed to being considered amounts that should be expensed in relation to the derecognition of the old asset.

This is in contrast to modifications of financial liabilities that result in derecognition, for which the new standard states that any costs or fees incurred are recognised as part of the gain or loss on extinguishment. Ignoring any such fees and costs, derecognition effectively results in an overall gain or loss equal to the difference between:

- the amortised cost of the old asset; and
- the fair value of the new asset minus the amount of expected credit losses initially recognised as an impairment allowance on the new asset (see 12.3.4.6).

# 12 Impairment

The following diagram summarises how the key concepts of the model are explained throughout this chapter.



## 12.1 Scope of the impairment requirements

### 12.1.1 General requirements

*IFRS 9.2, 4.2.1, 5.5.1*

The following table sets out instruments that are in and out of the scope of IFRS 9's impairment requirements.

In scope	Out of scope
<ul style="list-style-type: none"> <li>Financial assets that are debt instruments measured at amortised cost or at FVOCI (see 5.1) – these include loans, trade receivables and debt securities</li> <li>Loan commitments issued that are not measured at FVTPL</li> <li>Financial guarantee contracts issued that are in the scope of IFRS 9 and are not measured at FVTPL</li> <li>Lease receivables in the scope of IAS 17</li> <li>Contract assets in the scope of IFRS 15</li> </ul>	<ul style="list-style-type: none"> <li>Equity investments (see 12.1.2)</li> <li>Loan commitments issued that are measured at FVTPL</li> <li>Other financial instruments measured at FVTPL</li> </ul>

IFRS 9 has a single impairment model that applies to all financial instruments in its scope.

### Observation – Scope of the impairment requirements

IAS 39.2(h), 63–70,  
AG4(a), IFRS 9.BC5.259

The existence of several impairment models under IAS 39 creates complexity. Under IAS 39, there are different models for:

- assets at amortised cost;
- available-for-sale assets – debt instruments; and
- available-for-sale assets – equity instruments.

In addition, losses relating to loan commitments and financial guarantees issued by banks are generally accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This has created a practical issue for banks, because they often manage credit risk on financial guarantees and loan commitments in the same way as credit risk on loans and other debt instruments, whereas for accounting purposes they are treated differently.

In addition, for revolving credit facilities (see 12.4.3.2) banks often manage the amount receivable and the undrawn amount of the commitment together for risk management purposes – i.e. on a facility level.

Under IFRS 9, a single set of impairment requirements applies to all instruments in the scope of IFRS 9 that are not accounted for at FVTPL. This may simplify the requirements and align them more closely with the way banks manage their credit risk. However, differences may arise in practice between the way banks perform the calculations for internal risk management purposes and the specific requirements of IFRS 9. These are discussed further in 12.4.2.2 in respect of loan commitments.

The new model may also have an impact on corporates that apply IAS 39 to issued financial guarantee contracts, and therefore recognise a provision on such contracts only when it is probable that an outflow will occur. For discussion of the IFRS 9 impairment model's impact on financial guarantee contracts issued, see 12.4.9.1.

### Observation – FVOCI category

IFRS 9.BC5.124

Under IAS 39, the impairment of available-for-sale debt instruments is measured as the difference between the acquisition cost and the current fair value. This approach has been criticised, because once an impairment trigger occurs the impairment has to be recognised based on changes in fair value – even though fair value changes would be impacted by variables other than credit risk, such as changes in interest rates.

The IASB believes that applying a single impairment model to both financial assets measured at amortised cost and financial assets measured at FVOCI will:

- facilitate comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics; and
- reduce a significant source of complexity for both users and preparers of financial statements compared with IAS 39.

Accordingly, under IFRS 9 financial assets classified as at FVOCI and financial assets classified as at amortised cost are subject to the same single impairment model.

## 12.1.2 Equity investments

IFRS 9.4.1.4, 5.75

Investments in equity instruments are outside the scope of the new impairment requirements, because under IFRS 9 they are accounted for either:

- at FVTPL; or
- at FVOCI, with no reclassification of any fair value gains or losses to profit or loss (see 5.1.5 and 10.1).

Accordingly, equity investments in the scope of IFRS 9 are no longer tested for impairment.

### Observation – Impairment of equity investments

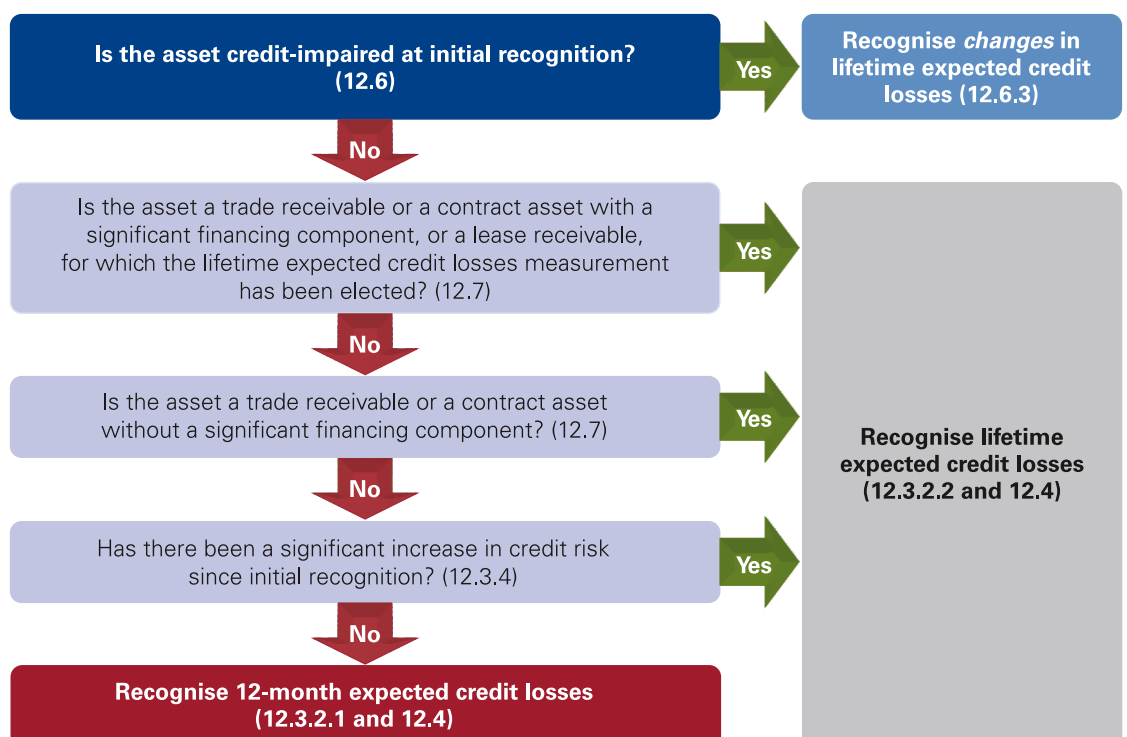
IAS 39.61,  
IAS 28.41A–C

Under IAS 39, specific requirements apply for recognising and measuring the impairment of equity investments. In addition to the general impairment triggers, equity investments are impaired if there is a 'significant or prolonged' decline in their fair value below cost. This test has proved difficult to apply, and has resulted in diversity in practice. The fact that equity investments in the scope of IFRS 9 are no longer tested for impairment will result in a helpful simplification.

However, IFRS 9 amends IAS 28 *Investments in Associates and Joint Ventures* to require the use of similar criteria to those currently in IAS 39 to determine whether there is objective evidence of impairment for investments in associates or joint ventures after applying the equity method. The criteria include an assessment of whether there is a significant or prolonged decline in the fair value of an investment. This means that the 'significant or prolonged' criterion will still be relevant for such investments.

## 12.2 Overview of the new impairment model

Under the IFRS 9 impairment model, expected credit losses are measured as either 12-month expected credit losses or lifetime expected credit losses. The flowchart below sets out a decision tree to follow in deciding which measurement basis to apply to a particular financial instrument.



## 12.3 The general approach to impairment

### 12.3.1 The expected credit loss concept

*IFRS 9.B5.5.7*

The IAS 39 incurred loss model was criticised for delaying the recognition of losses, for the complexity of having multiple impairment approaches, and for being difficult to understand, apply and interpret. IFRS 9 replaces this model with an expected credit loss approach. Under the new approach, it will no longer be necessary for a loss event to occur before an impairment loss is recognised and so, generally, all financial assets will carry a loss allowance (however, certain exceptions from recognising a loss allowance are available – see 12.6).

*IFRS 9 Appendix A, B5.5.28*

Expected credit losses are the present value of all cash shortfalls over the expected life of the financial instrument. The definition of ‘cash shortfalls’ and the measurement of expected credit losses are discussed in 12.4.

#### Observation – Day one loss

*IFRS 9.BC5.198*

The new impairment model generally requires entities to recognise expected credit losses in profit or loss for all financial assets – even those that are newly originated or acquired. Although IFRS 9 does not require the loss allowance to be recognised at initial recognition of the new financial asset but rather at the next reporting date, the effect is akin to recognising a day one loss. This is different from IAS 39, under which no impairment is recognised unless and until a loss event occurs after the initial recognition of a financial asset.

However, the initial amount of expected credit losses recognised is equal to 12-month expected credit losses (see 12.3.2.1) – except for certain trade and lease receivables, and contract assets (see 12.7.1). Therefore, the day one loss does not reflect all of the expected credit losses on the financial asset. In addition, no day one loss is recognised for POCI assets (see 12.6.2).

The IASB has acknowledged that the impairment model in IFRS 9 will result in an overstatement of expected credit losses for financial instruments, and that the initial carrying amount of financial assets will be below their fair value. However, the Board explained that this measurement of expected credit losses serves as a practical approximation of the model originally proposed in November 2009,<sup>9</sup> which was operationally very complex to implement.

Other things being equal, IFRS 9 means that banks that are growing their loan books will suffer a drag on their currently reported earnings, relative to IAS 39’s incurred loss model.

#### Observation – Financial assets acquired in a business combination

*IFRS 3.B41*

A financial asset acquired as part of a business combination does not attract a loss allowance at its date of acquisition. IFRS 3 explains that this is because the effects of uncertainty about future cash flows are included in the fair value measurement.

This rationale applies equally to financial assets that are originated or acquired outside of a business combination.

It appears that the guidance in IFRS 3 is provided specifically for the purpose of calculating goodwill, as any reduction in fair value by the expected credit loss allowance would have resulted in an overstatement of goodwill. Accordingly, it appears that under IFRS 9 an asset acquired in a business combination would attract a loss allowance at the first reporting date after it is recognised, even if that date is the date on which the business combination has taken place. This effectively means that, for the recognition of impairment, such assets will be treated in the same way as other financial assets and attract a day one loss.

<sup>9</sup> Exposure draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*.

IFRS 9.BCE131–  
BCE140

### Observation – Impact on equity on initial adoption and in future periods

Initial application of the IFRS 9 impairment requirements may result in a negative impact on equity. This is because equity will reflect not only incurred credit losses but also expected credit losses. This impact may be particularly large for banks and, potentially, insurers and other financial services entities. Initial application may also affect covenants and banks' regulatory capital, principally through the reduction of Common Equity Tier 1 capital for the latter. The magnitude of the impact on an entity may be substantially influenced by:

- the size and nature of its financial instruments and their classifications;
- the judgements that it makes in applying the IAS 39 requirements – e.g. judgements relating to the length of the emergence period for identifying losses that have been incurred but not reported (IBNR) and identifying impairment on individual assets; and
- the judgements that it makes in applying the new impairment requirements of IFRS 9.

However, regulators' possible responses to the increase in impairment losses introduced by IFRS 9 are currently unclear.

The IASB conducted fieldwork between April and June 2013 with 15 participants (both financial and non-financial entities) to understand the potential impact of the model then proposed and, in particular, how it would respond to changing economic conditions over time.<sup>10</sup> The fieldwork included simulations using real economic data based on a hypothetical scenario involving a changing macro-economic environment.

Almost all participants in the fieldwork reported that the amount of credit allowances would have significantly increased on transition and through the entire economic cycle, compared with the IAS 39 requirements. The estimated effects of that proposed model on the credit loss allowance compared with IAS 39 were quantified as follows.

Mortgage portfolios		
	Increase under the impairment ED compared with IAS 39	
	On transition	Worst economic forecast scenario
Total allowance	30% to 250%	80% to 400%
Allowance measured equal to lifetime expected credit losses	130% to 730%	450% to 540%
Other portfolios		
	Increase under the impairment ED compared with IAS 39	
	On transition	Worst economic forecast scenario
Total allowance	25% to 60%	50% to 150%
Allowance measured equal to lifetime expected credit losses	50% to 140%	110% to 210%

<sup>10</sup> For more details, see the IASB staff's agenda papers [5B](#) and [5E](#), which were discussed in the July and September 2013 IASB meetings, respectively.



This fieldwork was conducted on the basis of proposals in the 2013 impairment ED, issued in March 2013. However, the complete version of IFRS 9 includes several changes to the proposed model that was tested in the fieldwork. Key changes include:

- a clarification that the 30-day presumption (see 12.3.4.4) is not an absolute indicator that lifetime expected credit losses (see 12.3.2.2) should be recognised, but is presumed to be the latest point at which such losses should be recognised; and
- the requirement that for certain loan commitments, the period over which expected credit losses are measured is longer than the maximum contractual term.

The subsequent changes to the requirements might have impacted the results of the fieldwork had they been in place at that time. Also, some banks may have recognised increased levels of provisions under IAS 39 over the last year – e.g. some may have recalibrated emergence periods and loss parameters and re-evaluated how they identify forbearance or other triggers as representing objective evidence of impairment – which may also impact the overall effect of transition.

## Observations – Business implications

### Impact on KPIs and volatility in profit or loss

Transition to the expected credit loss model for measuring impairment is likely to have a significant impact on key performance indicators (KPIs) for many entities, but especially banks and other lenders. The new model may make equity and profit or loss more volatile because:

- credit losses will be recognised for all financial assets in the scope of the model – rather than only for those assets for which losses have been incurred;
- external data used as inputs may be volatile – e.g. ratings, credit spreads and predictions about future conditions; and
- any move from a 12-month expected credit losses measurement to a lifetime expected credit losses measurement – and vice versa – (see 12.3.4) may result in a large change in the corresponding loss allowance.

The IASB fieldwork discussed above indicated that the results of the proposed model were more sensitive to changing economic conditions – e.g. forward-looking macro-economic data – than the IAS 39 incurred loss model.

### Operationalising the new methodology

Operationalising the new IFRS 9 impairment methodology may be challenging. The methodology is likely to have a particularly significant impact on the systems and processes of banks, insurers and other financial services entities. Extended data and calculation requirements will include:

- estimates of 12-month expected credit losses (see 12.3.2.1);
- estimates of lifetime expected credit losses (see 12.3.2.2); and
- tracking information and data to determine whether a significant increase in credit risk has occurred or reversed (see 12.3.4).

Banks with less sophisticated approaches to credit risk management may currently lack the data or systems to carry out the expected credit losses calculations. Also, they may have little expertise in developing expected credit loss models.

## 12.3.2

### 12-month expected credit losses and lifetime expected credit losses

*IFRS 9.5.5.3–5*

Under IFRS 9, impairment is measured as either:

- 12-month expected credit losses; or
- lifetime expected credit losses.

The circumstances under which expected credit losses are measured as 12-month or lifetime expected credit losses are explained in 12.3.4, 12.6 and 12.7.

### 12.3.2.1

#### 12-month expected credit losses

*IFRS 9 Appendix A, BC5.5.43*

'12-month expected credit losses' are 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."

This means that 12-month expected credit losses are all cash shortfalls (see 12.4.2) that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months).

#### Observation – The concept of 12-month expected credit losses

*IFRS 9.BC5.195, BC5.198–199, BC5.203*

The IASB acknowledges that there is no conceptual basis for selecting 12 months of expected credit losses rather than any other period. Instead, this period has been selected because the IASB considers it to represent an appropriate balance between the benefits of a faithful representation of expected credit losses, and operational costs and complexity.

The Board notes that selecting a period longer than 12 months would lead to the recognition of a larger proportion of expected credit losses, and therefore increase the overstatement of expected credit losses at initial recognition.

The Board also observes that in many jurisdictions, regulated financial institutions already calculate a 12-month credit loss rate that is similar to the requirement under IFRS 9, and so implementing the model would be less costly for them. Financial institutions that already apply a 12-month expected credit losses concept for regulatory purposes will have to identify and quantify the effect of any differences in definition between the regulatory requirements and those of IFRS 9 (see 12.10).

#### Observation – Losses that result from default events that are possible in the next 12 months

Banks often gather information on the past performance of their assets to calculate the relevant loss statistics. For example, they may track a cohort of retail loans that have become 30 days past due, to determine what proportion of these loans does not pay in full and so results in a loss.

When using this information to estimate 12-month expected credit losses, entities will have to ensure that they:

- include only losses that result from a default in the next 12 months; and
- exclude losses that result from any subsequent defaults outside the 12-month period relating to the same loan.

This may be challenging.

See also 'Observation – Relationship between an actual default event and a significant increase in credit risk' in 12.3.4.1.2.

### 12.3.2.2 Lifetime expected credit losses

*IFRS 9 Appendix A*

'Lifetime expected credit losses' are defined as: "the expected credit losses that result from all possible default events over the expected life of the financial instrument."

### 12.3.2.3 Definition of default

*IFRS 9.B5.5.37*

IFRS 9 does not define the term 'default', but instead requires each entity to do so. The definition has to be consistent with that used for internal credit risk management purposes for the relevant financial instrument, and has to consider qualitative indicators – e.g. breaches of covenants – when appropriate. The 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 should be applied consistently, unless information that becomes available indicates that another default definition is more appropriate for a particular financial instrument.

#### Observation – Definition of 'default' and its impact on applying the model

*IFRS 9.BC5.248, BC5.251–252*

The IASB notes that entities can use their own definitions of default, including, where applicable, a regulatory definition – as long as the definitions are consistent with the entities' credit risk management practices (see 12.10) and consider qualitative indicators.

In this context, the staff noted<sup>11</sup> that some definitions of default that are used in practice for other purposes – e.g. by ratings agencies – are narrow and focus only on failure to make contractual payments. Others – e.g. those used by some regulators, such as the Basel Committee on Banking Supervision or the European Banking Authority – are broader, and also:

- capture failure to uphold some other aspects of the contractual terms – e.g. breaches of covenants or failure to submit audited financial statements; and
- consider the obligor's likeliness to pay future contractual payments in full before the payment is actually past due.

Entities will have to define the term 'default' in the context of their specific types of assets and in a way that is consistent with their credit risk management practices. In some cases, it may be appropriate to consider assets to be in default if a contractual payment is not made when it is due. In other cases, default may occur earlier – e.g. when a borrower breaches loan covenants, which may occur before any contractual payment is missed.

The definition of default may affect the amount of expected credit losses recognised (see 12.4), because the earlier an asset is considered to be in default, the more likely it is that the default event would be possible within the 12 months after the reporting date. However, the IASB has noted that expected credit losses are not expected to change as a result of differences in the definition of default, because of the counterbalancing interaction between the way the entity defines default and the credit losses that arise as a result of that definition of default.

### 12.3.3 When is it appropriate to recognise 12-month expected credit losses or lifetime expected credit losses?

*IFRS 9.5.5.5*

Expected credit losses are measured as 12-month expected credit losses unless:

- the credit risk on a financial instrument has increased significantly since initial recognition (see 12.3.4); or
- special measurement requirements apply (see 12.6 and 12.7).

<sup>11</sup> For more details, see the IASB staff's [agenda paper 5D](#), which was discussed in the IASB's September 2013 meeting.

## 12.3.4 Significant increase in credit risk

### 12.3.4.1 General requirements

#### 12.3.4.1.1 Definition of significant increase in credit risk

*IFRS 9.5.5.3, 5.5.5*

Expected credit losses are measured as lifetime expected credit losses if, at the reporting date, the credit risk on the financial instrument has increased significantly since its initial recognition.

*IFRS 9.B5.5.21*

IFRS 9 clarifies that an entity cannot align the timing of its recognition of lifetime expected credit losses to the date on which a financial asset becomes credit-impaired (see 12.6.1), or to its internal definition of default (see 12.3.2.3).

#### Observation – No definition of ‘significant increase in credit risk’

The term ‘significant increase’ is not defined in IFRS 9. Determining whether there has been a significant increase in credit risk is one of the most critical and difficult judgement areas in the model. Entities will need to decide how they will define this key term in the context of their instruments.

#### 12.3.4.1.2 Assessing whether credit risk has increased significantly

*IFRS 9.5.5.9*

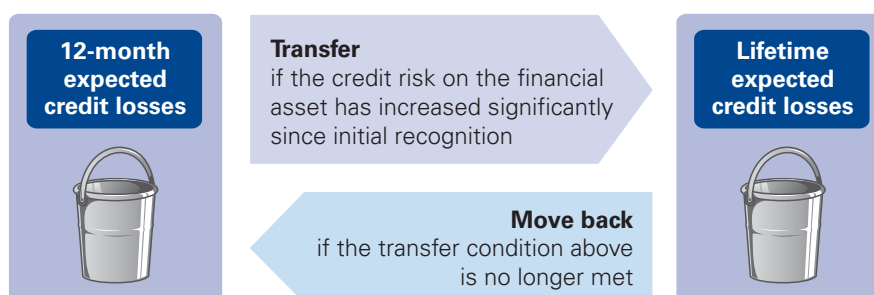
In assessing whether credit risk has increased significantly, an entity uses the change in the risk of default occurring over the expected life of the financial instrument, rather than changes in the magnitude of loss if the default were to occur. Therefore, changes in loss given default (LGD) are not considered for this purpose, although they are incorporated in the resulting measurement of expected credit losses (see 12.4).

*IFRS 9.5.5.9*

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 at initial recognition.

*IFRS 9.5.5.7*

An entity assesses whether there has been a significant increase in credit risk at each reporting date. The impairment model in IFRS 9 is symmetrical, and assets can move into and out of the lifetime expected credit losses category, as illustrated below.



*IFRS 9.B5.5.9, BC5.173–174*

To be ‘significant’, a larger absolute increase in the risk of default will be required for an asset with a higher risk of default at initial recognition than for an asset with a low risk of default at initial recognition. For example, an absolute change of 2 percent in the probability of default occurring (PD) will be more significant for an asset with an initial PD of 5 percent than for an asset with an initial PD of 20 percent. The basis for conclusions also indicates that to be significant, a larger absolute increase in the risk of default will be required for a longer-term financial asset than for a short-term financial asset.

IFRS 9.BC5.160

### Observation – Significant increase in credit risk – a relative concept

IFRS 9 explains that, in evaluating whether an increase in credit risk is significant, an entity compares the risk of default at initial recognition of an instrument with the risk of default at the reporting date.

Accordingly, there may be situations in which loans with a higher credit risk will carry a loss allowance equal to 12-month expected credit losses, whereas other loans with a lower credit risk will carry a loss allowance equal to lifetime expected credit losses.

During its deliberations, the IASB considered whether lifetime expected credit losses should be recognised on the basis of:

- an absolute assessment of the credit quality – i.e. whether the credit risk of the instrument is above a specified threshold that applies to all assets; or
- a relative assessment – i.e. whether the credit risk of the instrument has deteriorated relative to expectations at its initial recognition.

It concluded that although the absolute approach would be easier to apply because it is more closely aligned with the risk management process, it would provide very different information to users. This is because it would not approximate the economic effect of initial credit expectations and subsequent changes in expectations. In addition, it would be difficult to define an absolute level of deterioration at which lifetime recognition of losses would be appropriate for all instruments.

Accordingly, an entity will not be able to apply the significant increase concept by simply selecting a single absolute PD threshold and concluding that any instrument whose PD increases above that threshold has undergone a significant increase in credit risk. However, an approach similar to this may be appropriate for particular portfolios if all assets in the portfolio have a similar credit-risk at initial recognition (see 12.3.4.2.2).

### Example – Significant increase in credit risk – a relative concept

Bank 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' (see 12.3.4.3).

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

	Grade at initial recognition	Grade at reporting date
<b>Loan A</b>	2	5
<b>Loan B</b>	4	5

W assesses whether there has been a significant increase in credit risk in respect of the loans and reaches the following conclusions.

	Significant credit risk increase?	Recognise allowance equal to ...
<b>Loan A</b>	Yes	Lifetime expected credit losses
<b>Loan B</b>	No	12-month expected credit losses

The loans each attract a loss allowance 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.

### Observation – Relationship between an actual default event and a significant increase in credit risk

In defining 'default' for the purpose of assessing a significant increase in credit risk, entities will need to consider how this definition relates to the occurrence of a contractual default – i.e. payments not made when due under the contract (see 12.3.2.3, including 'Observation – Definition of 'default' and its impact on applying the model'). It may be that there is an actual contractual default – e.g. a missed interest payment – without there being a significant increase in credit risk.

For example, this could be the case when:

- the 30-day presumption is rebutted (see 12.3.4.4); or
- the 30-day presumption is not rebutted, but a payment is less than 30 days past due.

### Observation – Instruments with credit spreads that reset when the credit rating changes

*IFRS 9.B5.5.7*

Certain debt instruments include features under which the credit spread resets when their credit rating changes. IFRS 9 explains that the assessment of whether there has been a significant increase in credit risk is made relative to expectations at initial recognition, irrespective of whether a financial instrument has been repriced to reflect an increase in credit risk after initial recognition.

#### 12.3.4.1.3

#### Loan commitments and financial guarantee contracts

*IFRS 9.5.5.6, B5.5.47*

The assessment of a significant increase in credit risk requires an entity to identify the date on which it initially recognised a financial instrument, because any increase in credit risk is measured from that date. 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. This applies to both the drawn and undrawn amounts. This is because, for the purpose of applying the impairment requirements, a financial asset that is recognised as a result of the draw-down of a loan commitment is treated as a continuation of the loan commitment.

### Observation – Loans drawn down under loan commitments

*IFRS 9.B5.5.47*

It appears that the requirement of IFRS 9 that the date of initial recognition for loan commitments should be the date on which an entity becomes a party to the contract means that, for loans drawn down under loan commitments – e.g. revolving credit facilities – the assessment is made relative to the credit risk when the contract was signed, rather than the credit risk when each balance is drawn.

Certain loan agreements – e.g. credit cards or bank overdrafts – can have a life of many years, with balances being drawn daily and repaid (fully or partially) at short intervals – e.g. monthly. If the date of initial recognition for these instruments is considered to be the date on which the agreement with the customer was initially signed, then to assess whether credit risk has increased significantly since initial recognition entities may have to compare the current level of credit risk to a level that existed many years before. This would require entities to continue to track historical information about credit assessments dating back to the time when facilities were granted.

#### 12.3.4.1.4

#### Approaches used for assessing whether credit risk has increased significantly

*IFRS 9.B5.5.12*

IFRS 9 explains that an entity may apply various approaches when assessing whether there has been a significant increase in credit risk – including using different approaches for different financial instruments. An approach that does not include an explicit PD as an input, such as a credit loss rate approach, can be used provided that the entity is able to separate the changes in the risk of default

occurring from other changes in expected credit losses – e.g. due to collateral. 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.

### Observation – Counterparty assessment

IFRS 9.BC5.166–168

Generally, the assessment of whether there has been a significant increase in credit risk is made for a specific instrument rather than for a counterparty, because:

- the magnitude of changes in credit risk may be different for different instruments transacted with the same party; and
- different instruments issued by the same counterparty may have had a different credit risk at initial recognition – e.g. they may have been acquired at different points in time.

However, the IASB noted that assessing credit risk on a basis that considers a counterparty's credit risk more holistically may be consistent with the impairment requirements – e.g. to make an initial assessment of whether credit risk has increased significantly as part of an overall assessment, as long as this assessment satisfies the requirements of IFRS 9 on when to recognise lifetime expected credit losses, and the outcome would not be different to the outcome if the financial instruments had been assessed individually.

### Using the 12-month risk of default for the assessment

IFRS 9.B5.5.13–14

The method used to identify a significant increase in credit risk should consider the characteristics of the financial instrument and historical default patterns for comparable financial instruments. For financial instruments whose default patterns are not concentrated at a specific point during their expected life, changes in the 12-month risk of default may be a reasonable approximation of changes in the lifetime risk of default, unless circumstances indicate that a lifetime assessment is necessary. IFRS 9 includes the following examples of situations in which using the 12-month risk of default is not appropriate:

- for loans whose significant payment obligations are only after the next 12 months – e.g. bullet loans or financial instruments that are non-amortising in the first few years;
- when changes in macro-economic or other credit-related factors occur that are not adequately reflected in the 12-month risk of default; or
- when changes in credit-related factors occur that have an impact on credit risk that is more pronounced beyond 12 months.

### Observation – Identifying a significant increase in credit risk using the 12-month risk of default

IFRS 9.BC5.176–179

The 2013 impairment ED proposed that, generally, the lifetime risk of default would be used to evaluate whether an increase in credit risk is significant, and that using the 12-month risk of default would be permitted only if the information considered did not suggest that the outcome would differ.

However, during its redeliberations the IASB noted that it did not intend to require entities in the latter case to make the assessment based on both the 12-month and the lifetime risk of default to prove that the outcome would not differ, because this would not result in a simplification. The Board explained that the 12-month risk of default should generally be a reasonable approximation of the lifetime risk of default, and would therefore not be inconsistent with the requirements of the standard. However, it also noted that there may be circumstances in which the use of the 12-month risk of default would not be appropriate.

The IASB also noted that some entities already calculate a 12-month PD measure for regulatory requirements. Therefore, these entities could use their existing systems and methodologies as a starting point for assessing significant increases in credit risk, which would reduce the costs of implementation. However, they would have to identify the effect of any differences in definition between the regulatory requirements and those of IFRS 9 (see 12.10), as well as situations in which using a 12-month risk of default would be inappropriate.

#### 12.3.4.1.5

*IFRS 9.B5.5.11, BC5.174*

#### Assessing changes in the risk of default over time

IFRS 9 explains that, because of the relationship between the remaining life and the risk of default, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of default over time. For example, the risk of default over the remaining life of a loan will tend to reduce over time, as the remaining life becomes shorter. Therefore, if the actual risk of default of a particular loan has not reduced over time, this may indicate an increase in the credit risk of that loan. However, the standard states that this may not be the case for financial instruments that have significant payment obligations only close to maturity. In such cases, an entity should also consider other qualitative factors to determine a significant increase in credit risk.

#### Observation – Assessing changes in the risk of default on a comparable basis

*IFRS 9.BC5.173–174*

IFRS 9 does not specify how an entity could assess the change in credit risk other than simply comparing the change in the absolute risk of default over time, beyond noting that if the absolute risk of default does not decline over time, then this may indicate an increase in credit risk. One possible approach might be to adjust the absolute risk of default for different points in time to a comparable basis – e.g. an annualised average risk of default – or to estimate at initial recognition a default curve (with different PDs for different future periods) for the purposes of subsequent comparison. However, IFRS 9 does not provide detailed guidance as to whether such approaches would be acceptable.

Also, in making the assessment over time, a smaller absolute increase in the risk of default might be considered significant as the term of the financial asset becomes shorter (see 12.3.4.1.2).

#### Observation – Instruments with significant payment obligations only close to maturity

*IFRS 9.B5.5.11, B5.5.37*

IFRS 9 explains that, for instruments that have significant payment obligations only close to maturity, the risk of default may not necessarily decrease over time.

To the extent that the entity's definition of default (see 12.3.2.3) relates to non-payment in accordance with the terms of the contract, a default cannot occur until a payment obligation arises. However, in defining 'default' an entity should also consider qualitative factors – e.g. non-compliance with contractual covenants – which means that a default can arise during a particular period even if there are no contractual payments due in that period.

#### 12.3.4.2

*IFRS 9.5.5.4, B5.5.3*

#### Individual or collective basis of evaluation

The objective of the impairment requirements in IFRS 9 is to recognise lifetime expected credit losses for all financial instruments for which there has been a significant increase in credit risk since initial recognition – whether assessed on an individual or collective basis. The standard explains that, 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 – e.g. for many retail loans.



*IFRS 9.5.5.11,  
B5.5.1, B5.5.3*

In these cases, an assessment of whether there has been a significant increase in credit risk on an individual basis would not faithfully represent changes in credit risk since initial recognition, and so if more forward-looking information (see 12.3.4.5) is available on a collective basis, an entity makes the assessment on a collective basis.

#### 12.3.4.2.1

#### **Grouping financial instruments for collective assessment**

*IFRS 9.B5.5.5*

To assess significant increases in credit risk on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics.

*IFRS 9.B5.5.5*

The standard gives the following examples of shared credit risk characteristics:

- instrument type;
- credit risk ratings;
- collateral type;
- date of origination;
- remaining term to maturity;
- industry;
- geographical location of the borrower; and
- the value of collateral relative to the financial asset if it has an impact on the PD – e.g. loan-to-value ratios for non-recourse loans in some jurisdictions.

*IFRS 9.B5.5.6*

The aggregation of financial instruments may change over time as new information becomes available.

IFRS 9 provides the following illustrative example on assessing a significant increase in credit risk on a portfolio basis by grouping the instruments on the basis of shared credit risk characteristics.

#### **Example – Assessing a significant increase in credit risk on a portfolio basis**

*IFRS 9.IE38*

Bank F has a portfolio of mortgages that were provided to finance residential real estate in a specific region.

This region includes a mining community that is largely dependent on the export of coal and related products. F becomes aware of a significant decline in coal exports and anticipates the closure of several coal mines. F anticipates an increase in the unemployment rate in this community and determines that the credit risk and the risk of default of borrowers in the region who rely on the coal mines have significantly increased, even if those borrowers are not past due at the reporting date.

Accordingly, F segments its mortgage portfolio on the basis of industries – i.e. a shared credit risk characteristic – to identify borrowers that rely on the coal mines. For these mortgages, F recognises a loss allowance equal to lifetime expected credit losses.

However, F continues to recognise a loss allowance equal to 12-month expected credit losses for newly originated loans to borrowers who rely on the coal mines, because these have not experienced a significant increase in credit risk since initial recognition.

*IFRS 9.B5.5.6*

If an entity is not able to form, on the basis of shared credit risk characteristics, a group of financial instruments for which credit risk is considered to have increased significantly, but is able to identify a significant increase in credit risk for a portion of a group, then it recognises lifetime expected credit losses on this portion.

The following example demonstrates an assessment of a significant increase in credit risk on a collective basis when an entity is not able to group financial instruments for which the credit risk has increased significantly based on shared risk characteristics, but is able to estimate a portion of a portfolio on which credit risk has increased significantly.

**Example – Significant increases in credit risk for a portion of a portfolio***IFRS 9.IE39*

Bank G originates a homogeneous portfolio of 100 variable interest rate mortgage loans. Historically, an increase in interest rates has been a lead indicator of future defaults on similar mortgages. G does not have information on individual mortgages (except for past-due information) that would indicate a significant increase in credit risk, and is not able to group them on the basis of shared risk characteristics for this purpose.

Therefore, G assesses whether there is a significant increase in the credit risk of mortgages in the portfolio on a collective basis using information on expected increases in interest rates during the expected life of the mortgages.

Based on historical information, G estimates that an increase in interest rates of 1% will cause a significant increase in credit risk on 10% of the portfolio. None of the mortgage loans are past due.

Therefore, as a result of an anticipated increase in interest rates of 1%, G determines that there has been a significant increase in credit risk on 10% of the portfolio. Accordingly, G recognises lifetime expected credit losses on 10% of the portfolio and 12-month expected credit losses on 90% of the portfolio.

**12.3.4.2.2****Assessment by comparison with the maximum initial credit risk in a portfolio***IFRS 9.BC5.161*

The basis for conclusions indicates that the assessment of significant increases in credit risk could be implemented more simply for some groups of financial instruments by:

- establishing the maximum credit risk for the particular portfolio on initial recognition – e.g. by product type and/or region – that will not require the recognition of lifetime expected credit losses; and then
- comparing the credit risk of financial instruments in that portfolio at the reporting date with that maximum credit risk.

*IFRS 9.BC5.161*

However, this approach would only be possible if all of the financial instruments in the portfolio have a similar credit risk at initial recognition – e.g. a credit rating within a relatively narrow band. If this were not the case, it would not be possible to identify a single credit rating that would reflect a significant increase in credit risk for all assets.

IFRS 9 provides the following example to illustrate this point.

**Example – Assessment by comparison with the maximum initial credit risk***IFRS 9.IE40–IE42*

Bank N has a portfolio of automobile loans. N assigns an internal credit risk rating from 1 to 10 to each loan on origination, with 1 denoting the lowest credit risk and 10 denoting the highest credit risk. The risk of default occurring increases exponentially – meaning that the difference between Grades 1 and 2 is smaller than that between Grades 2 and 3, etc.

Loans in the portfolio are offered only to existing customers with an internal credit rating of 3 or 4 at initial recognition. Therefore, 4 is the maximum internal credit rating grade that N will accept for this portfolio of loans. N determines that all loans in the portfolio have a similar initial credit risk at initial recognition because they are graded either 3 or 4.

N deems that a change from Grade 3 to Grade 4 does not represent a significant increase in credit risk, but a change from Grade 4 to Grade 5 does represent a significant increase in credit risk. Therefore, a significant increase in credit risk occurs for each loan in the portfolio when its internal credit rating deteriorates beyond Grade 4 after initial recognition.

This means that N does not have to know the initial credit risk rating of each loan in the portfolio to assess the change in credit risk since initial recognition, but needs only to determine whether the credit risk rating of each loan in the portfolio is worse than Grade 4 at the reporting date.

However, N could not apply this approach with respect to a maximum initial credit risk of 7 for another portfolio in which loans are originated with an initial credit risk rating between 4 and 7, because this range of initial credit risk ratings is too wide.

### 12.3.4.3

#### Exception for assets with low credit risk

*IFRS 9.5.5.10,  
BC5.183–184*

As an exception from the general requirements, an entity may assume that the criterion for recognising lifetime expected credit losses is not met if the credit risk on the financial instrument is low at the reporting date. The IASB notes in the basis for conclusions that an entity can choose to apply this simplification on an instrument-by-instrument basis.

*IFRS 9.B5.5.22*

IFRS 9 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.

*IFRS 9.B5.5.23*

IFRS 9 states that a financial instrument with an external rating of 'investment grade' is an example of an instrument that may be considered to have low credit risk. However, a financial instrument does not have to be externally rated for the exception to apply. When an internal grade is used to determine whether the credit risk of an instrument is low, the internal assessment of low credit risk should equate to a globally understood definition of low credit risk for the risks and type of financial instrument being assessed. The assessment should be consistent with the perspective of a market participant, and should take into account all of the terms and conditions of the financial instruments.

*IFRS 9.B5.5.22*

A financial instrument is not considered to have a low credit risk simply because:

- the value of collateral results in a low risk of loss – this is because collateral usually affects the magnitude of the loss when default occurs, rather than the risk of default; or
- it has a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction in which the entity operates.

*IFRS 9.B5.5.24*

The low credit risk exception does not mean that there is a bright-line trigger for the recognition of lifetime expected credit losses when an instrument's credit risk ceases to be low. Instead, when an instrument no longer has low credit risk, the general requirements to assess whether there has been a significant increase in credit risk apply (see 12.3.4.1).

#### Observations – Low credit risk

*IFRS 9.B5.5.23, IE27*

##### Using external ratings to determine whether credit risk is low

IFRS 9 states that a financial instrument with an external rating of 'investment grade' is an example of an instrument that may be considered to have low credit risk.

However, an external rating is a lagging indicator, as it does not reflect events that occur or other relevant information that becomes available after the ratings agency last updated its rating. In addition, the definition of default used by a ratings agency may not be consistent with the definition used by the entity (see 'Observation – Definition of 'default' and its impact on applying the model' in 12.3.2.3).

Therefore, in order to conclude that an instrument with an external rating equivalent to 'investment grade' has low credit risk, the entity will need to consider whether there is evidence of an increase in credit risk that is not yet reflected in the rating.

### Application of the low credit risk exception for different assets

Entities will have to decide whether and how to apply the low credit risk exception to the specific assets that they hold, taking into account the internal credit ratings that they use. For example, banks will have to decide whether and how to apply it to corporate loans and other loans that are not externally rated.

Application of the low credit risk exception to retail loans may be very challenging in practice. For example, after initial recognition of such loans, the lender does not usually have up-to-date, detailed information on the credit risk and prospects of each borrower, so it may not be possible to demonstrate that the low credit risk definition is satisfied for each borrower.

Conversely, the low credit risk exemption will be a useful simplification in applying the new impairment model to debt securities that are rated externally.

#### 12.3.4.4 Payments that are more than 30 days past due

*IFRS 9.5.5.11, B5.5.2* IFRS 9 contains a rebuttable presumption that the condition for recognising lifetime expected credit losses 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 information that is more forward-looking than data about past-due payments is available without undue cost or effort, it should be considered in determining whether there has been a significant increase in credit risk, and the entity cannot rely solely on past-due data. For example, this information could be available at a portfolio level (see 12.3.4.2).

*IFRS 9.B5.5.19* IFRS 9 clarifies that this presumption is not an absolute indicator, but is presumed to be the latest point at which lifetime expected credit losses should be recognised, even when using forward-looking information.

*IFRS 9.5.5.11, B5.5.20* The presumption can be rebutted only if an entity has reasonable and supportable information demonstrating that even if contractual payments are more than 30 days past due, this does not represent a significant increase in credit risk. This might be the case if:

- non-payment was an administrative oversight instead of resulting from the borrower's financial difficulty; or
- historical evidence demonstrates that there is no correlation between a significant increase in the risk of default on financial assets and payments on them being more than 30 days past due; however, it does identify such a correlation for financial assets on which payments are more than 60 days past due.

#### 12.3.4.5 Information used for the assessment

*IFRS 9.5.5.4, B5.5.15–17* To assess whether there has been a significant increase in credit risk, an entity considers reasonable and supportable information that is available without undue cost or effort (see 12.4.6), and is relevant for the particular financial instrument being assessed. IFRS 9 sets out many examples of different sources of information and indicators that could be used.

*IFRS 9.B5.5.16* IFRS 9 states that credit risk analysis is a multi-factor and holistic analysis. Whether a specific factor is relevant, and its weight compared with other factors, will depend on:

- the type of financial instrument;
- the characteristics of the financial instrument; and
- the geographical region.

*IFRS 9.B5.5.16* Some of these factors or indicators may not be identifiable at an individual financial instrument level, but can and should be assessed for portfolios (or groups or portions of portfolios) (see 12.3.4.2).

*IFRS 9.B5.5.18*

IFRS 9 states that 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 types of information are relevant:

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

#### Observation – Information used in identifying a significant increase in credit risk

*IFRS 9.B5.5.17*

IFRS 9 allows a variety of information to be used in assessing whether there has been a significant increase in credit risk. It appears that this flexibility allows entities with sophisticated credit risk systems to use the sophisticated information available to them, and entities with simpler systems and processes to use simpler information. As a result, the timing of the transfer of a financial instrument to a lifetime expected credit losses measurement may depend not only on the entity's definition of the increase in credit risk that it considers significant, but also on the sophistication of its systems and processes.

However, any systems or processes used to generate the required information will have to meet the overall requirement to use reasonable and supportable information that is available without undue cost or effort.

#### Observation – Information available without undue cost or effort

*IFRS 9.IE26*

The information that is available without undue cost or effort may vary, depending on the type of financial instrument. If a lender has a direct relationship with a borrower, and the borrower prepares regular financial information that is made available to the lender, then it will be appropriate for the lender to use this information to make the estimates required by IFRS 9.

In other cases, an entity may be an investor in a quoted bond and may not have a one-to-one relationship with the borrower. In these circumstances, the lender could use only information that is publicly available – e.g. public announcements by the issuer of the bond, or reports by credit agencies.

### 12.3.4.6

#### Modified financial assets

*IFRS 9.5.5.12*

IFRS 9 provides guidance on estimating expected credit losses for financial assets that have been modified. If the contractual cash flows of a financial asset are modified, then the entity is required to distinguish between:

- a modification that results in derecognition; and
- a modification that does not result in derecognition (see 11.5.1).

*IFRS 9.5.5.12*

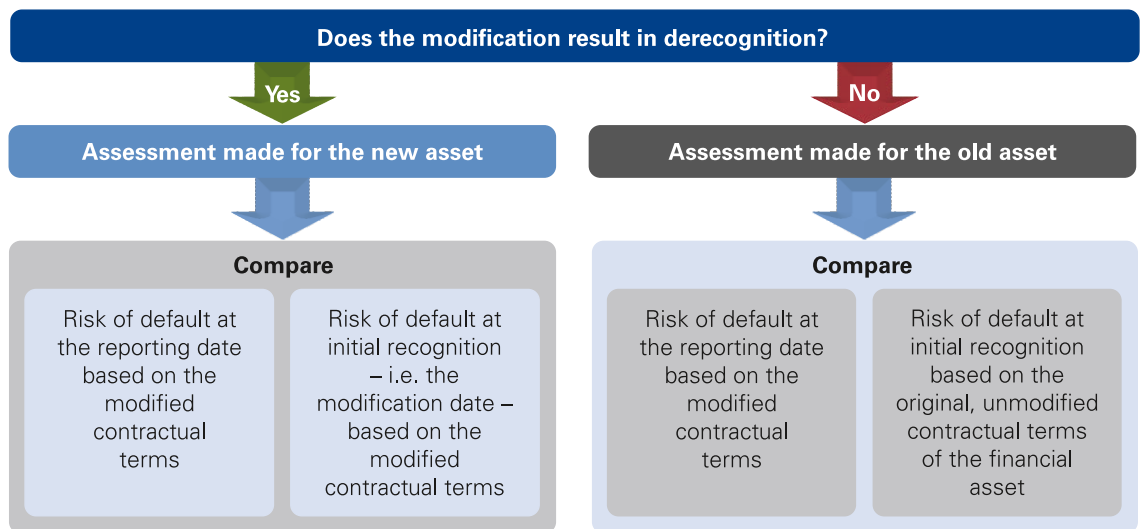
If the modification does not result in derecognition, then the subsequent assessment of whether there is a significant increase in credit risk is made by comparing:

- the risk of default at the reporting date based on the modified contractual terms of the financial asset; with
- the risk of default at initial recognition based on the original, unmodified contractual terms of the financial asset.

*IFRS 9.B5.5.25–26*

If the modification of a financial asset results in derecognition, then the modified asset is considered to be a new asset. Accordingly, the date of modification is treated as the date of initial recognition for the purposes of the impairment requirements.

The following diagram illustrates the assessment of whether the credit risk on a modified financial asset has increased significantly.



#### IFRS 9.B5.5.27

If the modification of a financial asset does not result in derecognition, then the modified asset should not be considered automatically to have lower credit risk merely because its cash flows have been modified. IFRS 9 states that, for an asset that is modified while having an allowance equal to lifetime expected credit losses, an example of evidence that the criteria for recognising lifetime expected credit losses are no longer met includes a history of up-to-date and timely payment performance against the modified contractual terms. Typically, a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to be improved – e.g. a history of missed or incomplete payments would not typically be ignored if the customer made one payment on time following the modification.

#### Example – Modified financial assets evaluated on the basis of past-due information

A lender cannot automatically assume that a modified asset has lower credit risk than the original unmodified asset, just because the loan is no longer past due. This is illustrated in the following example.

Lender L has a portfolio of retail loans for which it applies the presumption that the credit risk increases significantly if the loan is more than 30 days past due (see 12.3.4.4). One of the borrowers (Borrower B) is experiencing some difficulty in meeting the contractual payments, and so L modifies the contract by extending the maturity of the loan and reducing the monthly payments. The modification does not result in derecognition. At the time of the modification, the loan is 60 days in arrears. Following the modification, B is meeting the new contractual payments. L will have to exercise judgement – taking into account all reasonable and supportable information (e.g. historical experience on forbearance activities) – to determine whether the modified loan continues to meet the 'significant increase in credit risk' criterion.

#### IFRS 9.B5.5.26

IFRS 9 notes that in some unusual circumstances following a modification that results in derecognition, there could be evidence that the modified financial asset is credit-impaired at initial recognition – e.g. when there is a substantial modification of a distressed asset. For the accounting for such assets, see 12.6.

**12.3.4.7**

**Financial assets that have been reclassified**

*IFRS 9.B5.6.2*

If a financial asset has been reclassified out of the FVTPL measurement category into the amortised cost or FVOCI measurement category (see 8.3), then, for the purpose of assessing whether there has been a significant increase in credit risk, the reclassification date is treated as the date of initial recognition. Therefore, only changes in the asset’s credit risk following the reclassification date are considered.

Type of reclassification	Assessing significance of increase in credit risk
<p>The diagram shows two horizontal arrows pointing from left to right. The top arrow starts with a light blue rounded rectangle labeled 'FVTPL' and ends with a green rounded rectangle labeled 'Amortised cost'. The bottom arrow starts with a light blue rounded rectangle labeled 'FVTPL' and ends with a red rounded rectangle labeled 'FVOCI'.</p>	<p>Compare the credit risk at the reporting date to the credit risk at the reclassification date.</p>

*IFRS 9.B5.6.1(b)*

However, when a financial asset is reclassified between the amortised cost and FVOCI measurement categories (in either direction), then the credit risk at the asset’s original date of initial recognition (rather than the reclassification date) will continue to be used for assessing changes in credit risk. This is because both categories are subject to the same impairment model under IFRS 9 (see ‘Observation – FVOCI category’ in 12.1.1).

Type of reclassification	Assessing significance of increase in credit risk
<p>The diagram shows two horizontal arrows pointing from left to right. The top arrow starts with a green rounded rectangle labeled 'Amortised cost' and ends with a red rounded rectangle labeled 'FVOCI'. The bottom arrow starts with a red rounded rectangle labeled 'FVOCI' and ends with a green rounded rectangle labeled 'Amortised cost'.</p>	<p>Compare the credit risk at the reporting date to the credit risk at the date of initial recognition.</p>

*IFRS 9.B5.6.2*

If a financial asset is reclassified from the amortised cost or FVOCI measurement category into the FVTPL measurement category, then an impairment assessment no longer has to be performed.

Type of reclassification	Assessing significance of increase in credit risk
<p>The diagram shows two horizontal arrows pointing from left to right. The top arrow starts with a green rounded rectangle labeled 'Amortised cost' and ends with a light blue rounded rectangle labeled 'FVTPL'. The bottom arrow starts with a red rounded rectangle labeled 'FVOCI' and ends with a light blue rounded rectangle labeled 'FVTPL'.</p>	<p>Not applicable – assets measured at FVTPL do not carry a loss allowance.</p>

**Observation – Reclassifications into and out of the FVTPL measurement category**

At the reclassification date, the fair value of a financial asset reclassified from FVTPL into the amortised cost or FVOCI measurement category becomes its new gross carrying amount (see 8.3). At the next reporting date, an impairment loss is initially recognised for the asset. Therefore, similar to the origination or acquisition of a new financial asset that is initially classified as measured at amortised cost or FVOCI, a day one loss will result from this type of reclassification if the asset is not credit-impaired at the reclassification date (see 12.6). For further discussion of day one losses, see ‘Observation – Day one loss’ in 12.3.1.

By contrast, if an asset is reclassified from amortised cost or FVOCI to FVTPL, the fair value at the reclassification date will become the new carrying amount, but an impairment allowance will no longer be necessary. Therefore, a credit to profit or loss will arise relating to the reversal of the loss allowance previously associated with the reclassified asset.

**Example – Reclassifications out of FVTPL and into the amortised cost measurement category**

IFRS 9.IE104–IE107,  
IE110

Company C purchases a portfolio of bonds for 500 and classifies them as measured at FVTPL. In the next reporting period, C changes its business model such that the bonds are held in order to collect the contractual cash flows; accordingly, C reclassifies the portfolio into the amortised cost measurement category.

Assume that at the reclassification date:

- the fair value of the bonds is 490;
- the 12-month expected credit losses of the portfolio are estimated to be 4; and
- the bonds are not credit-impaired (see 12.6.1).

C records the following entries at the reclassification date.

	Debit	Credit
Bonds (at amortised cost)	490	
Bonds (at FVTPL)		490
Impairment expense (profit or loss)	4	
Loss allowance		4

The day one loss on the reclassification date is equal to the amount of 12-month expected credit losses at that date.

## 12.4

## Measurement of expected credit losses

### 12.4.1

### Overview

IFRS 9 Appendix A,  
B5.5.28

Expected credit losses are a probability-weighted estimate of credit losses over the expected life of the financial instrument (see 12.4.3). Credit losses are the present value of expected cash shortfalls (see 12.4.2).



IFRS 9.5.5.17

The measurement of expected credit losses should reflect:

- an unbiased and probability-weighted amount (see 12.4.4);
- the time value of money (see 12.4.5); and
- reasonable and supportable information that is available without undue cost or effort (see 12.4.6).

IFRS 9.B5.5.12

IFRS 9 does not prescribe a single method to measure expected credit losses. Rather, it acknowledges that the methods used to measure expected credit losses may vary based on the type of financial asset and the information available.

IFRS 9.B5.5.35

The standard allows entities to use practical expedients when estimating expected credit losses, provided that they are consistent with the principles above. It gives an example of such an expedient – i.e. a provision matrix to measure expected credit losses for trade receivables (see 12.7.3.3).

#### Observation – No practical expedient to measure impairment at fair value

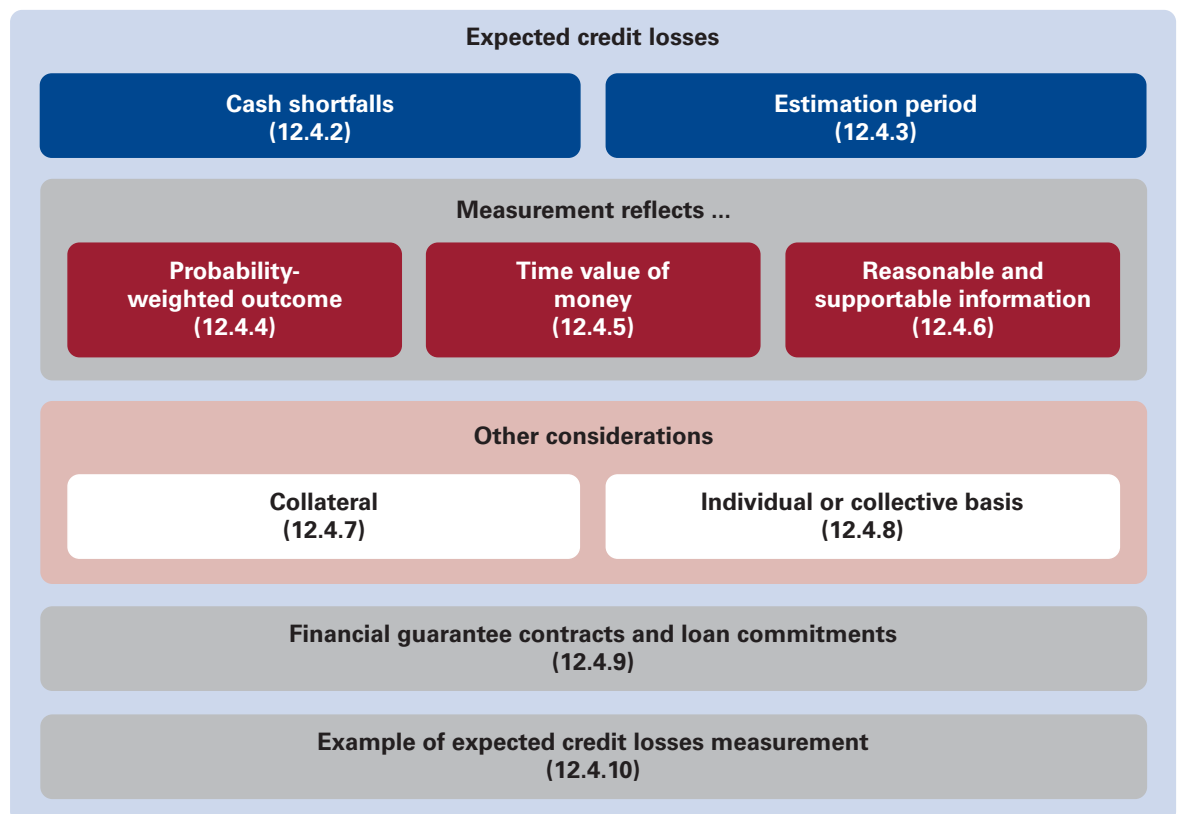
IAS 39.AG84,  
IFRS 9.B5.5.54

IFRS 9 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 requires that, as part of considering all reasonable and supportable information in measuring expected credit losses, an entity also considers observable market information about credit risk (see 12.4.6).

IFRS 9.5.5.8

The impairment loss (or reversal) recognised in profit or loss is the amount required to adjust the loss allowance to the appropriate amount at the reporting date.

The following topics are covered in the remainder of this section.



## 12.4.2 Definition of 'cash shortfall'

### 12.4.2.1 Overview

IFRS 9.B5.5.28

A cash shortfall is the difference between:

- the cash flows due to the entity in accordance with the contract; and
- the cash flows that the entity expects to receive.

Because estimation of credit losses considers the amount and timing of payments, a cash shortfall would arise even if the entity expects to be paid in full but later than the date on which payment is contractually due. This delay would give rise to an expected credit loss – except to the extent that the entity expects to receive additional interest in respect of the late payment that compensates it for the delay at a rate at least equal to the EIR.

IFRS 9 Appendix A, B5.5.43

For measuring 12-month and lifetime expected credit losses (see 12.3.2), cash shortfalls are identified as follows.

Type of loss allowance	Cash shortfalls
<b>12-month expected credit losses</b>	Those resulting from default events that are possible in the next 12 months (or a shorter period if the expected life is less than 12 months), weighted by the probability of that default occurring
<b>Lifetime expected credit losses</b>	Those resulting from default events that are possible over the expected life of the financial instrument, weighted by the probability of that default occurring

IFRS 9.B5.5.28

The term 'cash shortfall' refers to overall shortfalls against contractual terms, and not just shortfalls on particular dates when cash is received or due. Therefore, cash shortfalls consider later recoveries of missed payments as shown in the following example.

#### Example – Definition of 'cash shortfall'

On 31 January 2015, Company V originates a two-year loan with a principal of 100 and a 5% coupon payable annually. On 31 December 2015, V estimates that, if the borrower were to default, the estimated future cash flows would be as follows.

Date	Contractual cash flows	Expected cash flows	Shortfall
31 January 2016	5	3	2
15 February 2016	-	2	(2)
31 January 2017	105	70	35
31 March 2017	-	20	(20)

All shortfalls – i.e. both positive and negative amounts – are included in the measurement of the expected credit losses for the loan.

### Observation – Negative cash shortfalls

The standard does not provide specific guidance for cases in which the net present value of all cash shortfalls is expected to be negative – e.g. if the entity expects to recover additional interest as a penalty due to late payment.

#### 12.4.2.2

#### Loan commitments

*IFRS 9.B5.5.30*

For undrawn loan commitments, a cash shortfall is the difference between:

- the contractual cash flows that are due to an entity if the holder of the loan commitment draws down the loan; and
- the cash flows that the entity expects to receive if the loan is drawn down.

*IFRS 9.B5.5.31*

When estimating the drawn-down cash flows, the relevant amounts for each type of loss allowance are as follows.

Type of loss allowance	Drawn-down cash flows
<b>12-month expected credit losses</b>	Those that are expected to be drawn down in the next 12 months
<b>Lifetime expected credit losses</b>	Those that are expected to be drawn down during the life of the loan commitment

### Observation – Estimating future draw-downs

*IFRS 9.BC5.243–247*

The IASB acknowledges that the requirement to estimate future draw-downs for loan commitments would cause additional complexity, due to the uncertainty involved in estimating the behaviour of customers, especially over a long period. However, it notes that removing the requirement would cause an arbitrage between on- and off-balance sheet instruments.

The IASB notes that many financial institutions already provide similar information to regulators, and use it for internal credit risk management purposes. However, the existing information – and related processes and systems – may have to be adjusted to reflect the potentially different requirements in the new standard. For example, the new standard requires that draw-downs of loan commitments other than certain revolving credit facilities be determined over a period not longer than that for which the entity has a contractual obligation to extend credit, and not the period over which the entity expects to extend credit (see 12.4.3).

Banks' credit risk management systems often consider the full credit limit when estimating credit losses. This is because experience often indicates that when the receivable – e.g. a credit card loan – becomes problematic, the full amount of the credit limit has often been used.

#### 12.4.2.3

#### Financial guarantee contracts

*IFRS 9.B5.5.32*

For financial guarantee contracts, a cash shortfall is the difference between:

- the expected payments to reimburse the holder for a credit loss that it incurs; and
- any amount that an entity expects to receive from the holder, the debtor or any other party.

If the asset is fully guaranteed, then the estimation of cash shortfalls will be consistent with the estimation of cash shortfalls for the asset subject to the guarantee.

## 12.4.3 The estimation period – the expected life of the financial instrument

### 12.4.3.1 General requirements

*IFRS 9.5.5.19, B5.5.38* The maximum period over which expected credit losses are measured is the contractual period, or a shorter period – e.g. as a result of prepayments – over which there is exposure to credit risk on the financial instrument. This is the case even if a longer period is consistent with business practice. For loan commitments and financial guarantee contracts, this is the maximum contractual period over which an entity has a present contractual obligation to extend credit.

#### Observation – Maximum contractual period over which the entity is exposed to credit risk

Banks make different types of commitments to extend credit with different terms and conditions. Sometimes, the contractual period over which the entity is exposed to credit risk from those commitments may not be clear.

A lender may have a contingent right to withdraw a facility – e.g. when there has been a deterioration in the credit condition of the potential borrower. Careful analysis may be needed to determine the contractual period over which the entity is exposed to credit risk from those facilities.

### 12.4.3.2 Certain financial instruments that include both a loan and an undrawn commitment component

*IFRS 9.5.5.20, B5.5.39* Certain financial instruments include both a loan and an undrawn commitment component, and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit its exposure to credit losses to the contractual notice period.

*IFRS 9.B5.5.39* An example of such an instrument is a revolving credit facility, such as a credit card or an overdraft facility. These facilities can be contractually withdrawn by the lender with little notice – e.g. one day; however, in practice lenders continue to extend credit for a longer period and may only withdraw the facility after the credit risk of the borrower increases – i.e. when they become aware of adverse changes in the credit risk of the borrower – which could be too late to prevent some or all of the expected credit losses.

*IFRS 9.5.5.20* For such instruments (and only for such instruments), an entity measures expected credit losses over the period for which it is exposed to credit risk – and for which expected credit losses would not be mitigated by credit risk management actions – even if that period extends beyond the maximum contractual period.

*IFRS 9.B5.5.39* IFRS 9 explains that such instruments generally have the following characteristics:

- they do not have a fixed term or repayment structure, and usually have a short contractual cancellation period – e.g. one day;
- the contractual ability to cancel the contract is not enforced in the entity's normal day-to-day management activities, but only when the entity becomes aware of an increase in the credit risk at the facility level; and
- they are managed on a collective basis.

*IFRS 9.B5.5.40* When determining the period over which to estimate expected credit losses for such instruments, an entity should consider factors such as historical information and experience about:

- the period over which the entity was exposed to credit risk on similar financial instruments;
- the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and
- the credit risk management actions that the entity expects to take once the credit risk on the financial instrument has increased – e.g. the reduction or removal of undrawn limits.

### Observation – Period of estimation of expected credit losses for revolving facilities

*IFRS 9.5.5.20, B5.5.39, BC5.257–258*

The 2013 impairment ED proposed that the estimation of expected credit losses for all facilities should consider only the contractual period over which the entity is committed to provide credit.

However, for certain types of facilities, although contractually the lender may withdraw the credit line on demand or ask for an immediate repayment of the drawn balance, the lender would not normally have information on when it would be advisable to do so. Often, the key monitoring tool for such financial instruments is an 'overdue status', and by the time the loan is overdue, impairment losses may already have occurred. In addition, the contractual maturities are often set for protective reasons and are not actively enforced as part of the entity's normal credit risk management processes.

During redeliberations, the IASB noted that – for such facilities – the contractual ability to demand repayment and cancel the undrawn commitment would not necessarily limit an entity's exposure to credit losses to the contractual notice period. This is because the entity's exposure to credit losses during only the contractual notice period would not reflect the actual expectation of losses and the way in which those facilities are managed for credit risk purposes. Therefore, the IASB decided that, as an exception to the general guidance, for facilities that meet certain conditions, the period over which expected credit losses are determined should not be limited to the contractual period over which the entity is committed to provide credit.

However, application of some of the conditions is not clear and may require judgement. Paragraph 5.5.20 of IFRS 9, which introduces the exception, states that: "some financial instruments include both a loan and an undrawn commitment". This seems to indicate that in order for the exception to apply, a facility has to have both the drawn and undrawn component. However, in many cases, at a particular point in time a facility may only have an undrawn component but meet all of the conditions in paragraph B5.5.39 of IFRS 9. This would often be the case for a credit card facility, which is an example of an instrument to which the exception appears to be intended to apply.

Paragraph B5.5.39 explains that financial instruments qualifying for the exception generally possess certain characteristics, but does not state that these are necessary qualifying characteristics that have to be present in all cases. One of the characteristics in paragraph B5.5.39 is that the instruments are managed on a collective basis. However, the standard does not explain what the term 'managed on a collective basis' means.

### Example – Measurement of expected credit losses for a period longer than the contractual maximum period of the commitment

*IFRS 9.IE58–IE64*

Bank T provides credit cards to its customers. For credit risk management purposes, T does not distinguish between the drawn and undrawn balances. The credit cards have a one-day notice period, after which T has a contractual right to cancel the credit card; however, T does not enforce this right in its day-to-day management activities, but only cancels facilities when it becomes aware of an increase in credit risk and starts to monitor customers on an individual basis. Therefore, T does not consider its exposure to credit losses to be limited to the notice period.

On the basis of historical information and experience with similar portfolios, T determines that the expected period over which it is exposed to credit losses is 30 months.

At the reporting date, the outstanding balance on the credit card portfolio is 60, and the available undrawn balance is 40. In measuring the expected credit losses, T considers its expectations about future draw-downs over the expected life of the portfolio (or over the next 12 months if there has not been a significant increase in credit risk) using its credit risk models.

T determines that the exposure at default would be 70 (comprising the drawn balance of 60 and an additional 10 from the available undrawn balance), and T uses this exposure to measure the expected credit losses on the credit card portfolio.

This example does not consider the impact on the measurement of whether there has been a significant increase in credit risk in the portfolio or part of it. For discussion of identifying significant increases in credit risk at a portfolio level, see 12.3.4.2.

## 12.4.4 Probability-weighted outcome

*IFRS 9.5.5.17(a),  
5.5.18, B5.5.41*

The estimate of expected credit losses reflects an unbiased and probability-weighted amount, determined by evaluating a range of possible outcomes rather than based on a best- or worst-case scenario.

An entity is not required to identify every possible scenario, but the estimate should always reflect at least two scenarios:

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

*IFRS 9.B5.5.42*

IFRS 9 explains that, in practice, the requirement to consider at least two scenarios may not necessitate a complex analysis. In some cases, relatively simple modelling will be sufficient, without the need for a large number of detailed simulations of scenarios. The standard gives an example of a large group of financial instruments with shared risk characteristics, for which the average credit losses may be a reasonable estimate of the probability-weighted amount.

### Observation – Probability-weighted outcome

*IAS 39.AG86,  
IFRS 9.BC5.263*

IAS 39 allows the estimation process for impairment losses to result either in a single amount or in a range of possible amounts. In the latter case, the entity is required to recognise the best estimate within the range. By contrast, IFRS 9 does not allow expected credit losses to be measured using the most likely outcome or as the entity's best estimate of the ultimate outcome; rather, it requires the measurement to reflect the probability-weighted outcome.

### Observation – Explicit scenarios in calculating expected credit losses

*IFRS 9.B5.5.42*

IFRS 9 acknowledges that in some cases it will not be necessary to develop explicit scenarios. However, in each case, an entity will have to evaluate whether its proposed approach meets the general requirement that the loss estimate reflects an unbiased and probability-weighted amount.

## 12.4.5 Time value of money

*IFRS 9.5.5.17(b),  
B5.5.44–48*

The estimate of expected credit losses has to reflect the time value of money. The following discount rates are used to reflect the time value of money.

	Type of instrument	Discount rate
<i>IFRS 9.5.4.1(b), B5.5.44</i>	<b>Financial assets other than POCI assets and lease receivables</b>	The EIR determined at initial recognition or an approximation thereof (the current EIR for floating-rate financial assets)
<i>IFRS 9.5.4.1(a), B5.5.44</i>	<b>POCI assets</b>	The credit-adjusted EIR determined at initial recognition (see 11.2.2)
<i>IFRS 9.B5.5.46</i>	<b>Lease receivables</b>	The discount rate used in measuring the lease receivable in accordance with IAS 17
<i>IFRS 9.B5.5.47</i>	<b>Undrawn loan commitments</b>	The EIR, or an approximation thereof, that will be applied to discount the financial asset resulting from the loan commitment
<i>IFRS 9.B5.5.48</i>	<b>Undrawn loan commitments for which the EIR cannot be determined, and financial guarantee contracts</b>	The discount rate that reflects the current market assessment of the time value of money and the risks that are specific to the cash flows (but only if, and to the extent that, the risks are taken into account by adjusting the discount rate instead of adjusting the cash shortfalls being discounted)

*IFRS 9.B5.5.44* Expected credit losses are discounted to the reporting date, not to the expected default date or another date.

#### Observation – Using the EIR, or an approximation thereof, for discounting

The ability under IFRS 9 to use an approximation of the EIR is a welcome simplification that will reduce the operational challenge of implementing the standard while minimising the potential effect on comparability.

#### Observation – Determining the discount rate for loan commitments

*IFRS 9.B5.5.47*

Under IFRS 9, the discount rate used to calculate the expected credit losses for a loan commitment is the EIR (or an approximation thereof) that would apply to the financial asset resulting from the loan commitment.

To calculate the EIR that would apply to the financial asset resulting from the loan commitment, an entity needs to determine what the transaction price and/or the fair value of the asset will be on initial recognition (see 11.2.1).

Determining these amounts at initial recognition may depend on whether the loan is treated as:

- a continuation of the commitment (in which case, fair value is measured at the time of entering into the commitment); or
- an instrument separate from the loan commitment (in which case, fair value is measured at the time when the loan is made).

IAS 39 does not specify which of the above approaches is appropriate. IFRS 9 states that, for the purpose of applying the impairment requirements, a financial asset that is recognised following a draw-down on a loan commitment is treated as a continuation of that commitment, rather than a new financial instrument – but the new standard does not specify whether a similar logic applies for the initial measurement of the gross carrying amount of the loan.

## 12.4.6 Reasonable and supportable information

### 12.4.6.1 General requirements

*IFRS 9.5.5.17(c),  
B5.5.49*

IFRS 9 requires the estimates of expected credit losses 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. Information that is available for financial reporting purposes is considered to be available without undue cost or effort.

*IFRS 9.B5.5.50*

The 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 expected credit losses increases. An entity is not required to forecast future conditions over the entire expected life of the financial instrument. For periods far in the future, an entity could develop projections by extrapolating the information that is available for earlier periods.

*IFRS 9.B5.5.51*

An entity is not required to undertake an exhaustive search for information but needs to consider all reasonable and supportable information that is available without undue cost or effort that is relevant for the estimation.

The information used should include:

- factors that are specific to the borrower; and
- general economic conditions, including assessment of both the current conditions and the forecast direction of the change of conditions.

The standard gives examples of the following potential data sources:

- internal historical credit loss experience;
- internal and external ratings;
- the credit loss experience of other entities; and
- external reports and statistics.

*IFRS 9.B5.5.52*

An entity reviews the methodology and assumptions used for estimating expected credit losses regularly, to reduce any differences between estimates and actual credit losses.

#### Observation – Wider and more complex judgements

The judgements required under IFRS 9 may be wider and significantly more complex than under IAS 39.

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 IFRS 9's new expected credit loss model, estimates are needed for all financial assets. 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 as to future economic conditions; therefore, management will have to develop robust methodologies to ensure that their conclusions are reasonable and supportable, and that judgement is applied consistently.

### 12.4.6.2 Historical information

*IFRS 9.B5.5.52*

Historical information is an important base from which to measure expected credit losses. This base is adjusted on the basis of current observable data to reflect 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 such information and when it was calculated, compared to circumstances at the reporting date.

*IFRS 9.B5.5.53*

If expected credit losses are estimated using historical credit loss experience, then information about historical loss rates has to be applied to groups that are defined in a manner that is consistent with the groups for which the historical loss rates were observed.

*IFRS 9.B5.5.52*

The standard explains that estimates of changes in expected credit losses should reflect, and be directionally consistent with, changes in related observable data from period to period. Examples of such observable data are:

- unemployment rates;
- property prices;
- commodity prices;
- payment status; or
- other factors that are indicative of credit losses.

#### Example – Adjusting historical data to current economic conditions

Company Z has a portfolio of similar loans. Data about unemployment in Z's region is a key factor in estimating expected credit losses for these loans. Except for certain specific past-due exposures, Z has measured impairment in the portfolio as 12-month expected credit losses.

At the reporting date, the unemployment rate in the region is 8%. However, consensus estimates available to Z at the reporting date are that the unemployment rate will increase to 11% in the next 12 months. Accordingly, Z uses the 11% unemployment forecast in estimating expected credit losses for these loans. (Similarly, if consensus estimates were that the unemployment rate would reduce to 6%, then Z would use this data, which might cause a reduction in the loss allowance.)

In addition, Z considers whether, as a result of this forecast, the risk of default has increased such that a lifetime expected credit losses measurement is required for all, or a portion, of the portfolio (see 12.3.4).

### 12.4.6.3

#### Externally sourced information

*IFRS 9.B5.5.54*

Expected credit losses reflect an entity's own expectations of credit losses. However, an entity should also consider observable market information about the credit risk of the particular financial instrument or similar financial instruments.

#### Observation – Observable information about credit risk

*IFRS 9.B5.5.52–54*

Even though expected credit losses are an entity-specific estimation, IFRS 9 requires an entity to consider observable market information about credit risk. This may include market prices for the same or similar financial instruments.

However, when considering market information, market prices and credit spreads on financial assets do not directly yield an estimate of expected cash flows, because they include other elements – e.g. liquidity spreads or a premium for bearing the risk that credit losses may be greater than expected – and are not always observable. Therefore, using such information in the measurement of expected credit losses may be challenging and require judgement. In addition, IFRS 9 does not define the term 'observable' in this context.

### Observation – Debt instruments measured at FVOCI

*IFRS 9.B5.5.54*

Even though IFRS 9 requires an entity to consider observable market information about the credit risk of the particular financial instrument, the expected credit losses measurement for debt instruments that are measured at FVOCI is not necessarily the same as the fair value changes attributable to changes in credit risk recognised in OCI (see 10.1).

This is because expected credit losses are measured using the EIR (or an approximation thereof), rather than the market interest rate (see 12.4.5). Also, as noted above, expected credit losses reflect the entity's own expectations of credit losses informed by observable market information, rather than reflecting the views of market participants.

*IFRS 9.B5.5.51*

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).

## 12.4.7

### Collateral

*IFRS 9.B5.5.55*

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

*IFRS 9.B5.5.55*

Under IFRS 9, irrespective of whether foreclosure is probable the estimate of expected cash shortfalls on a collateralised financial asset reflects:

- the amount and timing of cash flows that are expected from foreclosure (including cash flows that are expected beyond the asset's contractual maturity); less
- costs for obtaining and selling the collateral.

### Observation – Cash flows resulting from foreclosure

*IAS 39.AG84, IG.E4.8*

The requirement that the estimate of expected cash flows for collateralised financial assets reflects the cash flows that may result from foreclosure is similar to the requirements in IAS 39.

However, under IAS 39 an entity may instead elect to measure impairment with reference to the fair value of the collateral at the reporting date – i.e. in effect, viewing any future changes in fair value as being irrelevant to determining the losses incurred at the reporting date.

Under the expected credit loss model in IFRS 9, it is clearer that the focus should be on the cash flows that the entity actually expects to receive in the future. Also, because expected cash flows are a probability-weighted estimate, they include possible scenarios in which the cash flows recoverable from collateral decrease (or, where relevant, increase).

In addition, because under IAS 39, some banks elect to measure impairment with reference to the fair value of the collateral, this may be an important change for them.

*IFRS 9.B5.5.55*

Similar to IAS 39, any collateral obtained as a result of foreclosure is not recognised as a separate asset unless it meets the recognition criteria in IFRS for the relevant asset. The following example illustrates the measurement of lifetime expected credit losses on a collateralised loan.

### Example – Measurement of lifetime expected credit losses of a collateralised loan

IFRS 9.IE18–IE23

Bank K holds a collateralised loan. K determines that the credit risk of the loan has increased significantly since initial recognition – i.e. the risk of default has increased significantly. However, as the value of the collateral is significantly higher than the amount due from the loan, the LGD is very small.

Although K does not believe that it is probable that it will suffer a credit loss if a default occurs, it recognises lifetime expected credit losses for the asset. This is because a significant increase in credit risk is assessed with reference to the risk of default rather than to the LGD. However, the amount of the loss would be very small, because the asset is expected to be fully recoverable through the collateral held under almost all possible scenarios.

## 12.4.8

### Individual or collective basis of measurement

IFRS 9.B5.5.4

IFRS 9 does not provide general guidance as to when expected credit losses should be measured on an individual or collective basis. However, it states that if an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime expected credit losses on an *individual* basis, then it measures lifetime expected credit losses on a *collective* basis, by considering comprehensive credit risk information.

IFRS 9.B5.5.4

In addition to using past-due information, this measurement should incorporate all relevant credit information – including forward-looking macro-economic information. This is required in order to approximate the result of recognising lifetime expected credit losses on an individual instrument level.

IFRS 9.B5.5.5

To measure expected credit losses on a collective basis, financial assets are grouped on the basis of shared credit risk characteristics. For examples of shared credit risk characteristics, see 12.3.4.2.1.

### Observation – Collective basis of assessment vs measurement

IFRS 9.B5.5.4–6

IFRS 9 refers to collective vs individual assessment in two separate contexts:

- when assessing whether an increase in credit risk is significant (see 12.3.4.2); and
- when measuring expected credit losses.

The standard does not state that both should be done on the same basis – i.e. individual or collective – for the same instruments.

Therefore, an asset might, for example, be evaluated for a significant increase in credit risk on an individual basis, but its expected credit losses be measured on a collective basis. For example, when an individual retail loan is more than 30 days past due (see 12.3.4.4), it may be considered that the credit risk on it has increased significantly, and that the lifetime expected credit losses measurement basis therefore applies. However, expected credit losses may be measured on a collective basis as part of a portfolio using information on portfolio default rates.

## 12.4.9

### Financial guarantee contracts and loan commitments

#### 12.4.9.1

#### Financial guarantee contracts

IFRS 9.4.2.1(c)

IFRS 9 requires liabilities that result from financial guarantee contracts in its scope to be measured, after initial recognition, at the higher of:

- the amount of the provision for expected credit losses; and
- the amount initially recognised (see Chapter 9), less the cumulative amount of income recognised in accordance with the principles of IFRS 15.

This 'higher of' approach is similar to that in IAS 39, except that under IAS 39 the provision for credit losses is calculated by applying IAS 37.

#### Observation – Measurement of expected credit losses for financial guarantee contracts

When an arm's length fee or premium for a financial guarantee is paid to the issuer in full at inception of the contract, no expected credit losses might be recognised in respect of the guarantee – either at initial recognition or subsequently – unless there are adverse developments. This is because:

- the amount initially recognised – i.e. the fair value of the financial guarantee – will reflect lifetime expected credit losses at that time; and
- expected credit losses on a good-quality instrument will usually decrease over time, so expected credit loss provisions calculated under IFRS 9 may generally be less than the amounts initially recognised, less the cumulative amount of income recognised under IFRS 15.

However, this may not be the case if the issuer of the guarantee is paid a fee or premium in installments over the life of the guarantee, rather than in full at inception. In this case, the fair value of the financial guarantee is likely to be zero at inception. Even though the definition of a cash shortfall for financial guarantee contracts (see 12.4.2.3) includes any amounts that the entity expects to receive, it is not clear whether this also includes future premium receipts. If they are not included, then it is likely that the amount of provision determined in accordance with IFRS 9 will always be higher than the fair value at initial recognition, which will result in the recognition of expected credit losses (and an impairment loss) at initial recognition and in subsequent periods.

This would mean that the recognition of an allowance for expected credit losses would depend on the manner in which the guarantee premium is collected.

#### Observation – Applying IFRS 15 principles to a financial guarantee contract

*IFRS 15.35*

IFRS 9 requires an entity to assess the cumulative amount of income recognised on a financial guarantee contract in accordance with the principles of IFRS 15. The general principle in IFRS 15 is that an entity recognises revenue to depict the transfer of goods and services to the customer, at an amount that reflects the consideration that it expects to be entitled to receive from the customer. However, IFRS 15 contains no specific guidance on how to apply this principle, or the more detailed requirements of IFRS 15, to financial guarantee contracts.

In the case of a financial guarantee contract, key practical questions are likely to include identifying the nature of the entity's obligation under the contract and assessing when that obligation is satisfied. There are two main possibilities under IFRS 15: an obligation may be satisfied over time (e.g. over the term of the contract) or at a point in time (e.g. on completion of the contract). If an obligation is satisfied over time, an entity identifies an appropriate method of measuring progress to complete satisfaction of the obligation.

### 12.4.9.2

#### Loan commitments issued with a below-market interest rate

*IFRS 9.4.2.1(d)*

Similar to the accounting for financial guarantee contracts, IFRS 9 retains a similar approach of measuring liabilities that result from commitments to provide a loan at a below-market interest rate after initial recognition at the higher of:

- the amount of the provision for expected credit losses; and
- the amount initially recognised (see Chapter 9), less the cumulative amount of income recognised in accordance with the principles of IFRS 15.

### Example – Loan commitment issued with a below-market interest rate

In practice, the accounting for loan commitments that are not measured at FVTPL may be different depending on whether the loan commitment is to provide a loan at or below a market interest rate. The following example illustrates this difference.

#### Below-market rate loan commitment

Company D issues a commitment to provide a loan at a below-market interest rate whose fair value on initial recognition is 10. D measures expected credit losses for the commitment at an amount equal to 12-month expected credit losses and estimates these to be 2.

On initial recognition, D records the loan commitment at its fair value of 10, which is the higher of:

- the provision for expected credit losses of 2; and
- the amount initially recognised (fair value of 10) less the cumulative amount of income recognised under IFRS 15 (zero, as the loan commitment has just been recognised).

No expected credit losses are recognised, because the fair value of the loan commitment is higher than the 12-month expected credit losses.

#### At-market rate loan commitment

Assume instead that D issued a loan commitment with an at-market interest rate for its fair value of 5, with the remaining facts unchanged. D would then record the fee received of 5 as a liability (see 11.2.1.2) and, in addition, would recognise a provision for expected credit losses of 2. This is because the specific measurement requirements for loan commitments issued with a below-market interest rate do not apply to other loan commitments issued.

#### Summary

This means that whether a provision for expected credit losses is recognised on a loan commitment may depend on whether the commitment is to provide a loan at or below a market interest rate.

## 12.4.10 Example of measurement of expected credit losses

IFRS 9 provides a number of illustrative examples. The following example illustrates a simple method of calculating both a 12-month expected credit loss allowance and a lifetime expected credit loss allowance.

### Example – Measurement of expected credit losses

IFRS 9.IE49–IE50

#### Fact pattern

Company X originates a 10-year loan for 1,000,000. The interest is paid annually. The loan's coupon and EIR are 5%.

#### Scenario 1 – Assume that recognition of 12-month expected credit losses is appropriate for this loan

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

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

The 12-month expected credit loss allowance is 1,250, which is calculated by multiplying the amount of cash flows receivable (1,050,000<sup>(a)</sup>) 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 that recognition of lifetime expected credit losses is appropriate for this loan**

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

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

The lifetime expected credit loss allowance is 47,619, which is calculated as  $(1,050,000 / 1.05^2)^{(b)} \times 20\% \times 25\%$ .

### **Summary**

The difference between calculating 12-month expected credit losses and lifetime expected credit losses 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 would be paid fully.

## 12.5

## Write-offs

*IFRS 9.5.4.4,  
B3.2.16(r), B5.4.9*

Under IFRS 9, the gross carrying amount of a financial asset is reduced when there is no reasonable expectation of recovery. A write-off constitutes a derecognition event. Write-offs can relate to a financial asset in its entirety, or to a portion of it.

*IFRS 9.BC5.81*

Although write-offs do not have an impact on profit or loss – because the amounts written off are reflected in the loss allowance – the standard notes that a definition of 'write-off' is needed to faithfully represent the gross carrying amount and for disclosure purposes.

### Observation – Derecognition of financial assets when a write-off event occurs

IAS 39.63

IAS 39 does not prescribe when the gross carrying amount of a financial asset should be reduced, other than under the general derecognition rules. Also, IAS 39 allows entities that do not use a loss allowance account to reduce the carrying amount of the asset directly to reflect impairment.

IFRS 9 changes this by requiring the use of a loss allowance account and the derecognition of the portion of an asset when the write-off criterion is met. In our experience, many entities – in particular, banks – carry loss allowance accounts and use write-off criteria similar to those described in IFRS 9. Accordingly, for these entities, implementing the new requirements may not lead to a significant change in existing practice. However, some banks have write-off criteria that are different from those in IFRS 9 – e.g. based on local legal requirements – and may therefore be impacted more by the new guidance on write-offs.

### Observation – Write-off of a portion of an asset

IFRS 9.3.2.2, B3.2.16(r),  
B5.4.9

IFRS 9 identifies a write-off as a derecognition event. It also explains that write-offs can relate to a financial asset in its entirety, or to a portion of it. As regards derecognition of a portion of an asset, under the general derecognition provisions of the standard, a part of a financial asset (rather than the whole asset) can be derecognised only if it comprises specifically identified cash flows or a fully proportionate share of the cash flows.

The standard provides the following example, which demonstrates a write-off that relates to a portion of an asset.

### Example – Write-off of a portion of an asset

IFRS 9.B5.4.9

Company R holds a collateralised financial asset and plans to foreclose the collateral.

R expects to recover no more than 30% of the financial asset from the collateral. R has no reasonable prospects of recovering any further cash flows from the financial asset. Therefore, it writes off the remaining 70% of the financial asset.

### Observation – Recovery of a written-off asset

IFRS 9.5.5.4

IFRS 9 does not discuss:

- whether a subsequent recovery should be accounted for as the recognition of a new financial asset;
- when a recovery should be recognised – e.g. on a change in the lender’s expectations, or on the receipt of cash; or
- how a recovery should be reflected in profit or loss.

## 12.6 Special approach for assets that are credit-impaired at initial recognition

### 12.6.1 Definition of 'credit-impaired' asset

*IFRS 9.5.5.13–14, Appendix A*

IFRS 9 sets out special rules for measuring the loss allowance and recognising interest revenue in respect of purchased or originated assets that are credit-impaired at initial recognition (purchased or originated credit-impaired or 'POCI' assets). An asset is credit-impaired if one or more events have occurred that have a detrimental impact on the estimated future cash flows of the asset. The definition lists the following examples of such events:

- significant financial difficulty of the issuer or the borrower;
- a breach of contract – e.g. a default or past-due event;
- a lender having granted a concession to the borrower – for economic or contractual reasons relating to the borrower's financial difficulty – that the lender would not otherwise consider;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase of a financial asset at a deep discount that reflects the incurred credit losses.

*IFRS 9 Appendix A*

It may not be possible to identify a single discrete event. Instead, the combined effect of several events may cause financial assets to become credit-impaired.

#### Observation – Interaction between definitions of 'credit-impaired' and 'default'

*IFRS 9 Appendix A, IFRS 9.5.5.37*

The definition of 'credit-impaired' under IFRS 9 may differ from the entity's definition of 'default' (see 12.3.2.3). However, an entity's definition of default should be consistent with its credit risk management, and should consider qualitative factors. For example, many financial institutions apply regulatory definitions of default for accounting and regulatory purposes – e.g. those issued by the Basel Committee on Banking Supervision under which a default is considered to have occurred when it is unlikely that the obligor will be able to repay its obligation (see 12.10). The assessment of whether such a definition is met may be based on similar criteria to those used for assessing whether an asset is credit-impaired. In these cases, the asset would be considered to be in default when it is credit-impaired.

#### Observation – Objective evidence of impairment vs credit-impaired financial assets

*IAS 39.59(a)–(e), IFRS 9 Appendix A*

Under IAS 39, an entity determines whether there is 'objective evidence of impairment' to identify incurred losses. The criteria and examples used for this assessment under IAS 39 are similar to those used in defining 'credit-impaired' under IFRS 9. The definition of credit-impaired is relevant in IFRS 9 when determining when an asset:

- is credit-impaired on initial recognition (a special expected credit loss approach and special interest recognition rules apply to these assets); and
- becomes credit-impaired after initial recognition (special interest recognition rules apply to these assets).

For further discussion of the calculation of credit-adjusted EIR and the recognition of interest revenue for credit-impaired assets, see 11.2.2 and 11.3.2.



## 12.6.2

### Initial measurement

*IFRS 9.5.5.13,  
Appendix A, B5.4.7*

At initial recognition, POCI assets do not carry an impairment allowance. Instead, lifetime expected credit losses are incorporated into the calculation of the EIR (see 11.2.2).

#### Example – Initial recognition of POCI assets

Company Y buys a portfolio of amortising loans with a remaining life of four years for 800, which is the fair value at that date. The remaining contractual cash flows at the time of purchase are 1,000 and the expected cash flows are as follows. Assume that all cash flows are expected to be paid at the year end.

Year	1	2	3	4
Expected cash flows	220	220	220	220

The EIR of 3.925% p.a. is calculated as the IRR of the initial purchase price – i.e. 800 – and the cash flows expected to be collected.

On initial recognition, the following journal entries arise.

	Debit	Credit
Loan asset	800	
Cash		800

## 12.6.3

### Subsequent measurement

*IFRS 9.5.5.13–14*

The expected credit losses for POCI assets are always measured at an amount equal to lifetime expected credit losses. However, the amount recognised as a loss allowance for such assets is not the total amount of lifetime expected credit losses, but instead the changes in lifetime expected credit losses since initial recognition of the asset.

*IFRS 9.5.5.14*

Favourable changes in lifetime expected credit losses are recognised as an impairment gain, even if the favourable changes are more than the amount previously recognised in profit or loss as impairment losses. This is a different presentation from IAS 39, under which reversals of impairment relate only to amounts previously recognised in profit or loss as impairment losses.

**Example – Subsequent measurement of POCI assets – No changes in expectations**

Continuing the example in 12.6.2, assume that Y's expectation about future cash flows from the portfolio at the end of Year 1 has not changed since initial recognition.

At the end of Year 1, Y calculates interest revenue of 31 by applying the EIR – i.e. 3.925% p.a. – to the amortised cost of the loan of 800. In addition, Y receives a cash payment of 220. Y records the following entries in Year 1.

	Debit	Credit
Loan asset	31	
Interest revenue		31
Cash	220	
Loan asset		220

This example illustrates that no impairment expense or allowance is recognised if, in subsequent periods, experience and expectations about the collectibility of cash flows are unchanged from expectations at initial recognition.

**Example – Subsequent measurement of POCI assets – Positive changes in expectations**

Alternatively, assume that the creditworthiness of the borrowers in the portfolio has improved and at the end of Year 1, Y expects the following cash flows to be collected.

Year	1	2	3	4
Expected cash flows	220	250	250	250

At the end of Year 1, Y calculates interest income of 31 by applying the EIR – i.e. 3.925% p.a. – to the amortised cost of the loan of 800, and records the following entries, as above, to recognise interest revenue and cash received.

	Debit	Credit
Loan asset	31	
Interest revenue		31
Cash	220	
Loan asset		220

In addition, the revised expected cash flows are discounted using the original EIR, and the resulting favourable change in lifetime expected credit losses of 83<sup>(a)</sup> is recognised as an impairment gain at the end of Year 1, as follows.

	Debit	Credit
Loss allowance	83	
Impairment gain		83

At the end of Year 1, the following balances are therefore recognised for the loan portfolio in the statement of financial position:

- a gross carrying amount of 611 (being 800 plus interest of 31 less cash received of 220); and
- a loss allowance, being a debit balance of 83.

**Note**

(a) Calculated as  $(30 / 1.03925) + (30 / 1.03925^2) + (30 / 1.03925^3)$ .

## 12.6.4

*IFRS 9.5.4.3,  
Appendix A*

### Modifications

When the contractual cash flows of a POCI asset are modified and the modification does not result in derecognition, the calculation of the modification gain or loss (see 11.5.2) is the difference between:

- the gross carrying amount of the asset before the modification; and
- the recalculated gross carrying amount.

The recalculated gross carrying amount is the present value of the modified contractual cash flows using the credit-adjusted EIR before the modification, which also considers the initial expected credit losses that were considered when calculating the credit-adjusted EIR (see 11.2.2).

#### Observation – Modification of a POCI asset

IFRS 9 does not explain how the initial expected credit losses that were considered when calculating the credit-adjusted EIR should be taken into account when calculating the modification gain or loss.

Therefore, application issues may arise in practice, requiring further analysis and the exercise of judgement.

## 12.7

### Simplified approach for trade and lease receivables and contract assets

#### 12.7.1

*IFRS 9.5.5.15–16*

#### Overview

The new standard includes the following simplifications for trade receivables and 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.

Type of financial asset	Measurement of loss allowance
<b>Trade receivables and contract assets that do not have a significant financing component</b>	Lifetime expected credit losses.
<b>Trade receivables and contract assets that have a significant financing component, and lease receivables</b>	<p>Policy election to measure the loss allowance either:</p> <ul style="list-style-type: none"> <li>• in accordance with the general approach (see 12.3); or</li> <li>• as lifetime expected credit losses.</li> </ul> <p>An entity may apply the policy election</p> <ul style="list-style-type: none"> <li>• for trade receivables, contract assets and lease receivables independently of each other.</li> </ul> <p>In addition, it may be applied separately for finance and operating lease receivables.<sup>12</sup></p>

## 12.7.2

*IFRS 9.5.5.15, Appendix A*

*IFRS 15.107, Appendix A, IE201–IE204*

## Definitions

IFRS 9 refers to trade receivables and contract assets that result from transactions that are in the scope of IFRS 15.<sup>13, 14</sup>

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. An example of a contract asset is when an entity delivers one product but the payment for the delivery is conditional on the delivery of another product in the contract.

For the determination of whether a trade receivable has a 'significant financing component', see Chapter 9.

*IFRS 9.5.5.15(b)*

IFRS 9 refers to lease receivables that result from transactions in the scope of IAS 17.

## 12.7.3

## Specific measurement issues

### 12.7.3.1

### Trade receivables

*IFRS 9.5.5.15(a)*

As explained in 12.7.1, the measurement of the loss allowance for trade receivables – whether as 12-month or lifetime expected credit losses – depends on:

- whether they contain a significant financing component; and
- an entity's accounting policy for trade receivables with a significant financing component.

<sup>12</sup> During its redeliberations, the IASB noted that the applicability of the accounting policy choice for lease receivables to different populations of those receivables would be further considered when the leases project is finalised.

<sup>13</sup> For further discussion of IFRS 15, see our publication [First Impressions: Revenue from contracts with customers](#), issued in June 2014.

<sup>14</sup> An entity that applies IFRS 9 before it applies IFRS 15 should apply the impairment requirements in IFRS 9 to those receivables that arise from transactions that are accounted for under IAS 18 *Revenue* and IAS 11 *Construction Contracts*.

## Observations – Measurement of expected credit losses for trade receivables

IFRS 15.9, Appendix A,  
IFRS 9.BC5.222

### Day one loss on initial recognition of trade receivables

Applying the new expected credit loss model will result in a day one loss on initial recognition of trade receivables or contract assets that arise from transactions in the scope of IFRS 15. This day one loss will be equal to the loss allowance recognised at the reporting date (see also 'Observation – Day one loss' in 12.3.1).

For trade receivables without a significant financing component, the recognition of an allowance for expected credit losses will tend to reduce the net carrying amount of the receivable towards its fair value. This is because the receivable is initially recognised at the transaction price as defined in IFRS 15, which is generally greater than fair value. This contrasts with the initial recognition of a loss allowance on other financial assets measured at amortised cost, where the loss allowance tends to reduce the net carrying amount to below fair value at initial recognition.

The results of commercial entities with a significant amount of trade receivables will be affected by the application of IFRS 9. However, the impact may be limited, because trade receivables are usually short-term – e.g. 90 days or less – and so the amount of expected credit loss is likely to be small.

IFRS 9.BC5.222

### Trade receivables that do not contain a significant financing component

Generally, 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 expected credit losses generally does not differ from measuring it as 12-month expected credit losses.

### Discount rate used to measure expected credit losses on trade receivables

Trade receivables without a significant financing component are measured at 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 expected credit losses generally would not be required.

However, further analysis and judgement may be required if a trade receivable is not paid when due and is rescheduled so as to effectively incorporate a significant financing component, and so using an EIR of zero may no longer be appropriate.

### 12.7.3.2

#### Lease receivables

IFRS 9.B5.5.34

The cash flows used for measuring the loss allowance should be consistent with the cash flows used in measuring the lease receivable under IAS 17.

IFRS 9.B5.5.46

The discount rate used to reflect the time value of money for calculating expected credit losses (see 12.4.5) is the discount rate used in measuring the lease receivable under IAS 17.

### 12.7.3.3

#### Practical expedients

IFRS 9.B5.5.35

IFRS 9 allows the use of practical expedients when measuring expected credit losses, and states that a provision matrix is an example of such an expedient for trade receivables. An entity that applies a provision matrix might, for example:

- consider whether it is appropriate to segment trade receivables – e.g. because its historical credit loss experience shows significantly different loss patterns for different customer segments; these segments could be based on geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer, such as wholesale or retail; and
- 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.

The standard includes the following example that demonstrates the use of a provision matrix to measure expected credit losses for trade receivables.

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

IFRS 9.IE74–IE77

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

M uses a provision matrix to determine the lifetime expected credit losses for the portfolio. It is based on M'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, M updates the observed default history and forward-looking estimates.

On this basis, M uses the following provision matrix.

	Expected credit loss	Trade receivables	Impairment allowance
Current	0.3%	15,000	45
1–30 days past due	1.6%	7,500	120
31–60 days past due	3.6%	4,000	144
61–90 days past due	6.6%	2,500	165
Over 90 days past due	10.6%	1,000	106
<b>Total</b>		<b>30,000</b>	<b>580</b>

## 12.8 Presentation of expected credit losses in the financial statements

### 12.8.1 Assets measured at amortised cost, lease receivables and contract assets

IFRS 9.5.5.1

An entity recognises expected credit losses as a loss allowance in the statement of financial position if they relate to a financial asset measured at amortised cost, a lease receivable or a contract asset. However, it is not required to present the loss allowance as a separate line item in the statement of financial position. The carrying amount of the assets in the statement of financial position is stated net of the loss allowance.

#### Observation – Using a loss allowance account

IAS 39.63, IFRS 9.5.5.1

Under IAS 39, an entity has the choice of using a loss allowance account or reducing the carrying amount of an asset measured at amortised cost directly. IFRS 9 requires the use of a loss allowance account for such assets.

## 12.8.2

*IFRS 9 Appendix A,  
IFRS 7.B8E, BC48V*

### Loan commitments and financial guarantee contracts

An entity recognises the loss allowance for expected credit losses as a provision if they relate to a loan commitment or a financial guarantee contract.

However, if a financial instrument includes both a drawn component – i.e. a financial asset – and an undrawn loan commitment component, and the entity cannot separately identify the expected credit losses on the loan commitment component from those on the financial asset component – i.e. the drawn amount – then it recognises the expected credit losses on the undrawn balance of the loan commitment together with the expected credit losses on the drawn amount.

To the extent that the combined amount of expected credit losses exceeds the gross carrying amount of the financial asset, the remaining balance is presented as a provision.

## 12.8.3

*IFRS 9.5.5.2,  
IFRS 7.16A*

### Debt instruments measured at FVOCI

No loss allowance is recognised in the statement of financial position in respect of debt instruments that are measured at FVOCI, because the carrying amount of these assets is their fair value. However, disclosures have to be provided about the loss allowance amount.

The new standard includes the following example on the recognition of the loss allowance for FVOCI assets.

#### Example – Recognition of impairment losses on debt instruments measured at FVOCI

*IFRS 9.IE78–IE80*

On 31 December 2015, Company Z purchases a debt instrument with a fair value of 1,000 and classifies it as measured at FVOCI. The instrument is not credit-impaired. Z estimates 12-month expected credit losses for the instrument of 10.

On initial recognition of the instrument, Z makes the following entries.

	Debit	Credit
Statement of financial position – debt securities	1,000	
Statement of financial position – cash		1,000
Profit or loss – impairment loss	10	
OCI		10

At the end of the next reporting period, the fair value of the debt instrument decreases to 950. Z concludes that there has not been a significant increase in credit risk since initial recognition and that the 12-month expected credit losses on 31 December 2016 are 30. Accordingly, Z makes the following entries at that date.

	Debit	Credit
Statement of financial position – debt securities		50 <sup>(a)</sup>
Profit or loss – impairment loss	20 <sup>(b)</sup>	
OCI	30 <sup>(c)</sup>	

#### Notes

- (a) Calculated as 1,000 - 950, being the amount needed to state the debt security at fair value as at the reporting date.
- (b) Calculated as 30 -10, being the change in expected credit losses since initial recognition.
- (c) Balancing amount.

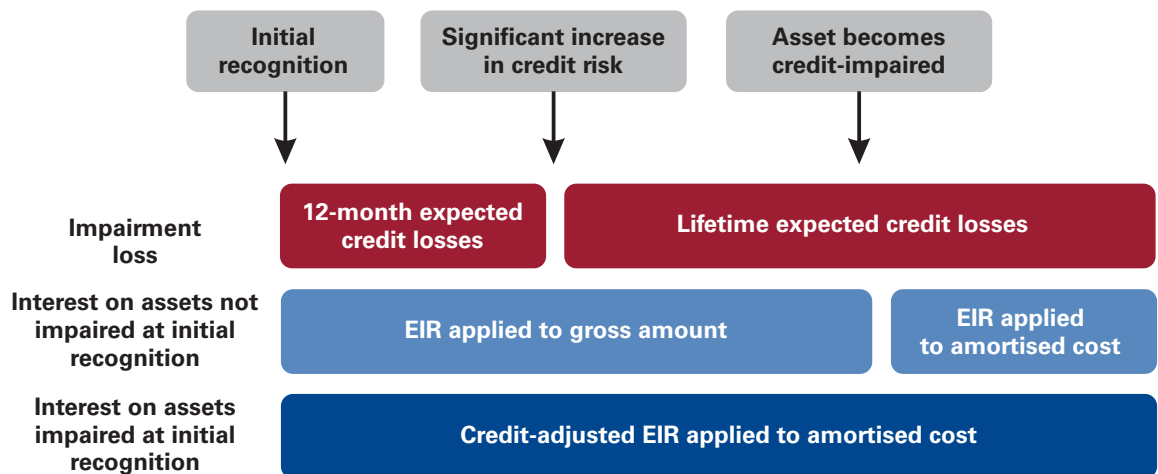
Z also provides disclosures about the accumulated impairment of 30 (see 14.2.3.3).

**Observation – Recognition of impairment losses on debt instruments measured at FVOCI**

The carrying amount of a debt instrument measured at FVOCI is its fair value. Accordingly, the recognition of an impairment loss does not affect the carrying amount of those assets, but is reflected as a debit to profit or loss and a credit to OCI.

## 12.9 Interaction between expected credit losses and interest revenue

There is a relationship between the guidance on the recognition of expected credit losses and the guidance on the recognition of interest income (see Chapter 11). The following diagram illustrates that interaction.



## 12.10 Comparison with Basel regulatory model

*IFRS 9.BC5.178, BC5.283*

The IASB notes that in many jurisdictions financial institutions already calculate a 12-month loss rate for regulatory purposes, and so implementing the model would be less costly for them. However, the Board also acknowledges that an entity may have to adjust these regulatory measurements to comply with the requirements in IFRS 9. In our experience, where financial institutions are looking at using the regulatory data for the calculation of expected credit losses under IFRS 9, they consider one of the following approaches:

- using data derived from regulatory models as a starting point for expected credit loss calculations; or
- using the regulatory calculations and adjusting them to arrive at the IFRS-compliant figures (only those banks that apply the AIRB approach – see below).

Under Basel, banks can apply different approaches for calculating regulatory capital, as follows.



Approach	Description
<b>Standardised approach</b>	Banks are required to use the risk weight values prescribed by the regulator and so would have limited ability to use the regulatory calculations to arrive at data that is compliant with IFRS 9 requirements.
<b>Foundation IRB approach<sup>15</sup> (FIRB)</b>	Banks use internal models to estimate the PDs, and the regulator prescribes LGDs and EADs. Banks may be able to use the data and systems applied for the regulatory PD estimates in their accounting calculations, subject to certain adjustments to ensure that the calculations comply with IFRS 9.
<b>Advanced IRB approach (AIRB)</b>	Banks are permitted to use internally developed models to calculate PDs, LGDs and EADs for their regulatory capital requirements. These banks are likely to have the largest scope for using their existing data, internal models and systems to arrive at expected credit loss estimates that comply with the requirements of IFRS 9, although many adjustments will still be required.

The table below outlines some of the key differences between the requirements of Basel and IFRS 9, assuming that an entity uses the AIRB approach for calculating its regulatory capital requirements.

	IFRS 9	Basel framework
<b>PD – Period over which it is estimated</b>	Depending on the asset, the PD is measured either: <ul style="list-style-type: none"> <li>• for the next 12 months; or</li> <li>• for the remaining life of the financial instrument.</li> </ul>	One measure is used – i.e. PD for the next 12 months. However, in certain cases – e.g. low-default portfolios – a multi-period PD over various time horizons may be considered to determine an effective 12-month PD.
<b>PD – Point at which it is estimated</b>	PD estimates are ‘point-in-time’ measures, based on an entity’s assessment at the reporting date of current and expected future conditions.	PD estimates could be based on internal rating methodologies that are anywhere on the spectrum from ‘point-in-time’ to ‘through-the-cycle’. In all cases, the estimates will be based on historical long-run average default rates.
<b>LGD and EAD observation period</b>	IFRS 9 contains no specific requirements about the observation period for the collection of historical data that is used for the calculations.	The minimum observation period for LGD and EAD is five years for retail exposures and seven years for sovereign, corporate and bank exposures.
<b>Definition of default</b>	IFRS 9 does not define the term ‘default’. Each entity has to define default consistently with its credit risk management, and the definition has to consider qualitative indicators – e.g. breaches of covenants – where appropriate. However, there is 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.	A default has occurred if either of the following two events has taken place: <ul style="list-style-type: none"> <li>• it is unlikely that the obligor will be able to repay its debt to the entity in full without the entity taking recourse to actions such as realising collateral; and/or</li> <li>• the obligor is more than 90 days past due on a material credit obligation.</li> </ul>

15 The ‘IRB approach’ is the internal-ratings based approach under the Basel regulatory framework.

	IFRS 9	Basel framework
<b>Floor in the calculation</b>	There are no prescribed floors in the calculation of credit losses.	PD and LGD estimates for certain types of exposures are subject to a prescribed regulatory floor.
<b>Discount rate</b>	<p>The discount rate depends on the type of the financial instrument, as follows.</p> <ul style="list-style-type: none"> <li>• For POCI assets, the discount rate is the credit-adjusted EIR.</li> <li>• For undrawn loan commitments and financial guarantee contracts, the discount rate is generally the EIR, or an approximation thereof, that is used to discount the financial asset resulting from the loan commitment (see 12.4.5).</li> <li>• For all other financial assets, the discount rate is the EIR or an approximation thereof.</li> </ul>	The discount rate is based on the weighted-average cost of capital or risk-free rate if adjusted for collateral value volatility.
<b>Collateral</b>	<p>The estimate of expected cash flows on a collateralised asset reflects:</p> <ul style="list-style-type: none"> <li>• the cash flows that may result from foreclosure; less</li> <li>• costs for obtaining and selling the collateral, irrespective of whether foreclosure is probable.</li> </ul>	An entity may incorporate any collateral within its LGD estimation, provided that it has sufficient data to support the LGD modelling methodology determined in line with the regulatory requirements. The collateral values are adjusted for volatility.
<b>Expected credit losses – Mechanics of calculation</b>	<p>Expected credit losses are a probability-weighted estimate of credit losses – i.e. the present value of all cash shortfalls. A cash shortfall is the difference between the cash due under the contract and cash flows expected to be received.</p> <p>The estimate of contractual cash flows takes into account prepayment, call and similar options. In general, the maximum period over which expected credit losses are measured is the maximum contractual period over which the entity is exposed to risk. However, for revolving credit facilities a longer period may be used (see 12.4.3.2).</p>	<p>Expected credit losses are calculated by applying the loss rate (PD x LGD) to the EAD.</p> <p>The EAD is the exposure expected to be outstanding if the facility were to default in the next year. It includes an estimate of expected future draw-downs:</p> <ul style="list-style-type: none"> <li>• through credit conversion factors (the percentage of the currently undrawn limit that will be drawn down at the time of default), for FIRB banks; or</li> <li>• as determined by the entity, for AIRB banks.</li> </ul>

	IFRS 9	Basel framework
<b>Economic assumptions for estimating credit losses</b>	Estimates of expected credit losses reflect an unbiased probability-weighted amount that is determined by evaluating a range of possible outcomes. It is neither an estimate of a worst-case scenario nor a best-case scenario.	Expected credit losses reflect downturn LGD and EAD – i.e. values factoring in macro-economic stress conditions.

The table above is an illustration of potential differences. In practice, the nature and extent of the differences will depend on many factors, including:

- the nature of an entity’s products and business;
- how the Basel framework has been implemented in a particular jurisdiction and by the entity; and
- the decisions made by the entity in implementing IFRS 9.

Therefore, despite considerable benefits from leveraging regulatory data, systems and processes to determine expected credit losses under IFRS 9, the extent of the work that may be needed to arrive at IFRS-compliant information is likely to be significant.

# 13 Hedge accounting

*IFRS 9.6*

IFRS 9 includes a new general hedge accounting model, which aligns hedge accounting more closely with risk management. The new model does not fundamentally change the types of hedging relationships or the requirement to measure and recognise ineffectiveness under IAS 39; however, under the new model more hedging strategies that are used for risk management may qualify for hedge accounting. The new requirements for general hedge accounting are discussed in our publication [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), issued in December 2013.

*IFRS 9.6.5.8, 6.5.10, 6.7.2*

IFRS 9 (2014) introduces consequential amendments to the hedge accounting requirements originally released in IFRS 9 (2013), to reflect the introduction of the new FVOCI classification category for financial assets. These amendments provide guidance on the application to FVOCI assets of:

- the fair value hedge accounting model; and
- the option to designate certain credit exposures as at FVTPL (see Section 4.4 in the above publication).

To avoid further delays to the mandatory effective date of IFRS 9, the IASB carved out its deliberations on macro hedge accounting as a separate project. The IASB has continued its deliberations on macro hedge accounting, and issued a discussion paper, DP 2014/01 *Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging*, in April 2014. This is discussed in our [New on the Horizon – Accounting for dynamic risk management activities](#).

*IFRS 9.6.1.3, 7.2.21*

Pending finalisation of the macro hedge accounting project, the hedge accounting model in IFRS 9 carries forward guidance from IAS 39 on portfolio fair value hedges of interest rate risk and also allows an entity an accounting policy choice to continue to apply all of the hedging requirements in IAS 39 rather than applying the new general hedge accounting model (see 15.2.4.1).

# 14 Presentation and disclosures

## 14.1 Presentation

IAS 1.82

IFRS 9 amends IAS 1 *Presentation of Financial Statements* to require the following line items to be presented in the profit or loss section of the statement of comprehensive income or in the statement of profit or loss:

- revenue, presenting separately interest revenue calculated using the effective interest method;
- gains or losses arising from the derecognition of financial assets measured at amortised cost;
- impairment losses (including reversals) determined in accordance with IFRS 9;
- gains or losses arising on reclassification of a financial asset out of the amortised cost category into the FVTPL category; and
- if a financial asset is reclassified out of the FVOCI category into the FVTPL category, any cumulative gain or loss previously recognised in OCI that is reclassified to profit or loss.

### Observation – Presentation of negative interest

IFRS 9.B4.1.7A

Sometimes, the interest rate on a financial asset or a financial liability is negative. A question then arises as to how this negative interest may be presented – e.g. whether negative interest on an asset may be presented in the statement of profit or loss:

- as negative interest revenue;
- as interest expense; or
- under another expense classification.

This issue was discussed by the IFRS Interpretations Committee in January 2013. However, the Committee did not reach a conclusion, and decided to wait until the IASB's redeliberations on IFRS 9 were complete.

Although IFRS 9 acknowledges that in extreme economic circumstances an interest rate could be negative and meet the SPPI criterion (see 5.2.1), it does not provide any guidance on how negative interest should be presented in profit or loss. Therefore, the issue remains unclear.

## 14.2 Disclosures

### 14.2.1 Overview

IFRS 9 amends IFRS 7 to introduce extensive new and amended disclosures. This section discusses disclosures relating to the classification and measurement requirements of the standard, including impairment, that are required on an ongoing basis. Disclosures on transition are discussed in 15.3. Disclosures on hedge accounting are discussed in our publication [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), issued in December 2013. This section does not include a comprehensive list of all relevant disclosures required by IFRS 7, but instead focuses on explaining key aspects of the changes made by IFRS 9.

### 14.2.2 Classification and measurement of financial assets and financial liabilities

IFRS 7.8

Similar to currently effective IFRS 7, under the changes introduced by IFRS 9 entities are required to disclose the carrying amounts of each measurement category of financial instruments either in

the statement of financial position or in the notes. IFRS 7, as amended by IFRS 9, lists the following categories in the context of this disclosure:

- financial assets and, separately, financial liabilities measured at FVTPL, distinguishing between:
  - those designated into the category; and
  - those mandatorily measured at FVTPL (see 5.1 and 6.1–6.2);
- financial assets and, separately, financial liabilities measured at amortised cost; and
- financial assets measured at FVOCI, distinguishing between:
  - financial assets mandatorily measured at FVOCI (see 5.1.3); and
  - investments in equity instruments designated as such on initial recognition (see 5.1.5).

The ‘designated as at FVTPL’ category includes both financial assets designated at initial recognition and credit exposures designated at initial recognition or subsequently.<sup>16</sup>

#### 14.2.2.1 **Financial assets or financial liabilities designated as at FVTPL**

*IFRS 7.9*

For financial assets designated as at FVTPL (see 5.1.4), entities are required to provide the same information about credit risk as is required for loans and receivables designated as at FVTPL under currently effective IFRS 7.

*IFRS 7.10–10A*

IFRS 9 extends the disclosure requirements for financial liabilities designated as at FVTPL to require the following additional information if an entity is required to present the effects of changes in that liability’s credit risk in OCI (see 6.2):

- any transfers of the cumulative gain or loss within equity during the period, including the reason for the transfer; and
- if the liability is derecognised during the period, then the amount (if any) presented in OCI that was realised at derecognition.

*IFRS 7.11*

IFRS 9 also extends the disclosures for financial liabilities designated as at FVTPL to require the following information:

- a detailed description of the methodologies used to determine whether presenting the effects of changes in a liability’s credit risk in OCI would create or enlarge an accounting mismatch in profit or loss (see 10.2.1.2); and
- if an entity presents the effects of changes in a liability’s credit risk in profit or loss, then a detailed description of the economic relationship that it expects will result in the effects of changes in the liability’s credit risk being offset in profit or loss by a change in the fair value of another financial instrument measured at FVTPL.

#### 14.2.2.2 **Investments in equity instruments designated as at FVOCI**

*IFRS 7.11A*

If an entity has designated investments in equity instruments as at FVOCI (see 5.1.5), it discloses:

- which investments in equity instruments have been so designated;
- the reasons for the designation;
- the fair value of each investment at the reporting date;
- dividends recognised during the period, separately for investments derecognised during the reporting period and those held at the reporting date; and
- any transfers of the cumulative gain or loss within equity during the period and the reason for those transfers.

<sup>16</sup> The designation of credit exposures as at FVTPL is discussed in Section 4.4 of our [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), issued in December 2013.

*IFRS 7.11B*

If an entity derecognised investments in equity instruments measured at FVOCI during the reporting period, it discloses:

- the reasons for disposing of the investments;
- the fair value of the investments at the date of derecognition; and
- the cumulative gain or loss on disposal.

### 14.2.2.3

#### Reclassifications

*IFRS 7.12B–D*

IFRS 9 introduces new disclosure requirements for reclassifications of financial assets, as follows.

Type of reclassification	Period during which disclosures are required	Disclosures required
<b>All reclassifications in the current or previous reporting period</b>	Period of reclassification and the period following reclassification	<ul style="list-style-type: none"> <li>• Date of reclassification</li> <li>• Detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements</li> <li>• Amount reclassified into and out of each category</li> </ul>
<b>Reclassifications from FVTPL to amortised cost or FVOCI</b>	Each reporting period following reclassification until derecognition	<ul style="list-style-type: none"> <li>• EIR determined on the date of reclassification</li> <li>• Interest revenue recognised</li> </ul>
<b>Reclassifications from FVOCI to amortised cost, or from FVTPL to amortised cost or FVOCI</b>	Current reporting period	<ul style="list-style-type: none"> <li>• Fair value of the financial assets at the reporting date</li> <li>• Fair value gain or loss that would have been recognised in profit or loss or OCI during the reporting period if the financial assets had not been reclassified</li> </ul>

### 14.2.2.4

#### Other disclosures

*IFRS 7.20, 20A*

IFRS 9 amends IFRS 7 to update the disclosure requirements for items of income and expense and gains or losses, to conform with the measurement categories of IFRS 9. Additionally, it introduces a requirement to disclose:

- an analysis of the gain or loss recognised in the statement of profit or loss and OCI arising from the derecognition of financial assets measured at amortised cost, showing separately gains and losses arising from derecognition of those financial assets; and
- the reasons for derecognising those financial assets.

## 14.2.3

### Credit risk and expected credit losses

#### 14.2.3.1

##### General principles

*IFRS 7.35B, 35E*

IFRS 9 introduces new disclosure requirements about credit risk for financial instruments to which the new impairment model is applied. These disclosures should be sufficient to enable users of the financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

IFRS 7.35B, 35D, 35E

<b>To meet this objective, entities have to:</b>	
<b>Disclose:</b>	<ul style="list-style-type: none"> <li>● Information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses – including the methods, assumptions and information used to measure expected credit losses</li> <li>● Quantitative and qualitative information to evaluate the amounts in the financial statements arising from expected credit losses – including changes and the reasons for those changes, in the amount of expected credit losses</li> <li>● Information about an entity's credit risk exposure – including significant credit risk concentrations</li> </ul>
<b>Consider:</b>	<ul style="list-style-type: none"> <li>● How much detail to disclose</li> <li>● How much emphasis to place on each of the requirements</li> <li>● The appropriate level of aggregation or disaggregation</li> <li>● Whether users of financial statements need additional explanations to evaluate the quantitative information disclosed</li> </ul>

IFRS 7.35A

Reduced disclosures apply to trade receivables, contract assets and lease receivables for which the loss allowance is always equal to lifetime expected credit losses. Disclosures that are not required for those assets are highlighted in each section.

IFRS 7.35C

The disclosures required by the standard may be given either in:

- the financial statements; or
- another statement that is available on the same terms and at the same time as the financial statements (with a cross-reference from the financial statements).

IFRS 7.IG20A–D

The standard is accompanied by illustrative examples of disclosures of:

- a reconciliation of movements in loss allowances;
- an explanation of significant changes in gross carrying amounts (see 14.2.3.3.1); and
- information about credit risk exposures and concentrations (see 14.2.3.4).

### Observation – Extensive disclosure requirements

IFRS 9 introduces many new disclosure requirements on credit risk and expected credit losses that will require substantial effort to prepare. Some of these disclosures are at a granular level that may lead to large amounts of information being added to the financial statements. The requirements in IFRS 7 may also overlap with other requirements – e.g. the disclosures recommended by the Enhanced Disclosure Task Force in its report *Enhancing the Risk Disclosures of Banks*, issued in October 2012.<sup>17</sup>

Entities will need to consider how to present the information so that users find it easy to locate and understand. This may mean that projects implementing IFRS 9 will need to place considerable emphasis on disclosure requirements, and in particular on making strategic decisions early in the project as to how disclosure objectives will be met.

<sup>17</sup> See our [In the Headlines – Improving risk disclosures in financial reports \(issue 2012/14\)](#).



### 14.2.3.2 Credit risk management practices

#### 14.2.3.2.1 General principles

*IFRS 7.35F, B8A–B*

An entity is required to explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective, an entity discloses information that enables users of the financial statements to understand and evaluate:

- how it determines whether the credit risk of financial instruments has increased significantly since initial recognition, including whether and how:
  - financial instruments are considered to have low credit risk (see 12.3.4.3), including the classes of financial instruments to which the low credit risk exception has been applied; and
  - the presumption that financial assets with contractual payments more than 30 days past due have a significant increase in credit risk (see 12.3.4.4) has been rebutted;
- its definitions of default for different financial instruments, including the reasons for selecting those definitions;
- how instruments are grouped if expected credit losses are measured on a collective basis (see 12.4.8);
- how it determines that financial assets are credit-impaired (see 12.6.1);
- its write-off policy, including the indicators that there is no reasonable expectation of recovery; and
- how the modification requirements (see 12.3.4.6) have been applied, including how the entity:
  - determines whether the credit risk of a financial asset that has been modified while subject to a lifetime expected credit loss allowance has improved to the extent that the loss allowance reverts to being measured at an amount equal to 12-month expected credit losses; and
  - monitors the extent to which the loss allowance on those assets subsequently reverts to being measured at an amount equal to lifetime expected credit losses.

#### Observation – Judgements needed to identify significant increases in credit risk

Determining whether an increase in the credit risk of a financial asset is significant is one of the key areas of judgement in the standard, and one of the key drivers of the overall size of the credit loss allowance. Accordingly, it will be very important that a clear explanation is provided as to how this judgement has been exercised.

#### 14.2.3.2.2 Expected credit loss calculations

*IFRS 7.35G, B8C*

An entity is required to explain the inputs, assumptions and estimation techniques used when:

- estimating 12-month and lifetime expected credit losses;
- determining whether the credit risk of financial instruments has increased significantly since initial recognition; and
- determining whether financial assets are credit-impaired.

This will include explaining:

- the basis of inputs and assumptions;
- how forward-looking information has been incorporated into the determination of expected credit losses, including the use of macro-economic information; and
- changes in estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

### Observation – Disclosure about inputs to expected credit loss calculations

Although these disclosures are qualitative in nature, they go beyond the current requirements under IFRS 7, and entities may need to make a substantial effort to collect the necessary information and decide how to summarise it in a meaningful way.

## 14.2.3.3 Amounts arising from expected credit losses

### 14.2.3.3.1 Reconciliations

*IFRS 7.35H, B8E*

An entity is required to provide, by class of financial instrument, reconciliations from the opening balance to the closing balance of the impairment loss allowance. The reconciliation is given separately for loss allowances against assets and for provisions (unless presented together – see 12.8.2), and shows the changes during the period for:

- instruments for which 12-month expected credit losses are recognised;
- instruments for which lifetime expected credit losses are recognised, separately for:
  - financial instruments that are not credit-impaired;
  - financial assets that are credit-impaired at the reporting date, but are not POCI assets; and
  - trade receivables, contract assets or lease receivables for which the loss allowances are always measured as lifetime expected credit losses; and
- POCI assets.

*IFRS 7.88D*

An entity also provides a narrative explanation of the changes in the loss allowances disclosed in the reconciliation.

*IFRS 7.35I*

The reconciliation is also supplemented by an explanation of how significant changes in the respective gross carrying amounts of financial instruments during the period contributed to the changes in the loss allowances. This explanation should include relevant qualitative and quantitative information. Examples of such changes may include:

- originations or acquisitions of financial instruments;
- modifications of contractual cash flows that do not result in derecognition (see 11.5);
- derecognitions (including write-offs); and
- movements between the 12-month and lifetime expected credit losses measurement categories (and vice versa).

### Observation – Reconciliations

*IFRS 7.35I, BC48Q–S*

If an entity uses an allowance to recognise impairment, currently effective IFRS 7 requires disclosure of a reconciliation of movements in the allowance for each class of financial assets. However, it does not require disclosure of movements in the gross carrying amounts of financial assets. The disclosures required by IFRS 9's consequential amendments to IFRS 7 are a significant addition to the current requirements, and substantial effort may be needed to collect the required data.

The IASB received feedback from preparers saying that the costs associated with disclosing separate reconciliations of the gross carrying amounts would be substantial. However, users of financial statements have consistently and strongly expressed the view that reconciliations would greatly enhance the transparency of an entity’s financial asset portfolio. To address both concerns, the IASB decided to simplify the requirements proposed in the 2013 impairment ED by focusing only on key drivers for changes in the gross carrying amounts to the extent that they contribute to changes in the loss allowance.

The IASB also acknowledged that even though the most relevant and useful information is usually provided by disclosing gross movements, in some circumstances – or for some types of financial assets – this information will be more useful on a net basis (e.g. for trade receivables that are accounted for under the general approach for measuring impairment – see 12.7.1). The net presentation may also be more useful for short-term instruments – e.g. credit cards and overdrafts – that are originated and repaid in full within a short period.

**14.2.3.3.2**

**Modifications**

*IFRS 7.35J*

The following disclosures are required in respect of a financial asset that has been modified while subject to a lifetime expected credit loss allowance, but whose modification does not result in derecognition.

Disclosures required in period of modification	Disclosures required until derecognition
<ul style="list-style-type: none"> <li>• Amortised cost before the modification</li> <li>• Net modification gain or loss</li> </ul>	<ul style="list-style-type: none"> <li>• Gross carrying amount at the reporting date of financial assets whose loss allowance changed to 12-month expected credit losses during the reporting period</li> </ul>

*IFRS 7.35A*

These disclosure requirements apply to trade receivables, contract assets and lease receivables on which lifetime expected credit losses are always recognised, only if they are modified while more than 30 days past due.

**Observation – Net modification gain or loss**

IFRS 9 does not define the term ‘net modification gain or loss’. Therefore, it may not be clear how this amount should be calculated. It may refer to the net sum of all relevant modification gains and losses (see 11.5.2). An alternative approach might be to calculate the amount as the modification gain or loss for each asset, net of the change in the impairment allowance resulting from the modification – i.e. based on the change in the amortised cost of the asset.

**Observation – Modification of assets**

The amendment to IFRS 7 requires disclosure in respect of assets (other than certain trade and lease receivables and contract assets) that have been modified at any time, if:

- they were modified while subject to a lifetime expected credit loss allowance; and
- during the reporting period, their measurement changed to 12-month expected credit losses.

Significant effort may be required to monitor such assets for all periods until derecognition, in order to ascertain whether the measurement of expected credit losses has changed to 12-month expected credit losses during the current reporting period.

### Observation – Disclosures about modifications or forbearance

The disclosures for modified financial assets (including the disclosures in 14.2.3.2.1) expand the existing requirements of paragraph B5(g) of IFRS 7. Recently, disclosures in this area have been a focus of attention for regulators – particularly relating to banks' forbearance activities.<sup>18</sup> Banks may therefore already be collecting information that could help with the new disclosures.

#### 14.2.3.3.3

#### Collateral

The disclosures in respect of collateral are different for financial assets to which the impairment provisions of IFRS 9 apply, and for those to which the impairment provisions do not apply – e.g. financial assets measured at FVTPL.

##### *IFRS 7.36(a)–(b)*

The disclosure requirements for financial instruments that are not subject to the impairment requirements of IFRS 9 are the same following adoption of IFRS 9 as those currently required by IFRS 7 for all financial assets.

##### *IFRS 7.35A, 35K*

For financial instruments that are subject to the impairment requirements of IFRS 9, IFRS 7 (as amended by IFRS 9) includes modified disclosure requirements for collateral and other credit enhancements. The objective of these disclosures is to enable users of the financial statements to understand the effect of collateral and other credit enhancements on the amounts arising from expected credit losses. These disclosures are required by class of financial instrument, and include:

- the amount that best represents the entity's maximum exposure to credit risk at the reporting date, without taking account of any collateral held or other credit enhancements;
- except for lease receivables, a narrative description of collateral held as security and other credit enhancements, including:
  - a discussion on the nature and quality of the collateral held;
  - an explanation of any significant changes in quality as a result of a deterioration or changes in the entity's collateral policies during the reporting period; and
  - information about financial instruments for which the entity has not recognised a loss allowance because of the collateral; and
- quantitative information about the collateral held as security and other credit enhancements – e.g. quantification of the extent to which collateral and other credit enhancements mitigate credit risk – for financial assets that are credit-impaired at the reporting date.

##### *IFRS 7.8F*

For these modified disclosure requirements, an entity is not required to disclose information about the fair value of the collateral and other credit enhancements, or to quantify the exact value of the collateral that was included in the calculation of expected credit losses – i.e. the LGD.

##### *IFRS 7.8G*

The narrative description of collateral and its effect on expected credit losses might include information about:

- the main types of collateral held as security and other credit enhancements – e.g. guarantees, credit derivatives and other agreements;
- the volume of collateral held and other credit enhancements, and their significance in terms of the loss allowance;
- the policies and process for valuing and managing collateral and other credit enhancements;

<sup>18</sup> See our [In the Headlines – Regulators focus on forbearance \(issue 2012/25\)](#), which looks at the [public statement](#) issued on this subject by the European Securities and Market Authority (ESMA) in December 2012; our [In the Headlines – Focus areas for regulators: Reinforcing the need for consistency and clarity \(issue 2013/17\)](#) and [In the Headlines – Improving the quality of disclosures \(issue 2013/18\)](#), which look at ESMA's enforcement priorities and recommendations on the quality of disclosures and also Recommendation 27 of the [Enhanced Disclosure Task Force \(EDTF\) report](#).

- the main types of counterparties to collateral and other credit enhancements, and their creditworthiness; and
- information about risk concentrations within the collateral and other credit enhancements.

#### Observation – Disclosure about collateral

*IFRS 7.36(b), BC48AA*

Paragraph 36(b) of IFRS 7 (both under the existing requirements and as amended by IFRS 9) requires disclosure of the financial effect of collateral and other credit enhancements. IFRS 7 does not specify how an entity should apply the term ‘financial effect’ in practice – e.g. when it is appropriate to provide qualitative (rather than quantitative) disclosure of the financial effect of collateral.

The new disclosure requirements about collateral that apply to financial instruments that are subject to the impairment requirements of IFRS 9 state more clearly that:

- qualitative information is required for all financial instruments; and
- quantitative information is required only for financial assets that are credit-impaired at the reporting date.

In addition, the new disclosure requirements clarify that information about the fair value of the collateral is not required to be disclosed.

#### Observation – Disclosures of maximum exposure to credit risk

*IFRS 7.35K(a), 36(a)*

The disclosure of the maximum exposure to credit risk is generally required for all financial instruments in the scope of IFRS 7 (as amended by IFRS 9). However, the disclosure is not required for financial instruments to which the impairment requirements of IFRS 9 are not applied, and whose carrying amount best represents the maximum exposure to credit risk.

This is a change to the requirements of IFRS 7 – before being amended by IFRS 9 – under which this disclosure is not required for all financial instruments whose carrying amount best represents the maximum exposure to credit risk regardless of whether they are subject to the impairment requirements.

#### 14.2.3.3.4

##### Written-off assets

*IFRS 7.35L*

An entity discloses the contractual amount outstanding of financial assets written off during the reporting period, that are still subject to enforcement activity.

#### 14.2.3.3.5

##### POCI assets

*IFRS 7.35H(c)*

For POCI assets, in addition to the reconciliations as set out in 14.2.3.3.1, an entity discloses the total amount of undiscounted expected credit losses at initial recognition on financial assets initially recognised during the reporting period.

#### 14.2.3.4

##### Credit risk exposure

*IFRS 7.35M, B8I*

To enable users of the financial statements to assess an entity’s credit risk exposure, and to understand its significant credit risk concentrations, an entity is required to disclose, by credit risk rating grades (or by past-due status if the entity uses only past-due information to assess significant increases in credit risk – see 12.3.4.4):

- the gross carrying amount of financial assets; and
- the exposure to credit risk on loan commitments and financial guarantee contracts.

*IFRS 7.35M*

This information is disclosed separately for:

- financial assets that are subject to a 12-month expected credit loss allowance;
- financial assets that are subject to a lifetime expected credit loss allowance but that are not credit-impaired;
- financial assets that are credit-impaired at the reporting date but are not POCI assets;
- POCI assets; and
- trade receivables, contract assets and lease receivables for which lifetime expected credit losses are always recognised.

*IFRS 7.8I*

The number of credit risk rating grades used for the disclosure has to be consistent with the number that the entity reports to key management personnel for credit risk management purposes.

*IFRS 7.35N*

For trade receivables, contract assets and lease receivables for which lifetime expected credit losses are always recognised, this disclosure may be based on a provision matrix (see 12.7.3.3).

*IFRS 7.8J*

When expected credit losses are measured on a collective basis (see 12.4.8), an entity may not be able to allocate the gross carrying amounts (or exposures) to the credit risk rating grades for which lifetime expected credit losses are recognised. In these cases, the entity:

- provides the above disclosures for those financial instruments that can be directly allocated to a credit risk rating grade; and
- discloses separately the gross carrying amount of financial instruments for which lifetime expected credit losses are measured on a collective basis.

*IFRS 7.8H*

A concentration of credit risk exists when a number of counterparties are located in a geographical region or are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

### Observation – Disclosure of risk profile

The new disclosure requirements are detailed, and effort will be needed to source the information.

Some entities may have similar data already available if it is used for risk management purposes or for regulatory reporting – e.g. for Basel Committee Pillar 3 disclosures or for European Banking Supervisors' Guidance on Common Reporting (COREP) purposes. For these entities, implementing the disclosure requirements may be less costly, but effort will be needed to identify differences between the data needed for regulatory purposes and for the new disclosure requirements.

**14.2.3.5****Impairment losses arising from contracts with customers***IFRS 15.113(b)*

IFRS 15 requires an entity to disclose separately from other impairment losses, impairment losses recognised on trade receivables or contract assets arising from the entity's contracts with customers.

# 15 Effective date and transition

## 15.1 Overview

IFRS 9.7.1.1

IFRS 9 is effective for annual periods beginning on or after 1 January 2018. Earlier application is permitted. If an entity applies IFRS 9 for an earlier period, it discloses that fact.

IFRS 9.7.1.2, 7.2.21,  
7.2.27–28, 7.3.2,  
BCE.210

If an entity applies IFRS 9 early, it is required to apply all of the requirements of the standard at the same time. There are three exceptions to this principle.

- Until the mandatory effective date of 1 January 2018, an entity is allowed to early adopt the own-credit requirements introduced by IFRS 9 (2010) (see 6.2) in isolation, without applying the other requirements of IFRS 9. If an entity chooses this option, then it discloses this fact and provides on an ongoing basis the disclosures for financial liabilities that are designated as measured at FVTPL (see 14.2.2.1).
- When an entity first applies the standard, it may choose to continue to apply the hedge accounting requirements of IAS 39 rather than those of IFRS 9 until the macro hedge accounting project is completed (see 15.2.4).
- Special requirements exist for sequential adoption from previous versions of IFRS 9 (see 15.2.4).

This chapter generally considers the transition requirements in the version of IFRS 9 issued in 2014 (referred to as IFRS 9 (2014) in this chapter) for existing IFRS preparers. Transition requirements for first-time adopters of IFRS are discussed in 15.4.

### Observation – Early adoption of new ‘own credit risk’ requirements

Because the mandatory effective date of IFRS 9 was deferred several times since IFRS 9 (2010) was issued, the IASB decided to permit early adoption of the own credit risk requirements in isolation. This decision is likely to be welcomed, especially by banks.

IFRS 9.BC7.35–40

Requirements in the following standards are relevant to an entity’s transition to IFRS 9.

Standards	Transition requirements	Section
IFRS 9 <i>Financial Instruments</i>	<ul style="list-style-type: none"> <li>• Effective date and general transition requirements for initial application of the standard.</li> <li>• Specific transition requirements for classification and measurement, impairment, and hedge accounting.<sup>19</sup></li> </ul>	15.2.1 15.2.2 15.2.3 15.2.4
IAS 8 <i>Accounting Policies, Changes in Accounting Estimates and Errors</i>	<ul style="list-style-type: none"> <li>• General guidance on retrospective application of a new standard.</li> </ul>	15.2.1 15.2.3.1 15.3 15.4
IFRS 7 <i>Financial Instruments: Disclosures</i>	<ul style="list-style-type: none"> <li>• Disclosure requirements that are applicable when an entity first applies IFRS 9.</li> </ul>	15.3
IFRS 1 <i>First-time Adoption of IFRS</i>	<ul style="list-style-type: none"> <li>• Requirements for a first-time adopter preparing its first financial statements under IFRS 9.</li> </ul>	15.4

<sup>19</sup> For further discussion on this issue, see our publication [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), issued in December 2013.

## 15.2 Transition

### 15.2.1 General principle

*IFRS 9.72.1, IAS 8.22*

The general principle in IFRS 9 is for retrospective application in accordance with IAS 8. Retrospective application means that the new requirements are applied to transactions, other events and conditions as if those requirements had always been applied.

#### 15.2.1.1 Exemptions from the general principle

*IFRS 9.72.15, 72.20*

IFRS 9 contains certain exemptions from full retrospective application for the classification and measurement requirements of the new standard, including impairment. These include an exception from the requirement to restate comparative information, which also applies if an entity elects to early adopt the own credit requirements in 6.2 in isolation (see 15.1). If an entity does not restate prior periods, it recognises any difference between the previous carrying amount and the carrying amount at the beginning of the annual period that includes the date of initial application (DIA) in the opening retained earnings (or other component of equity, as appropriate) of the annual reporting period that includes the DIA. Entities are allowed to restate comparatives if, and only if, this is possible without the use of hindsight. If an entity restates prior periods, the restated financial information should reflect all of the requirements of the new standard.

*IFRS 9.72.22, 72.26*

The hedge accounting requirements of IFRS 9 are generally applied prospectively, with limited exceptions – in particular, comparative information may need to be restated for certain elements of hedge accounting that are applied retrospectively (see Section 12.2 in our [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#)).

*IFRS 9.72.1*

IFRS 9 is not applied to financial assets or financial liabilities that have been derecognised at the DIA (see 15.2.1.2). Accordingly, even when an entity restates comparative information to reflect the adoption of IFRS 9, information related to financial assets and financial liabilities that are derecognised before the DIA will continue to be reported in accordance with IAS 39.

#### 15.2.1.2 Date of initial application

*IFRS 9.72.2*

The transition requirements refer to the DIA, which is the beginning of the reporting period in which an entity first applies IFRS 9. The DIA of IFRS 9 (2014) has to be after its issue date – i.e. after 24 July 2014.

*IFRS 9.72.3–5, 72.8–10*

Identifying the DIA affects several assessments that are necessary when applying IFRS 9. Examples include:

- assessing the objective of the business model within which financial assets are held (see 15.2.2.1);
- designating an investment in an equity instrument that is not held for trading as at FVOCI (see 15.2.2.3);
- designating, or revoking designations of, financial assets or financial liabilities as at FVTPL (see 15.2.2.5); and
- assessing 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 (see 15.2.2.6).



## 15.2.2 Transition requirements for classification and measurement

IFRS 9 contains specific transition requirements for the following items.

Classification	Measurement
<ul style="list-style-type: none"> <li>• Business model assessment</li> <li>• SPPI criterion assessment</li> <li>• Investments in equity instruments</li> <li>• Designations of own-use contracts</li> <li>• Fair value option designations</li> <li>• Own credit risk on liabilities designated as at FVTPL</li> </ul>	<ul style="list-style-type: none"> <li>• Hybrid contracts</li> <li>• Effective interest method</li> <li>• Unquoted equity investments</li> </ul>

### 15.2.2.1 Business model assessment

*IFRS 9.7.2.3*

On adopting IFRS 9, an entity assesses the nature of the business model in which its financial assets are held, to determine whether they meet the criteria to be measured at amortised cost or FVOCI. 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.

### 15.2.2.2 SPPI criterion assessment

*IFRS 9.7.2.4, 7.2.5, IFRS 7.42R–S*

An entity assesses whether the SPPI criterion is met by applying the guidance in IFRS 9 on the basis of facts and circumstances existing at the time of initial recognition of the financial asset. There are two exceptions to this requirement.

Exception	Description
<b>Modified time value of money element</b>	If it is impracticable to assess a modified time value of money element (see 5.2.2.1) based on the facts and circumstances that existed at initial recognition of the financial asset, then the contractual cash flow assessment is made without taking into account the requirements related to the modification of the time value of money element.
<b>Significance of the fair value of a prepayment feature</b>	If it is impracticable to assess whether the fair value of a prepayment feature was significant based on the facts and circumstances that existed at initial recognition of the financial asset (see 5.2.3.1), then the contractual cash flow assessment is made without taking into account the exception for certain prepayment features in 5.2.3.1.

If the entity applies the above exceptions, then it discloses the carrying amounts of the relevant assets until they are derecognised (see 15.3.1.2).

### Observation – Impracticability exceptions to assessment of the SPPI criterion at initial recognition

IFRS 9.BC7.55–56

The IASB introduced the concept of ‘modified time value of money’ to address concerns over IFRS 9 (2009) that some financial assets that are viewed as ‘plain vanilla’ or ‘normal lending’ would not meet the SPPI criterion. In addition, the IASB decided to provide the narrow exception for particular prepayable financial assets that would otherwise fail the SPPI criterion.

As explained above, the new standard contains impracticability exceptions, which are available when assessing the SPPI criterion at initial recognition for a modified time value of money element, and for the significance of the fair value of a prepayment feature. Applying the impracticability exceptions would mean a more restrictive application of the SPPI criterion that would be likely to result in a failure to meet it, for the following reasons.

- For a modified time value of money element, the assessment is made without the notion of a modified economic relationship. The IASB states that this means that an entity would apply the guidance in IFRS 9 (2009). The guidance in paragraph B4.1.13 of IFRS 9 (2009) suggests that a mismatch between the interest rate tenor and the reset period of a financial asset would generally fail the SPPI criterion.
- For a prepayment feature, the assessment is made without the exception included in 5.2.3.1. This exception is only relevant if the SPPI criterion would otherwise be failed.

However, the impracticability exception for assessing the significance of the fair value of a prepayment feature at initial recognition may not be relevant in many cases, because of the application of the embedded derivative requirements under IAS 39 – i.e. a prepayment feature for which the exception in 5.2.3.1 would be relevant is likely to have been required to be separately accounted for as an embedded derivative at FVTPL under IAS 39, suggesting that the significance of its fair value at initial recognition would have been considered previously.

### Observation – Contractually linked instruments

IFRS 9.B4.1.21(c)

One condition that contractually linked instruments (a tranche) have to meet in order to satisfy the SPPI criterion is that the exposure to credit risk in that particular tranche has to be equal to or less than the exposure to credit risk of the underlying pool of financial instruments (see 5.2.6).

There is no exemption from retrospective application for this assessment. Therefore, it appears that this assessment should be based on the facts and circumstances that existed at the date on which the entity initially recognised its investment in the instrument, and not at the DIA.

### 15.2.2.3

#### Investments in equity instruments

IFRS 9.72.8

At the DIA, an entity may elect to present changes in the fair value of an investment in an equity instrument that is not held for trading in OCI. The entity makes this election on the basis of the facts and circumstances that exist at the DIA.

### Observation – Investments in equity instruments

IFRS 9.5.75, B72.1

To determine the eligibility of an investment in an equity instrument for the option to present the changes in fair value in OCI on transition, an entity determines whether the asset is held for trading as if it had acquired the asset on the DIA. Therefore, it appears that it is possible to elect to present the changes in fair value in OCI for an investment in an equity instrument that was classified as held-for-trading at the original date of acquisition if it does not meet the held-for-trading definition at the DIA.

**15.2.2.4 Designations of own-use contracts**

**Observation – Designations of own-use contracts**

IFRS 9.2.4–5

Under IFRS 9, a contract meeting the own-use exemption (see Chapter 3) can be designated, at inception, as at FVTPL when this is necessary to eliminate or significantly reduce an accounting mismatch. This fair value option was published for the first time as part of the version of IFRS 9 issued in 2013 (IFRS 9 (2013)); it was done by adding paragraph 5A to IAS 39, because the scope of IFRS 9 (2013) was still defined by reference to IAS 39. IFRS 9 (2013) also included the following transition provision, by adding paragraph 108E to IAS 39.

*“Paragraph 5A was added by IFRS 9, as amended in November 2013. When that paragraph is first applied, an entity is permitted to make the designation introduced by that paragraph for contracts that already exist on that date but only if it designates all similar contracts. The change in the net assets resulting from such designations on transition is recognised as an adjustment to retained earnings. Therefore, the accounting treatment is not applied retrospectively.”*

IFRS 9 (2014) deletes paragraph 5A of IAS 39 and incorporates the new own-use fair value option as paragraph 2.5 of IFRS 9. IFRS 9 (2014) also deletes paragraph 108E of IAS 39, but without incorporating an equivalent transition provision into IFRS 9. If this is not clarified, it may mean that the permission provided in paragraph 108E of IAS 39 to designate existing contracts on transition is not available to an existing IFRS reporter that adopts IFRS 9 (2014).

This issue does not arise for a first-time adopter of IFRS, because IFRS 9 (2014) preserves an equivalent transition exemption in paragraph D33 of IFRS 1 (see 15.4).

**15.2.2.5 Fair value option designations**

IFRS 9.7.2.8–10

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		On transition to IFRS 9	
		Qualifying criterion for fair value option based on reducing an accounting mismatch	
IAS 39	Fair value option under IAS 39	<i>is met at the DIA</i>	<i>is not met at the DIA</i>
	Not designated	Designation is permitted	Designation is not possible
	Designation based on reducing an accounting mismatch	Previous designation may be revoked	Previous designation has to be revoked
	Designation based on the criterion that a group of financial assets were managed on a fair value basis	Previous designation has to be revoked	Previous designation has to be revoked
	Designation based on the criterion that a financial asset contained an embedded derivative	New designation is permitted	New designation is not permitted – i.e. classify based on the general criteria in IFRS 9 and the business model at the DIA

Financial liabilities		On transition to IFRS 9		
		Qualifying criterion for fair value option based on reducing an accounting mismatch		Liabilities managed on a fair value basis or containing an embedded derivative
IAS 39	Fair value option under IAS 39	<i>is met at the DIA</i>	<i>is not met at the DIA</i>	
	Not designated	Designation is permitted	Designation is not possible	Designation is not possible
	Designation based on reducing an accounting mismatch	Previous designation may be revoked	Previous designation has to be revoked	Designation is not possible
	Designation based on the criterion that a group of financial liabilities were managed on a fair value basis	Not permitted to revoke previous designation		
	Designation based on the criterion that a financial liability contained an embedded derivative			

**15.2.2.6****Own credit risk on liabilities designated as at FVTPL***IFRS 9.7.2.14*

On transition, an entity assesses 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 (see 6.2.1). The assessment is made on the basis of facts and circumstances that exist at the DIA of IFRS 9. The accounting treatment is applied retrospectively.

**15.2.2.7****Hybrid contracts***IFRS 9.7.2.6–7*

If a hybrid instrument was required to be separated into a non-derivative host contract and an embedded derivative under IAS 39, then its fair value may not have been measured in the comparative periods. If such a hybrid instrument is measured at FVTPL under IFRS 9, then the fair value of the entire instrument at the end of each comparative period is deemed to be the sum of the fair values of the components at those dates (see 7.1).

At the DIA, an entity recognises any difference between the fair value of the entire hybrid instrument and the sum of the fair values of its components in the opening retained earnings (or other component of equity, as appropriate) of the reporting period.

**15.2.2.8****Effective interest method***IFRS 9.7.2.11, IAS 8.5*

It may be impracticable to retrospectively apply the effective interest method to certain financial instruments (see Chapter 11). 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.

### Observation – Previously reclassified financial assets

Under IAS 39, an entity may have reclassified a financial asset from a fair value measurement category (i.e. held-for-trading or available-for-sale) to an amortised cost category (e.g. loans and receivables). The entity would have reclassified the financial asset at its fair value, and this fair value would have become the new amortised cost. On transition to IFRS 9, entities are generally required to retrospectively apply the classification and measurement requirements as if the new classification under IFRS 9 had always been applied.

Therefore, it appears that if such a previously reclassified financial asset is classified as measured at amortised cost or FVOCI under IFRS 9, then the gross carrying amount should be recalculated as if the asset had always been measured at amortised cost or FVOCI (subject to the above impracticability exceptions), rather than by carrying forward its measurement under IAS 39.

#### 15.2.2.9

#### Unquoted equity investments

*IFRS 9.72.12–13*

As a further exception to retrospective application, if unquoted equity investments or related derivatives were previously measured at cost, then those investments are measured at fair value at the DIA. The difference between the fair value and the previous carrying amount of the instrument at the DIA is recorded as an adjustment to the opening retained earnings (or other component of equity, as appropriate) in the reporting period containing the DIA. Therefore, only fair value changes after the DIA are recognised in profit or loss or OCI.

#### 15.2.3

#### Transition requirements for impairment

*IFRS 9.72.17*

The new impairment requirements of IFRS 9 are applied retrospectively in accordance with IAS 8, subject to certain exemptions described below.

*IFRS 9.72.19*

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

- the low credit risk exception (see 12.3.4.3); and
- the rebuttable presumption for contractual payments that are more than 30 days past due (see 12.3.4.4) if the entity identifies significant increases in credit risk based on past-due information.

#### 15.2.3.1

#### ‘Undue cost or effort’

*IFRS 9.B72.2–4*

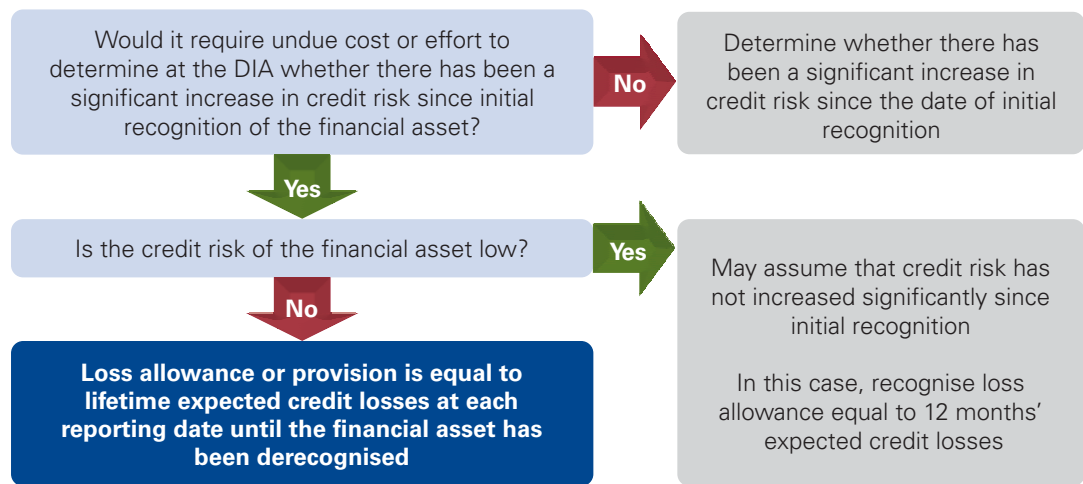
An entity is not required to undertake an exhaustive search for information for determining, at the DIA, whether there has been a significant increase in credit risk since initial recognition of a financial asset. Instead, the entity approximates the credit risk on initial recognition by considering information that is reasonably available without undue cost or effort. Such information comprises all internal and external information, including portfolio information.

An entity with little historical information can use the following sources of information:

- information from internal reports and statistics – e.g. that may have been generated when deciding whether to launch a new product;
- information about similar products; or
- peer group experience for comparable financial instruments.

*IFRS 9.72.18, 72.20*

If, at the DIA, determining whether there has been a significant increase in the credit risk since the initial recognition of a financial instrument would require undue cost or effort, then the loss allowance or provision is measured as lifetime expected credit losses (see 12.3.2) 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, 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’ expected credit losses (see 12.3.4.3).



## 15.2.4 Previous versions of IFRS 9

### 15.2.4.1 Adoption of different versions of IFRS 9

#### *IFRS 9.7.1.2, 7.3.2*

IFRS 9 has been published in stages, and a number of versions are in existence. An entity will no longer be able to adopt a previous version of IFRS 9, if the entity's relevant DIA is after 31 January 2015. However, entities that initially apply a previous version on or before 31 January 2015 may continue to apply that version until IFRS 9's mandatory effective date of 1 January 2018. Also, until the mandatory effective date of 1 January 2018, an entity is allowed to early adopt the own credit requirements in IFRS 9 (2010) in isolation (see 15.1).

#### *IFRS 9.7.2.21*

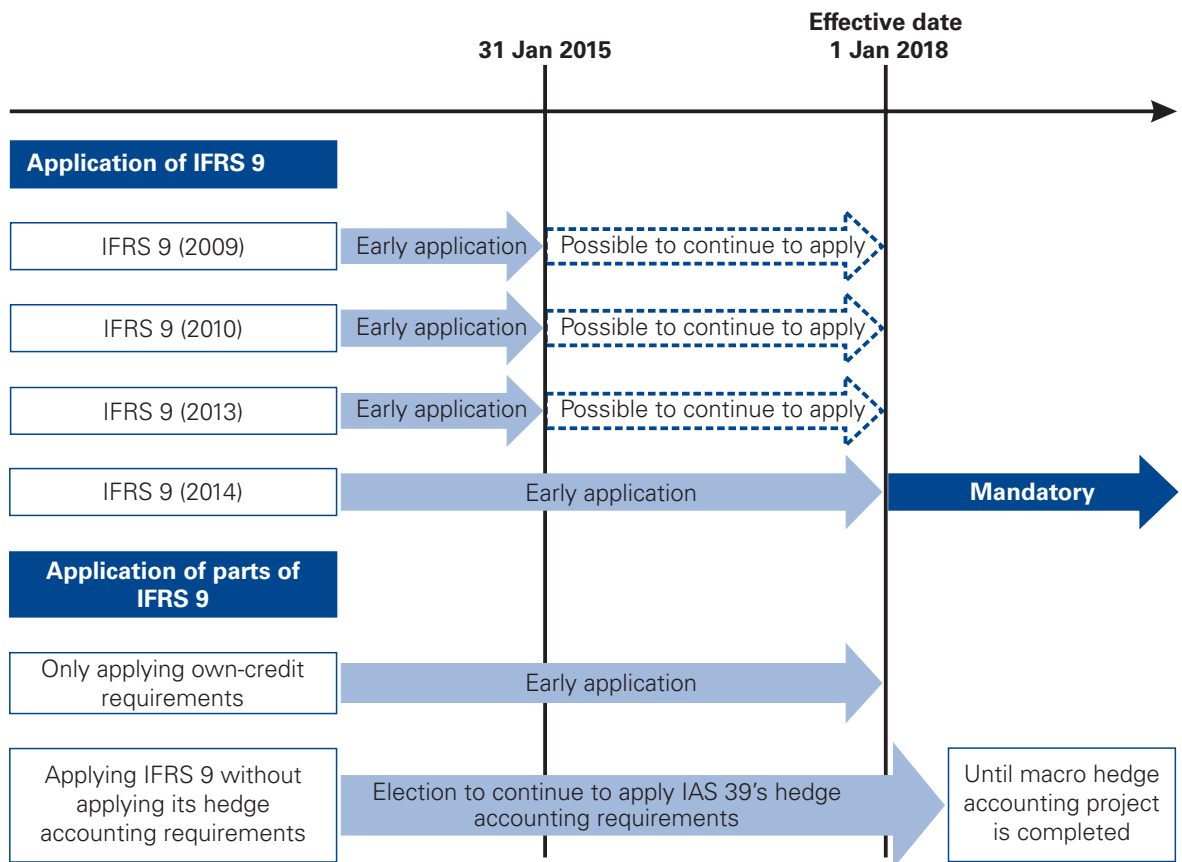
In addition, until the IASB's macro hedging project is finalised, an entity that applies IFRS 9 (2013) or IFRS 9 (2014) may elect to continue applying the hedge accounting requirements in IAS 39.<sup>20</sup>

The following options for adopting the various versions of IFRS 9 and IAS 39 may be possible until 1 January 2018 (or until the macro hedge accounting project is complete, in the case of the option to continue to apply IAS 39's hedging requirements):

- IAS 39;
- IAS 39 with adoption of the requirements in IFRS 9 for presenting the effects of changes in a financial liability's credit risk in OCI;
- IFRS 9 (2009) with or without adoption of the requirements for presenting the effects of changes in a financial liability's credit risk in OCI;
- IFRS 9 (2010);
- IFRS 9 (2013) with or without an election to continue to apply IAS 39's hedge accounting requirements; or
- IFRS 9 (2014) with or without an election to continue to apply IAS 39's hedge accounting requirements.

The diagram below illustrates the various options for applying IFRS 9 that may be available to an entity.

<sup>20</sup> For further discussion on this issue, see our [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), issued in December 2013.



### Observation – Adoption of previous versions of IFRS 9

IFRS 9.73.2

Entities with December year ends will be able to initially apply any of the previous versions of IFRS 9 in their 2015 financial statements. This is because the DIA (first day of the 2015 calendar year – i.e. 1 January 2015) would fall before 1 February 2015, which is the cut-off date for the beginning of the accounting periods in which these earlier versions can be initially applied.

### 15.2.4.2

#### Sequential application of IFRS 9

IFRS 9.72.27

If an entity adopts IFRS 9 (2014) without having first adopted an earlier version of the standard, then it has a single DIA for IFRS 9. If an entity early adopts an earlier version of IFRS 9 and later adopts the IFRS 9 (2014), then the entity may have a different DIA for each version of IFRS 9 that it has adopted.

The DIA of the later version of IFRS 9 generally does not impact the previous adoption of an earlier version. Instead, it is used in applying the incremental transition requirements and reliefs of the subsequently adopted IFRS 9.

**Example – Sequential application of IFRS 9**

Company X adopts the complete IFRS 9 without having first adopted an earlier version of the standard. Company Y first adopts IFRS 9 (2009) and then the complete IFRS 9. Companies X and Y determine the DIA for each version of the standard as follows.

	Earlier version	Complete IFRS 9	DIA
Entity X	✗	✓	Use DIA of the complete IFRS 9 for all requirements
Entity Y	✓ IFRS 9 (2009)	✓	Use DIA of IFRS 9 (2009) for the requirements of IFRS 9 (2009) Use DIA of the complete IFRS 9 for incremental requirements and reliefs of the complete IFRS 9

## 15.3 Disclosures on initial application of IFRS 9

*IAS 8.28, IFRS 7.42Q*

In the period of initial adoption of IFRS 9, an entity provides the disclosures specified in IAS 8. However, in this period, an entity is not required to disclose the line item amounts that would have been reported in accordance with the classification and measurement requirements (which include requirements for amortised cost and impairment) of:

- IFRS 9 for prior periods; and
- IAS 39 for the current period.

### 15.3.1 Classification and measurement

The disclosure requirements on adoption of IFRS 9 (2014) depend on whether an entity transitions:

- from IAS 39 (and so applies the classification and measurement requirements of IFRS 9 for the first time); or
- from an earlier version of IFRS 9.

More extensive disclosures are required in the former case. This section highlights the key disclosures, but does not reproduce all of the disclosures required by the standard.

#### 15.3.1.1 Disclosures relevant to all transitions

*IFRS 7.42I–J*

On adoption of IFRS 9, an entity discloses in the reporting period that includes the DIA:

- the original measurement category and carrying amount determined under IAS 39 or an earlier version of IFRS 9; 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 IFRS 9 and the reasons for any designations or de-designations of financial assets and financial liabilities as at FVTPL. The entity also discloses the amount of any financial assets and financial liabilities that were previously designated as at FVTPL but are no longer so designated, distinguishing between mandatory and elective de-designations.



### 15.3.1.2

#### Additional disclosures on transition from IAS 39

IFRS 7.42L

An entity discloses the changes in the classifications of financial assets and financial liabilities as 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 IFRS 9.

IFRS 7.42M–N

The entity discloses the impact of these reclassifications, as follows.

Type of reclassification as a result of transition to IFRS 9	Disclosures
<b>Financial assets and financial liabilities reclassified out of FVTPL or FVOCI to amortised cost</b>	The fair value of the financial assets or financial liabilities at the reporting date.
<b>Financial assets reclassified out of FVTPL to FVOCI</b>	The fair value gain or loss that would have been recognised in profit or loss or OCI during the reporting period if the financial assets or financial liabilities had not been reclassified.
<b>Financial assets and financial liabilities reclassified out of FVTPL to any other measurement category</b>	The EIR determined as at the DIA and the interest revenue or expense recognised in the reporting period in which the entity initially applies the classification and measurement requirements for financial assets in IFRS 9. In some cases, this disclosure has to be made for each period until the financial instruments are derecognised.

IFRS 7.42R–S

Additional disclosures have to be made if certain exceptions relating to impracticability are used on transition (see 15.2.2.2).

### 15.3.2

#### Impairment

IFRS 7.42P

On the DIA of the impairment requirements of IFRS 9, 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 at the DIA.

## 15.4

### First-time adopters of IFRS

IFRS 1.B2,B3,B8–B9,  
D19–D19C

A first-time adopter of IFRS that applies IFRS 9 in its first IFRS financial statements applies similar transition requirements to those described in 15.2 when relevant, but references to the DIA are generally replaced with references to the date of transition to IFRS. Furthermore, in contrast to the transition provisions of IFRS 9, which require an assessment of the SPPI criterion at inception of the instrument (see 15.2.2.2), the provisions in IFRS 1 require the assessment to take place at the date of transition.

### Observation – DIA and date of transition

*IFRS 1.7 Appendix A, E1*

IFRS 1, as amended by IFRS 9, does not refer to the DIA, but instead refers to the date of transition. Under IFRS 9, the DIA is the beginning of the period in which an entity first applies IFRS 9. Under IFRS 1, the date of transition is the beginning of the earliest period for which an entity presents full comparative information under IFRS in its first IFRS financial statements. Therefore, assuming that one year of full comparative information is presented, the date of transition for a first-time adopter is one year earlier than the DIA would be for an existing IFRS preparer that initially applied IFRS 9 in the current reporting period. Generally, a first-time adopter should apply consistent accounting policies both in its first IFRS reporting period and in the comparative period; however, there is an exemption from applying IFRS 9 in the comparative period for entities that adopt IFRS for the first time for an annual period beginning before 1 January 2019 (see below).

In addition, the following exemptions are also applicable for first-time adopters.

*IFRS 1.D33*

IFRS 9 permits certain contracts to buy or sell a non-financial item to be designated at inception as measured at FVTPL (see Chapter 3). A first-time adopter may irrevocably designate an existing contract that meets the own-use scope exemption at the date of transition to IFRS as at FVTPL, but only if it designates all similar contracts in this way.

*IFRS 1.E1–E2*

If an entity adopts IFRS for the first time for an annual reporting period beginning before 1 January 2019, then it does not have to restate comparative information in its first IFRS financial statements under IFRS 9. This exemption also includes IFRS 7 disclosures related to assets that are in the scope of IFRS 9. If a first-time adopter applies this exemption, then the following requirements apply.

- In applying IFRS 9, the 'date of transition' is the beginning of the first IFRS reporting period.
- The entity applies its previous GAAP in comparative periods to items that are in the scope of IFRS 9.
- The entity discloses the fact that the exemption is applied, as well as the basis of preparation of the comparative information.
- The difference arising on adoption of IFRS 9 is treated as arising from a change in accounting policy and the entity provides related disclosures required by IAS 8. However, the entity is only required to disclose the effects on financial statement line item amounts for amounts that are presented in the statement of financial position at the comparative period's reporting date.
- The entity provides additional disclosures if compliance with the specific requirements in IFRS is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

### Observation – Adoption of previous versions of IFRS 9

*IFRS 1.7–8*

The general requirements of IFRS 1 for early application are as follows.

- A first-time adopter is required to use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies have to comply with each IFRS that is effective at the end of its first IFRS reporting period
- A first-time adopter may apply a new IFRS that is not yet mandatory if that IFRS permits early application.

Existing IFRS preparers that adopt IFRS 9 on or before 31 January 2015 are able to adopt a previous version of IFRS 9 (see 15.2.4). However, there is no explicit guidance in IFRS 9 (2014) or in IFRS 1 (as amended by IFRS 9 (2014)) that discusses application of a previous version of IFRS 9 by a first-time adopter.

# 16 FASB proposals and US GAAP convergence

The project to revise the accounting for financial instruments started in 2008 as a joint project between the IASB and FASB. One of the project's aims was to reduce key differences between the requirements of IFRS and US GAAP. However, the Boards ultimately decided to continue in different directions. Therefore, the FASB's revised guidance on financial instruments is expected to be different from IFRS 9, and so convergence is not expected to be achieved. At the time of issuing this publication, the FASB is continuing to deliberate its project. The FASB's progress can be summarised as follows.

## 16.1 Classification and measurement of financial assets and financial liabilities

The FASB issued an exposure draft of a proposed classification and measurement model in February 2013 that was similar to the model in IFRS 9. However, during its redeliberations the FASB decided to retain most of the current US GAAP classification and measurement model for financial assets and financial liabilities, and to focus on making targeted improvements. The final FASB classification and measurement standard is expected to be issued in the first half of 2015.

## 16.2 Impairment

The FASB issued an exposure draft of a proposed impairment model in December 2012 that was different to the model in IFRS 9. Although the FASB's proposed model was also an expected credit loss model, it included a single measurement approach based on lifetime expected credit losses. The FASB is still deliberating the proposals. The final FASB impairment model is expected to be issued in the first half of 2015.

## 16.3 Hedge accounting

The FASB hedge accounting proposals were put forward in an exposure draft in May 2010. There are significant differences between the hedge accounting proposals in the FASB's exposure draft and IFRS 9. In February 2011, the FASB issued an invitation to comment on selected hedge accounting issues, in order to solicit input on the IASB's proposals on hedge accounting. In August 2011, the FASB discussed the feedback received on the invitation to comment, but reached no decisions. The FASB will perform research and consider the feedback received to determine its plan for redeliberations on hedge accounting. There is no specific timetable for the redeliberations.

# About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

## Content

Our *First Impressions* publications are prepared on the release of a new standard, interpretation or other significant amendment to the requirements of IFRS. They discuss the key elements of the new requirements and highlight areas that may result in a change of practice. Examples are provided to help you assess the impact of implementation.

This edition considers the requirements of the complete version of IFRS 9 *Financial Instruments* (2014), focusing on the classification and measurement of financial assets and financial liabilities, including the impairment of financial assets. The new general hedge accounting model, which forms part of the complete IFRS 9, was originally issued in November 2013 and is discussed in our [First Impressions: IFRS 9 \(2013\) – Hedge accounting and transition](#), published in December 2013.

The text of this publication is referenced to IFRSs in issue at 30 August 2014; references in the left-hand margin identify the relevant paragraphs.

In many cases, further analysis and interpretation may be needed to enable an entity to apply IFRS to its own facts, circumstances and individual transactions. Furthermore, some of the information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change as practice develops.

We will update and supplement the interpretation guidance and examples in this publication by adding additional interpretative guidance to *Insights to IFRS*, our practical guide to IFRS.

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