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IFRS 9: Financial Instruments – high level summary

Background

IFRS 9 Financial Instruments is the IASB's replacement of IAS 39 Financial Instruments: Recognition and Measurement. The Standard includes requirements for recognition and measurement, impairment, derecognition and general hedge accounting.

The version of IFRS 9 issued in 2014 supersedes all previous versions and is mandatorily effective for periods beginning on or after 1 January 2018 with early adoption permitted (subject to local endorsement requirements). For a limited period, previous versions of IFRS 9[1] may be adopted early, provided the relevant date of initial application is before 1 February 2015 (again, subject to local endorsement requirements).

> **Observation**
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> The International Accounting Standards Board (IASB) has published an exposure draft (ED/2015/11) that proposes amendments to IFRS 4 Insurance Contracts that are intended to address concerns about the different effective dates of IFRS 9 Financial Instruments and the forthcoming new insurance contracts standard. The deadline of comments ended on 8 February and at the time of writing the IASB was considering the responses received.

The purpose of this publication is to provide a high-level overview of the IFRS 9 requirements, focusing on the areas which are different from IAS 39. The following areas are considered:

- classification and measurement of financial assets;
- impairment;
- classification and measurement of financial liabilities; and
- hedge accounting.

The derecognition model in IFRS 9 is carried over unchanged from IAS 39 and is therefore not considered further in this paper.

Overview of IFRS 9

Classification and measurement of financial instruments

Initial measurement of financial instruments

Under IFRS 9 all financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs. This requirement is consistent with IAS 39.

Financial assets: subsequent measurement

Financial asset classification and measurement is an area where many changes have been introduced by IFRS 9. Consistent with IAS 39, the classification of a financial asset is determined at initial recognition, however, if certain conditions are met, an asset may subsequently need to be reclassified.

Subsequent to initial recognition, all assets within the scope of IFRS 9 are measured at:

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

The FVTOCI classification is mandatory for certain debt instrument assets unless the option to FVTPL ('the fair value option') is taken. Whilst for equity investments, the FVTOCI classification is an election. The requirements for reclassifying gains or losses recognised in other comprehensive income (OCI) are different for debt and equity investments. For debt instruments measured at FVTOCI, interest income (calculated using the effective interest rate method), foreign currency gains or losses and impairment gains or losses are recognised directly in profit or loss. The difference between cumulative fair value gains or losses and the cumulative amounts recognised in profi or loss is recognised in OCI until derecognition, when the amounts in OCI are reclassified to profit or loss. This

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contrasts with the accounting treatment for investments in equity instruments designated at FVTOCI under which only dividend income is recognised in profit or loss with all other gains and losses recognised in OCI and there is no reclassification on derecognition.

Debt instruments

A debt instrument that meets the following two conditions must be measured at amortised cost unless the asset is designated at FVTPL under the fair value option (see below):

- **Business model test:** The financial asset is held within a business model whose objective is to hold financial assets to collect their contractual cash flows (rather than to sell the assets prior to their contractual maturity to realise changes in fair value).
- **Cash flow characteristics test:** The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A debt instrument that meets the cash flow characteristics test and is not designated at FVTPL under the fair value option must be measured at FVTOCI if it is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and sell financial assets.

All other debt instrument assets are measured at fair value through profit or loss (FVTPL).

Observation

The FVTOCI category for debt instruments is not the same as the available-for-sale category under IAS 39. Under IAS 39, impairment gains and losses are based on fair value, whereas under IFRS 9, impairment is based on expected losses and is measured consistently with amortised cost assets (see below).

Also, the criteria for measuring at FVTOCI are based on the entity's business model, which is not the case for the available-for-sale category. For example under IAS 39, certain instruments can be elected to be classified as available-for-sale, whereas under IFRS 9 the FVTOCI classification cannot be elected for debt instruments.

Contractual cash flow characteristics test

Only debt instruments are capable of meeting the contractual cash flows characteristics test required by IFRS 9. Derivative assets and investments in equity instruments will not meet the criteria. Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding 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. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement.

The assessment as to whether contractual cash flows are solely payments of principal and interest is made in the currency in which the financial asset is denominated. Judgement is needed in assessing whether a payment (or non- payment) of a contractual cash flow that only arises as a result of the occurrence or non-occurrence of a contingent event leads to the instrument failing the contractual cash flow characteristics test. An entity should consider what risk leads to the occurrence of the contingent event and whether that risk is consistent with risks associated with a basic lending arrangement. The contractual cash flows characteristics assessment should consider all the contractual terms of the instrument, not just those contractual cash flows that are most likely to fall due. When an asset may be prepaid, the contractual cash flow characteristics assessment requires consideration of the contractual cash flows both before and after the timing of the prepayment option, irrespective of the probability that the instrument may be repaid prior to maturity.

IFRS 9 contains detailed guidance regarding the assessment of the contractual cash flows of an asset and has specific requirements for non-recourse assets and contractually linked instruments.

Business model assessment

An assessment of business models for managing financial assets is fundamental to the classification of financial assets. An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective. The 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 and should be determined at a higher level of aggregation. However, an entity may have more than one business model for managing its financial assets.

IFRS 9 provides guidance on how to determine whether a business model is to manage assets to collect contractual cash flows or to both collect contractual cash flows and to sell financial assets. When sales of financial assets, other than in response to credit deterioration, are more than infrequent and more than insignificant in value (either individually or in aggregate) an assessment is needed to determine whether such sales are consistent with an objective of collecting contractual cash flows. Further, sales of financial assets may be consistent with the objective of collecting contractual cash flows if they are made close to the maturity of the financial assets and the proceeds from the sales approximate to the collection of the remaining contractual cash flows.

Observation

Entities will need to assess their business models for holding financial assets. For some entities, such as non-financial corporates, the assessment may be relatively simple as their financial assets may be limited to trade receivables and bank deposits that are clearly held to collect contractual cash flows. Entities that have a broader range of activities involving financial assets, e.g. lenders, investors in debt securities held for treasury activities and insurance entities will need to perform greater analysis to understand the business model that applies and consider the motivations that would lead to disposals of financial assets.

Entities will also need to reassess their business models each reporting period to determine whether the business model has changed since the preceding period. Increasing levels of sales of financial assets held within a business model that previously met the amortised cost or FVTOCI criteria may be evidence that the business model has changed and, therefore, warrant reclassification of financial assets.

Fair value option

IFRS 9 contains an option to designate, at initial recognition, a financial asset as measured at FVTPL if doing so eliminates or significantly reduces an 'accounting mismatch' that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. Financial assets designated at FVTPL are not subject to the reclassification requirements of IFRS 9.

Observation

Under IAS 39, the fair value option for financial assets can also be applied when the asset is part of a group of assets or assets and liabilities that is managed on a fair value basis or when it has an embedded derivative that is not closely related.

Under IFRS 9 assets managed on a fair value basis are by default accounted for at FVTPL because they fail the business model test. Hybrid debt instruments that are financial assets with non-closely related embedded derivatives under IAS 39 would generally fail to meet the contractual cash flow characteristic test, and thus would also be accounted for at FVTPL under IFRS 9.

Equity investments

All equity investments in scope of IFRS 9 are measured at fair value in the statement of financial position, with value changes recognised in profit or loss, except for those equity investments for which the entity has elected to present value changes in other comprehensive income.

The option to designate an equity instrument at FVTOCI is available at initial recognition and is irrevocable. This designation results in all gains and losses being presented in OCI except dividend income which is recognised in profit or loss.

Observation

Under IAS 39, investments in equity instruments and derivatives (whether assets or liabilities) that are linked to and must be settled by delivery of unquoted equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured, could be measured at cost. Cost should be used only if there is a significant range of possible fair value estimates and the probabilities of the various

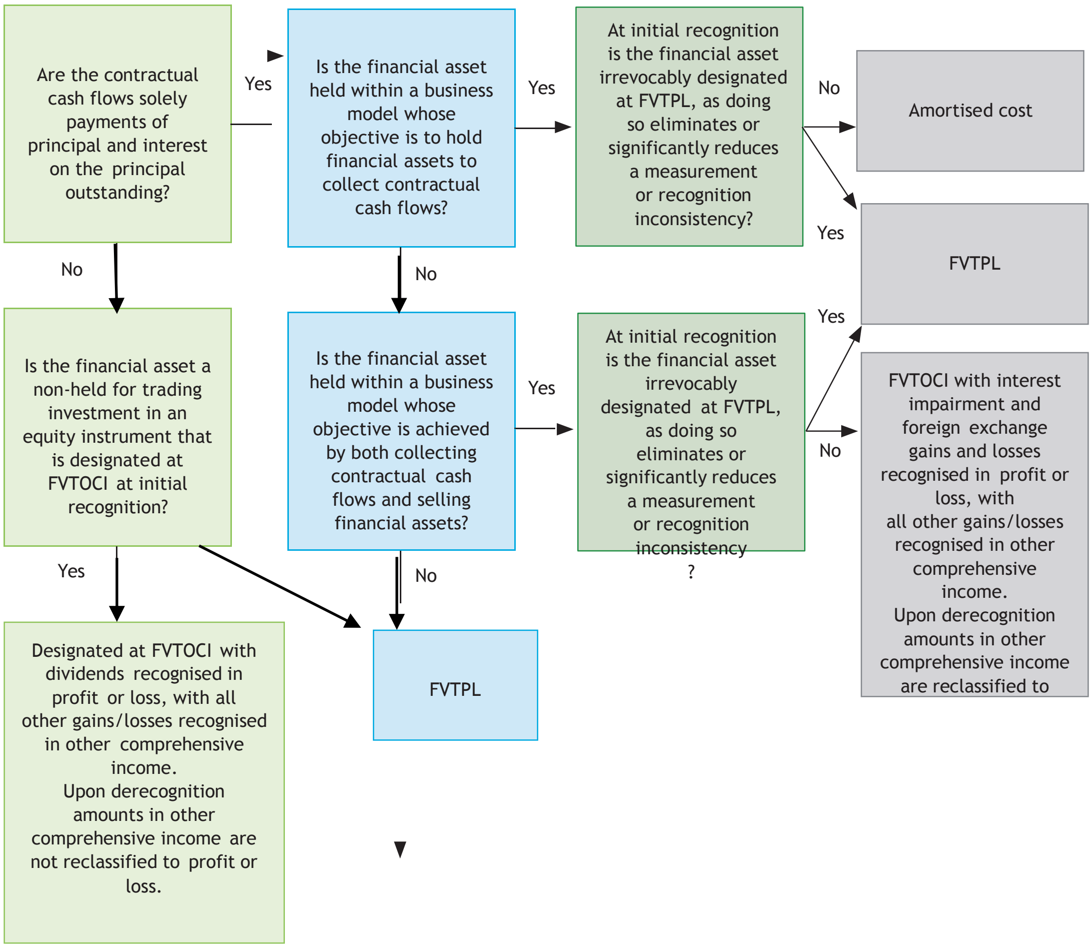
estimates cannot be reasonably assessed. This cost exception is not included in IFRS 9. However, IFRS 9 contains guidance on when cost may be the best estimate of fair value and also when it might not be representative of fair value.

Observation

For equity instruments designated at FVTOCI under IFRS 9,only dividend income is recognised in profit or loss, all other gains and losses are recognised in OCI without reclassification on derecognition. This differs than the treatment of AFS equity instruments under IAS 39 where gains and losses recognised in OCI are reclassified on derecognition or impairment.

Summary of classification and measurement model for financial assets.

The diagram below summarises the application of the classification and measurement model for financial assets discussed above.



Financial liabilities: Subsequent measurement

The IFRS 9 accounting model for financial liabilities is broadly the same as that in IAS 39. However, there are two key differences compared to IAS 39.

- ***The presentation of the effects of changes in fair value attributable to an entity's credit risk.***

Financial liabilities held for trading, (e.g. derivative liabilities), as well as loan commitments and financial guarantee contracts that are designated at FVTPL under the fair value option, will continue to be measured at fair value with all changes being recognised in profit or loss. However, for all other financial liabilities designated as at FVTPL using the fair value option, IFRS 9 requires the amount of the change in the liability's fair value attributable to changes in the credit risk to be recognised in OCI with the remaining amount of change in fair value recognised in profit or loss, unless this treatment of the credit risk component creates or enlarges a measurement mismatch. Amounts presented in other comprehensive income are not subsequently transferred to profit or loss.

Observation

In cases where amounts payable under an obligation are only paid when amounts are due on specified assets (e.g. with some asset-backed securities), care is required in differentiating between credit risk and asset-specific performance risk. IFRS 9 is clear that asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation but rather it is related to the risk that a single asset or a group of assets will perform poorly (or not at all). Therefore any changes in fair value attributable to asset-specific performance should be recognised in profit or loss, not in other comprehensive income.

- ***The elimination of the cost exemption for derivative liabilities to be settled by the delivery of unquoted equity instruments.***

The part of IFRS 9 dealing with financial assets removed the cost exemption in IAS 39 for unquoted equity instruments and related derivative assets where fair value is not reliably determinable. IFRS 9 also removed the cost exemption for derivative liabilities that will be settled by delivering unquoted equity instruments whose fair value cannot be determined reliably (e.g. a written option where, on exercise, an entity would deliver unquoted shares to the holder of the option). Therefore all derivatives on unquoted equity instruments, whether assets or liabilities, are measured at fair value under IFRS 9.

Fair value option

The IFRS 9 eligibility requirements for applying the fair value option to measure financial liabilities at FVTPL are consistent with those of IAS 39.

Derivatives

All derivatives in scope of IFRS 9, including those linked to unquoted equity investments, are measured at fair value. Fair value changes are recognised in profit or loss unless the entity has elected to apply hedge accounting by designating the derivative as a hedging instrument in an eligible hedging relationship in which some or all gains or losses may be recognised in other comprehensive income.

Embedded derivatives

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host, with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

The embedded derivative concept that exists in IAS 39 has been included in IFRS 9 to apply only to hosts that are not financial assets within the scope of the Standard, i.e. financial liabilities and host contacts not in the scope of IFRS 9, such as leases, purchase contracts, service contracts, etc. Consequently, embedded derivatives that, under IAS 39, would have been separately accounted for at FVTPL, because they were not closely related to a host financial asset will no longer be separated. Instead, the contractual cash flows of the financial asset are assessed in their entirety, and the asset as a whole is measured at FVTPL if the contractual cash flow characteristics test is not passed.

The embedded derivative guidance that exists in IAS 39 is included in IFRS 9 to help identify when an embedded derivative is closely related to a financial liability host contract or a host contract not within the scope of the Standard (e.g. lease contracts, insurance contracts, contracts for the purchase or sale of non-financial items).

Reclassification

For financial assets, reclassification is required between FVTPL, FVTOCI and amortised cost; if and only if the entity’s business model objective for its financial assets changes so its previous business model assessment would no longer apply.

IFRS 9 does not allow reclassification:

- when the fair value option has been elected in any circumstance for a financial asset;
- or equity investments (measured at FVTPL or FVTOCI); or
- for financial liabilities.

If an entity reclassifies a financial asset, it is required to apply the reclassification prospectively from the reclassification date, defined as the first day of the first reporting period following the change in business model that results in the entity reclassifying financial assets. Previously recognised gains, losses (including impairment gains or losses) or interest are not restated.

Impairment

IFRS 9 introduces a new impairment model based on expected losses, (rather than incurred loss as per IAS 39) which has a wider scope of application than IAS 39.

Scope

IFRS 9 requires the same expected loss impairment model to apply to all of the following:

- financial assets measured at amortised cost;
- financial assets mandatorily measured at FVTOCI;
- loan commitments when there is a present obligation to extend credit (except where these are measured at FVTPL);
- financial guarantee contracts to which IFRS 9 is applied (except those measured at FVTPL);
- lease receivables within the scope of IAS 17 Leases (or, when applied, IFRS 16 Leases); and
- contract assets within the scope of IFRS 15 Revenue from Contracts with Customers.

> **Observation**
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> IFRS 9 requires the same measurement basis for impairment for all items in the scope of the impairment requirements. This differs from IAS 39, under which impairment is calculated differently for amortised cost assets and available-for-sale assets. Further, IFRS 9 applies the same measurement approach to certain loan commitments and financial guarantee contracts where previously these were measured with reference to IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

General approach

With the exception of purchased or originated credit-impaired financial assets (which are considered separately below), expected credit losses are required to be measured through a loss allowance at an amount equal to:

- 12-month expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or
- lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

A loss allowance for lifetime expected credit losses is required for a financial instrument if the credit risk on that financial instrument has increased significantly since initial recognition. It is also required for contract assets or trade receivables that are not, according to IFRS 15, considered to contain a significant financing component.

Additionally, entities can elect an accounting policy of recognising lifetime expected credit losses for all contract assets and/or all trade receivables, including those that contain a significant financing component. The same election is also separately permitted for lease receivables.

For all other financial instruments, expected credit losses are measured at an amount equal to the 12-month expected credit losses.

Observation

The term '12-month expected credit losses' might intuitively sound like an allowance for the cash shortfalls that are possible in the next 12 months, however, this is not the case. The Standard states that 12-month expected credit losses are a portion of the lifetime expected credit losses and represent the lifetime cash shortfalls 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), weighted by the probability of that default occurring. Therefore, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months, nor the cash shortfalls that are predicted over the next 12 months.

Significant increase in credit risk

A significant increase in credit risk is defined as a significant increase in the probability of a default occurring since initial recognition. Under the Standard, an entity may use various approaches to assess whether credit risk has increased significantly (provided that the approach is consistent with the IFRS 9 requirements). An approach can be consistent with the requirements even if it does not include an explicit probability of default occurring as an input. The application guidance provides a list of factors that may assist an entity in making the assessment. Also, whilst in principle the assessment of whether a loss allowance should be based on lifetime expected credit losses is to be made on an individual asset basis, some factors or indicators might not be available at an instrument level.

In this case, the entity should perform the assessment on appropriate groups or portions of a portfolio of financial instruments. The requirements contain a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due.

IFRS 9 also requires that (other than for purchased or originated credit impaired financial instruments) if a significant increase in credit risk that had taken place since initial recognition, has reversed by a subsequent reporting period (i.e., at the reporting date credit risk has not significantly increased since initial recognition) then the loss allowance reverts to 12-month expected credit losses.

As a practical expedient, IFRS 9 allows an entity to assume that the credit risk on a financial instrument has not increased significantly if it is determined to have a 'low' credit risk at the reporting date. The Standard considers credit risk to be 'low' if there is 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 ability of the borrower to fulfil its contractual cash flow obligations. The Standard suggests that an 'investment grade' rating might be an indicator for a low credit risk.

Purchased or originated credit-impaired financial assets

Purchased or originated credit-impaired financial assets are treated differently because the asset is credit-impaired at initial recognition. For these assets, an entity would recognise all changes in lifetime expected credit losses since initial recognition as a loss allowance with any changes recognised in profit or loss. Under the requirements, any favourable changes for such assets are an impairment gain even if the resulting expected cash flows of a financial asset exceed the estimated cash flows on initial recognition.

Credit-impaired financial assets

Under IFRS 9 a financial asset is credit-impaired when one or more events have occurred that have a detrimental impact on the expected future cash flows of the financial asset. It includes observable data that has come to the attention of the holder of a financial asset about the following events:

- significant financial difficulty of the issuer or borrower;
- a breach of contract, such as a default or past-due event;
- the lenders for economic or contractual reasons relating to the borrower's financial difficulty granting the borrower a concession that would not otherwise be considered;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for the financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects incurred credit losses.

Observation

These indicators are consistent with those included in IAS 39 for identifying objective evidence of impairment.

Basis for estimating expected credit losses

The measurement of expected credit losses shall reflect an unbiased and probability-weighted amount that is determined by evaluating the range of possible outcomes as well as incorporating the time value of money. Also, the entity should consider reasonable and supportable information about past events, current conditions and reasonable and supportable forecasts of future economic conditions when measuring expected credit losses.

The Standard defines expected credit losses as the weighted average of credit losses with the weightings being the respective risks of a default occurring. Not every possible scenario must be considered but, at a minimum, the risk or probability that a credit loss occurs must be considered, even if the probability of a credit loss occurring is low.

An entity is required to incorporate reasonable and supportable information (i.e., that which is reasonably available at the reporting date). Information is reasonably available if obtaining it does not involve undue cost or effort (with information available for financial reporting purposes qualifying as such).

For application of the model to a loan commitment, an entity will consider the risk of a default occurring under the loan to be advanced, whilst application of the model for financial guarantee contracts requires consideration of the risk of a default occurring on the specified debtor.

An entity may use practical expedients when estimating expected credit losses if they are consistent with the principles in the Standard (e.g. expected credit losses on trade receivables may be calculated using a provision matrix where a fixed provision rate applies depending on the number of days that a trade receivable is outstanding).

To reflect time value of money, expected losses should be discounted to the reporting date using the effective interest rate of the asset (or an approximation thereof) that was determined at initial recognition. A "credit-adjusted effective interest rate" should be used for expected credit losses of purchased or originated credit-impaired financial assets.

Expected credit losses of undrawn loan commitments should be discounted by using the effective interest rate (or an approximation thereof) that will be applied when recognising the financial asset resulting from the commitment. If the effective interest rate of a loan commitment cannot be determined, the discount rate should reflect the current market assessment of 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. This approach should also be used to discount expected credit losses of financial guarantee contracts for which the effective interest rate cannot be determined.

Observation

IFRS 9 is clear that, even for an individual financial asset, the measurement of expected credit losses must include the probability weighting of credit losses even if these are unlikely and the most probable outcome is the collection of the full contractual cash flows. The requirements in effect prohibit an entity from estimating expected credit losses solely on the basis of the most likely outcome.

Modifications and write-offs

If a renegotiation or other modification of the contractual cash flows of a financial asset results in derecognition under IFRS 9, the revised instrument is treated as a new instrument. The impairment model would then apply to the new instrument as normal.

If a renegotiation or other modification of the contractual cash flows of a financial asset does not result in derecognition, the entity recalculates the gross carrying amount of the financial asset (i.e. amortised cost amount before adjusting for any loss allowance). This is done by discounting the new expected contractual cash flows (post modification) at the original effective interest rate and recognising any resulting modification gain or loss in profit or loss. From this date, the entity assesses whether the credit risk of the financial instrument has increased significantly since initial recognition of the instrument by comparing the credit risk at the reporting date (under modified terms) to that at initial recognition (under original, unmodified terms).

The Standard requires an entity to directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectation of recovery. IFRS 9 states that a write-off constitutes a derecognition event and may relate to either the asset in its entirety or a portion of it.

Presentation

Whilst interest revenue is always required to be presented as a separate line item, it is calculated differently according to the status of the asset with regard to credit impairment.

For a financial asset that is not a purchased or originated credit-impaired financial asset, or has not become credit-impaired (see 'Credit-impaired financial assets' above) since initial recognition, interest revenue is calculated using a 'gross method' of applying the effective interest rate method to the gross carrying amount of the asset (i.e. its carrying amount excluding the loss allowance).

For a financial asset that is not a purchased or originated credit-impaired financial asset but subsequently has become credit-impaired, from the beginning of the next reporting period, interest revenue is calculated using a 'net method' of applying the effective interest rate to the net amortised cost balance (i.e. including the loss allowance).

If following a period of using the 'net method', the credit risk of the financial instrument improves so that the financial asset is no longer credit-impaired and the improvement can be related objectively to an event since the net method was applied, the calculation of interest revenue reverts to the 'gross method' from the beginning of the next reporting period.

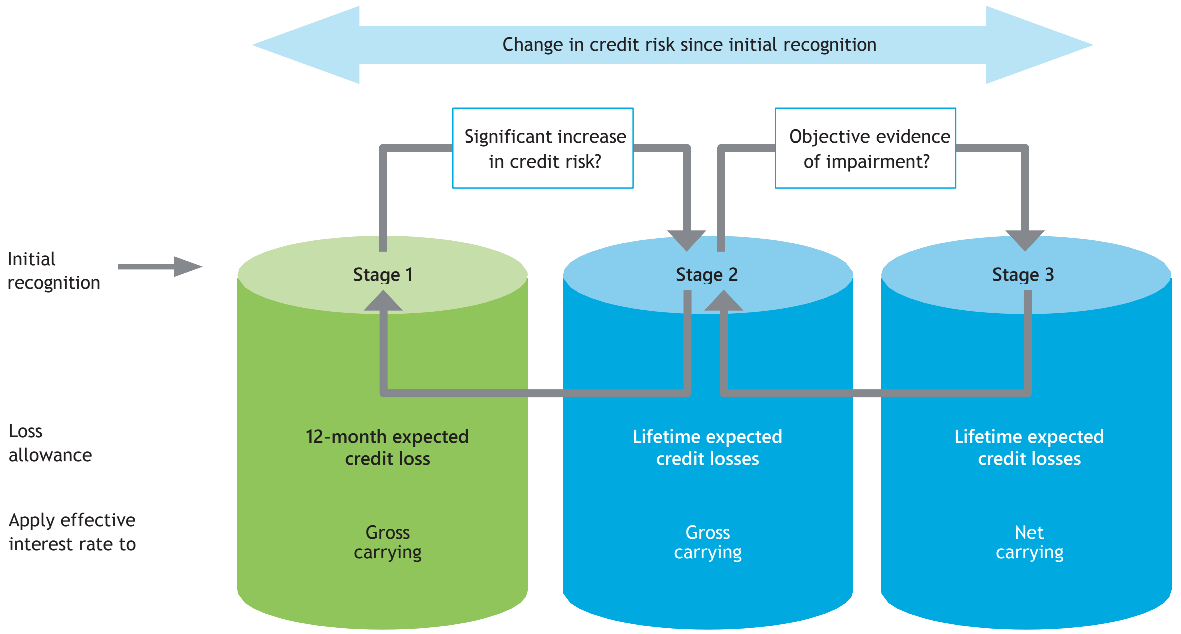
Observation

The trigger point for the change in presentation of interest income on financial assets from the gross method to the net method is based on them becoming credit impaired. This is different from the criteria used to move from 12-month expected credit losses to lifetime expected credit losses which is based on a significant deterioration in the credit risk of the financial asset.

Finally, in the case of purchased or originated credit-impaired financial assets, interest revenue is always recognised by applying the credit-adjusted effective interest rate to the amortised cost carrying amount. The credit-adjusted effective interest rate is the rate that discounts the cash flows expected on initial recognition (explicitly taking account of expected credit losses as well as contractual terms of the instrument) back to the amortised cost at initial recognition.

IAS 1 *Presentation of Financial Statements* require that impairment losses, including reversals of impairment losses and impairment gains (in the case of purchased or originated credit-impaired financial assets), are presented in a separate line item in the statement of profit or loss and other comprehensive income.

The IFRS 9 general impairment model is summarised below.



Hedge accounting

The application of the hedge accounting requirements in IFRS 9 is optional. If certain eligibility and qualification criteria are met, hedge accounting can allow an entity to reflect its risk management activities in the financial statements by matching gains or losses on hedging instruments (e.g. derivatives) with losses or gains on the risk exposures they hedge (e.g. foreign currency sales).

The hedge accounting model in IFRS 9 is not designed to accommodate hedging of open, dynamic portfolios. For a fair value hedge of interest rate risk of a portfolio of financial assets or liabilities an entity adopting IFRS 9 can apply the hedge accounting requirements in IAS 39 in combination with the general 'macro' hedge accounting requirements in IFRS 9.

Furthermore, when an entity first applies IFRS 9, it may choose as its accounting policy choice to continue to apply all of the hedge accounting requirements of IAS 39 instead of the requirements of Chapter 6 of IFRS 9. The following summarises the hedge requirements of Chapter 6 of IFRS 9 and how they compare with IAS 39.

Qualifying criteria for hedge accounting

A hedging relationship qualifies for hedge accounting only if all of the following criteria are met:

- the hedging relationship consists only of eligible hedging instruments and eligible hedged items;
- at inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge; and
- the hedging relationship meets all of the hedge effectiveness requirements.

Hedging instruments

The main difference in IFRS 9 compared to IAS 39 is that the inclusion of non-derivative financial instruments measured at FVTPL can be eligible hedging instruments. The bulk of changes in respect of hedging instruments relate to how they are accounted for, specifically, the accounting for option contracts, forwards and foreign currency basis spread.

Option contracts

Under IAS 39, entities that hedge account with option contracts generally recognise the fair value change in the time value component of the option in profit or loss. However, risk management generally views the time value of an option (usually equal to the premium paid at inception) as a cost of hedging. In other words, a cost incurred to protect the entity against unfavourable changes in price. This risk management is included in IFRS 9. Under IFRS 9 the accounting for the time value can be viewed as a two-step process.

The first step is to defer in OCI, over the term of the hedge, the fair value change of the time value component of the option contract to the extent that it relates to the hedged item.

The second step is to reclassify amounts from equity to profit or loss. However, the basis of this reclassification depends on the categorisation of the hedged item which will be either:

- *a transaction related hedged item* (e.g. a hedge of a forecast transaction); or
- *a period related hedged item* (e.g. a hedge of an existing item, such as inventory, over a period of time).

For transaction related hedged items the cumulative change in fair value deferred in OCI is recognised in profit or loss at the same time as the hedged item. If the hedged item first gives rise to the recognition of a non-financial asset or a non-financial liability the amount in equity is recognised in the statement of financial position and recorded as part of the initial carrying amount of the hedged item. This amount is recognised in profit or loss at the same time as the hedged item affects profit or loss in accordance with the normal accounting for that hedged item.

For period related hedged items the reclassification of amounts deferred in equity is different. Instead of matching the option cost with a specific transaction, the amount of the original time value of the option that relates to the hedged item is amortised from equity to profit or loss on a rational basis (e.g. straight line) over the term of the hedging relationship.

Forward contracts and foreign currency basis spreads

Under IAS 39, if only the spot component of a forward contract is designated in a hedge, the forward points are recognised in profit or loss on a fair value basis – giving rise to volatility in profit or loss. Under IFRS 9, an alternative accounting treatment for forward points is provided which, unlike the accounting for the time value of an option contract, is a choice rather than a requirement. If applied, the accounting treatment is similar to that of the time value of an option when hedging a period related hedged item as described above. That is, the fair value change of the forward points is deferred in OCI and reclassified through profit or loss over the hedged period on a rational basis.

Under IFRS 9, an entity may also exclude the foreign currency basis spread from a designated hedging instrument and may apply the same accounting treatment described above for the forward points.

Hedged items

IFRS 9 introduces more significant changes to the types of items that are eligible for hedge accounting and how entities can designate those hedged items.

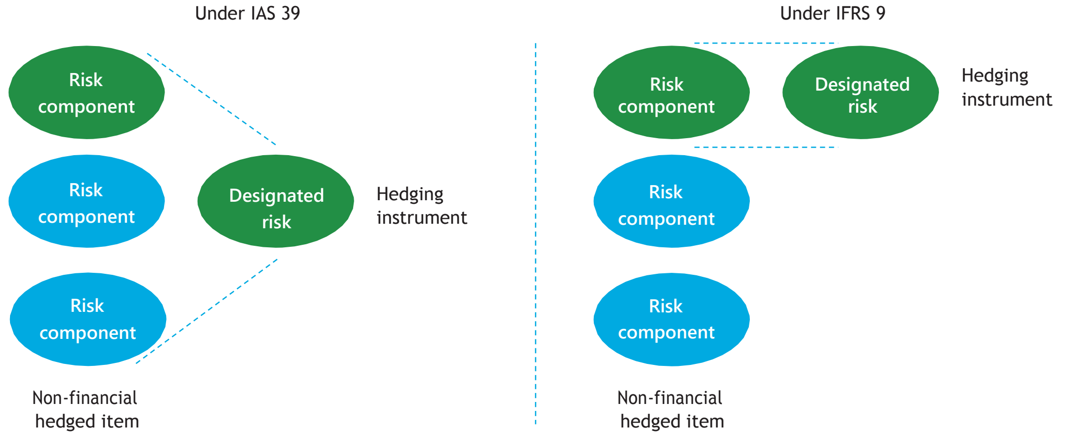
Risk component hedging

Under IAS 39 an entity may hedge part or all of the cash flows of a financial item due to all risks inherent in the hedged item, or it may choose to hedge part or all of the cash flows due to only specific risks. This approach is known as 'hedging portions' and is only permitted if the risk of the financial item can be identified and hedge effectiveness can be assessed and measured reliably.

IFRS 9 extends the eligibility of risk components to include non-financial items, provided the component is separately identifiable and reliably measurable. Consequently, entities may apply hedge accounting for risk components of non- financial items that would not be permitted under IAS 39 (e.g. the crude oil component of jet fuel). It is noteworthy that the risk component does not necessarily have to be contractually specified for it to be separately identifiable.

However, if the risk component is not contractually specified it may be more difficult to isolate parts of the market price into identifiable and measurable risk components. In particular, it will be challenging for entities to analyse how market participants price certain non-financial items to determine whether a risk component is separately identifiable and reliably measurable.

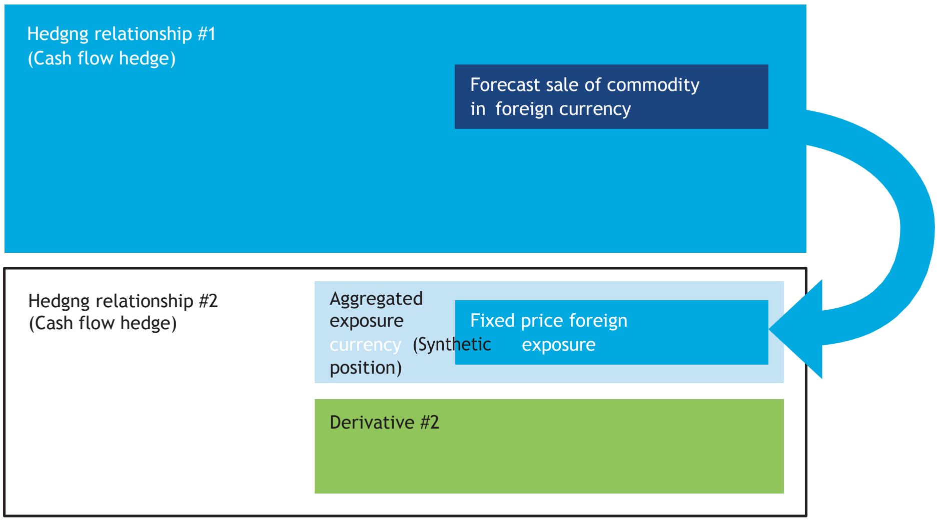
Hedging risk components



Aggregated exposures

IFRS 9 permits an aggregated exposure that includes a derivative to be an eligible hedged item. This is a change from IAS 39 which explicitly prohibits a derivative from being designated as a hedged item (unless it is a written option designated as an offset to a purchased option).

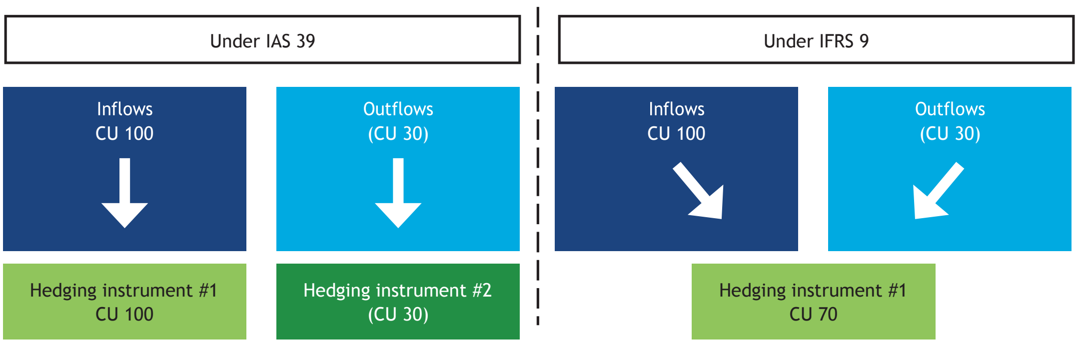
This can be achieved by designating an exposure and a derivative as the hedged item in a hedge relationship, as outlined below.



In this example Derivative #2 may be designated as a hedging instrument of the aggregated exposure that includes the Exposure plus Derivative #1.

Under IFRS 9, groups of items (e.g. a group of assets) and a net position (e.g. the net of assets and liabilities, or net of forecast sales and purchases) may be hedged collectively as a group, provided the group consists of individually eligible hedged items and the risks of those items are managed together. For a cash flow hedge of a group of items, where the variabilities in cash flows are not expected to be approximately proportional to the overall variability of cash flows of the group, only a hedge of foreign currency risk is permitted. For such hedges the designation of that net position should specify the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

Cash flow hedges of net positions for foreign exchange risk



Accounting for qualifying hedging relationships

Under IFRS 9 the three types of hedging relationships (fair value hedge, cash flow hedge and hedge of a net investment in a foreign operation) are the same as under IAS 39. The accounting treatment for each type of hedge relationship is also the same as that under IAS 39, with the exception that an entity is required to apply a basis adjustment when a forecast transaction in a cash flow hedge results in the recognition of a non-financial item. Under IAS 39 entities are permitted to apply whether to basis adjustment. As noted above, the accounting treatment of the time value of an option designated as a hedging instrument and the forward points and the foreign currency basis spread of hedging instruments is also different.

Hedge effectiveness requirements

The qualifying criteria in the IFRS 9 hedge accounting model significantly differ from those in IAS 39. To qualify for hedge accounting under IAS 39, the hedging instrument must be highly effective at achieving offsetting changes in fair value or cash flows attributable to the hedged risk both prospectively and retrospectively. To be highly effective, the level of offset must be between 80 percent and 125 percent. Entities must perform quantitative effectiveness tests on an ongoing basis to demonstrate that the hedging relationship qualifies for hedge accounting.

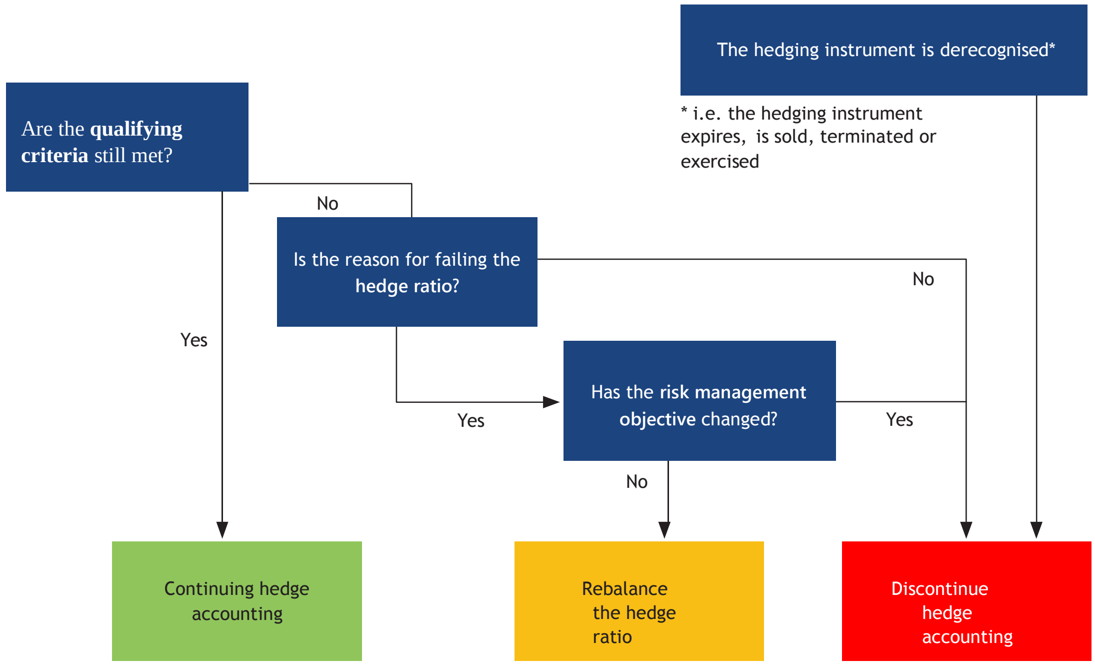
The IFRS 9 hedge accounting model employs a more principles-based approach. In order to qualify for hedge accounting, the hedge relationship must meet the hedge effectiveness criteria at the beginning of each hedged period which requires that:

- there is an economic relationship between the hedged item and the hedging instrument;
- the effect of credit risk does not dominate the value changes that result from that economic relationship; and
- the hedge ratio of the hedging relationship is the same as that actually used in the economic hedge.

Rebalancing and discontinuation

If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity is required to adjust the hedge ratio of the hedging relationship (i.e. rebalances the hedge) so that it meets the qualifying criteria again.

An entity discontinues hedge accounting prospectively only when the hedging relationship (or a part of a hedging relationship) ceases to meet the qualifying criteria (after any rebalancing). This includes instances when the hedging instrument expires or is sold, terminated or exercised. Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (in which case hedge accounting continues for the remainder of the hedging relationship). Unlike under IAS 39, hedge accounting may not be voluntarily discontinued if the criteria for discontinuation are not met.



Credit exposures designated at FVTPL

If an entity uses a credit derivative measured at FVTPL to manage the credit risk of a financial instrument (credit exposure) it may designate all or a proportion of that financial instrument as measured at FVTPL if:

- the name of the credit exposure, e.g. the borrower or the holder of a loan commitment, matches the reference

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entity of the credit derivative ('name matching'); and

- the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

An entity may make this designation irrespective of whether the financial instrument that is managed for credit risk is within the scope of IFRS 9 (for example, it can apply to loan commitments that are, other than for impairment, outside the scope of IFRS 9). The entity may designate that financial instrument at, or subsequent to, initial recognition, or while it is committed but unrecognised and shall document the designation concurrently.

If designated after initial recognition, any difference in the previous carrying amount and fair value is recognised immediately in profit or loss.

An entity discontinues measuring the financial instrument that gave rise to the credit risk at FVTPL if the qualifying criteria are no longer met and the instrument is not otherwise required to be measured at FVTPL. The fair value at discontinuation becomes its new carrying amount.

Disclosures

IFRS 9 amends the requirements of IFRS 7 *Financial Instruments: Disclosures*, introducing a number of new disclosures relating to classification and measurement, impairment and hedge accounting.

The classification and measurement disclosures include a requirement to analyse gains and losses resulting from the derecognition of financial assets measured at amortised cost. The purpose of these disclosures is to highlight the degree to which, and reasons why, amortised cost assets are derecognised before maturity, in light of the business model objective for those assets being held to collect. IAS 1 is also amended to require a line item in the income statement for gains and losses arising from the derecognition of financial assets measured at amortised cost.

The credit risk disclosures require information about credit risk management practices and credit risk exposures. In addition, extensive qualitative and quantitative information about amounts arising from, and changes in, expected credit losses is required. This includes detailed reconciliations of the loss allowance by class. The disclosures are designed to allow users to understand the application and effect of the IFRS 9 impairment model, including information about the judgements made when applying the model.

The hedge accounting disclosures are also extensive and also apply to those entities that, upon adopting IFRS 9, elect to continue to apply the hedge accounting requirements of IAS 39. The disclosures require information about an entity's risk management strategy and its effect on future cash flows. Detailed disclosures about the effect hedge accounting has had on the primary financial statements is also required.

Transition to IFRS 9

IFRS 9 is effective for annual periods beginning on or after 1 January 2018 and, subject to local endorsement requirements, is available for early adoption. An entity with a date of initial application before 1 February 2015 can apply earlier versions of IFRS 9 in the annual periods that begin prior to 1 January 2018, again subject to local endorsement requirements.

IFRS 9 should be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* subject to certain exemptions and exceptions some of which are considered below.

- ***The effective interest method requirements.***

If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method, the entity treats the fair value of the financial asset or financial liability at the end of each comparative period as the gross carrying amount of the financial asset or the amortised cost of the financial liability. In such circumstances, the fair value of the financial asset or financial liability at the date of initial application is treated as the new gross carrying amount of that financial asset or the new amortised cost of that financial liability at the date of initial application of IFRS 9.

- ***Impairment measurement requirements.***

The impairment requirements are applied retrospectively subject to meeting specific exceptions. At the date of initial application, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that the financial instrument was initially recognised (or for loan commitments and financial guarantee contracts the date that the entity became a party to the irrevocable commitment) and compare that to the credit risk at the date of initial application of IFRS 9. If it would require undue cost or effort at the date of initial application to determine whether there has been a significant increase in credit risk since initial recognition, an entity should recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised. However, if the financial instrument has low credit risk at the reporting date, the entity may assume that the credit risk has not increased significantly since initial recognition.

- ***Hedge accounting requirements.***

  On initial application of IFRS 9, an entity can decide to continue applying the hedge accounting requirements of IAS 39 instead of the requirements set out in IFRS 9. This decision applies to all of the entity's hedging relationships. The requirements for hedge accounting in IFRS 9 are generally applied prospectively. To apply hedge accounting from the date of initial application all qualifying criteria must be met at that date. However, the accounting for the time value of options should be applied retrospectively if, in accordance with IAS 39, only the change in an option's intrinsic value was designated as a hedging instrument in a hedging relationship. This only applies to hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. Under the same provision, the accounting for the forward element of forward contracts may be applied retrospectively, if, in accordance with IAS 39, only the change in the spot element of a forward contract was designated as a hedging instrument in a hedging relationship. If electing retrospective application this should be applied to all hedging relationships that qualify for this election. Similarly the accounting for foreign currency basis spreads may be applied retrospectively for those hedging relationships that existed at the beginning of the earliest reporting period or were designated thereafter, which may be elected on a hedge-by-hedge basis.

  The date of initial application for IFRS 9 is the date when an entity first applies the Standard. To reduce the burden for preparers when an entity first applies IFRS 9 it is not required to restate prior periods. However, entities are required to provide comprehensive disclosures about financial assets and liabilities at the date of initial application.

  If an entity transitioning from IAS 39 chooses to restate prior year comparatives, it is required to apply IAS 39 in the comparative period to items that have already been derecognised at the date of initial application. Consequently a combination of IAS 39 and IFRS 9 could apply in the comparative period.

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