



IFRS IN PRACTICE 2019

IFRS 9 *Financial Instruments*

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1. INTRODUCTION

IFRS 9 *Financial Instruments*¹ (IFRS 9) was developed by the International Accounting Standards Board (IASB) to replace IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). The IASB completed IFRS 9 in July 2014, by publishing a final standard which incorporates the requirements of all three phases of the financial instruments projects, being:

- Classification and Measurement;
- Impairment; and
- Hedge Accounting.

The IAS 39 requirements related to recognition and derecognition were carried forward unchanged to IFRS 9.

This *IFRS in Practice* sets out practical guidance and examples about the application of key aspects of IFRS 9.

Key differences between IFRS 9 and IAS 39 are summarised below:

Classification and measurement of financial assets

IFRS 9 replaces the rules based model in IAS 39 with an approach which bases classification and measurement on the business model of an entity, and on the cash flows associated with each financial asset. This has resulted in:

- i. Elimination of the 'held to maturity', 'loans and receivables' and 'available-for-sale' categories. Instead, IFRS 9 introduces two classification categories: 'amortised cost' and 'fair value through other comprehensive income' to accompany 'fair value through profit or loss'.
- ii. Elimination of the requirement to separately account for (i.e. bifurcate) embedded derivatives in financial assets. However, the concept of embedded derivatives has been retained for financial liabilities and for non-financial assets.
- iii. Elimination of the limited exemption to measure unquoted equity investments at cost rather than at fair value, in the rare circumstances in which the range of reasonable fair value measurements is significant and the probabilities of the various estimates cannot reasonably be assessed.

Classification and measurement of financial liabilities

During the development of IFRS 9, the IASB received feedback that most of the existing requirements for financial liabilities in IAS 39 worked satisfactorily. Consequently, those requirements were brought forward largely unchanged, with those instruments held for trading being measured at fair value through profit or loss and most others at amortised cost. However, in a key change for those financial liabilities designated as at fair value through profit or loss, IFRS 9 introduces a requirement for most changes in fair value related to an entity's credit risk to be recorded in other comprehensive income and not profit or loss. This change was made to eliminate the counter intuitive effect of a decline in an entity's creditworthiness resulting in gains being recorded in profit or loss for those liabilities.

As noted above, the concept of embedded derivatives has been retained for financial liabilities and for non-financial assets. This means, for example, that certain structured debt instruments will continue to be accounted for as amortised cost host contracts with separable embedded derivatives, rather than requiring the entire debt instrument to be measured at fair value (as would be the case if embedded derivatives had been eliminated and the instrument was assessed as a single unit of account).

¹ We refer to IFRS 9 (2014) Financial Instruments as issued by the IASB in July 2014, unless otherwise stated.

Impairment

IFRS 9 sets out a new forward looking 'expected loss' impairment model which replaces the incurred loss model in IAS 39 and applies to:

- Financial assets measured at amortised cost;
- Debt investments measured at fair value through other comprehensive income; and
- Certain loan commitments and financial guarantee contracts.

Under the IFRS 9 'expected loss' model, a credit event (or impairment 'trigger') no longer has to occur before credit losses are recognised. An entity will now always recognise (at a minimum) 12-month expected credit losses in profit or loss. Lifetime expected losses will be recognised on assets for which there is a significant increase in credit risk after initial recognition.

Hedge accounting

In contrast to the complex and rules based approach in IAS 39, the new hedge accounting requirements in IFRS 9 provide a better link to risk management and treasury operations and are simpler to apply. The model makes applying hedge accounting easier, allowing entities to apply hedge accounting more broadly, and reduces the extent of 'artificial' profit or loss volatility.

Key changes introduced include:

- Simplified effectiveness testing, including removal of the 80-125% highly effective threshold;
- More items qualify for hedge accounting, e.g. hedging the benchmark pricing component of commodity contracts and net foreign exchange cash positions;
- Entities can hedge account more effectively for exposures that give rise to two risk positions (e.g. interest rate risk and foreign exchange risk, or commodity risk and foreign exchange risk) that are managed by separate derivatives over different periods; and
- Less profit or loss volatility when using options, forwards and foreign currency swaps.

Effective date

The effective date of IFRS 9 is for annual reporting periods beginning on or after 1 January 2018. Early adoption is permitted.

Amendments

Since the issuance of IFRS 9 in July 2014, two amendments to the standard have been made. In September 2016, the IASB issued *Applying IFRS 9 'Financial Instruments' with IFRS 4 'Insurance Contracts' (Amendments to IFRS 4)* to address concerns about the different effective dates of IFRS 9 and IFRS 17 *Insurance Contracts* (IFRS 17). These concerns relate mainly to the potential for insurers to produce financial statements that contain two very significant changes in accounting in a short period of time, and volatility that might arise in financial statements during the period between the effective date of IFRS 9 and the new insurance standard IFRS 17, due to changes in measurement requirements. The amendments permit either the deferral of the adoption of IFRS 9 for entities whose predominant activity is issuing insurance contracts or an overlay approach which moves the additional volatility created by having non-aligned effective dates from profit or loss to other comprehensive income. An entity choosing to apply the overlay approach retrospectively to qualifying financial assets does so when it first applies IFRS 9. An entity choosing to apply the deferral approach does so for annual periods beginning on or after 1 January 2018.

The second amendment was issued October 2017. The IASB issued *Prepayment Features with Negative Compensation (Amendments to IFRS 9)* to address the concerns about how IFRS 9 classifies particular prepayable financial assets. *Prepayment Features with Negative Compensation* amends the existing requirements in IFRS 9 regarding termination rights in order to allow measurement at amortised cost (or, depending on the business model, at fair value through other comprehensive income) even in the case of negative compensation payments. Under the amendments, whether compensation on prepayment is payable or receivable by the borrower is not relevant. The calculation of this compensation payment must be the same for both the case of an early repayment penalty and the case of an early repayment gain. The amendments are to be applied retrospectively for annual periods beginning on or after 1 January 2019 with early application permitted.

The final amendments also contain additional paragraphs in the Basis for Conclusions regarding the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability. The additional paragraphs confirm that an entity recognises any adjustment to the amortised cost of the financial liability arising from a modification or exchange in profit or loss at the date of the modification or exchange. No change was made to any of the associated requirements in IFRS 9, meaning that the accounting approach is required to be adopted at the same point as IFRS 9, being periods beginning on or after 1 January 2018.

Convergence with US GAAP

The IASB's project was initially carried out as a joint project with the US Financial Accounting Standards Board (FASB). However, the FASB ultimately decided to make more limited changes to the classification and measurement of financial instruments and the hedge accounting model, and to develop a more US specific impairment model for financial assets. The FASB's 'current expected credit losses' model requires the recognition of the full amount of expected credit losses upon initial recognition of a financial asset.

2. DEFINITIONS AND SCOPE

2.1. Definitions

A financial instrument is any contract that gives rise to a financial asset of one entity, and a financial liability or equity instrument of another entity. This means that items that will be settled through the receipt or delivery of goods or services are not financial instruments, nor typically are tax assets and liabilities as these arise through legal rather than contractual requirements.

The definitions of a financial asset, a financial liability and an equity instrument are set out below.

A financial asset is defined as any asset that is:

- Cash;
- A contractual right;
 - To receive cash or another financial asset from another entity;
 - To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity.
- An equity instrument of another entity;
- A contract that will or may be settled in the entity's own equity instruments and is:
 - A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include puttable equity instruments or instruments that include a contractual obligation for the entity to deliver a pro rata share of its net assets only on liquidation, that do not meet the definition of equity but are classified as such under IAS 32 *Financial Instruments: Presentation* (IAS 32), nor do they include instruments that are contracts for the future receipt or delivery of an entity's own equity instruments.

A financial liability is defined as any liability that is:

- A contractual obligation;
 - To deliver cash or another financial asset to another entity;
 - To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.
- A contract that will or may be settled in the entity's own equity instruments and is:
 - A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include certain instruments as set out above in the equivalent part of the definition of financial assets.

An equity instrument is defined as:

- Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Certain financial instruments that meet the definition of a financial liability are classified as equity instruments. These are:

- Puttable financial instruments that meet certain specified conditions;
- Financial instruments which contain a contractual obligation for the issuing entity to deliver to the holder a pro rata share of its net assets only on liquidation, but liquidation is either certain to occur and outside the control of the entity (e.g. for a limited life entity) or is uncertain to occur but can be triggered at the option of the instrument holder.

IAS 32 sets out a framework for the accounting treatment of contracts and transactions in an entity's own equity instruments and derivatives where the underlying is an entity's own equity instruments. Certain of those contracts and transactions give rise to financial liabilities from the issuer's perspective, even though they are settled in the entity's own equity shares.

2.2. Scope

A number of financial assets and liabilities are scoped out of IFRS 9. These, together with the accounting standards that apply to them, are as follows:

Interest in subsidiaries	IFRS 10/IAS 27
Interests in associates and joint ventures	IAS 27, IAS 28
Employer's rights and obligations under employee benefit plans	IAS 19
Insurance contracts (except embedded derivatives and some financial guarantee contracts)	IFRS 4/IFRS 17
Financial instruments with discretionary participation features	IFRS 4/IFRS 17
Share-based payments	IFRS 2
Rights and obligations under leases	IAS 17/IFRS 16
An entity's own equity instruments	IAS 32
Financial liabilities issued by an entity that are classified as equity in accordance with IAS 32.16A to 16D	IAS 32
Forward contracts between an acquirer and selling shareholder for a transaction that meets the definition of a business combination whose terms do not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction	IFRS 3
Loan commitments, other than for the IFRS 9 requirements for impairment and derecognition (except those which are designated at FVTPL, can be settled net or represent a commitment to provide a loan at a below-market interest rate which are in the scope of IFRS 9 in its entirety).	-
Reimbursement rights for provisions	IAS 37
Financial instruments that represent rights and obligations within the scope of IFRS 15 <i>Revenue from Contracts with Customers</i> , except those which IFRS 15 specifies are accounted for in accordance with IFRS 9	IFRS 15

In addition, certain contracts to buy or sell a non-financial item (such as a commodity, motor vehicles or aircraft) may be required to be accounted for in accordance with IFRS 9. Although non-financial items fall outside the scope of IFRS 9, if those contracts can be settled net in cash, then they are within the scope of IFRS 9 (subject to an exception). This is because these contracts meet the definition of a derivative:

- Their value changes in response to the change in a commodity price or foreign exchange rate or another market index;
- They require no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- They are settled at a future date.

A number of different ways exist in which a contract to buy or sell a non-financial item can be settled net. These include:

- The contractual terms permit net settlement;
- The ability to settle net is not explicit in the contract, but the entity has a practice of settling similar contracts net;
- For similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period to generate a profit or dealer's margin;
- The non-financial item is readily convertible to cash.

The exception is where, despite the ability to settle net, the entity meets what is termed the 'own use' exemption. This applies where the purpose of entering into the contract is to meet the entity's expected purchase, sale or usage requirements².

In practice, this exemption is applied restrictively and care is needed in determining whether it applies. 'Past practice' which provides evidence of any regular or foreseeable events giving rise to net settlement would block the ability to apply the own use exemption to similar contracts in the future. Only net settlement that arises from unexpected events that could not have been foreseen at contract inception (such as an unexpected extended breakdown of a production plant or exceptional weather conditions such as an earthquake giving rise to a suspension of production) would not taint the application of own use exemption.

Example 1 – Applying the 'own use' scope exemption – Net settlement

Entity XYZ enters in to a contract to buy 100 tonnes of copper for CU200/tonne. The contract permits XYZ to take physical delivery of the copper at the end of 12 months or to settle net in cash, based on the difference between the spot price in 12 months' time and CU200/tonne. Entity XYZ has a practice of settling net in cash (i.e. if the copper price at the end of year 1 is CU250/tonne, then Entity XYZ will receive CU50/tonne).

Question: Does the 'own use' scope exemption apply?

Answer: The entity has a practice of settling the contract net therefore the 'own use' scope exemption does not apply. Consequently, the contract is within the scope of IFRS 9.

The contract contains a derivative because:

- Fair value of the contract changes in response to changes in the copper price;
- No initial net investment (no initial cash paid upfront); and
- Settled at a future date – in 12 months' time.

Entity XYZ applies derivative accounting for this contract and accounts for the contract at fair value through profit or loss.

² Nevertheless, IFRS 9 permits an entity to irrevocably designate at contract inception such 'own use' contracts to buy or sell a non-financial items as measured at fair value through profit or loss if this designation eliminates or significantly reduces an 'accounting mismatch'.

Example 1A – Applying the 'own use' scope exemption

Same facts as Example 1, except that Entity XYZ:

- Is a company that manufactures copper wire; and
- Has a practice of taking delivery of the copper and using it to manufacture copper wires.

Question: Does the own use scope exemption apply?

Answer: The 'own use' scope exemption applies because:

- Entity XYZ is an entity that manufactures copper wires and has a practice of taking delivery of copper and using it for manufacture, so the contract is for its own use requirements;
- Entity XYZ does not have a practice of settling net.

Therefore the contract is not within the scope of IFRS 9 and derivative accounting is not applied.

Example 1B – Applying the 'own use' scope exemption

Same facts as Example 1, except that Entity XYZ:

- Usually has sufficient stock of copper to last 3 or 4 months for manufacturing copper wires;
- Has a practice of settling net when the contract is 'in the money' i.e. if the spot copper price is more than the fixed price of CU200 e.g. CU250, it will settle the contract net and receive CU5,000 $[(CU250 - CU200) \times 100]$; and
- Has a practice of taking delivery of the copper at CU200/tonne when the contract is out of the money (i.e. if the spot copper price is less than CU200), because the profit margin on the sale of copper wire more than covers the cost of copper.

Question: Does the own use scope exemption apply?

Answer: The 'own use' scope exemption does not apply because although Entity XYZ is an entity that uses copper to manufacture wires, Entity XYZ has a practice of settling net when the contract is in the money. Therefore the contract is within the scope of IFRS 9; and Entity XYZ accounts for the contract as a derivative.

Example 2 – Applying the 'own use' scope exemption

Entity XYZ is a company that manufactures copper wires and enters in to a contract to buy 100 tonnes of copper for CU200/tonne. The contract permits Entity XYZ to take physical delivery of the copper at the end of 6 months or to settle net in cash. Entity XYZ has a practice of taking delivery of the copper.

After 3 months, there was a storm; and the warehouse and factory area were flooded. Entity XYZ cannot take delivery of the copper and so it net settles the contract.

Question: Does the 'own use' scope exemption apply?

Answer: Whether the 'own use' scope exemption applies for such contracts in the future requires judgement; and consideration may need to be given to the entity's business and its intention of entering into the contract, the entity's historical behaviour, reasons for net settlement and relative frequency of net settlement. In this example, it may be possible to qualify for the own use scope exemption if the storm is a one off unexpected event.

Example 3 – Applying the 'own use' scope exemption

Entity XYZ is a company that manufactures copper wires. Entity XYZ enters in to a contract to buy 100 tonnes of copper for CU200/tonne. The contract permits XYZ to take physical delivery of the copper at the end of 6 months or to settle net in cash. Entity XYZ usually takes delivery of the copper, but sometimes (every couple of months) XYZ gets its forecast customer orders wrong and runs out of warehouse space (because it has a small warehouse). In these circumstances, Entity XYZ will settle the contract net.

Question: Does the own use scope exemption apply?

Answer: Like in Example 2, whether the 'own use' scope exemption applies requires judgement, and consideration may need to be given to the entity's business and its intention of entering into the contract, the entity's historical behaviour, reasons for net settlement and relative frequency of net settlement.

It is likely that Entity XYZ fails the own use scope exemption because of the frequency of occurrence of the net settlement (net settlement occurs every couple of months).

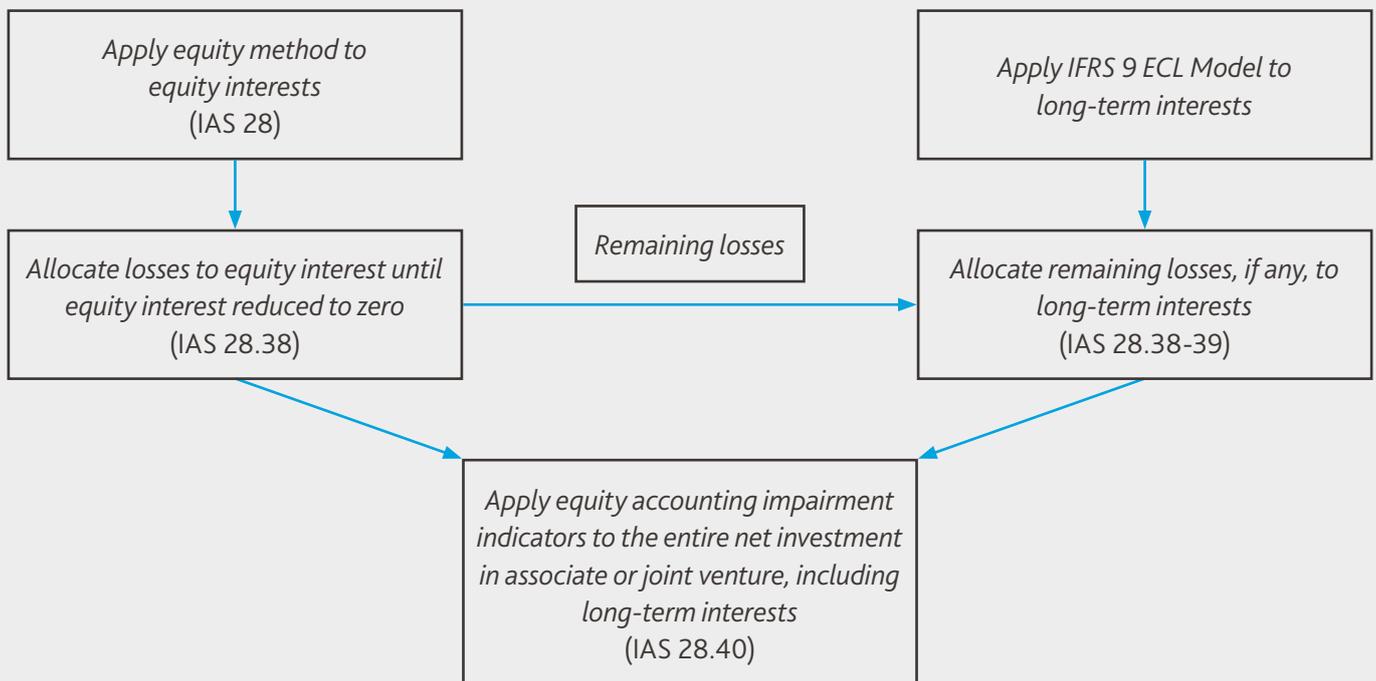
In October 2017, IAS 28 *Investments in Associates and Joint Ventures* was amended to clarify the accounting for long-term interests in associates and joint ventures. These amendments clarify that entities apply IFRS 9 *Financial Instruments* to long-term interests in an associate or joint venture to which the equity method is not applied. In this context, a distinction is made between those investments that are accounted for using the equity method (to which a share of net assets in the investee is applied) and the accounting for long-term interest (to which a share of profits or losses may be applied).

BDO comment

The first step is to determine if the interest is in the scope of IAS 28 or IFRS 9.

IAS 28.14A states that 'IFRS 9 is also applied to other financial instruments in an associate or joint venture where the equity method is not applied, such as long-term interests that, in substance, form part of the entity's net investment in an associate or joint venture.' As stated in IAS 28.38, 'such items may include preference shares and long-term receivables or loans, but do not include trade receivables, trade payables or any long-term receivables for which adequate collateral exists, such as secured loans.'

Once each component has been identified as either being equity accounted or a long-term interest, the approach set out in the following diagram is required to be followed:



BDO comment (continued)

This is illustrated by the following two examples:

Example 4A

Entity A holds a 30 percent interest in Entity B. At 31 December 20x1 the equity interest is CU15,000. Entity A also provided a CU5,000 long-term loan to Entity B on 1 October 31 20x1. Entity B generated CU10,000 in losses during 20x1.

First, Entity A applies the IFRS 9 ECL model to the long-term loan determining that a CU1,000 expected credit loss should be recognised leaving a net long-term loan of CU4,000.

Second, Entity A applies the equity method to the CU15,000 equity interest by allocating the losses of CU3,000 to the equity interest leaving a balance of CU12,000.

The third step does not result in any adjustment to the long term interest, because Entity A does not have losses greater than the amount of the equity accounted interest.

Fourth, Entity A applies the IAS 28 impairment indicators to the net investment in Entity B.

The net investment at 31 December 20x1 is the total of the equity and long-term interests in Entity B of CU16,000 (CU12,000 equity interest plus CU4,000 long-term loan). Entity A notes that, although Entity B has generated losses during the reporting period, there is not objective evidence of impairment. The final balance of the net investment in Entity B at 31 December 20x1 is CU16,000.

Example 4B

The same facts as Example 4A except Entity B generated CU60,000 of losses during 20x1 and is experiencing significant financial difficulty.

First, Entity A applies the IFRS 9 ECL model to the long-term loan determining that a CU1,500 expected credit loss should be recognised leaving a net long-term loan of CU3,500.

Second, Entity A applies the equity method to the CU15,000 equity interest by allocating CU15,000 of the losses to the equity interest which results in the equity accounted component reaching zero (CU3,000 of losses remain to be applied).

Third, Entity A allocates the remaining CU3,000 of losses to the long-term loan leaving a remaining balance of CU500.

Fourth, Entity A applies the IAS 28 impairment indicators to the net investment in Entity B.

The net investment at 31 December 20x1 is the total of the equity and long-term interests in Entity B of CU500.

Entity A notes that there is objective evidence of Impairment of its net investment in Entity B (indicators exist as noted in IAS 28.41A-C), since Entity B is experiencing significant financial difficulty. It is determined that an impairment of CU500 should be recorded. The final balance of the net investment in Entity B at 31 December 20x1 is CU0 (CU500 less CU500 impairment).

3. FINANCIAL ASSETS – CLASSIFICATION

IFRS 9 has introduced a number of new measurement categories, whilst eliminating some of the previous categories under IAS 39. Under IFRS 9, financial assets are classified into one of the four categories:

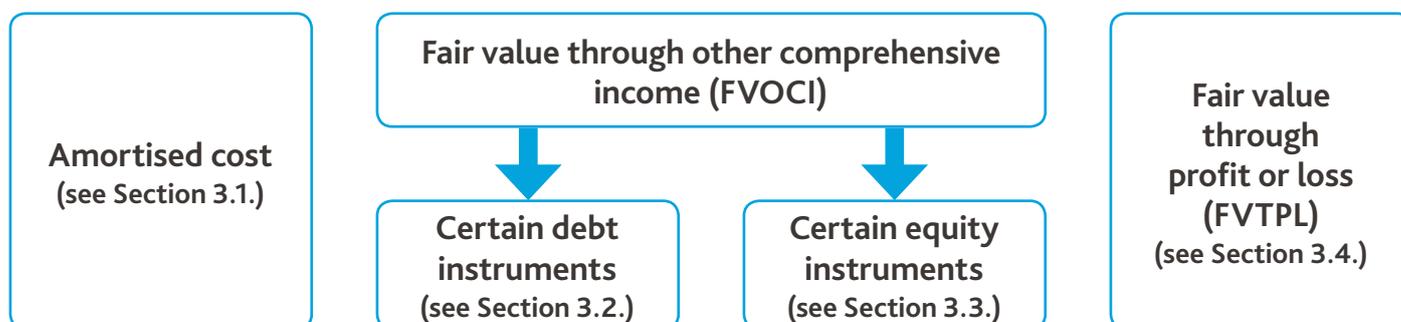


Figure 1: Categories of financial assets under IFRS 9

3.1. Amortised cost

A financial asset is classified as subsequently measured at amortised cost under IFRS 9 if it meets both of the following criteria:

- Hold to collect business model test – The asset is held within a business model whose objective is to hold the financial asset in order to collect contractual cash flows; and
- Solely payments of principal and interest (SPPI) contractual cash flow characteristics test – The contractual terms of the financial asset give rise to cash flows that are SPPI on the principal amount outstanding on a specified date.

Examples of financial instruments that are likely to be classified and accounted for at amortised cost under IFRS 9 include:

- Trade receivables;
- Loan receivables with 'basic' features;
- Investments in government bonds that are not held for trading;
- Investments in term deposits at standard interest rates.

3.1.1. Hold to collect business model

To qualify for amortised cost classification, the financial asset must be in a hold to collect business model. That is, it must be in a business model in which the entity's objective is to hold the financial asset to collect the contractual cash flows from the financial asset rather than with a view to selling the asset to realise a profit or loss. For example, trade receivables held by a manufacturing entity are likely to fall within the hold to collect business model if the trade receivables do not contain a significant financing component in accordance with IFRS 15, as the manufacturing entity is likely to have the intention to collect the cash flows from those trade receivables.

The hold to collect business model does not require that financial assets are always held until their maturity. An entity's business model can still be to hold financial assets to collect contractual cash flows, even when sales of financial assets occur. There is a specific exception where financial assets are sold as a result of an increase in the assets' credit risk.

IFRS 9.B4.1.3A notes that sales, irrespective of their frequency and value due to an increase in the assets' credit risk, are not inconsistent with the hold to collect business model because the credit quality of financial assets is relevant to the entity's ability to collect contractual cash flows. In addition, although there is a presumption that the hold to collect requirements will not be met when there are sales that are more than infrequent or more than insignificant it is necessary to consider why sales occurred and whether or not they are 'one off'. However, if more than an infrequent number of sales or a more than insignificant value of sales are made out of a portfolio, the entity should assess whether and how the sales are consistent with the hold to collect objective. This assessment should include the reason(s) why the sales do not represent a change in the entity's business model as well as the expected frequency of sales, and whether the assets that are sold are held for an extended period of time relative to their contractual maturities.

BDO comment

Examples of sales that would not contradict holding financial assets to collect contractual cash flows include:

- *Selling the financial asset close to its maturity (meaning that there is little difference between the fair value of the remaining contractual cash flows and the cash flows arising from the sale),*
- *Selling the financial asset to realise cash to deal with an unforeseen need for liquidity,*
- *Selling the financial asset as a result of changes in tax laws,*
- *Selling the financial asset due to significant internal restructuring or business combinations; or*
- *Selling the financial asset due to concerns about the collectability of the contractual cash flows (i.e. increase in credit risk).*

Allowing for infrequent sales without compromising the ability to measure financial assets at amortised cost under IFRS 9 is a key difference in comparison with the 'held to maturity' category under IAS 39. The IAS 39 'held to maturity' category 'penalises' the entity (by prohibiting the entity to use the held to maturity category for two years, other than in strictly limited circumstances) if the entity sells a more than insignificant amount of financial assets that it has classified as held to maturity, prior to their maturity.

Example 5 – Hold to collect business model

Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity in which to invest those funds so it buys short dated (6 month maturity) high quality government bonds in order to generate interest income. It is not considered likely but, if a suitable investment opportunity arises before the maturity date, the entity will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise it will hold the bonds to their maturity date.

Question: Is the hold to collect business model test met?

Answer: Consideration of the facts and circumstances are required. It is likely that the government bonds would meet the hold to collect business model test, as the entity's objective appears to be holding the government bonds and collecting the contractual cash flows which consist of the contractual interest payments and, on maturity, the principal amount. If the bond were to be sold prior to its maturity date, the fair value of the cash flows arising would be similar to those which would be collected by continuing to hold the bonds.

The following would not be consistent with the hold to collect business model:

- The objective for managing the debt investments is to realise cash flows through sale;
- The performance of the debt investment is evaluated on a fair value basis; or
- A portfolio of assets that meets the definition of held for trading.

3.1.2. The SPPI contractual cash flow characteristics test

The second condition for a financial asset to qualify for amortised cost classification is that the financial asset must meet the SPPI contractual cash flow characteristics test.

Contractual cash flows are considered to be SPPI if the contractual terms of the financial asset only give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding on specified dates (i.e. the contractual cash flows are consistent with a basic lending arrangement).

Principal is the fair value of the financial asset at initial recognition, which may be different from the contractually stated principal (e.g. a bond that is purchased or originated at a premium or discount).

Whilst the consideration for the time value of money and credit risk are typically the most significant elements of 'interest', IFRS 9 acknowledges that it can also contain other elements such as consideration for liquidity risk, profit margin and service or administrative costs. If the lending arrangement includes a clause that compensates the lender for these other elements and they do not result in a change in the nature of the lending arrangement (i.e. profit margin is maintained) then the inclusion of these elements are consistent with a normal lending arrangement.

BDO comment

It is common for lending arrangements to contain clauses which permit the lending bank to adjust the interest rate charged. Where a bank has published interest rates that apply across a range of products that it offers to its customers, those rates will often be driven by general market interest rates and may be linked to specified benchmark interest rates. In those circumstances, it may be possible to conclude without significant analysis that the cash flows meet SPPI. However, in other cases the interest rate may change as a result of a future contingent event, or the lender may have full discretion to vary the interest rate charged during the term of a loan (with the borrower having an option to prepay the loan without penalty if it does not wish to accept the new rate). In those cases, judgement will be required in assessing whether the contractual cash flows are consistent with a basic lending arrangement.

However, if the contractual cash flows are linked to features such as changes in equity or commodity prices, they would not pass the SPPI test because they introduce exposure to risks or volatility that are unrelated to a basic lending arrangement.

BDO comment

A typical example of an instrument where the contractual cash flows would not meet SPPI would be a debt instrument with an interest rate that is linked to the issuer's share price. Similarly, a debt instrument with an equity conversion feature, under which the holder has an option to convert the debt instrument into a fixed number of the issuer's equity shares on maturity, would not meet the SPPI test. However, if an issuer uses its own shares as a 'currency' to settle a convertible debt instrument, then this might meet the SPPI test. This could be in circumstances in which the equity conversion feature is for a variable number of the issuer's equity shares that have a fair value equal to the unpaid principal and interest, and the equity shares are quoted on a public market. However, if the issuer was a private company then it is likely that the SPPI test would be failed because of liquidity risk.

BDO comment

The SPPI contractual cash flow test means that only debt instruments can qualify to be measured at amortised cost. The terms of an equity instrument are never capable of giving rise to SPPI. Derivatives would also fail SPPI due to leverage.

Example 6 – SPPI test for loan with zero interest and no fixed repayment terms

Parent A provides a loan to Subsidiary B. The loan is classified as a current liability in Subsidiary B's financial statements and has the following terms:

- No interest;
- Repayable on demand of Parent A.

Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Answer: Yes. The terms provide for the repayment of the principal amount of the loan on demand.

Example 7 – SPPI test for loan with zero interest repayable in five years

Parent A provides a loan of CU10 million to Subsidiary B. The loan has the following terms:

- No interest;
- Repayable in five years.

Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Answer: Yes. The principal (fair value) is CU10 million discounted to its present value using the market interest rate at initial recognition. The final repayment of CU10 million represents a payment of principal and accrued interest.

Example 8 – SPPI test for a loan with interest rate cap

Entity B lends Entity C CU5 million for five years, subject to the following terms:

- Interest is based on the prevailing variable market interest rate;
- Variable interest rate is capped at 8%;
- Repayable in five years.

Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Answer: Yes. Contractual cash flows of both a fixed rate instrument and a floating rate instrument are payments of principal and interest as long as the interest reflects consideration for the time value of money and credit risk.

Therefore, a loan that contains a combination of a fixed and variable interest rate meets the contractual cash flow characteristics test.

Example 9 – SPPI test for loan with profit linked element

Entity D lends Entity E CU500 million for five years at an interest rate of 5%.

Entity E is a property developer that will use the funds to buy a piece of land and construct residential apartments for sale. In addition to the 5% interest, Entity D will be entitled to an additional 10% of the final net profits from the project.

Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Answer: No. The profit linked element means that the contractual cash flows do not reflect only payments of principal and interest that consist of only the time value of money and credit risk.

Therefore, the loan will fail the requirements for amortised cost classification. Entity D will account for the loan at fair value through profit or loss.

3.1.2.1. Modified time value of money

In some financial assets in certain jurisdictions, the time value of money element of interest may be modified in a way that is imperfect. Examples of modifications include:

- Instruments with variable interest rates where the frequency of interest rate reset does not match the tenor (or maturity) of the instrument, such as instruments where interest is reset monthly to a quarterly rate. Certain Japanese government bonds have a semi-annual interest rate reset but the rate is always reset to a 10-year rate regardless of maturity (known as Japanese 10-year constant maturity bonds);
- Instruments with a variable interest rate but the variable interest is reset before the start of the interest period (for example, two months before so that the rate at the date of reset is not the current floating rate, but is instead the floating rate two months before).

Where the time value component of the interest rate has been modified (such as for the instruments set out above), a further assessment is required to determine whether the time value component is significantly different from a benchmark instrument. The assessment can be qualitative or quantitative. It is necessary to determine how different the contractual undiscounted cash flows are in comparison with the undiscounted cash flows that could arise if the time value of money element was not modified (benchmark cash flows).

For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with identical contractual terms and the identical credit quality except the variable interest rate is reset monthly to a one-month interest rate. The comparison would take into account not only the existing difference in rates, but also the potential difference arising from possible future changes in interest rates.

If it is clear, with little or no analysis, that the contractual (undiscounted) cash flows on the financial asset under the assessment could (or could not) be significantly different from the (undiscounted) benchmark cash flows, it is not necessary to perform a detailed assessment. The term 'significantly different' is not defined and no quantitative threshold is provided, but in practice only a small variation would be permitted.

Example 10 – SPPI test – Modified time value of money

Entity B invests in a variable interest rate bond that matures in five years with interest payable every six months. The variable interest is reset every six months to a 5 year rate. At the time of initial investment, the 6 month interest rate is not significantly different to the 5 year rate.

Question: Can Entity B conclude that the modification is not significant without any additional analysis?

Answer: No. Entity B cannot simply conclude based on the relationship between the 5 year rate and the 6 month rate at the date of initial investment. Rather Entity B must also consider whether the relationship between the 5 year interest rate and the 6 month interest rate could change over the life of the bond such that the contractual (undiscounted) cash flows over the life of the bond could be significantly different from the (undiscounted) benchmark cash flows.

Entity B is only required to consider reasonably possible scenarios rather than every possible scenario. If Entity B is unable to conclude that the contractual (undiscounted) cash flows could not be significantly different from the (undiscounted) benchmark cash flows, the financial asset does not meet the SPPI criteria and therefore must be measured at fair value through profit or loss.

3.1.2.2. Regulated interest rates

In some jurisdictions, the government or a regulatory authority establishes interest rates. For example, such government regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. Under IFRS 9, a regulated interest rate may be used as a proxy for the time value of money element for the purpose of applying the SPPI test if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

BDO comment

The exception to regulated interest rates would apply in jurisdictions such as China, where the government determines interest rates and other interest rates are typically not permitted for similar transactions. However, it will be necessary to monitor developments in China and other jurisdictions in which this exception is considered to apply. If circumstances change such that, for example, there is a free choice of obtaining a loan at an open market rate or the government determined rate, it is likely that the exception would no longer apply.

3.1.2.3. Prepayment and extension terms

Debt instruments often contain prepayment options for the issuer, put options for the holder and extension option terms. These do not necessarily violate the SPPI contractual cash flow characteristics test. The entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are SPPI on the principal amount outstanding. An example provided in IFRS 9 is a contractual term that permits the issuer (i.e. the debtor) to prepay a debt instrument or permits the holder (i.e. the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract.

A debt instrument that would otherwise give rise to cash flows that are SPPI on the principal amount outstanding, but does not do so only as a result of a contractual term that permits (or requires) the issuer to prepay the debt instrument or permits (or requires) the holder to put a debt instrument back to the issuer before maturity is eligible to be measured at amortised cost or fair value through other comprehensive income (depending on the entity's business model) if:

- a) The financial asset is acquired or originated at a premium or discount to the contractual par amount;
- b) The prepayment or put amount represents substantially all the contractual par amount and accrued (but unpaid) contractual interest (the prepayment or put amount may include reasonable additional compensation for early repayment); and
- c) When initially recognised, the fair value of the prepayment feature is insignificant.

To make this determination, contractual cash flows both before and after the change in cash flows should be assessed. The nature of contingent event(s) (i.e. the trigger) may also need to be assessed.

Similarly, a debt instrument with an extension option would still meet the SPPI test if the terms in the extension period result in contractual cash flows that also meet the SPPI test.

Example 11 – SPPI test for loan with prepayment option

Entity D lends Entity E CU5 million at a fixed interest rate. The loan is repayable in 5 years. Entity E has the option to repay the loan at any time at CU5 million plus any accrued interest plus a prepayment penalty fee of 2.5% which reduces by 0.5% for each complete period of one year during which the loan has been outstanding.

Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Answer: Yes. The prepayment option is not contingent on any future event.

The prepayment penalty is considered to be reasonable additional compensation for early contract termination.

Example 12 – SPPI test for loan with extension option (with rate reset)

Company K lends Company L CU10 million at a fixed market interest rate. The loan is repayable in 5 years. Company L has the right to extend the term for another 3 years. If Company L decides to extend the loan, a variable market interest rate will be charged from year 6 to 8.

Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Answer: Yes. Extension options meet the SPPI test if the terms result in contractual cash flows during the extension period that are SPPI on the principal amount outstanding, which may include reasonable additional compensation for the extension of the contract (IFRS 9.B.4.1.11(c)).

Example 13 – SPPI test for loan with extension option (with no rate reset)

Company M lends Company N CU10 million at a fixed market interest rate of 5%. The loan is repayable in 5 years. Company N has the right to extend the term for another 3 years at the original fixed interest rate of 5%.

Question: Does the loan meet the SPPI contractual cash flows characteristic test during the extension period?

Answer: Yes. This is because the coupon rate is fixed at inception of the loan, and the rate is not leveraged. The contractual terms of the loan require the principal amount to be advanced at inception and repaid on maturity. There are no other cash flow or contingent features.

Note this is different to the accounting requirement under IAS 39 where the extension option is considered to be an embedded derivative that is not closely related under the guidance in Paragraph IAS 39.AG30(c). Under IAS 39 either the embedded derivative would need to be separately accounted for at fair value through profit or loss or an election made to measure the entire loan at fair value through profit or loss.

3.1.2.4. Other provisions that change the timing or amount of cash flows

Other contractual provisions that change the timing or amount of cash flows can still meet the SPPI test if their effect is consistent with the return of a basic lending arrangement.

For example, an instrument with an interest rate that is reset to a higher rate if the debtor misses a particular number of payments can still meet the SPPI test as the resulting change in the contractual terms is likely to represent consideration for the increase in credit risk of the instrument. Other instruments where the interest payment is linked to net debt/earnings before interest tax, depreciation and amortisation (EBITDA) ratio (where the ratio is intended to be a proxy reflecting the borrower's credit risk) are unlikely to meet the SPPI test, except in rare cases when a genuine link can be made between the linkage feature and the required SPPI features.

Example 14 – SPPI test for loan with interest rate reset

Company I lends Company J CU5 million at a fixed interest rate of 8%. The loan is repayable in five years. If Company J misses two interest payments, the interest rate is reset to 15%.

Question: Does the loan meet the SPPI contractual cash flows characteristic test?

Answer: Yes, because there is a relationship between the missed payment and an increase in credit risk (IFRS 9.B4.1.10).

However, a financial instrument with an interest rate that resets to a higher rate if a specified equity index reaches a particular level (e.g. FTSE 100 reaching 8,000 points) will not meet the SPPI test, because there is no relationship between the change in equity index and credit risk.

A non-recourse provision does not in itself preclude a financial asset from meeting the SPPI contractual cash flow characteristics test. A non-recourse provision has the effect that, if the borrower defaults, the lender would only be able to recover its claim through the asset that has been pledged as security over the loan. The borrower has no further obligation beyond the asset that has been pledged. When there is a non-recourse provision, a lender needs to 'look through' to the underlying assets or cash flows to determine whether the contractual cash flows of the financial assets are solely payments of principal and interest on the principal amount outstanding. If the terms of the financial asset (including the effect of the non-recourse provision) give rise to any other cash flows or limit the cash flows in a manner that is inconsistent with SPPI, then the loan does not meet the contractual cash flow characteristics test. Whether, the underlying assets are financial or non-financial assets does not in itself affect this assessment.

3.1.2.5. Other examples

Example 15 – SPPI test for convertible note

Question: Does an investment in a convertible note that converts into equity instruments of the issuer meet the SPPI contractual cash flows characteristic test?

Answer: No. IFRS 9 requires analysis of the terms of the convertible note in its entirety. The interest rate in a convertible note does not reflect the consideration for the time value of money and the credit risk (except when the shares are used as a currency, with a variable number of shares being issued that are equal in value to the unpaid principal and interest – see Section 3.1.2.). The interest rate is usually set lower than the market interest rate. The overall return is also linked to the value of the equity of the issuer such that the conversion feature would potentially enhance the overall return.

See Section 3.5.

Example 16 – SPPI test for commodity linked note

Question: Does an investment in a bond with contractual interest payments linked to a commodity price (e.g. the price of gold, copper etc.) meet the SPPI contractual cash flows characteristic test?

Answer: No, because the interest rate reflects the changes in the specified commodity price and not compensation for the time value of money and credit risk.

See Section 3.5.

Example 17 – SPPI test for deferred consideration receivable in a business combination

Company O sold one of its subsidiaries to Company P. The purchase consideration consists of a deferred payment of CU10 million payable in two years.

Question: Does the receivable meet the SPPI contractual cash flows characteristic test?

Answer: Yes, the initial principal amount (fair value) is CU10 million discounted at the market interest rate for two years. The payment of CU10 million represents principal and accrued interest.

3.2. Debt instruments at FVOCI

A debt instrument is classified as subsequently measured at fair value through other comprehensive income (FVOCI) under IFRS 9 if it meets both of the following criteria:

- Hold to collect and sell business model test: The asset is held within a business model whose objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset; and
- SPPI contractual 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 (see Section 3.1.2).

This business model typically involves greater frequency and volume of sales than the hold to collect business model discussed in Section 3.1.1. Integral to this business model is an intention to sell the instrument before the investment matures.

Examples of financial instruments that may be classified and accounted for at FVOCI under IFRS 9 include:

- Investments in government bonds where the investment period is likely to be shorter than maturity;
- Investments in corporate bonds where the investment period is likely to be shorter than maturity.

It is unlikely that intercompany loans or trade receivables would be classified in the FVOCI category.

BDO comment

IFRS 9 does not specify a threshold value or frequency of sales that must occur under the hold to collect and sell business model. However, in its Basis for Conclusions, the IASB has noted that information about sales and sales patterns are useful in determining how an entity manages its financial assets and how the related cash flows will be realised. This is because information about past sales combined with expectations about future sales (including the frequency, value and nature of such sales) provide evidence about the objective of the business model. Information about historical sales helps an entity to support and verify its business model assessment. Nevertheless, entities should consider the reasons for any sale (e.g. whether it arises from an isolated event) and whether sales are consistent with a hold to collect and sell business objective.

Example 18 – Hold to collect or hold to collect and sell business model test

Entity A sold one of its diverse business operations and currently has CU10 million of cash. It has not yet found another suitable investment opportunity in which to invest its funds so it buys medium dated (3 year maturity) high quality government bonds in order to generate interest income.

It is considered likely that a suitable investment opportunity will be found before the maturity date, and in that case Entity A will sell the bonds and use the proceeds for the acquisition of a business operation. Otherwise, Entity A plans to hold the bonds to their contractual maturity.

Question: Are the criteria for a hold to collect or hold to collect and sell business model met?

Answer: It is likely that the government bonds would not meet the hold to collect business model test because it is considered likely that the bonds will be sold well before their contractual maturity. However, it is likely that the investment would meet the hold to collect and sell business model test.

The accounting requirements for debt instruments classified as FVOCI are:

- Interest income is recognised in profit or loss using the effective interest rate method that is applied to financial assets measured at amortised cost;
- Foreign exchange gains and losses on the amortised cost are recognised in profit or loss;
- Credit impairment losses/reversals are recognised in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost (please refer to Chapter 6 of this publication for further details);
- Other changes in the carrying amount on remeasurement to fair value are recognised in OCI;
- The cumulative fair value gain or loss recognised in OCI is recycled from OCI to profit or loss when the related financial asset is derecognised.

BDO comment

For debt instruments that are classified as FVOCI entities will need to track both the amortised cost and fair value. The amounts recorded in profit or loss will reflect amortised cost and the balance sheet will reflect the fair value of the financial asset.

Example 19 – FVOCI for debt instruments

On 1.1.20X1 a financial asset is purchased at its face value of CU1,000. The contractual term is ten years with an annual coupon of 6%.

On 31.12.20X1 a coupon payment is reached. The fair value of the financial asset decreases to CU950. 12-month expected credit losses as determined under the impairment model are CU30. On 1.1.20X2 the financial asset is sold for CU950.

Question: What are the journal entries on initial recognition, 31.12.20X1 and 1.1.20X2 under the FVOCI category?

Answer:

1 January 20X1

Dr	Financial asset	CU1,000	
	Cr	Cash	CU1,000

Being the initial recognition of the financial asset at FVOCI.

31 December 20X1

Dr	Cash	CU60	
	Cr	Interest income	CU60
Dr	Impairment loss (P&L)	CU30	
Dr	OCI	CU20	
	Cr	Financial asset	CU50

Being the receipt of the coupon payment, recognition of a CU30 impairment loss at the end of the reporting period and the change in fair value of the financial asset. The impairment allowance is recognised in OCI instead of reducing the carrying amount of the financial asset in the balance sheet, because the carrying amount is required to be the fair value of the debt instrument.

1 January 20X2

Dr	Cash	CU950	
	Cr	Financial asset	CU950
Dr	Loss on sale (P&L)	CU20	
	Cr	OCI	CU20

Being the sale of the financial asset and reclassification adjustment of the accumulated loss from OCI to profit or loss.

3.3. Equity investments at FVOCI

IFRS 9 requires all equity investments to be measured at fair value. The default approach is for all changes in fair value to be recognised in profit or loss.

However, for equity investments that are neither held for trading nor contingent consideration recognised by an acquirer in a business combination, entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI, with all subsequent changes in fair value being recognised in other comprehensive income (OCI) in accordance with IFRS 9.5.7.5. This election is available for each separate investment.

Under this new FVOCI category, fair value changes are recognised in OCI while dividends are recognised in profit or loss (unless they clearly represent a recovery of part of the cost of the investment). Although it might appear similar to the 'Available-for-Sale' category in IAS 39, it is important to note that this is a new measurement category which is different. In particular under the new category, on disposal of the investment the cumulative change in fair value is not recycled to profit or loss. However entities have the ability to transfer amounts between reserves within equity (i.e. between the FVOCI reserve and retained earnings).

With regard to transaction costs incurred on equity investments, requirements for the recognition of gains and losses are set out in Section 5.7. of IFRS 9. These include that subsequent changes in the fair value of the equity instrument are recognised in OCI. IFRS 13 sets out requirements for fair value measurement. As part of the guidance for determining fair value, IFRS 13.25 states that the 'price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs.'

IAS 1.88 & 89 require that 'an entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise.' IFRS 9 does not either require or permit transaction costs arising on the sale of an equity instrument designated at FVOCI to be recognised in OCI or in equity. Consequently, transaction costs on the ultimate disposal of equity instruments designated at FVOCI are required to be recognised in profit or loss.

Example 20 – Equity investments classified at FVOCI

Entity X has a 31 December financial year end and pays tax at a rate of 30%. It prepares financial statements on an annual basis (it does not prepare interim financial statements). On 1 January 20X3, Entity X acquires 100 shares of List Co for CU10,000 with transaction costs of CU2 directly attributable to the acquisition of the instrument.

If the asset was sold, a commission of CU3 would be incurred. However, this is not included in the measurement of fair value. This treatment is consistent with the requirements of IFRS 9.IG.E1.1 which notes that 'transaction costs **expected to be incurred** on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.'

The journal entry at 1 January 20X3 is as follows:

1 January 20X3			
Dr	Financial asset (Equity investment at FVOCI)	CU10,002	
	Cr Cash		CU10,002

Being the purchase of 100 shares in List Co for CU10,000. In accordance with IFRS 9.5.1.1 and the example in IFRS 9.B5.2.2, on initial recognition the equity instrument was recorded at CU10,002 (fair value plus transaction costs).

Example 20 – Equity investments classified at FVOCI (continued)

On 31 December 20X3, the fair value of the 100 shares in List Co has declined to CU8,000. The journal entries at 31 December 20X3 are as follows:

31 December 20X3			
Dr	OCI	CU2,002	
	Cr	Financial asset (Equity investment at FVOCI)	CU2,002
Dr	Deferred tax asset	CU600	
	Cr	OCI	CU600

Being the change in fair value of the equity investment and its related tax effects. Entity X disregards the possible commission on sale and recognises a loss of CU2,002 (CU10,002 less CU8,000) in OCI. This is in compliance with IFRS 9.IG.E.1.1 where it states that 'for financial instruments that are measured at fair value through OCI (FVOCI)..., transaction costs are recognised in OCI as part of a change in fair value at the next remeasurement.

Carrying values at 31 December 20X3 are:

	Carrying value
Financial asset (Equity investment at FVOCI)	CU8,000
Deferred tax asset	CU600
Accumulated OCI	CU1,402

On 31 March 20X4, Entity X receives a cash dividend of CU500. The journal entry at 31 March 20X4 to record the dividend is as follows:

31 March 20X4			
Dr	Cash	CU500	
	Cr	Profit or loss	CU500

Being the receipt of the cash dividend of CU500.

On 31 December 20X4, the fair value of the 100 shares in List Co is CU13,000 and Entity X decides to dispose of the entire investment. The journal entries at 31 December 20X4 are as follows (before recording the disposal):

31 December 20X4			
Dr	Financial asset (Equity investment at FVOCI)	CU5,000	
	Cr	OCI	CU5,000
Dr	OCI	CU1,500	
	Cr	Deferred tax asset	CU600
	Cr	Deferred tax liability	CU900

Being the change in fair value of the equity investments during the period to 31 December 20X4 and the related tax effects.

Example 20 – Equity investments classified at FVOCI (continued)

Carrying values at 31 December 20X4 before recording the disposal are:

	Carrying value
Financial asset (Equity investment at FVOCI)	CU13,000
Deferred tax liability	CU900
Accumulated OCI	CU(2,098)

The journal entry for the disposal is:

31 December 20X4			
Dr	Cash	CU12,997	
Dr	Transaction costs	CU3	
	Cr	Financial asset (Equity investment at FVOCI)	CU13,000
Dr	Deferred tax liability	CU900	
	Cr	Tax payable	CU900

Being disposal of the equity investment and the related tax effects.

The following table sets out the carrying values at 31 December 20X4 after disposal:

	Carrying value
Cash	CU13,000
Financial asset (Equity investment at FVOCI)	-
Tax payable	CU900
Accumulated OCI	CU2,100

Note: On disposal, the cumulative changes in fair value remains in OCI; however, transaction costs on the ultimate disposal of equity investments at FVOCI are required to be recognised in profit or loss. Entities can transfer the cumulative OCI balance to another reserve within equity, such as retained earnings.

3.4. Financial assets at FVTPL

Fair value through profit or loss (FVTPL) is the residual category in IFRS 9. A financial asset is classified and measured at FVTPL if the financial asset is:

- A held-for-trading financial asset;
- A debt instrument that does not qualify to be measured at amortised cost or FVOCI;
- An equity investment which the entity has not elected to classify as at FVOCI (refer to Section 3.3.).

Examples of financial assets that are likely to fall into the FVTPL category include:

- Investments in shares of listed companies that the entity has not elected to account for as at FVOCI;
- Derivatives that have not been designated in a hedging relationship, e.g.:
 - Interest rate swaps;
 - Commodity futures/option contracts;
 - Foreign exchange futures/option contracts;
- Investments in convertible notes, commodity linked bonds;
- Contingent consideration receivable from the sale of a business;
- Any other financial assets that fail SPPI.

BDO comment

Other than for held for trading financial assets that must be carried at FVTPL (e.g. derivatives), the FVTPL category under IFRS 9 is a residual category. This is in contrast to IAS 39, where the residual category is 'Available-for-Sale' (FVOCI). Under IFRS 9, consideration is first given to whether a financial asset is to be measured at amortised cost or FVOCI and, if it is not, it will be measured at FVTPL.

Example 21 – Contingent consideration receivable

Entity B owns five retail chains. It sold one of its retail chains to Entity C. As part of the purchase consideration, Entity B is entitled to additional consideration of CU3 million if the retail chain meets certain profit targets over the next 3 years.

Question: How should Entity B classify the contingent consideration receivable?

Answer: The terms of the contingent consideration receivable fail the SPPI cash flow characteristics test because the payment is linked to the future profitability of the retail chain which has been sold. The contingent consideration receivable is measured at fair value through profit or loss.

3.5. Interaction of debt factoring with the classification model

In accordance with the application guidance in IFRS 9, accounting derecognition is considered a sale for the purposes of assessing the business model; consequently, debt factoring that results in derecognition must be taken into account as part of the assessment.

This means that entities that factor some or all of their trade receivables may be unable to conclude that those receivables are part of a 'hold to collect' business model which would preclude amortised cost classification (even if the SPPI test is met). This means that classification at fair value through other comprehensive income (FVOCI) or at fair value through profit or loss (FVTPL) may be required. The examples below illustrate some common scenarios that could arise.

Example 22 – Mixed portfolio

Company A holds a portfolio of trade receivables which meet the SPPI test and are either held to collect their cash flows or are subject to factoring arrangements that result in derecognition. In the past factoring has been frequent and significant in value but this depends on the day to day liquidity needs. At initial recognition, it is not known which receivables will be subject to factoring.

In this example, the portfolio of trade receivables is likely to fail the 'hold to collect' criteria and instead meet the 'hold to collect and sell' criteria. This is because cash flows are being generated through a combination of collection and sales (by factoring) and it is not known at initial recognition which receivables will be factored. This would result in a FVOCI classification meaning that Company A would be required to maintain both fair value and amortised cost (including Expected Credit Losses) accounting records.

Example 23 – Segregated portfolio

Company B holds a portfolio of trade receivables which meet the SPPI test. The trade receivables relate to customers in two different countries; Country X receivables are held to collect their cash flows whereas Country Y receivables are always subject to factoring arrangements (as payment terms in that region are much longer than average). The factoring arrangement results in derecognition.

In this example, it seems likely that Company B will be in a position to segregate its portfolio and apply different business models to each sub-portfolio. Country X receivables would be in a 'hold to collect' business model and classified at amortised cost whereas Country Y receivables would be in an 'other' business model ('hold to sell') and classified at FVTPL.

Some factoring arrangements do not result in accounting derecognition (e.g. if the seller legally transfers the rights to the cash flows to a factoring company but retains the bad debt risk by providing a guarantee). Whether legal form sales of this nature should be taken into account when assessing the business model is not specifically addressed in IFRS 9 and consequently, this is likely to be an area of judgment and accounting policy choice. This is because the arrangement changes how the seller generates cash flows (i.e. the seller receives a cash payment immediately from the factor, with the factor being entitled to the contractual cash flows from the receivables). This means that when assessing the business model some entities will choose to include legal form sales under which the rights to cash flows from the trade receivables have been transferred to another party whereas other entities will choose to only include sales that meet the accounting derecognition requirements.

3.6. Hybrid contracts containing embedded derivatives

A hybrid contract is a financial instrument that contains both a non-derivative host contract and an embedded derivative.

Under IAS 39, the derivative embedded within a hybrid contract is bifurcated from the host contract and accounted for separately if:

- A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative;
- The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract; and
- The hybrid (combined) instrument is not measured at FVTPL.

In order to simplify the accounting, IFRS 9 has eliminated the requirement to separately account for embedded derivatives for financial assets. Instead, IFRS 9 requires entities to assess the hybrid contract as a whole for classification. If the terms of the hybrid contract still meet the criteria for subsequent measurement at amortised cost or FVOCI for debt instruments (see Sections 3.1. and 3.2. above) then it is accounted for at amortised cost or FVOCI, otherwise it is measured at FVTPL. However, the existing requirements for embedded derivatives still apply to financial and other liabilities, and to contracts for assets that are not within the scope of IFRS 9.

Example 24 – Convertible note receivable – Difference between IAS 39 and IFRS 9

Entity A invests in a CU1,000 convertible note issued by Entity B. The convertible note pays a 5% annual coupon with a maturity of three years. At any point prior to its maturity, Entity A has the option to convert the note into 1,000 shares of Entity B.

The market interest rate for a similar instrument without the conversion feature would be 8%.

IAS 39

The instrument contains:

- Debt host contract – An annual coupon receivable of 5% and CU1,000 on maturity; and
- Embedded equity option – Option to buy shares at CU1.

The equity option derivative is not closely related to the debt host contract.

The entity therefore has two options:

- i. Bifurcate the instrument, that is:
 - Equity option at FVTPL;
 - Host debt contract at amortised cost.
- ii. Designate entire contract at FVTPL.

IFRS 9

No bifurcation, consider the instrument in its entirety:

- The coupon rate is lower than the market interest rate, and therefore does not reflect the consideration for the time value of money and credit risk;
- Return is also linked to the value of the equity conversion.

Therefore, the instrument fails the SPPI test for classification at amortised cost.

Accordingly, the entity must account for the entire instrument at FVTPL.

Example 25 – Gold linked note receivable – Difference between IAS 39 and IFRS 9

Entity A invests CU1,000 in a debt instrument which pays a coupon that is based on the gold price (gold linked note). The note matures in three years and pays a coupon based on the market price for gold.

Question: How should Entity A account for the note under IAS 39 and IFRS 9?

IAS 39

The instrument contains:

- Debt host contract to receive CU1,000 in three years;
- Derivative that is based on the market price of gold which is not closely related to the debt host contract.

The entity therefore has two options:

- i. Bifurcate the instrument, that is:
 - Commodity swap (receive fixed/pay Gold linked coupons) at FVTPL;
 - Host debt contract at amortised cost.
- ii. Designate entire contract at FVTPL.

IFRS 9

Consider the instrument in its entirety:

- The coupon rate is linked to the value of the gold price and does not reflect the consideration for the time value of money and credit risk.

Therefore, the instrument fails the SPPI test for classification at amortised cost.

Accordingly, the entity must account for the entire instrument at FVTPL.

4. FINANCIAL LIABILITIES – CLASSIFICATION

The classification and measurement of financial liabilities in accordance with IFRS 9 *Financial Instruments* remains largely unchanged from IAS 39 *Financial Instruments: Recognition and Measurement*.

Financial liabilities are classified as either:

- Financial liabilities at amortised cost; or
- Financial liabilities as at fair value through profit or loss (FVTPL).

Financial liabilities are measured at amortised cost unless either:

- The financial liability is held for trading and is therefore required to be measured at FVTPL (e.g. derivatives not designated in a hedging relationship); or
- The entity elects to measure the financial liability at FVTPL (using the fair value option).

In contrast to financial assets, the existing requirements in IAS 39 for the separation of embedded derivatives have been continued for financial liabilities, meaning that financial liabilities to be measured at amortised cost would still need to be analysed to determine whether they contain any embedded derivatives that are required to be accounted for separately at FVTPL.

Examples of financial liabilities that are likely to be classified and measured either at amortised cost or at FVTPL include:

Amortised cost	FVTPL
<ul style="list-style-type: none"> – Trade payables; – Loan payables with standard interest rates (such as a benchmark rate plus a margin) or the host contract arising from a loan agreement which contains separable embedded derivatives; – Bank borrowings. 	<ul style="list-style-type: none"> – Interest rate swaps (not designated in a hedging relationship); – Commodity futures/option contracts (not designated in a hedging relationship); – Foreign exchange future/option contracts (not designated in a hedging relationship); – Convertible note liabilities designated at FVTPL; – Contingent consideration payable that arises from one or more business combinations.

Figure 2: Examples for classification of financial liabilities

The key change under IFRS 9 for financial liabilities, in comparison with IAS 39, is for the presentation of changes in fair value arising from changes in an entity's own credit risk status for financial liabilities that have been designated as at FVTPL. This change is expected mainly to affect financial institutions but can also apply to entities that have entered into a hybrid contract that contains an embedded derivative, for which the entity has elected to measure the entire contract at fair value. An approach of measuring the entire instrument at fair value is often followed because it simplifies future fair value calculations and the accounting requirements.

For example, an entity issues a convertible note and has assessed that the note contains a debt host liability and an embedded derivative liability. Instead of separately accounting for the debt host liability at amortised cost and the embedded derivative liability at FVTPL, the issuer elects to account for the entire convertible note at FVTPL.

For the measurement of changes in the fair value of a financial liability due to changes in credit risk, please refer to Section 5.2.2.

5. MEASUREMENT

5.1. Measurement on initial recognition

The requirements for the initial measurement of financial assets and liabilities under IFRS 9 *Financial Instruments* were carried forward from IAS 39 *Financial Instruments: Recognition and Measurement*. At initial recognition a financial instrument is measured at fair value including transaction costs unless the financial instrument is carried at FVTPL, in which case the transaction costs are immediately recognised in profit or loss. The fair value is determined in accordance with IFRS 13 *Fair Value Measurement*.

For more information about IFRS 13, please refer to BDO's publication *Need to Know – IFRS 13 Fair Value Measurement*, available from the IFRS section of our website (www.bdo.global).

5.1.1. Day one gains and losses

The best evidence of fair value at initial recognition is usually the transaction price, represented by the fair value of the consideration given or received in exchange for the financial instrument. Any difference between the fair value measured by the entity and the transaction price is recognised:

- In profit or loss, if the estimate is measured by a quoted price in an active market or based on a valuation technique that uses only data from observable markets; and
- Deferred as an adjustment to the carrying amount of the financial instrument in all other cases.

BDO comment

The new expected loss impairment model under IFRS 9 requires an entity to recognise 12-month expected credit losses for all financial assets (unless the exemption for trade/lease receivables or contract assets applies (see Section 5.2.1)). However, this adjustment does not represent a day one loss because the fair value is determined first, with credit losses then being deducted. IFRS 9 does not explicitly require the recognition of 12-month expected credit losses immediately after initial recognition, but an entity would need to recognise a loss allowance equal to 12-month expected credit losses no later than at the first reporting date after the initial recognition of the financial asset.

5.1.2. Trade receivables

IFRS 9 includes an exception for the measurement on initial recognition of trade receivables without a significant financing component. These are required to be recognised at the transaction price (as defined in IFRS 15 *Revenue from Contracts with Customers*) instead of fair value.

For trade receivables with a significant financing component, any differences arising between the amount of revenue recognised in accordance with IFRS 15 – which is measured at the transaction price in accordance with IFRS 15 – and the fair value of the trade receivable is recognised as an expense in profit or loss. The existence of a significant financing component is determined in accordance with the guidance set out in Paragraphs 60-65 of IFRS 15 *Revenue from Contracts with Customers*.

BDO comment

In practice, short-term receivables and payables with no stated interest rate would continue to be measured at their invoiced amount, because the effect of discounting is likely to be immaterial.

5.1.3. Transaction costs

Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. Examples of transaction costs are: fees and commissions paid to agents, advisers, brokers and dealers; levies by regulatory agencies and securities exchanges; transfer taxes and duties; credit assessment fees; registration charges and similar costs.

Judgement may be required when applying the definition of transaction costs in practice. Costs that do not qualify as transaction costs are debt premiums or discounts, financing costs, internal administration costs and holding costs.

For all financial instruments that are not measured at FVTPL the treatment of transaction costs is made on an instrument-by-instrument basis and either increase (financial asset) or decrease (financial liability) the amount initially recognised in the financial statements. All other transaction related costs that do not qualify as transaction costs are expensed as they are incurred.

5.1.4. Collateralised notes

Collateralised notes are initially recognised as a financial liability at fair value with subsequent measurement at amortised cost. On initial recognition, the expected cash flows are reduced by the expected credit losses in the underlying pool of assets. The EIR is then calculated based on discounting the remaining expected cash flows to the fair value.

5.2. Subsequent measurement

5.2.1. Financial assets

After initial recognition, financial assets are either measured at amortised cost (see Section 5.2.3.) or at fair value. As with the initial recognition of financial instruments (see Section 5.1.), the fair value is determined by applying the guidance set out in IFRS 13.

IFRS 9 removed the exception from IAS 39 to account for certain equity investments at cost from IAS 39 and requires entities to measure all equity investments at fair value. However, IFRS 9 states that in limited circumstances cost is an appropriate estimate of fair value, which may be situations where:

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

However, cost is never the best estimate for the fair value of quoted equity investments. Furthermore, it was noted by the IASB that cost would never apply to equity investments held by particular entities such as financial institutions and investment funds.

5.2.2. Financial liabilities

5.2.2.1. General requirements

For the purpose of subsequent measurement financial liabilities are either measured at amortised cost (see Section 5.2.3.) or at FVTPL (see Section 5.2.2.2.). Fair value is determined in accordance with IFRS 13.

5.2.2.2. Financial liabilities at FVTPL – Changes in credit risk

In a major change from IAS 39 the new guidance under IFRS 9 requires that when an entity designates a financial liability at FVTPL, the changes in fair value that relate to changes in the entity's own credit status are normally presented in other comprehensive income instead of profit or loss. This is to eliminate the counter intuitive effect that would otherwise arise, that the poorer the financial condition of an entity, the higher the discount rate that will apply when measuring the fair value of its financial liability and the higher the associated gain recognised in profit or loss.

This means that, under IFRS 9, entities will typically have to determine the change in fair value of the financial liability as a whole, and then perform a separate calculation to determine the change in fair value that is attributable to changes in their own credit status, and present those changes in other comprehensive income (OCI). The remaining changes in fair value will be presented in profit or loss.

The cumulative changes in fair value arising from changes in an entity's own credit status that is recognised in OCI are not subsequently recycled to profit or loss when the financial liability is derecognised. However, IFRS 9 permits entities to transfer the amount within equity after derecognition of the financial liability.

Example 26 – Recognising changes in fair value due to changes in own credit risk

Entity A issued a bond under conditions that qualify for the fair value option in IFRS 9, and decided to designate the liability to be accounted for at fair value through profit or loss (FVTPL). At the end of the financial reporting period, Entity A determines that CU2 of the change in the fair value of the bond of CU10 is due to a change in Entity A's credit risk.

Question: How should Entity A account for the fair value change?

31 March 20X4			
Dr	Financial liability (Bond)	CU10	
	Cr OCI		CU2
	Cr Profit or loss		CU8

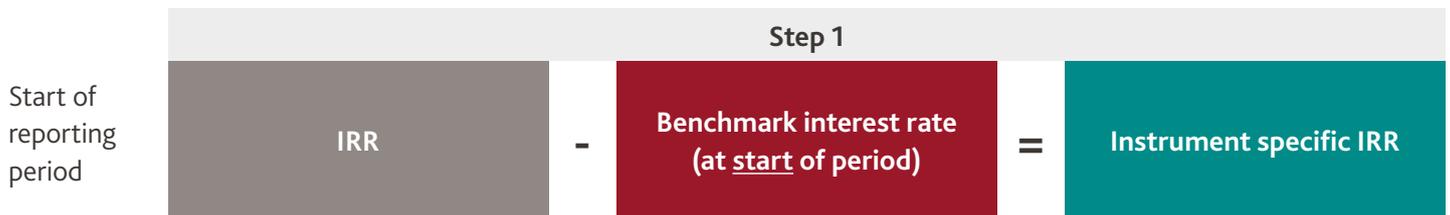
An entity determines the amount of the fair value change attributable to changes in its own credit risk either:

- (i) As the amount of the change in the fair value that is not attributable to changes in market conditions that give rise to market risk, which includes changes in:
 - Benchmark interest rates;
 - Prices of other financial instruments;
 - Commodity prices;
 - Foreign exchange rates;
 - Index of prices and rates.
- (ii) Using another method if that method more faithfully represents the related portion of the change in fair value.

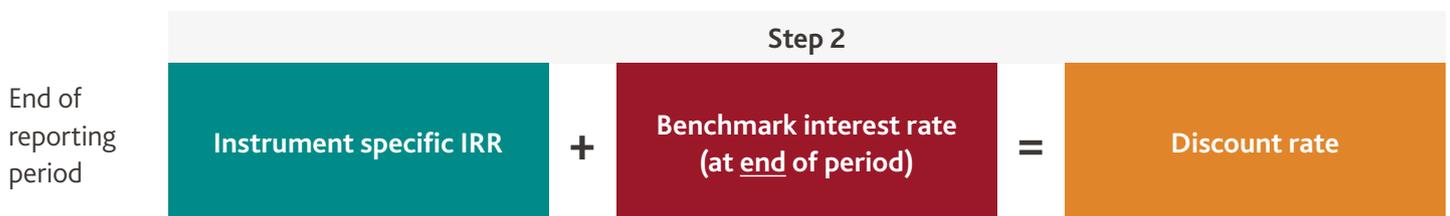
If the only significant relevant changes in market conditions are due to changes in an observed benchmark interest rate, the amount attributable to changes in an entity's own credit risk can be estimated using the default method, which is based on the calculation of the financial instrument's internal rate of return (IRR).

BDO comment

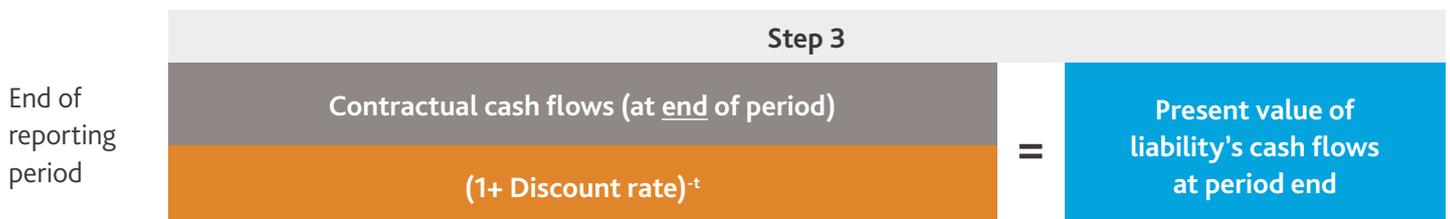
The benchmark interest rate is not explicitly defined by IFRS 9. However, usually the benchmark interest rate is a risk-free rate which excludes all changes which are due to changes in an entity's own credit risk. Examples of benchmark rates are interbank rates such as LIBOR or EURIBOR.



In the first step, the entity computes the liability's IRR at the start of the reporting period using the fair value of the liability and the liability's contractual cash flows at the start of the reporting period. It deducts from the IRR the observed benchmark interest rate at the start of the period. The result is an instrument specific IRR margin.



Secondly, the entity derives the discount rate, which is the sum of the instrument specific IRR margin (calculated in Step 1) and the benchmark interest rate at the end of the reporting period, in order to calculate the present value of the contractual cash flows.



In the third step, the entity determines the present value of the contractual cash flows of the liability at the end of the reporting period, using the discount rate derived in Step 2.



Finally, the entity deducts the present value of the liability's cash flows at the period end as determined under Step 3) from the fair value of the financial liability at the end of the reporting period. The result is the change in the fair value of the financial liability attributable to an entity's own credit risk.

5.2.3. Amortised cost measurement

The guidance on amortised cost measurement and the effective interest rate method is largely unchanged from IAS 39 and applies to:

- Financial assets and financial liabilities measured at amortised cost; and
- Debt instrument assets that are measured at FVOCI.

The amortised cost measurement requirements apply to debt instruments measured at FVOCI because IFRS 9 requires that those debt instruments affect profit or loss in the same way as if they were measured at amortised cost.

Amortised cost is defined in IFRS 9 as the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

5.2.3.1. Effective interest method

IFRS 9 requires that amortised cost is calculated using the effective interest method, which allocates interest income and expense at a constant rate over the term of the instrument. The effective interest rate of a financial asset or financial liability is calculated at initial recognition and is the rate that exactly discounts the estimated future cash flows through the expected life of the financial asset or financial liability to the:

- Gross carrying amount (before deducting provisions for impairment) of a financial asset; or
- Amortised cost of a financial liability.

At initial recognition the amortised cost of a financial asset or financial liability is normally equal to the fair value (the transaction price other than in very limited circumstances – see Section 5.1.1.) of the financial instrument adjusted for the related transaction costs.

For the calculation of the effective interest rate, an entity estimates the expected cash flows considering all contractual terms including any fees, transaction costs, and other premiums or discounts. Debt premiums or discounts, financing costs or internal administrative or holding costs are not eligible transaction costs. Because transaction costs are included as part of the initial carrying amount of the financial instrument, the recognition of these costs in profit or loss is spread over the term of the instrument through the application of the effective interest method.

Example 27 – Calculating the effective interest rate

Entity A acquires a debt instrument with a nominal value of CU100 at the beginning of year 20X1 for CU90. Transaction costs in relation to the acquisition are CU8. The instrument bears a 5% coupon, which is paid annually. The instrument matures in five years at the end of 20X5. Entity A accounts for the debt instrument at amortised cost.

Question: How does entity A calculate the effective interest rate?

Answer: The internal rate of return (IRR) of the cash flows is the interest rate that discounts the expected cash flows to the initial carrying amount of CU98. The IRR is calculated using the following formula:

$$\frac{\text{CU5}}{1.0547} + \frac{\text{CU5}}{1.0547^2} + \frac{\text{CU5}}{1.0547^3} + \frac{\text{CU5}}{1.0547^4} + \frac{\text{CU105}}{1.0547^5} = \text{CU98}$$

Year	Carrying amount at 1.1	Effective interest (5.47%)	Cash flow	Carrying amount at 31.12
20X1	CU98.00	CU5.36	(CU5.00)	CU98.36
20X2	CU98.36	CU5.38	(CU5.00)	CU98.74
20X3	CU98.74	CU5.40	(CU5.00)	CU99.14
20X4	CU99.14	CU5.42	(CU5.00)	CU99.56
20X5	CU99.56	CU5.44	(CU105.00)	CU0.00

The determination of the effective interest rate is based on the estimated cash flows arising from the asset. Expected credit losses are not included as part of the cash flows for the calculation of the effective interest rate method. This is because the gross carrying amount of a financial asset is adjusted for a loss allowance, which is not part of the effective interest rate calculation.

Changes in the expected cash flows will result in a recalculation of the gross carrying amount of an asset and the amortised cost of a financial liability. The revised expected cash flows are discounted using the original effective interest rate of the instrument. Any difference from the previous amount is recognised in profit or loss.

5.2.3.2. Revisions of estimates of cash flows

For revisions of estimates of cash flows for floating rate financial assets and floating rate financial liabilities with a variable market rate of interest, the re-estimation of the cash flows driven by the movements in the market rate of interest will affect and change the effective interest rate. However, the re-estimation of the cash flows does normally not significantly affect the carrying amount of the asset or liability. For practical reasons, the carrying amount is therefore typically not updated at each reporting date.

This is different from the accounting for a change in the estimated cash flows for financial instruments with either:

- A fixed rate of interest; or
- A variable rate that does not represent a market rate.

Examples of such instruments include loans with interest payments linked to future revenue, production output, or profit. In this case the entity recalculates the carrying amount by computing the present value of the estimated future cash flows at the financial instrument's original effective interest rate. The resulting adjustment to the carrying amount is recognised as a gain or loss in profit or loss.

Example 28 – Adjustment of the carrying amount of a loan with interest linked to EBITDA

On 1 January 20X5, Entity A takes out a loan with Entity B for CU1,000 for three years. The interest payments on the loan are 10% of Entity A's EBITDA. On 1 January 20X5, Entity A expects the following EBITDA figures (The determination of whether there is an embedded derivative is not dealt with in this section. See Section 3.5. for this discussion).

Year	EBITDA	10% of EBITDA
31/12/20X5	CU1,000	CU100
31/12/20X6	CU2,500	CU250
31/12/20X7	CU3,000	CU300

- Questions:**
- What is Entity A's initial journal entry on 1 January 20X5?
 - What is the effective interest rate of the loan?
 - What are Entity A's journal entries at 31 December 20X5?

Answer (a)

1 January 20X5			
Dr	Cash	CU1,000	
	Cr	Loan payable	CU1,000

To recognise the loan at its initial carrying amount of CU1,000.

Answer (b)

The effective interest rate of the loan is 20.4%, being the interest rate that discounts the expected cash flows to the initial carrying amount of CU1,000.

$$\frac{CU100}{1.204} + \frac{CU250}{1.204^2} + \frac{CU1,300}{1.204^3} = CU1,000$$

Answer (c)

On 31 December 20X5, Entity A's actual EBITDA for the year is CU1,200 Entity A makes a payment of CU120 to Entity B. Entity A also re-estimates its expected EBITDA for the next two years.

Year	EBITDA	10% of EBITDA
31/12/20X6	CU2,800	CU280
31/12/20X7	CU3,500	CU350

31 December 20X5			
Dr	Interest expense*	CU204	
	Cr	Cash	CU120
	Cr	Loan payable	CU84

* Amount would qualify for capitalisation if the borrowing is for a qualifying asset under IAS 23 *Borrowing Costs*.

Example 28 – Adjustment of the carrying amount of a loan with interest linked to EBITDA (continued)**Answer (c) (continued)**

As at 31 December 20X5, Entity A recalculates the carrying amount of the loan based on the revised expected future repayments.

Year	EBITDA	Repayments	Discounted at 20.4% EIR
31/12/20X6	CU2,800	CU280	CU233 (CU280/1.204)
31/12/20X7	CU3,500	CU350	CU241 (CU350/1.204 ²)
31/12/20X7		CU1,000	CU690 (CU1,000/1.204 ²)
Revised carrying amount of loan at 31/12/20X5:			CU1,164

Calculation of the difference of the revised carrying amount.

Revised carrying amount of loan at 31/12/20X5	CU1,164
Carrying amount before recalculation	
CU1,000 (initial carrying amount) + CU84 (effective interest)	CU1,084
Difference	CU80

31 December 20X5			
Dr	Profit or loss*	CU80	
	Cr	Loan payable	CU80

To recognise the change in estimates of cash flows.

* Amount would qualify for capitalisation if the borrowing is for a qualifying asset under IAS 23 *Borrowing Costs*.

For floating rate instruments the effective interest rate is required to be updated when cash flows are re-adjusted for changes in the market rate of interest. In line with current practice under IAS 39, two approaches are usually applied in practice to calculate the effective interest rate:

- Using the actual benchmark interest rate set for the relevant period; or
- Taking into account expectations about future interest rates and changes in the expectations.

Example 29 – Calculating the effective interest rate for floating rate instruments

Entity A issues a debt instrument at a principal amount outstanding of CU100 at the beginning of 20X1, which matures in three years (20X3). The coupon rate of the instrument is defined as 12-month LIBOR plus 2%.

The 12-month LIBOR at initial recognition is 2% and expected to be 3% in 20X2 and 4% in 20X3.

Question: How is the effective interest rate for the floating rate instrument calculated?

Answer: As with the guidance under IAS 39, there are two options to calculate the effective interest rate for floating rate debt under IFRS 9.

Actual benchmark interest rate for the period	Expectations about future interest rates
<p>The initial effective interest rate is 4% Being the 12-month LIBOR at 2% + 2%.</p>	<p>The initial effective interest rate is approximately 5% Being the internal rate of return of:</p> <ul style="list-style-type: none"> – The expected coupons to be received (CU4, CU5, CU6); and – The principal amount repayable at maturity of CU100.

5.2.3.3. POCI assets, and financial assets which become credit impaired

A different treatment applies to financial assets where credit losses already exist when those assets are acquired or originated by the reporting entity. For these so called 'purchased or originated credit-impaired financial assets' (POCI assets), future lifetime expected credit losses are taken into account when estimating the contractual cash flows, resulting in a credit adjusted effective interest rate.

If a financial asset becomes credit-impaired after initial recognition and moves to **Stage 3** of the impairment model (see Section 6.), the effective interest rate is applied to the net carrying value, which includes the loss allowance. IFRS 9.BC5.78 states that 'the IASB is of the view that, conceptually, an entity should assess whether financial assets have become credit-impaired on an ongoing basis, thus altering the presentation of interest revenue as the underlying economics change. However, the IASB noted that such an approach would be unduly onerous for preparers to apply. Thus, the IASB decided that an entity should be required to make the assessment of whether a financial asset is credit-impaired at the reporting date and then change the interest calculation from the beginning of the following reporting period.' If the financial asset ceases to be credit impaired with the result of a reversal of the impairment, the application of the effective interest rate reverts to the gross carrying amount. However, this does not apply to POCI assets which never revert to a gross basis.

5.2.3.4. Modifications of financial assets and financial liabilities

For financial assets that are modified, IFRS 9 includes new guidance for the measurement of the amortised cost of modified financial assets where the modification does not result in derecognition.

BDO comment

Consistent with the previous IAS 39 guidance, financial assets are derecognised under IFRS 9 when the rights to the cash flows expire or the asset is transferred to another party, provided certain restrictive criteria are met.

In an agenda decision of the IFRS Interpretations Committee from September 2012 it was noted that in the absence of explicit guidance for the derecognition of a financial asset arising from a modification, an analogy might be made to the guidance for the modification of financial liabilities under which a substantial change in terms results in derecognition of the existing financial liability and the recognition of a new one. Based on that approach a substantial change exists if the difference between the present value of the modified future cash flows using the original effective interest rate, and the present value of the original cash flows, is at least 10%. However, there is no requirement to apply this threshold by analogy, meaning that judgement may need to be applied.

For a modification that does not result in derecognition, the difference between the present value of the modified cash flows discounted using the original effective interest rate and the present value of the original cash flows, is recognised in profit or loss as a gain or loss from modification. Costs or fees in relation to the modification of the financial asset are recognised as part of the carrying amount of the asset and amortised over the remaining term of the instrument. A modification of the original financial asset that results in the derecognition of the financial asset, requires the recognition of a new financial asset in line with the general requirements for the initial recognition (i.e. at fair value plus transaction costs). However, IFRS 9 does not include guidance to determine which costs and fees may be eligible for capitalisation, rather than being amounts which should be attributed to the derecognition of the old debt and therefore expensed immediately.

The guidance for the treatment of modifications of financial liabilities that do not result in derecognition has changed from IAS 39 wherein an entity could apply the policy that if a modification of a financial liability does not result in derecognition, changes in the contractual cash flows could be amortised over the remaining term of the modified instrument by recalculating the effective interest rate of the instrument. Under IFRS 9 a gain or loss will be recognised in profit or loss for the difference between the original contractual cash flows and the modified cash flows discounted at the original effective interest rate (IFRS 9.B5.4.6).

Example 30 – Modification of financial liabilities

Entity A borrowed \$100 million. Subsequently, Entity A has entered into a modification arrangement to repay part of the floating-rate loan and to modify the terms of the outstanding portion to be carried forward. In this scenario Entity A agrees to pay \$44 million at the time of the modification and \$50 million in the future based on the revised terms, rather than repaying \$100 million in the future based on the original terms. The maturity date of the existing loan, and the portion to be carried forward, are the same and the new loan is at a revised floating rate. The legal costs associated with the modification are \$20,000.

	Original	Revised
Face amount	CU100,000,000	CU50,000,000
Carrying amount (PV of cash flows at original EIR – Entire loan)	CU94,000,000	
Payment required on restructuring		CU44,000,000
PV of cash flows at original EIR – Portion remaining outstanding	CU47,000,000	CU54,000,000

When there is a partial repayment questions often arise about the 10% test – Do you use the entire loan or only the amount that remains outstanding. Whether you look at the remaining loan or the entire loan will impact the conclusion.

Using the entire loan: $((44 + 54) - 94) / 94 = 4.26\%$

Using only the remaining loan: $(54 - 47) / 47 = 14.89\%$

In this case, changes are being made to the contractual terms of the entire loan (that is, both the amount being repaid and the remaining outstanding portion). Consequently, the assessment is carried out for the whole loan, and not simply the portion that will be left outstanding. The legal costs are excluded from the cash flows as part of the 10% test because these are not fees payable to the loan counterparty.

As this example demonstrates, if the assessment was carried out only for the remaining loan it would be concluded that there is an extinguishment. However, if the assessment was carried out for the entire loan it would be concluded that the modification does not result in extinguishment, based on the fact that the difference for the entire loan is less than 10%.

The journal entries to account for the non-substantial modification are as follows:

Dr	Profit or loss (difference between the carrying amount of \$94M and \$98M (the present value of the revised cash flows discounted at the original EIR))	CU4,000,000	
	Cr	Loan payable	CU4,000,000

To record the non-substantial modification.

Dr	Loan payable	CU20,000	
	Cr	Accounts payable	CU20,000

To record the transaction costs.

The transaction costs are adjusted against the carrying amount of the loan rather than expensed in a non-substantial modification. The future EIR is updated going forward, but only for the impact of the transaction costs not for the revised future cash flows on the loan. The result is only the transaction costs of CU20,000 are recognised over the remaining term of the loan as an expense, whilst the impact of the revised cash flows on the loan is taken to profit or loss at the time of the modification.

If the modification does result in the derecognition of the financial liability then the old liability is derecognised and a new liability is recognised, with the effective interest rate being calculated based on the revised terms. Any costs or fees incurred are recognised in profit or loss as part of the gain or loss on extinguishment and do not adjust the carrying amount of the new liability.

BDO comment

The example above illustrates that it is important to ensure that the derecognition test is applied to either the appropriate portion of, or the whole, loan. As a general principle, if part of a loan is to be modified and the contractual terms of the remaining portion are unchanged, then the derecognition test would be applied to the portion that is modified. In contrast, if part of a loan is to be repaid and the contractual terms for the portion that will be left outstanding will be changed, as in the example above, the analysis treats the entire loan as a single unit of account.

As a result of the change in modification guidance, the following examples are provided to illustrate when to apply IFRS 9.B5.4.5 (formerly IAS 39.AG7) or B5.4.6 (formerly IAS 39.AG8) to changes in the cash flows of a financial liability. These examples are also applicable to financial assets, since these paragraphs apply to both financial assets and financial liabilities.

Example 31A – Financial liability credit spread reset

Entity A took out a 10 year floating rate debt loan with Bank Z, with the interest rate based on 3m LIBOR + credit spread. Credit spread is reset if the debt/equity ratio and the interest cover ratio reaches certain thresholds. The purposes of the reset is to avoid the need to renegotiate the loan when the Entity A's credit risk changes.

Question: Does the entity apply IFRS 9.B5.4.5 or B5.4.6?

Answer: The entity applies IFRS 9.B5.4.5, i.e. update EIR. It has been widely accepted in practice that resetting the benchmark component i.e. LIBOR component relates to IFRS 9.B.5.4.5, therefore, resetting only the credit spread should also be accounted for in accordance with Paragraph B5.4.5 (that is, provided that the predefined changes reasonably approximate expected changes in market rates, IFRS 9.B5.4.5 can be applied).

Example 31B – Financial liability interest rate modification

Entity C took out a 5 year fixed rate loan paying 10% interest with Bank Z. Entity C then subsequently experiences financial difficulty and renegotiates with Bank Z to pay 8% interest extend the loan for another 2 years.

Question: Does the entity apply IFRS 9.B5.4.5 or B5.4.6?

Answer: The entity applies IFRS 9.B5.4.6 applies (catch-up adjustment). The change in interest rate does not reflect movements in market rate of interest. The reset of the rates is directionally inconsistent with higher credit risk, i.e. the reset of the rate is lower rather than Entity C being charged a higher rate.

Example 31C – Financial liability interest rate renegotiation

Entity D took out a 8 year fixed rate loan with Bank Z. The loan is prepayable but would require Entity D to pay an additional amount as compensation for changing the rate. The additional compensation amount is being viewed as reasonable. After 5 years, Entity B renegotiates with Bank Z for a new fixed market interest rate.

Question: Does the entity apply IFRS 9.B5.4.5 or B5.4.6?

Answer: The entity applies IFRS 9.B5.4.6 (catch-up adjustment). The modification is not a result of a change in the market rates of interest.

Example 31D – Troubled debt restructuring

Entity E took out a 10 year floating rate debt loan with Bank Z, with the interest rate based on 3m LIBOR + 3.5%. Entity E is close to breaching the required debt/equity ratio as stated in the bank covenant. Entity E renegotiates the loan to remove the debt/equity ratio requirement in return for an additional 2.5% credit margin which is added to the interest rate. The new credit spread of 6% reflects Entity E's current credit risk.

Question: Does the entity apply IFRS 9.B5.4.5 or B5.4.6?

Answer: The entity applies IFRS 9.B5.4.6. The original loan contract does not contain any terms that provides for the credit margin to be changed/reset. The change in the rate is a result of renegotiation of the terms.

IFRS 9.B5.4.5 applies where there is something in the original terms that stipulates for the credit margin to be reset and which approximates the expected change in market credit spreads.

Example 31E – Financial liability renegotiation of terms

Entity F took out a 10 year fixed rate loan with Bank Z. Interest rates have decreased since Entity F took out the loan. The terms of the loan do not allow Entity F to repay early. Entity F renegotiates with Bank Z to reduce future interest rate payments to reflect some of the fall in the market interest rates. Effectively, both Entity F and Bank Z share in the benefits of the fall in rates).

Question: Does the entity apply IFRS 9.B5.4.5 or B5.4.6?

Answer: The entity applies IFRS 9.B5.4.6. The original loan contract does not contain any terms that provides for the rate to be changed. The change in the rate is a result of renegotiation of the terms.

Example 31F – Financial liability linked to inflation index

Entity G issues bonds of \$100m, the coupon of the bonds and principal repayment amounts are linked to changes in the inflation index of Country X.

Question: Does the entity apply IFRS 9.B5.4.5 or B5.4.6?

Answer: The entity has an accounting policy choice to apply either IFRS 9.B5.4.5 or B5.4.6. In July 2008, the IFRIC (now the IFRS Interpretations Committee) issued an agenda decision which noted that judgement was required to determine whether an instrument was a floating rate instrument within the scope of IAS 39.AG7 or an instrument within the scope of IAS 39.AG8. Since the applicable guidance in those paragraphs has not changed from their transposition into IFRS 9 (although the wording of IFRS 9.B5.4.6 was modified), similar judgement is required when accounting for those instruments in accordance with IFRS 9.

6. IMPAIRMENT

6.1. Scope

The following financial instruments are included within the scope of the impairment requirements in IFRS 9:

- Debt instruments measured at amortised cost, e.g.
 - Trade receivables;
 - Loans receivable from related parties or key management personnel;
 - Deferred consideration receivable; and
 - Intercompany loans in separate financial statements.
- Debt instruments that are measured at fair value through other comprehensive income (FVOCI), e.g. long dated government or corporate bond;
- Issued loan commitments (except those measured at FVTPL);
- Issued financial guarantee contracts (except those measured at FVTPL);
- Lease receivables within the scope of IAS 17 *Leases* (or IFRS 16 *Leases*);
- Contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*;
- Receivables arising from transactions within the scope of IAS 18 *Revenue* and IAS 11 *Construction Contracts* (if adoption of IFRS 9 is before the adoption of IFRS 15).

6.2. Overview of the new impairment model

IFRS 9 establishes a three-stage impairment model, based on whether there has been a significant increase in the credit risk of a financial asset since its initial recognition. These three-stages then determine the amount of impairment to be recognised as expected credit losses (ECL) at each reporting date as well as the amount of interest revenue to be recorded in future periods:

- **Stage 1:** Credit risk has not increased significantly since initial recognition – Recognise 12-months ECL, and recognise interest on a gross basis;
- **Stage 2:** Credit risk has increased significantly since initial recognition – Recognise lifetime ECL, and recognise interest on a gross basis;
- **Stage 3:** Financial asset is credit impaired (using the criteria currently included in IAS 39) – Recognise lifetime ECL, and present interest on a net basis (i.e. on the gross carrying amount less credit allowance).

The recognition of impairment (and interest revenue) is summarised below:

Stage	1	2	3
Recognition of Impairment	12-month expected credit losses	Lifetime expected credit losses	
Recognition of interest	Effective interest on the gross carrying amount		Effective interest on the net carrying amount

Figure 3: Summary of the recognition of impairment (and interest revenue) under IFRS 9

However as a practical expedient, a simplified model applies for:

- Trade receivables or contract assets without a significant financing component (or when the IFRS 15 Paragraph 63 practical expedient is applied for the effects of a significant financing component to those with maturities of less than 12 months) (see Section 7.4.1. below); and
- Other long-term trade receivables or contract assets with a significant financing component and lease receivables if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses (see Section 7.4.2. below).

In estimating ECLs, entities must consider a range of possible outcomes and not the 'most likely' outcome. The standard requires that at a minimum, entities must consider the probability that:

- A credit loss occurs; and
- No credit loss occurs.

6.3. General impairment model

6.3.1. Recognition of impairment – 12-month expected credit losses

12-month ECLs are calculated by multiplying the probability of a default occurring in the next 12 months by the total (lifetime) ECLs that would result from that default, regardless of when those losses occur. Therefore, 12-month expected credit losses represent a financial asset's lifetime expected credit losses that are expected to arise from default events that are possible within the 12 month period following origination of an asset, or from each reporting date for those assets in **Stage 1**.

BDO comment

The distinction between 12-month expected credit losses to be calculated in accordance with IFRS 9 and the cash shortfalls that are anticipated to arise over the next 12 months is important.

As an example, the death of a credit card borrower does lead, in a number of cases, to the outstanding balance becoming impaired. Linking this to the accounting requirements, the IFRS 9 model therefore requires the prediction on initial recognition (and at each reporting date) of the likelihood of the borrower dying in the next 12 months and hence triggering an impairment event. Given the very large number of balances, it is likely that this would be calculated on a portfolio basis and not for each individual balance.

6.3.2. Recognition of impairment – Lifetime expected credit losses

Lifetime expected credit losses are the present value of expected credit losses that arise if a borrower defaults on its obligation at any point throughout the term of a lender's financial asset. This requires an entity to consider all possible default events during the term of the financial asset in the analysis. Lifetime expected credit losses are calculated based on a weighted average of the expected credit losses, with the weightings being based on the respective probabilities of default.

Example 32 – Measuring ECLs on cross-company guarantees

Background

Many cross company guarantee arrangements will meet the definition of financial guarantee contracts (FGCs) and will fall within the scope of IFRS 9 (except in cases where they are accounted for as insurance contracts under IFRS 4 *Insurance Contracts*). In accordance with IFRS 9, unless the FGC is classified and measured at FVPL, it will be within the scope of the ECL requirements.

The issue which arises in practice is how cash shortfalls on an issued cross company guarantee should be estimated for the purposes of measuring ECL in an entity's stand-alone financial statements.

Example

Group X consists of Parent A and its 5 wholly owned subsidiaries (B, C, D, E and F). Subsidiary B borrows £100m from Bank Y on 1 January 2018. The loan is unsecured but benefits from a cross company guarantee arrangement which was entered into at the same time as the loan. Under this arrangement, all group entities are jointly and severally liable for any losses that Bank Y incurs on its loan to Subsidiary B.

Assume that the cross company guarantee meets the FGC definition, is not accounted for under IFRS 4 and is not classified and measured at FVPL. Consequently, each group member (excluding Subsidiary B) is required to apply the ECL model (General Approach) to the FGC at the reporting date. This means that each entity within the group would be required to:

- i. Assess the changes (since initial recognition) in the risk that Subsidiary B (being the specified debtor) will default on the loan to Bank Y (see IFRS 9.B5.5.6); and
- ii. Estimate cash shortfalls and measure 12-month or lifetime ECL in accordance with the guidance in IFRS 9.B5.5.32: 'For a financial guarantee contract, the entity is required to make payments only in the event of a default by the debtor in accordance with the terms of the instrument that is guaranteed. Accordingly, cash shortfalls are the expected payments to reimburse the holder for a credit loss that it incurs less any amounts that the entity expects to receive from the holder, the debtor or any other party. If the asset is fully guaranteed, the estimation of cash shortfalls for a financial guarantee contract would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.'

Question: When estimating the cash shortfalls for the purposes of measuring ECL, should each entity factor in the likelihood that it will be the entity called upon under the FCG?

Answer: **Yes.** IFRS 9.B5.5.32 states that the cash shortfalls for a FGC are 'the expected payments to reimburse the holder for a credit loss that it incurs'. The expected payments depend not only on the possible cash shortfalls on the underlying loan but also the likelihood of that particular entity being called upon to make payments under the guarantee. However, the total amount of cash shortfalls estimated by all group entities should equal the cash shortfalls that Bank Y would have incurred on the underlying loan absent the guarantee.

6.3.3. Determining significant increases in credit risk and credit-impaired financial assets

The transition from recognising 12-month expected credit losses (i.e. **Stage 1**) to lifetime expected credit losses (i.e. **Stage 2**) in IFRS 9 is based on the notion of a significant increase in credit risk over the remaining life of the instrument in comparison with the credit risk on initial recognition. The focus is on the changes in the risk of a default, and not the changes in the amount of expected credit losses. For example, for highly collateralised financial assets such as real estate backed loans, when a borrower is expected to be affected by the downturn in its local economy with a consequent increase in credit risk, that loan would move to **Stage 2**, even though the actual loss suffered may be small because the lender can recover most of the amount due by selling the collateral.

A significant increase in credit risk (moving from **Stage 1** to **Stage 2**) can include:

- Changes in general economic and/or market conditions (e.g. expected increase in unemployment rates, interest rates);
- Significant changes in the operating results or financial position of the borrower;
- Changes in the amount of financial support available to an entity (e.g. from its parent);
- Expected or potential breaches of covenants;
- Expected delay in payment (Note: Actual payment delay may not arise until after there has been a significant increase in credit risk).

BDO comment

*Entities will need to develop clear policies to identify the new point of transition between **Stage 1** and **Stage 2**, incorporating indicators set out in the application guidance as appropriate.*

Credit-impaired financial assets are those for which one or more events that have a detrimental effect on the estimated future cash flows have already occurred. This is similar to the point at which an incurred loss would have been recognised under IAS 39. These financial assets would be in **Stage 3** and lifetime expected losses would be recognised. Indicators that an asset is credit-impaired would include observable data about the following events:

- Actual breach of contract (e.g. default or delinquency in payments);
- Granting of a concession to the borrower due to the borrower's financial difficulty;
- Probable that the borrower will enter bankruptcy or other financial reorganisation.

Example 33 – Write off of a portion of a credit-impaired financial asset

An entity has a financial asset of CU1,000 collateralised by equipment. The financial asset is classified as a **Stage 3** credit impaired asset, and the Entity plans to collect the collateral. The entity expects recovery of a maximum of 50 percent of the financial asset from the collateral and does not anticipate any collection of additional cash for the deficit (that is, the entity has no reasonable prospects of recovering any cash flows in excess of 50 percent of the financial asset).

Write-offs are addressed in IFRS 9.5.4.4 which requires that 'An entity shall directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectations of recovering a financial asset in its entirety or a portion thereof. A write-off constitutes a derecognition event (see IFRS 9.B3.2.16(r)).' IFRS 9.BC5.81 further states that 'in the IASB's view, a definition of 'write-off' is necessary to faithfully represent the gross carrying amount of the financial assets within the scope of IFRS 9.'

Although the derecognition requirements for a part or all of a financial assets are set out in IFRS 9.3.2.2, IFRS 9.5.4.4 refers to Paragraph B3.2.16(r) which sets out examples of the application of the derecognition principles. Subparagraph (r) states that a write-off is when 'an entity has no reasonable expectations of recovering the contractual cash flows on a financial asset in its entirety or a portion thereof.'

Both IFRS 9.5.4.4 and B3.2.16(r) refer to a portion of the financial asset. Although Paragraph B3.2.16(r) refers to Paragraph 3.2.6 (which forms part of Chapter 3.2 of IFRS 9), in our view if it was intended that write-offs need to comply with the derecognition requirements of Paragraph 3.2.2 then there would have been a reference to Chapter 3.2 in its entirety from both Paragraphs 3.2.2 and 5.4.4.

IFRS 9.B5.4.9 gives an example of the application of IFRS 9.5.4.4 where it states that 'write-offs can relate to a financial asset in its entirety or to a portion of it. For example, an entity plans to enforce the collateral on a financial asset and expects to recover no more than 30 per cent of the financial asset from the collateral. If the entity has no reasonable prospects of recovering any further cash flows from the financial asset, it should write off the remaining 70 per cent of the financial asset.'

Therefore, in the example above the impaired uncollectible CU500 (50 percent of the financial asset) is written off when the entity has no reasonable expectation of recovering that portion of the financial asset.

6.3.4. Exception for low credit risk financial assets

IFRS 9 includes a practical expedient for low credit risk financial assets. Essentially financial assets with an external (or equivalent internal) rating equivalent to investment grade are considered to be low credit risk. Examples of financial assets that might be considered low credit risk include bonds issued by governments or corporates that have an external BBB credit rating or above. For low credit risk credit financial assets only 12-month expected credit losses are recognised. IFRS 9 does not require the low credit risk exception to apply in the first reporting period that includes the initial recognition of the related financial asset, or at the date of initial application (DIA).

IFRS 9.BC5,184 notes that the IASB considered whether to allow entities to have an accounting policy choice on whether to apply the requirement to assess whether a financial instrument is considered to have low credit risk at the reporting date. However, because the relief was intended to provide relief from a requirement to track changes in the credit risk of high quality financial instruments, it was decided that the assessment of low credit risk could be made on an instrument by instrument basis.

BDO comment

*An entity might originate a financial asset which, at the end of the reporting period, is in **Stage 2** and is not low credit risk. Lifetime ECLs would be recognised. If, at the end of the next reporting period, the asset is still in **Stage 2** but is now low credit risk then the practical expedient can be applied.*

Because the use of the practical expedient is not an accounting policy choice, entities can choose whether the exception is applied for each financial instrument at each reporting date. However, in our view it would be inappropriate for the practical expedient to be applied inconsistently from one period to the next in order to achieve a desired accounting result.

6.4. Simplified impairment model

6.4.1. Trade receivables and contract assets without a significant financing component

For trade receivables and contract assets that do not contain a significant financing component in accordance with IFRS 15 (so generally trade receivables and contract assets with a maturity of 12 months or less), 'lifetime expected credit losses' are required to be recognised. Because the maturities will typically be 12 months or less, the credit loss for 12-month and lifetime ECLs would be the same.

BDO comment

A financier (e.g. a bank) might acquire trade receivables as a result of a factoring arrangement when the originator derecognises the trade receivables and they are transferred to the financier. In those cases, the financier cannot apply the simplified approach to the factored trade receivables, because it did not originate them by supplying goods or services to a customer. The simplified model is only applicable to trade receivables that result from transactions that are within the scope of IFRS 15.

The new impairment model allows entities to calculate ECLs on trade receivables using a provision matrix. In practice, many entities already estimate credit losses using a provision matrix where trade receivables are grouped based on different customer attributes and different historical loss patterns (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer). Under the new model, entities will need to update their historical provision rates with current and forward looking estimates. A similar approach might be followed for contract assets.

BDO comment

There are two key differences between the IAS 39 impairment model and the new model for impairment of trade receivables:

- *Entities will not wait until the receivable is past due before recognising a provision; and*
- *The amount of credit losses recognised is based on forward looking estimates that reflect current and forecast credit conditions.*

Example 34 – Applying the new impairment model to trade receivables

Company M has trade receivables of CU30 million at 31 December 20X4. The customer base consists of a large number of small clients. In order to determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates, adjusted for forward looking estimates. At every reporting date, the historical observed default rates and forward looking estimates are updated. Company M estimates the following provision matrix at 31 December 20X4:

	Expected default rate	Gross carrying amount	Credit loss allowance (Default rate x Gross carrying amount)
Current	0.3%	CU15,000,000	CU45,000
1-30 days past due	1.6%	CU7,500,000	CU120,000
31-60 days past due	3.6%	CU4,000,000	CU144,000
61-90 days past due	6.6%	CU2,500,000	CU165,000
More than 90 days past due	10.6%	CU1,000,000	CU106,000
Totals		CU30,000,000	CU580,000

One year later, at 31 December 20X5, Company M revises its forward looking estimates, which incorporate a deterioration in general economic conditions. Company M has a portfolio of trade receivables of CU34 million in 20X5.

	Expected default rate	Gross carrying amount	Credit loss allowance (Default rate x Gross carrying amount)
Current	0.5%	CU16,000,000	CU80,000
1-30 days past due	1.8%	CU8,000,000	CU144,000
31-60 days past due	3.8%	CU5,000,000	CU190,000
61-90 days past due	7.0%	CU3,500,000	CU245,000
More than 90 days past due	11.0%	CU1,500,000	CU165,000
Totals		CU34,000,000	CU824,000

The credit loss allowance is increased by CU244,000 from CU580,000 at 31 December 20X4 to CU824,000 as at 31 December 20X5. The journal entry at 31 December 20X5 would be:

31 December 20X5			
Dr	Expected credit loss	CU244,000	
	Cr	Credit loss allowance	CU244,000

Example 35 – Applying the new impairment model to trade receivables

Company X has trade receivables of CU100 million at 31 December 20X8. In order to determine the expected credit losses for the portfolio, Company X uses a provision matrix based on a credit rating score. Each customer is assigned a credit rating score based on their geographical location (e.g. postcode), industry and payment behaviour. The provision matrix is based on its historical observed default rates, adjusted for forward looking estimates. Company X estimates the following provision matrix at 31 December 20X8:

Rating score	Expected default rate (A)	Gross carrying amount (B)	Credit loss allowance (A x B)
80-100	0.5%	CU49,000,000	CU245,000
60-79	1.5%	CU20,000,000	CU300,000
40-59	3.5%	CU15,000,000	CU525,000
20-39	7.5%	CU4,000,000	CU1,050,000
0-19	15.0%	CU2,000,000	CU300,000
Totals		CU100,000,000	CU2,420,000

Company X provides for CU2,420,000 in its credit loss allowance account. The CU2,420,000 also include the provision for trade receivables that are current (i.e. not yet overdue).

6.4.2. Other long term trade receivables, contract assets and lease receivables

For other long term trade receivables and lease receivables, entities have an accounting policy choice to apply either the general three-stage approach or the 'simplified approach' of recognising lifetime expected losses.

Applying the 'simplified approach' alleviates some of the operational challenges associated with the 'general' model, e.g. assessing whether there has been a significant increase in credit risk. However, applying the 'simplified' model may lead to a higher debt provision than the 'full' model because:

- Under the 'simplified approach', all expected credit losses would be provided for at the first reporting date;
- Under the 'full' model, initially only a portion (12 months) of expected credit losses are provided for (provisions for lifetime expected credit losses are not recognised until there has been a significant increase in credit risk of the receivable under the 'full' model).

6.5. Further implications

6.5.1. Related party, key management personnel and intercompany loan receivables

IFRS 9 does not provide any practical expedients for related party, key management personnel and intercompany loan receivables. This means that expected credit loss provisions (and the related disclosures) are dealt with by using the 'full' three-stage model, which requires:

- To recognise 12-month of expected credit losses on initial recognition; and
- Life-time expected credit losses if the credit risk of the borrower increased significantly.

Full disclosure under the three-stage model would also have to be provided.

Example 36 – Applying the three-stage model to a related party loan

Mr. A is a director of Company A and is also the sole shareholder of Company C. Company C is therefore a related party to Company A.

- On 1 January 20X1, Company A provided a CU100 loan to Company C for four years at an annual interest rate of 10%;
- On 31 December 20X2, Company C is expected to have cash flow problems in future due to a deterioration in economic conditions;
- On 31 December 20X3, the loan is extended for another three years because Company C is in financial difficulty does not have enough cash to repay the loan.

Question: How should the loan be accounted for under the three-stage expected loss model?

Answer:

31 December 20X1

- Loan is in **Stage 1**;
- Estimate the probability that company C will default over the next 12 months;
- Assume there is a 1% probability of company C defaulting in the next 12 months and, if there is a default, Company A will not get any amount back (100% loss);
- Recognise provision of CU1 (1% x CU100);
- Recognise interest on the gross carrying amount of the loan (CU100 x 10%).

31 December 20X2

- Loan is in **Stage 2**
It is considered that credit risk has increased significantly as Company C is expected to have cash flow in future problems due to a deterioration in economic conditions;
- The probability that company C will default over the remaining life of the loan is estimated at 35% and, if there is a default, there will be a 100% loss;
- Recognise a provision of CU35 (35% x CU100);
- Recognise interest on the gross carrying amount of the loan (CU100 x 10%).

Example 36 – Applying the three-stage model to a related party loan (continued)**Answer: (continued)****31 December 20X3**

- Loan is in **Stage 3**
Due to liquidity problems, Company C is in financial difficulty and is not able to repay the loan and relies on an extension of the loan for three years. The loan is therefore credit impaired;
- Company A estimates that the probability of default over the remaining life of the loan is 60% and, if there is a default, there will be a 100% loss;
- Recognise a provision of CU60 (60% x CU100);
- Recognise interest on the net carrying amount of the loan (CU40 x 10%) from the beginning of the next reporting period.

	Stage	Gross amount	Loss allowance	Interest
31/12/20X1	Stage 1	CU100	CU1	CU10 (CU100 x 10%)
31/12/20X2	Stage 2	CU100	CU35	CU10 (CU100 x 10%) (loan was still in Stage 1 throughout the year)
31/12/20X3	Stage 3	CU100	CU60	CU10 (CU100 x 10%) (loan was still in Stage 2 throughout the year)
31/12/20X4	Stage 3	CU100	CU60	CU4 (CU40 x 10%)

Example 37 – Loan to fellow subsidiary guaranteed by the parent

Parent A has two wholly owned subsidiaries B and C. Subsidiary C owns four of the five major and well known consumer brands of the group.

Parent A is in a strong financial position and is expected to inject cash into Subsidiary C to cover Subsidiary C's cash outflows over the next years.

- On 1 January 20X8, Subsidiary B provides a loan of CU1,000 to Subsidiary C for three years;
- The loan is guaranteed by Parent A;
- On 31 December 20X9, Subsidiary C is expected to have cash flow problems due to deterioration in economic conditions and decreasing profits arising from reductions in consumer spending.

Question: Do the facts on 31 December 20X9 give rise to a significant increase in credit risk and therefore require the recognition of lifetime ECL?

Answer: IFRS 9.B5.5.17(k) notes that one factor that should be assessed in determining whether there has been a significant increase in credit risk is the change in the quality of the guarantee provided by a parent, if the parent has an incentive and the financial ability to prevent a default by capital or cash infusion.

It appears that Parent A is in a strong financial position and has an incentive to prevent Subsidiary C from default by providing it with additional funds. It is therefore considered that there has been no significant increase in credit risk and the loan should remain in **Stage 1**. However, Subsidiary B needs to monitor Parent A's financial position and also whether there has been any change in circumstances that would lessen or reduce the incentive for Parent A to prevent default by Subsidiary C.

Example 38 – Measuring ECL for intercompany loan that is repayable on demand

Parent A has a wholly owned Subsidiary B. On 31 December 20X5 Parent A provides a loan to Subsidiary B for CU100. Subsidiary B has no other cash and plans to use the CU100 to fund research and development activities. The loan has no interest and is repayable on demand. Parent A does not expect to request repayment of the loan within the next 12 months and classifies the loan as non-current. On initial recognition, the loan is measured at its fair value. There is specific guidance in IFRS 9 which requires financial assets and liabilities to be measured on initial recognition at their transaction price (which is the best estimate of fair value), unless there is a difference between the transaction price and fair value, and the fair value is evidenced by a quoted price in an active market or is based on a valuation technique that uses only data from observable markets. However, as an exception, if the interest-free loan from Parent A was a term loan (for example, for three years) a different approach would be followed. The amount to be repaid at the end of three years would be discounted at a market rate of interest that would apply if the loan was between unrelated parties, with the difference between the amount advanced and the amount at which the loan asset is recorded (that is, the present value of the benefit being gifted by Parent A to Subsidiary B through the granting of a three year interest-free loan) being added to Parent A's carrying amount of its investment in Subsidiary B, and accounted for as a capital contribution by Subsidiary B.

Question: How does the three-stage impairment model apply to the loan?

Answer: The loan is repayable on demand so contractual period is immediate repayment. The maximum period to consider in measuring expected credit losses is the maximum contractual period (IFRS 9.5.5.19). Parent A should provide for on demand ECL (i.e. the probability of default subsidiary B if loan is called, multiplied by the amount of the loss). If the loan is called upon the immediately, the probability of default is likely to be 100% (assuming Subsidiary B has already used some or all of the CU100 in its research and development activities). The amount of impairment would therefore depend on the amount for which the assets could be sold or whether alternative finance can be obtained by Subsidiary B. If assets could be sold and/or alternative finance can be obtained to cover the full amount of the loan amount, then the impairment loss could be close to zero if the risk of default occurring was low (subject to an adjustment for the risk that the full amount of the loan would not be covered in full). This is because, although expected credit losses consider the amount and timing of payments, there would be no effect of discounting because the effective interest rate is zero.

6.5.2. Off-balance sheet financial items

Provisions for off-balance sheet financial items such as loan commitments and financial guarantees (when those items are not measured at FVTPL) are currently within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* which results in a different recognition approach from the incurred loss model in IAS 39 *Financial Instruments: Recognition and Measurement*.

Under IFRS 9, the scope of the three-stage impairment model is extended to apply to the accounting for:

- Loan commitments by the issuer (see Section 6.5.2.1.);
- Financial instruments that include a loan and an undrawn commitment components (see Section 6.5.2.2.);
- Financial guarantee contracts (see Section 6.5.2.3.).

6.5.2.1. Loan commitments

Loan commitments arise when an entity enters into a contract to provide a loan to another party. At the end of each reporting period, 12-month expected credit losses are initially provided for such loan commitments. Where there has been a significant increase in the risk of a default occurring on the loan to which a loan commitment relates, lifetime expected credit losses are recognised.

Stage	Apply to	Recognise
Stage 1 – No significant increase in credit risk	Expected portion to be drawn down within the next 12 months	12-month expected credit losses
Stage 2 – Significant increase in credit risk	Expected portion to be drawn down over the remaining life of the facility	Lifetime expected credit losses

For loan commitments, expected credit losses are the present value of the difference between:

- The contractual cash flows for amounts that are repayable 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.

The discount rate used to discount expected credit losses is the effective interest rate for the financial asset that results from the loan commitment. If the effective interest rate cannot be determined, then an entity uses a rate that reflects the current market assessment of the time value of money and the risks that are specific to the cash flows.

The remaining life of a loan commitment is the maximum contractual period during which an entity has exposure to credit risk. Consequently, if the entity has the ability to withdraw a loan commitment, the maximum period to consider when estimating credit losses is the period up to the date on which the entity is able to cancel the facility and not a longer period, even if that would be consistent with its business practice. Consequently, if the issuer of a loan commitment could withdraw that commitment with one day's notice, the period over which expected losses are estimated is that one day period even if the issuer expects to maintain the loan commitment over a longer period.

In terms of presentation, because the loss allowance would not relate to any balance sheet line item, the expected loss estimate is recognised and presented as a provision.

The scope of loan commitments may extend beyond more 'traditional' lending arrangements to cover arrangements such as a commitment to commence a finance lease at a future date, and a commitment by a retailer that issues a store card account to a customer which will result in the customer obtaining credit on the future purchase of goods or services from the retailer.

In some cases, such as an irrevocable finance lease agreement, it is clear that there is a firm commitment at inception to provide credit in future. In others, it may not be so clear such as where the issuer of a store card may have the discretion to refuse to sell products or services to a customer with a store card in future. Key parts of the analysis are whether the agreement that contains the commitment to extend credit meets the definition of a financial instrument in IAS 32 and, if so, whether the agreement represents a firm commitment to provide credit under pre-specified terms and conditions.

6.5.2.2. *Financial instruments that include a loan and an undrawn commitment component*

There is an exception to the requirement to consider only the contractual period of a loan or loan commitment, when estimating expected losses. The exception applies to arrangements that include a loan and an undrawn commitment component (such as credit cards and overdraft facilities). Although these facilities can contractually be withdrawn by a lender with as little as one day's notice, in practice because of the way in which the exposure is managed credit is extended for a longer period with the facility only being withdrawn after the credit risk associated with the borrower's account has been identified as having increased significantly. For example, the issuer of credit cards typically manages accounts on a collective basis, and might only take action when a particular account displays certain characteristics, such as being repeatedly over its credit limit or where the lender is consistently receiving only minimum repayments.

In those cases only, when estimating expected credit losses, the lender will look forward beyond the contractual date on which it could demand repayment.

In contrast, certain mortgage products are extended by lenders on a rolling six month basis; although the contractual maturity is no more than six months, in practice the loans may 'roll forward' for periods of 20-30 years. However, because there is no undrawn component these loans do not qualify for the exception and, instead, expected losses are calculated based on the short six month term contractual maturity, and not the longer expected maturity.

6.5.2.3. *Financial guarantee contracts*

Financial guarantee contracts are recognised as a financial liability at the time the guarantee is issued. The liability is initially measured at fair value. The fair value of a financial guarantee contract is the present value of the difference between the net contractual cash flows required under a debt instrument, and the net contractual cash flows that would have been required without the guarantee. The present value is calculated using a risk free rate of interest.

At the end of each subsequent reporting period financial guarantees are measured at the higher of:

- The amount of the loss allowance; and
- The amount initially recognised less cumulative amortisation, where appropriate.

The amount of the loss allowance at each subsequent reporting period initially equal to 12-month expected credit losses. However, where there has been a significant increase in the risk that the specified debtor will default on the contract, the calculation is for lifetime expected credit losses.

Expected credit losses for a financial guarantee contract are the cash shortfalls adjusted by the risks that are specific to the cash flows.

Cash shortfalls are 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.

Example 39A – Financial guarantee contract

- On 1 January 20X8, Company A guarantees a CU1,000 loan of Subsidiary B which Bank XYZ has provided to Subsidiary B for three years at 7%. The capital amount advanced will be repaid at the end of the three year term;
- If Company A had not issued a guarantee Bank XYZ would have charged Subsidiary B an interest rate of 10%;
- On January 20X8 and 31 December 20X8 and 20X9, the lifetime probabilities that Subsidiary B will default on the loan are 3.5%, 3% and 3% respectively On 31 December 20X8 and 20X9, the probabilities that the Subsidiary B will default on the loan in the next 12 months are 2% and 3% respectively.

Question: How should Company A account for the financial guarantee contract under IFRS 9?

Answer:

1 January 20X8

The financial guarantee contract is initially measured at fair value. The fair value of the guarantee is CU75, being the present value of the difference between:

- The net contractual cash flows that would have been required without the guarantee = 1,000 (CU100 /1.1+CU100/1.1²+CU1,100/1.1³); and
- The net contractual cash flows required under the loan = CU925 (CU70/1.1+CU70/1.1²+CU1,070/1.1³).

1 January 20X8

Dr	Investment in subsidiary	CU75.00	
	Cr	Liability	CU75.00

Being the fair value of the guarantee on initial recognition.

31 December 20X8

In order to assess whether there has been a significant increase in credit risk, IFRS 9.5.5.9 requires a comparison to be made of the probability of default over the expected life of the financial instrument at the reporting date, in comparison with the probability of default at initial recognition. In this case, the absolute probability of default has declined from 3.5% to 3%; this indicates that the probability of default has remained relatively stable because the longer the period to maturity of a particular financial instrument, the greater the probability of default for a given level of risk. Consequently, Company A will provide for 12-month expected credit losses.

There is a 2% probability that Subsidiary B will default on the loan in the next 12 months. If Subsidiary B does default, Company A does not expect to recover any amount from Subsidiary B. The 12-month expected credit losses are therefore CU20 (CU1,000 X 2%).

The initial amount recognised less cumulative amortisation is CU52.50 (CU75-CU22.50 (being CU30/1.1³)), which is higher than the 12-month expected credit losses (CU20). The liability is adjusted to CU52.50 as follows:

31 December 20X8

Dr	Liability	CU22.50	
	Cr	Profit or loss	CU22.50

Being amortisation of the liability recognised for the financial guarantee.

Example 39A – Financial guarantee contract (continued)**Answer: (continued)****31 December 20X9**

There is still a 3% probability that Subsidiary B will default on the loan in the next 12 months. If Subsidiary B does default, Company A does not expect to recover any amount from Subsidiary B. Company A determines that, overall, there has not been a significant increase in credit risk and therefore continues to recognise 12-month expected losses of CU30 (CU1,000 X 3%).

The initial amount recognised less amortisation is CU27.50 (CU52.50-(CU30/1.1²)), as follows

31 December 20X9			
Dr	Liability	CU27.50	
	Cr	Profit or loss	CU27.50

Being amortised of the liability recognized for the financial guarantee.

The 12-month expected credit losses (CU30) are higher than the initial amount less cumulative amortisation (CU27.50), the liability is adjusted as follows:

31 December 20X9			
Dr	Profit or loss	CU2.50	
	Cr	Liability	CU2.50

To record the liability at the amount of the loan loss allowance (CU27.50-CU30).

Example 39B – Financial guarantee contract

- Same facts as Example 39A above;
- Except that on 31 December 20X8, there is a significant increase in the risk that Subsidiary B will default on the loan. The probability of default over the remaining life of the loan (two years) is 60%.

Question: How should Company A account for the financial guarantee contract on 31 December 20X8?

Answer: Assume that if Subsidiary B does default, Company A does not expect to recover any amount from Subsidiary B. The lifetime expected credit losses (ignoring the effect of discounting which has been excluded to simplify the example) are CU600 (CU1,000 x 60%), and the carrying amount of the liability is adjusted as follows:

31 December 20X9			
Dr	Profit or loss	CU525	
	Cr	Liability	CU525

To record the liability at the amount of the loan loss allowance (CU600-CU75).

6.6. Impairment Transition Group discussions

Shortly after the release of IFRS 9, the IASB set up a Transition Resource Group for Impairment of Financial Instruments (ITG) to discuss implementation issues related to the new impairment model for financial assets. The ITG consisted of preparers and auditors with expertise in this area. Whilst most of the ITG discussions were from a banking context, some issues will pose practical challenges for all entities. Although the discussions did not give rise to authoritative guidance, entities should be aware of the discussions to ensure that IFRS 9 implementation is consistent with the IFRS 9 requirements as the ITG discussions do provide useful guidance to application of the new impairment model.

The ITG held three meetings in 2015 and discussed 22 agenda papers. Below we summarise the issues that are likely to be most relevant and widely applicable to all entities.

6.6.1. Impact of future uncertain events

The ITG concluded that there are no definitive answers when predicting future credit losses or when identifying whether there had been a significant increase in credit risk in relation to the impact of future uncertain events. Rather entities should apply an appropriate process to consider forward looking estimates and properly disclose those events or conditions it has included or excluded in its expected losses. Whilst the ITG concluded that the new model would require entities to factor in the effects of future one-time uncertain events that have not been included in an entity's budgets and forecasts, it accepted that some events including the possibility of a Greek exit from the EU or a vote in favour Scottish independence would not be included due to insufficient reasonable and supportable information.

This issue is widely applicable because entities will be required to forecast and calculate ECLs for all receivables (regardless of whether they apply the simplified model or the full three-stage model applies). In calculating ECLs, entities will need to consider all available, reasonable and supportable information that could have an impact on credit losses (either directly or indirectly) regardless of whether it has been included in internal budgets and management forecasts and (other than in extreme cases, such as those noted above) regardless of how uncertain or remote that event might be. Information that is required to be considered relevant data that needs to be purchased from third parties.

For entities that are corporates, this is likely to mean that consideration would need to be given as to how macroeconomic information (e.g. a collapse in stock market, iron ore price, oil price etc.) and other events could affect the recovery of trade receivables. For example:

- If an entity's customers are in the mining services or mining industry, how might commodity prices affect the recovery of its trade receivables?
- If an entity's customers are in the property development industry, how might a collapse in property prices affect the recovery of its trade receivables?
- If an entity's customers are in the plastics industry, how might a fall in oil price affect the recovery of its trade receivables?
- If an entity's customers are affected by the strengthening/weakening of a particular foreign currency, how might a move in the foreign currency exchange rate affect the recovery of its trade receivables?

6.6.2. Forecast of future economic conditions

The ITG discussed the challenges of whether and how to incorporate new information and events that occur after the reporting date but before the signing date of financial statements.

Scenario

- Entity A has a December year end;
- Entity A's trade receivables consists of customers that are iron ore miners;
- At 31 December 20X6, the spot iron ore price is CU80/tonne.
The consensus forecast price for iron ore is also CU80/tonne;
- On 31 January 20X7 the iron ore price collapses to CU30/tonne.
The collapse of the iron ore price is a result of oversupply and too little demand from steel mills.

Question: Should Entity A, for its 31 December 20X6 financial statements factor in the effect of the iron ore price collapse in to the calculation of ECL and assessment of significant increase in credit risk?

Answer: The ITG noted that IAS 10 *Events after the Reporting Date* states that bankruptcy of a customer that occurs after the reporting period usually confirms that the customer was credit impaired at the end of the reporting period and is therefore an adjusting event.

The ITG concluded that determining whether such information is an adjusting event or a non-adjusting event requires judgement. The ITG noted that a change in interest rates or the outcome of a public vote after the reporting date are non-adjusting events but the expected movements in interest rates and expected outcomes of a future public vote at reporting date should be taken into account.

This is likely to mean consideration would be required to determine whether any subsequent events that arise after the reporting date indicate conditions that existed at reporting date and whether expectations of those events at reporting date have been sufficiently factored in to the ECL calculation, e.g.:

- Subsequent significant increase/decrease in commodity prices after reporting date;
- Subsequent significant increase/decrease in exchange rate after reporting date;
- Subsequent significant changes in stock market after reporting date;
- Subsequent changes in government and government policy after reporting date.

In the case of the iron ore example above the subsequent fall in the iron ore price would not be factored into Entity A's bad debt provisioning as at 31 December. This is because the market did not forecast the collapse in the iron ore price at reporting date. It is therefore effectively a non-adjusting post balance sheet event, with the application of hindsight not being allowed to adjust the entity's forecasts.

6.6.3. Incorporating forward-looking information

The ITG concluded that depending on the characteristics of a portfolio of receivables, forecasts of future economic conditions and scenarios (e.g. unemployment rates, interest rates etc.) might have different relevance to individual receivables or sub-portfolios of receivables. This issue is relevant to entities with receivables and/or subsidiaries with customers from different geographical regions and/or industries. Macroeconomics information may affect customers in different industries or geographic location differently, e.g.:

- The possibility of Country Y exiting an economic trading zone is more likely to affect the recovery of trade receivables from customers within that economic trading zone;
- Country X's GDP growth would have a greater impact on trade receivables from customers operating in Country X.

Therefore corporates will have to determine loss provisions based on the characteristics of sub-portfolios of their receivables, rather than treating all receivables in the same way when predicting ECLs.

6.6.4. Non-linear relationships

The ITG concluded that it is necessary to consider multiple future scenarios in cases where the relationship between the different future scenarios and credit losses are non-linear. This issue is relevant to corporates because the effects of macroeconomic factors (e.g. GDP growth, commodity prices, exchange rates etc.) on expected credit losses are typically non-linear.

Examples of possible non-linear relationships include:

- Commodity prices and bad debt on receivables from customers from in the mining industry;
- Exchange rates and bad debt on receivables from customers in the tourism industry.

The ITG discussed the following two examples:

Example 1

Unemployment	Probability	Credit loss
4%	20%	CU30
5%	50%	CU70
6%	30%	CU170

In this example, there is a non-linear relationship between the different possible future scenarios (unemployment rates) and credit losses. The ECL is a probability-weighted amount and is therefore CU92 $((CU30 \times 0.2) + (CU70 \times 0.5) + (CU170 \times 0.3))$. It would not be acceptable under IFRS 9 to use the most likely outcome of 5% unemployment and ECL of CU 70.

Example 2

- An entity has a mortgage portfolio where there is a non-linear relationship between changes in interest rates and credit losses
- An entity obtains 10 independent forecasts of forward-looking interest rates:

	25 bps increase	100 bps increase
# of economists	7	3

It is not correct to assume a 25bps increase because this is the most likely scenario. Two possible approaches would be consistent with IFRS 9 are:

- Run two calculations with the first using a 25 basis points (bps) increase and the second using 100bps increase as the inputs and then weight the outcomes based on their probabilities of 70% and 30%;
- Perform a single calculation assuming a 25bps increase, because this is the most likely outcome but add on an 'overlay' adjustment to take into account the credible minority view of a 100 bps increase.

Entities would need to give consideration to the different credit loss outcomes on receivables based on multiple scenarios and not just the most likely scenarios, e.g.:

- For entities with customers in the mining industry, consider the impact on credit losses for different possible future iron ore price movements;
- For entities with customers that are importers/exporters, consider the impact on credit losses for different possible future exchange rate movements.

6.6.5. Assets with a maturity of less than 12 months

The ITG concluded that entities would still be required to assess significant increase in credit risk for assets with maturity of less than 12 months even though the provision account for **Stage 1** (12m ECL) and **Stage 2** (lifetime ECL) is the same. This is because the ITG notes that IFRS 7 *Financial Instruments: Disclosures* requires separate disclosures of allowance for those receivables that are in **Stage 1** and **Stage 2**. This means that entities need to establish criteria (including systems and processes) for assessing significant increase in credit risk for those short-term receivables where the full three-stage model applies (e.g. related party or intercompany loan receivables).

6.6.6. Sale of a defaulted loan

The ITG discussed whether sales proceeds from selling loan on which the borrower has defaulted (e.g. to a specialist buyer of this type of debt) can be included the calculation of ECLs (subject to certain conditions).

Example

Company A has a portfolio receivable that is 120 days overdue (and so have defaulted) and are credit impaired.

Rather than attempting to collect the cash flows from its customers directly, Company A sells the loan to Entity X which is a specialist in recovering cash flows from this type of debt instrument.

The ITG concluded that cash flows expected from the sale of such defaulted loans should be included in calculating ECLs if selling the loan is one of the recovery methods that the entity expects to pursue in a default scenario.

BDO comment

This question is relevant because the projected sale price, discounted by the effective interest rate, can be significantly different from the cash flows the entity would otherwise expect to recover directly from the debtor. This may mean a lower impairment amount being recorded when sales proceeds are more than the amount that can be expected to be recovered from the debtor directly.

6.6.7. Lease commitments and store credit card/accounts

The ITG discussed whether the new impairment model would also apply to:

- Lease commitments – i.e. commitment by a lessor to commence a finance lease at a future date; and
- Store credit cards/accounts – i.e. commitment by a retailer through the issue of a store account to give a customer credit when the customer buys goods or services from the retailer in future.

The views at the ITG discussions were that the new impairment requirement would not apply to the above items because they do not meet the definition of a financial instrument. The new impairment model would apply from:

- The commencement of the lease when a lease receivable is recognised; and
- When the goods or services are sold and a trade receivable is recognised for store accounts/store credit cards.

6.6.8. Presentation of loss allowance account

The ITG concluded that IAS 1 *Financial Statements Presentation* does not specifically require the loss allowance account to be presented separately but the loss allowance is required to be separately disclosed in the notes under IFRS 7 *Financial Instruments: Disclosures*.

6.6.9. Loss allowance for credit impaired assets

The ITG discussed the calculation of the gross carrying amount and loss allowance for credit-impaired (i.e. **Stage 3**) financial assets.

Example

- On 31 December 20X1, the gross carrying amount of the asset was CU100;
- Effective Interest rate is 10%;
- Asset becomes credit-impaired and the loss allowance is CU60;
- Asset's amortised cost is therefore CU40;
- On 31 December 20X2, no cash has been received and there is no change to the expected cash flows;
- Interest revenue recognised is CU4 (CU40 × 10%);
- Amortised cost is CU44 = CU40 + (CU40 × 10%)

The ITG discussed the following three approaches (which are currently commonly seen in practice) in calculating the gross carrying amount, loss allowance and amortised cost and concluded that that only approach A is acceptable under IFRS 9.

Approach	A	B	C
Gross carrying amount	CU110 (CU100+(CU100×10%))	CU104 (CU100+CU4)	CU100
Loss allowance	CU66 ((CU60+CU60×10%) or (CU110-44))	(CU60)	(CU56)
Amortised cost	CU44	CU44	CU44

7. HEDGE ACCOUNTING

7.1. Introduction

Both IAS 39 and IFRS 9 require all derivatives to be recorded at fair value at each reporting date. Unless hedge accounting is applied, changes in the fair value of derivatives are recognised immediately in profit or loss.

The hedge accounting requirements in IAS 39 are rules based and complex and do not always reflect the economics or hedge objectives of an entity's risk management strategy. In contrast IFRS 9 aligns hedge accounting more closely with an entity's risk management strategy. In doing so, IFRS 9 permits hedge accounting when using a wider range of hedging instruments and to hedge account for a wider range of risks (e.g. risk components of non-financial items). The result is a more principle based approach which can be easier to apply and better reflects an entity's risk management strategy.

Whilst there are some fundamental changes to the hedge accounting model, the general accounting mechanics of hedge accounting under IAS 39 remain largely unchanged. More specifically:

- IFRS 9 retains the cash flow, fair value, and net investment hedge accounting models;
- Entities are still required to measure and recognise any hedge ineffectiveness in profit or loss;
- Hedge documentation is still required at the inception of the hedge;
- Hedge accounting will remain optional, although the option in IAS 39 to de-designate a hedge that still meets the hedge accounting requirements has been eliminated.

7.2. Qualifying criteria and effectiveness testing

The effectiveness of a hedging relationship is the extent to which changes in the fair value or cash flow of the hedging instrument offset changes in the fair value or cash flows of the hedged item.

In addition to other criteria (including hedge documentation) the ability to demonstrate a highly effective hedge relationship was required in order to apply hedge accounting under IAS 39. A hedge relationship was considered to be highly effective, if the relative fair value or cash flow changes of the hedged item and the hedging instrument (i.e. the offset) were expected to be, and were, within a range of 80-125% (a quantitative effectiveness test).

Under IFRS 9, it is necessary for a hedging relationship to consist only of eligible hedging instruments and eligible hedged items. In addition, on inception of the hedging relationship there must be formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. However, the 80-125% quantitative threshold criterion for applying hedge accounting under IAS 39 has been removed. Instead, IFRS 9 requires that the hedge relationship meets all of the following hedge effectiveness requirements:

- i. **Economic relationship** – An economic relationship exists between the hedged item and the hedging instrument – meaning that the hedging instrument and the hedged item must be expected to have offsetting changes in fair value.
For example, an entity with a Sterling functional currency might sell goods or services to customers that use US dollars. If the entity entered into a forward contract to exchange US dollars for Sterling on a specified future date (to coincide with the expected date of US dollar payments by customers), changes in the fair value of that forward contract would be expected to offset changes in the fair value of cash to be collected that is denominated in US dollars.
- ii. **Credit risk** – The effect of credit risk does not dominate the fair value changes – i.e. the fair value changes due to credit risk should not be a significant driver of the changes in fair value of either the hedging instrument or the hedged item.
- iii. **Hedge ratio** – The hedge ratio is required to be designated based on actual quantities of the hedged item and hedging instrument (unless doing so would create deliberate hedge ineffectiveness) – i.e. the hedge ratio applied for hedge accounting purposes should be the same as the hedge ratio used for risk management purposes.

For example, an entity hedges 90% of the foreign exchange exposure of a financial instrument. The hedging relationship should be designated using a hedge ratio resulting from 90% of the foreign currency exposure and the quantity of the hedging instrument that the entity actually uses to hedge the 90%.

BDO comment

In practice, the 80-125% quantitative hedge effectiveness criterion in IAS 39 has been found to be restrictive and operationally onerous, and has prevented some economic hedging relationships from qualifying for hedge accounting.

The removal of the 80-125% quantitative threshold means that even if at the end of a reporting period the hedge is only 70% effective, the entity would recognise 30% of ineffectiveness in profit or loss but would not discontinue hedge accounting. In contrast, under the IAS 39 model the entity would have to discontinue hedge accounting because retrospective effectiveness of 70% is not within the 80-125% range.

Under the new requirements, although retrospective testing will be required in order to determine the extent of any hedge ineffectiveness to be recorded in profit or loss, in order for an ongoing arrangement to qualify for hedge accounting only prospective hedge effectiveness testing is required.

- i. For simple hedge relationships, entities are expected to be able to apply a qualitative test (e.g. critical terms match where the risk, quantity and timing of the hedged item matches the hedging instrument).
- ii. For more complex hedging relationships, such as where the hedged item is of a different grade to the hedging instrument (e.g. where a basis difference exists, such as between GBP LIBOR and USD LIBOR) a more detailed quantitative test is likely to be required.

The new requirements in IFRS 9 may lead to entities having to exercise additional judgement in practice for complex hedges. This may include:

- Establishing an appropriate hedge ratio;
- Establishing whether or not an economic relationship exists;
- Determining whether a quantitative test should be applied or whether a qualitative test is sufficient.

BDO comment

For a simple interest rate swap and for foreign exchange contracts in which the currency, amounts, maturity and other critical terms match, it is expected that the new requirements will be easier to apply and make qualifying for hedge accounting more likely.

Example 40 – Effectiveness testing – Hedge of foreign exchange rate risk

Entity C with a Local Currency (LC) functional currency has forecast sales receipts of Foreign Currency (FC) 1 million in six months' time. It does not wish to be exposed to changes in the LC/FC exchange rate so it enters into a foreign exchange forward contract to sell FC1 million in return for LC in six months. Assume that the credit risk of the derivative counterparty is not expected to deteriorate significantly (meaning that changes in the fair value of the derivative are not expected to be dominated by the effects of changes in credit risk).

Question: How are the effectiveness testing criteria under IFRS 9 met?

Answer: Effectiveness testing is satisfied by the critical terms match test. The critical terms of the hedged item, being the forecast sales, match the critical terms of the derivative, i.e.:

- Same quantity – FC1 million;
- Same underlying risk – FC/LC exchange rate;
- Same timing – Settlement date of the contract matches the timing of the sales receipts in FC.

Example 41 – Effectiveness testing – Hedge of floating interest rate risk

Entity B has a CU10 million loan on which it pays interest at a rate of 3 month LIBOR. It enters into a CU10 million notional amount pay-fixed-receive 3 month LIBOR floating interest rate swap (IRS) to manage its exposure to changes in the 3 month LIBOR rate. The quarterly interest payment dates on the loan match the quarterly settlement dates of the IRS.

Entity B designates the following hedge relationship:

- Hedged item: CU10 million floating interest rate loan;
- Hedging instrument: CU10 million pay-fixed-receive-floating IRS.

Question: How are the effectiveness testing criteria under IFRS 9 met?

Answer: Effectiveness testing is satisfied by the critical terms match test. The critical terms of the hedged item, being the future quarterly interest payments, match the critical terms of the derivative.

The effectiveness test is therefore satisfied (assuming the effects of credit risk are insignificant):

- Same quantity – CU10 million;
- Same underlying risk – 3 month LIBOR;
- Same timing – Interest payment dates of the loan match the timing of the swap payments.

Example 42 – Effectiveness testing if critical terms do not match

Question: What sort of quantitative assessment would be required if the critical terms of the hedged item and the hedging instrument do not match?

Answer: When the terms of the hedged item and hedging instrument are not closely aligned, IFRS 9.B6.4.16 notes that *'it might only be possible for an entity to conclude on the basis of a quantitative assessment that an economic relationship exists between the hedged item and the hedging instrument'*.

IFRS 9 does not provide any specific guidance regarding what types of quantitative assessments would be appropriate for demonstrating that an economic relationship exists between a hedged item and a hedging instrument.

An entity's risk management approach is the main source of information to perform the assessment of whether a hedging relationship meets the hedge effectiveness requirements. This means that the management information (or analysis) used for decision-making purposes can be used as a basis for assessing whether a hedging relationship meets the hedge effectiveness requirements (IFRS 9.B6.4.18). In other cases an entity would need to choose an appropriate methodology to assess whether a hedging relationship meets the hedge effectiveness requirements.

Example 43 – Alternative effectiveness testing if critical terms do not match

Question: When the critical terms do not match, would ratio or regression analysis performed on the same basis as a prospective test under IAS 39 be sufficient to demonstrate an economic relationship?

Answer: **Yes**, but only if the underlying risks of the hedged item and hedging instrument are the same or obviously related (e.g. West Texas Intermediate and Brent for crude oil price, or 1 month LIBOR vs 6 month LIBOR). Without this qualitative link between the underlying of the hedging instrument and the hedged risk, the ratio/regression analysis merely shows a statistical relationship between the hedged item and hedging instrument which does not by itself support a valid conclusion that an economic relationship exists.

7.2.1. Determining hedge effectiveness for net investment hedges

The IFRS Interpretations Committee received a request to clarify how hedge effectiveness should be assessed for net investment hedges. In particular, should the 'lower of' test that is required for cash flow hedges be applied?

The IFRS Interpretations Committee observed that IFRS 9 states that 'hedges of a net investment in a foreign operation... shall be accounted for similarly to cash flow hedges...' and that IFRS 9.6.5.12 (a) which deals with net investment hedges also references Paragraph 6.5.11 which deals with the accounting for cash flow hedges and includes the 'lower of' test. The IFRS Interpretations Committee concluded that this indicated that, when accounting for net investment hedges under IFRS 9, an entity should apply the 'lower of' test required for cash flow hedges in determining the effective portion of the gains or losses arising from the hedging instrument³.

The IFRS Interpretations Committee also noted that the application of the 'lower of' test also avoids recycling of foreign exchange differences that have been recognised in other comprehensive income in respect of the foreign operation, before the disposal of that foreign operation.

³ March 2016 IFRIC Update.

7.3. Hedged items

The new hedge accounting model under IFRS 9 allows more items to qualify as eligible hedged items in comparison with IAS 39.

7.3.1. Risk components as hedged items

Under IAS 39, risk components of financial items (e.g. hedging the LIBOR as a benchmark component of a floating rate loan) are already eligible hedged items. This is because IAS 39 permits an identifiable and separately measurable component of a financial asset or liability to be a hedged item. However, this does not extend to non-financial items, for which only a foreign exchange component can be separated. This is because it was considered to be too difficult to isolate and measure cash flows relating to different risks.

In contrast, the new hedge accounting model in IFRS 9 aligns the requirements of financial and non-financial items such that risk components of non-financial items can also be eligible hedged items.

To be an eligible risk component, the risk component needs to be separately identifiable and reliably measurable. The eligible risk component can be contractually or non-contractually specified. If the risk component is non-contractually specified, then in order to assess whether it meets both of the separately identifiable and reliably measurable criteria an analysis of the linkage between the risk component and the hedged item in that particular market structure is required i.e. how the particular risk affects the fair value of the hedged item.

BDO comment

From an accounting perspective, allowing non-financial risk components to be eligible hedged items means that, when measuring hedge effectiveness (i.e. the degree of offset), entities can compare changes in the fair value of the hedging instrument (e.g. derivative) with changes in the fair value of the particular risk component rather than the whole item, thereby achieving a greater degree of offset (and hence hedge effectiveness) with a corresponding reduction in profit or loss volatility.

The prohibition on the designation of non-financial risk components in IAS 39 often led to a failure to meet the highly effective (80-125% offset) requirement, meaning that hedge accounting could not be applied.

Under IFRS 9 there is the potential to apply hedge accounting to price components within a commodity contract. Examples include the crude oil component of jet fuel, the diesel benchmark index component of diesel purchases, the iron ore benchmark index component in iron ore supply contracts, the coffee benchmark index in coffee purchase/supply contracts, and the sugar benchmark index in sugar purchase/supply contracts.

Example 44 – Hedging diesel purchases

On 1 January 20X5, to secure a fixed price for diesel, Entity C enters into a derivative contract to buy 10,000 barrels of diesel at CU120 per barrel which is the price based on the ULSD 10PPM SG Diesel Index (ultra-low sulphur diesel 10 parts per million with Singapore delivery) settling in 12 months.

The actual price Entity C pays for the diesel is the terminal gate price which is calculated based on the ULSD 10PPM SG Diesel Index price adjusted for excise duties, freight, insurance and terminal charges.



Figure 4: Pricing formula of the diesel purchase contract

Note that in many cases, contracts for the purchase of diesel will involve foreign exchange risk as well as commodity price risk. In order to simplify the example, foreign exchange risk has not been included. However, this would be capable of being hedged separately.

Analysis under IAS 39

Under IAS 39, hedge accounting can only be applied to the terminal gate price of diesel. This results in hedge ineffectiveness being recorded in respect of the movements of the other pricing adjustments (i.e. excise duties, freight, insurance and terminal charges). These pricing adjustments can vary substantially, resulting in the 80-125% effectiveness test being failed with a consequent inability to apply hedge accounting either from the outset (because it is not highly probable that the 80-125% range will be met) or during the term of the hedge.

Assume the following forecast prices:

	ULSD 10PPM SG Diesel Index	Pricing adjustments	Terminal Gate Price for diesel purchases
1/1/20X5	CU120	CU85	CU205
30/6/20X5	CU130	CU90	CU220
31/12/20X5	CU100	CU60	CU160

Example 44 – Hedging diesel purchases (continued)**Analysis under IAS 39 (continued)**

	Cumulative FV change in forecast Terminal Gate Price for diesel purchases (hedged item)	Cumulative FV change in derivative (based on the ULSD 10PPM SG diesel index) (hedging instrument)	Hedge Effectiveness under IAS 39
30/6/20X5	CU(15) (CU205-CU220)	CU10 (CU130-CU120)	153% (CU15/CU10)
31/12/20X5	CU45 (CU205-CU160)	(CU20) (CU100-CU120)	225% (CU45/CU20)

Note that in order to simplify this example, the effects of time value of money and any credit/debit value adjustments have not been included in the calculations.

Conclusion under IAS 39:

Fail hedge accounting because hedge effectiveness is outside the 80-125% range.

Analysis under IFRS 9

IFRS 9 allows entities to apply hedge accounting to pricing components within a contract, meaning that Entity C can apply hedge accounting to the ULSD 10PPM SG Diesel Index pricing component only.

	Cumulative FV change in ULSD 10PPM SG diesel index component of the forecast terminal gate price for diesel purchases (hedged item)	Cumulative FV change in derivative (based on the ULSD 10PPM SG diesel index) (hedging instrument)	Hedge Effectiveness under IFRS 9
30/6/20X5	CU(10) (CU120-CU130)	CU10 (CU130-CU120)	100% (CU10/CU10)
31/12/20X5	CU20 (CU120-CU100)	(CU20) (CU100-CU120)	100% (CU20/CU20)

Note that in order to simplify this example, the effects of time value of money and any credit/debit value adjustments have not been included in the calculations.

Example 45 – Hedging iron ore supply contracts

On 1 January 20X5, Entity B enters into a contract to supply 100,000 metric tonnes (mt) of iron ore in 12 months. The supply contract price is based on the 'Steel Index TSI 62% Fe CFR Tianjin Port' (TSI 62% Fe) adjusted for a discount or a premium for the iron content, chemical specification, sizing adjustments, freight and other pricing adjustments.



Figure 5: Pricing formula of the iron ore supply contract

To secure a fixed price for the iron ore benchmark component, Entity B enters into a forward contract (priced based on TSI 62% Fe) to sell 100,000mt of iron ore for CU65/mt to settle against the index average of December 20X5.

Analysis under IAS 39

Under the IAS 39, hedge accounting can only be applied to the iron ore sales contract price (which includes the other pricing adjustments). This results in hedge ineffectiveness being recorded in respect of movements in the other pricing adjustments (i.e. discount/premium, freight and other adjustments). In many cases these pricing adjustments can vary substantially resulting in the 80-125% effectiveness test being failed, either from the outset (because it is not highly probable that the 80-125% range will be met) or during the term of the hedge.

Assume the following forecast sales prices:

	TSI Index component	Pricing adjustments	Forecast final supply contract price
1/1/20X5	CU75	CU15	CU90
30/6/20X5	CU85	CU20	CU105
31/12/20X5	CU50	CU21	CU71

Example 45 – Hedging iron ore supply contracts (continued)**Analysis under IAS 39 (continued)**

	Cumulative FV change in forecast final contract price (hedged item)	Cumulative FV change in derivative (based on the iron ore price index) (hedging instrument)	Hedge Effectiveness under IAS 39
30/6/20X5	CU15 (CU105-CU90)	CU(10) (CU75-CU85)	150% (CU15/CU10)
31/12/20X5	CU(19) (CU71-CU90)	CU25 (CU75-CU50)	76% (CU19/CU25)

Note that in order to simplify this example, the effects of time value of money and any credit/debit value adjustments have not been included in the calculations.

Conclusion under IAS 39:

Fall hedge accounting because hedge effectiveness is outside the 80-125% range.

Analysis under IFRS 9

IFRS 9 allows entities to apply hedge accounting to pricing components within a contract, meaning that Entity B can apply hedge accounting to the 'TSI 62% Fe' pricing component only.

	Cumulative FV change in forecast final contract price (hedged item)	Cumulative FV change in derivative (based on the iron ore price index) (hedging instrument)	Hedge Effectiveness under IAS 39
30/6/20X5	CU10 (CU85-CU75)	CU(10) (CU75-CU85)	100% (CU10/CU10)
31/12/20X5	CU(25) (CU50-CU75)	CU25 (CU75-CU50)	100% (CU25/CU25)

Note that in order to simplify this example, the effects of time value of money and any credit/debit value adjustments have not been included in the calculations.

Example 46 – Contractually specified risk component (hedging coffee index)

Entity A enters into contracts to purchase 100 tonnes of coffee in 6 months. The contract price for the coffee is based on the 'Coffee C ICE futures' plus a 5% logistics fee. Entity A enters into 'Coffee C ICE futures' contracts to hedge the variability in the coffee price.



Figure 6: Pricing formula of the coffee price contract

Under IFRS 9, the 'Coffee C ICE future' can be separately identified as a contractually specified component of the pricing contract, meaning that Entity A can designate the 'Coffee C ICE futures' component of the contract price as a hedged item. This means that Entity A will compare:

- Changes in the fair value of the coffee futures derivative (hedging instrument) with the
- Coffee futures component in the contract price (hedged item).

If all other factors matched, such as the timing of the purchase and maturity of the 'Coffee C ICE futures', and any other changes in fair value were insignificant (such as changes arising from the credit status of the derivative counterparty), 100% hedge effectiveness would result.

In contrast, under IAS 39, because the hedge accounting requirements do not permit the designation of risk components in non-financial items, Entity A would only be able to designate the purchase coffee contract in its entirety as the hedged item. This would result in hedge ineffectiveness being recorded in respect of movements in the fair value of the logistics fee component.

Example 47 – Non-contractually specified risk component (hedging coffee index)

Entity B enters into Coffee C ICE futures contracts to hedge its highly probable forecast coffee purchase in two years.

There is no contractually specified risk component, as the purchase contracts have not yet been signed. However, the entity knows from past experience that the purchased contracts will be priced based on 'Coffee C ICE futures' plus a 5% logistics fee.

Therefore it concludes that the Coffee C ICE futures price is a risk component of the forecast coffee purchases.

Under IFRS 9, Entity B can designate the Coffee C ICE futures component of those forecast future purchases as an eligible hedged item. The effects of the hedge are the same as outlined in the example above.

Example 48 – Non-contractually specified risk component (jet fuel vs crude oil)

Entity A enters into contracts to purchase jet fuel. The structure of the price of jet fuel includes the crude oil price as an identifiable component (see illustration below). In order to hedge the variability in crude oil prices, Entity A enters into crude oil futures.

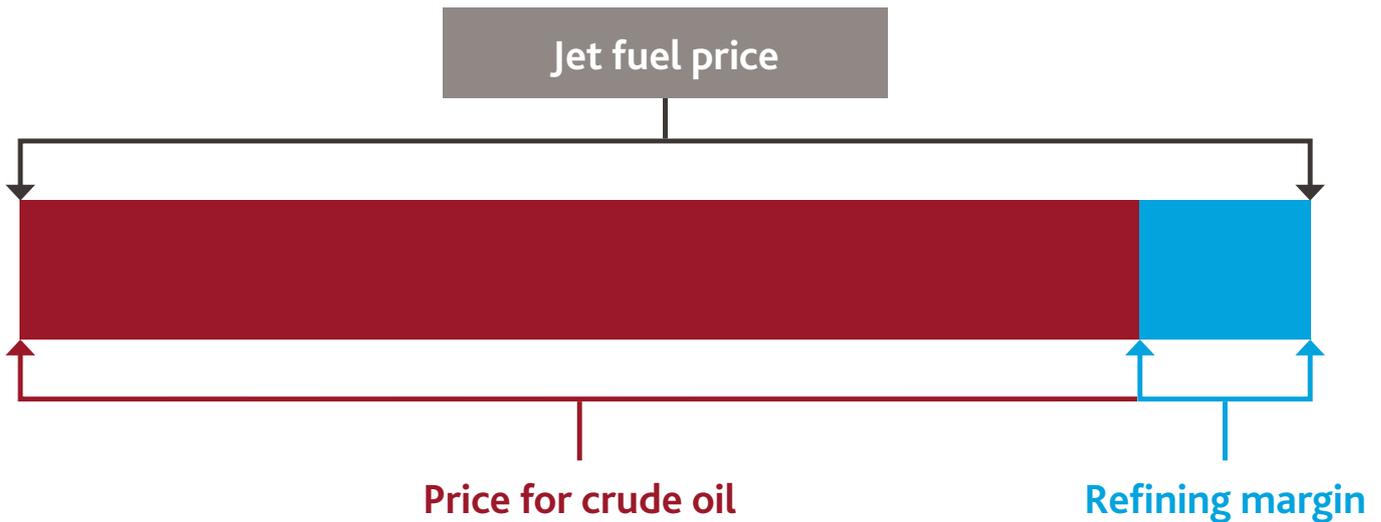


Figure 7: Risk components of the price of jet fuel

Under IFRS 9, Entity A can designate the crude oil component of the jet fuel price as a hedged item because the market structure for jet fuel prices is such that crude oil is a building block of jet fuel prices.

This means that Entity A compares changes in the fair value of crude oil futures with changes in the fair value of crude oil, giving Entity A greater offset than under the IAS 39 model. Under IAS 39, Entity A could only designate the changes in the crude oil futures against the entire jet fuel price, which would result in hedge ineffectiveness due to future changes in the refining margin. These changes can be large enough to prevent the hedging relationship falling within the 80-125% highly effective range and can therefore prevent hedge accounting.

BDO comment

As the examples illustrate, identifying a contractually specified risk component can be relatively straightforward. However identifying a non-contractually specified risk component in non-financial items often involves more judgement and analysis. Such an analysis may involve discussions with the sales or purchasing departments in order to obtain more information about how an item is priced within a particular market and how the value of the related risk components can be reconciled to the total price of the item.

7.3.2. Aggregated exposures

An aggregated exposure is a combination of a derivative item and a non-derivative item, and was introduced by IFRS 9.

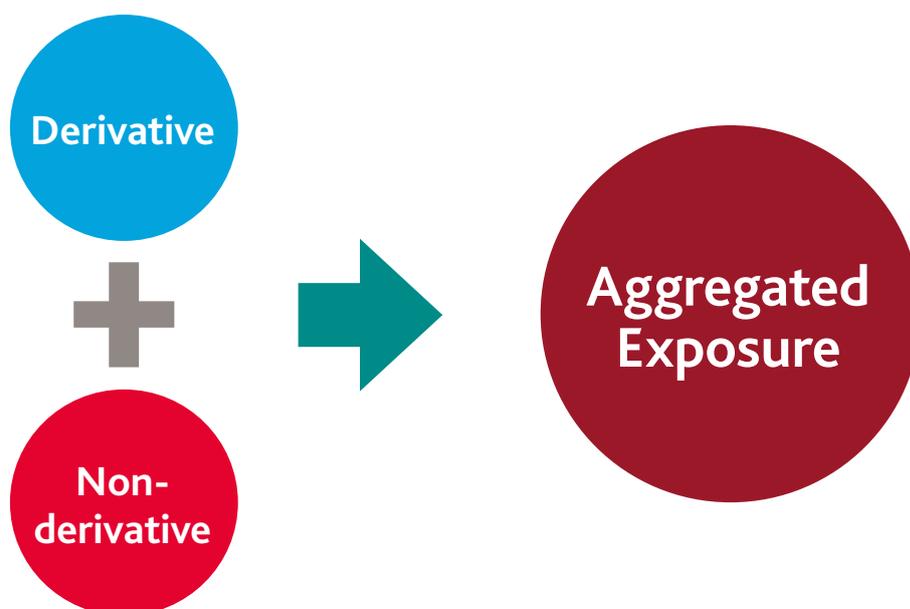


Figure 8: Aggregated exposure

The ability to account for an aggregated exposure as a single instrument for hedge accounting is important. This is because, under IAS 39, derivatives are not eligible hedged items and therefore do not qualify for hedge accounting. However this is different from the risk management of some entities which manage their overall risk exposure by entering into offsetting derivative contracts. From an accounting perspective under IAS 39 the hedge needs to be de-designated and a new one designated each time a new derivative contract is entered into.

For example, an entity might have a risk management policy to have 50% of its borrowing at a fixed rate and 50% at a floating rate. Existing loans mature and new ones are taken out, the entity enters into new interest rate swaps in order to maintain compliance with its 50% fixed rate and 50% floating rate policy.

The requirement in IAS 39 to de-designate the existing, and re-designate a new, hedging relationship gives rise not only to complexity but also to hedge ineffectiveness, due to the designation of existing derivatives with a non-zero fair value at the date of designation.

In contrast, IFRS 9 allows an entity to designate an exposure that combines one or more derivatives and a non-derivative (an aggregated exposure) as a hedged item, provided that the aggregated exposure is managed as one exposure.

Example 49 – Aggregated exposures – Foreign exchange and interest rate risk

Entity C has Local Currency (LC) as its functional currency, and issues private placement bonds in the US with a maturity of 10 years and a fixed interest rate payable of 5%.

To manage the foreign exchange risk from US dollar (USD) denominated debt, Entity C enters into a 10 year cross-currency interest rate swap (CCIRS). Under the CCIRS, Entity C pays floating rate interest payments in LC and receives fixed rate USD interest payments.

Entity C's interest rate risk management strategy subsequently changes, to require fixed interest rates from year two to year five in its local currency. Therefore, Entity C enters into a second derivative instrument, being an interest rate swap under which it pays fixed interest payments and receives floating interest payments in LC. The effect is that the local floating interest payments in years two to five are swapped to fixed rate LC interest payments.

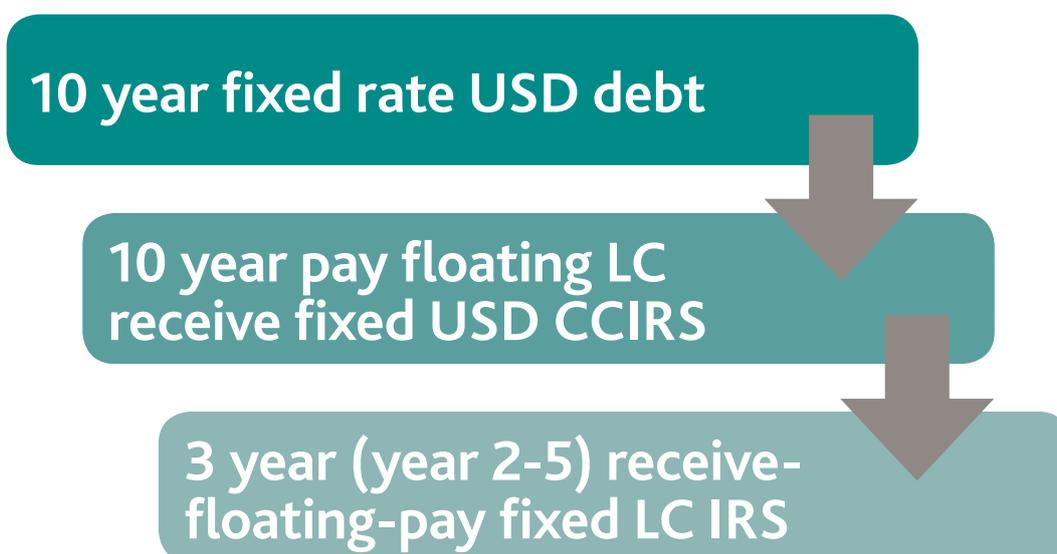


Figure 9: Hedged items and hedging instruments

Under IFRS 9, Entity C would be able to designate the following relationships:

- i. First hedging relationship – To mitigate the exposure to foreign exchange (FX) risk:
 - Hedged item: 10 year fixed rate USD debt;
 - Hedging instrument: 10 year CCIRS.
- ii. Second hedging relationship – To mitigate the exposure to local interest rate risk in years 2-5:
 - Hedged item: floating interest rate payments (years 2-5) – The aggregated exposure of the first hedging relationship (which would be left in place);
 - Hedging instrument: pay fixed receive floating interest rates in its local currency.

Example 49 – Aggregated exposures – Foreign exchange and interest rate risk (continued)

This means that when Entity C wants to fix its floating rate exposure in its local currency from years two to five by entering into a three-year receive-floating-pay-fixed interest rate swap (IRS), under IFRS 9 Entity C treats the combined exposure of the debt and CCIRS (termed the 'aggregated exposure') as a hedged item and establishes a second hedging relationship for years 2-5.

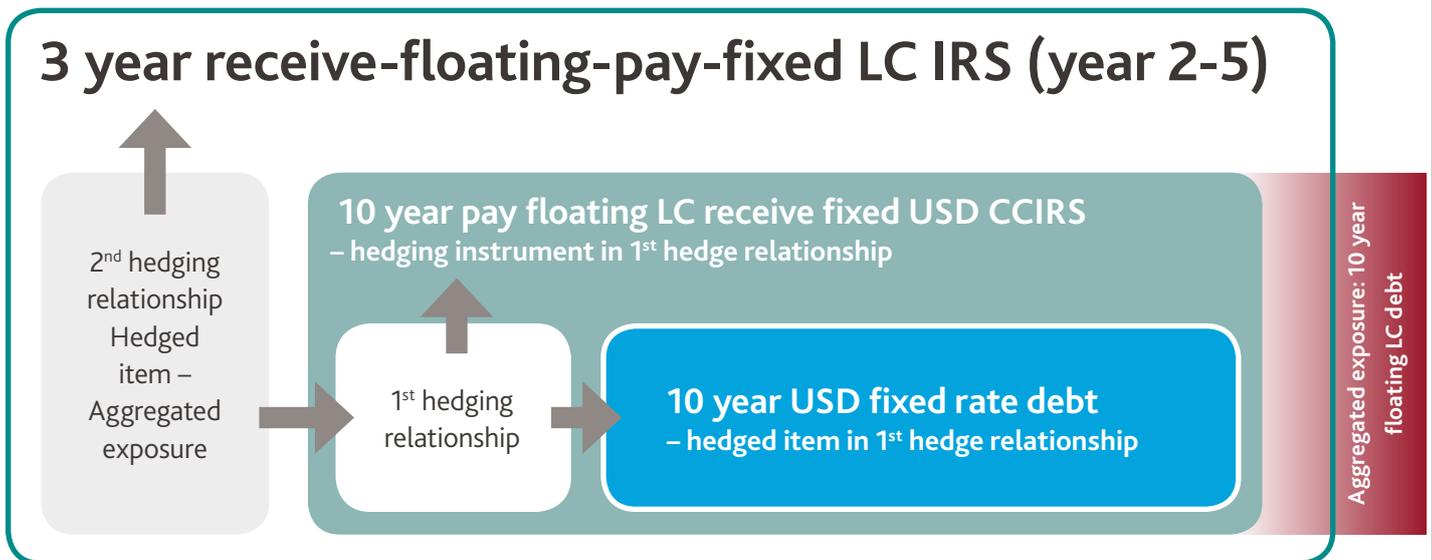


Figure 10: Hedge relationship established under the new requirements for aggregated exposures

BDO comment

Although IAS 39 permits entities to jointly designate the two derivatives (i.e. the IRS and the CCIRS) against the debt, it **prohibits** entities from designating an additional derivative after the inception of a hedge relationship because the designation of a derivative as a hedged item is not permitted.

This is a troublesome area in practice under IAS 39 as many entities manage their foreign exchange risk and interest rate risk separately.

For the example above, under IAS 39, Entity C would have had to de-designate its first hedging relationship at the start of year 2 and re-designate an entirely new hedging relationship, with the hedged item being the 10-year fixed rate USD debt and the hedging instruments being the two derivatives. This would be expected to lead to hedge ineffectiveness because, at the start of year 2, the first derivative would be expected to have a non-zero fair value. The extent of this hedge ineffectiveness could be large enough to result in failure to meet the 80-125% highly effective criterion.

Aggregated exposures can also arise in commodity contracts that are denominated in a foreign currency.

Example 50 – Aggregated exposures – Commodity and foreign exchange risk

Entity D has Local Currency (LC) as its functional currency. Entity D enters into a contract to purchase coffee in three years in USD. To manage the variability in coffee prices Entity D also enters into a three year USD coffee future. Because Entity D's functional currency is not USD, it is also exposed to USD foreign exchange risk (FX risk).

To manage the FX risk, Entity D enters into a foreign exchange contract for two years (a three year contract is not entered into, because Entity D is expecting to receive US dollars in year three from another source meaning that it is already economically hedged).



Figure 11: Hedged items and hedging instruments

Under IFRS 9, Entity D would establish **two** hedging relationships:

- i. First hedging relationship – To fix the **coffee price** in three years:
 - Hedged item: USD coffee purchase in three years;
 - Hedging instrument: 3 year coffee futures in USD.
- ii. Second hedging relationship – To fix the **USD exchange rate** for two years:
 - Hedged item: USD outflow in two years (the aggregated exposure);
 - Hedging instrument: 2 year USD/LC FX contract.

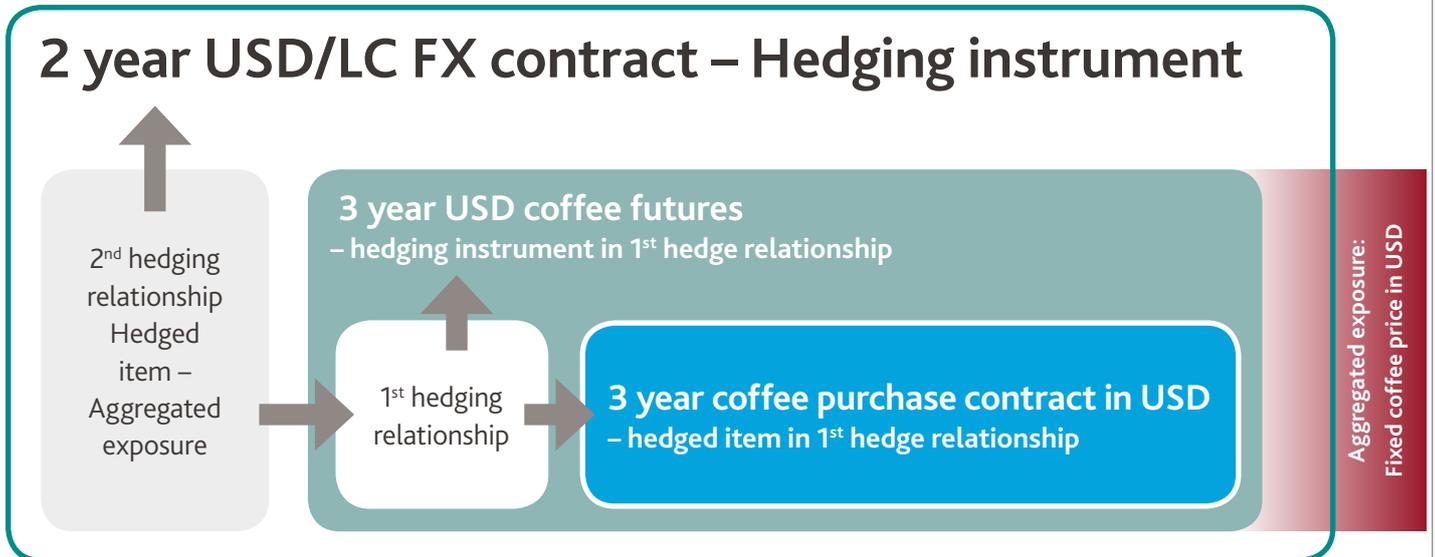
Example 50 – Aggregated exposures – Commodity and foreign exchange risk (continued)

Figure 12: Hedge relationships established under the new requirements

BDO comment

By allowing aggregated exposures to qualify as eligible hedged items, the new model enables entities to achieve hedge accounting more easily when they manage multiple risks as part of their risk management strategy. This permits entities to better reflect their risk management activities in the financial statements.

7.4. Hedging instruments

Under IFRS 9, new guidance was added in relation to the use of hedging instruments with the aim of further aligning hedge accounting with internal risk management. In a major change in comparison with IAS 39, certain components of hedging instruments are treated as a 'cost of a hedging' and may be deferred or amortised. The following arrangements are dealt with below:

- Time value component of options (Section 7.4.1.);
- Time value component of zero-cost collars (Section 7.4.2.);
- Forward point component of forwards (Section 7.4.3.);
- Foreign-currency basis spread for foreign currency swaps (Section 7.4.4.).

7.4.1. Options

The value of an option contains an **intrinsic value** component and a **time value** component:

- **Intrinsic value** is the difference between the option exercise price and the spot price;
- **Time value** is the residual difference between the option's total fair value and its intrinsic value.

Example 51 – Time value of a call option to acquire gold

Entity A acquires a call option to buy gold at CU1,000, at which point the spot price for gold is CU1,100. The option has an intrinsic value of CU100. If the fair value of the option is CU150, then the time value of the option is CU50 (i.e. CU150 - CU100).

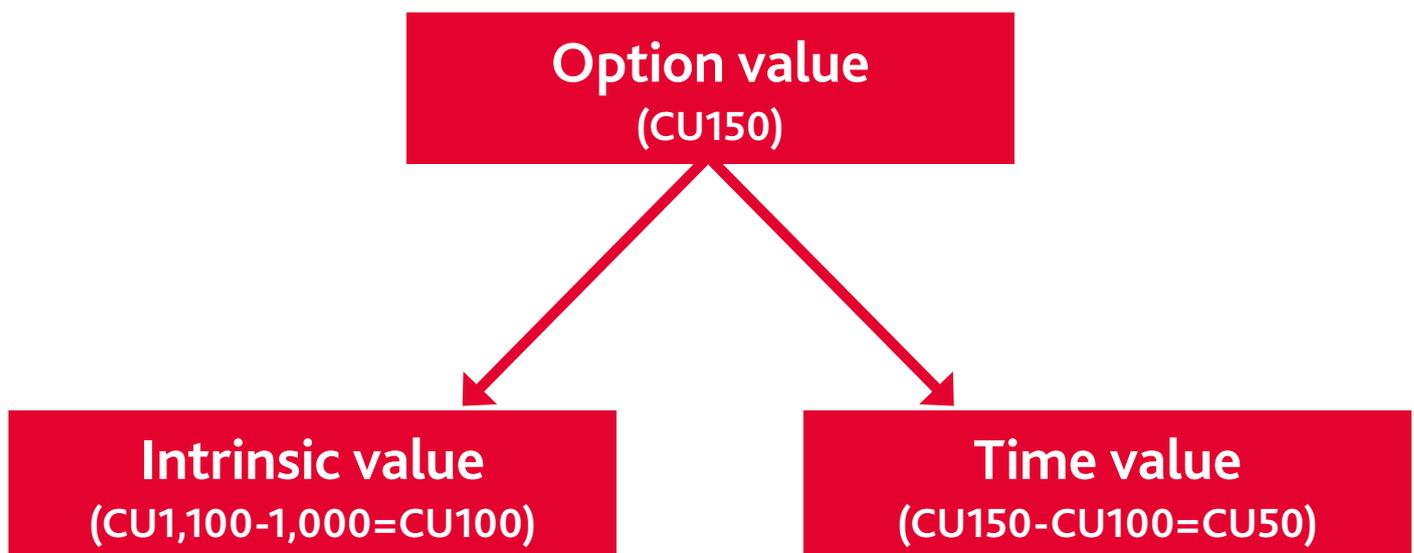


Figure 13: Option value

When using an option as a hedging instrument, IAS 39 allows entities to designate either the whole contract, or only the intrinsic value of the option, as the hedging instrument. If the entire contract is designated as the hedging instrument, hedge ineffectiveness normally results because the related hedged item typically does not have a time value component. If only the intrinsic value of the option is designated as the hedging instrument, although hedge effectiveness may be improved, all changes in the time value component of the option will be recorded in profit or loss (this component will be accounted for at FVTPL, in the same way as a derivative that is not designated in a hedging relationship). This introduces profit or loss volatility from changes in time value over the life of the option.

Under IFRS 9, an entity can continue to designate only the intrinsic value of the option as the hedging instrument, but the changes in time value will be recorded in other comprehensive income (OCI) instead of profit or loss, meaning that profit or loss volatility will be reduced.

As a result, the option's time value at initial recognition is effectively dealt with as a transaction costs. This is accounted for as follows:

Hedged item	Initial time value	Example
Transaction related hedged item	The initial time value is deferred in OCI and capitalised into the cost of the hedged item.	Commodity put option to hedge forecast sales of a commodity. Foreign exchange call option to hedge the forecast purchase of a machine in foreign currency.
Time period related hedged item	The initial time value is deferred in OCI and amortised over the term of the hedging relationship.	Interest rate cap on a floating interest rate loan.

Figure 14: Accounting for the time value of options under the new model when only the intrinsic value is designated as the hedging instrument

The following charts are examples of how the time value component of the option can change over its contractual term. The time value component will always be zero at option expiry date (at which point the option can have only an intrinsic value) but, as shown in the graphs below, the decay in time value will typically not be on a straight line basis. As noted above, under IFRS 9 changes in time value are recorded in OCI.

Time value of options – Transaction related hedged item

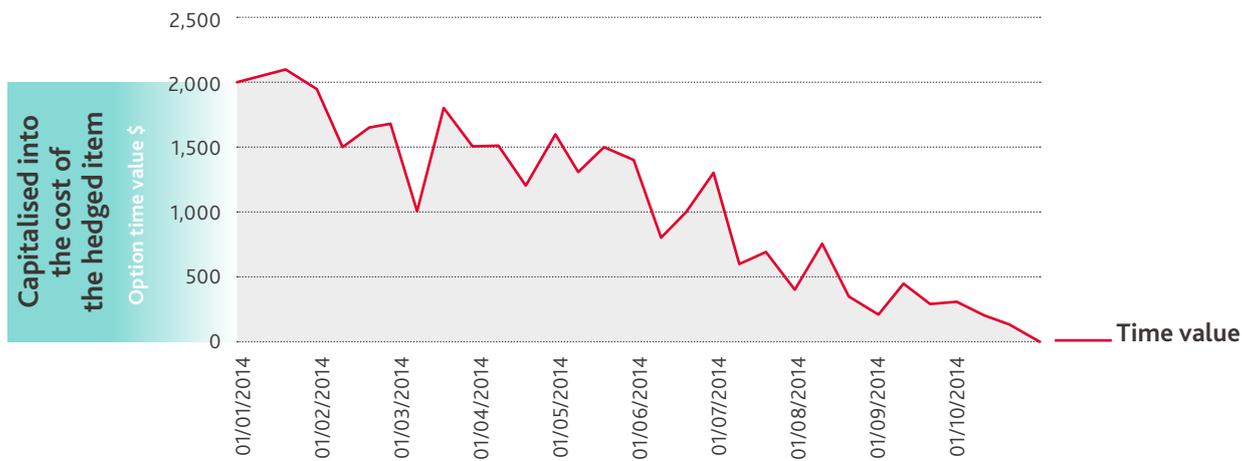


Figure 15: The changes in time value of options and the treatment of initial time value for transaction related hedged items

Time value of options – Time period related hedged item

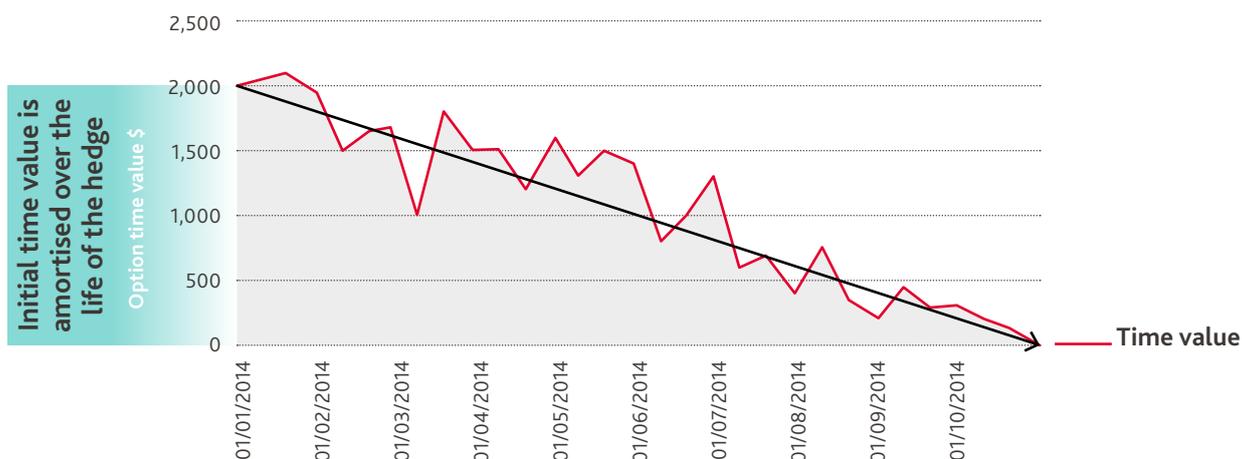


Figure 16: The changes in time value of options and the treatment of initial time value for time period related hedged items

Example 52 – Time value of options – Transaction related hedged item – Foreign exchange rate risk – IAS 39 and IFRS 9 compared

1 October 20X4

Entity A enters into a contract to purchase goods from an overseas supplier. The goods will be delivered in six months' time and FC500,000 is payable on delivery. Entity A wishes to seek protection from adverse movements in the LC/FC exchange rate. On 1 October 20X4, it takes out an option contract to purchase FC500,000 in six months' time at 0.75 LC/FC. Entity A paid an option premium of LC10,000 for the option. The spot rate on 1 October 20X4 is 0.75 LC/FC. The option's intrinsic value is LC0, and the time value is LC10,000 (Fair value - Intrinsic value = time value; LC10,000 - LC 0 = LC10,000).

If the spot exchange rate in six months' time is less than 0.75 LC/FC then Entity A would exercise the option and pay LC666,667 (FC500,000/0.75). If the spot exchange rate in six months' time is more than LC/FC 0.75 then Entity A will transact at the market rate and pay less than LC 666,667 for the inventory, but will receive nothing from the option contract. The option effectively allows Entity A to cap the purchase price at LC666,667.

Hedge accounting under IAS 39

Note that in order to improve hedge effectiveness, Entity A designates only the intrinsic value of the option contract as the hedging instrument. Note that neither IAS 39 or IFRS 9 include specific guidance on the calculation of the intrinsic value; therefore, there is a choice to use either the spot rate or the forward price/rate in determining the intrinsic value of the option. For this example the spot rate is used to calculate the intrinsic value.

Journal entry:

1 October 20X4			
Dr	Option	LC10,000	
	Cr	Cash	LC10,000

Being the fair value of the option and cash paid.

31 December 20X4

The spot rate is LC/FC 0.70. Assume the option's fair value is now LC60,000.

The option's intrinsic value is LC 47,619 $([(FC500,000/0.70)-(FC500,000/0.75)])$ representing the gain the holder of the option would make by buying FC at 0.75 LC/FC compared with the spot rate of 0.70 LC/FC.

The option's time value is LC12,381 (LC60,000-LC47,619).

Journal entry under IAS 39:

1 October 20X4			
Dr	Option	LC50,000	
	Cr	Equity (OCI) – Cash flow hedge reserve	LC47,619
	Cr	Profit or loss	LC2,381

Being the changes in fair value of the option (LC60,000-LC10,000), the associated changes in intrinsic value (LC47,619-LC0) in OCI and changes in time value in profit or loss (LC12,381-LC10,000)

Under IAS 39, this results in a gain in profit or loss arising from the increase in time value, giving rise to volatility in reported results.

Example 52 – Time value of options – Transaction related hedged item – Foreign exchange rate risk – IAS 39 and IFRS 9 compared (continued)

Hedge accounting under IAS 39 (continued)

31 March 20X5

Assume that the FC/LC exchange rate remains at 0.70 LC/FC. The fair value of the option is LC47,619. There is no change to the intrinsic value of the option because the LC/FC exchange rate remains the same. However the option now no longer has any time value because it has reached its expiry date.

Journal entries under IAS 39:

31 March 20X5		
Dr	Inventory	LC714,286
	Cr	Cash (FC500,000/0.70)
		LC714,286

Being Inventory and cash paid at the spot rate at 31 March 20X5 (FC500,000/0.70).

31 March 20X5		
Dr	Profit or loss	LC12,381
	Cr	Option
		LC12,381

Being the change in fair value of the option's time value (LC60,000-LC47,619), comprising the change in time value which is recorded in profit or loss.

31 March 20X5		
Dr	Cash	LC47,619
	Cr	Option
		LC47,619

Being the settlement of the option.

31 March 20X5		
Dr	Equity (OCI) – Cash flow hedge reserve	LC47,619
	Cr	Inventory
		LC47,619

Being the adjustment of the initial carrying amount of the inventory (Note: Entity A adopts this approach as an accounting policy choice under IAS 39.)

Impact on the income statement and OCI under IAS 39 hedge accounting

	20X4	20X5
Gain/loss from derivatives	LC2,381	LC(12,381)
Cost of goods sold	-	LC666,667
Cash flow hedge reserve (OCI)	LC47,619	LC(47,619)

Note that inventory (cost of LC714,286 less the basis adjustment of LC47,619) has subsequently been expensed as cost of goods sold.

Example 52 – Time value of options – Transaction related hedged item – Foreign exchange rate risk – IAS 39 and IFRS 9 compared (continued)

Hedge accounting under IAS 39 (continued)

Under IAS 39, even though hedge accounting has been applied, profit or loss volatility still arises when entities use option strategies because the movements in time value component are recorded in profit or loss. Note that this volatility would arise regardless of whether only the intrinsic value of the option, or the entire option, was designated as the hedging instrument because the hedged item does not have time value.

Hedge accounting under IFRS 9

Under IFRS 9 intrinsic value of the option contract is designated as the hedging instrument. Changes in time value are recorded in OCI instead of profit or loss, and the initial time value is capitalised into the cost of inventory. Entity A designates only the intrinsic value of the option contract as the hedging instrument because this will improve (and may result in perfect) hedge effectiveness.

Journal entries under IFRS 9

31 October 20X4

Dr	Option	LC10,000	
	Cr	Cash	LC10,000

Being the fair value of the option and cash paid.

31 December 20X4

Dr	Option	LC50,000	
	Cr	Equity (OCI) – Cash flow hedge reserve	LC47,619
	Cr	Equity (OCI) – Option time value reserve	LC2,381

Being the changes in fair value of the option, with the associated changes in intrinsic value and time value being recorded in OCI.

31 March 20X5

Dr	Inventory	LC714,286	
	Cr	Cash (FC500,000/0.70)	LC714,286

Being Inventory and cash paid at the spot rate at 31 March 20X5 (FC500/1.70).

31 March 20X5

Dr	Equity (OCI) – Option time value reserve	LC12,381	
	Cr	Option	LC12,381

Being the changes in fair value of the option (LC60,000-LC47,619) with the associated changes in intrinsic value (zero as noted above since there is no change to the intrinsic value because the LC/FX exchange rate remains the same) and time value being recorded in OCI.

Example 52 – Time value of options – Transaction related hedged item – Foreign exchange rate risk – IAS 39 and IFRS 9 compared (continued)

Hedge accounting under IFRS 9 (continued)

31 March 20X5

Dr	Cash	LC47,619	
	Cr	Option	LC47,619

Being the settlement of the option.

31 March 20X5

Dr	Equity (OCI) – Cash flow hedge reserve	LC47,619	
	Cr	Inventory	LC47,619

To capitalise the intrinsic value of the option (the settlement amount on maturity) into the cost of inventory.

Dr	Inventory	LC10,000	
	Cr	Equity (OCI) – Option time value reserve	LC10,000

To capitalise the initial time value of the option (in this case the premium paid, as there was no intrinsic value on initial recognition) into the cost of inventory.

Note: this last adjustment is directly from equity to the inventory carrying amount, and is not recorded in OCI.

Impact on the income statement and OCI under IFRS 9

	20X4	20X5
Gain/loss from derivatives	-	-
Cost of goods sold	-	LC676,667
Cash flow hedge reserve (OCI)	LC47,619	LC(47,619)
Option time value reserve (OCI)	LC2,381	LC(2,381)

Under IFRS 9, both the changes in intrinsic value and time value component of the options are recorded in OCI until the purchase transaction occurs. When the purchase transaction occurs, the amount in the cash flow hedge reserve (being the cumulative changes in the intrinsic value) is reclassified to the inventory, which is subsequently expensed to cost of goods sold reflecting the hedge objective to cap the purchase price at LC666,667. The option premium LC10,000, being viewed as a transaction cost, is also capitalised into the cost of inventory and subsequently expensed to cost of goods sold.

Example 53 – Time value of options – Transaction related hedged item – Commodity price

- Entity X is a copper producer and wishes to hedge sales that are forecast to take place on 30 September 20X4;
- On 1 January 20X4 Entity X enters into a put option to sell 1,000 tonnes of copper for CU50/tonne. The put option expires on 30 September 20X4 (assume that the hedge is 100% effective);
- The copper spot price on 1 January 20X4 is CU50/tonne;
- Entity X pays CU2,000 for the put option;
- Initial time value is CU2,000
(CU2,000 - ((CU50-CU50) x 1,000 tonnes).

1 January 20X4

Dr	Option	CU2,000	
	Cr	Cash	CU2,000

To recognise the purchase of the option.

Subsequently, on 1 March 20X4:

- The fair value of the option is CU5,000;
- The copper spot price is CU46/tonne;
- Intrinsic value is CU4,000
((CU50-CU46) x 1,000 tonnes);
- The time value of the option is CU1,000
(CU5,000 - CU4,000).

1 March 20X4

Dr	Option	CU3,000	
Dr	OCI – Option time value reserve	CU1,000	
	Cr	OCI – Cash flow hedge (CFH) reserve	CU4,000

To recognise the change in fair value of the option, taking the change in the intrinsic component (the hedging instrument) to the CFH reserve, and recognising the change in time value in the option time value reserve.

Example 53 – Time value of options – Transaction related hedged item – Commodity price (continued)

Subsequently, on 30 September 20X4:

- The fair value of the option is CU 10,000;
- The copper spot price is CU40/tonne;
- The time value of the option is CU0;
- 1,000 tonnes of copper are sold at the spot rate.

30 September 20X4			
Dr	Trade receivable	CU40,000	
	Cr	Sales revenue	CU40,000

To recognise sales of 1,000 tonnes of copper at spot rate of CU40/tonne.

30 September 20X4			
Dr	Option	CU5,000	
Dr	OCI – Option time value reserve	CU1,000	
	Cr	Cash flow hedge (CFH) reserve	CU6,000

To recognise the change in fair value of the option, taking the change in the intrinsic component (the hedging instrument) to the CFH reserve, and recognising the change in time value in the option time value reserve.

30 September 20X4			
Dr	OCI – CFH reserve	CU10,000	
Dr	Sales	CU2,000	
	Cr	Sales	CU10,000
	Cr	OCI – Option time value reserve	CU2,000

To reclassify the amount in the CFH reserve and the option time value reserve against sales revenue.

Calculation of copper sales revenue	
Copper sales at spot rate	CU40,000
Gain or loss recycled from cash flow hedge reserve	CU10,000
Initial time value of option	CU(2,000)
Total	CU48,000

Adjustments to sales revenue from hedging copper sales using copper put option

Example 54 – Time value of options – Time period related hedged item

Entity X enters into a 5 year interest rate cap in order to limit the interest rate on its 5 year floating rate loan to 8%. Entity X pays CU2,000 for the interest rate cap. Assume that the interest rate cap is at (or out of) the money at initial recognition (that is, the market rate of interest is 8% or less) and therefore it has a zero intrinsic value at initial recognition. Under IFRS 9, the initial time value of CU2,000 will be amortised over five years to profit or loss. Subsequent changes in time value are recognised in OCI.

BDO comment

Note that only the change in time value to the extent that it relates to the hedged item is recognised in OCI.

It is only if the critical terms of the option (i.e. nominal amount, expiry date and the underlying) match the hedged item that all of the changes in time value after initial recognition are recognised in OCI and the entire initial time value is deferred.

If the critical terms of the option and the hedged item do not match, the cumulative difference between the time value of the option and the aligned time value (i.e. the time value that perfectly matches the hedged item) is taken to profit or loss.

7.4.2. Zero cost collars

Entering into options results in increased costs for an entity, which is comparable to a situation in which an entity enters into an insurance policy.

To reduce costs, it is not uncommon for entities to enter into 'zero cost collars' which are essentially a combination of a purchased option, and a written option. The strike prices of the two options are set such that the premium the entity would pay for the purchased option component exactly offsets the premium the entity would have received for the written option component. This results in a net premium of zero (hence the reference to 'zero cost').

Although the initial (net) time value may be zero, during the period to maturity the time value of the purchased and written option components will fluctuate and are unlikely to offset each other to a net zero amount.

The accounting for the time value of options under IFRS 9 also applies to time value arising from zero cost collars. This means that entities recognise the subsequent changes in time value in OCI for those instruments.

The graph below illustrates an example of changes in the time value of a zero cost collar.

- i. Under IAS 39, the changes in time value result in profit or loss volatility;
- ii. Under IFRS 9, if the entity hedge accounts and all critical terms of the hedged item and hedging instrument match, the resulting volatility will be recorded in OCI instead.

Time value of zero cost collars

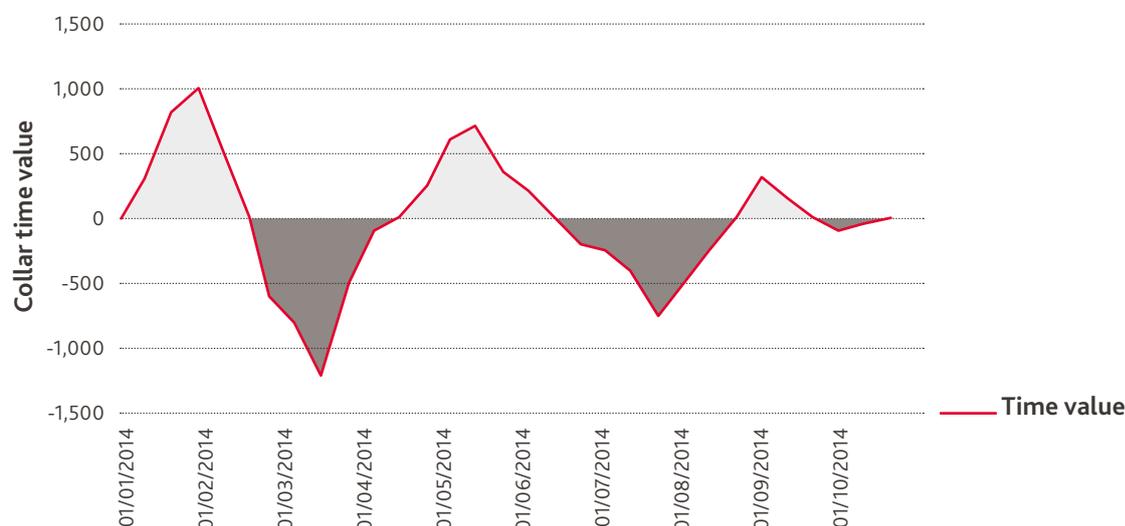


Figure 18: Changes in time value component – Zero cost collars

Note: Assuming that the options are at (or out of) the money and therefore the initial premiums represent only the options' time value.

7.4.3. Forward contracts

Forward contracts have a spot component and a forward points component. In a similar way to the accounting for purchased options, entities are allowed to separate the forward point component from the forward instrument and designate only the change in the spot component as the hedging instrument.

However, the characteristics of the forward points are different depending on the underlying risk. For example, for:

- Foreign currency forwards, the forward points represent the interest rate differential between the two currencies; and for
- Commodity forwards the forward points reflect storage and other costs (often referred to the 'cost of carry').

Under IAS 39, in the same way as for options, an entity can designate either the whole contract, or only the spot element of the forward, as the hedging instrument.

- i. If the entire contract is designated as the hedging instrument, hedge ineffectiveness is likely to arise due to the effect of the forward points where the hedged item is required to be measured at the spot rate.
- ii. If only the spot component is designated as the hedging instrument, hedge effectiveness may be improved as the hedging instrument will be a better offset of changes in the fair value of the hedged item. However, the changes in the fair value of the forward points will be recognised in profit or loss as this element will be accounted for in the same way as a stand-alone derivative (FVTPL).

Under IFRS 9, when an entity designates only the spot component of the forward as the hedging instrument, the entity is permitted to recognise the changes in the forward points in OCI and amortise the fair value of the forward points on initial recognition of the forward contract over the term of the hedging relationship. This reduces profit or loss volatility.

Example 55 – Forward points

Entity X provides a foreign currency (FC) loan of FC1,000 to one of its suppliers. Entity X takes out a foreign exchange forward contract (FX forward contract) to offset the spot foreign exchange movements related to the loan between the foreign currency and its functional currency.

Under IAS 21 *The Effects of Changes in Foreign Exchange Rates*, Entity X is required to remeasure the loan at the spot rate.

To improve hedge effectiveness, Entity X designates only the spot element in the FX forward contract to offset the changes in the spot foreign exchange prices of the loan. The forward points element is accounted for as at FVTPL.

Under IFRS 9:

- Changes in fair value of the forward points can be recognised in OCI;
- The fair value of the forward points on initial recognition of the forward contract will be amortised over the period of the hedge.

In summary, under IFRS 9 the entity accounts for the separate components of the hedge relationship as follows:

Foreign currency loan <i>(Hedged item)</i>	Changes in spot FX to profit or loss (IAS 21)
Foreign currency forward <i>(Hedging instrument)</i>	Changes in spot FX to profit or loss Changes in forward points to OCI

Figure 19: Accounting treatment under IFRS 9

BDO comment

As with the treatment of the time value of money component of options, only the change in the forward points can be recognised in OCI to the extent that this component relates to the hedged item. It is only if the critical terms of the forward (i.e. nominal amount, expiry date and the underlying) match the hedged item that all of the subsequent changes in value can be recognised in OCI and the entire initial forward points are deferred.

If the critical terms of the forward contract and the hedged item do not match, the cumulative difference between the fair value of the forward points of the forward contract and the aligned forward points fair value (the forward points value that perfectly matches the hedged item) is taken to profit or loss.

7.4.4. Foreign currency swaps and basis spread

Foreign currency (FX) basis spread is a pricing element in foreign currency swaps (e.g. foreign currency interest rate swaps) that reflects the 'cost' of exchanging two currencies. It arises mainly due to the supply and demand for different currencies and the perceived credit risk of different reference rates/main players (large financial institutions) in the FX market. The FX basis spread results in volatility in the fair value of the hedging instrument which does not exist in the hedged item. This results in hedge ineffectiveness.

Under the new model in IFRS 9, entities can apply the same accounting as for forward points to the FX basis spread component of foreign currency swap when designating the foreign currency swap as a hedging instrument. This means that the fair value of the FX basis spread component on initial recognition of the swap can be amortised over the hedging relationship with subsequent changes in the fair value of the FX basis spread being recognised in other comprehensive income (OCI).

BDO comment

Note that, in the same way as for options and forwards as discussed above, the change in fair value of the FX basis spread can only be recognised in OCI to the extent that its critical terms match those of the hedged item (see BDO comment in Sections 7.4.1. and 7.4.3. above).

7.5. Presentation

7.5.1. Fair value hedges

In a fair value hedge, the hedging instrument is measured at fair value, with the portion of the hedged item to which the hedging instrument relates also being measured at fair value for the risk being hedged.

The gain or loss on the hedging instrument is recognised in profit or loss (or other comprehensive income, if the hedging instrument hedges an equity instrument that an entity has elected to present changes of an investment in an equity instrument in fair value in other comprehensive income).

The hedging gain or loss on the hedged item adjusts the carrying amount of the hedged item (if applicable) and is recognised in profit or loss (or other comprehensive income, if the hedging instrument hedges an equity instrument that an entity has elected to present changes of an investment in an equity instrument in fair value in other comprehensive income).

The effective portion of the hedging instrument is included in interest revenue in profit or loss, together with amortisation of hedge adjustments made to the hedged item using the adjusted effective interest rate (which will apply when a fair value hedge has been discontinued). Other amounts recognised in profit or loss are not included within interest revenue.

7.5.2. Cash flow hedges

The portion of the gain or loss on the hedging instrument determined to be an effective hedge is recognised in the cash flow hedge reserve in other comprehensive income. These amounts are reclassified to profit or loss and included in interest revenue in accordance with IFRS 9. Any remaining gain or loss on the hedging instrument is hedge ineffectiveness that is recognised in profit or loss and not included in interest revenue.

7.5.3. Hedge of a net investment in a foreign operation

Hedges of a net investment in a foreign operation are accounted for similarly to cash flow hedges. The effective portion of the hedge accumulated gains or losses in the foreign currency translation reserve are reclassified to profit or loss as a reclassification adjustment when there is a complete or partial disposal of the foreign operation.

7.5.4. Hedges of a group of items

For the hedge of a group of items that affect different line items in the statement of profit or loss and other comprehensive income, any hedging gains or losses are presented in a separate line from that of the hedged items. The result is that the line item for the hedged item is unaffected.

For a fair value hedge of a group of assets and liabilities, the gains or losses are recognised as an adjustment of the carrying amount of the respective individual items included in the group.

7.5.5. Derivatives not designated as qualifying hedging relationships

The gains and losses on derivatives not designated as qualifying hedging relationships are recognised directly in profit or loss.

Where interest rate risk is hedged but hedge accounting is not applied, the fair value change or interest accrued and realised on the interest rate swap is not included in interest revenue. However, it is acceptable to present additional line items that include interest income on derivatives measured at fair value through profit or loss.

Example 56 – Derivative Presentation

Client A has entered into a number of derivative contracts, details of which are set out below. The group has decided not to adopt hedge accounting, as the Finance Director planned to focus his attention on rectifying the group's declining market share and increasing trading losses.

Question: How should the arrangement set out below be accounted for?

In the current year the group took out a fixed-rate loan. The fixed rate was swapped into a floating rate using a receive fixed/pay floating rate swap. The Finance Director decided that he would use the fair value option, designating the loan as at fair value through profit or loss. This was on the basis that the designation would at least reduce the extent of the mismatch in accounting that would otherwise result from accounting for the loan at amortised cost, and the derivative at FVTPL. The Finance Director has netted the change in value of the derivative contract recorded in the income statement against the change in value of the fixed rate loan.

Answer: Although the derivative and related loan have not been designated in a qualifying hedging relationship, the Finance Director used the fair value option to achieve a form of quasi hedge accounting, as permitted by IFRS 9.

In consequence, it is considered acceptable for the changes in fair value of the derivative contract and the related loan to be netted on the face of the statement of profit and loss and other comprehensive income. This is on the basis that the relationship would have qualified to be designated in a hedging relationship had the company wished to do so, and that the fair value option is designated to allow entities to achieve a similar result to hedge accounting for fair value hedging relationships.

7.5.6. Presentation of gains and losses

The line items within the statement of profit or loss and other comprehensive income to which the gains and losses of hedging transactions should be included are not specified by IFRS 9.

BDO comment

The effective part of gains or losses on hedging instruments, that are designated in a qualifying hedging relationship, are presented in the line item to which the hedged transaction relates. If the hedging instrument is an option or forward contract, then the time value or forward points component will be accounted for as a cost of hedging.

8. PRESENTATION

8.1. Equity investments designated at FVOCI disclosure

At the DIA, an entity may designate an investment in an equity instrument at FVOCI unless the investment is held for trading (see Section 9.1.3.). IFRS 7 Paragraph 11A(a) requires the disclosure of 'which investments in equity instruments have been designated to be measured at fair value through other comprehensive income.'

BDO comment

The entity should generally disclose the name of each individual investment, unless the individual investment is not material to the entity. Materiality can be qualitative as well as quantitative, so judgement should be applied. In addition, the term "which investments in equity instruments" can be interpreted as disclosure by category – e.g., investments in different types of entities (e.g. by jurisdiction, industry or reason for the investment).

8.2. Presentation of interest moving from Stage 3 to Stage 2 or 1

At its March 2019 meeting, the IFRS Interpretations Committee finalised an agenda decision in response to a request it had received about how amounts are required to be presented in profit or loss when a credit impaired asset is subsequently cured (that is, it is either paid in full or is no longer credit impaired).

When a financial asset is not credit impaired, interest revenue is calculated and recognised using the gross carrying amount of the financial asset. However, if a financial asset becomes credit impaired, interest revenue is calculated and recognised using the amortised cost (that is, the gross carrying amount less the provision). This means that, for a financial asset with a gross carrying amount of CU100, which generates interest revenue at a rate of 10% paid annually, interest revenue of CU10 will be recognised in each year. However, if that asset is credit impaired and the ECL provision is (say) CU40, then interest revenue of CU6 (10% x CU60) will be recognised. If the financial asset subsequently 'cures', the issue is where the reversal of CU4 should be recognised.

Based on the definitions in IFRS 9. Appendix A, the gross carrying amount, amortised cost and loss allowance are all discounted amounts. Changes in those amounts during a reporting period therefore include the effect of the unwinding of discount.

IFRS 9.5.5.8 requires the recognition in profit or loss, as an impairment gain or loss, the amount of expected credit losses (or reversals) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with IFRS 9. For a credit impaired financial asset that has subsequently cured, this includes the unwinding of discount on the loss allowance during the period in which the financial asset was credit impaired. In the example above, assuming the financial asset was credit impaired for a period of one year, this would amount to CU4 (10% x the loss allowance of CU40). This means that, when looked at in isolation, the reversal of credit losses recognised in respect of a credit impaired financial asset could exceed the impairment losses recognised in profit or loss.

This accounting arises from how IFRS 9.5.4.1 requires interest revenue to be calculated using the effective interest method. When a financial asset is credit impaired, as noted above, interest revenue is recognised on the amortised cost of the financial asset (CU60) and not the gross carrying amount (CU100). Consequently, any reversal of credit losses arising from a cured financial asset in excess of impairment losses cannot be recognised as interest revenue, because under the requirements of IFRS 9 that excess does not represent interest revenue.

9. TRANSITION

The date of initial application (DIA) of IFRS 9 is the beginning of the reporting period when an entity first applies IFRS 9.

The general principle for the first-time application of IFRS 9 is for retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which is that the new requirements are applied as if those requirements had always been applied. However, certain exemptions exist from the retrospective application, being:

- An option not to restate comparative information with differences being recorded in opening retained earnings (or other equity component if appropriate);
- Prospective application of the hedge accounting requirements with limited exceptions (see Section 7.3.);
- No application of IFRS 9 to financial instruments that are derecognised before the DIA.

BDO comment

If an entity adopts IFRS 9 in its interim reports that comply with IAS 34 Interim Financial Reporting, the DIA can be the beginning of an interim period other than the beginning of an annual period.

Example 57 – Early adoption

Assume Entity B has a December year end and it prepares the following interim reports that comply with IAS 34 *Interim Financial Reporting*:

- 31 March First quarter financial statements;
- 30 June Half-year financial statements;
- 30 September Third quarter financial statements.

Question: Is it possible for Entity B to early apply IFRS 9 from:

- 1 April
- 1 July
- 1 October?

Answer: Yes, an entity can adopt IFRS 9 in its interim reports that comply with IAS 34, because the DIA can be the beginning of an interim period other than the beginning of an annual period.

9.1. Classification and measurement

9.1.1. General requirements

At its DIA, an entity must assess the business model on the basis of the facts and circumstances that exist at the DIA. However, for the SPPI contractual cash flow test IFRS 9 is applied retrospectively to determine whether a financial asset meets the conditions for a classification as at:

- Amortised cost;
- Fair value through other comprehensive income (FVOCI) for debt instruments;
- FVOCI for equity investments; or
- Fair value through profit or loss (FVTPL).

Once the classification assessment is made, that classification applies to the financial asset retrospectively (irrespective of the entity's business model in prior reporting periods). The standard does not apply to items that have already been derecognised at the date of initial application.

The following diagram sets out the likely potential reclassifications from the IAS 39 categories to the IFRS 9 categories for financial assets.

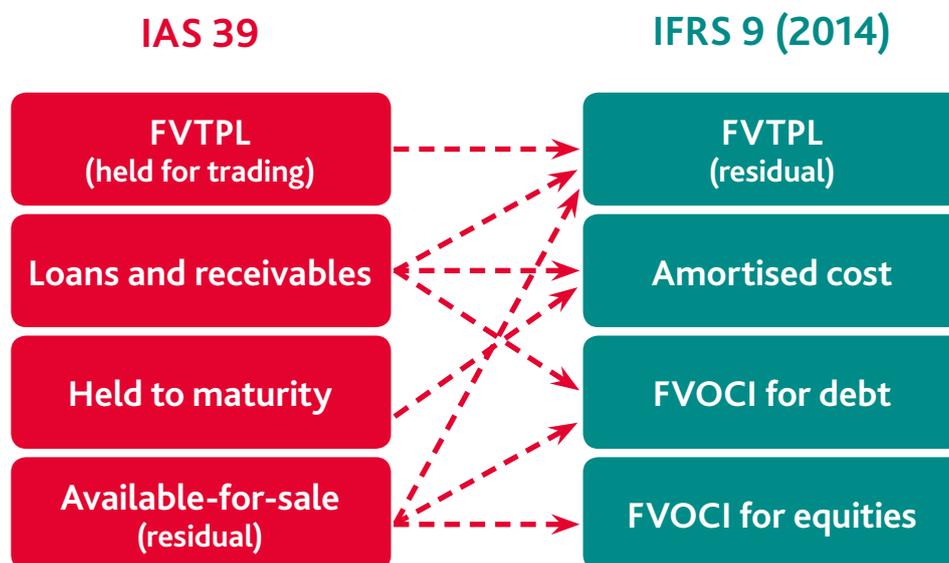


Figure 20: The likely reclassifications of financial assets from IAS 39 to IFRS 9

BDO comment

Although the categories of IFRS 9 might appear similar to those of IAS 39, there are key differences. Under IAS 39, the available-for-sale category (measured at FVOCI except for impairment and some foreign exchange differences) was a residual category to be used if a financial asset did not fall into any of the other three categories; it was also optional unless a financial asset was required to be measured at FVTPL. In contrast, the FVOCI category in IFRS 9 is for a clearly defined group of financial assets and the residual category is FVTPL.

Despite the fact that the standard is to be adopted retrospectively in accordance with IAS 8, an entity is not required on initial application to restate comparatives. Instead it is required to provide the disclosures set out in Paragraphs 42L-42O of IFRS 7 *Financial Instruments: Disclosures*.

Example 58 – Financial instruments recognised before the DIA of IFRS 9

Entity A decides to apply IFRS 9 from 1 January 2017.

On 30 September 2016, Entity A sold an available-for-sale equity investment and recognised a gain of CU30 which included the effect of reclassifying the related amount from the available-for-sale reserve to profit or loss.

Question: Are there any adjustments required on transition for the equity instrument?

Answer: No. The DIA is 1 January 2017, and IFRS 9 does not apply to financial instruments that have already been derecognised by the DIA.

9.1.2. Financial assets or financial liabilities designated at FVTPL

The option to designate financial assets or financial liabilities at FVTPL is re-opened at the date of initial application of IFRS 9 in accordance with Paragraphs 7.2.8(a) and 7.2.10(a). This paragraph states that such a designation is made on the basis of the facts and circumstances that exist at the date of initial application, and that this classification is applied retrospectively. As noted in IFRS 9 Paragraphs 4.1.5 and 4.2.2(a) this redesignation is designed to allow entities to revisit financial asset and financial liabilities designations if doing so eliminates or significantly reduces accounting mismatch that would otherwise arise from measuring the assets or liabilities or recognising the gains and losses on them on a different basis.

The fair value option may be applied to individual financial assets and liabilities. In some cases, financial assets and liabilities may be designated together if the joint designation eliminates or substantially reduces a measurement mismatch (for example, a financial asset that would otherwise be measured at FVOCI and a financial liability that would otherwise be measured at amortised cost).

9.1.3. Equity investments at fair value through other comprehensive income

At the DIA, an entity may designate an investment in an equity instrument at FVOCI unless the investment is held for trading. The election is to be applied retrospectively.

For unquoted equity investments measured at cost under IAS 39, an entity will need to determine the fair value of the equity investment at the DIA. The difference between the previous carrying amount and the fair value at the DIA is recognised in opening retained earnings or other reserves (if it is designated at FVOCI).

Example 59 – Impairment loss before transition

Entity B bought an equity investment in an unlisted company on 1 January 2013 for CU100. As the equity instrument was not held for trading it was classified by Entity B as an available-for-sale financial asset.

However, because the investment did not have a quoted market price in an active market and its fair value could not be reliably determined, the equity investment was measured at cost (less impairment) under IAS 39. On 31 December 2013 Entity B recognised an impairment loss of CU40 in profit or loss. Entity B applies IFRS 9 for the first time in the annual reporting period ended 31 December 2015. It elects to measure the equity investment at FVOCI. In accordance with the transitional provisions of IFRS 9, Entity B is not required to restate comparatives but is required to provide the disclosures set out in IFRS 7.42L-42O.

The fair value of the investment on 1 January 2015 is determined to be CU75. The carrying value of the investment under IAS 39 at 31 December 2014 is CU60.

Question: How should Entity B account for the investment on transition?

Answer: The DIA of Entity B is 1 January 2015. Entity B recognises the difference of CU15 in its opening retained earnings or other reserves (if it is designated at FVOCI) at 1 January 2015.

The CU40 impairment loss previously recognised in profit or loss would be reclassified from retained earnings to accumulated OCI on transition.

9.1.4. Hybrid contracts (contracts with embedded derivatives)

A hybrid contract that is to be classified as at FVTPL under IFRS 9 may have been accounted for under IAS 39 as a host contract and a separable embedded derivative. This means that the entire (combined) hybrid contract will not have been measured at fair value in the comparative period, with the two components being dealt with separately. On transition, the holder recognises in its opening retained earnings any difference between the fair value of the entire hybrid contract and the sum of the fair values of the two components of the hybrid contract.

The rationale for this approach is that, in previous financial statements in which it applied IAS 39, an entity may not have determined the fair value of a hybrid contract in its entirety at fair value. However, it would have been required to measure the components (the host contract and the embedded derivative(s)) at fair value for the purposes of disclosures required by IFRS 7.

Example 60 – Convertible note on transition

Entity C acquired an investment in a convertible note on 1 January 2013. Under IAS 39 the convertible note was bifurcated as follows:

- Embedded derivative accounted for at FVTPL (carrying value at 31 December 2014: CU30); and
- Debt host contract measured at amortised cost (carrying value at 31 December 2014: CU990).

Entity C applies IFRS 9 for the first time in its annual reporting period ending 31 December 2015.

Question: How should Entity B account for the investment on transition?

Answer: The DIA of Entity C is 1 January 2015. In accordance with the transitional provisions of IFRS 9, Entity C is not required to restate comparatives but is required to provide the disclosures set out in IFRS 7.42L-42O. On 1 January 2015 the fair value of the convertible note (as a single combined instrument) is CU980. The fair values of the two components on 1 January 2015 were as follows:

- Embedded derivative is CU30;
- Host debt contract is CU960 (note that in this case the fair value is lower than the previous amortised cost carrying amount).

The total fair value of the components is CU 990. Entity C recognises the difference of CU10 in opening retained earnings at 1 January 2015.

9.1.5. Impracticable to apply the effective interest method retrospectively

If it is impracticable for an entity to retrospectively apply the effective interest method to financial instruments classified at amortised cost in accordance with IFRS 9 that were previously measured at fair value, the transitional requirements depend on whether an entity restates its comparatives.

If an entity restates its comparatives, then the fair value of the financial instrument at the end of each comparative period is used as a proxy for its amortised cost.

If an entity does not restate comparatives, the entity treats the fair value of the financial instrument at the date of initial application as its new amortised cost.

9.2. Impairment

The new requirements apply retrospectively, which is consistent with the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, there are some special transition rules and concessions that are available.

On the DIA, an entity is required to disclose information that permits the reconciliation of the ending impairment allowance under IAS 39 or the provisions under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening loss allowance or provision determined in accordance with the new model in IFRS 9. The disclosure would be provided by the related measurement categories in accordance with IAS 39 and IFRS 9 for financial assets, and the effect of changes in the measurement category on the loss allowance at that date would be shown separately.

BDO comment

Entities will need to decide on their transition policy, assess what information is available and whether additional information needs to be gathered for transition to the new impairment model. It will also be necessary to consider what new systems and processes need to be implemented to enable transitioning to the new model.

Example 61 – Trade receivables on transition

Company M has trade receivables of CU30 million at 31 December 2017 and transitions to IFRS 9 on 1 January 2018. Under IAS 39, it provides for credit losses by applying a provision matrix based on the number of days past due and the historical default rates.

	Historical default rates (A)	Gross carrying amount (B)
Current	-	CU15,000,000
1-30 days past due	1%	CU7,500,000
31-60 days past due	2%	CU4,000,000
61-90 days past due	6%	CU2,500,000
>90 days past due	10%	CU1,000,000
Total		CU30,000,000

Example 61 – Trade receivables on transition (continued)

The credit loss allowance balance at 31 December 2017 based on IAS 39 is CU405,000.

On transition to IFRS 9, Company M estimates the following provision matrix (based on historical observable default rates and adjusted for forward looking estimates).

	Expected default rates (A)	Gross carrying amount (B)
Current	0.3%	CU15,000,000
1-30 days past due	1.6%	CU7,500,000
31-60 days past due	3.6%	CU4,000,000
61-90 days past due	6.6%	CU2,500,000
>90 days past due	10.6%	CU1,000,000
Total		CU30,000,000

On 1 January 2018 the new credit allowance is CU580,000.

The journal entry is:

1 January 2018			
Dr	Retained earnings	CU175,000	
	Cr	Credit loss allowance	CU175,000

BDO comment

Under the IFRS 9 impairment model management is required to predict the future expected default rate taking into account expectations of changes in future macro and microeconomic conditions. The loss allowance based on IAS 39 will not be the same as under IFRS 9. Note that under IFRS 9, provisions are also made for expected losses arising on trade receivables that are not yet past due. However, the expected credit loss model on IFRS 9 is different from, and is not equivalent to, what is often currently termed a 'general provision' model.

9.2.1. Transitioning to the full three-stage impairment model

Transition to the full three-stage impairment model is more complex. The full three-stage impairment model applies to:

- Intercompany or related party loan receivables;
- Other loan receivables at amortised cost or FVOCI;
- Any government or corporates bonds that are classified at amortised cost or FVOCI; and
- Any issued financial guaranteed contracts and loan commitments (not classified at FVTPL).

Because the impairment requirements apply retrospectively on transition, entities are required to compare:

- The credit risk of the financial asset at initial recognition; and
- The credit risk at the date of initial application.

If there has been no significant increase in credit risk, then an entity recognises 12 months expected credit losses on transition. If there has been significant increase in credit risk, then an entity recognises lifetime expected credit losses on transition.

However the following practical expedients can be used to simplify transition (although it should be noted that the extent to which some of these can be used will depend on whether this is justified by the size and complexity of the entity):

- Apply the 30 days past due test to determine which assets are deemed to have experienced significant increase in credit risk;
- If the asset is determined to be low credit risk then 12 months of expected credit losses are provided (if the asset is not determined to be low credit risk, lifetime expected credit losses, may be required);
- If applying the full retrospective method requires undue cost or effort, (e.g. if there has been very limited data on the credit quality of the loans entered into many years ago), then on the date of initial application, entities may simply recognise lifetime expected credit losses on the financial asset. However, if this approach is followed then lifetime expected credit losses are required to be recognised for all future periods, until the financial asset is derecognised.

Example 62 – Intercompany loan on transition

On 1 January 2015, Parent A lends Subsidiary B CU5m for 5 years. Parent A transitions to IFRS 9 on 1 January 2018. As at 31 December 2017, all of the payments were up to date and no provision was recognised. Subsidiary B's operating results remain profitable and have been meeting management budgets.

Question: How should Parent A account for the loan on transition to IFRS 9 on 1 January 2018?

Answer:

- Parent A assesses that there has not been a significant increase in credit risk in Subsidiary B since 1 January 2015 therefore recognise 12 months expected losses;
- Assume the estimated 12mths expected loss is 0.5%.

Journal entry on transition would be:

1 January 2018			
Dr	Opening retained earnings	CU25,000	
	Cr Credit loss allowance		CU25,000

Example 63 – Government bonds on transition

As at 31 December 2017, Entity Z has a government bond AA rated investment of CU10,000. Entity Z transitions to IFRS 9 on 1 January 2018 and the bonds are classified at FVOCI.

Question: How should Entity Z account for the bond on transition to IFRS 9?

Answer:

- The bonds are considered to be 'low credit risk' because it is an investment grade;
- Entity Z estimates that the 0.05% probability of default in the next 12 months.

Journal entry on 1 January 2018 on transition would be:

1 January 2018			
Dr	Opening retained earnings	CU50	
	Cr Credit loss allowance		CU50

9.3. Hedge accounting

The new hedge accounting requirements apply prospectively with limited exceptions. The following practical expedients are allowed at transition:

- Entities can consider applying the new model, immediately after ceasing to apply IAS 39 (i.e. de-designate the old IAS 39 hedging relationship and start a new hedging relationship under the new model);
- The starting point for rebalancing will be the hedge ratio used under IAS 39 (the designated volume of the hedging instrument and the hedged items under IAS 39).

Retrospective application applies only to the accounting for:

- The time value of options where the entity has designated only the intrinsic element of the option as the hedging instrument (Section 7.4.1.); and
- Forward points and foreign currency basis spreads (Sections 7.4.3. and 7.4.4.) where the entity has designated only the spot element of the forward as the hedging instrument.

The above retrospective application applies to those types of hedging relationships that exist at the beginning of the comparative period (or later). This means that the previously recognised changes in time the value of options, forward points or foreign currency basis spreads under the existing IAS 39 model will be reclassified from retained earnings to accumulated OCI.

For contracts that fall under the 'own use' scope exemption entities may make a one off election for all existing contracts (on an all or nothing basis for similar contracts) to account for these contracts at fair value if applying fair value accounting to these contracts eliminates or significantly reduces an accounting mismatch.

BDO comment

Prospective application means that entities cannot go back and re-designate risk components of non-financial items, aggregated exposures and groups and net positions to existing hedging relationships. However, entities would be able to voluntarily discontinue the existing hedging relationship under IAS 39 and re-designate under the new model from the DIA.

If an entity does decide to de-designate an existing IAS 39 hedging relationship and designate a new one under IFRS 9, it should be noted that because this is likely to involve the designation of a non-zero fair value derivative, any associated hedge ineffectiveness will need to be recorded. However, for IAS 39 compliant hedge relationships that clearly comply with the hedge accounting requirements of IAS 39, it may not be necessary to de-/re-designate.

9.3.1. IFRS 9 Transition issues relating to hedging

The IFRS Interpretations Committee was asked to consider the following two transitional issues.

The first issue being considered relates to whether an entity can treat a hedging relationship as a continuing hedging relationship on transition from IAS 39 to IFRS 9 if the entity changes the hedged item in a hedging relationship from an entire non-financial item (as permitted by IAS 39) to a component of the non-financial item (as permitted by IFRS 9) in order to align the hedge with the entity's risk management objective. The Interpretations Committee noted that when an entity changes the hedged item in a hedging relationship from an entire non-financial item to a component of the non-financial item upon transition to IFRS 9, it is required to do so on a prospective basis (as per IFRS 9.7.2.22). The original hedge relationship could not be treated as a continuing hedge relationship on transition to IFRS 9.

The second issue is whether an entity can continue with its original hedge designation of the entire non-financial item on transition to IFRS 9 when the entity's risk management objective is to hedge only a component of the non-financial item. The Interpretations noted that hedge designations of an entire non-financial item could continue on transition to IFRS 9 as long as they meet the qualifying criteria in IFRS 9. IFRS 9.BC6.97-100 supports the use of hedge designations that are not exact copies of actual risk management ('proxy hedging') as long as they actual reflect risk management.

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