EFRAG STAFF PAPER FOR PUBLIC MEETING

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Understanding the main changes brought by IFRS 9

Background of the Standard

1 IFRS 9 replaces almost all parts of IAS 39 *Financial Instruments: Recognition and Measurement*. Work on replacing IAS 39 was accelerated following the financial crisis when interested parties, including the G20, the Financial Crisis Advisory Group and the Financial Stability Board highlighted a number of areas in financial instruments accounting that needed to change. These included, inter alia, the timeliness of recognition of credit losses, the complexity of multiple impairment models and the reporting in profit or loss of changes in own credit worthiness.

2 The overall scope and recognition/derecognition model of IFRS 9 *Financial Instruments* are materially the same as IAS 39, but there are significant changes to:

(a) Classification and Measurement;

(b) Impairment; and

(c) Hedge Accounting.

How the issues have been addressed

3 IFRS 9 changes the classification requirements for financial assets, using a single approach for all types of financial assets. Only basic lending instruments are potentially eligible for measurement at amortised cost and all other financial assets are measured at fair value. Measuring all non-basic lending instruments at fair value has led to the elimination of the multiple impairment models in IAS 39 and the design of a single model based on the principle of expected, rather than incurred, credit losses results in earlier recognition of credit losses. The hedge accounting requirements more closely align hedge accounting with risk management practices.

What has changed?

Classification and measurement

Financial Assets

4 The classification and measurement approach for financial assets in IFRS 9 is based upon the contractual cash flow characteristics of the financial assets, and for financial assets that are assessed to be ‘basic lending instruments’ the entity’s business model for managing the financial assets.

5 IFRS 9 distinguishes basic lending instruments as having contractual cash flows that are assessed as being Solely Payments of Principal and Interest (‘SPPI’) on the

principal amount outstanding from other instruments, with contractual cash flows that are not assessed to be SPPI.

6 Within the assessment of payments being SPPI, 'principal' is the fair value of the financial asset at initial recognition, which changes over time to reflect any repayments of that principal. Interest is described broadly, as including consideration for the time value of money, credit risk, other basic lending risks (such as liquidity risk), costs (such as administrative costs) and a profit margin consistent with a basic lending arrangement.

7 All financial assets that have contractual cash flows that are not assessed as being SPPI are measured at fair value, with changes in the fair value presented in profit or loss. This is because the IASB decided that fair value is the best predictor of future net cash inflows for these assets. The IASB has nonetheless decided that entities could opt irrevocably at inception on an instrument-by-instrument basis to account for equity instruments at fair value through Other Comprehensive Income, without reclassification in profit or loss of gains or losses upon derecognition.

The business model within which financial assets are managed

8 For financial assets that have contractual cash flows that are assessed as being SPPI, the financial reporting depends upon the business model the entity uses to manage the assets in order to generate cash flows - by collecting contractual cash flows, selling financial assets or both. The business model is assessed on a level that reflects how financial assets are managed to achieve a particular business objective. The business model does not depend upon management's intentions for an individual instrument, and is therefore determined on a higher level of aggregation, but IFRS 9 acknowledges that a single reporting entity may have more than one business model for managing its financial assets and therefore classification need not be determined at the reporting entity level.

9 The business model for managing financial assets is a matter of fact rather than an assertion, and the standard states that it is typically observable through the activities that the entity undertakes to achieve the objectives of the business model. Evidence of the nature of the business model includes:

(a) How the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;

(b) The risks that affect the performance of the business model and the way in which those risks are managed; and

(c) How managers of the business are compensated.

10 SPPI financial assets that are managed within a business model whose objective is to hold assets in order to collect contractual cash flows are measured at amortised cost less impairment, with all changes in this measurement presented in profit or loss.

11 SPPI financial assets that are managed within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets have the same presentation in profit or loss as SPPI financial assets that are managed within a business model whose objective is to hold assets in order to collect contractual cash flows. However, for the balance sheet, such financial assets are measured at fair value. The difference between an instrument's amortised cost

measurement (which is used to calculate the presentation in profit or loss) and its fair value is presented in OCI.

12 SPPI financial assets that are managed within any other business model are measured at fair value through profit or loss. There is an irrevocable option at initial recognition to hold any SPPI financial asset, irrespective of the business model, at fair value through profit or loss if such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch').

Determining whether cash flows are Solely Payments of Principal and Interest

13 IFRS 9 provides extensive guidance to assist in determining whether contractual cash flows are SPPI. For contractual cash flows to be SPPI they must include returns consistent with a basic lending arrangement, for example, if the contractual cash flows include a return for equity price risk then that would not be consistent with the contractual cash flows being SPPI.

When a business model changes

14 Because the classification model for SPPI is based upon the business model within which financial instruments are managed, IFRS 9 requires reclassification if that business model changes. Such changes are expected to be very infrequent, and must be significant to the entity's operations and demonstrable to external parties, for example when the entity acquires, disposes of or terminates a business line. No other reclassification is permitted. In comparison to IAS 39, IFRS 9's requirements are more restrictive. Consequential amendments to IFRS 7 *Financial Instruments: Disclosures* require detailed disclosures about such reclassifications (including the amount of financial assets moved into and out of different measurement categories and a detailed explanation of the change in business model and its effect).

Improving consistency in the definition of equity instruments

15 The definition of equity instruments now mirrors the accounting requirements for the issuer under IAS 32 *Financial Instruments: Presentation*. Financial instruments are therefore not classified as equity instruments if they include a contractual obligation for the issuer to transfer cash or another financial asset, even if the amount of cash to be received is not fixed or determinable, or is based on entity-specific variables (for example shares in open ended investment funds or shares puttable to the issuer at fair value).

<u>Financial Liabilities</u>

16 Except for the accounting for changes in own credit risk described below, all IFRS 9 requirements for financial liabilities are carried forward from IAS 39, including the bifurcation of particular embedded derivatives. As a result, many financial liabilities, apart from derivatives or financial liabilities that an entity designates under the fair value option, will continue to be measured at amortised cost.

Changes in own credit risk

17 IFRS 9 introduces new requirements for the accounting and presentation of changes in the fair value of a financial liability when the entity has chosen at inception to measure that financial liability at fair value under the fair value option. This responds to criticism that it was counterintuitive for an entity to recognise a gain in profit or loss due to a deterioration of its own credit standing. Under IFRS 9, a change in fair value due to the change in the entity's own credit risk is reported in OCI unless such presentation would create or enlarge an accounting mismatch in profit or loss. The

accumulated amounts presented in OCI are not reclassified to profit or loss if the liability is repaid early.

Impairment

18 The impairment section of IFRS 9 reflects a fundamentally different approach to that of IAS 39 in that the loss recognition model is based on ‘expected’ rather than ‘incurred’ losses. This change was designed to address concerns raised during the financial crisis that IAS 39, as it was implemented, recognised impairment losses on financial assets too late. The model in IFRS 9 is conceptually a ‘loss allowance’ model, recognising a provision for expected credit losses on financial assets before any losses have been incurred and updating the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments. Credit losses are the present value of the difference between the contractual cash flows that are contractually due to the entity and the cash flows that the entity actually expects to receive.

19 The expected credit losses model applies to financial assets measured at amortised cost, debt instruments measured at fair value through OCI, loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss, lease receivables that are within the scope of IAS 17 *Leases* and trade receivables or contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*.

20 The loss allowance model requires an entity to base its measurement of expected credit losses on reasonable and supportable information, including historical, current and forward-looking information, which is available without undue cost or effort. It has three stages:

(a) Stage 1: At the reporting date, if credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses.

12-month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that could result from default events that are possible within 12 months from the reporting date. The 12-month expected credit losses amount is intended to be a proxy for the amount of credit losses expected to be covered by interest margin.

(b) Stage 2: At each reporting date, if the credit risk increases significantly from initial recognition and the resulting credit quality is not considered to be low credit risk, full lifetime expected credit losses are recognised.

(c) Stage 3: A financial asset reaches state 3 if it is specifically identified as credit-impaired. At this stage, recognition of interest revenue changes as described below and lifetime expected credit losses continue to be recognised, potentially on the basis of revised estimates.

21 In stages 1 and 2, interest revenue is calculated on the gross carrying amount of the financial asset. However, in stage 3, interest revenue is calculated based on the gross carrying amount less the loss allowance.

22 For purchased or originated credit-impaired financial assets the cumulative changes in lifetime expected credit losses since initial recognition are recognised as a loss allowance.

23 The new model is accompanied by enhanced disclosures about expected credit losses and credit risk. For example, entities are required to provide information that explains the basis for their expected credit loss calculations and how they measure expected credit losses and assess changes in credit risk.

Hedge Accounting

24 The requirements in IAS 39 for hedge accounting were widely regarded as rule-based, difficult to implement and inconsistent with risk management practices. The main changes to the hedge accounting requirements in IAS 39 have been made to meet the objective of reflecting risk management practices. As a result, IFRS 9 retains the three hedge accounting models from IAS 39 but with some changes to the fair value and cash flow hedge accounting models.

25 IFRS 9 expands the range of hedged items to include items such as risk components of non-financial items and aggregated exposures. The range of hedging instruments is also expanded: for example non-derivative financial instruments measured at fair value can be used to hedge risks other than foreign exchange risk.

26 The hedge effectiveness requirements needed to qualify for hedge accounting have changed so they are less rules-based. Hedged items and hedging instruments need to be connected through an economic relationship, and value changes that result from that economic relationship should not be dominated by credit risk. A designated hedging relationship is required to reflect what is actually being hedged and the entity is required to document the arrangement in advance and identify how hedge effectiveness will be assessed and the sources of hedge ineffectiveness. Any hedge ineffectiveness is recognised in profit or loss.

27 IFRS 9 introduces the concept of 'rebalancing'. Rebalancing refers to adjustments to the designated quantities of either the hedged item or the hedging instrument of an existing hedging relationship for the purpose of maintaining a hedge ratio. This allows entities to respond to changes that arise from the underlying instrument or risk variables. However, entities may not voluntarily de-designate the hedge accounting relationship when the hedge accounting relationship continues to reflect the risk management objective.

28 Credit risk is not a hedgeable risk. However, IFRS 9 permits an entity to designate a credit risk exposure at fair value through profit or loss. As an alternative to hedge accounting, the use of the fair value option is extended for own-use contracts.

Macro-hedging practices

29 IFRS 9 does not address specific accounting for open portfolios of hedged items or macro hedging: this is part of a separate IASB project. Consequently, entities can elect to apply IAS 39 to account for the portfolio fair value hedge of interest rate risk.

30 IFRS 9 also provides entities with an accounting policy choice between applying the hedge accounting requirements of IFRS 9 and continuing to apply the existing hedge accounting requirements in IAS 39 for all hedge accounting. This accounting policy choice is intended to remain available until the work on macro hedge accounting has been finalised.

When does the Standard become effective?

31 The Standard has a mandatory effective date of annual periods beginning on or after 1 January 2018 with early application permitted. The section of IFRS 9 on the

presentation of changes in own credit risk can be applied prior to adopting the rest of IFRS 9.