EFRAG STAFF PAPER FOR PUBLIC MEETING

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EFRAG's evaluation of the costs and benefits of IFRS 9

1 EFRAG has considered whether, and if so to what extent, implementing IFRS 9 in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from its adoption.

Cost for preparers

2 EFRAG has carried out an initial assessment of the cost implications for preparers resulting from IFRS 9 *Financial Instruments*.

One-off costs

Classification and Measurement

3 The one-off costs will depend on the individual circumstances of the entity, i.e. the type (and diversity of) business models for its financial assets as well as the contractual cash flow characteristics of the instruments.

4 Preparers are expected to incur significant one-off costs to undertake the initial analysis of business models and contractual cash flows on transition; to develop new processes, systems and controls; to develop valuation systems for specific financial assets which were previously measured at amortised cost; to adjust the accounting systems to accommodate the calculation of modification losses; to prepare disclosures related to transition; to obtain expert advice for compliance and explaining to users of financial statements the differences between the information produced under IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9.

5 The fact that upon transition to IFRS 9 there is no requirement to restate the financial information for previous periods will help contain the costs for preparers in implementing IFRS 9.

Cost-benefit issue

6 Entities that issue contracts that are within the scope of IFRS 4 *Insurance Contracts* will need to consider the possibility of accounting mismatches between IFRS 9 and their current accounting for insurance contracts when implementing IFRS 9. They will then need to reassess the application of IFRS 9 when the new insurance contracts standard 4 becomes effective in order to reflect their asset-liability management appropriately. Even though this may not result in doubling the costs of implementing IFRS 9, some doubt the benefits of the first implementation effort.

Impairment

System changes

7 The costs of applying the expected credit loss model will vary depending on the diversity of investment strategies and the sophistication of existing credit risk management systems.

8 Participants in the 2013 ED *Financial instruments: Expected Credit Losses* field-test acknowledged that there would be further significant cost including IT costs for development and roll-out of systems, tools and processes for collecting data, tracking credit risk and calculating expected credit losses. New systems and controls will also be required in order to integrate information produced for credit risk management or other business purposes into their financial reporting process.

9 In determining significant increases in credit risk, entities will need to develop systems for tracking the credit risk at initial recognition, identifying increases in credit risk on a timely basis both at individual instrument and collective level. The transitional relief significantly reduces the costs with respect to instruments recognised before the application of IFRS 9 because the lifetime expected credit losses can be recognised with respect to the current level of credit risk or the past due status.

10 Calculation of expected credit losses will require development of systems for collecting historical information about defaults, loss rates, and behavioural aspects of exposures. At the time of transition to IFRS 9, many entities will lack sufficient historical data and the entities will have to find reliable methods for extrapolating the short-term observations over the period of the life of their exposures. Measurement of expected credit losses will require systems for projection of future conditions affecting the exposure and for their extrapolation beyond the horizon of reasonable forecasts. This may include adjustments of through-the-cycle parameters calculated by financial institutions for prudential regulatory purposes. Calculations are based on present values and the introduction of discounting at the instrument's effective interest rate to the reporting date will bring additional challenges.

Disclosures

11 The implementation costs to comply with the disclosure requirements will impose a significant burden on preparers. As identified in the field-test, disclosure requirements are comprehensive and are frequently prescriptive rather than principle-based.

12 With respect to specific disclosure requirements, participants in the field-test highlighted the costs of reconciliations between opening and closing balances for the gross carrying amount of financial assets and loss allowances because the data in the accounting and risk systems have to be combined and other information may need to be collected.

13 EFRAG also expects that additional costs will be incurred by preparers to explain to users specific aspects of applying the new impairment model to support the users' understanding of the information presented.

Hedging

14 Because IFRS 9 requires prospective application of the hedging requirements, EFRAG assesses that the main one-off costs are expected to be:

(a) educating staff and preparing new reporting systems and procedures for the disclosure requirements;

(b) costs of collecting information about hedge of risk components of non-financial items (i.e. commodity risk); and

(c) updating of the documentation for existing hedging relationships.

Other costs

15 As highlighted in the field-test, entities will incur high one-off costs to:

(a) educate personnel;

(b) define roles and responsibilities and new procedures and workflows; and

(c) update the accounting system, including the disclosures for the annual report.

Ongoing costs

Classification and Measurement

16 One of the main ongoing costs of applying IFRS 9 will be the need for entities to monitor the frequency and magnitude of sales in order to decide whether there is a change in the classification of financial assets. Entities will also incur costs in classifying new financial assets with respect to meeting the SPPI criteria.

17 The requirement in IFRS 9 to determine fair value on a recurring basis for investments in equity instruments and financial assets whose cash flows are assessed as not being SPPI is expected to involve significant costs and efforts. In the cases where entities applying IFRS might not have internal systems or expertise to determine easily the fair value of unquoted equity investments held, they may need to rely on external experts at significant cost.

18 There will be also new disclosure requirements which will result in the need to capture more data than under the current disclosure requirements in IFRS 7 (e.g. additional disclosures about investments in equity instruments measured at fair value through OCI, disclosures for reclassifications).

Impairment

19 The principle of using reasonable and supportable information available without undue cost or effort allows the entities to consider the level of sophistication of their credit risk management systems and thus alleviates the cost burden. However, this also implies that the availability of the information will improve and the threshold for undue costs will lower over time. Entities are likely to further develop their impairment systems which will bring some costs on an ongoing basis.

Measurement of expected credit losses

20 The ongoing cost of measuring a loss allowance at an amount equal to 12-month expected credit losses will be higher for financial institutions that do not use an internal-ratings based approach for regulatory purposes.

21 For non-financial institutions, the calculation of 12-month and lifetime expected credit losses are a new concept that would not normally be required for other management purposes. As a result, they are unlikely to have applied such a calculation in the past. This will require ongoing monitoring of systems and processes.

22 For both financial and non-financial institutions, ongoing costs will be incurred in connection with obtaining calculation inputs and improving their quality over time.

Hedging

23 The ongoing costs will be different from entity to entity and depend on an entity's facts and circumstances so it is difficult to provide a general assessment of the impact. The size of the ongoing costs will be influenced by the type of hedging

instruments and hedged items each individual entity uses, as well as their implementation of hedge accounting in terms of processes and systems.

24 IFRS 9 generally keeps the mechanics of hedge accounting for fair value, cash flow and net investment hedges the same, which will reduce the costs of compliance with IFRS 9. Further, IFRS 9 permits entities to apply the IAS 39 requirements for the portfolio fair value hedge of interest rate risk while accounting for all other hedge relationships according to IFRS 9. Consequently, the introduction of IFRS 9 would not adversely affect the ability and costs for portfolio fair value hedge activities. In addition, the migration from macro cash flow hedge requirements under IAS 39 to the hedge accounting requirements of IFRS 9 should not lead to extra costs for preparers as the new requirements do not change how risk components of financial items can be designated as hedged items.

25 As indicated in EFRAG's field test on general hedge accounting, ongoing costs may relate to application of the hedge ratio and rebalancing. However, as these requirements have been further clarified in the finalisation process of IFRS 9, these costs may be lower than initially assessed.

26 In determining hedge effectiveness, entities need to assess the effect of credit risk on the hedge relationship. This may bring some operational complexities, although the application of the hedge effectiveness requirements has been simplified compared to the ones required under IAS 39. However, as the assessment is to be done on a 'should not dominate'-basis, the costs related to this assessment are not expected to be extremely high.

27 Although used for an economic hedge IFRS 9 does not consider the hypothetical derivative as a method in its own right for assessing hedge effectiveness. It is one possible way of determining an input for other methods. One may argue that this could increase the operational cost of preparers, however EFRAG notes that other methods exist to demonstrate hedge effectiveness. Consequently, EFRAG believes that the impact on operational cost for preparers may be minimal.

28 IFRS 9 expands the notion of 'costs of hedging' so as to include foreign currency basis spreads, the reason for this being that foreign currency basis spreads are considered as a charge of a forward exchange one currency into another. Such an approach is a practical expedient and thus cost-reducing.

29 When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option, the change in fair value of the time value is recognised in OCI. However the accounting treatment differs depending on whether the option hedges a transaction related hedged item or a time-period related hedged item. This may lead to an increase in operational costs of applying the hedge accounting requirements.

<u>Other ongoing costs</u>

30 Other ongoing costs are expected to be:

(a) Collecting the relevant disclosures;

(b) Ongoing system development and training;

(c) Maintenance of systems and management of data, models and processes;

(d) Complex ongoing processes and procedures; and

(e) Audit costs.

Conclusion

31 Overall, EFRAG's initial assessment is that IFRS 9 is likely to result in significant costs for preparers related to implementation of IFRS 9 and ongoing costs of complying with the standard.

Costs for users

32 EFRAG has carried out an initial assessment of the cost implications for users resulting from IFRS 9.

One-off costs

33 EFRAG's initial assessment is that users may have to incur one-off costs to read and understand IFRS 9 and the impact on the classification of financial instruments, including the available options, and the immediate impact of the impairment requirements. The mechanics of hedge accounting for fair value, cash flow and net investment hedges are already well known by users, which will not lead to any additional cost.

34 EFRAG assesses that users will have to organise special meetings with preparers in order to understand how they have implemented the standard and the implications for their organisation. EFRAG assesses that these one-off costs will be significant.

35 Users will incur particularly high costs for understanding the financial statements of entities that issue contracts within the scope of IFRS 4 *Insurance Contracts.* This is because the effective dates for IFRS 9 and the forthcoming Insurance Contracts standard are not aligned. Classification and measurement of financial assets following IFRS 9 may have to be reassessed at the moment of implementing the forthcoming Insurance Contracts standard.

Ongoing costs

Classification and Measurement

36 The ongoing costs for users are generally unlikely to be significant since the requirements will lead to relevant, understandable and comparable information and it is not expected that users will have to restate financial statements. Changes in an entity's business model and consequential costs of analysis are expected to be rare.

Impairment

37 The assessment of changes in credit risk since initial recognition and calculation of expected credit losses inherently involves a significant amount of subjectivity and therefore reduces the verifiability and comparability of reported amounts. On the other hand, disclosures help in improving the verifiability and comparability. Analyses of all the information available is likely to result in ongoing costs for analysis applied by users of financial statements.

Conclusion

38 Overall, EFRAG's initial assessment is that, based on the above analysis, IFRS 9 is not likely to result in significant costs for users after the transition.

Benefits for preparers and users

39 EFRAG has carried out an initial assessment of the benefits for users and preparers resulting from IFRS 9.

Classification and Measurement

40 The extent of the benefit for preparers will depend on existing practices and the industry within which the preparer operates.

41 IFRS 9 provides a number of illustrative examples and detailed application guidance that illustrate various aspects of IFRS 9 classification and measurement requirements, which is expected to limit the initial and ongoing costs of compliance for preparers.

42 For financial assets that are assessed as having contractual cash flows that are SPPI, classification and measurement aligned with the entity's business model would mean that the entity's internal management and financial reporting would be better aligned. This is expected to result in lower ongoing costs for preparers.

43 For financial assets that are assessed as having cash flows that are not SPPI, the removal of the complex rules regarding bifurcation of embedded derivatives means that it is simpler to identify the cash flows that are measured at fair value (i.e. it is all of the contractual cash flows of the financial asset, not just some).

44 Users will benefit from relevant and transparent information because the classification and measurement requirements in IFRS 9 will reflect how the cash flows of financial assets are expected to be realised given the entity's business model and the nature of the contractual cash flows. However, if the effective date of IFRS 9 is not aligned with a new Insurance Contracts standard, users of financial statements of insurers may face two significant changes within a relatively short period of time.

Impairment

45 Users of financial statements will benefit from the information about expected credit losses being provided on a timely basis. This will help them to predict future cash flows on financial instruments.

46 Furthermore, the model provides a link between the pricing of an asset, credit quality upon initial recognition and the deterioration in credit quality over time. As a result, users will be able to distinguish between instruments for which the credit risk increased significantly and resulted in economic losses and instruments with no significant credit deterioration for which the credit losses are largely absorbed by the interest cash flows.

47 Users will be assisted with the comprehensive disclosures that will help them understand the models, assumptions and inputs used to recognise expected credit losses. They will also find information about the absolute level of credit risk of financial instruments.

48 Preparers will benefit from the fact that existing credit risk management processes are capable of being leveraged to fulfil the IFRS 9 requirements.

49 Systems and processes which are necessary to comply with the expected credit loss model are generally also needed to manage the business model effectively. Once they are in place, the information should help preparers in better pricing of financial instruments and thus lead to better business decisions regarding lending and investing. Moreover, preparers with less sophisticated systems are more likely to identify potential credit losses emerging while there is time to address them.

Hedging

50 The following hedging requirements of IFRS 9 are expected to bring the following benefits for preparers and users:

(a) Better consistency between accounting and risk management;

(b) Less need for non-GAAP information to explain hedge accounting to users; and

(c) Availability of standardised and more transparent information resulting in a better understanding of an entity's performance.

51 Under IFRS 9, the financial statements will be more closely aligned with risk management reducing costs for preparers and making it easier for them to explain how their risk management functions and users the opportunity to better understand these activities. This should contribute to better economic decision making through improved financial reporting. This is especially the case for corporates as the standard allows for hedge accounting of non-financial risk components which will better reflect commercial reality.

52 The new hedge effectiveness requirements, including the possibility to rebalance a hedge accounting relationship, will benefit users and preparers as effectiveness will be assessed based on the (continuing) existence of an economic relationship between hedged item and hedging instrument and not based on breaching bright lines.

53 FRS 9 considers the time value of an option as a premium paid for protection against risk and, consequently, aligns the accounting for the time value with the risk management perspective. This will be beneficial for users and preparers as the time value paid is treated as a cost of hedging instead of as held for trading with the resulting volatility recognised in profit or loss.

54 IFRS 9 requires comprehensive information to be disclosed in a single note to allow users to understand the effects of hedge accounting on the financial statements. In addition, the disclosures provide a higher level of transparency on hedge accounting activities which would permit users to more readily develop their view of an entity's risks and how they are hedge accounted for.

Conclusion

55 Overall, EFRAG's initial assessment is that users are likely to benefit from IFRS 9, as the information resulting from it will be relevant and transparent and therefore will enhance their analysis.

56 Also, EFRAG's initial assessment is that preparers are likely to benefit from IFRS 9 due to the reasons stated above.

Overall Conclusion

57 EFRAG staff's initial assessment is that the, overall, benefits for preparers and users in implementing IFRS 9 are likely to outweigh costs for both preparers and users associated in implementing those requirements.

58 EFRAG acknowledges that this may not be the case for insurers, unless the effective date of IFRS 9 and the forthcoming Insurance Contracts standard are aligned. However, when taking into account the benefits of a simpler classification and measurement model and the production of information that is easier to understand, EFRAG believes that the benefits of IFRS 9 outweigh the associated costs.