EFRAG
European Financial Reporting Advisory Group



EFRAG STAFF PAPER FOR PUBLIC MEETING

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# Is IFRS 9 an improvement over IAS 39?

## Objective

1 The objective of this note is to assess whether IFRS 9 *Financial Instruments* is an improvement compared to IAS 39 *Financial Instruments: Recognition and Measurement.* That is, this note assesses whether, in comparison with IAS 39, the requirements of IFRS 9 increase the quality of financial reporting in providing information which is more relevant, more reliable, less complex and/or more understandable.

## Classification and Measurement

2 EFRAG has focused its assessment on the areas which it considered the most affected by the change from IAS 39 to IFRS 9. It is worth noting that except for the accounting for an entity's own credit risk, no change has been introduced in the accounting for liabilities or in the derecognition requirements. Hence, this section addresses the following topics:

(a) The classification and measurement approach for financial assets, including the treatment of embedded derivatives;

(b) Reclassifications; and,

(c) Classification of financial liabilities: own credit risk.

*The classification and measurement approach for financial assets, including the treatment of embedded derivatives*

3 Under IAS 39 financial assets are classified into four categories each of them calling for specific measurement requirements:

(a) Fair value through profit or loss;

(b) Held to maturity;

(c) Loans and receivables; and

(d) Available for sale.

4 In addition, all financial assets can be designated at fair value through profit or loss when specific conditions are fulfilled.

5 In considering how the classification and measurement approach of IFRS 9 compares to the IAS 39 approach, the following aspects of IAS 39 need to be considered:

(a) Accounting designations based on intent were constrained by rules such as tainting in order to provide consistency over time in the measurement;

(b) Bifurcation of embedded derivatives allowed the separation of complex or unpredictable cash flows from the 'simple' host instrument.

6 Under IFRS 9, the classification and measurement approach for financial assets 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 determination of the entity's business model for managing the financial assets. This results in the following classification and measurement categories:

(a) Amortised cost for financial assets that are basic lending instruments and are managed in a hold-to-collect business model;

(b) Fair value through other comprehensive income for financial assets that are basic lending instruments and are managed in a hold-to-collect and sell business model; and

(c) Fair value through profit or loss for other financial assets.

7 In addition:

(a) an entity may make an irrevocable election at initial recognition for equity instruments that are not held for trading to present subsequent fair value measurement gains or losses in other comprehensive income;

(b) bifurcation of hybrid assets is prohibited, and

(c) all financial assets can be designated as at fair value through profit or loss to avoid accounting mismatches.

<u>Analysis</u>

8 A classification approach based on the entity's business model increases the relevant nature of the resulting information, as it reflects an entity's purpose in respect of that asset. IFRS 9 has introduced reliance on the business model in the accounting for basic lending instruments. EFRAG assesses this as providing more relevant information compared with the accounting for basic lending instruments in IAS 39. The business model is based on factual information rather than on an accounting designation as required under IAS 39. The business model test also allows the provision of information on a higher level of aggregation than an instrument-by-instrument basis and consequently simplifies the accounting. EFRAG staff assesses that for these reasons users will be provided with more understandable and reliable information on all basic lending instruments. In making this assessment, EFRAG staff takes into account how the cash flow characteristics test operates under IFRS 9, the objective being to capture all instruments that are managed as basic lending instruments.

9 An exception to this positive assessment can be made as IFRS 9 prohibits the separation of embedded derivatives, even though the cash flows of the host contract may be similar to and managed with basic lending instruments while the cash flows from the embedded derivatives are managed through the trading desk. In contrast, IAS 39 required the separation of the components when the embedded derivative

was not closely related to the host. In practice however this change may have limited application as IAS 39 allowed the fair value option to be applied to all hybrid contracts and there is evidence that this option (rather than bifurcation) is widely used.

10 Under IFRS 9 all financial assets other than basic lending instruments used in a hold-to-collect or a held-to-collect and sell business model are measured at fair value through profit or loss, regardless of the business model that applies to them. Whilst IAS 39 categories were not specifically reliant on an entity's business model, the various categories of measurement, together with the ability to bifurcate embedded derivatives and the instrument-by-instrument designation, allowed an entity to reflect their business intent to a large extent in the accounting for financial assets. For this reason, some think that IAS 39 provided more relevant information for financial assets other than basic lending instruments. It is arguable, however, that the level of understandability by users of this reporting was low, as IAS 39 allowed a lot of flexibility in the selection of a measurement basis, including the scope of the fair value option. Also, entities do not generally manage on an instrument-by-instrument basis but rather on a more aggregated level, and therefore an instrument-by-instrument designation generates complexity.

11 The criticism expressed above that IFRS 9 does not allow the business model to influence the measurement of financial assets other than basic lending instruments could be mitigated by the option included in IFRS 9 to account for equity instruments at fair value through OCI. Whilst this is an option, the option is restricted to equity instruments that are not held for trading and therefore opens the possibility of distinguishing between equity instruments held for trading and equity instruments that are invested in the longer term. However changes in fair value other than dividends are not recycled into profit or loss and no impairment loss is recognised in profit or loss. It is arguable therefore that, in contrast to IAS 39 when equity instruments can be classified as available for sale, users will not always have the ability to easily assess the performance of the entity's investment activities.

12 On the basis of the analysis above, EFRAG staff assesses that both sets of requirements for financial assets other than basic lending instruments have their strengths and weaknesses and that one cannot be deemed superior to the other.

*Reclassifications*

13 IAS 39 includes detailed reclassification requirements based upon:

(a) The classification categories;

(b) The type of financial asset; and

(c) The conditions triggering reclassification.

14 IFRS 9 includes a principle that reclassification of financial assets is required when the business model for managing those financial assets has changed. Guidance is provided however that restricts the circumstances in which a change of business model is deemed to occur.

Analysis

15 EFRAG staff assesses that the reclassification requirements under IFRS 9 are more restrictive than those in IAS 39 and do not allow entities to address particular situations. This may reduce the relevance of the resulting information. For example, if an active market vanishes, an entity's preferred business model, including how the assets are managed and performance assessed, may not have changed.

However, because the entity may not have the practical ability to operate in accordance with the desired business model, it may need to change its business model in the short term. Lack of reclassification in such circumstances may reduce the relevance of the information provided. Circumstances in which reclassifications are necessary, such as the most recent financial crisis, are expected to be rare.

*Classification of financial liabilities: own credit risk*

16 If an entity measures a financial liability at fair value under the fair value option, IAS 39 requires the entire fair value change to be presented in profit or loss. This implies that changes in a liability's credit risk are affecting profit or loss even when the liability is not held for trading.

17 When an entity elects to measure a financial liability at fair value through profit or loss in its entirety, IFRS 9 requires that the changes in fair value due to changes in the entity's own credit risk are presented in other comprehensive income. The only exception to this requirement is if doing so would create or enlarge an accounting mismatch in profit or loss, in which case an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.

Analysis

18 EFRAG staff assesses that this requirement improves the relevance of reported profit or loss as an entity will generally not realise the effects of changes in the liability's credit risk unless that liability is held for trading.

*Conclusion on Classification and Measurement*

19 The overall comparison of the IFRS 9 Classification and Measurement requirements with those of IAS 39 does not lead to a conclusion that IFRS 9 is superior in all respects. Whilst the accounting for basic lending instruments and own credit risk for financial liabilities will improve financial reporting, it is not possible to reach the same conclusion for all other financial instruments. Accounting for financial instruments other than basic lending instruments will provide relevant information under IFRS 9, but that will be in a different manner from the relevance of the information provided under IAS 39.

**Impairment of financial assets**

20 In assessing whether the impairment requirements of IFRS 9 constitute an improvement to those of IAS 39, EFRAG staff has focused on the following topics:

(a) The scope of the impairment model;

(b) The expected credit loss model;

(c) Measurement of impairment for FVOCI category;

(d) The role of probability weighting and the use of judgement;

(e) The use of a loss allowance and write-off; and

(f) Impairment disclosures.

*The scope of the impairment model*

21 Under IAS 39, different impairment requirements apply depending on the nature and categories of the financial assets, that is different guidance for assets at amortised cost, available-for-sale debt instruments and available-for-sale equity instruments.

22 IAS 39 provides specific requirements for available-for-sale equity instruments in addition to the general impairment triggers. Equity instruments are impaired if there is a "significant or prolonged" decline in their fair value below cost. This test has been difficult to apply and resulted in diversity in practice.

23 Furthermore, losses on loan commitments and financial guarantees issued by entities are accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* even though the credit risk on loan commitments and guarantees is generally managed in the same way as the credit risk on loans and other debt instruments. That is, similar risks are accounted for differently.

24 This has resulted in complexity for both preparers who find the requirements in IAS 39 inconsistent with their credit risk management practices and users who find it difficult to understand the rationale leading to the impairment.

25 IFRS 9 brings a single impairment model that applies to all financial instruments in the scope of IFRS 9 that are not accounted for at fair value through profit or loss.

Analysis

26 EFRAG staff thinks that having a single impairment model will reduce complexity and potentially more closely align impairment requirements with credit risk management practices. However, the increased reliance on estimates may reduce the reliability of the impairment measures.

27 EFRAG staff also notes that the introduction of a single model is achieved at the cost of introducing options such as the option for the accounting for equity instruments at fair value through other comprehensive income without recycling because of the lack of an appropriate impairment model for equity instruments. The recognition of losses on equity instruments in other comprehensive income without any recognition in profit or loss even when the instrument can be deemed impaired can arguably obscure the view on an entity's performance for investors who would usually expect to have all impairment losses included in profit or loss.

28 Therefore, EFRAG staff believes that the benefits of a single impairment model are impaired by the additional complexity in options and the lack of recognition of losses in profit or loss on equity instruments that are measured at fair value through other comprehensive income.

*The expected credit loss model*

29 Under IAS 39, no impairment is recognised unless and until a loss event occurs after the initial recognition of a financial asset. During the recent financial crisis, this "incurred loss" approach was criticised for delaying the recognition of losses and for being difficult to understand and apply.

30 The new IFRS 9 expected credit losses model (ECL) is a forward looking model that aims at addressing this criticism of "too little, too late" by requiring the recognition of a day one loss representing 12-month expected credit losses for all financial assets that are not measured at fair value through profit or loss with operational simplifications for lease receivables, trade receivables and contract assets. Full lifetime expected credit losses are recognised where there has been a significant increase in credit risk since initial recognition.

Analysis

31 EFRAG staff notes that while the IFRS 9 impairment model will result in the overstatement of expected credit losses for financial instruments issued given that not all financial assets are impaired at initial recognition, the early recognition of

expected credit losses is likely to improve investors' confidence in the financial reporting of financial instruments.

*Measurement of impairment for FVOCI category*

32 Under IAS 39, the impairment of debt instruments that are recognised at fair value through other comprehensive income is measured as the difference between the acquisition cost and the current fair value. This means that once an impairment trigger occurs, the impairment is calculated based on changes in fair value. This approach has been criticised because fair value changes are not only impacted by credit risk, but also by other parameters such as interest rates.

33 Under the IFRS 9 expected credit losses model, the impairment loss is measured as the present value of contractual cash shortfalls discounted using an effective interest rate. The impairment loss is recognised in profit or loss and the fair value adjustment is recognised in other comprehensive income.

Analysis

34 EFRAG staff assesses that the requirements of IFRS 9 will address the criticisms of IAS 39 and improve the relevance of financial information: performance reported in profit or loss is based on amortised cost while fair value is presented in the balance sheet.

*The role of probability-weighting and the use of judgement*

35 Under IAS 39, it is possible to estimate impairment losses as either a single amount or as a best estimate from a range of possible amounts. This is sometimes criticised as lacking sufficient reliability as it is not clear why an entity would pick one number from a range of possible outcomes as its best estimate of the impairment loss.

36 In contrast, IFRS 9 does not allow expected credit losses to be measured using the most likely outcome or as the entity's best estimate of the ultimate amount because the expected credit losses model requires the measurement to reflect the probability-weighted cash shortfalls through the use of the probability of default and the loss given default.

Analysis

37 EFRAG staff believes that probability-weighting improves the reliability of the impairment amount calculated.

38 However, EFRAG staff thinks that the benefits of probability-weighting may be outweighed by the amount of judgement required under IFRS 9 when compared with IAS 39. This is because under the IAS 39 incurred loss model, the expected cash flows are estimated and recognised only when an impairment trigger has been reached. In most cases this happens when the borrower is already under financial difficulties and the analysis focuses on the amount that can still be recovered from available assets that the borrower may have.

39 In contrast, the IFRS 9 expected credit loss model requires estimates for all financial assets. For longer term assets, these estimates will include assumptions about forward looking macro-economic data that can span far into the future. Entities will have to develop robust methodologies to ensure that their estimates are reasonable and supportable and their judgements are applied consistently. It is expected however that such estimates are already at least partly available to support entities' credit risk management. Where IFRS 9 would require that they are further enhanced, this development could be deemed beneficial to the entity as a whole.

*The use of a loss allowance account and write-off*

40 IAS 39 allows a choice of using a loss allowance account or reducing the carrying amount of an asset measured at amortised cost directly to reflect impairment. In contrast, IFRS 9 requires the use of a loss allowance account for amortised cost assets and derecognition of the portion of an asset when the write-off criterion is met.

Analysis

41 EFRAG staff notes that in practice most banks carry loss allowance accounts and use write-off criteria similar to those in IFRS 9. However, IFRS 9 guidance will enhance clarity for those corporate entities that do not use the loss allowance account and entities whose write-off policies are driven by local legislation.

*Impairment disclosures*

42 Through the amendments to IFRS 7 *Financial Instruments: Disclosures*, IFRS 9 introduces extensive disclosures to identify and explain the amounts in the financial statements that arise from expected credit losses and the effect of deterioration and improvement in credit risk.

*Conclusion on the comparison of IFRS 9 and IAS 39 impairment models*

43 EFRAG staff assesses that while the new impairment disclosures will represent a significant challenge for management, especially financial institutions, as the detailed level of information is likely to require significant changes to systems and processes, IFRS 9 significantly improves transparency in the way impairment losses are calculated and reported, which in turn will enhance investors' confidence. More importantly, the use of the expected credit loss model will eliminate the current potential for overstatement of interest income in the absence of accounting for credit losses that are factored in the interest charged to customers.

**General hedge accounting**

44 EFRAG has focused its assessment on the areas which it considered the most affected by the change from IAS 39 to IFRS 9. Hence, this chapter addresses the following topics:

(a) Reflecting risk management;

(b) Eligibility of hedged items;

(c) Eligibility of hedging instruments;

(d) Effectiveness testing and rebalancing; and

(e) Treatment of credit risk.

*Reflecting risk management*

45 In contrast to IAS 39, the objective of hedge accounting under IFRS 9 has been clearly defined and is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or in particular cases other comprehensive income.

Analysis

46 EFRAG staff assesses that putting the risk management strategy of an entity central to the objective of hedge accounting enhances the relevant nature of the resulting

information. Reflecting in the financial statements how an entity is managing its risks is providing more information to users than hedge accounting information under IAS 39 where that link is not necessarily available.

*Eligibility of hedged items*

47 The definition of a hedged item remained unchanged under IFRS 9. However, IFRS 9 allows a broader category of hedged items. This includes:

(a) Risk components of non-financial items in addition to risk components of financial items;

(b) Net positions in particular circumstances;

(c) Portfolio layers for both cash flow hedges and fair value hedges in particular circumstances. Restrictions apply to prepayable items; and

(d) Aggregated exposures.

Analysis

48 EFRAG staff assesses that IFRS 9 provides more possibilities for designation of hedged items than IAS 39. Consequently, IFRS 9 provides entities the possibility in designating hedge accounting relationships in order to reflect their risk management strategy.

*Eligibility of hedging instruments*

49 As under IAS 39, derivatives can be designated as hedging instrument under IFRS 9. IFRS 9 also allows non-derivative financial instruments not only to be designated as hedging instruments for foreign currency risk but also for other risks if these non-derivative financial instruments are measured at fair value through profit or loss.

50 In contrast to IAS 39, derivatives embedded in financial assets are no longer eligible as hedging instruments. This is because IFRS 9 no longer allows bifurcation of embedded derivatives for financial assets.

51 Under IAS 39, changes in the time value of an option are recognised in profit or loss. Under IFRS 9 changes in the aligned time value of an option are deferred in other comprehensive income. The timing of reclassification to profit or loss depends on the nature of the underlying hedged item (i.e. whether it is transaction-related or time-period related).

52 Under IAS 39, entities have two possibilities to hedge foreign currency risk; they can either hedge the forward rate or the spot rate. IFRS 9 confirms both possibilities but provides an additional one. Where an entity designates only the change in the spot element as the hedging instrument an entity can apply the accounting for the time value of options to the forward element of a forward contract.

53 IAS 39 provides no specific treatment for currency basis spreads. In contrast, under IFRS 9 currency basis spreads are considered as costs of the hedge relationship and changes can be recognised through other comprehensive income.

Analysis

54 EFRAG staff assesses that, with the exception for embedded derivatives of financial assets, IFRS 9 provides a wider range of possible hedging instruments than IAS 39.

Consequently, IFRS 9 provides entities with a greater possibility in designating hedge accounting relationships in order to reflect their risk management strategy.

*Effectiveness testing and rebalancing*

55 Under IAS 39, the effectiveness of the hedge accounting relationship has to be able to be reliably measured and is expected to be highly effective prospectively. Retrospectively the hedge should achieve offsetting changes in fair value or cash flows attributable to the hedged risk within a range of 80-125%.

56 Under IFRS 9 hedge effectiveness is measured using the following criteria:

(a) There is an economic relationship between the hedged item and the hedging instrument;

(b) The effect of credit risk does not dominate the value changes that result from that economic relationship; and

(c) The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item.

57 In contrast to IAS 39, IFRS 9 does not permit voluntary de-designation of hedge accounting relationships if the risk management objective remains identical, but permits rebalancing of the hedge relationship.

Analysis

58 EFRAG staff assesses that the removal of the 80-125% effective range improves hedge accounting possibilities for many risk management strategies. It also removes a ‘bright-line’ rule: a hedge under IAS 39 which was 81% effective would achieve hedge accounting, and a hedge which was 79% effective would not. Hence the full fair value movements of the derivative would be recorded in profit or loss without any offsetting of the hedged item. From a risk management perspective the difference between a 79% and an 81% effectiveness was minimal, but accounting did not reflect this.

59 EFRAG staff assesses that the possibility of rebalancing a hedge accounting relationship helps to reflect better hedge accounting relationships in the financial statements consistently with risk management practices.

*Treatment of credit risk*

60 IAS 39 does not provide a specific solution for dealing with credit risk. IFRS 9 states that the credit risk of a debt instrument cannot be isolated and thus does not meet the eligibility criteria to be designated as a hedged item. However, IFRS 9 provides an option to designate the financial instrument at fair value through profit or loss when specific conditions are fulfilled.

Analysis

61 EFRAG staff notes that economic hedges of credit risk using credit derivatives are a common practice. It could therefore be argued that a standard on hedge accounting should address these practices. However EFRAG staff also acknowledges that the pricing in credit derivative markets and cash markets are not always strongly correlated, and accepts that this limitation is necessary to support reliable information.

62 Furthermore compared to IAS 39 entities can now benefit from clear guidance in IFRS 9 on how to deal with this risk type.

*Conclusion on the comparison of IFRS 9 and IAS 39 hedging requirements*

63 EFRAG staff assesses that the hedging requirements in IFRS 9 provide more relevant information than those in IAS 39 because thy permit a better reflection of an entity's hedging practices.

**Questions for EFRAG Board**

64 Are EFRAG Board members aware of other issues that would require a comparison of IAS 39 and IFRS 9?

65 Note: EFRAG Board will be asked whether to include this analysis in its assessment of whether IFRS 9 is conducive to the European public good only after EFRAG TEG has had the opportunity to approve it.