

Applying IFRS

IFRS 9 for non-financial entities

March 2016

Contents

1. Introduction	3
2. Classification of financial instruments	4
2.1 Contractual cash flow characteristics test	5
2.2 Business model assessment	9
2.3 Equity instruments designated at FVOCI	13
2.4 Fair value option	14
3. Impairment of financial assets	15
3.1 General approach	15
3.2 Simplified approach	24
3.3 Originated credit impaired financial assets	25
3.4 Impairment disclosures	26
4. Hedge accounting	29
4.1 Qualifying criteria	30
4.2 Rebalancing the hedge ratio	33
4.3 Risk components	35
4.4 Aggregated exposures	37
4.5 Accounting for the costs of hedging	38
4.6 Own use contracts	41
4.7 Hedge accounting disclosures	43
5. Effective date and transition	48
5.1 Effective date	48
5.2 Transition (retrospective application)	48

What you need to know

- ▶ The most significant effect of IFRS 9 for most non-financial entities will be the application of the new hedge accounting model. This model is less rules-based than the model set out in IAS 39 and should enable a wider range of economic hedging strategies to achieve hedge accounting. There are, however, significant disclosure requirements to help communicate these risk management activities to users of the accounts.
- ▶ Although the effect of IFRS 9 is not as great on non-financial entities, the impact of adopting IFRS 9 should not be underestimated.
- ▶ While the classification of financial liabilities will not normally change, the classification of financial assets will depend on their nature and how they are managed. More complex financial assets will need to be recorded at fair value through profit or loss, but there will no longer be a requirement to separate derivatives embedded in financial assets.
- ▶ The new expected credit losses (ECL) impairment requirements may not have a significant impact on short-term trade receivables, but they will for longer-term receivables, contract assets and debt securities, that are not recorded at fair value through profit or loss. If an entity prepares separate financial statements under IFRS, then the ECL model will also apply to intragroup loans.

1. Introduction

In July 2014, the International Accounting Standards Board (IASB or the Board) issued the final version of IFRS 9 *Financial Instruments* (IFRS 9 or the standard), bringing together the classification and measurement, impairment and hedge accounting sections of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and all previous versions of IFRS 9. The standard is effective for annual periods beginning on or after 1 January 2018.

This publication sets out the requirements of the standard that are most relevant for non-financial entities and discusses the most significant impacts, using a case study.

Section 2 of this publication sets out the new requirements for classifying financial instruments. The focus of Section 2 is on the classification of financial assets as the classification of financial liabilities remains largely unchanged compared with IAS 39. Section 3 describes the new expected loss impairment model for impairment, Section 4 discusses the new hedge accounting requirements and section 5 covers transition.

Illustration 1-1 sets out the relevant facts for the case study which is used throughout this publication to illustrate the requirements of IFRS 9.

Illustration 1-1 – Financial instruments held by Choco

Choco Limited (hereafter referred to as 'Choco') is a wholly owned subsidiary of a large retailer. The principal activity of Choco is to manufacture and sell chocolate, both to companies within the group for further processing or distribution, as well as externally to retailers. It has CU as its functional currency.

The following table is a list the financial instruments held by Choco, which will form the basis for the illustrations throughout the publication.

Financial assets

Investment in equity instruments	Choco has invested in listed shares of some of its suppliers and customers (the shareholdings of which are all less than 5% of the respective entities). The purpose of this portfolio is to hold the shares for the long term in order to commit to a strategic alliance with the supplier or customer.
Investment in debt instruments	The investment in debt instruments comprises a portfolio of government and corporate bonds. The bonds are plain vanilla in the sense that the contractual terms of the bonds give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. Choco holds these bonds for liquidity purposes. Therefore, it may sell some of the portfolio in order to meet cash flow needs (e.g., for acquisitions). This is expected to happen on a regular basis such that the entity expects to sell assets on a more-than-infrequent basis and that those sales are significant in value.

Illustration 1-1 – Financial instruments held by Choco (cont'd)

Loan to parent company	<p>Choco has provided long-term finance in the form of an interest free loan to its parent company. The loan is due to be repaid in five years' time at its par value of CU1,000,000. A market related interest rate for a loan with similar terms would have been 6% p.a. on initial recognition.</p> <p>Choco intends to hold the loan until its maturity. Neither Choco nor the parent has an option to call or prepay the loan.</p>
Trade receivables	<p>Payment in respect of sales is due within 30 days of invoice date. Choco has no intention of factoring its trade receivables.</p>
Cash and cash equivalents	<p>Cash and cash equivalents comprises a current account, which is a non-interest bearing demand deposit.</p>
Financial liabilities	
Listed debt	<p>Choco issued fixed coupon bonds which are listed and actively traded on an exchange. The bonds have a ten-year maturity.</p>
Other	
Derivatives	<p>Choco has entered into cocoa futures contracts in order to hedge the future acquisition of cocoa required for its production needs.</p> <p>Choco sometimes enters into interest rate options in order to participate in gains due to declining interest rates on long term borrowings.</p> <p>Choco also sometimes enters into foreign currency options if it sometimes has to contract major acquisitions such as machines.</p>
Guarantee	<p>Choco has provided a guarantee for the borrowings of a fellow subsidiary.</p>

The only change in respect of financial liabilities is that for those designated at FVTPL, fair value changes attributable to own credit risk are presented in OCI.

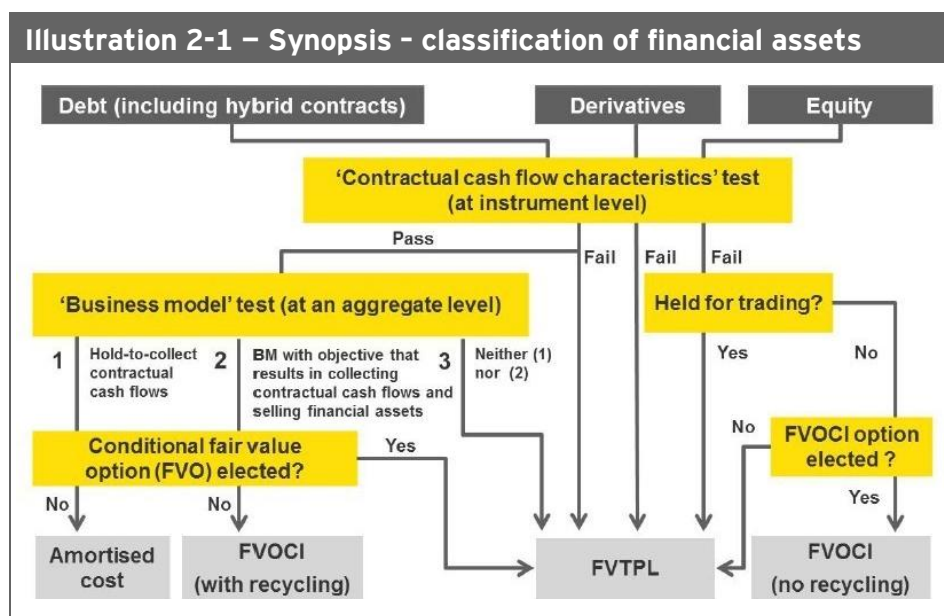
2. Classification of financial instruments

IFRS 9 introduces a new model for classifying financial assets. In respect of financial liabilities, all IAS 39 requirements have been carried forward to IFRS 9, including the criteria for using the fair value option and the requirements related to the separation of embedded derivatives from hybrid contracts. The only change introduced by IFRS 9 in respect of financial liabilities is related to liabilities designated as at fair value through profit or loss (FVTPL) using the fair value option. The part of the fair value changes of such financial liabilities that is attributable to the change in the entity's own credit risk is presented in other comprehensive income (OCI) instead of profit or loss, unless doing so would introduce an accounting mismatch. In this case, the whole fair value change is presented in profit or loss. This section therefore exclusively focuses on the classification of financial assets.

The standard introduces principle-based requirements for the classification of financial assets, using the following measurement categories:

- ▶ Debt instruments at amortised cost
- ▶ Debt instruments at fair value through OCI (FVOCI) with cumulative gains and losses reclassified to profit or loss upon derecognition
- ▶ Debt instruments, derivatives and equity instruments at FVPL
- ▶ Equity instruments designated at FVOCI with no recycling of gains and losses upon derecognition

The classification of financial assets is summarised in Illustration 2-1. It depends on the financial asset's contractual cash flow characteristics and the entity's business model for managing the financial assets. The remainder of this section explains those two assessments in more detail and also covers the FVOCI option for equity instruments as well as the conditional fair value option for debt instruments.



2.1 Contractual cash flow characteristics test

In order for a financial asset to qualify for amortised cost or FVOCI it needs to give rise to cash flows that are 'solely payments of principal and interest' on the principal amount outstanding.¹ This assessment is colloquially referred to as the SPPI test. It is performed at an instrument level.

For the purposes of applying the SPPI test, 'the principal' is described as 'the fair value of the financial asset at initial recognition' and may change over the life of the financial asset, as there are repayments of principal and/or unwinding of any premium or discount on acquisition.² The use of principal in this sense also addresses how financial assets that are issued at below market conditions are treated. For an instrument that is issued with a below market rate (e.g., an interest-free loan from a subsidiary to its parent), the effective interest rate is

¹ See paragraphs IFRS 9.4.1.2(b) and 4.1.2A(b).

² See paragraph IFRS 9.4.1.4(a).

Interest is the return on a basic lending arrangement to the holder, which generally includes consideration for the time value of money and credit risk.

imputed using a comparable market rate of interest. This results in a fair value at initial recognition, and hence a principal, that is below the amount of cash transferred.³

The standard describes 'interest' as the return on a basic lending arrangement to the holder, which generally includes consideration for the time value of money, credit risk, liquidity risk, a profit margin and consideration for costs associated with holding the financial asset over time (such as servicing costs). The standard states that, in extreme economic circumstances, interest can be negative⁴ if an entity pays, in effect, a fee for the safekeeping of its money for a particular period and that fee exceeds the consideration for the time value of money, credit risk and other basic lending risks and costs.

Many instruments have features that do not represent payments of principal and interest, e.g., a conversion option into shares of the issuer, a link to a commodity price or leverage. The standard makes it clear that such features are disregarded only if they are non-genuine (i.e., extremely rare, highly abnormal, and very unlikely to occur) or *de minimis* (which is not defined in the standard but a dictionary definition is that the magnitude of the impact is too trivial or minor to merit consideration).⁵ In all other cases, such instruments would fail the test and would be measured at fair value through profit or loss, irrespective of the business model. This means that all derivatives and equity instruments are classified and measured at FVTPL by default as they fail the SPPI test (also see 2.3 below).

The time value of money component of interest represents just the consideration for the passage of time.⁶ The standard addresses features that modify the time value of money, such as any mismatch between interest rate reset periods and tenors, average or lagging interest rates. It states that an instrument will fail the SPPI test if the resulting undiscounted contractual cash flows could be 'significantly different' from the undiscounted cash flows of a benchmark instrument that does not have such features⁷.

The standard states that an entity must measure trade receivables at their transaction price (as defined in IFRS 15 *Revenue from Contracts with Customers*) if the trade receivables do not contain a significant financing component in accordance with IFRS 15 (or when the entity applies the practical expedient in accordance with paragraph 63 of IFRS 15).⁸ This means that the principal is deemed to be the amount resulting from a transaction in the scope of IFRS 15 (or IAS 18 *Revenue*). It follows that the effective interest rate is deemed to be zero.

³ In case of a loan for a subsidiary to its parent, following the economic substance of the transaction, the difference between the fair value at initial recognition and the cash transferred is likely accounted for as a distribution.

⁴ See paragraph IFRS 9.B4.1.7A.

⁵ See paragraph IFRS 9.B4.1.18.

⁶ See paragraphs IFRS 9.4.1.4(b) and B4.17A.

⁷ See paragraphs IFRS 9.B4.19C-9E and also refer to [Applying IFRS - Classification of financial instruments under IFRS 9](#) (May 2015) for a more detailed discussion on modifications to the time value of money.

⁸ See paragraph IFRS 9.5.1.3.

For a current account, which is repayable on demand, an argument can be made in theory that the contractual period is not zero but just a very short period. That is because it may take a few hours or even a day until the cash is transferred from the account. Following this argument, an effective interest rate would need to be imputed and the current account initially recognised at a discount. However, in practice, the interest element is often deemed to be zero because of the very short contractual period and the current account is recognised at its contractual paramount.

There are also financial assets that contain contractual provisions that change the timing or amount of contractual cash flows (other than a modification of the time value of money). A common example is a loan with a variable interest rate. Such a rate would meet the SPPI condition if it represents consideration for the time value of money, the credit risk associated with the principal amount outstanding during a particular period of time and other basic lending risks and costs as well as a profit margin. Although the rate varies, the credit spread may be determined at initial recognition only, and so may be fixed.

The presence of a prepayment option for an asset that is issued at a premium or discount could potentially prevent the asset from passing the SPPI test.

Other examples are assets that may be prepaid before maturity or whose term might be extended by the issuer or the holder. Assets with prepayment options generally meet the SPPI test if the prepayment amount substantially represents the unpaid amount of principal (as defined, above) and accrued (but unpaid) contractual interest. The presence of an at par prepayment option could potentially prevent an asset from passing the SPPI test if that asset was acquired at a significant premium or discount. That is because, on prepayment, the lender would realise a gain or loss that is not part of a basic lending return. However, the standard allows the asset to pass the SPPI test if the fair value of the prepayment feature on initial recognition of the financial asset was insignificant.⁹ For an asset with an extension option, the contractual cash flows that could arise over the extension period need to be solely payments of principal and interest on the principal amount outstanding. Both prepayment and extension options may include reasonable compensation for early termination or extension.¹⁰

The SPPI test should be applied to an entire financial asset, even if it contains an embedded derivative. Consequently, in contrast to the requirements of IAS 39, a derivative embedded within a hybrid (combined) contract containing a financial asset host is not accounted for separately.

Illustration 2-2 shows how the criteria above are applied to the various financial instruments held by Choco. The illustration only includes financial assets as the new classification model for financial assets does not apply to financial liabilities.

⁹ See paragraphs IFRS 9.B4.1.11(b) and B4.1.12.

¹⁰ See paragraphs IFRS 9.B4.1.11-12.

Illustration 2-2 – The SPPI test applied to Choco

Investment in equity instruments	Equity instruments fail the SPPI test because the cash flows resulting from such instruments do not represent payments of principal and interest on the principal outstanding.
Investment in debt instruments	As the government and corporate bonds are plain vanilla and give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, they meet the SPPI test.
Loan to parent company	<p>The fact that the loan to the parent earns no interest does not mean that it fails the SPPI test. For the purpose of the SPPI test, the fair value at initial recognition is considered 'the principal' for the SPPI test. Unchanged from the requirements of IAS 39 and IFRS 13 <i>Fair Value Measurement</i>, the fair value of a loan that carries no interest is measured as the present value of all future cash receipts, discounted using the prevailing market rate of interest for a similar instrument (similar to currency, term, type of interest rate and other factors) with a similar credit rating. In this example that rate is assumed to be 6%, which results in a present value on initial recognition of CU747,258 for a five-year loan of CU1,000,000.¹¹</p> <p>The fair value at initial recognition is the basis on which an entity calculates the effective interest rate (EIR). This means that, although the loan pays no coupon, Choco still recognises interest revenue at the effective interest rate. The imputed interest is considered compensation for the time value of money, credit risk and other risks and costs under a basic lending arrangement.</p> <p>In this example, neither the borrower nor the lender has a prepayment option. A prepayment option could result in the instrument failing the SPPI test as it is, in effect, issued at a discount.</p> <p>The balance of the cash paid when the loan was first made would normally be accounted for either as an investment in a subsidiary (if made by a parent), or as a distribution (if made by a subsidiary).</p>
Trade receivables	<p>The principal is deemed to be the amount resulting from a transaction in the scope of IFRS 15 or IAS 18.</p> <p>Choco determines that the trade receivables do not include a significant financing component and, hence, there is no interest or put another way, Choco deems the interest element to be zero.</p>

¹¹ Following the economic substance of the transaction, the difference between CU747,258 and CU1,000,000 is considered a distribution from the subsidiary to the parent.

Illustration 2-2 – The SPPI test applied to Choco (cont'd)

	The trade receivables of Choco only involve a single cash flow – the payment of the amount resulting from a transaction in the scope of IFRS 15 or IAS 18, which is deemed to be the principal, as stated above. Therefore, the cash flows resulting from the receivables meet the SPPI test of payments of principal and interest despite the interest component being zero.
Cash and cash equivalents	Because of the short term nature of the instrument, Choco recognises the current account at its contractual par amount. Similar to trade receivables, the current account involves one single cash flow which is the repayment of the principal. Therefore, the cash flows resulting from the receivables meet the SPPI test of payments of principal and interest despite the interest component being zero.
Derivatives	Derivatives fail the SPPI test. They include considerable leverage which is a non-SPPI feature. ¹²

2.2 Business model assessment

In addition to the results from the SPPI test, the classification is dependent on the business model under which the entity holds the financial asset. The standard does not prescribe whether the business model assessment is performed before or after the SPPI test and, depending on an entity's portfolio, it can be more efficient to make the assessment in either order, so as to avoid unnecessary work. An entity's business model for managing financial assets refers to how an entity manages its financial assets in order to generate cash flows. That is, the entity's business model determines whether cash flows will result from collecting contractual cash flows, selling the financial assets or both.

An entity will need to use judgement when it assesses its business model for managing financial assets and the assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment.¹³ A business model is typically observable through particular activities undertaken by the entity to achieve its objective, such as how its performance is evaluated, how its managers are remunerated and how its risks are managed, plus the frequency and magnitude of sales.

There is no concept of 'tainting' as with the IAS 39 held-to-maturity classification.

The assessment is performed based on scenarios that the entity can reasonably expect to occur and is not based on 'worst case' or 'stress case' scenarios. There is also no concept of 'tainting' as with the IAS 39 held-to-maturity classification; if an entity changes the way it manages financial assets over time, it will classify newly originated or newly purchased financial assets under the new business model, but will keep the classification of existing assets under the old business model.

¹² See paragraph IFRS 9.B4.1.9.

¹³ See paragraph IFRS 9.B4.1.2B.

An entity's business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective and is not dependent on management's intentions for an individual instrument. Instead of this assessment being performed on an instrument-by-instrument basis, entities should determine a higher level of aggregation of financial assets for the purposes of the business model assessment. A single entity may have more than one business model for managing its financial instruments and therefore the assessment need not be determined at the reporting entity level.¹⁴

2.2.1 Amortised cost business models

A debt instrument is normally measured at amortised cost if it is held within a business model whose objective is to hold assets in order to collect contractual cash flows, provided it also passes the SPPI test.¹⁵

In determining whether cash flows are going to be realised by collecting the financial assets' contractual cash flows, it is necessary to consider the following: the frequency and value of sales in prior periods; whether the sales were of assets close to maturity; the reasons for those sales; and expectations for future sales activity. However, the standard states that sales, in themselves, do not determine the business model and cannot be considered in isolation. It goes on to say that, instead, information about past sales and expectations for future sales provides evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised. An entity must consider information about past sales in terms of the reasons for the sales and the conditions that existed at that time compared to current conditions.¹⁶

Based on these considerations, an entity needs to determine the predictive value of the past sales for the expectations of future sales. When performing this assessment, the standard makes it clear that it is irrelevant whether a third party (such as a banking regulator in the case of some liquidity portfolios held by banks) imposes the requirement to sell the financial assets, or whether that activity is at the entity's discretion.

How we see it

The standard is slightly cryptic concerning the role of sales. When it states that 'sales in themselves do not determine the business model',¹⁷ the emphasis seems to be on past sales, in our view. Given the guidance in the standard, the magnitude and frequency of sales is important evidence in determining an entity's business models. However, the key point is that the standard requires the consideration of expected future sales while past sales are of relevance only as a source of evidence.

Some financial instruments may be sold in terms of their legal form but not their economic substance. For example, an entity may sell trade receivables as part of a factoring programme and provide a guarantee to the buyer to compensate it for any defaults by the debtors, in which case, it retains substantially all

¹⁴ Refer to *Applying IFRS - Classification of financial instruments under IFRS 9 (May 2015)* for a more detailed discussion on the level at which the business model assessment is performed.

¹⁵ See paragraph IFRS 9.4.1.2.

¹⁶ See paragraph IFRS 9.B4.1.2C.

¹⁷ See paragraph IFRS 9.B4.1.2C.

the risks and rewards of the assets and the financial assets would not be derecognised in line with the requirements of IFRS 9.

The inevitable question that arises in these circumstances is whether these transactions should be regarded as sales when applying the business model assessment. In this context, IFRS 9 contains, in example 3 of paragraph B4.1.4, only one passing reference to derecognition, but it suggests that it is the accounting treatment, and not the legal form of a transaction, that determines whether the entity has ceased to hold an asset to collect contractual cash flows. However, as the IASB did not provide the basis for the treatment in the example quoted above, it is not clear if accounting derecognition should always be the basis for the assessment. We therefore believe that for factoring arrangements an entity has an accounting policy choice of whether it considers the legal form of the sale or the economic substance of the transaction when analysing sales within a portfolio.

Amortised cost financial assets are subsequently measured using the effective interest method and are subject to the impairment requirements in IFRS 9 (see section 3 below). Gains and losses are recognised in profit or loss when the instrument is derecognised or impaired.

2.2.2 FVOCI business models

A debt instrument is normally measured at FVOCI if it is held within a business model in which the assets are managed to achieve a particular objective by both collecting contractual cash flows and selling financial assets, provided it also passes the SPPI test.

According to the IASB, the new FVOCI measurement category is intended for portfolios of debt instruments, for which amortised cost (interest) information, as well as fair value information, is relevant and useful. This will be the case if their performance is affected by both contractual cash flows and the realisation of fair values through sales.¹⁸

For debt financial instruments at FVOCI, interest income, foreign exchange revaluation and impairment losses or reversals are recognised in profit or loss and computed in the same manner as for financial assets measured at amortised cost. The remaining fair value changes are recognised in OCI. Upon derecognition, the cumulative fair value change recognised in OCI is recycled to profit or loss.

The FVOCI category differs from the AFS category in IAS 39 in several respects.

The FVOCI category is in some ways similar to the available-for-sale (AFS) category in IAS 39 but differs from it in several respects. First, the AFS category is essentially a residual classification and an unrestricted election (unless the financial instrument was held for trading, in which case, it would be required to be measured at FVTPL). In contrast, the FVOCI classification under IFRS 9 reflects a business model evidenced by the way a group of financial assets is managed and its performance is reported and is neither a residual nor an election. Second, financial assets measured at FVOCI will be subject to the same impairment model as those measured at amortised cost. Accordingly, although measured at fair value, the profit or loss treatment will be the same as for an amortised cost asset, with the difference between amortised cost and fair value

¹⁸ See paragraph IFRS 9.BCE.24.

recorded in OCI until the asset is derecognised. Third, only relatively simple debt instruments (i.e., debt instruments without features that would fail the SPPI test) will qualify for measurement at FVOCI.

2.2.3 Other business models

IFRS 9 requires financial assets to be measured at FVTPL if they are not held within either a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. A business model that results in measurement at FVTPL is, for example, one where the financial assets are held for trading. Another example is where the assets are managed on a fair value basis. In each case, the entity manages the financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets' fair values and manages the assets to realise those fair values. As consequence, the entity's objective will typically result in active buying and selling.

How we see it

As set out in IFRS 9, FVOCI is a defined category and is neither a residual nor an election. However, in practice, entities may identify those debt instruments that are held to collect contractual cash flows, those that are held for trading, those managed on a fair value basis and those for which the entity applies the fair value option to avoid a measurement mismatch, and then measure the remaining debt instruments at FVOCI. Consequently, the FVOCI category might, in effect, be used as a residual, just because it is far easier to articulate business models that would be classified at amortised cost or at FVTPL.

Illustration 2-3 below applies the business model assessment to the financial assets held by Choco. The illustration only includes those financial assets that have passed the SPPI test as described and shown in section 2.1 above.

Illustration 2-3 – The business model assessment applied to Choco

Investment in debt instruments	The business model is to maintain liquidity for the entity, should the need arise, which leads to sales that are more than infrequent and significant in value. Therefore, the bonds are managed under an objective that results in both collecting the contractual cash flows and selling the bonds. The portfolio of bonds is therefore classified as measured at FVOCI.
Loan to parent company	Choco intends to hold the loan to collect the contractual cash flows. Consequently, this loan is classified as subsequently measured at amortised cost.
Trade receivables	Choco's intention is to hold the receivables to collect the contractual cash flows. Therefore, they are classified as measured at amortised cost.
Cash and cash equivalents	Choco holds the current account in order to collect contractual cash flows. The current account is therefore classified as measured at amortised cost.

2.3 Equity instruments designated at FVOCI

Equity instruments are normally measured at FVTPL unless the entity chooses, on an instrument-by-instrument basis on initial recognition, to present fair value changes in OCI. This option is irrevocable and applies only to equity instruments, which are neither held for trading nor are contingent consideration in a business combination. For the purpose of this election, 'equity instrument' is used as defined in IAS 32 *Financial Instruments: Presentation*. Unlike debt instruments, gains and losses in OCI are not recycled on disposal and there is no impairment accounting. This means, compared to the current AFS accounting under IAS 39, there is no longer a requirement to consider whether or not there is a significant or prolonged decline in the value of the equity instruments. If the fair value of the investment declines, this decrease would merely be recorded as a reduction in equity through OCI.

This option was designed to deal with strategic investments that an entity does not expect to sell, although the standard does not make this a condition for its use. Paragraph 11A of IFRS 7 *Financial Instrument: Disclosures* states that an entity must identify those investments to which it applied the FVOCI option and disclose, among other information, the fair value for each such investment at the end of the reporting period. The standard specifically states that this is required for each such investment, if deemed material. This disclosure requirement may be onerous if an entity makes significant use of the FVOCI option and may act as a disincentive for its use. However, we believe that the concept of materiality will need to be applied, such that the disclosures required are provided separately for investments that are themselves material and aggregated disclosures may suffice for immaterial items.

Although most gains and losses on investments in equity instruments designated at FVOCI will be recognised in OCI, dividends are normally required to be recognised in profit or loss. However, the IASB noted that dividends could represent a return *of* investment, instead of a return *on* investment. Consequently, the IASB decided that dividends that clearly represent a recovery of part of the cost of the investment are not recognised in profit or loss.¹⁹ Determining when a dividend does or does not clearly represent a recovery of cost would require judgement in practice, especially as the standard is silent on this.

It is worthwhile mentioning that there is a difference between IAS 39 and IFRS when measuring unquoted equity instruments. Paragraph 46(c) of IAS 39 allows an entity to measure investments in equity instruments at cost if those instruments do not have a quoted price in an active market and their fair value cannot be reliably measured. Under IFRS 9, there is no such possibility and investments in equities need to be measured at fair value in accordance with IFRS 13. Consequently, we expect that an additional effort will be needed to value such investments. Such valuation could, for example, be based on an EBITDA multiple or some other projected cash flow technique.

¹⁹ See paragraphs IFRS 9.5.7.6 and IFRS 9.BC5.25(a).

Illustration 2-4 below shows some considerations made by Choco when it applies the FVOCI option to its investments in equity instruments.

Illustration 2-4 – The FVOCI option applied to Choco

Investment in equity instruments

Choco's intention in respect of the portfolio of shares is to hold them for a long period as a strategic investment. Therefore, due to the fact that shares are not held for trading, Choco is allowed to elect irrevocably to present gains and losses on these equity investments in OCI. This means that Choco need never assess whether the shares are impaired as it will not be able to record any gains on sale through profit or loss.

If Choco were actively buying and selling the shares with the objective of realising short-term fluctuations in their price, the shares would be held for trading and would be required to be classified and measured at FVTPL.

2.4 Fair value option

Notwithstanding the criteria for debt instruments to be classified at amortised cost or at FVOCI, as described above, an entity may irrevocably designate a debt instrument as measured at fair value through profit or loss on initial recognition. This is allowed if doing so eliminates, or significantly reduces, an accounting mismatch.

The notion of an accounting mismatch involves two propositions. First, that an entity has particular financial assets and liabilities that are measured on different bases; and second, that there is an economic relationship between those assets and liabilities. For example, an entity may enter into an interest rate derivative to manage the interest rate risk of a liability. In the absence of any particular designation, the derivative is measured at fair value through profit or loss and the related liability is measured at amortised cost. In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured at fair value through profit or loss. The fair value option may be useful in instances where the arrangement does not qualify for hedge accounting.

The presence of an accounting mismatch is the only remaining situation in which the fair value option is available for financial assets. This is because financial assets that are managed on a fair value basis and most financial assets with an embedded derivative (that gives rise to cash flows that fail the SPPI test) are required to be measured at FVTPL because of the business model assessment and the SPPI test, respectively. While this limits the scope of the fair value option for financial assets, the scope remains the same for financial liabilities compared to IAS 39.

3. Impairment of financial assets

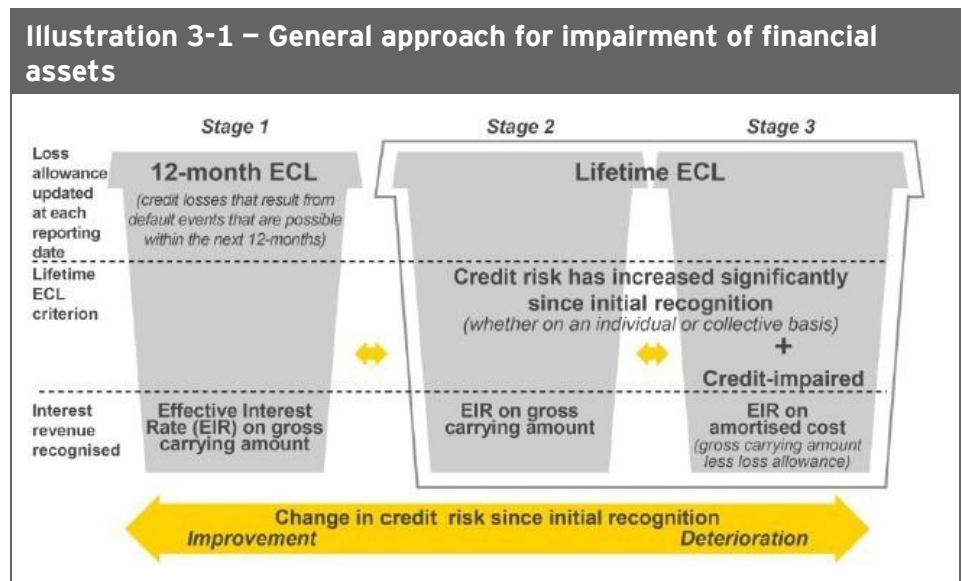
With the introduction of the new impairment model in IFRS 9, the IASB addressed the key concern that the incurred loss model in IAS 39 contributed to the delayed recognition of credit losses which arose as a result of the financial crisis. The new impairment requirements are based on a forward-looking expected credit loss (ECL) model. The model applies to debt instruments measured at amortised cost or at FVOCI, as well as lease receivables, trade receivables, contracts assets (as defined in IFRS 15), and loan commitments and financial guarantee contracts that are not at FVPL.

In applying the IFRS 9 impairment requirements, an entity needs to apply one of the following approaches, which are explained in more detail further below:

- ▶ The general approach, which will be applied to most loans and debt securities
- ▶ The simplified approach, which will be applied to most trade receivables
- ▶ The purchased or originated credit-impaired approach

3.1 General approach

The diagram below summarises the general approach and is discussed further below:



Under the general approach, entities must recognise ECLs in two stages. For credit exposures for which there has not been a significant increase in credit risk since initial recognition (i.e., 'good' exposures), entities are required to provide for credit losses that result from default events 'that are possible' within the next 12-months (a 12-month ECL - Stage 1 in illustration 3-1 above). For those credit exposures for which there has been a significant increase in credit risk since initial recognition, a loss allowance is required for credit losses expected over the remaining life of the exposure, irrespective of the timing of the default (a lifetime ECL - Stages 2 and 3 in illustration 3-1 above). The loss allowance reduces the carrying amount of the financial asset in all three stages described above.

If the financial asset becomes credit-impaired (Stage 3 in Illustration 3-1 above), interest revenue is calculated by applying the EIR to the amortised cost (i.e., the impaired amount net of the loss allowance) rather than the gross carrying amount. This is in contrast to financial assets which are in Stage 1 or 2, for which interest revenue is recognised by applying the EIR on the gross carrying amount. Loss events that indicate that a financial asset is credit-impaired are defined in Appendix A of the standard and are the same as currently used for the impairment assessment under IAS 39. Amongst others, these are, for example, significant financial difficulty of the issuer or the borrower or a default or breach of a covenant.

'Default' is not defined, but there is a rebuttable presumption that default does not occur later than 90 days past due.

The 12-month ECL requirement is the proportion of the lifetime ECLs associated with the probability of default in the next 12 months. It is not, therefore, the cash flows that the entity expects to lose over that period. 'Default', for the purposes of the 12-months ECL and for entry to Stage 3, is not defined. The standard is clear that default is broader than failure to pay and entities would need to consider other qualitative indicators of default (e.g., covenant breaches). There is also a rebuttable presumption that default does not occur later than 90 days past due (DPD).

3.1.1 Assessing significant changes in credit risk

The assessment of a significant increase or decrease in credit risk is key in establishing the point of switching between the requirement to measure an allowance based on 12-month ECLs and one that is based on lifetime ECLs. In general, financial assets should be assessed as having increased significantly in credit risk earlier than when they become credit-impaired or default.

At each reporting date, an entity is required to assess significant increases (and decreases) in credit risk based on the change in the risk of a default occurring over the expected life of the financial instrument rather than the change in the amount of ECLs. This means that the allowance for a fully collateralised asset may need to be based on lifetime ECLs (and disclosed as such) even though no loss is expected to arise.

The IASB noted that it did not intend to prescribe a specific or mechanistic approach to assess changes in credit risk and that the appropriate approach will vary according to the level of sophistication of the entity, the financial instrument and the availability of data.²⁰ It is important to stress that the assessment of significant increases in credit risk often involves a multifactor and holistic analysis. The importance and relevance of each specific factor will depend on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region.²¹ The standard is clear that in certain circumstances, qualitative and non-statistical quantitative information may be sufficient to determine that a financial instrument has met the criterion for the recognition of lifetime ECLs.²² That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, the assessment may be based on quantitative information or a mixture of quantitative and qualitative information.

²⁰ See paragraph IFRS 9.BC5.157.

²¹ See paragraph IFRS 9.B5.5.16.

²² See paragraph IFRS 9.B5.5.18.

The standard provides a non-exhaustive list of factors or indicators which an entity should consider when determining whether the recognition of lifetime ECLs is required.²³ Some of the factors or indicators that may be more relevant to corporates are, as follows:

- ▶ Significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, (e.g. changes in the credit spread that would result if a similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date)
- ▶ An actual or expected significant change in the financial instrument's external or internal credit rating
- ▶ Existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates
- ▶ An actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that result in a significant change in the borrower's ability to meet its debt obligations
- ▶ An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology
- ▶ Significant changes, such as reductions, in financial support from a parent entity, or other affiliate or shareholder, or an actual or expected significant change in the quality of credit enhancement, that are expected to reduce the borrower's economic incentive to make scheduled contractual payments. An example would be if a parent decides to no longer provide financial support to a subsidiary, which as a result would face bankruptcy or receivership. Credit quality enhancements or support include the consideration of the financial condition of the guarantor
- ▶ Expected changes in the loan documentation (i.e., changes in contract terms) including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument
- ▶ Significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group (e.g., an increase in the expected number or extent of delayed contractual payments)
- ▶ Significant changes in the quality of the guarantee provided by a shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion
- ▶ Past due information of debtors

²³ See paragraph IFRS 9.B5.5.17.

The assessment of whether credit risk has significantly increased depends, critically, on an interpretation of the word 'significant'. Judgement is required when assessing whether or not changes in credit risk are significant. What is significant depends on:

- ▶ The original credit risk at initial recognition: a given percentage point change in absolute probability of default (PD) for a financial instrument with a lower initial credit risk will be more significant than for those with a higher initial credit risk.
- ▶ The expected life or term structure: the risk of a default occurring for financial instruments with similar credit risk increases, the longer the expected life of the financial instruments. Due to the relationship between the expected life and the risk of a default occurring, an entity cannot simply compare the absolute risk of a default occurring over time, e.g., if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is the same after five years, then this indicates that the credit risk has increased, as normally the risk of default will reduce as maturity approaches. The standard also states that, for financial instruments that have significant payment obligations close to the maturity of the financial instrument (e.g., those where the principal is only repaid at maturity), the risk of a default occurring may not necessarily decrease as time passes.²⁴ In such cases, an entity needs to consider other qualitative factors.

The low credit risk simplifications allows entities to assume no significant increases in credit risk have occurred if a financial instrument has low credit risk (equivalent to investment grade).

When applying the general approach, a number of operational simplifications and presumptions are available to help entities assess significant increases in credit risk since initial recognition. These include:

- ▶ If a financial instrument has low credit risk (equivalent to investment grade quality), then an entity may assume no significant increases in credit risk have occurred.
- ▶ If forward-looking information (either on an individual or collective basis) is not available, there is a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 DPD.
- ▶ The change in risk of a default occurring in the next 12 months may often be used as an approximation for the change in risk of a default occurring over the remaining life.
- ▶ The assessment may be made on a collective basis or at the level of the counterparty.

The low credit risk simplification may be useful for a non-financial institution as it provides relief for entities from tracking changes in the credit risk of high quality financial instruments. The standard states that a financial instrument is considered to have low credit risk if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily reduce the ability of the borrower to fulfil its contractual cash flow obligations.²⁵ However, collateral does not influence whether a financial instrument has a low credit risk.

²⁴ See paragraph IFRS 9.B5.5.11.

²⁵ See paragraph IFRS 9.5.5.22.

The description of low credit risk is broadly equivalent to what rating agencies define as 'investment grade' quality assets. This is equivalent to or better than a rating of BBB- by Standard & Poor's and Fitch or Baa3 for Moody's. Nevertheless, it is important to emphasise that the default rates provided by external rating agencies are historical information. Entities need to understand the sources of these historical default rates and update the data for current and forward-looking information when measuring ECLs or assessing credit deterioration. Also, although ratings are forward-looking, it is sometimes suggested that changes in credit ratings may not be reflected in a timely manner. Therefore, entities may have to take account of expected change in ratings in assessing whether exposures are low risk.

3.1.3 Measurement and recognition of ECLs

The standard defines credit loss as the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original EIR. It goes on to define ECLs as 'the weighted average of credit losses with the respective risks of a default occurring as the weights'.²⁶ The expected cash flows will include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms.

Lifetime ECLs are the expected credit losses that result from all possible default events over the expected life of a financial instrument. This means that an entity needs to estimate the risk of a default occurring on the financial instrument during its expected life. The 12-month ECLs is defined as a portion of the lifetime ECL that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.²⁷

Financial institutions often already have sophisticated expected loss models and systems for capital adequacy purposes, including data such as the probability of default (PD), loss given default (LGD) and exposure at default (EAD). We do not expect many non-financial entities to have models and systems in place that capture such information. For financial instrument that are rated, for example, listed bonds, an entity may be able to use historical default rates implied by the external credit ratings. Another possibility is the use of credit default swap (CDS) spreads and bond spreads. In addition, an LGD of 60% is commonly assumed for listed corporate bonds.

How we see it

It should be stressed that the historical default rates implied by credit ratings assigned by agencies such as Standard & Poor's, are historical rates for corporate debt and so they would not, without adjustment, satisfy the requirements of the standard. IFRS 9 requires the calculation of ECLs, based on current conditions and forecasts of future conditions, to be based on reasonable and supportable information. A significant challenge in applying the IFRS 9 impairment requirements to quoted bonds is that the historical experience of losses by rating grade can differ significantly from the view of the market, as reflected in, for instance, CDS spreads and bond spreads.

²⁶ See IFRS 9 Appendix A.

²⁷ See IFRS 9 Appendix A, and paragraph B5.5.43.

Measurement of ECLs is even more difficult and judgmental if the financial asset is not rated and no market observable information is available. In that case, the entity would be required to estimate the reasonably possible loss scenarios and the respective probabilities to arrive at an unbiased and probability-weighted amount that reflects the time value of money, based on reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.²⁸

Whichever ECL approach is applied, in measuring ECLs, entities would need to take into account:

- ▶ *The period over which to estimate ECLs:* Entities must consider the maximum contractual period (including extension options of the borrower). However, for revolving credit facilities (e.g., credit cards and overdrafts), this period extends beyond the contractual period, to the period over which the entities are exposed to credit risk and the ECL would not be mitigated by credit risk management actions. This is to be calculated based on historical experience.
- ▶ *Probability-weighted outcomes:* Although entities do not need to identify every possible scenario, they will need to take into account the possibility that a credit loss occurs, no matter how low that possibility is. This is not the same as the most likely outcome or a single best estimate.
- ▶ *The time value of money:* For financial assets, the ECL is discounted to the reporting date using an approximation of the EIR that is determined at initial recognition. For loan commitments and financial guarantee contracts, the EIR of the resulting asset will be applied and if this is not determinable, then the current rate representing the risk of the cash flows is used.
- ▶ *Reasonable and supportable information:* Entities need to consider reasonable and supportable information that is reasonably available as of the reporting date about past events, current conditions and forecasts of future economic conditions. Entities should consider whether estimates of ECLs should be back-tested and re-calibrated to reduce differences between estimates losses and actual losses.

The ECLs in respect of an amortised cost instrument are recognised as a loss allowance against the gross carrying amount of the asset, with the resulting loss being recognised in profit or loss.

For debt instruments measured at FVOCI, the ECLs do not reduce the carrying amount in the statement of financial position, which remains at fair value. Instead, an amount equal to the allowance that would arise if the asset was measured at amortised cost is recognised in OCI as the 'accumulated impairment amount'. This means that impairment losses (or reversals) are charged to profit or loss with a corresponding entry in OCI.

²⁸ See paragraph IFRS 9.5.5.17.

How we see it

For corporates, the use of the ECL model will most likely not lead to a major increase in allowances for most trade receivables because of their short-term nature. Moreover, the standard includes practical expedients, in particular the use of a provision matrix (discussed further at 3.2), which should help in measuring the loss allowance for short-term trade receivables. However, the model may give rise to challenges for the measurement of long-term trade receivables, bank deposits and loans and debt securities that are measured at amortised cost or at FVOCI, e.g., a corporate that has a large portfolio of debt securities that are currently held as available-for-sale under IAS 39, is likely to classify its holdings as measured at FVOCI if they meet the SPPI test and are held under a business model whose objective results in holding the financial assets to collect contractual cash flows and selling the financial assets. For these securities, the corporate would be required to recognise a loss allowance based on 12-month ECLs even for debt securities that are highly rated (e.g., AAA or AA rated bonds).

Illustration 3-2 shows how the general approach is applied to the investments in debt instruments that as (as described in section 2.2 above), are measured at FVOCI.

Illustration 3-2 – The general approach applied to investments in debt instruments measured at FVOCI

Choco needs to apply the general approach to the listed bonds. It needs to determine whether or not there has been a significant increase in credit risk since origination and, hence, whether it should provide for 12-month ECLs or lifetime ECLs.

Even though the bonds are measured at FVOCI, the impairment requirements of IFRS 9 are still applicable, as the change in value attributed to impairment is required to be presented as an impairment loss in profit or loss. As the bonds are externally rated and the current rating indicates a low credit risk, Choco applies the low credit operational simplification as described above.

The following numerical example is adapted from Example 13 of the Implementation Guidance to IFRS 9²⁹ but features one additional period in which it is assumed that the credit risk significantly increases.

Choco purchases bonds with a fair value of CU1,000 on 15 December 20X0 and measures them at FVOCI. The bonds have an interest rate of 5% over the contractual term of 10 years, and a 5% EIR. At initial recognition the entity determines that the asset is not purchased or originated credit-impaired.

Acquisition of the bond

DR Financial asset - FVOCI	CU1,000	
CR Cash		CU1,000

²⁹ See paragraphs IFRS 9.IE78-IE81.

Illustration 3-2 – The general approach applied to investments in debt instruments measured at FVOCI (cont'd)

On 31 December 20X0, (the first reporting date), the fair value of the bond has decreased to CU950 as a result of changes in market interest rates. The bond is rated AA+ by Fitch and by applying the low credit risk simplification, Choco determines that there has not been a significant increase in credit risk since initial recognition and that the ECLs should be measured on a 12-month basis. To calculate the ECLs, Choco applies the implied 12-month PD for a rating of AA+ (assumed to be 2 % in this example) and an LGD of 60%, resulting in a 12-month ECL of CU12. For simplicity, journal entries for interest revenue are not provided.

Recognise fair value decrease through OCI, with the impairment recorded through profit or loss

DR OCI	CU38	
DR Impairment loss	CU12	
	CR Financial asset - FVOCI	CU50

On 31 December 20X1 (the second reporting date), the fair value of the bond has further decreased to CU850 as a result of changes in market interest rates, but also because of uncertainties arising from the exposure of the issuer to adverse business and economic conditions. This exposure has significantly increased the risk of a default occurring on the bond which was evidenced by a drop in the external rating provided by Fitch to BBB- (i.e., below investment grade). Choco has therefore concluded that credit risk has significantly increased. Based on the implied lifetime PD for a BBB- rating (assumed to be 15%) and an LGD of 60%, Choco determines the lifetime expected loss to be CU90.

Recognise fair value decrease through OCI, with the impairment recorded through profit or loss

DR OCI	CU22	
DR Impairment loss	CU78	
	CR Financial asset - FVOCI	CU100

On 1 January 20X2, the Choco decides to sell the bonds for CU850, which is the fair value at that date.

Derecognise the bonds at the date of sale

DR Cash	CU850	
	CR Financial asset - FVOCI	CU850

Recycle cumulative reserve in OCI to profit or loss on disposal of the bonds

DR Loss (profit or loss)	CU60	
	CR OCI	CU60

Illustration 3-3 shows how the general approach is applied to the loan to the parent company that, as described in section 2.2 above, is measured at amortised cost.

Illustration 3-3 –The general approach applied to a loan measured at amortised cost

Choco needs to apply the general approach to the loan to the parent company because it does not fall within the scope of the simplified approach for trade receivables, contract assets and lease receivables.

Choco needs to determine whether or not there has been a significant increase in credit risk since origination of the loan and, hence, whether it needs to provide for 12-month ECLs or lifetime ECLs. At initial recognition (and assuming the loan is not credit-impaired at that time), Choco recognises a loss allowance based on the portion of the lifetime ECLs associated with the PD in the 12 months after the reporting date. If there is a significant increase in credit risk, Choco needs to recognise a loss allowance based on lifetime ECLs.

There is a rebuttable presumption that if a loan is more than 30 days past due, there has been a significant increase in credit risk. As the loan to the parent is interest free, past due information is not available. Choco considers qualitative factors when assessing whether or not there has been a significant increase in credit risk with regards to the loan such as:

- ▶ Adverse forecasts for the parent's operating results, perhaps as a result of the discontinuance of a major segment of the parent
- ▶ Evidence of working capital deficiencies or liquidity problems of the parent
- ▶ Changes in the credit spread of the parent that indicate an increase in credit risk, or if there is a deterioration in the external grading of the issued bonds, (assuming the parent has issued bonds with the same expected life)

Similar to the method applied in illustration 3.2 above, Choco could use PDs implied from ratings, if available, or CDS or bond spreads to help determining whether or not there is a significant increase in credit risk on the loan and to calculate the ECL. If such information is not available, Choco would need to estimate all the required parameters to calculate the ECL based on other reasonable and supportable information. This approach is likely to require the use of judgement.

Cash and cash equivalents, such as current accounts that are classified as financial assets measured at amortised cost, are also subject to the general approach. However, due to the fact that a current account is on demand, 12-month and lifetime expected losses are the same. This means that the expected credit losses will be small. However, being subject to the general approach, an entity would still need to track the credit risk in order to identify significant deterioration as this information is required for disclosure purposes.³⁰

³⁰ Refer to [Applying IFRS - Impairment of financial instruments under IFRS 9](#) (December 2014) - Section 12.3 'Quantitative and qualitative information about amounts arising from expected credit losses' for more detail. Also refer to paper 8 in [Applying IFRS - ITG discusses IFRS 9 impairment issues at December 2015 ITG meeting](#) (December 2015).

3.1.4 Financial guarantee contracts

The general approach also applies to loan commitments and financial guarantee contracts not measured at FVTPL for which impairment was previously accounted for under IAS 37. Entities will now have to provide for either 12-month or lifetime ECLs in accordance with IFRS 9. However, the application of certain key elements of impairment may warrant some further clarification which is provided in the table below:

Illustration 3-4 –The general approach applied to a financial guarantee contract	
Date of initial recognition in applying the impairment requirements	Date that the entity becomes a party to the guarantee.
Period over which to estimate ECLs	The maximum contractual period over which the entity has a present contractual obligation to extend credit.
Cash shortfalls in measuring ECLs	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.
Rate used in discounting ECLs	The current rate representing the risk of the cash flows is used.
Assessment of significant increases in credit risk	The changes in the risk that the specified debtor will default on the contract.

3.2 Simplified approach

The simplified approach does not require the tracking of changes in credit risk, but instead requires the recognition of lifetime ECLs at all times. For trade receivables or contract assets that do not contain a significant financing component, entities are required to apply the simplified approach. For trade receivables or contract assets that do contain a significant financing component, and lease receivables, entities have a policy choice to apply the simplified approach or the general approach.

IFRS 9 allows using a provision matrix as a practical expedient for determining ECLs on trade receivables. Many corporates may already use a provision matrix to calculate their current impairment allowance, but they would need to consider how they can incorporate forward-looking information into their historical customer default rates. Entities would also need to group receivables into various customer segments that have similar loss patterns (e.g. by geography, product type, customer rating or type of collateral).

Illustration 3-5 shows how the simplified approach is applied to trade receivables without a significant financing component.

Illustration 3-5 – The simplified approach applied to trade receivables

Choco concludes that its trade receivables do not include a significant financing component because they are due within 30 days of the invoice date. Hence, Choco would need to apply the simplified approach and recognise lifetime ECLs on the trade receivables. Choco applies the provision matrix as a practical expedient to calculate ECLs under the simplified approach.

Example 12 of IFRS 9 has been adapted to Choco's situation:³¹

Choco has a portfolio of trade receivables of CU30 million as at 31 December 20X1 and operates only in one geographical region. The customer base consists of a large number of clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms.

The provision matrix is based on Choco's historical observed default rates and is adjusted for forward-looking estimates. At every reporting date, the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case, it is forecast that economic conditions, for example, the gross domestic product, will deteriorate over the next year leading to an increased number of defaults in the retail sector. It should be noted that the assessment of the correlation between unemployment and ECLs and the size of the effect is likely to be very judgmental.

The trade receivables from the large number of small customers amount to CU30 million and are measured using the provision matrix.

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

In determining lifetime ECLs for trade receivables without a significant financing component, the time value of money will not need to be considered as it is insignificant. The ECLs will therefore not need to be discounted or, if discounted, it would be a rate of 0%.

3.3 Originated credit impaired financial assets

In respect of financial assets that are considered to be credit-impaired on acquisition or origination, the EIR is calculated taking into account the initial lifetime ECLs in the estimated cash flows, resulting in a credit adjusted EIR.

³¹ See paragraphs IFRS 9.IE74-IE77

This means that the resulting fair value at initial recognition already takes into account lifetime expected losses and there is no additional 12-month ECL allowance. Indicators of whether an asset is credit-impaired on acquisition or origination are the same as for stage 3. At each reporting date, the entity updates its estimated cash flows and adjusts the loss allowance accordingly.

3.4 Impairment disclosures

The impairment disclosures have been expanded significantly in comparison to the existing disclosures required under IFRS 7. The objective of the new disclosures is to enable users to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

The disclosures should provide:

- ▶ Information about the entity's credit risk management practices and how they relate to the recognition and measurement of ECLs, including the methods, assumptions and information used to measure those losses.³²
- ▶ Quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from ECLs, including changes in the amount of those losses and the reasons for those changes.³³
- ▶ Information about the entity's credit risk exposure, i.e., the credit risk inherent in its financial assets and commitments to extend credit, including significant credit risk concentrations.³⁴

The credit risk disclosure requirements have been expanded significantly as a result of IFRS 9.

How we see it

It is critical for entities to align their credit risk management and financial reporting systems and processes, not only to estimate the loss allowance for ECLs, but also to produce sufficiently detailed information to meet the new disclosure requirements in IFRS 7.

The credit risk disclosure requirements are less onerous than what was proposed in the 2013 Exposure Draft. Nevertheless, they have been expanded significantly when compared to those currently in IFRS 7 and are supplemented by some detailed implementation guidance. The new credit risk disclosure requirements will enable users of financial statements to understand better an entity's credit risk management practices, its credit risk exposures, expected credit losses estimates and changes in credit risks. In order to meet this objective, an entity will need to disclose both quantitative and qualitative information that includes the following:

- ▶ Inputs, assumptions and estimation used (and any changes) to determine significant increases in credit risk of financial instruments, including the application of the low credit risk and more than 30 days past due operational simplifications

³² Refer to *Applying IFRS - Impairment of financial instruments under IFRS 9* (December 2014) - Section 12.2 'Credit risk management practices' for more detail.

³³ Refer to *Applying IFRS - Impairment of financial instruments under IFRS 9* (December 2014) - Section 12.3 'Quantitative and qualitative information about amounts arising from expected credit losses' for more detail.

³⁴ Refer to *Applying IFRS - Impairment of financial instruments under IFRS 9* (December 2014) - Section 12.4 'Credit risk exposure' for more detail.

- ▶ Inputs, assumptions and techniques used (and any changes) in measuring 12-month and lifetime ECLs, including the definition of default and the incorporation of forward-looking information
- ▶ How the financial instruments were grouped if the measurement of expected credit losses was performed on a collective basis
- ▶ How collateral and other credit enhancements affect the estimate of expected credit losses, including a description of the nature and quality of collateral held and quantitative information about the collateral for financial assets that are credit-impaired
- ▶ A reconciliation of the opening and closing balance of the loss allowance and explanations of the changes. This disclosure is required to be shown separately for:
 - ▶ Financial instruments that are measured using 12-month ECLs
 - ▶ Those that are measured using lifetime ECLs; financial assets that are credit-impaired on initial recognition
 - ▶ Those that are subsequently credit-impaired
 - ▶ Trade receivables, contract assets and lease receivables measured under the simplified approach
- ▶ Explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance
- ▶ Inputs, assumptions and techniques used (and any changes) to determine whether a financial asset is credit-impaired
- ▶ Qualitative and quantitative disclosures for financial assets that have been modified
- ▶ Qualitative and quantitative disclosures on the entity's credit risk exposure and significant credit risk concentrations
- ▶ The write-off policy and amounts written off during the period that are still subject to enforcement activity

An entity will need to determine how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements, the appropriate level of aggregation or disaggregation and additional explanations or information necessary to evaluate the quantitative information disclosed and meet the above objectives.

Illustration 3-6 below shows how Choco could disclose the reconciliation of the loss allowance. The reconciliation needs to be provided for each class of financial assets. The illustration below uses the example of investment in corporate debt instruments:

Illustration 3-6 – Reconciliation of the loss allowance

Loss allowance on investments in corporate debt instruments	12-month ECLs	Lifetime ECLs - not credit-impaired financial assets	Lifetime ECLs - credit-impaired financial assets	Lifetime ECLs - simplified approach applied to trade receivables, contract assets and lease receivables	Purchased or originated credit impaired financial assets	Total
As at 1 January 2018 ⁽⁵⁾ :	56.3	247.4	36.7	n/a ⁽⁴⁾	3.4	343.8
Exchange and other adjustments ⁽³⁾	2.4	9.3	1.8	n/a	(0.7)	12.8
Amounts written off	(2.8)	(9.6)	(13.5)	n/a	(1.2)	(27.1)
Unwinding of Discount ⁽¹⁾	0.5	7.4	1.7	n/a	0.1	9.7
New financial assets originated or purchased ⁽¹⁾	12.7	-	-	n/a	-	12.7
Transfers ⁽¹⁾						
▶ to 12-month ECLs	4.3	(12.7)	(0.4)	n/a	-	(8.8)
▶ to Lifetime ECLs - not credit-impaired financial assets	(5.2)	22.8	(3.4)	n/a	-	14.2
▶ to Lifetime ECLs - credit-impaired financial assets	(2.4)	(14.7)	23.3	n/a	-	6.2
Financial assets derecognised during period (not written off) i.e., repayments, modifications, sales, etc. ⁽²⁾	(14.6)	(23.8)	(2.4)	n/a	(3.7)	(44.5)
Changes in models/risk parameters ⁽¹⁾	3.4	8.1	2.7	n/a	1.6	15.8
As at 31 December 2018	54.6	234.2	46.5	n/a	(0.5)	334.8

(1) Charge to profit or loss. The amount relating to the unwinding of discount will be recorded in the impairment charge for columns one, two and four, but will be an implicit reduction in interest revenue for columns three and five.³⁵

Note that for the transfers, the amounts differ by column, as the figures in columns two, three and four are lifetime ECLs and those in column one are only 12-month ECLs. The net effect across the columns will be the net impact on profit or loss.

It will also be apparent that the numbers shown in the table will depend on the order in which these various items are applied, e.g., whether the transfers between columns are calculated before the changes in risk parameters. Similarly, while we have shown a 'nil' number for columns two and three for new assets recognised in the period, strictly there could be something to record, if impairment is only assessed at the end of the period; an asset may have already significantly increased in credit risk before it is first assessed for impairment, in which case, it would not be transferred from column one.

(2) None of these amounts will be reflected in the impairment charge in profit or loss. Any difference between the amortised cost and the consideration received on derecognition is recorded in profit or loss and would be presented in the new mandatory line 'gains and losses arising from the derecognition of financial assets measured at amortised cost'.

(3) Part of this amount may be recorded in profit or loss as FX revaluation and part through OCI if it relates to the retranslation of an overseas subsidiary.

(4) The simplified approach does not apply to investments in debt instruments.

(5) For illustrative purposes, only one period is presented. However, after the year of initial application, entities need to disclose this information also for comparative periods."

³⁵ Refer to [Applying IFRS - ITG discusses IFRS 9 impairment issues at December 2015 ITG meeting](#) (December 2015) paper 9 for more details on the Measurement of the loss allowance for credit-impaired financial assets

4. Hedge accounting

Hedge accounting under IAS 39 is often criticised as being complex and rules-based, ultimately not reflecting an entity's risk management activities. Consequently, the objective of IFRS 9 is to reflect the effect of an entity's risk management activities in the financial statements. This includes replacing some of the arbitrary rules with more principles-based requirements and allowing more hedging instruments and hedged items to qualify for hedge accounting. Overall, this should result in more risk management strategies qualifying for hedge accounting and provide a better link between an entity's risk management strategy, the rationale for hedging and the impact of hedging on the financial statements.

Summary of the key changes:

- ▶ Hedge effectiveness testing is prospective only and can be qualitative depending on the complexity of the hedge. The 80-125% range is replaced by an objectives-based test that focuses on the economic relationship between the hedged item and the hedging instrument, and the effect of credit risk on that economic relationship.
- ▶ IFRS 9 allows risk components of non-financial items to be designated as the hedged item, provided the risk component is separately identifiable and reliably measureable. Under IAS 39, this was only possible for financial items or when hedging foreign exchange risk.
- ▶ IFRS 9 introduces the concept of costs of hedging. The time value of an option, the forward element of a forward contract and any foreign currency basis spread can be excluded from the designation of a financial instrument as the hedging instrument and accounted for as costs of hedging. This means that, instead of the fair value changes of these elements affecting profit or loss like a trading instrument, these amounts are allocated to profit or loss similar to transaction costs (which can include basis adjustments), while fair value changes are temporarily recognised in OCI.
- ▶ More designations of groups of items as the hedged item are possible, including layer designations and some net positions.

IFRS 9 introduces more extensive disclosure requirements that are intended to provide more relevant information.

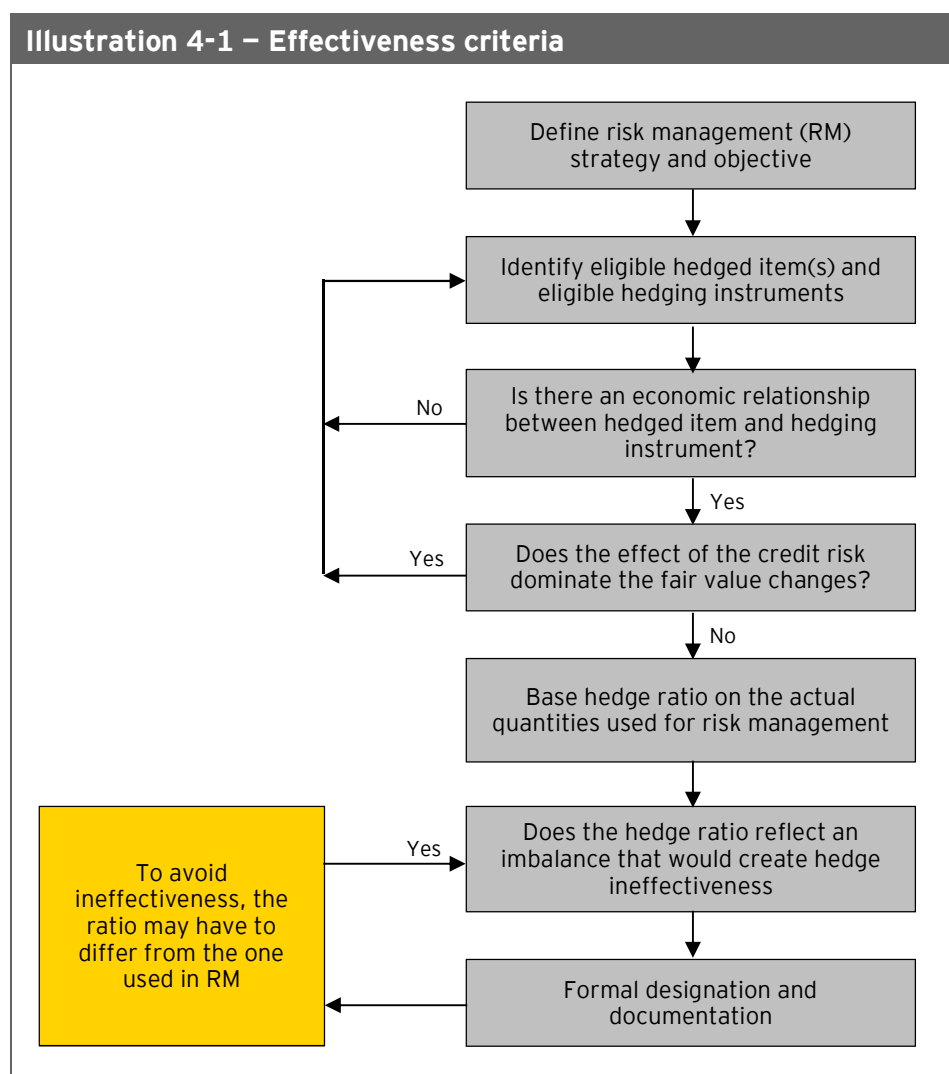
Most of the basics of hedge accounting do not change as a result of IFRS 9. Hedge accounting remains optional and there are still three types of hedging relationships: fair value hedges, cash flow hedges, and hedges of net investments in foreign operations. However, IFRS 9 is stricter than IAS 39 when it comes to the accounting for the amount accumulated in the hedging reserve. The treatment depends on the nature of the underlying hedged transaction. If the hedged transaction results in the recognition of a non-financial asset/liability, then the amount in OCI is required to be treated as a basis adjustment to the recognised non-financial asset/liability. In all other circumstances, the OCI will be reclassified to profit or loss as the hedged cash flows affect profit or loss.

Instead of going into the details of the hedge accounting requirements, this section focuses on, and provides examples for, those differences between

hedge accounting under IAS 39 and IFRS 9 that may be of more relevance to non-financial entities.³⁶

4.1 Qualifying criteria

The required steps for designating a hedging relationship can be summarised in a flow chart, as follows:



IFRS 9 distinguishes between the risk management strategy and the risk management objective:

- The risk management strategy is established at the level at which the entity decides how it manages risk and identifies the risks to which it is exposed and whether and how the risk management activities should address those risks, e.g., a risk management strategy could identify changes in interest rates of loans as a risk and define a specific target range for the fixed to floating rate ratio for those loans. The strategy is typically maintained for a relatively long period of time. However, it may include some flexibility to react to changes in circumstances.

³⁶ Refer to *Applying IFRS - Hedge Accounting under IFRS 9* (February 2014) for more details.

- ▶ The risk management objective, on the contrary, is set at the level of an individual hedging relationship and defines how a particular hedging instrument is designated to hedge a particular hedged item. For example, this would define how a specific interest rate swap is used to 'convert' a specific fixed rate liability into a floating rate liability. Hence, a risk management strategy would usually be supported by many risk management objectives.

Understanding the difference between the risk management strategy and the risk management objective is critical. If there is a change in a risk management objective or, if the entity no longer pursues that objective, then the entity would have to discontinue applying hedge accounting for hedging relationship designated under that risk management objective. Consequentially, if there is no change in the risk management objective, the entity is not allowed to voluntarily discontinue hedge accounting.

Unchanged from IAS 39, to qualify for hedge accounting, a hedging relationship has to consist of eligible hedging instruments and eligible hedged items. However, there are some changes in IFRS 9 in terms of what are considered to be eligible hedged items (an example of which - the designation of a non-financial risk component - is discussed in section 4.3. below).

At inception of the hedging relationship there still has to be formal designation and documentation (including how the entity's risk management objective underlying the hedging relationship fits within the overall risk management strategy). The documentation has to include an identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (this includes the documentation of the hedge ratio and potential sources of ineffectiveness).

Under IFRS 9, a hedging relationship qualifies for hedge accounting if it meets both of the following effectiveness requirements:

- ▶ There is 'an economic relationship' between the hedged item and the hedging instrument.
- ▶ The effect of credit risk does not 'dominate the value changes' that result from that economic relationship.

The hedge ratio of the hedging relationship is the same as that resulting from the quantity of 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. However, that designation must not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.³⁷ IFRS 9 further clarifies that an accounting outcome that would be inconsistent with the purpose of hedge accounting as the result of failing to adjust the hedge ratio for risk management purposes, would not meet the qualifying criteria for hedge accounting. This anti-abuse provision was introduced because the IASB was specifically concerned with deliberate under-hedging. This means that an entity cannot deliberately

³⁷ See paragraph IFRS 9.6.4.1(c).

under-or over-hedge in order to minimise ineffectiveness in cash flow hedges or to create additional fair value adjustments to the hedged item in fair value hedges, respectively.³⁸

4.1.1 Economic relationship

The hedging instrument and hedged item must, based on an economic rationale, be expected to move in opposite directions as a result of a change in the hedged risk. A statistical correlation may provide corroboration of an economic relationship, but is not, in itself, solely determinative (as correlation does not in itself imply causality). To make this determination, both quantitative and qualitative factors should be considered. The assessment should also include an analysis of the possible behaviour of the hedging relationship during its term, to ascertain whether it can be expected to meet the risk management objective. We would expect it to be rare for an entity to enter into a hedge for economic purposes where there would not be an economic relationship.

4.1.2 Impact of credit risk

Credit risk can arise on both the hedging instrument and the hedged item in the form of the counterparty's credit risk or the entity's own credit risk. In order to achieve hedge accounting, credit risk should not dominate the value changes of either the hedged item or the hedging instrument.

An example of credit risk dominating a hedging relationship would be when an entity hedges an exposure to commodity price risk with an uncollateralised derivative and the credit standing of the counterparty to that derivative deteriorates severely. In this case the effect of the changes in the counterparty's credit standing might outweigh the effect of changes in the commodity price on the fair value of the hedging instrument.³⁹

Collateralisation of the hedged and hedging instruments significantly reduces the credit risk for both parties involved, so that credit risk is unlikely to dominate the change in their fair value.

How we see it

The standard does not define 'dominate' and entities need to apply judgement when this rather high threshold, in our view, is reached. In practice, risk managers would normally seek other ways to hedge an exposure before credit risk dominates the value changes that result from the economic relationship.

4.1.3 Setting the hedge ratio

The hedge ratio is the ratio between the amount of hedged item and the amount of hedging instrument. Risk managers will generally set the hedge ratio to maximise the effectiveness of the hedge and, because the hedged item and hedging instrument will not necessarily share the same sensitivity to movements in the underlying risk, the hedge ratio will not necessarily be 1:1. (This difference in sensitivity is referred to as basis risk). The hedge ratio used for accounting purposes should normally be the same as that used for risk

³⁸ Refer to [Applying IFRS - Hedge accounting under IFRS 9](#) (February 2014) - Illustrative Example 22 and 23 for more detail.

³⁹ See paragraph IFRS 9.B6.4.8.

management purposes, although the amount of the hedging instrument that is used for economic purposes need not be the same as that designated for accounting purposes (e.g., if an entity has a copper price exposure of 97 tons of copper which it entirely hedges for risk management purposes using 100 tons of copper futures contracts, it might choose to apply hedge accounting to only 90 tons, but if so, it would designate only 92.8 tons of futures ($90/97$ of 100).

Rebalancing under IFRS 9 allows entities to refine their hedge ratio without discontinuation and redesignation and, in doing so, reduces this source of recorded ineffectiveness.

4.2 Rebalancing the hedge ratio

The newly introduced concept of rebalancing comprises only changes to the hedge ratio to reflect expected changes in the relationship between the hedged item and the hedging instrument. Any other changes made to the quantities of the hedged item or hedging instrument would not be rebalancing. Therefore, rebalancing is only relevant if there is basis risk between the hedged item and the hedging instrument. It only affects the expected relative sensitivity between the hedged item and the hedging instrument going forward, as ineffectiveness from past changes in the sensitivity will have already been recognised in profit or loss.

An entity would also have to discontinue hedge accounting if it turns out that there is no longer an economic relationship (e.g., the abandonment of a currency peg). This makes sense, as whether there is an economic relationship is a matter of fact that cannot be altered by adjusting the hedge ratio. The same is true for the impact of credit risk; if credit risk is now dominating the hedging relationship, then the entity has to discontinue hedge accounting.

But the hedge ratio may need to be adjusted if it turns out that the hedged item and hedging instrument do not move in relation to each other as expected. The entity has to assess whether it expects this to continue to be the case going forward. If so, the entity is likely to rebalance the hedge ratio to reflect the change in the expected relationship. Rebalancing under IFRS 9 allows entities to refine their hedge ratio without discontinuation and redesignation and, in doing so, reduces this source of recorded ineffectiveness.

Entities are not required to rebalance for every change in basis risk such that the optimal ratio is designated at all times. Quite often, ineffectiveness results from fluctuations around an otherwise relatively stable hedge ratio. Some entities might want to adjust the hedge, while others may want to continue monitoring for developments. It is, of course, sometimes difficult to say whether something is really a change in trend or just further oscillation around the same trend - judgement is required.

To sum up, what matters is what is done for risk management purposes. So only when rebalancing takes place for risk management purposes, would it normally apply to the accounting treatment.

Rebalancing can be achieved by:

- ▶ Increasing or decreasing the volume of the hedged item
- Or
- ▶ Increasing or decreasing the volume of the hedging instrument

The required steps for assessment and rebalancing are summarised in illustration 4-2:

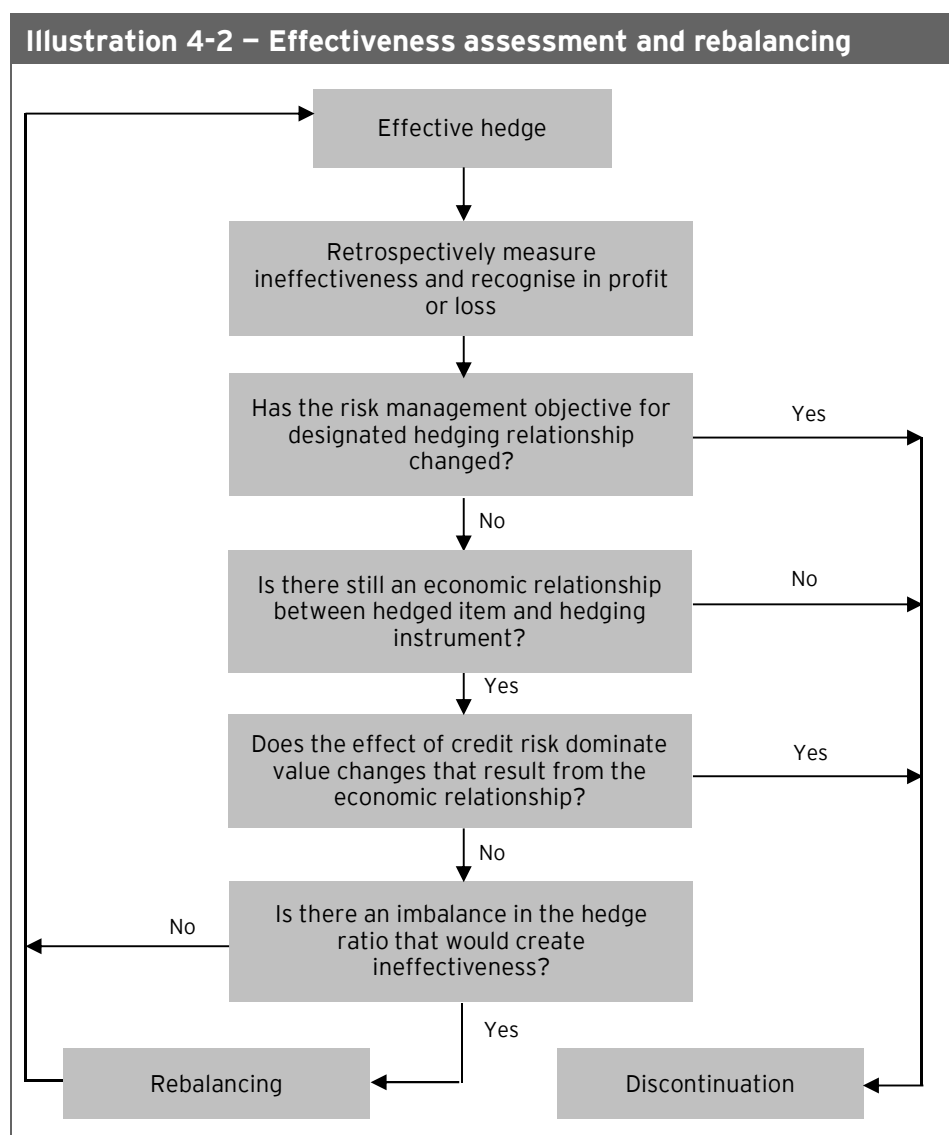


Illustration 4-3 applies the concept of rebalancing to Choco.

Illustration 4-3 – Rebalancing applied to Choco

At 1 January 20x1, Choco expects to purchase 200 tonnes of cocoa in three months' time and hedges the price risk by entering into cocoa futures. However, as there are some quality differences between the cocoa purchased and the cocoa benchmark, there is basis risk involved. Choco runs a regression analysis between the cocoa market price and the cocoa future price and determines a ratio of 1.05:1. To avoid ineffectiveness due to basis risk, Choco designates futures contracts of 210 tonnes of cocoa in a cash flow hedge to hedge the highly probable forecast purchase of 200 tonnes of cocoa.

As at 31 March 20x1, the cumulative change in fair value of the hedged item is CU600 (gain), while the cumulative change in fair value of the hedging instrument is CU760 (loss).

Illustration 4-3 – Rebalancing applied to Choco (cont'd)

Choco would account for the hedging relationship, as follows:

DR Hedging loss - OCI	CU600	
DR Hedging ineffectiveness - profit or loss	CU160	
CR Derivatives - hedging instruments		CU760

Under the requirements of IAS 39, the hedging relationship would not be considered highly effective (it is 127% effective, which is just outside the permitted 80%-125% range). But under IFRS 9, hedge accounting does not 'fail'.

The treasurer of Choco is very sensitive to ineffectiveness and also believes that in this instance the ineffectiveness is an indication that the hedge ratio no longer appropriately reflects the relationship between the hedging instrument and the hedged item. Therefore, the treasurer rebalances the hedging relationship (by adjusting the hedge ratio). Going forward, the treasurer expects a different relationship between the two prices and decides to rebalance the hedge ratio to 0.95:1.

To rebalance at 31 March 20x1, the treasurer can either increase the volume of hedged items (i.e. the highly probable cocoa purchases) or close out part of the hedging instrument. Given that the highly probable cocoa purchases are fixed according to Choco's usage requirements, Choco decides to do the latter, that is, reducing the hedging instrument by an equivalent of 20 tonnes of cocoa.

Of the total of 210 tonnes of cocoa futures, 20 tonnes with associated losses of CU72 are no longer part of the hedging relationship as they are closed out.

Choco accounts for the rebalancing as follows:

DR Derivatives - hedging instruments	CU72	
CR Cash		CU72

As the hedged forecast transaction will result in the recognition of a non-financial asset (i.e., the cocoa), Choco will be required to remove the cash flow hedge reserve and include it directly in the initial cost of the asset.⁴⁰ This will be not be accounted for as a reclassification adjustment (as contemplated in IAS 1 *Presentation of Financial Statements*) and hence will not affect OCI.

4.3 Risk components

Under IAS 39, a non-financial item could only be designated as the hedged item for its foreign currency risk or all its risks in their entirety, although there was no such restriction for financial items. This resulted in many risk management activities not qualifying for hedge accounting under IAS 39.

However, IFRS 9 permits the designation of a risk component of a non-financial item as the hedged item in a hedging relationship, provided the risk component is separately identifiable and reliably measurable. This is likely to enable many more common risk management strategies to qualify for hedge accounting and will result in less ineffectiveness recorded in profit or loss. Managing a specific risk component reflects that hedging all risks is often not needed, or is not economical, or not possible (because of a lack of suitable hedging instruments). Therefore, corporates may think of reconsidering their current hedge

The risk component of a non-financial item may be designated in a hedge relationship if it is separately identifiable and reliably measurable.

⁴⁰ See paragraph IFRS 9.6.5.11(d)(i).

relationships and risk management strategies in order to benefit from the new hedging requirements of IFRS 9.

Purchase or sale contracts sometimes contain clauses that link the contract price via a specified formula to a benchmark price of a commodity, but not all contracts define the various pricing elements and, therefore, specify risk components. IFRS 9 does not require the risk component to be contractually specified in order to be eligible for hedge accounting. In such cases, the assessment as to whether a risk component is separately identifiable and reliably measurable has to be made 'within the context of the particular market structure to which the risk or risks relate and in which the hedging activity takes place. Such a determination requires an evaluation of the relevant facts and circumstances, which differ by risk and market'.⁴¹

The assessment of whether a risk component qualifies for hedge accounting is mainly driven by an analysis of whether there are different pricing factors that have a distinguishable effect on the item as a whole (in terms of its value or its cash flows). This evaluation would always have to be based on relevant facts and circumstances.

The standard uses the refinement of crude oil to jet fuel as an example to demonstrate how the assessment of the market structure could be made to conclude that crude oil is an eligible risk component of jet fuel. Crude oil is a physical input of the most common production process for jet fuel and there is a well-established price relationship between the two.

Extending this example, crude oil is also a major input in the production process for plastic. However, the manufacturing process is complex and involves a number of steps. The process starts with crude oil being distilled into its separate 'fractions', of which only one (naphtha) is used for making plastic. Naphtha then undergoes a number of further processes before the various types of plastic are finally produced.

Generally, the further downstream in the production process an item is, the more difficult it is to find a distinguishable effect of any single pricing factor. The mere fact that a commodity is a major physical input in a production process does not automatically translate into a separately identifiable effect on the price of the item as a whole. For example, crude oil price changes are unlikely to have a distinguishable effect on the retail price of plastic toys even though, in the longer term, changes in the crude oil price might influence the price of such toys to some degree. Similarly, the price for pasta at food retailers in the medium to long term also responds to changes in the price for wheat, but there is no distinguishable direct effect of wheat price changes on the retail price for pasta, which remains unchanged for longer periods even though the wheat price changes. If retail prices are periodically adjusted in a way that also directionally reflects the effect of wheat price changes, that is not sufficient to constitute a separately identifiable risk component.

⁴¹ See paragraph IFRS 9.B6.3.9.

How we see it

Allowing non-contractually specified risk components as eligible hedged items opens up a new area of judgement. The assessment of the market structure will normally require the involvement of personnel with a good understanding of the drivers of market prices (e.g., members of the sales or procurement departments responsible for the underlying transactions).

Illustration 4-4 below shows how Choco might apply the ability to designate risk components of a non-financial hedged item. This differs from the fact pattern in illustration 4-3, in which Choco designates the entire hedged item.

Illustration 4-4 – Designation of a non-financial risk component

Choco purchases cocoa from its supplier at a price that is linked to the cocoa benchmark price and, in part, to transportation charges that include a diesel price indexation. The purchase contracts are also adjusted to a quality coefficient that is reset annually for a crop period.

Choco intends to hedge itself against price changes related to the benchmark cocoa price, but does not want to hedge the price variability resulting from the diesel costs and the quality coefficient. Therefore, Choco enters into cocoa futures contracts whereby it purchases cocoa for the relevant delivery months. For each relevant delivery month, Choco designates the futures contracts as a hedging instrument in a cash flow hedge of the benchmark cocoa price risk component of the future cocoa purchases under its supply contract.

In this case, the risk component is contractually specified by the pricing formula in the supply contract. This means it is separately identifiable, because the entity knows exactly which part of the change in the future purchase price of cocoa under its particular supply contract results from changes in the benchmark price for cocoa and which part of the price change results from changes in the diesel index. The risk component can also be reliably measured using the price in the futures market for the relevant delivery months as inputs for calculating the present value of the cumulative change in the hedged cash flows.

4.4 Aggregated exposures

Entities often purchase or sell items (in particular, commodities) that expose them to more than one type of risk, e.g., price risk and foreign currency risk. When hedging those risk exposures, entities do not always hedge each risk for the same time period.

Illustration 4-5 below describes a common fact pattern.

Illustration 4-5 – Aggregated exposures

Choco is expecting to purchase cocoa in 12 months. The cocoa price is fluctuating and is denominated in foreign currency (FC) for Choco. It is therefore exposed to two main risks: the cocoa price risk, and the foreign exchange risk.

Choco first decides to hedge the cocoa price fluctuation risk using a cocoa futures contract. By doing so, Choco now has a fixed-price cocoa purchase denominated in a foreign currency and is therefore still exposed to foreign exchange risk.⁴²

Three months later, Choco decides to hedge the foreign exchange risk by entering into a foreign exchange forward contract to buy a fixed amount of FC in nine months. By doing so, the entity is hedging the aggregated exposure, which is the combination of the original exposure to variability of the cocoa price and the cocoa futures contract.

Applying IAS 39 to the fact pattern above, the entity has two choices:

- ▶ Discontinue the first hedging relationship (i.e., the cocoa price risk hedge) and re-designate a new relationship with joint designation of the cocoa futures contract and the foreign exchange forward contract as the hedging instrument. This is likely to lead to some 'accounting' hedge ineffectiveness, as the cocoa futures contract will now have a non-zero fair value on designation of the new relationship.
- ▶ Maintain the cocoa price risk hedge and designate the foreign exchange forward contract in a second relationship as a hedge of the variable FC cocoa price. Even if the other IAS 39 requirements could be met, this means that the volume of hedged item is constantly changing as the variable cocoa price is hedged for foreign exchange risk, which will likely have an impact on the effectiveness of the hedging relationship.

IFRS 9 expands the range of eligible hedged items by including aggregated exposures that are a combination of an exposure that could qualify as a hedged item and a derivative.

Consequently, in the scenario described in illustration 4-5 above, Choco could designate a foreign exchange forward contract in a cash flow hedge of the combination of the original exposure and the cocoa futures contract (i.e., the aggregated exposure) leaving the first hedging relationship intact. Therefore, it would no longer be necessary to discontinue and re-designate the first hedging relationship.

4.5 Accounting for the costs of hedging

Currently under IAS 39, entities can designate the intrinsic value of an option or the spot element of a forward contract. When doing so, the changes in fair value of the time value of the option or the forward points of the forward contract are accounted for in profit or loss. This was criticised by many constituents as they see the time value or forward points as an unavoidable cost of hedging that

⁴² In this example, we assume there is no 'basis risk' between the cocoa price exposures in the expected purchase and the futures contract, such as the effect of quality and the location of delivery.

IFRS 9 allows entities to 'add-on' a risk exposure to an existing hedge resulting in an aggregated exposure being hedged, without affecting the initial hedging relationship.

should be accounted for accordingly. In response to these concerns, the IFRS 9 hedging model contains a new accounting requirement, in which only the intrinsic value or the spot element is designated in the hedge relationship. To the extent that it relates to the hedged item, the fluctuation in the fair value of the time value is first recorded in OCI instead of profit or loss. The subsequent treatment depends on the nature of the hedged transaction. IFRS 9 differentiates between transaction related hedged items and time-period related hedged items:⁴³

- ▶ *Transaction related hedged item*: the time value of an option or the forward points of a forward contract have the character of part of the cost of the transaction. An example would be a hedge of a forecast commodity purchase. The amount that is accumulated in OCI is removed similarly to amounts accumulated in the cash flow hedge reserve, i.e. if the hedged transaction subsequently results in the recognition of a non-financial item, the amount becomes a 'basis adjustment', otherwise the amount is reclassified to profit or loss in the same period, or periods, during which the hedged cash flows affect profit or loss.
- ▶ *Time-period related hedged item*: the time value of an option or the forward points of a forward have the character of the cost of protection against a risk over a particular period of time. An example would be a hedge of commodity inventory over a six-month period. The amount that is accumulated in OCI is amortised on a systematic and rational basis to profit or loss as a reclassification adjustment. The amortisation period is the period during which the hedge adjustment for the intrinsic value of the option or the spot element of the forward could affect profit or loss (or OCI if the option is designated as a hedge of an equity instrument accounted for at FVOCI).

This means that the distinction between transaction-related hedged items and time-period related hedged items reflects how the accounting for the hedged item will eventually affect profit or loss.

This new treatment is mandatory for the time value of options, but may also be applied to the forward points of forwards or to foreign currency basis spreads.

It is important to note that because this accounting for 'costs of hedging' only applies if the time value of the option is excluded from the designation of the hedging relationship, the amounts deferred in accumulated OCI are not part of the cash flow hedge reserve but are, instead, a different component of equity. The cash flow hedge reserve only includes amounts that are gains or losses on hedging instruments that are determined to be an effective hedge (i.e., amounts that are included in the designation of a hedging relationship). By default, the time value will be zero at expiry of an option contract. For a transaction-related hedged item, recognising the fair value changes of the time value in OCI means that, on expiry, the time value that existed at designation will have accumulated in OCI. Once the hedged transaction happens, the accounting for the accumulated time value follows the accounting for any changes in fair value of the intrinsic value of the option (that were also accumulated in OCI).⁴⁴

⁴³ See paragraphs IFRS 9.6.5.15 and B6.5.29.

⁴⁴ See paragraph IFRS 9.6.5.15.

Illustration 4-6 – Hedging the purchase of a machine (transaction related)

In the first quarter of a year, a Choco plans to purchase a new machine for its manufacturing process. Delivery of the machine is expected in the third quarter and the purchase price will be FC5m. Choco is exposed to foreign currency risk on this forecast transaction and buys a call option to purchase FC 5m, as it wishes to hedge the downside risk only. The terms of the option match the terms of the forecast transaction. The entity designates only the intrinsic value of the call option in a cash flow hedge of the highly probable forecast purchase of the machine.

At inception, the time value of the option amounts to CU30,000. After inception, the time value of the option amounts to CU16,000 at the end of the first quarter, CU7,000 at the end of the second quarter and zero at maturity.

Applying the IFRS 9 accounting requirements to the time value of the option results in the following movement within OCI and the reserve within equity for accumulating amounts in relation to the time value of options associated with transaction related hedged items:

(All amounts in CU thousands)	Q1	Q2	Q3
Reserve at beginning of quarter	–	(14)	(23)
Change in time value of option	(14)	(9)	(7)
Basis adjustment to machine	–	–	30
Reserve at end of quarter	(14)	(23)	–

For time-period related hedged items, the standard does not prescribe what 'on a systematic and rational basis' means in the context of amortising the time value from OCI to profit or loss. A straight-line amortisation is likely to be appropriate in most cases, in our view.

Illustration 4-7– Hedging interest rate risk of a bond (time period related)

Choco issued fixed rate debt. As it expects declining interest rates in the next two years and wants to participate in that effect, it purchases an interest option with a maturity of two years. Only the intrinsic value of the cap is designated as a hedging instrument in a fair value hedge.

The time value on designation is CU20, which is amortised to profit or loss on a straight-line basis over the protection period (i.e., the first two years). After inception, the time value of the option amounts to CU13 at the end of the first year.

Applying the IFRS 9 accounting requirements to the time value of the option results in the following movement within OCI and the reserve within equity for accumulating amounts in relation to the time value of options associated with time-period related hedged items:

	Year 1	Year 2
Reserve at beginning of year	–	3
Change in time value of option	(7)	(13)
Amortisation of time value at inception	10	10
Reserve at end of year	3	–
Effect on OCI for the year	3	(3)
Effect on profit or loss for the year	(10)	(10)

The accounting for the time value of options would also apply to combinations of options, for example, when hedging a highly probable forecast transaction with a zero-cost collar. When designating the intrinsic value only, the volatility resulting from changes in the time values of the two options would be recognised in OCI. However, the amortisation (in the case of time-period related hedged items) or the transaction costs deferred at the end of the life of the hedging relationship (for transaction related hedged items) would be nil when using a zero-cost collar.⁴⁵

4.6 Own use contracts

Applying hedge accounting for own use contracts can be administratively burdensome. Therefore, entities may elect to use the fair value option.

Many commodity purchase and sale contracts meet the criteria for net settlement in cash because the commodities are readily convertible to cash and would be accounted for similar to financial derivatives. However, such contracts are excluded from the scope of IFRS 9 if they were entered into, and continue to be held, for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the 'own use' scope exception. Own use contracts are accounted for as normal sales or purchase contracts (i.e., executory contracts), with the idea that any fair value change in the contract is not relevant given the contract is for the entity's own use. An own use contract would only be accounted for in the case that it becomes onerous, in which case the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* would apply.

If an entity enters into a derivative to hedge risks arising from such own use contracts, the own use exception creates an accounting mismatch because the fair value change of the derivative used for risk management purposes cannot be offset against fair value changes of the own use contract.

To eliminate this accounting mismatch, current IFRS only provide the possibility to apply hedge accounting by designating an own use contract (which meets the definition of a firm commitment) as the hedged item in a fair value hedge. However, hedge accounting in these circumstances may be administratively burdensome as a result of having to comply with hedge accounting documentation requirements as well as monitoring the hedge effectiveness. Furthermore, entities enter into large volumes of commodity contracts and, within the large volume of contracts, some positions may offset each other. An entity would therefore typically hedge on a net basis.⁴⁶

IFRS 9 introduced a fair value option for own use contracts. At inception of a contract, an entity may make an irrevocable designation to measure an own use contract at FVTPL (the fair value option). However, such designation is only allowed if it eliminates or significantly reduces an accounting mismatch. On initial application of IFRS 9, an entity may designate own use contracts that exist at that date as measured at FVTPL, but only if it designated all similar contracts.⁴⁷

⁴⁵ See paragraph IFRS 9.B6.5.31.

⁴⁶ See paragraph IFRS 9.BC22.19.BC22.24.

⁴⁷ See paragraph IFRS 9.7.2.14A.

Illustration 4-8 – Own use contracts

Assuming a different set of facts in comparison to those in illustration 4-3 and illustration 4-4 above, Choco has entered into cocoa futures contracts in order to hedge the risk of purchase contracts entered into to acquire cocoa required for production. The futures contracts are settled net in cash and would be classified as financial derivatives under IFRS 9. The purchase contracts would be excluded from the scope of IFRS 9 as they are entered into for the purpose of the receipt of a non-financial item (cocoa) in accordance with Choco's expected purchase requirements. The purchase contracts would therefore be considered to be executory contracts. These would only be accounted for as the seller of the cocoa performs its obligation and delivers the cocoa unless the contracts are considered onerous, in which case the requirements of IAS 37 would apply.

Under IFRS 9, the own use contract may be designated as at FVTPL. This would ensure that there wouldn't be a mismatch between the accounting of the futures contracts at FVTPL (the risk management activity) and the underlying economically hedged item (the purchase contracts).

The following examples illustrate the accounting if:

- ▶ Scenario A: the fair value option is not used
- ▶ Scenario B: the fair value option is used

There would be a third scenario in which Choco would apply hedge accounting. However, the basic hedge accounting mechanics are already covered in illustration 4-3.

At 1 January 20x1, Choco enters into a contract to purchase 100 tonnes of cocoa in 6 months' time for CU6,000 which is the forward price at that date. At the same time, Choco enters into a futures contract to sell 100 tonnes of cocoa for CU6,000 to economically hedge this purchase.

As at 31 March 20x1, the forward price for cocoa rose to CU6,500 per tonne. The cumulative change in fair value of the purchase contract is CU500 (gain), while the cumulative change in fair value of the futures contract is assumed to be CU480 (loss).

As at 30 June 20x1, the spot price for cocoa is CU6,710 per tonne. The cumulative fair value change of the purchase contract since 1 January 20x1 is CU710), while the cumulative fair value change of the futures contract is CU700 (loss).

The futures contract is settled daily in cash.

Scenario A

Choco has not elected to designate the purchase contract at fair value through profit or loss. The purchase contract is accounted for as an executory contract.

The journal entries that Choco would process at 31 March 20x1 would be the following:

DR Fair value loss on futures contract	CU480	
		CR Bank
		CU480

Recognition of the fair value of the futures derivative contract through profit or loss

Illustration 4-8 – Own use contracts (cont'd)

The journal entries that Choco would process at 30 June 20x1 would be the following:

DR Fair value loss on futures contract	CU220	
CR Bank		CU220

Recognition of the fair value of the futures derivative contract through profit or loss

DR Cocoa inventory	CU6,000	
CR Bank		CU6,000

Acquisition of cocoa inventory

Scenario B

Choco has elected to designate the purchase contract at FVTPL as it significantly reduces an accounting mismatch. The accounting mismatch arises due to the futures contracts being measured at FVTPL, whilst the own-use contract would normally be treated as an executory contract.

The journal entries that Choco would process at 31 March 20x1 would be the following:

DR Own-use purchase contract	CU500	
CR Fair value gain on own-use contract		CU500

Recognition of the fair value of the own-use contract through profit or loss

DR Fair value loss on futures contract	CU480	
CR Bank		CU480

Recognition of the fair value of the futures derivative contract through profit or loss

The journal entries that Choco would process at 30 June 20x1 would be the following:

DR Own-use purchase contract	CU210	
CR Fair value gain on own-use contract		CU210

Recognition of the fair value of the own-use contract through profit or loss

DR Fair value loss on futures contract	CU220	
CR Bank		CU220

Recognition of the fair value of the futures derivative contract through profit or loss

DR Cocoa inventory	CU6,710	
CR Bank		CU6,000
CR Own-use purchase contract		CU710

Acquisition of cocoa inventory

4.7 Hedge accounting disclosures

Many constituents, users in particular, have asked for improved disclosures that link more clearly an entity's risk management activities and how it applies hedge accounting. Linking the two requires an understanding of an entity's risk management strategy, which is why the IASB has introduced a requirement for a much more detailed qualitative description of the risk management strategy of

the entity. These disclosures of risk management strategies will, however, only be required where hedge accounting is applied.

The objective of the new hedge accounting disclosures is that entities must disclose information about:

- ▶ The risk management strategy and how it is applied to manage risks⁴⁸
- ▶ How the risk management activities may affect the amount, timing and uncertainty of future cash flows⁴⁹
- ▶ The effect that hedge accounting has had on the statement of financial position, the statement of comprehensive income and the statement of changes in equity⁵⁰

In applying this objective, an entity has to consider the necessary level of detail, the balance between different disclosure requirements, the appropriate level of disaggregation and whether additional explanations are necessary to meet the objective.

The hedge accounting disclosures should be presented in a single note or a separate section of the financial statements. An entity may include information by cross-referencing to information presented elsewhere, such as a risk report, provided that information is available to users of the financial statements on the same terms as the financial statements and at the same time.

4.7.1 Risk management strategy

The risk management strategy has to be described by type of risk, and this description must include how each risk arises and how, and to what extent, the risk is managed. This description must also include whether the entity hedges only a part of the risk exposure, such as a nominal component or selected contractual cash flows. To satisfy this requirement, an entity must disclose:

- ▶ The hedging instruments and how they are used to hedge the risk exposure
- ▶ Why the entity believes there is an economic relationship between the hedged item and the hedging instrument
- ▶ How the hedge ratio is determined
- ▶ The expected sources of ineffectiveness

When only a component of a risk exposure is hedged, an entity must also disclose how it determined the component and how the component relates to the item in its entirety. In our view, this would include a description of whether the risk component is contractually specified and, if not, how the entity determined that the non-contractually specified risk component is separately identifiable and reliably measurable.

Illustration 4-7 provides an illustration of how Choco could meet the disclosure requirements related to its risk management strategy. The example uses the same assumption as Illustration 4-4.

⁴⁸ Refer to *Applying IFRS - Hedge accounting under IFRS 9* (February 2014) - Section 9.2 'Risk management strategy' for more detail.

⁴⁹ Refer to *Applying IFRS - Hedge accounting under IFRS 9* (February 2014) - Section 9.3 'The amount, timing and uncertainty of future cash flows' for more detail.

⁵⁰ Refer to *Applying IFRS - Hedge accounting under IFRS 9* (February 2014) - Section 9.4 'The effects of hedge accounting on the financial position and performance' for more detail.

The new disclosures include a requirement for a much more detailed qualitative description of the risk management strategy of the entity, but only where hedge accounting is applied.

Illustration 4-9 – Illustrative disclosure of risk management strategy for commodity price risk

Cocoa price risk

Fluctuations in the cocoa price are the main source of market risk for Choco. Choco purchases cocoa from various suppliers in a certain specified quality. For this purpose, Choco enters into long-term contracts (for between 1 and 3 years) with its suppliers, in which the future cocoa price is indexed to the benchmark cocoa price, adjusted for transport cost that are indexed to diesel prices plus a quality coefficient that is reset annually for a crop period. In order to secure the volume of cocoa needed, supply contracts are always entered into (or renewed) at least one year prior to harvest.

Choco forecasts the monthly volume of expected cocoa purchases for a period of 18 months and manages the cocoa price risk exposure on a 12-month rolling basis. For this purpose, it enters into futures contracts on the benchmark price and designates the futures contracts in cash flow hedges of the cocoa benchmark price risk component of its future cocoa purchases. Some of those purchases are committed minimum volumes under the contracts and some purchases are highly probable forecast transactions (i.e., quantities in excess of the minimum purchase volumes or for periods for which no contract has yet been entered into). The underlying risk of the cocoa futures contracts is identical to the hedged risk component (i.e., the cocoa benchmark price). Therefore, Choco has established a hedge ratio of 1:1 for all its hedging relationships. The benchmark price risk component is contractually specified in its purchase contracts. As such, Choco considers the risk component to be separately identifiable and reliably measurable, based on the price of cocoa futures.

Choco does not hedge its exposure to the variability in the purchase price of cocoa that results from the annual reset of the quality coefficient, because hedging that risk would require highly bespoke financial instruments that, in Choco's view, are not economical.

The exposure of Choco to the variability in the purchase price of cocoa that results from the diesel price indexation of the transport costs is integrated into its general risk management of logistics costs that aggregates exposures resulting from various logistics processes of Choco.

Choco determines the cocoa benchmark price risk component that it designates as the hedged item on the basis of the pricing formula in its cocoa supply contracts (see the above description). That benchmark component is the largest pricing element. The quality coefficient depends on the particular crop in the region from which Choco sources its cocoa, depending mainly on weather conditions that affect size and quality of the crop. Sometimes pest and plant diseases can have similar effects. Over the last 10 crop periods, the quality coefficient ranged between CU0.02 and CU0.27 per pound (lb). For the effect of the diesel price indexation, refer to the section 'Logistics costs management' in the Risk Management Report that is included in this Annual Report.

More information about how Choco manages its risk, including the extent to which Choco hedges the hedging instruments used and sources of ineffectiveness, is provided in the Risk Management Report (see section called 'Commodity Price Risk Management').

The risk management strategy disclosures are an important cornerstone of the new hedge accounting model, as they provide the link between an entity's risk management activities and how they affect the financial statements. The notes should also disclose the key judgements the entity has used in applying the new hedge accounting model, including those used to determine whether an economic relationship exists between the hedged item and the hedging instrument, how the hedge ratio was set and how risk components were identified, just to mention a few.

Disclosures have to be made by type of risk, rather than the type of hedging relationship (e.g., cash flow hedge or fair value hedge). This should enable users to follow the various disclosures by type of risk, resulting in a much better understanding of the hedging activities and their impact on the financial statements.

4.7.2 The amount, timing and uncertainty of future cash flows

For most hedge relationships, quantitative information should be disclosed by risk category that allows the evaluation of the terms and conditions of the hedging instruments and how they affect the amount, timing and uncertainty of future cash flows. This should include a breakdown disclosing the profile of the timing of the hedging instrument's nominal amount and, if applicable, its average price or rate (e.g., strike or forward prices). However, different information should be given where a dynamic hedging process is used.

For all hedges, a description of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term should be disclosed by risk category. If other sources of hedge ineffectiveness emerge in a hedging relationship, those sources should be disclosed by risk category along with an explanation of the resulting hedge ineffectiveness.

For cash flow hedges, a description of any forecast transaction for which hedge accounting had been used in the previous period, but which is no longer expected to occur, should be disclosed.

Illustration 4-8 is an example of how Choco might provide information of the profile of the timing of the hedging instrument's nominal amount and its average price.

Illustration 4-10 – Illustrative disclosure of timing, nominal amount and average price of cocoa futures contracts

As of 31 December 20x0, Choco holds the following cocoa futures contracts to hedge the exposure on its cocoa purchases over the next twelve months:

	Month of maturity					Total
	Jan	Feb	Mar	...	Dec	
Notional amount (in tonnes)	1,275	1,425	1,350	...	1,200	16,275
Average hedged rate (in thousand CU per tonne)	1.22	1.25	1.28	...	1.39	1.33

4.7.3 The effects of hedge accounting on the financial position and performance

IFRS 7 sets out a specific requirement to disclose the effect hedge accounting has on the entity's financial position and performance. All disclosures are required in a tabular format and by type of risk.

Instead of reproducing the specific requirements of IFRS 7, we provide examples below of how those disclosures might look applied to Choco:

Illustration 4-11 – Illustrative disclosure of the effects of hedge accounting on the financial position and performance

The impact of hedging instruments designated in hedging relationships as of 31 December 20x0 on the statement of financial position of Choco is, as follows (values are in CU1 million unless otherwise specified):

Cash flow hedges	Notional amount	Carrying amount	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Cocoa price risk			Short-term derivative financial liabilities	
Cocoa futures	16,275 tonnes	(4.5)		(1.0)
FX risk			Short-term derivative financial assets	
Option to buy FC	FC 5m	0.5		0.1

Fair value hedges	Notional amount	Carrying amount	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Interest rate option	10	0.5	Long-term derivative financial assets	0.1

The impact of hedged items designated in hedging relationships as of 31 December 20x0 on the statement of financial position of Choco is, as follows:

Cash flow hedges	Change in value used for measuring ineffectiveness	Cash flow hedge reserve
Cocoa price risk		
Cocoa purchases	1.0	4.5
FX risk		
Forecast machine purchase	(0.09)	(0.47)

Fair value hedges	Carrying amount	Thereof accumulated fair value adjustments	Line item in the statement of financial position	Change in fair value used for measuring ineffectiveness for the period
Interest rate risk				
Fixed rate borrowings	(10.51)	(0.51)	Long-term borrowings	(0.11)

Illustration 4-11 – Illustrative disclosure of the effects of hedge accounting on the financial position and performance (cont'd)

The above hedging relationships affected profit or loss and other comprehensive income, as follows:

Cash flow hedges	Hedging gain or loss recognised in OCI	Ineffectiveness recognised in profit or loss	Line item in the statement of profit or loss	Amount reclassified from OCI to profit or loss	Line item in the statement of profit or loss
Cocoa price risk					
Hedges of forecast cocoa purchases	(1.0)	-	-	-	-
FX risk					
Forecast machine purchase	0.09	0.01	Foreign currency translation	0.05	Foreign currency translation
Fair value hedges					
Interest rate risk					
Hedge of fixed rate borrowings			0.01	Other financial expenses	

IFRS 7 further requires a reconciliation of the components in equity that arise in connection with hedge accounting (such as the hedging reserve) and an analysis of OCI. That information needs to be disaggregated by risk category, which can be done in the notes.

5. Effective date and transition

5.1 Effective date

IFRS 9 is effective for annual periods beginning on or after 1 January 2018. Entities are permitted to apply the standard earlier, although if they do, this fact should be disclosed and all of the requirements (including the classification and measurement, impairment and hedge accounting requirements) in the standard must be applied at the same time.

5.2 Transition (retrospective application)

IFRS 9 contains a general requirement that it should be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, the standard does specify a number of exceptions.

An entity may elect to early adopt only the new accounting treatment of fair value gains and losses arising from own credit risk on liabilities designated at FVTPL without applying the other requirements of IFRS 9.

IFRS 9 requires prospective application of the hedge accounting requirements except for those for the cost of hedging, which need to be applied retrospectively.⁵¹ The standard grants an exception to restating comparatives for classification and measurement and impairment but not for hedge accounting.⁵² This means that comparative periods need to be restated for the effect of retrospectively applying the costs of hedging requirements if those are applied, even if an entity chooses not to restate for the effect of applying the classification and measurement and impairment requirements of IFRS 9.

An entity does not need to restate comparatives, but would instead adjust the opening retained earnings in the year of initial application.

5.2.1 Classification and measurement

The business model assessment must be based on the facts and circumstances that exist at the date of initial application, while the cash flow characteristics need to be considered based on those that existed at the date of initial recognition of the financial asset and not at the date of initial application. The resulting classification must be applied retrospectively.

5.2.2 Impairment

At the date of initial application, an entity must use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that a financial instrument was initially recognised (or for loan commitments and financial guarantee contracts at the date that the entity became a party to the irrevocable commitment) and compare that to the credit risk at the date of initial application of IFRS 9.

An entity may consider internal and external information, including information used for collective assessment and information about similar products or peer group experience for comparable financial instruments. When determining whether there have been significant increases in credit risk since initial recognition, an entity is not required to undertake an exhaustive search for information.

If an entity is unable to determine whether there have been significant increases in credit risk since initial recognition without undue cost or effort, then the entity must recognise a loss allowance based on lifetime ECLs at each reporting date until the financial instrument is derecognised. However, if at subsequent reporting dates, the entity is able to determine that the financial instrument has low credit risk at the reporting date, then it would recognise a loss allowance based only on 12-month ECLs.

5.2.3 Hedge accounting

An entity may choose to apply the hedge accounting requirements of IAS 39 or IFRS 9. This policy choice however must be applied to all hedging relationships. This policy choice exists due to the fact that the IASB's project on accounting for dynamic risk management has not been finalised. Therefore, in an effort to reduce the complexity that may arise with adopting various parts of hedge accounting at different stages, the IASB has permitted this policy choice until such time as the macro hedge accounting is finalised. This choice is unlikely to be relevant for most corporates.

⁵¹ See paragraphs IFRS 9.7.2.21 and 7.2.26.

⁵² See paragraphs IFRS 9.7.2.15 and 7.7.2.15.

Hedge accounting in accordance with IFRS 9 applies prospectively, with some limited exceptions.

A hedging relationship can only be designated on a prospective basis, in order to avoid the use of hindsight. An entity may only apply the new hedge accounting requirements to a hedging relationship if all the IFRS 9 qualifying criteria are met. Many preparers will already be applying hedge accounting under IAS 39 before transitioning to IFRS 9. For such entities, the standard clarifies that hedging relationships under IAS 39 which also qualify for hedge accounting under IFRS 9, are treated as continuing hedges. Hedge accounting under IAS 39 ceases in the moment when hedge accounting under IFRS 9 starts. As a result, there are no accounting entries on transition. However, entities might have to rebalance their hedges on transition to fulfil the new effectiveness requirements under IFRS 9, in which case, any resulting gain or loss must be recognised in profit or loss.

The exceptions to prospective application of the new standard apply to: the new accounting treatment for the time value of options (when only the intrinsic value is designated), for the forward element of forward contracts when only the spot element is designated), and for the foreign currency basis spread of financial instruments, if that is excluded from the designation as the hedging instrument.

5.2.4 Transition disclosures

When IFRS 9 is first applied, IFRS 7 requires an entity to provide the disclosures that are mentioned further below. These disclosures should be provided, irrespective of whether comparatives are restated (see 5.2 above). The following information should be disclosed in a table, unless another format is more appropriate, for each class of financial assets and financial liabilities at the date of initial application:

- ▶ The original measurement category and carrying amount determined in accordance with IAS 39
- ▶ The new measurement category and carrying amount determined in accordance with IFRS 9
- ▶ The amount of any financial assets and financial liabilities that were previously designated as measured at FVTPL but are no longer so designated, distinguishing between those that are required to be reclassified and those which an entity elects to reclassify

An entity should also disclose qualitative information to provide an understanding of how the classification requirements in IFRS 9 were applied to those financial assets whose classification has changed as a result of applying IFRS 9 and the reasons for any designation or de-designation of financial assets or financial liabilities as measured at FVTPL.

For instruments that are reclassified such that they are no longer measured at FVTPL, but at amortised cost or, for financial assets, at FVOCI, an entity needs to disclose the instrument's fair value, fair value gains or losses that would have been recognised if the instrument was measured at FVTPL, the effective interest rate as well as the interest revenue or expense recognised. If an entity treats the fair value of a financial asset or a financial liability as its amortised cost at the date of initial application, the effective interest rate as well as the interest revenue and expense need to be disclosed for each reporting period

following reclassification until derecognition. Otherwise, this disclosure need only be made for the annual period in which the entity initially applies IFRS 9.

These disclosures, together with other information in the financial statements, must permit reconciliation as at the date of initial application between the measurement categories presented in accordance with IAS 39 and IFRS 9, and the class of financial instrument.

Further, information should be disclosed that permits the reconciliation as at the date of initial application of the ending impairment allowances in accordance with IAS 39 and the provisions in accordance with IAS 37 to the opening loss allowances determined in accordance with IFRS 9. For financial assets, this disclosure should be provided in the related financial assets' measurement categories in accordance with IAS 39 and IFRS 9 and show separately the effect of the changes in the measurement category on the loss allowance at that date.

If, at the date of initial application of IFRS 9, it is impracticable (as defined in IAS 8) to assess a modified time value of money element or whether the fair value of a prepayment feature was insignificant, based on the facts and circumstances that existed at the initial recognition of the financial asset, the contractual cash flow characteristics of that asset should be based on the facts and circumstances that existed at that time, without taking into account the requirements related to the modification of the time value of money or the exception for prepayment features as appropriate. The carrying amount of the financial assets whose contractual cash flow characteristics have been assessed in this way should be disclosed, separately for each of the two situations above, at each reporting date until those financial assets are derecognised.

About EY

The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About EY's International Financial Reporting Standards Group

A global set of accounting standards provides the global economy with one measure to assess and compare the performance of companies. For companies applying or transitioning to International Financial Reporting Standards (IFRS), authoritative and timely guidance is essential as the standards continue to change. The impact stretches beyond accounting and reporting, to key business decisions you make. We have developed extensive global resources – people and knowledge – to support our clients applying IFRS and to help our client teams. Because we understand that you need a tailored service as much as consistent methodologies, we work to give you the benefit of our deep subject matter knowledge, our broad sector experience and the latest insights from our work worldwide.

© 2016 EYGM Limited.
All Rights Reserved.

EYG No. AU3724

ED None

ey.com