



IFRS IN PRACTICE 2016

IFRS 9 *Financial Instruments*

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1. INTRODUCTION

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

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

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

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

Classification and measurement of financial assets

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

- i. Elimination of the 'held to maturity' category
- ii. Elimination of the 'available-for-sale' category
- iii. Elimination of the requirement to separately account for (i.e. bifurcate) embedded derivatives in financial assets. However, the concept of embedded derivatives has been retained for financial liabilities and for non-financial assets.
- iv. The changes in the fair value of financial liabilities measured at fair value through profit or loss, attributable to changes in the entity's own credit status, are presented in other comprehensive income rather than profit or loss
- v. Elimination of the limited exemption to measure unquoted equity investments at cost rather than at fair value, in the rare circumstances in which the range of reasonable fair value measurements is significant and the probabilities of the various estimates cannot reasonably be assessed.

Classification and measurement of financial liabilities

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

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

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

Impairment

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

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

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

Hedge accounting

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

Key changes introduced include:

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

The effective date of the fully completed version of IFRS 9 is for annual reporting periods beginning on or after 1 January 2018 with retrospective application. Early adoption is permitted. Entities that report in accordance with EU-endorsed IFRS cannot adopt IFRS 9 until its endorsement for use in the EU, which is currently scheduled for the second half of 2015.²

Convergence with US GAAP

The IASB's project was initially carried out as a joint project with the US Financial Accounting Standards Board (FASB). However, the FASB ultimately decided to make more limited changes to the classification and measurement of financial instruments, and to develop a more US specific impairment model for financial assets.

² EU Endorsement status report as at 23 July 2015.

2. DEFINITIONS AND SCOPE

2.1. Definitions

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

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

A financial asset is defined as any asset that is:

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

A financial liability is defined as any liability that is:

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

An equity instrument is defined as:

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

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

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

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

2.2. Scope

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

Interests in subsidiaries	IFRS 10/IAS 27
Interests in associates and joint ventures	IAS 27, IAS 28
Employer's rights and obligations under employee benefit plans	IAS 19
Insurance contracts (except embedded derivatives and some financial guarantee contracts)	IFRS 4
Financial instruments with discretionary participation features	IFRS 4
Share-based Payments	IFRS 2
Rights and obligations under leases	IAS 17
An entity's own equity instruments	IAS 32
Financial liabilities issued by an entity that are classified as equity in accordance with IAS 32.16A to D	IAS 32
Forward contracts between an acquirer and selling shareholder for a transaction that meets the definition of a business combination	IFRS 3
Loan commitments, other than for the IFRS 9 requirements for impairment and derecognition (except those which are designated at FVTPL, can be settled net or represent a commitment to provide a loan at a below-market interest rate which are in the scope of IFRS 9 in its entirety).	-
Reimbursement rights for provisions	IAS 37
Financial instruments that represent rights and obligations within the scope of IFRS 15 <i>Revenue from Contracts with Customers</i> , except those which IFRS 15 specifies are accounted for in accordance with IFRS 9	IFRS 15

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

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

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

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

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

3. FINANCIAL ASSETS – CLASSIFICATION

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

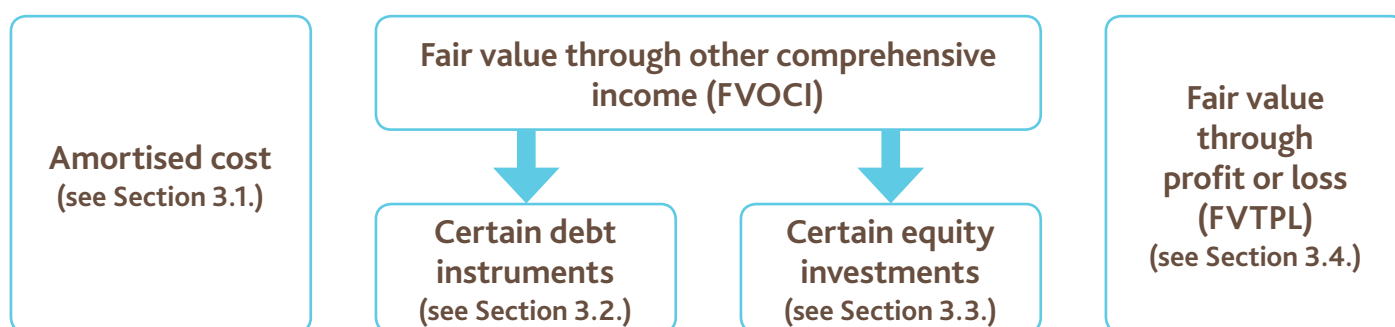


Figure 1: Categories of financial assets under IFRS 9

3.1. Amortised cost

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

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

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

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

3.1.1. 'Hold-to-collect' business model

To qualify for amortised cost classification, the financial asset must be in a 'hold-to-collect' business model. That is, it must be in a business model in which the entity's objective is to hold the financial asset to collect the contractual cash flows from the financial asset rather than with a view to selling the asset to realise a profit or loss. For example, trade receivables held by a manufacturing entity are likely to fall within the 'hold-to-collect' business model, as the manufacturing entity is likely to have the intention to collect the cash flows from those trade receivables.

The 'hold-to-collect' business model does not require that financial assets are always held until their maturity. An entity's business model can still be to hold financial assets to collect contractual cash flows, even when sales of financial assets occur. However, if more than an infrequent number of sales are made out of a portfolio, the entity should assess whether and how the sales are consistent with the 'hold-to-collect' objective. This assessment should include the reason(s) for the sales, the expected frequency of sales, and whether the assets that are sold are held for an extended period of time relative to their contractual maturities.

BDO comment

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

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

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

Example 1 – 'Hold-to collect' business model

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

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

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

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

- The objective for managing the debt investments is to realise cash flows through sale
- The performance of the debt investment is evaluated on a fair value basis.

3.1.2. The 'SPPI' contractual cash flow characteristics test

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

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

Whilst the consideration for the time value of money and credit risk is typically the most significant element of 'interest', in a change from previous versions of IFRS 9, IFRS 9 (2014) acknowledges that it can also contain other elements such as liquidity, profit margin and service or administrative costs.

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

BDO comment

The SPPI contractual cash flow test means that only debt instruments can qualify to be measured at amortised cost. The terms of an equity instrument are never capable of giving rise to solely payments of principal and interest.

Example 2 – SPPI test for loan with zero interest and no fixed repayment terms

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

- No interest
- No fixed repayment terms
- Repayable on demand of Parent A.

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

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

Example 3 – SPPI test for loan with zero interest repayable in five years

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

- No interest
- Repayable in five years.

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

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

Example 4 – SPPI test for a loan with interest rate cap

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

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

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

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

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

Example 5 – SPPI test for loan with profit linked element

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

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

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

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

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

3.1.2.1. Modified time value of money

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

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

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

For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with identical contractual terms and the identical credit quality except the variable interest rate is reset monthly to a one-month interest rate.

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

Example 6 – SPPI test: Modified time value of money

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

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

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

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

3.1.2.2. Regulated interest rates

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

BDO comment

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

3.1.2.3. Prepayment and extension terms

Debt instruments often contain prepayment and extension option terms. These do not necessarily violate the SPPI contractual cash flow characteristics test.

A debt instrument with a **prepayment option** can still meet the SPPI test if the prepayment amount represents substantially all the unpaid amounts of principal and interest outstanding (the prepayment amount may include reasonable additional compensation for early repayment) and the prepayment is not contingent on any future events other than to protect:

- a) The holder against the credit deterioration of the issuer (e.g. defaults, credit downgrades or loan covenant violations), or a change in control of the issuer, or
- b) The holder or issuer against changes in relevant taxation or law.

Similarly, a debt instrument with an **extension option** would still meet the SPPI test if the terms in the extension period result in contractual cash flows that also meet the SPPI test and the extension provision is not contingent on future events other than the criteria set out in subparagraphs a) and b) above.

Example 7 – SPPI test for loan with prepayment option

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

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

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

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

Example 8 – SPPI test for loan with extension option (with rate reset)

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

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

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

Example 9 – SPPI test for loan with extension option (with no rate reset)

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

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

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

Note this is different to the accounting requirement under IAS 39 where the extension option is considered to be an embedded derivative that is not closely related under the guidance in paragraph IAS 39.AG30(c) and therefore needs to be separately accounted for at fair value through profit or loss (unless the entity elects to measure the entire loan at fair value through profit or loss).

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

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

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

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

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

Example 10 – SPPI test for loan with interest rate reset

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

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

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

3.1.2.5. Other examples

Example 11 – SPPI test for convertible note

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

Answer: No. IFRS 9 requires analysis of the terms of the convertible bond in its entirety. The interest rate in a convertible note typically does not reflect the consideration for the time value of money and the credit risk. The interest rate is usually set lower than the market interest rate. The overall return is also linked to the value of the equity of the issuer such that the conversion feature would potentially enhance the overall return.

Refer to Section 3.5.

Example 12 – SPPI test for commodity linked note

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

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

Refer to Section 3.5.

Example 13 – SPPI test for deferred consideration receivable in a business combination

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

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

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

3.2. Debt instruments at FVOCI

A financial asset is measured at fair value through other comprehensive income (FVOCI) under IFRS 9 if it meets both of the following criteria:

- 'Hold-to-collect and sell' business model test: The asset is held within a business model whose objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset, and
- 'SPPI' contractual cash flow characteristics test: The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (discussed in Section 3.1.2).

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

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

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

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

BDO comment

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

Example 14 – 'Hold-to collect' business model test for sale before maturity

Same facts as Example 1:

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

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

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

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

The accounting requirements for debt instruments classified as FVOCI are:

- Interest income is recognised in profit or loss using the effective interest rate method that is applied to financial assets measured at amortised cost
- Credit impairment losses/reversals are recognised in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost (please refer to Chapter 4 of this publication for further details).
- Other changes in the carrying amount on remeasurement to fair value are recognised in OCI
- The cumulative fair value gain or loss recognised in OCI is recycled from OCI to profit or loss when the related financial asset is derecognised.

BDO comment

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

Example 15 – FVOCI for debt instruments

On 1.1.20X1 a financial asset is purchased at its face value of CU1,000. The contractual term is ten years with an annual coupon of 6%. Expected credit losses as determined under the impairment model are CU20.

On 31.12.20X1 the fair value of the financial asset decreases to CU950. Expected losses increase by CU10 to CU30. A coupon payment is received.

On 1.1.20X2 the financial asset is sold for CU950.

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

Answer:

1.1.20X1

Dr	Financial asset	CU1,000	
	Cr Cash		CU1,000
Dr	Impairment loss (P&L)	CU20	
	Cr OCI (loss allowance)		CU20

Being the initial recognition of the financial asset at FVOCI and the recognition of the initial impairment allowance in OCI.

31.12.20X1

Dr	Cash	CU60	
	Cr Interest income		CU60
Dr	Impairment loss (P&L)	CU10	
Dr	OCI (of which CU20 loss allowance)	CU40	
	Cr Financial asset		CU50

Being the receipt of the coupon payment, recognition of an additional CU10 impairment loss and the change in fair value of the financial asset.

1.1.20X2

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

Being the sale of the financial asset and recognition of the loss on sale.

3.3. Equity investments at FVOCI

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

However, for equity investments that are not held for trading, entities can make an irrevocable election at initial recognition to classify the instruments as at FVOCI, with all subsequent changes in fair value being recognised in other comprehensive income (OCI). This election is available for each separate investment.

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

Example 16 – Equity investments classified at FVOCI

Entity X has a 31 December financial year end and pays tax at a rate of 30%. It prepares financial statements on an annual basis (it does not prepare interim financial statements). On 1 January 20X3, Entity X acquires 100 shares of List Co for CU10,000. The journal entry at 1 January 20X3 is as follows:

1 January 20X3

Dr	Financial asset (Equity investment FVOCI)	CU10,000	
	Cr	Cash	CU10,000

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

31 December 20X3

Dr	OCI	CU2,000	
	Cr	Financial asset (Equity investment FVOCI)	CU2,000
Dr	Deferred tax asset	CU600	
	Cr	OCI	CU600

Carrying values at 31 December 20X3 are:

	Carrying value
Financial asset (Equity investment at FVOCI)	CU8,000
Deferred tax asset	CU600
Accumulated OCI	CU(1,400)

Example 16 – Equity investments classified at FVOCI (continued)

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

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

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

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

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

	Carrying value
Financial asset (Equity investment at FVOCI)	CU13,000
Deferred tax liability	CU900
Accumulated OCI	CU2,100

The journal entry for the disposal is:

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

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

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

Note: On disposal, the cumulative changes in fair value remains in OCI. Entities can transfer the cumulative OCI balance to another reserve within equity, such as retained earnings.

3.4. Financial instruments at FVTPL

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

- A held-for-trading financial asset
- A debt instrument that does not qualify to be measured at amortised cost or FVOCI
- An equity investment which the entity has not elected to classify as at FVOCI
- A financial asset where the entity has elected to measure the asset at FVTPL under the fair value option (FVO).

Examples of financial instruments that are likely to fall under the FVTPL category include:

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

BDO comment

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

Example 17 – Contingent consideration receivable

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

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

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

3.5. Hybrid contracts containing embedded derivatives

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

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

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

In order to simplify the accounting, IFRS 9 has eliminated the requirement to separately account for embedded derivatives for financial assets. Instead, IFRS 9 requires entities to assess the hybrid contract as a whole for classification. If the terms of the hybrid contract still meet the criteria for subsequent measurement at amortised cost or FVOCI for debt instruments (see Section 3.1. and 3.2. above) then it is accounted for at amortised cost or FVOCI, otherwise it is measured at FVTPL.

However, the existing requirements for embedded derivatives still apply to financial liabilities, and to contracts for assets that are not within the scope of IFRS 9.

Example 18 – Convertible note receivable: Difference between IAS 39 and IFRS 9

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

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

IAS 39	IFRS 9
<p>The instrument contains:</p> <ul style="list-style-type: none"> – Debt host contract – an annual coupon receivable of 5% and CU1,000 on maturity, and – Embedded equity option – option to buy shares at CU1. <p>The equity option derivative is not closely related to the debt host contract.</p> <p>The entity therefore has two options:</p> <ol style="list-style-type: none"> i. Bifurcate the instrument, that is: <ul style="list-style-type: none"> – Equity option at FVTPL – Host debt contract at amortised cost. ii. Designate entire contract at FVTPL. 	<p>No bifurcation, consider the instrument in its entirety:</p> <ul style="list-style-type: none"> – The coupon rate is lower than the market interest rate, and therefore does not reflect the consideration for the time value of money and credit risk – Return is also linked to the value of the equity conversion. <p>Therefore, the instrument fails the SPPI test for classification at amortised cost.</p> <p>Accordingly, the entity must account for the entire instrument at FVTPL.</p>

Example 19 – Gold linked note receivable: Difference between IAS 39 and IFRS 9

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

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

IAS 39

The instrument contains:

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

The entity therefore has two options:

- i. Bifurcate the instrument, that is:
 - Gold linked derivative at FVTPL
 - Host debt contract at amortised cost.
- ii. Designate entire contract at FVTPL.

IFRS 9

Consider the instrument in its entirety:

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

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

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

4. FINANCIAL LIABILITIES – CLASSIFICATION

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

Financial liabilities are either classified as:

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

Financial liabilities are measured at amortised cost unless either:

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

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

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

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

Figure 2: Examples for classification of financial liabilities

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

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

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

5. MEASUREMENT

5.1. Measurement on initial recognition

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

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

<http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/Need%20to%20Know%20%20-%20IFRS%2013%20Fair%20Value%20Measurement%20%28print%29.pdf>

5.1.1. Day one gains and losses

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

- In profit or loss, if the estimate is evidenced by a quoted price in an active market; and
- Deferred as an adjustment to the carrying amount of the financial instrument in all other cases.

BDO comment

The new expected loss impairment model under IFRS 9 requires an entity to recognise 12-month expected credit losses for all financial assets (unless the exemption for trade/lease receivables or contract assets applies (see Section 5.2.1.). However, this adjustment does not represent a day one loss because the fair value is determined first, with credit losses then being deducted. IFRS 9 does not explicitly require the recognition of 12-month expected credit losses immediately after initial recognition, but an entity would need to recognise a loss allowance equal to 12-month expected credit losses at the first reporting date after the initial recognition of the financial asset.

5.1.2. Trade receivables

IFRS 9 provides an exception for the initial recognition of trade receivables without significant financing component to be recognised at the transaction price instead of fair value. The existence of a significant financing component is determined in accordance with the guidance set out in paragraphs 60-65 of IFRS 15 *Revenue from Contracts with Customers*.

For trade receivables with a significant financing component, any differences arising from the revenue recognised based on the transaction price in accordance with IFRS 15 and the fair value of the trade receivable is recognised as an expense in profit or loss.

BDO comment

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

5.1.3. *Transaction costs*

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

Significant judgement may be required to interpret the definition of transaction costs in practice. Cost that do not qualify as transaction costs are debt premiums or discounts, financing costs, internal administration costs and holding costs.

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

5.2. Subsequent measurement

5.2.1. *Financial assets*

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

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

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

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

5.2.2. *Financial liabilities*

5.2.2.1. *General requirements*

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

5.2.2.2. *Financial liabilities at FVTPL – changes in own credit risk*

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

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

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

Example 20 – Recognising fair value changes due to changes in own credit risk

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

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

Dr	Financial liability (Bond)	CU10	
	Cr OCI		CU2
	Cr Profit or loss		CU8

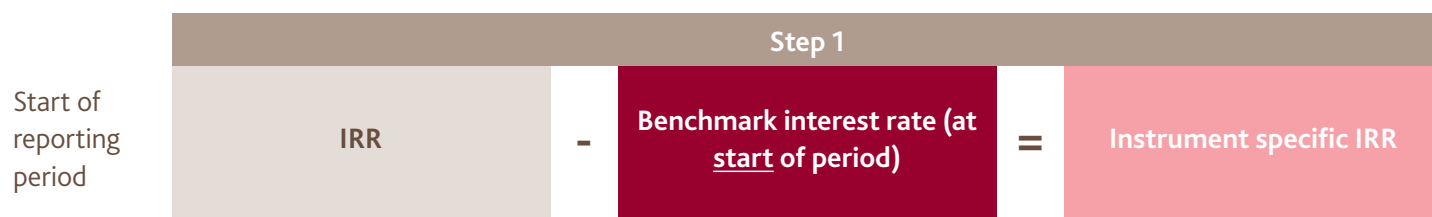
An entity determines the amount of the fair value change attributable to changes in its own credit risk either:

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

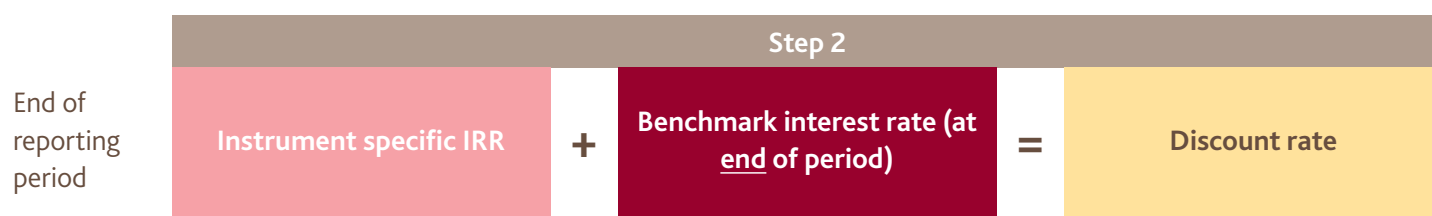
If the only significant relevant changes in market conditions are due to changes in an observed benchmark interest rate, the amount attributable to changes in an entity's own credit risk can be estimated using the default method, which is based on the calculation of the financial instrument's internal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

BDO comment

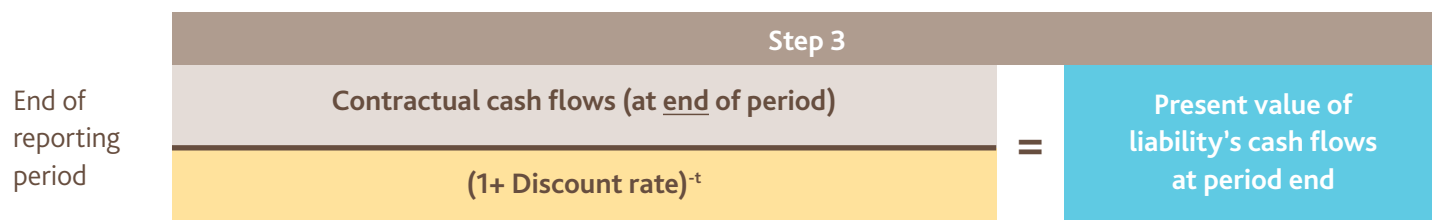
The benchmark interest rate is not explicitly defined by IFRS 9. However, usually the benchmark interest rate is a risk-free rate which excludes all changes which are due to changes in an entity's own credit risk. Examples of benchmark rates are interbank rates such as LIBOR or EURIBOR.



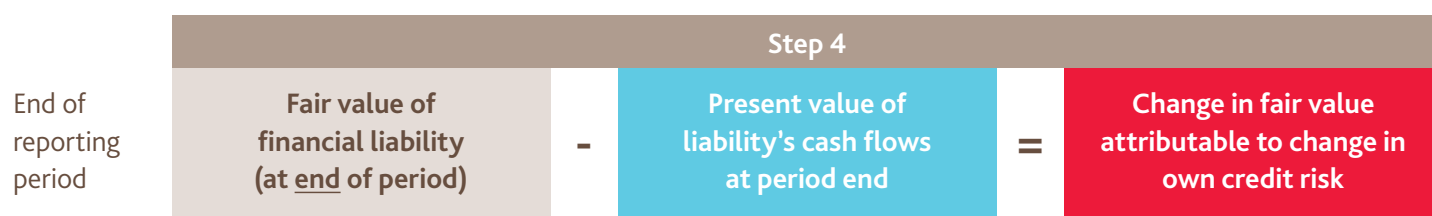
In the first step, the entity computes the liability's IRR at the start of the reporting period using the fair value of the liability and the liability's contractual cash flows at the start of the reporting period. It deducts from the IRR the observed benchmark interest rate at the start of the period.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



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



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



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

5.2.3. Amortised cost measurement

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

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

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

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

5.2.3.1. Effective interest method

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

- Gross carrying amount of a financial asset (revenue) or to the
- Amortised cost of a financial liability (expense).

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

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

Example 21 – Calculating the effective interest rate

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

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

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

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

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

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

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

5.2.3.2. Revisions of estimates of cash flows

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

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

- A fixed rate of interest or
- A variable rate that does not represent a market rate (such as LIBOR).

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

Example 22 – Adjustment of the carrying amount of a loan with interest linked to EBITDA

On 1 January 20X5, Entity A takes out a loan with Entity B for CU1,000 for three years. The interest payments on the loan are 10% of Entity A's EBITDA. On 1 January 20X5, Entity A expects the following EBITDA figures.

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

Questions: (a) What is Entity A's initial journal entry on 1 January 20X5?

(b) What is the effective interest rate of the loan?

(c) What are Entity A's journal entries at 31 December 20X5?

Answer (a)

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

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

Answer (b)

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

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

Answer (c)

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

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

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

To recognise interest expense at the effective interest rate of 20.4% and the cash payment of CU120.

Example 22 – Adjustment of the carrying amount of a loan with interest linked to EBITDA (continued)**Answer (c) (continued)**

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

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

Calculation of the difference of the revised carrying amount.

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

31 December 20X5

Dr	Profit or loss*	CU80	
	Cr	Loan payable	CU80

To recognise the change in estimates of cash flows.

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

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

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

Example 23 – Calculating the effective interest rate for floating rate instruments

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

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

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

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

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

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

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

If a financial asset becomes credit-impaired after initial recognition and move to **Stage 3** of the impairment model (see Section 6.), the effective interest rate is applied to the net carrying value, which includes the loss allowance. If the financial asset ceases to be credit impaired with the result of a reversal of the impairment, the application of the effective interest rate reverts to the gross carrying amount. However, this does not apply to POCI assets which never revert to a gross basis.

5.2.3.4. Modifications of financial assets and financial liabilities

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

BDO comment

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

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

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

The guidance for the treatment of modifications of financial liabilities that do not result in derecognition is unchanged from IAS 39. Accordingly, if a modification of a financial liability does not result in derecognition, any costs or fees incurred are recognised as an adjustment to the carrying amount of the liability and are amortised over the remaining term of the modified instrument by recalculating the effective interest rate of the instrument. If the modification does result in the derecognition of the financial liability then the old liability is derecognised and a new liability is recognised, with the effective interest rate being calculated based on the revised terms. Any costs or fees incurred are recognised in profit or loss as part of the gain or loss on extinguishment and do not adjust the carrying amount of the new liability.

6. IMPAIRMENT

6.1. Scope

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

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

6.2. Overview of the new impairment model

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

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

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

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

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

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

- Trade receivables with maturities of less than 12 months (see Section 6.4.1. below); and
- Other long term trade and lease receivables (see Section 6.4.2. below).

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

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

6.3. General impairment model

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

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

BDO comment

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

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

6.3.2. Recognition of impairment – Lifetime expected credit losses

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

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

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

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

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

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

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

BDO comment

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

6.4. Simplified impairment model

6.4.1. Trade receivables and contract assets without significant financing component

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

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

BDO comment

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

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

Example 24 – Applying the new impairment model to trade receivables

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

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

Example 24 – Applying the new impairment model to trade receivables (continued)

One year later, at 31 December 20X5, Company M revises its forward looking estimates, which incorporate a deterioration in general economic conditions. Company M has a portfolio of trade receivables of CU34million in 20X5.

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

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

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

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

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

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

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

6.5. Further implications

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

IFRS 9 does not provide any practical expedients for related party, key management personnel and intercompany loan receivables. This means that expected credit losses (and the related disclosures) would have to be provided based on the 'full' three-stage model, which requires:

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

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

Example 25 – Applying the three-stage model to a related party loan

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

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

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

Example 25 – Applying the three-stage model to a related party loan (continued)**Answer:****31 December 20X1**

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

31 December 20X2

- Loan is in **Stage 2**
It is considered that credit risk has increased significantly as Company C is expected to have cash flow problems due to a deterioration in economic conditions
- The probability that the loan will default over the remaining life of the loan is estimated at 35%
- Recognise a provision of CU35 (35% \times CU100)
- Recognise interest on the gross carrying amount of the loan (CU100 \times 10%)

31 December 20X3

- Loan is in **Stage 3**
Due to liquidity problems, Company A is not able to repay the loan and relies on an extension of the loan by three years. The loan is therefore credit impaired
- Company A estimates that the probability of default over the remaining life of the loan is 60%
- Recognise a provision of CU60 (60% \times CU100)
- Recognise interest on the net carrying amount of the loan (CU40 \times 10%) from the point at which the loan moves to **Stage 3**.

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

Example 26 – Loan to sister subsidiary guaranteed by the parent

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

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

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

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

Answer:

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

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

6.5.2. Off-balance sheet financial items

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

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

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

6.5.2.1. Loan commitments

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

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

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

- The contractual cash flows if the holder of the loan commitment draws down the loan; and
- The cash flows that the entity expects to receive if the loan is drawn down.

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

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

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

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

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

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

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

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

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

6.5.2.3. Financial guarantee contracts

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

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

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

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

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

Cash shortfalls are the difference between:

- The expected payments to reimburse the holder for a credit loss that it incurs; and
- Any amount that an entity expects to receive from the holder, the debtor or any other party.

Example 27 – Financial guarantee contract

- On 1 January 20X8, Company A guarantees a CU1,000 loan of Subsidiary B which Bank XYZ has provided to Subsidiary B for three years at 7%
- If Company A has not issued a guarantee Bank XYZ would have charged Subsidiary B an interest rate of 10%
- On 31 December 20X8, there is a 1% probability that Subsidiary B will default on the loan in the next 12 months
- On 31 December 20X9, there is a 3% probability that Subsidiary B will default on the loan in the next 12 months.

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

Example 27 – Financial guarantee contract (continued)**Answer:****1 January 20X8**

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

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

1 January 20X8

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

Being the fair value of the guarantee on initial recognition.

31 December 20X8

Assume that there is 3% probability that Subsidiary B will default on the loan in the next 12 months. If Subsidiary B does default, Company A does not expect to recover any amount from Subsidiary B. The 12-month expected credit losses are therefore CU30 (CU1,000 X 3%).

The initial amount recognised less amortisation is CU52.50 (CU75-CU22.50 (being CU30/1.1³)), which is higher than the 12-month expected credit losses (CU10). The liability is adjusted to CU52.50 as follows:

31 December 20X8

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

Being amortisation of the liability recognised for the financial guarantee.

31 December 20X9

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

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

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

31 December 20X9

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

To record the liability at the amount of the loan loss allowance (CU52.50-CU30).

Example 27A – Financial guarantee contract

- Same facts as Example 25 above
- Except that on 31 December 20X8, there is a significant increase in the risk that Subsidiary B will default on the loan. The probability of default over the remaining life of the loan (two years) is 60%.

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

Answer:

Assume that if Subsidiary B does default, Company A does not expect to recover any amount from Subsidiary B. The lifetime expected credit losses are CU600 (CU1,000 × 60%), and the carrying amount of the liability is adjusted as follows:

31 December 20X8			
Dr	Profit or loss	CU525	
	Cr Liability		CU525

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

7. HEDGE ACCOUNTING

7.1. Introduction

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

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

7.2. Qualifying criteria and effectiveness testing

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

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

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

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

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

BDO comment

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

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

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

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

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

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

BDO comment

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

Example 28 – Effectiveness testing – Hedge of foreign exchange rate risk

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

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

Answer:

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

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

Example 29 – Effectiveness testing – Hedge of floating interest rate risk

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

Entity B designates the following hedge relationship:

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

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

Answer:

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

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

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

Example 30 – Effectiveness testing if critical terms do not match

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

Answer:

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

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

An entity's risk management approach is the main source of information to perform the assessment of whether a hedging relationship meets the hedge effectiveness requirements. This means that the management information (or analysis) used for decision-making purposes can be used as a basis for assessing whether a hedging relationship meets the hedge effectiveness requirements (IFRS 9.B6.4.18). In other cases an entity would need to choose an appropriate methodology to assess whether a hedging relationship meets the hedge effectiveness requirements (see Example 29 above).

Example 31 – Alternative effectiveness testing if critical terms do not match

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

Answer:

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

7.3. Hedged items

The new hedging model under IFRS 9 allows more items to qualify as eligible hedged items in comparison with IAS 39 *Financial Instruments: Recognition and Measurement*.

7.3.1. Risk components as hedged items

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

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

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

BDO comment

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

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

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

Example 32 – Hedging diesel purchases

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

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



Figure 4: Pricing formula of the diesel purchase contract

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

Analysis under IAS 39

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

Assume the following forecast prices:

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

Example 32 – Hedging diesel purchases (continued)**Analysis under IAS 39 (continued)**

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

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

Conclusion under IAS 39:

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

Analysis under IFRS 9

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

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

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

Example 33 – Hedging iron ore supply contracts

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



Figure 5: Pricing formula of the iron ore supply contract

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

Analysis under IAS 39

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

Assume the following forecast sales prices:

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

Example 33 – Hedging iron ore supply contracts (continued)**Analysis under IAS 39 (continued)**

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

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

Analysis under IFRS 9

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

	Cumulative FV change in iron ore price index of the forecast final contract price (hedged item)	Cumulative FV change in derivative (based on the iron ore price index) (hedging instrument)	Hedge Effectiveness under IFRS 9
30/6/20X5	CU10 (CU85-CU75)	CU(10) (CU75-CU85)	100% (CU10/CU10)
31/12/20X5	CU(25) (CU50-CU75)	CU25 (CU75-CU50)	100% (CU25/CU25)

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

Example 34 – Contractually specified risk component (hedging coffee index)

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



Figure 6: Pricing formula of the coffee price contract

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

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

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

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

Example 35 – Non-contractually specified risk component (hedging coffee index)

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

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

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

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

Example 36 – Non-contractually specified risk component (jet fuel vs crude oil)

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

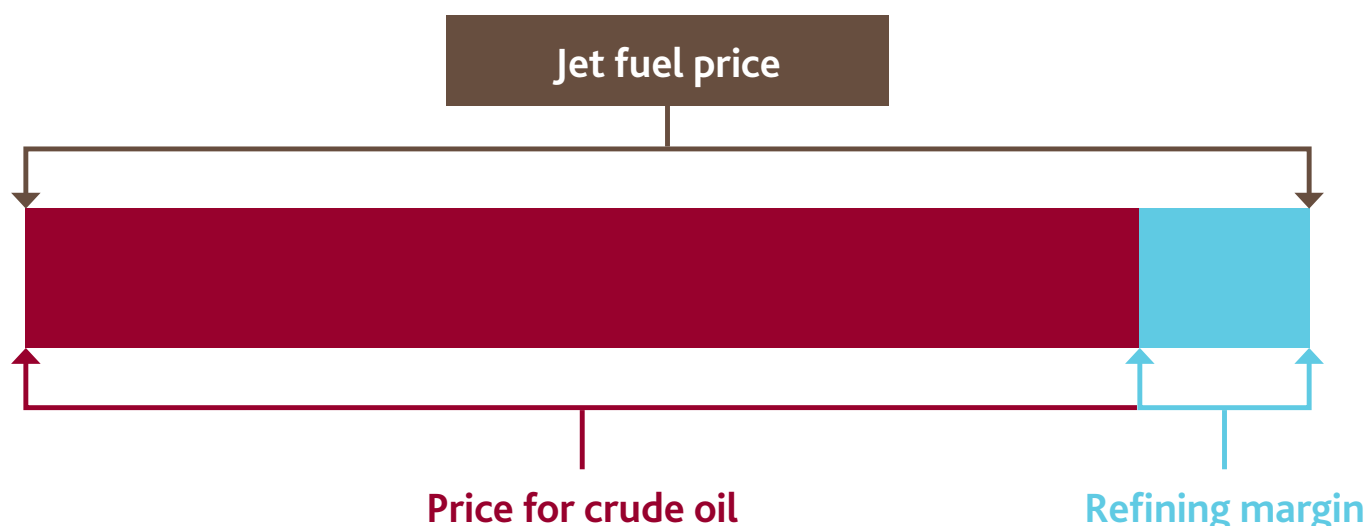


Figure 7: Risk components of the price of jet fuel

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

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

BDO comment

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

7.3.2. Aggregated exposures

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

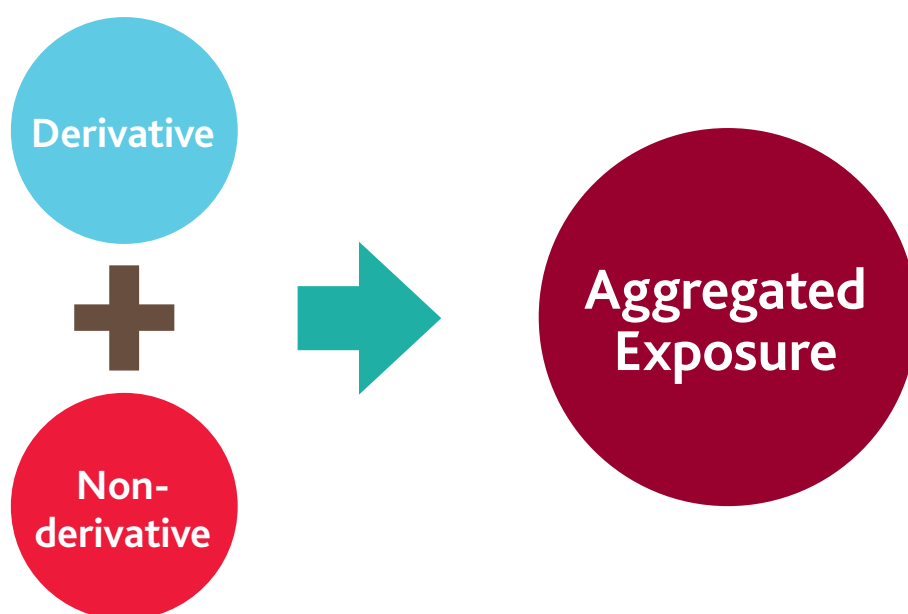


Figure 8: Aggregated exposure

Under IAS 39, derivatives are not eligible hedge items and do not qualify for hedge accounting. However this is different from the risk management of some entities managing its overall risk exposure by entering into offsetting derivative contracts. From an accounting perspective the hedge needs to be de-designated and a new one designated each time a new derivative contract is entered into.

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

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

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

Example 37 – Aggregated exposures – Foreign exchange and interest rate risk

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

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

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

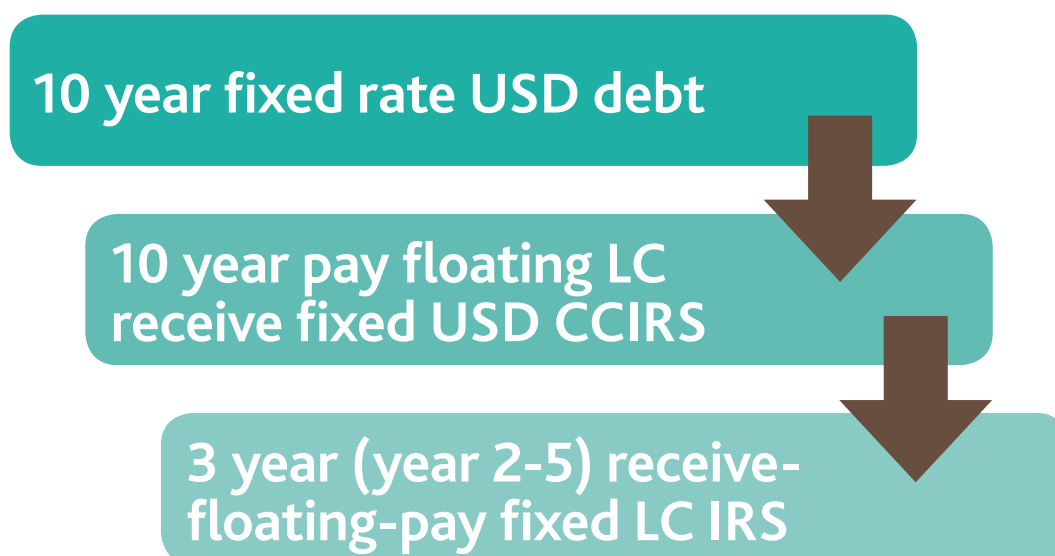


Figure 9: Hedged items and hedging instruments

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

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

Example 37 – Aggregated exposures – Foreign exchange and interest rate risk (continued)

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

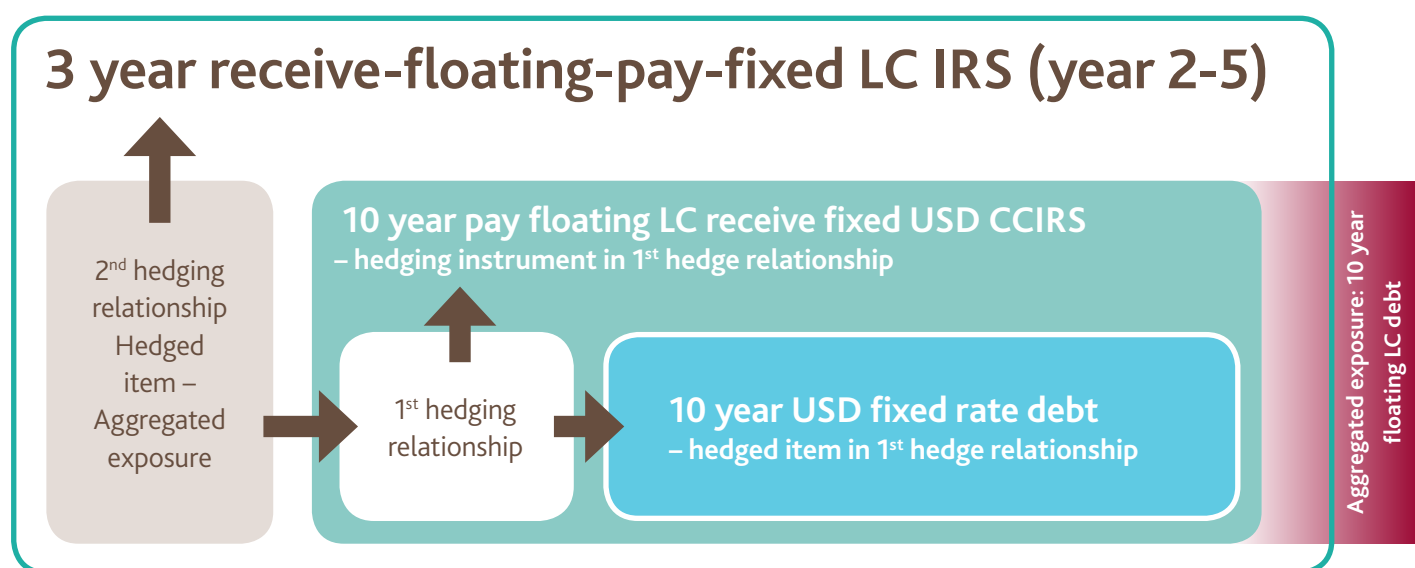


Figure 10: Hedge relationship established under the new requirements for aggregated exposures

BDO comment

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

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

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

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

Example 38 – Aggregated exposures – Commodity and foreign exchange risk

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

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



Figure 11: Hedged items and hedging instruments

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

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

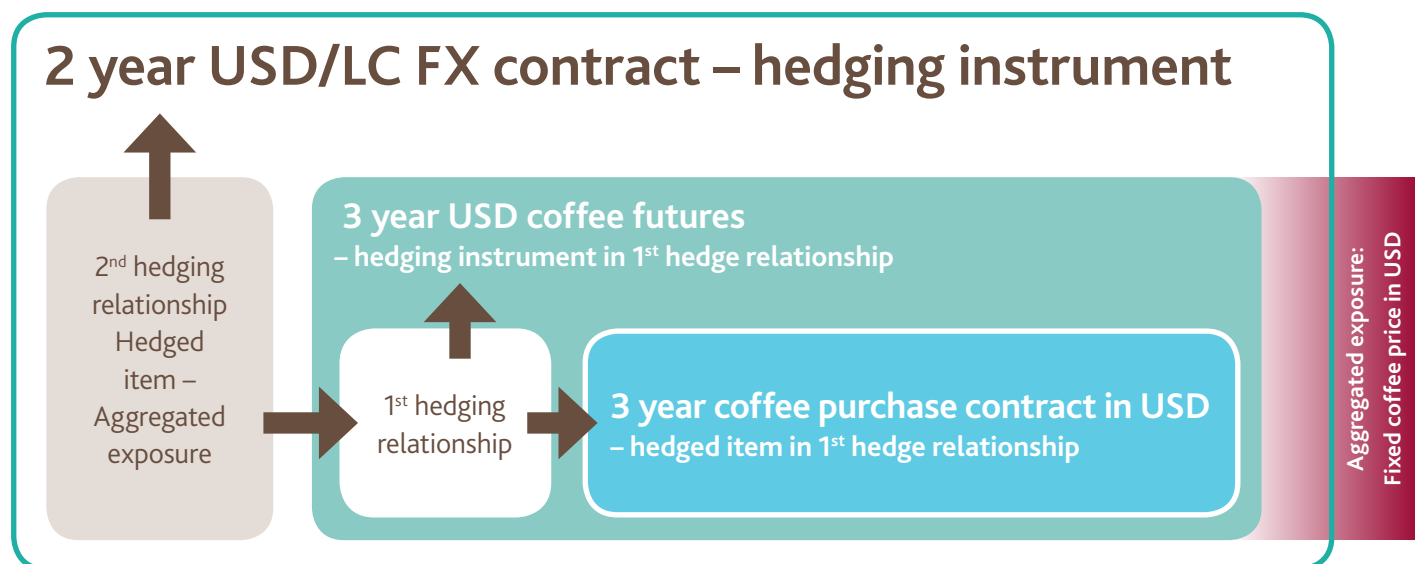
Example 38 – Aggregated exposures – Commodity and foreign exchange risk (continued)

Figure 12: Hedge relationships established under the new requirements

BDO comment

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

7.4. Hedging instruments

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

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

7.4.1. Options

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

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

Example 39 – Time value of a call option to acquire gold

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

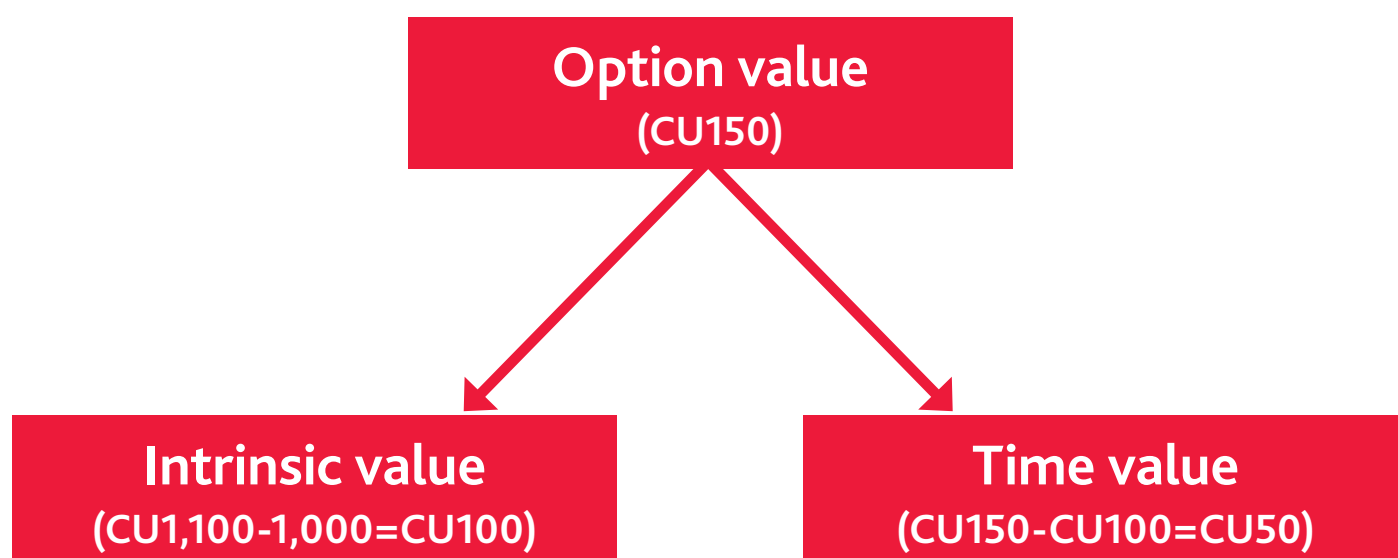


Figure 13: Option value

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

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

The option's time value at initial recognition is then accounted for as follows:

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

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

The following charts are examples of how the time value component of the option can change over its contractual term. The time value component will always be zero at option expiry date (at which point the option can have only an intrinsic value). As noted above, under IFRS 9 changes in time value are recorded in OCI.

Time value of options – Transaction related hedged item

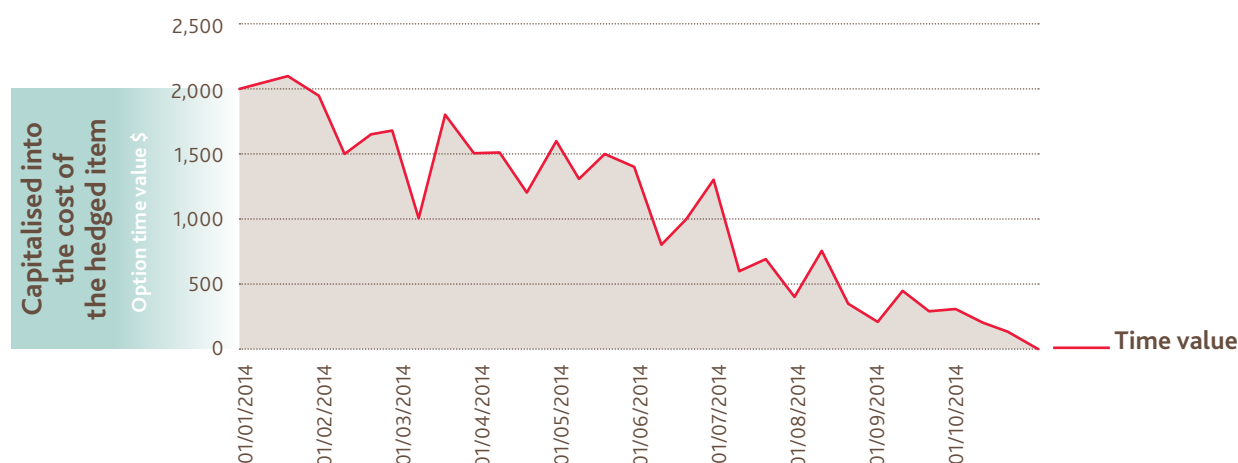


Figure 15: The changes in time value of options and the treatment of initial time value for transaction related hedged items

Time value of options – Time period related hedged item

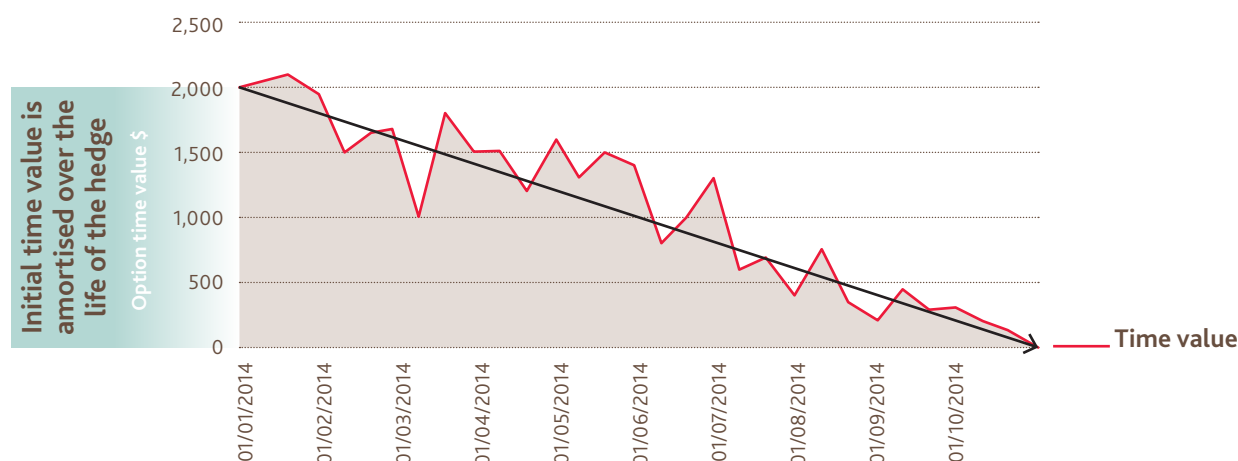


Figure 16: The changes in time value of options and the treatment of initial time value for time period related hedged items

Example 40 – Time value of options – Transaction related hedged item – Foreign exchange rate risk – IAS 39 and IFRS 9 compared

1 October 20X4

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

If the spot exchange rate in six months' time is less than 0.75 LC/FC then Entity A would exercise the option and pay LC666,667 (FC500,000/0.75). If the spot exchange rate in six months' time is more than LC/FC 0.75 then Entity A will transact at the market rate and pay less than LC 666,667. The option effectively allows Entity A to cap the purchase price at LC666,667.

Hedge accounting under IAS 39

Note that in order to improve hedge effectiveness, Entity A designates only the intrinsic value of the option contract as the hedging instrument.

Journal entry on 1 October 20X4

Dr	Option	LC10,000	
	Cr Cash		LC10,000

Being the fair value of the option and cash paid.

31 December 20X4

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

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

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

Journal entry under IAS 39

Dr	Option	LC50,000	
	Cr Equity (OCI) – cash flow hedge reserve		LC47,619
	Cr Profit or loss		LC2,381

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

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

Example 40 – Time value of options – Transaction related hedged item – Foreign exchange rate risk – IAS 39 and IFRS 9 compared (continued)

Hedge accounting under IAS 39 (continued)

31 March 20X5

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

Journal entries under IAS 39

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

Being Inventory and cash paid at the spot rate at 31 March 20X5.

Dr	Profit or loss	LC12,381	
	Cr	Option	LC12,381

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

Dr	Cash	LC47,619	
	Cr	Option	LC47,619

Being the settlement of the option.

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

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

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

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

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

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

Example 40 – Time value of options – Transaction related hedged item – Foreign exchange rate risk – IAS 39 and IFRS 9 compared (continued)

Hedge accounting under IFRS 9

Under IFRS 9 the entire option contract is designated as the hedging instrument. Changes in time value are recorded in OCI instead of profit or loss, and the initial time value is capitalised into the cost of inventory.

31 October 20X4

Journal entry under IFRS 9

Dr	Option	LC10,000	
	Cr Cash		LC10,000

Being the fair value of the option and cash paid.

31 December 20X4

Journal entry under IFRS 9

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

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

31 March 20X5

Journal entries under IFRS 9

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

Being Inventory and cash paid at the spot rate at 31 March 20X5.

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

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

Dr	Cash	LC47,619	
	Cr Option		LC47,619

Being the settlement of the option.

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

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

Example 40 – Time value of options – Transaction related hedged item – Foreign exchange rate risk – IAS 39 and IFRS 9 compared (continued)

Hedge accounting under IFRS 9 (continued)

Impact on the income statement and OCI under IFRS 9

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

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

Example 41 – Time value of options – Transaction related hedged item – Commodity price

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

1 January 20X4

Dr	Option	CU2,000	
	Cr	Cash	CU2,000

To recognise the purchase of the option.

Subsequently, on 1 March 20X4:

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

1 March 20X4

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

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

Example 41 – Time value of options – Transaction related hedged item – Commodity price (continued)

Subsequently, on 30 September 20X4:

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

30 September 20X4

Dr	Trade receivable	CU40,000	
	Cr	Sales revenue	CU40,000

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

30 September 20X4

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

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

30 September 20X4

Dr	OCI – CFH reserve	CU10,000	
Dr	Sales	CU2,000	
	Cr	Sales	CU10,000
	Cr	OCI – Option time value reserve	CU2,000

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

Calculation of copper sales revenue

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

Figure 17: Adjustments to sales revenue from hedging copper sales using copper put option

Example 42 – Time value of options – Time period related hedged item

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

BDO comment

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

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

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

7.4.2. Zero cost collars

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

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

Although the initial (net) time value may be zero³, during the period to maturity the time value of the purchased and written option components will fluctuate and are unlikely to offset each other to a net zero amount.

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

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

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

³ Assuming that the options are at (or out of) the money and therefore the initial premiums represent only the options' time value.

Time value of zero cost collars

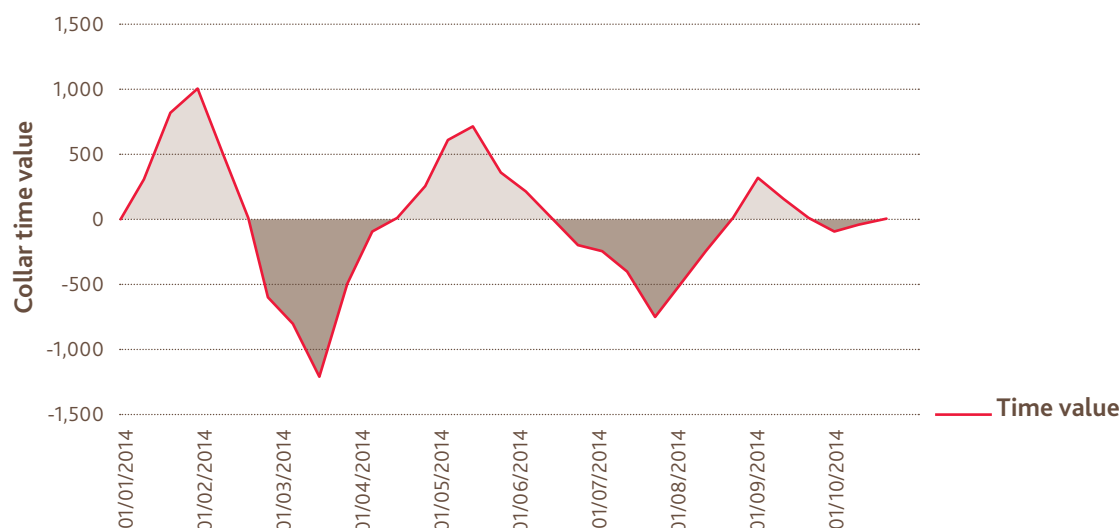


Figure 18: Changes in time value component – zero cost collars

7.4.3. Forward contracts

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

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

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

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

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

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

Example 43 – Forward points

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

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

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

Under IFRS 9:

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

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

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

Figure 19: Accounting treatment under IFRS 9

BDO comment

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

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

7.4.4. Foreign currency swaps and basis spread

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

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

BDO comment

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

8. TRANSITION

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

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

- No restatement of comparative information with differences being recorded in opening retained earnings (or other equity component if appropriate)
- Prospective application of the hedge accounting requirements with limited exceptions (see Section 8.3.)
- No application of IFRS 9 to financial instruments that are derecognised before the DIA.

BDO comment

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

Example 44 – Early adoption

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

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

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

- 1 April
- 1 July
- 1 October?

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

8.1. Classification and measurement

8.1.1. General requirements

At its DIA, an entity must assess on the basis of the facts and circumstances that exist at the DIA, whether a financial asset meets the conditions for a classification as at:

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

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

The following diagram sets out the likely potential reclassifications from the IAS 39 *Financial Instruments: Recognition and Measurement* categories to the IFRS 9 categories for financial assets.

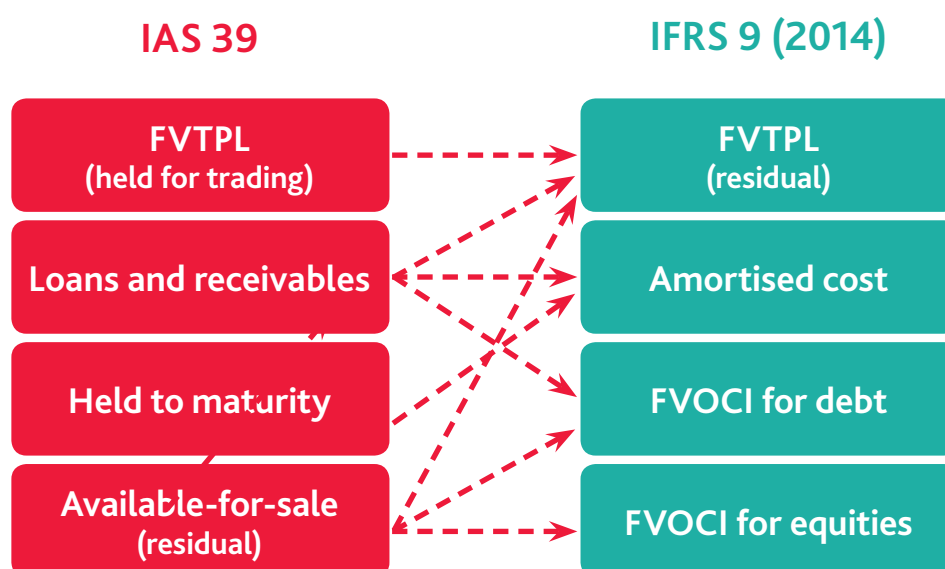


Figure 20: The likely reclassifications of financial assets from IAS 39 to IFRS 9

BDO comment

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

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

Example 45 – Financial instruments recognised before the DIA of IFRS 9

Entity A decides to apply IFRS 9 from 1 January 2015.

On 30 September 2014, Entity A sold an available-for-sale equity investment and recognised a gain of CU30 which included the effect of reclassifying the related amount from the available-for-sale reserve to profit or loss.

Question: Are there any adjustments required on transition?

Answer: No. The DIA is 1 January 2015, and IFRS 9 does not apply to financial instruments that have already been derecognised by the DIA.

8.1.2. Equity investments at fair value through other comprehensive income

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

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

Example 46 – Impairment loss before transition

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

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

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

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

Answer: The DIA of Entity B is 1 January 2015. Entity B recognises the difference of CU15 in its opening retained earnings at 1 January 2015.

The CU40 impairment loss previously recognised in profit or loss would be reclassified from retained earnings to accumulated OCI on transition.

8.1.3. Hybrid contracts (contracts with embedded derivatives)

A hybrid contract that is to be classified as at FVTPL under IFRS 9 may have been accounted for under IAS 39 as a host contract and a separable embedded derivative. This means that the entire (combined) hybrid contract will not have been measured at fair value in the comparative period, with the two components being dealt with separately. On transition, the holder would recognise in its opening retained earnings any difference between the fair value of the entire hybrid contract and the sum of the fair values of the two components of the hybrid contract.

The rationale for this approach is that, in previous financial statements in which it applied IAS 39, an entity may not have determined the fair value of a hybrid contract in its entirety at fair value. However, it would have been required to measure the components (the host contract and the embedded derivative(s)) at fair value for the purposes of disclosures required by IFRS 7.

Example 47 – Convertible note on transition

Entity C acquired an investment in a convertible note on 1 January 2013. Under IAS 39 the convertible note was bifurcated as follows:

- Embedded derivative accounted for at FVTPL (carrying value at 31 December 2014: CU30), and
- Debt host contract measured at amortised cost (carrying value at 31 December 2014: CU990).

Entity C applies IFRS 9 for the first time in its annual reporting period ending 31 December 2015.

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

Answer:

The DIA of Entity C is 1 January 2015. In accordance with the transitional provisions of IFRS 9, Entity C is not required to restate comparatives but is required to provide the disclosures set out in IFRS 7.42L-42O. On 1 January 2015 the fair value of the convertible note (as a single combined instrument) is CU980. The fair values of the two components on 1 January 2015 were as follows:

- Embedded derivative is CU30
- Host debt contract is CU960 (note that in this case the fair value is lower than the previous amortised cost carrying amount).

The total fair value of the components is CU 990. Entity C recognises the difference of CU10 in opening retained earnings at 1 January 2015.

8.1.4. Impracticable to apply the effective interest method retrospectively

If it is impracticable for an entity to retrospectively apply the effective interest method, or the impairment requirements to financial instruments classified at amortised cost in accordance with IFRS 9 that were previously measured at fair value, the transitional requirements depend on whether an entity restates its comparatives.

If an entity restates its comparatives, then the fair value of the financial instrument at the end of each comparative period is used as a proxy for its amortised cost.

If an entity does not restate comparatives, the entity treats the fair value of the financial instrument at the date of initial application as its new amortised cost.

8.2. Impairment

The new requirements apply retrospectively, which is consistent with the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, there are some special transition rules and concessions that are available.

On the DIA, an entity is required to disclose information that permits the reconciliation of the ending impairment allowance under IAS 39 or the provisions under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening loss allowance or provision determined in accordance with the new model in IFRS 9. The disclosure would be provided by the related measurement categories in accordance with IAS 39 and IFRS 9 for financial assets, and the effect of changes in the measurement category on the loss allowance at that date would be shown separately.

BDO comment

Entities will need to decide on their transition policy, assess what information is available and whether additional information needs to be gathered for transition to the new impairment model. It will also be necessary to consider what new systems and processes need to be implemented to enable transitioning to the new model.

8.3. Hedge accounting

The new hedge accounting requirements apply prospectively with limited exceptions. The following practical expedients are allowed at transition:

- Entities can consider applying the new model, immediately after ceasing to apply IAS 39 (i.e. de-designate the old IAS 39 hedging relationship and start a new hedging relationship under the new model)
- The starting point for rebalancing will be the hedge ratio used under IAS 39 (the designated volume of the hedging instrument and the hedged items under IAS 39).

Retrospective application applies to the accounting for:

- The time value of options where the entity has designated only the intrinsic element of the option as the hedging instrument (Section 7.4.1.), and
- Forward points and foreign currency basis spreads (Sections 7.4.3. and 7.4.4.) where the entity has designated only the spot element of the forward as the hedging instrument.

The above retrospective application applies to those types of hedging relationships that exist at the beginning of the comparative period (or later). This means that the previously recognised changes in time the value of options, forward points or foreign currency basis spreads under the existing IAS 39 model will be reclassified from retained earnings to accumulated OCI.

For contracts that fall under the 'own use' scope exemption entities may make a one off election for all existing contracts (on an all or nothing basis for similar contracts) to account for these contracts at fair value if applying fair value accounting to these contracts eliminates or significantly reduces an accounting mismatch.

BDO comment

Prospective application means that entities cannot go back and re-designate risk components of non-financial items, aggregated exposures and groups and net positions to existing hedging relationships. However, entities would be able to voluntarily discontinue the existing hedging relationship under IAS 39 and re-designate under the new model from the DIA.

If an entity does decide to de-designate an existing IAS 39 hedging relationship and designate a new one under IFRS 9, it should be noted that because this is likely to involve the designation of a non zero fair value derivative, any associated hedge ineffectiveness will need to be recorded. However, for IAS 39 compliant hedge relationships that clearly comply with the hedge accounting requirements of IAS 39, it may not be necessary to de-/re-designate.

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For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below.

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