



MAZARS INSIGHTS

IFRS FOR FINANCIAL INSTRUMENTS

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INTRODUCTION

The Mazars Insight series on IFRS aim at helping preparers, users and auditors of financial statements develop their theoretical and practical understanding of IFRSs. Our objective is to provide our readers, whether beginners or experts, with useful tools which provide clarity and insight on the challenging issues that may be encountered when applying IFRSs. Concepts are explained in a pedagogical way and illustrated by numerous practical examples.

This IFRS Insight addresses the accounting for financial instruments under IFRS. It draws on several relevant IFRS standards to tackle, in one manual, the entire range of challenges related to financial instruments among which: recognition and derecognition, classification and measurement, impairment for credit risk, derivatives and hedging, and related disclosures. It includes all the new requirements introduced by IFRS 9 and the related amendments to other standards such as IFRS 7.

After a two-pager providing an overview of IFRS requirements for financial instruments in 10 key points, a table of content shows the list of chapters. Each chapter starts with a detailed table of content to direct readers straight to the topic they are searching for. Many cross references have been inserted for improved reading experience. We draw specific attention to chapter 2 which comprises the definitions and the list of abbreviations and acronyms used in this manual.

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IFRS Lead Partner for Financial Instruments

10 KEY POINTS TO REMEMBER

1. Scope

The accounting treatment of financial instruments under IFRS is defined by several standards. IFRS 9 – *Financial Instruments* provides requirements for recognition and derecognition, classification, measurement (including impairment) and hedge accounting. IAS 32 – *Financial Instruments: Presentation* provides principles for distinguishing issued debt and equity instruments as well as requirements for offsetting financial assets and financial liabilities. IFRS 7 – *Financial Instruments: Disclosures* deals with most of the disclosure requirements, and IFRS 13 – *Fair Value Measurement* provides guidance on fair value measurement and related disclosure requirements. Each of these standards has specific scope exclusions, even for items that meet the definition of financial instruments. (see **chapter 1**)

2. Initial recognition

All financial instruments are initially recognised when the entity becomes party to the contract. Financial assets or liabilities are initially measured at their fair value plus or minus transaction costs, except financial instruments classified at FV-PL for which transaction costs are directly expensed into profit or loss. However, trade receivables are initially measured at their transaction price if they do not contain a significant financing component in accordance with IFRS 15. When the transaction price differs from the initial fair value of that financial instrument, a so called “day one gain or loss” may need to be recognised upon initial recognition in profit or loss. (see **chapter 6**)

3. Classification of financial assets

Financial assets whose contractual cash flows are Solely Payments of Principal and Interest (the SPPI test) will be classified in accordance with the entity’s business model for managing the asset: Amortised Cost if they are subject to a Hold-To-Collect business model, FV-OCI if they are held within a Hold-To-Collect-and-Sell business model, or FV-PL in any other situation. Financial assets that do not pass the SPPI test (e.g. derivatives and equity instruments) must be classified in the FV-PL category, except for some equity instruments which the entity may irrevocably classify in FV-OCINR.

Subsequent reclassifications are limited to SPPI financial assets, upon a change in the entity’s business model and are thus expected to be very infrequent.

Subject to specific conditions (e.g. when a situation of an accounting mismatch would otherwise arise), an entity may irrevocably classify any financial asset as measured at FV-PL upon initial recognition. (see **chapter 7**)

4. Impairment for expected credit losses

Entities must recognise an allowance for expected credit losses for all financial assets classified in the Amortised Cost or FV-OCI category, as well as for most loan commitments and financial guarantees issued. Upon initial recognition of the instrument, the loss allowance is equal to the credit losses that the entity expects as a result from default events occurring within the next 12 months (12MECL). This amount is updated at each reporting date. When a Significant Increase in the Credit Risk (SICR) of the asset is identified, the loss allowance must be measured at an amount equal to the credit losses that the entity expects to occur over the full remaining life of the asset (LTECL).

Purchased or originated credit-impaired (POCI) assets (i.e. assets with existing incurred credit losses upon initial recognition) follow a separate impairment and revenue recognition model.

A simplified expected credit loss impairment approach is mandatory for short term trade receivables and contract assets, and optional for other trade receivables and contract assets, and lease receivables. (see **chapter 9**).

5. Classification of financial liabilities

Most financial liabilities are classified in the Amortised Cost category unless they are held for trading, or meet the conditions for a voluntary classification in the FV-PL category upon their initial recognition. (see **chapter 8**)

6. Debt vs. Equity

Financial instruments issued that are in the scope of IAS 32 must be analysed to determine whether they meet the definition of an equity instrument or that of a financial liability. An instrument is generally classified as a financial liability if it requires the entity either to deliver cash or another financial asset, or to deliver a variable number of its own equity instruments. A derivative may qualify as an equity instrument if it will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of own equity instruments. Compound instruments contain both a liability and an equity component which must be accounted for separately.

7. Embedded derivatives

Derivative instruments may be either stand-alone contracts, or a feature embedded in a financial liability host contract or a non-financial host contract. Embedded derivatives must be bifurcated and accounted for separately as a stand-alone derivative if they are not economically closely related to their host contract. (see **chapter 13**)

8. Hedge accounting

Under IAS 39 and IFRS 9, most derivatives are by default measured at FV-PL whereas non-derivative financial assets and financial liabilities are often measured at amortised cost or FV-OCI. This situation may trigger accounting mismatches in profit or loss despite a proper economic offset between the hedging derivative and the hedged exposure. To better reflect the hedging strategy of the entity, IFRS 9 provides specific and optional accounting treatments for hedging relationships. The accounting impact depends on the nature of the hedging relationship (fair value hedge, cash flow hedge or net investment hedge). Hedge accounting is subject to eligibility, effectiveness and documentation -related conditions. (see **chapter 14**)

9. Derecognition

A financial asset is derecognised when and only when the contractual rights to the cash flows expire, or when the asset is transferred and this transfer meets the derecognition requirements. This test relies mainly on two criteria: the transfer of the contractual rights to the cash flows, and the transfer of the risks and rewards of ownership of the financial asset.

A financial liability is removed from the statement of financial position when it is extinguished. An exchange or modification of debt instruments, between an existing lender and borrower, is considered as an extinguishment of the original instrument if the terms of the original and the "new" instrument are substantially different.

10. Disclosures on financial instruments

The disclosure requirements aim at enabling the users to assess the significance of financial instruments for the entity, the nature and extent of risks arising from them, and how the entity manages those risks. (see **chapter 16**)

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CHAPTER 1

SCOPE OF STANDARDS APPLICABLE TO FINANCIAL INSTRUMENTS



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1.1. Introduction

An entity may need to use principally five different standards to account properly for financial instruments under IFRS. We will first present the purpose of each of these standards. We will then focus on the scope of the main IFRS standard for financial instruments, IFRS 9, and provide a specific focus on “own-use contracts”. Finally, we will present synoptic tables to provide a comparative scope overview between IAS 32, IFRS 7 and IFRS 9.

The five main IFRS standards dealing with financial instruments are the following:

IFRS 9 – Financial Instruments

The objective of IFRS 9 is to define principles for the financial reporting of financial instruments that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity’s future cash flows (IFRS 9.1).

IFRS 9 deals with:

- initial recognition and derecognition of financial instruments (see **chapters 6, 10 and 11**);
- classification principles of financial instruments (see **chapter 7** for financial assets and **chapter 8** for financial liabilities);
- measurement requirements at initial recognition (**chapter 6**) and subsequently (see **chapter 9**);
- impairment requirements for financial instruments (see **chapter 9**); and
- hedge accounting (see **chapter 14**).

IAS 32 – Financial Instruments: Presentation

IAS 32 aims at setting principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments from the perspective of the issuer, the classification of related interest, dividends, losses and gains and circumstances in which financial assets and financial liabilities should be offset.

IFRS 7 – Financial Instruments: Disclosures

IFRS 7 deals with most of the disclosures requirements related to financial instruments and is a complement to the principles defined by IAS 32 and IFRS 9.

Its objective is to require entities to provide disclosures in their financial statements that enable users to evaluate:

- the significance of financial instruments for the entity’s financial position and performance; and
- the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.

IFRS 13 – Fair Value Measurement

IFRS 13 defines the concept of fair value (see **chapter 3**), setting out in a single IFRS a framework for measuring fair value, and requiring disclosures about fair value measurements (see **section 16.6.4**).

Fair value being one of the two measurement methods used for financial instruments, IFRS 13 provides highly relevant input in accounting for financial instruments under IFRS.

IAS 39 – Financial Instruments: Recognition and Measurement

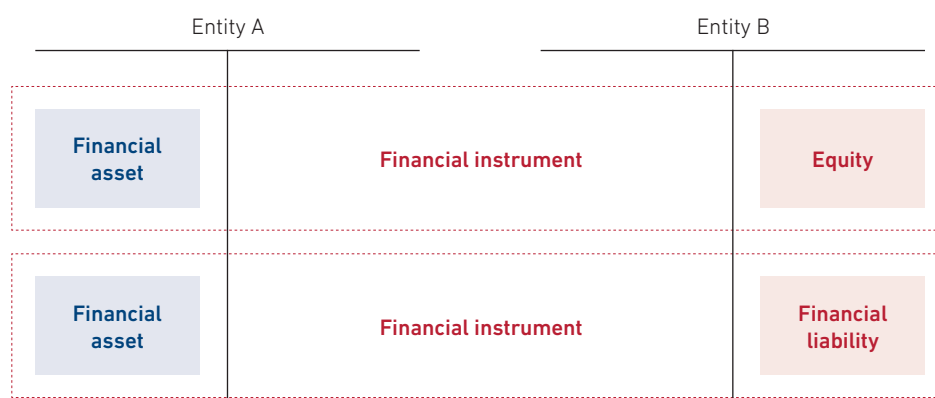
IAS 39 is the former IFRS standard for financial instruments. It was replaced by IFRS 9. However, IFRS 9 transition requirements allow entities to continue to apply some or all of IAS 39 requirements under specific circumstances.

The scope of IFRS 9 is mostly defined as all financial instruments, except for some of them. Therefore, we will start by defining which instruments are financial instruments and which ones are not. Then, we will detail the financial instruments that are excluded from the scope of IFRS 9. We will also present a specific focus on the contracts to buy or sell a non-financial item such as commodities. Finally, we will compare the scope of IFRS 9 to the scope of IAS 32 and then to that of IFRS 7.

1.2. Financial instruments under IFRS**1.2.1. IFRS definition of a financial instrument**

IAS 32.11 defines a financial instrument as “any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity”.

Figure 1.1



To make the definition of a financial instrument easier to understand, it is necessary to explain some basic terms:

- IAS 32.13 defines a **contract** as an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.
- IAS 32.14 defines an entity as individuals, partnerships, incorporated bodies, trusts and government agencies.

A **financial asset** is any asset that is:

- cash;
- an equity instrument of another entity;

- a contractual right:
 - > to receive cash or another financial asset from another entity; or
 - > to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is not qualified as equity instrument.

A **financial liability** is any liability that is:

- a contractual obligation:
 - > to deliver cash or another financial asset to another entity, or
 - > to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments and is not qualified as equity instrument.

An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities (see **chapter 5**).

The definition of a financial instrument under IFRS is principle-based. This definition will include a wide range of instruments as well as a wide range of legal formats. The most common examples of financial instruments are presented in the next section.

1.2.2. Examples of financial instruments

1.2.2.1. Simple financial instruments

Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and recognised in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability (IAS 32.AG3).

Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

- trade accounts receivable and payable;
- notes receivable and payable;
- loans receivable and payable; and
- bonds receivable and payable.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive) (IAS 32.AG4).

1.2.2.2. Derivative financial instruments

Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument (for the definition of a derivative financial instrument, see **chapter 2**).

On inception, derivative financial instruments give one party a contractual right to exchange financial assets or financial liabilities with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets or financial liabilities with another party under conditions that are potentially unfavourable (IAS 32.AG16).

Examples are: financial options, futures and forwards, interest rate and currency swaps, interest rate caps, collars and floors, loan commitments, note issuance facilities and letters of credit.

1.2.2.3. Loan commitments

IFRS 9.BCZ2.2 defines a loan commitment as a firm commitment to provide credit under pre-specified terms and conditions. A commitment to grant a loan at a specified interest rate during a fixed period meets the definition of a derivative. As such, most loan commitments should fall into the scope of IFRS 9. However, IFRS 9 decided to exclude some of them from the scope of its classification requirements (see **section 1.3.8**).

1.2.2.4. Lease contracts

IAS 32.AG9 specifies that a lease contract creates symmetrical obligations for the lessor to receive, and for the lessee to pay, a stream of payments.

Under a finance lease as defined by IFRS 16, a lessor regards this contract as a financial instrument whereas under an operating lease, a lessor continues to account for the underlying asset itself. Consequently, under an operating lease, only individual payments currently due and payable are financial instruments.

1.2.2.5. Trade receivables

As stated by IAS 32.AG21, a contract that implies the receipt / delivery of physical assets will generate a financial instrument when the payment is deferred past the delivery date, even if no invoice is issued at that same date.

When they are assets, these financial instruments are called trade receivables.

1.2.2.6. Insurance contracts

Insurance contracts as defined by IFRS 4 are most of the time financial instruments. An insurance contract is a contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder (IFRS 4 Appendix A).

The definition refers to insurance risk as opposed to a financial risk. A financial risk is a risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (IFRS 4 Appendix A).

Nevertheless, an insurance contract is generally a basic right / obligation to receive / pay cash upon the occurrence of a specified event. It therefore generally meets the definition of a financial instrument.

1.2.3. Examples of non-financial instruments

1.2.3.1. Physical assets, leased assets and intangible assets

Physical assets (like inventories, property, equipment, etc.), leased assets and intangible assets (like patents or trademarks for instance) do not give rise to a present right to receive cash or another financial asset (IAS 32.AG10).

1.2.3.2. Assets / liabilities for which the future economic benefit is the receipt / outflow of goods or services

Because they do not give rise to an obligation of receiving cash (or another financial instrument), prepaid expenses, deferred revenue and most warranty obligations are not financial instruments (IAS 32.AG11).

Except as required by IFRS 15 - *Revenue from Contracts with Customers*, a contract that involves the receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit (IAS 32.AG21).

1.2.3.3. Assets or liabilities that are not contractual

A financial instrument triggers “contractual” rights and obligations. Some obligations / rights to pay / receive cash are not contractual and are therefore not financial instruments. The most common example is an income tax liability. As it is not an obligation created by a contract, it is not a financial instrument.

Another example is a constructive obligation that enters the scope of IAS 37 - *Provisions, contingent liabilities and contingent assets* (IAS 32.AG12).

1.2.3.4. Gold Bullion

IFRS 9.IG.B.1 states clearly that a gold bullion is a commodity. It isn't a financial instrument because there is no contractual right to receive cash or another financial instrument encompassed in a gold bullion.

1.3. Financial instruments excluded from the scope of IFRS 9

IFRS 9 must be applied to all financial instruments except those that are detailed hereafter.

1.3.1. Interests in subsidiaries, associates and joint-ventures

The scopes of IAS 32, IFRS 9 and IFRS 7 exclude interests in subsidiaries, associates and joint ventures that are accounted for according to, respectively, IFRS 10 – *Consolidated Financial Statements*, IAS 27 – *Separate Financial Statements* and IAS 28 – *Investments in Associates and Joint Ventures*.

However, in some very specific cases, either IFRS 10, IAS 28 or IAS 27 require or permit to apply IFRS 9. In those cases, the financial instruments enter the scopes of IFRS 9, IAS 32 and IFRS 7 (IFRS 9.2.1(a), IAS 32.4(a), IFRS 7.3(a)).

Derivatives on interests in subsidiaries, associates or joint ventures, are in the scope of IAS 32. They are also in the scope of IFRS 7 and IFRS 9 except if they meet the definition of an equity instrument in the entity in IAS 32.

1.3.2. Lease contracts under IFRS 16

Rights and obligations under lease contracts are excluded from the scope of IFRS 9 except in the following cases:

- all derivatives embedded in lease contracts are in the scope of the embedded derivatives requirements of IFRS 9;
- by the lessor, all lease receivables recognised are in the scope of the derecognition and impairment requirements of IFRS 9;
- by the lessee, lease liabilities are in the scope of the derecognition requirements of IFRS 9 for financial liabilities.

1.3.3. Rights and obligations according to IAS 19

Employers' rights and obligations under employee benefit plans are excluded from the scope of IFRS 9, IAS 32 and IFRS 7 (IFRS 9.2.1(c) ; IAS 32.4(a) and IFRS 7.3(b)), where employee benefit plans means all forms of consideration given by an entity in exchange for a service rendered by employees or for the termination of employment (as per the definitions in IAS 19.8).

As confirmed by the IFRS Interpretations Committee (IFRS IC) in November 2005, the exclusion of IAS 32 applies to all employee benefits covered by IAS 19, even long-service leave.

1.3.4. Issued equity instruments

When an entity issues financial instruments that satisfy the definition of an equity instrument according to IAS 32, this financial instrument is out the scope of IFRS 9 (IFRS 9.2.1(d)).

When an issued financial instrument does not meet the IAS 32 definition of an equity instrument, but is required to be classified as an equity instrument under the specific paragraphs IAS 32.16 A - B for puttable instruments or IAS 32.16 C - D for instruments that comprise an obligation to deliver a prorata share of the net asset of the entity only on liquidation, it is excluded from the scope of IFRS 9 and IFRS 7 (IFRS 9.2.1(d)).

1.3.5. Insurance contracts

The following contracts are excluded from the scopes of IAS 32, IFRS 9 and IFRS 7:

- insurance contracts as defined by IFRS 4.



Please note that the exclusion applies to all insurance contracts and not only the insurance contracts that are in the scope of IFRS 4. This is important because IFRS 4 excludes from its scope, for example, insurance contracts held that are not re-insurance contracts.

This exclusion also applies to an embedded derivative in an insurance contract that is itself an insurance contract (IFRS 4.7).

Please note that an investment contract that has the legal form of an insurance contract but does not expose the insurer to significant insurance risk is not an insurance contract. An example can be life insurance contracts that effectively are investment contracts with insignificant mortality risk (such contracts are non-insurance financial instruments or service contracts) (IFRS 4.B19(a)).

- contracts that are within the scope of IFRS 4 because they contain a discretionary participation feature (i.e. essentially rights of the holder to receive additional benefits at the discretion of the issuer – see IFRS 4 Appendix A for more details on this concept). Please note that those contracts even though out of the scope of IAS 32 and IFRS 9, are in the scope of IFRS 7.

Please note that financial guarantee-related issues are addressed in the next section.

1.3.6. Financial guarantee contracts

1.3.6.1. Definition of financial guarantee contracts

A financial guarantee is a contract that requires its issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor failed to make payment when due in accordance with the original or modified terms of a debt instrument (IFRS 9 Appendix A).

As specified by IFRS 9.B2.5, the legal form of a financial guarantee contract (guarantee, letter of credit, credit default swap or insurance contract) would not impact its IFRS definition.

A financial guarantee will require a **reimbursement of an incurred loss**. Some credit-related guarantees do not, as a precondition for payment, require that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. Such contracts are neither financial guarantees nor insurance contracts and must therefore be qualified as a derivative instrument and be accounted for in accordance with IFRS 9 requirements (IFRS 9.B2.5(b)).



Determining whether the cash flows of a contract are a reimbursement of an incurred loss or not could sometimes require the exercise of judgement. It could be the case, for instance, when the end of the guarantee arises when the enforcement actions are still on-going, meaning before the actual amount of the incurred loss is known.

The incurred loss that is reimbursed by the contract should relate to a **debt instrument** which is not defined in IFRS 9.



In our opinion, the following could be considered as debt instruments: debt securities of course, but also trade debts or debts linked to a finance lease contract for instance.

1.3.6.2. Applying IFRS 4 vs. IFRS 9 to financial guarantee contracts

Financial guarantee contracts are within the scope of IFRS 9 except if (IFRS 9.2.1(e)):

- an issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts; and
- the issuer has elected to apply IFRS 4 to such financial guarantee contracts. This election is made contract by contract but is irrevocable.



Financial guarantee contracts are often issued by financial institutions. The above exception was introduced in the context of the first application of IFRS 4. The aim of this requirement was to require banks to apply IFRS 9 (formerly IAS 39) to such contracts, but to offer to insurance entities an option to account for financial guarantees in accordance with IFRS 4 if they elect to do so.

1.3.7. Forward contracts between an acquirer and a selling shareholder in an IFRS 3 business combination

Any forward contract between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination within the scope of IFRS 3 – *Business Combinations* at a future acquisition date, is excluded from the scope of IFRS 9. The term of the forward should not exceed a reasonable period normally necessary to obtain any required approvals and to complete the transaction (IFRS 9.2.1(f)).

1.3.8. Loan commitments excluded from the scope of classification of IFRS 9

Despite the fact that most loan commitments should fall within the scope of IFRS 9 as derivatives (see **section 1.2.2.3**), the IASB decided to exclude **some** loan commitments to simplify their accounting for holders and issuers of those loan commitments (IFRS 9.BCZ.2.3).

This exclusion applies to loan commitments that lead to an asset being recognised at amortised cost and consists in neither recognising these loan commitments nor measuring the changes in their fair value. However, this exclusion must not be applied to the following loan commitments:



- loan commitments that are designated at fair value through profit or loss if it reduces an accounting mismatch or if the associated risk exposure is managed on a fair value basis (IFRS 9.2.3(a));
- loan commitments that are mandatory at fair value through profit or loss because the entity has a past practice of selling the assets resulting from loan commitments in the same class (IFRS 9.2.3(a)); loan commitments that can be settled net in cash or by delivering or issuing another financial instrument because they are derivatives (IFRS 9.2.3(b));
- commitments to provide a loan at a below-market interest rate (IFRS 9.2.3(c)).

This scope exclusion grants a consistent treatment between the loan commitment and a loan measured at amortised cost the carrying amount of which is not affected by changes in market interest rate or credit spread.

In practice, many loan commitments will benefit from this IFRS 9 exclusion. However, a dedicated analysis should be performed when an entity sells its loans, as in syndication activities for instance.

Please note that all loan commitments not measured at FV-PL are in the scope of the impairment and derecognition requirements of IFRS 9 (IFRS 9.2.1(g)).

1.3.9. Share-based payments transactions (IFRS 2)

IAS 32.4(f)(i), IFRS 9.2.1(h) and IFRS 7.3(e) exclude from the scope of IAS 32, IFRS 7 and IFRS 9, contracts and obligations under share-based payment transactions for which IFRS 2 – *Share-based payment* applies.

However, those contracts should be treated as financial instruments following the rules applying to contracts to buy and sell non-financial item (see **section 1.4**)

1.3.10. Reimbursement rights recorded in accordance with IAS 37

Reimbursement rights of an entity for expenditure that it is required to make to settle a liability that it recognises as a provision in accordance with IAS 37 or for which, in an earlier period, it recognised a provision in accordance with IAS 37 are excluded from the scope of IFRS 9 (IFRS 9.2.1(i)).

Please note that there is no such exclusion from the scope of IAS 32 and IFRS 7.

1.3.11. Rights and obligations under IFRS 15¹

IFRS 9.2.1(j) excludes from the scope of classification of IFRS 9 all rights and obligations that are within the scope IFRS 15 – *Revenue from Contracts with Customers* except for those for which IFRS 15 requires otherwise.

In other words, this exclusion will mainly apply to **contract assets**. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer (IFRS 15.107), when that right depends on something other than the passage of time (for example, the future performance of the entity).

¹ If more information is needed, please refer to Mazars Insights: IFRS 15 Key points of the revenue recognition standard. <https://www.mazars.com/Home/Services/Audit-Assurance-Reporting/Financial-Reporting/IFRS-Transition/IFRS-15-Key-Revenue-recognition-standard-in-100Q-A>

Contract assets must be distinguished from trade receivables that must be recognised in accordance with IFRS 9 requirements. A **trade receivable** is an entity's right to consideration that is unconditional. A right to consideration is unconditional if only the passage of time is required before payment of that consideration is due (IFRS 15.108).

Please note that the contract assets initially recognised under IFRS 15 are however within the scope of IFRS 9 impairment requirements as required by IFRS 15.107 and IFRS 9.2.2 (see **chapter 9**).

1.4. Contracts to buy or sell a non-financial item and “Own-use” contracts

1.4.1. Purpose of the scope exception

Industrial entities may regularly enter into contracts to buy or sell non-financial items (e.g. commodities) at a fixed price and with a future settlement and delivery. Such agreement may meet the definition of a derivative and as such would have to be measured at FV-PL. However, it was not the intention of the Board to require any such contract to be accounted for as a financial derivative. IFRS 9 therefore comes with a scope exception, often referred as “own-use contracts”, to address this issue.

1.4.2. Scope of the own-use contracts exception

Contracts to buy or sell a non-financial item that was entered into and continues to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements are excluded from the scope of IFRS 9 (IFRS 9.2.4). Such contracts are often referred as “**own-use**” contracts.

It is important to note that this scope exception refers to a “receipt or delivery”. Therefore, contracts that can only be settled net in cash or another financial instrument, or by exchanging financial instruments cannot qualify as “own-use contracts”.

An entity should perform an analysis to determine whether the contracts were entered into and continue to be held for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements when the terms of the contract (IFRS 9.2.6):

- permit either party to settle it net in cash or another financial instrument or by exchanging financial instruments; or
- are on an underlying non-financial item that is readily convertible to cash.

IFRS 9 imposes a non-rebuttable presumption that a contract to buy or sell a non-financial item is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and must therefore be included in the scope of IFRS 9 when (IFRS 9.2.6):

- the ability to settle net in cash or another financial instrument, or by exchanging financial instruments, is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments (whether with the counterparty, by entering into offsetting contracts or by selling the contract before its exercise or lapse); or
- when, for similar contracts, the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin.

A similar non-rebuttable presumption exists that a written option to buy or sell a non-financial item is not entered into for the purpose of the receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements and is therefore within the scope of IFRS 9 if:

- it can be settled net in cash or another financial instrument, or by exchanging financial instruments; or
- the non-financial item that is the subject of the contract is readily convertible to cash.

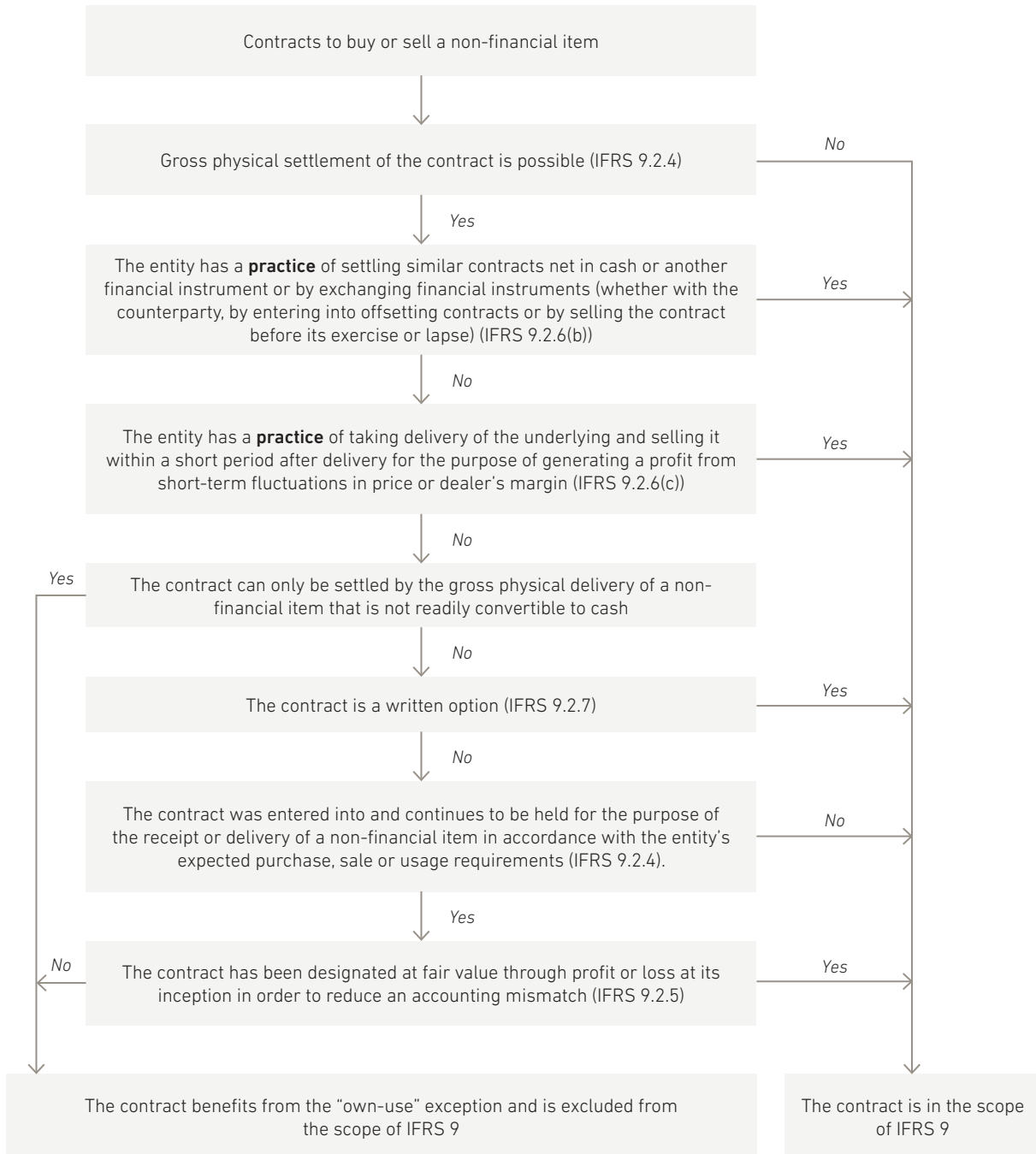
1.4.3. Fair value option for own-use contracts

A contract to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contract was a financial instrument, may be irrevocably designated as measured at fair value through profit or loss even if it was entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (IFRS 9.2.5).

This designation is available only at inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency (sometimes referred to as an "accounting mismatch") that would otherwise arise from not recognising that contract because it is excluded from the scope of IFRS 9.

1.4.4. Own-use contract decision tree

Figure 1.2



1.5. Synoptic table of comparative scopes by type of instruments

Figure 1.3

	Which instruments?	IAS 32	IFRS 9				IFRS 7	Other standards
			Classification	Impairment	Derecognition	Embedded derivative		
Some common financial instruments	Derivatives ²	✓	✓	✗	✓	n/a	✓	n/a
	Investments in debt instruments	✓	✓	✓	✓	✗	✓	n/a
	Investments in equity instruments as defined in IAS 32 ^{3,4}	✓	✓	✗	✓	✗	✓	n/a
Interests in subsidiaries, associates and joint ventures IFRS 9.2.1(a)	Exception cases in which IFRS 10, IAS 27 or IAS 28 allow or require to apply some or all of IFRS 9's requirements	✓	Refer to the relevant standard i.e. IFRS 10 or IAS 27 or IAS 28				✓	n/a
	Other interests in subsidiaries, associates and joint ventures	✗	✗	✗	✗	✓	✗	IAS 27, IAS 28, IFRS 10, IFRS 12
	Derivatives on interests in a subsidiary, associate or joint venture that meet the definition of an equity instrument of the entity (according to IAS 32)	✓	✗	✗	✗	n/a	✗	n/a
	Other derivatives on interests in a subsidiary, associate or joint venture	✓	✓	✗	✓	n/a	✓	n/a
Equity instruments IFRS 9.2.1(d)	Issued Equity instruments following the definition of IAS 32 ⁵	✓	✗	✗	✗	✓	✓	n/a
	Issued instruments required to be presented as equity following IAS 32.16 A or B or C or D	✓	✗	✗	✗	✓	✗	n/a

² Including embedded derivatives accounted for separately as required by IFRS 9.

³ Other than interests in subsidiaries, associates and joint ventures.

⁴ Including options and warrants and instruments required to be presented as equity following IAS 32.16 A or B or C or D.

⁵ Including derivative instruments.

	Which instruments?	IAS 32	IFRS 9				IFRS 7	Other standards
			Classification	Impairment	Derecognition	Embedded derivative		
Contract to buy or sell non-financial items IFRS 9.2.4-7	Contracts that do not qualify for the "own-use exception"	✓	✓	✗	✓	n/a	✓	n/a
	Own-use contracts	✗	✗	✗	✗	✓	✗	
	Contracts to buy or sell non-financial items that are designated or mandatorily measured at FV-PL.	✓	✓	✗	✓	✗	✓	n/a
Loan Commitments IFRS 9.2.3	Loan commitments designated at FV-PL or mandatorily measured at FV-PL (IFRS 9.2.3)	✓	✓	✗	✓	✗	✓	n/a
	Commitment to provide a loan at below-market rate (IFRS 9.2.3(c))	✓	✗	✓	✓	✓	✓	IFRS 15
	Other loan commitments (IFRS 9.2.1(g))	✓	✗	✓	✓	✓	✓	n/a
Share-based payment contracts (IFRS 2) IFRS 9.2.1(h)	Treasury shares purchased, sold, issued or cancelled in relation to a share-based payment arrangement	✓	✗	✗	✗	✓	✗	IFRS 2
	All other financial contracts	✗	✗	✗	✗	✓	✗	IFRS 2
Forward contracts between an acquirer and a selling shareholder in an IFRS 3 business Combination IFRS 9.2.1(f)	Forward contracts in a business combination with a reasonable period to complete the transaction	✓	✗	✗	✗	✓	✓	
	Forward contracts in a business combination with more than a reasonable period to complete the transaction	✓	✓	✗	✓	n/a	✓	

	Which instruments?	IAS 32	IFRS 9				IFRS 7	Other standards
			Classification	Impairment	Derecognition	Embedded derivative		
Insurance contracts IFRS 9.2.1(e)	A contract that is within the scope of IFRS 4 because of its discretionary participation features	Partially	x	x	x	✓	Only to the extent of any bifurcated embedded derivative	IFRS 4
	Financial guarantee contracts issued for which IFRS 9 applies	✓	✓	✓	✓	✓	✓	n/a
	Other insurance contracts	x	x	x	x	✓	x	IFRS 4
Rights and obligations under IFRS 15⁶ IFRS 9.2.1(j)	Contract assets	x	x	✓	x	✓	Impairment gain or loss only	IFRS 15
	Trade receivables	✓	✓	✓	✓	✓	✓	IFRS 15
	Trade payables	✓	✓	x	✓	✓	✓	IFRS 15
IFRS 9.2.1(i)	Reimbursement Rights recorded in accordance with IAS 37	✓	x	x	x	x	✓	IAS 37
IFRS 16 contracts IFRS 9.2.1(b)	<u>At the lessee:</u> lease payables / liabilities	✓	x	x	✓	✓	✓	IFRS 16
	<u>At the lessor:</u> lease receivables	✓	x	✓	✓	✓	✓	IFRS 16
IFRS 9.2.1(c)	Employer's rights and obligations under IAS 19	x	x	x	x	x	x	IAS 19

⁶ If more information is needed, please refer to Mazars Insight: IFRS 15 Key points of the revenue recognition standard. <https://www.mazars.com/Home/Services/Audit-Assurance-Reporting/Financial-Reporting/IFRS-Transition/IFRS-15-Key-Revenue-recognition-standard-in-100Q-A>

CHAPTER 2

DEFINITIONS, ACRONYMS AND ABBREVIATIONS USED



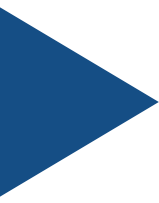


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2.1. Definitions

The following definitions are extracted from standards IFRS 9, IAS 32, IFRS 7 or IFRS 13:

2.1.1. General definitions

Financial instrument (IAS 32.11) Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Equity instrument (IAS 32.11) Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Financial asset (IAS 32.11) Any asset that is:

- cash;
- an equity instrument of another entity;
- a contractual right:
 - > to receive cash or another financial asset from another entity; or
 - > to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- 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 financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B of IAS 32, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D of IAS 32, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

Financial liability
(IAS 32.11)

Any liability that is:

- a contractual obligation:
 - > to deliver cash or another financial asset to another entity; or
 - > to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- 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, rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments. Also, for these purposes the entity's own equity instruments do not include puttable financial instruments that are classified as equity instruments in accordance with paragraphs 16A and 16B of IAS 32, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D of IAS 32, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.

As an exception, an instrument that meets the definition of a financial liability is classified as an equity instrument if it has all the features and meets the conditions in paragraphs 16A and 16B or paragraphs 16C and 16D of IAS 32.

2.1.2. Amortised cost and effective interest rate-related definitions

Amortised cost
of a financial asset
or financial liability
(IFRS 9 Appendix A)

The amount at which the financial asset or financial liability is measured at initial recognition minus the 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 (see **section 2.1.3**).

Effective interest method
(IFRS 9 Appendix A)

The method that is used in the calculation of the amortised cost of a financial asset or a financial liability and in the allocation and recognition of the interest revenue or interest expense in profit or loss over the relevant period.

Effective interest rate (IFRS 9 Appendix A) The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability. When calculating the effective interest rate, an entity shall estimate the expected cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but shall not consider the expected credit losses (see **section 2.1.3**). The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Credit-adjusted effective interest rate (IFRS 9 Appendix A) The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset to the amortised cost of a financial asset that is a purchased or originated credit-impaired financial asset (see **section 2.1.3**). When calculating the credit-adjusted effective interest rate, an entity shall estimate the expected cash flows by considering all contractual terms of the financial asset (for example, prepayment, extension, call and similar options) and expected credit losses (see **section 2.1.3**). The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts. There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the cash flows or the remaining life of a financial instrument (or group of financial instruments), the entity shall use the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).

Gross carrying amount of a financial asset (IFRS 9 Appendix A) The amortised cost of a financial asset, before adjusting for any loss allowance (see **section 2.1.3**).

<p>Modification gain or loss (IFRS 9 Appendix A)</p>	<p>The amount arising from adjusting the gross carrying amount of a financial asset to reflect the renegotiated or modified contractual cash flows. The entity recalculates the gross carrying amount of a financial asset as the present value of the estimated future cash payments or receipts through the expected life of the renegotiated or modified financial asset that are discounted at the financial asset's original effective interest rate (or the original credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets) or, when applicable, the revised effective interest rate calculated in accordance with paragraph 6.5.10 of IFRS 9. When estimating the expected cash flows of a financial asset, an entity shall consider all contractual terms of the financial asset (for example, prepayment, call and similar options) but shall not consider the expected credit losses, unless the financial asset is a purchased or originated credit-impaired financial asset, in which case an entity shall also consider the initial expected credit losses that were considered when calculating the original credit-adjusted effective interest rate.</p>
<p>Transaction costs (IFRS 9 Appendix A)</p>	<p>Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.</p>

2.1.3. Impairment-related definitions

<p>Credit risk (IFRS 7 Appendix A)</p>	<p>The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation</p>
<p>Credit risk rating grades (IFRS 7 Appendix A)</p>	<p>Rating of credit risk based on the risk of a default occurring on the financial instrument.</p>
<p>Credit loss (IFRS 9 Appendix A)</p>	<p>The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets). An entity shall estimate cash flows by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms. There is a presumption that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.</p>

Credit-impaired financial asset
(IFRS 9 Appendix A)

A financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired include observable data about the following events:

- significant financial difficulty of the issuer or the borrower;
- a breach of contract, such as a default or past due event;
- the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
- it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event - instead, the combined effect of several events may have caused financial assets to become credit-impaired.

Expected credit loss
(IFRS 9 Appendix A)

The weighted average of credit losses with the respective risks of a default occurring as the weights.

Impairment gain or loss
(IFRS 9 Appendix A)

Gains or losses that are recognised in profit or loss in accordance with paragraph 5.5.8 of IFRS 9 and that arise from applying the impairment requirements in Section 5.5 of IFRS 9.

Lifetime expected credit losses
(IFRS 9 Appendix A)

The expected credit losses that result from all possible default events over the expected life of a financial instrument.

12-month expected credit losses
(IFRS 9 Appendix A)

The portion of lifetime expected losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Loss allowance
(IFRS 9 Appendix A)

The allowance for expected credit losses on financial assets measured in accordance with paragraph 4.1.2 of IFRS 9, lease receivables and contract assets, the accumulated impairment amount for financial assets measured in accordance with paragraph 4.1.2A of IFRS 9 and the provision for expected credit losses on loan commitments and financial guarantee contracts.

Past due (IFRS 9 Appendix A)	A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.
POCI/ Purchased or originated financial asset (IFRS 9 Appendix A)	Purchased or originated financial asset(s) that are credit-impaired on initial recognition.

2.1.4. Derivatives and hedging-related definitions

Derivative (IFRS 9 Appendix A)	<p>A financial instrument or other contract within the scope of IFRS 9 with all three of the following characteristics:</p> <ul style="list-style-type: none"> — its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying'). — it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. — it is settled at a future date.
Embedded derivative (IFRS 9.4.3.1)	A component of a contract that also includes a non-derivative host with the effect that some of the cash flows of the combined contract vary in a way similar to a stand-alone derivative.
Firm commitment (IFRS 9 Appendix A)	A binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates.
Forecast transaction (IFRS 9 Appendix A)	An uncommitted but anticipated future transaction.
Hedge effectiveness (IAS 39.9)	The degree to which changes in the fair value or cash flows of the hedged item that are attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument.
Hedge ratio (IFRS 9 Appendix A)	The relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

2.1.5. Other definitions

Contract assets (IFRS 9 Appendix A)	Those rights that IFRS 15 – <i>Revenue from Contracts with Customers</i> specifies are accounted for in accordance with IFRS 9 for the purposes of recognising and measuring impairment gains or losses.
Derecognition (IFRS 9 Appendix A)	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.
Dividends (IFRS 9 Appendix A)	Distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital.
Entity (IAS 32.14)	In IAS 32, 'entity' includes individuals, partnerships, incorporated bodies, trusts and government agencies.
Fair value (IFRS 13.9)	The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
Financial guarantee contract (IFRS 9 Appendix A)	A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.
Held for trading (IFRS 9 Appendix A)	A financial asset or financial liability that: <ul style="list-style-type: none">— is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;— on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or— is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
Puttable instruments (IAS 32.11)	A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or the death or retirement of the instrument holder.
Reclassification date (IFRS 9 Appendix A)	The first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets.
Regular way purchase or sale (IFRS 9 Appendix A)	A purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

Settlement date (IFRS 9.B3.1.6)	The date that an asset is delivered to or by an entity.
Trade date (IFRS 9.B3.1.5)	The date that an entity commits itself to purchase or sell an asset.

2.2. Acronyms and abbreviations used

The following acronyms and abbreviations are used in our publication with the meaning explained hereafter:

12MECL	Twelve-Months Expected Credit Losses
12M PD	Twelve-Months Probability of Default
AC	Amortised Cost
AG	Application Guidance (part of an IFRS standard)
BC	Basis for Conclusions
B/S	Balance-Sheet (statement of financial position)
CA-EIR	Credit-Adjusted Effective Interest Rate
CDS	Credit Default Swap
CFH	Cash Flow Hedge
CLI	Contractually-Linked Instruments
CMS	Constant Maturity Swap
CU	Currency Unit
CVA	Credit Valuation Adjustment
DPD	Days Past Due
DVA	Debit Valuation Adjustment
EAD	Exposure At Default
EBA	European Banking Authority
EBITDA	Earnings Before Interest, Tax, Depreciation and Amortisation
EDTF	Enhanced Disclosure Taskforce
ECL	Expected Credit Losses
EIR	Effective Interest Rate
ESMA	European Securities and Markets Authority
EURIBOR	Euro Interbank Offered Rate
FV	Fair Value
FVA	Funding Valuation Adjustment

FVH	Fair Value Hedge
FV-OCI	Fair Value through Other Comprehensive Income with subsequent recycling to profit or loss
FV-OCINR	Fair Value through Other Comprehensive without subsequent recycling to profit or loss
FV-PL	Fair Value through Profit or Loss
HFT	Held-for-Trading financial instruments
HQLA	High Quality Liquid Assets
HTC	Hold-to-Collect business model for managing financial assets
HTCS	Hold-to-Collect-and-Sell business model for managing financial assets
IASB	International Accounting Standards Board
IAS	International Accounting Standards
IE	Illustrative Examples
IFRIC	International Financial Reporting Interpretation Committee
IFRS	International Financial Reporting Standards
IFRS IC	IFRS Interpretations Committee
IG	Implementation Guidance
IRS	Interest Rate Swap
ISDA	International Swaps and Derivatives Association
ITG	IFRS Transition Resource Group for Impairment of Financial Instruments
LGD	Loss Given Default
LTECL	Lifetime Expected Credit Losses
LT PD	Lifetime Probability of Default
NIH	Net Investment Hedge
OBS	Off Balance-Sheet
OCI	Other Comprehensive Income
PD	Probability of Default
P&L	Profit or Loss
POCI	Purchased or Originated Credit Impaired assets
SICR	Significant Increase in Credit Risk
SPPI	Solely Payments of Principal and Interest
SPE	Special Purpose Entity
SPV	Special Purpose Vehicle

CHAPTER 4

AMORTISED COST



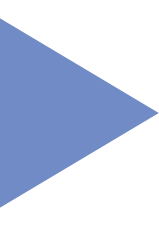


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4.1. Introduction

Following their initial recognition in the balance sheet, financial instruments are measured either at fair value or at amortised cost depending on their contractual features and the entity's business model for managing them, as explained in **chapter 7**.

The principles of fair value measurement are detailed in **chapter 3** whereas **chapter 4** deals with the principles for the calculation of the amortised cost.

The amortised cost of a financial instrument takes into account all the contractual terms and conditions of the instrument (e.g. its amortisation schedule, type of interest rate, etc.). It does not reflect however the changes in its market value. Amortised cost therefore normally generates less volatility in the financial statements than measurement at fair value.

IFRS 9 requires that amortised cost be determined using the Effective Interest Rate method which is a technique for allocating the different fees, costs and remuneration (interest payments, premiums, discounts...) of a debt financial instrument over its expected life.

Note: in this chapter, to simplify the examples, we will assume that no impairment on financial assets takes place at their initial recognition or during subsequent periods, so amortised cost is systematically equal to gross carrying amount.

4.2. Scope

Amortised cost must be calculated for the following financial assets / liabilities:

- **financial assets and financial liabilities measured on the balance sheet at their amortised cost** subsequently to their initial recognition. These include:
 - > financial assets that meet the following criteria:
 - they both pass the SPPI test and are managed within the Hold-to-Collect business model (see **sections 7.4.3** and **7.4.2.2**),
 - and they have not been designated by the entity as measured at FV-PL (see **section 7.4.5**);
 - > most financial liabilities, except for (a) all derivatives and (b) for financial liabilities held-for-trading or designated as measured at FV-PL, subject to conditions (see IFRS 7.4.2.1 and **chapter 8**).
- **financial assets that are debt instruments measured at fair value through other comprehensive income with recycling to profit or loss (FV-OCI)**. These are financial assets that:
 - > both pass the SPPI test and are managed within the Hold-to-Collect-and-Sell business model (see **sections 7.4.3** and **7.4.2.3**); and
 - > have not been designated by the entity as measured at FV-PL (see **section 7.4.5**).

Even though financial assets in the FV-OCI category are not presented on the balance sheet at their amortised cost (but rather at their fair value), entities do need to calculate their amortised cost at each reporting date. This is because the FV-OCI category leads simply to (a) present the fair value of the asset on the balance sheet and (b) determine the impacts in profit or loss of the period (i.e.

Interest revenue and impairment losses and gains) in accordance with amortised cost measurement. Thus, the impacts in OCI act mechanically as a buffer between the two measurement methods.

See **chapter 9** for details on which categories of financial instruments are measured at amortised cost or at fair value after their initial recognition.

4.3. Definitions

IFRS 9 (Appendix A) defines amortised cost as:

- the amount at which a financial asset or a 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 allowance¹.

The effective interest rate (EIR) method is a technique used to calculate the amortised cost of a financial asset or a financial liability and allocate and recognise the financial revenues / expenses in profit or loss over the relevant period.

The effective interest rate is the rate that exactly discounts the **estimated** cash payments or receipts through the **expected** life of a financial asset (or financial liability) to the gross carrying amount of that financial asset (or financial liability) (IFRS 9 Appendix A).

The effective interest rate of a financial instrument is normally determined once and for all upon the initial recognition of that instrument. It will only be revised subsequently in one of the following 5 situations:

- > floating rate instruments with EIR calculated in accordance with IFRS 9.B5.4.5 (see **section 4.7**);
- > when new transaction costs are incurred (for example, costs incurred in relation to a modification of the contractual terms of a financial instrument that does not lead to its derecognition); or
- > upon the discontinuation of a fair value hedge of a financial instrument measured at amortised cost (IFRS 9.6.5.10, see **chapter 14** for more details); or
- > when a financial instrument ceases to be remeasured at fair value in accordance with the option to designate a credit exposure as measured at FV-PL (see **chapter 14**); or
- > upon the reclassification of a financial asset out the FV-PL category into the amortised cost or FV-OCI category (IFRS 9.5.6.3, 5.6.6 and B5.6.2, see **section 7.5**).

When calculating the effective interest rate, an entity must estimate the **expected** cash flows by considering all the contractual terms of the financial instrument (for example, prepayment, extension, call and similar options) but must not consider the expected credit losses. The only exception is the very specific case of Purchased or Originated Credit Impaired instruments (POCI). See **chapter 9** for more details on this specific accounting treatment.

¹ In this chapter, to simplify the examples, we will assume that no impairment on financial assets takes place at their initial recognition or during subsequent periods, so amortised cost is systematically equal to gross carrying amount.

The calculation of the EIR also includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see below), transaction costs / fees and all other premiums or discounts.

IFRS 9 (Appendix A) defines **transaction costs** as incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

Fees that are an integral part of the effective interest rate of a financial instrument include:

- origination fees received by the entity relating to the creation or acquisition of a financial asset. Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument;
- commitment fees received by the entity to originate a loan when the loan commitment is not measured at FV-PL and if it is probable that the entity will enter into a specific lending arrangement. These fees are regarded as compensation for an ongoing involvement with the acquisition of a financial instrument. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry;
- origination fees paid on issuing financial liabilities measured at amortised cost. These fees are an integral part of generating an involvement with a financial liability. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the IFRS 9 financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

Fees that are **not** an integral part of the effective interest rate of a financial instrument are accounted for in accordance with IFRS 15. They include:

- fees charged for servicing a loan;
- commitment fees to originate a loan when the loan commitment is measured at FV-PL, or if it is unlikely that a specific lending arrangement will be entered into; and
- loan syndication fees received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants).

4.4. Amortised cost and initial recognition

Any financial instrument that will subsequently be measured at amortised cost is initially recognised at its initial **fair value, plus or minus transaction costs** that are directly attributable to the acquisition or issue of that financial instrument (IFRS 9.5.1.1), **plus or minus any fees** that are an integral part of the effective interest rate (IFRS 9.B5.4.1).

For a financial liability, transaction costs as well as fees paid upfront are deducted from the fair value at initial recognition (IFRS 9.IG.E.1.1).

Example 4.1

For a debt issued for €100 where €5 were paid to the bank in fees and costs, the initial amortised cost is equal to €95.

For a financial asset, transaction costs are added to the fair value at initial recognition (IFRS 9.IG.E.1.1) whereas fees received upfront are deducted from the fair value at initial recognition.

Example 4.2

For a bond purchased for €100 where €1 transaction cost was incurred (e.g. intermediary fees), the initial amortised cost is equal to €101.

Example 4.3

For a loan granted for €100 where €3 upfront fees (prepaid interest) have been received by the bank, the initial amortised cost is equal to €97.

For more information on the initial measurement of financial instruments, see **chapter 6**.

4.5. Amortised cost at subsequent periods: a numerical example of amortised cost and EIR calculation

The following example illustrates the principles underlying the calculation of the amortised cost and the effective interest rate (EIR) for a fixed-rate financial asset:

- On 1 January 2019, entity A purchases a non-amortising, non-callable debt instrument with five years remaining to maturity for its fair value of €995 and incurs transaction costs of €5. The instrument has a nominal value of €1,250 and carries a contractual fixed interest of 4.7% payable annually at the end of each year ($4.7\% * €1,250 = €59$). Its redemption amount is equal to its nominal value plus accrued interest.
- The instrument qualifies for a measurement at amortised cost. As explained in the preceding section, its initial carrying amount is the sum of the initial fair value plus transaction costs, i.e. €1,000.
- The Effective Interest Rate (EIR) is the rate that exactly discounts the expected cash flows of this financial asset, presented in the table below, to its initial gross carrying amount (i.e. €995 + €5 = €1,000 in this example). In practice, entities will need to establish a timetable of all the expected cash flows of the financial instrument (see the table below) and then use for example an Excel formula to determine this rate. The table below summarises the timing of the expected cash flows of the instrument:



Figure 4.1

in €	01/01/19	31/12/19	31/12/20	31/12/21	31/12/22	31/12/23
Undiscounted cash flows	-1,000	59	59	59	59	1,309

In the present case, using an Excel formula, the EIR amounts to 10%. The following table shows that the sum of the discounted cash flows amounts to zero:

Figure 4.2

in €	01/01/19	31/12/19	31/12/20	31/12/21	31/12/22	31/12/23	Total
Acquisition cost (1)	-1,000						-1,000
Interest revenue (2)		59	59	59	59	59	294
Reimbursement of the principal at the maturity date (3)						1,250	1,250
TOTAL OF EXPECTED CASH FLOWS	-1,000	59	59	59	59	1,309	544
EXPECTED CASH FLOWS DISCOUNTED AT EIR (10%)	-1,000	53	49	44	40	814	0

(1) including transaction costs (commissions, fees...) to be included in the initial carrying amount of the asset

(2) $4.7\% * €1,250 = €59$

(3) in our example, redemption price equals the nominal value

The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each annual reporting period:

Figure 4.3

in €	(a)	(b = a * 10%)	(c)	(d = a + b - c)
	Amortised cost at the beginning of the reporting period	Interest income to be recognised in P&L	Cash flows	Amortised cost at the end of the reporting period
2019	1,000	100	59	1,041
2020	1,041	104	59	1,086
2021	1,086	108	59	1,136
2022	1,136	113	59	1,190
2023	1,190	119	1,309	0

Even if effective interest rate calculation principles are straightforward the implementation for some complex instruments could be challenging. **Section 4.8** provides additional examples on how to calculate the amortised cost for financial instruments.

4.6. Revision or modification of cash flows

4.6.1. Revision of cash flow estimates

The EIR of a financial instrument carried at amortised cost is determined on the basis of the contractual cash flows expected by the entity. Some cash flows are not certain to occur, or their timing may not be known with certainty from the outset because of contractually specified contingencies / options. Entities must make estimates for these cash flows when initially calculating the effective interest rate. One example of such situation is cash flows resulting from early repayment options: the initial assumption as to the early repayment date and its amount (or the absence of early repayment) will have a direct impact on the initial effective interest rate. Another example where estimates are needed is the case of an instrument with an interest step-up mechanism where the step-up is not certain to occur (e.g. step-up of 5 b.p. in case of a downgrade of the borrower by an external credit agency).

The amortised cost mechanics will be more complex for such instruments since the amortised cost will have to be recalculated whenever there is a revision of the initially expected cash flows. Revision of estimated cash flows occurs, for example, when an entity no longer expects to early repay its financial liability whose early repayment was initially integrated in the effective interest rate calculation.

IFRS 9.B5.4.6 requires that when an entity revises its estimates of cash flows of a financial instrument measured at amortised cost, the carrying amount of the financial instrument is adjusted to reflect the “newly” expected cash flows. The analysis of the revision or modification of cash flows under this section excludes any change in the expected credit losses.

To calculate the adjustment mentioned above, the entity recalculates the gross carrying amount of the financial asset or financial liability as the present value of the “newly” expected contractual cash flows (i.e. the **revised**) discounted using the financial instrument’s **original** effective interest rate (see IFRS 9.6.5.10). The difference between the previous carrying amount of the instrument and the new carrying amount thus calculated at the date of revision is accounted for immediately as of the cash flows’ estimates revision date as income or expense in profit or loss: this is the so-called “catch-up” adjustment. The “catch-up” mechanism is further illustrated in **section 4.8.1**, for a prepayable financial instrument.

4.6.2. Contractual modification of cash flows

A revision of estimated cash flows differs from a modification of cash flows as the former occurs without any modification to the contractual terms and conditions of the financial instrument. If the contractual terms of a debt instrument are modified, the entity first determines whether this modification shall trigger the derecognition of the instrument (see **chapters 10** and **11**).

Whenever the contractual terms and conditions of a financial instrument are modified and this modification does not result in the derecognition of that instrument (see **chapters 10** and **11**), the carrying amount of the financial instrument is adjusted to reflect the “modified” cash flows (IFRS 9.5.4.3 and BC4.253). As the asset has not been derecognised, the original EIR is maintained and will be used to determine the amount of the “catch-up” adjustment that will be recognised in profit or loss in a way similar to the one described in **section 4.6.1**.

4.7. Floating rate debt instruments

IFRS 9 does not provide clear guidance for the calculation of the amortised cost of floating rate debt instruments.

For floating rate instruments entities do not have a contractual schedule with known amounts of interest. The interest contractual amounts for future periods are uncertain upon the initial recognition of the financial instrument. Applying the guidance in **section 4.6.1** to the revision of contractual cash flows of a floating rate instrument, the EIR would be calculated initially based on the projected levels of the underlying floating rate index over the entire expected life of the instrument, and subsequent revisions to the initially expected cash flows would give rise to a “catch-up” gain or loss in profit or loss at each reporting date, while still using the initially set EIR over the remaining periods. This approach would be quite complex to implement.

IFRS 9.B5.4.5 specifies that re-estimation of the cash flows of a floating rate financial instrument to reflect the movements in the market rates alters the effective interest rate and that if a floating-rate financial instrument is recognised initially at an amount equal to the principal receivable or payable on maturity, re-estimating the future interest payments normally has no significant effect on the carrying amount of the asset or the liability.



In the absence of more specific guidance, most entities use, for floating rate instrument, an effective interest rate that is re-estimated at each reset of the underlying rate. Such an approach may be declined in several ways. One sophisticated way is presented further in **section 4.8.3**.

In practice, the most common interpretation is to simply account for periodic floating-rate payments on an accrual basis in the period they are earned, adjusted to take into account amortisation of transaction costs and other premium or discount.

4.8. Illustrative examples

4.8.1. Fixed rate debt instrument with a prepayment option

Assume the same example as in **section 4.5** except that the contract specifies that the borrower has an option to early repay the instrument without penalty.

At inception, entity A expects that the borrower will repay the instrument at the end of the third year and includes this assumption in the calculation of the effective interest rate. The following table summarises the timing of the expected cash flows of the instrument:

Figure 4.4

in €	01/01/19	31/12/19	31/12/20	31/12/21	Total
Acquisition cost (1)	-1,000				-1,000
Interest revenue (2)		59	59	59	176
Reimbursement of the principal at the maturity date (3)				1,250	1,250
Total of expected cash flows	-1,000	59	59	1,309	426
Expected cash flows discounted at EIR (13.2%)	-1,000	52	46	902	0

(1) including transaction costs (commissions, fees...) to be included in the initial carrying amount of the asset
(2) $4.7\% * €1,250 = €59$
(3) in our example, redemption price equals the nominal value

The effective interest rate in this case amounts to 13.2% (this rate exactly discounts the expected cash flows of the financial instrument, as presented in the table below, to its initial amortised cost).

Figure 4.5

in €	01/01/19	31/12/19	31/12/20	31/12/21	Total
Expected cash flows discounted at EIR (13,2%)	-1,000	52	46	902	0

The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each annual reporting period in the scenario where the cash flows are realised as expected (i.e. complete reimbursement occurs at the end of the third year):

Figure 4.6

in €	(a) Amortised cost at the beginning of the reporting period	(b = a * 13.2%) Interest income to be recognised in P&L	(c) Cash flows	(d = a + b - c) Amortised cost at the end of the reporting period
2019	1,000	132	59	1,073
2020	1,073	142	59	1,156
2021	1,156	153	1,309	0

4.8.2. Revision of estimates

Assume the same fact pattern as in the example of **section 4.8.1**.

At 31 December 2020, entity A revises its estimates for the cash flows and expects now that the reimbursement will occur at the end of 2022 rather than at the end of 2021 as initially expected.

At 31 December 2020, entity A adjusts the carrying amount of the debt instrument to reflect the newly expected cash flows (reminder: the **revised** cash flows are discounted using the **original** effective interest rate). Any difference between the carrying amount just before the revision of cash flows and the carrying amount just after the revision of cash flows should be recognised in profit or loss (IFRS 9.B5.4.6, see **section 4.6**).

In this example, the carrying amount of the debt instrument following the revision of cash flow estimates at 31 December 2020 amounts to €1,073.

Figure 4.7

in €	31/12/20	31/12/21	31/12/22	31/12/23	Total
Revised cash flows*	0	59	1,309	0	
Revised cash flows discounted at the original EIR (13.2%)	0	52	1,021	0	1,073

*following the revision of the early repayment date

Thus, at 31 December 2020, entity A recognises a catch up adjustment of €83 ($€1,156^2 - €1,073$) triggering a loss in profit or loss. This reflects the fact that the principal will be repaid later than expected initially, thus resulting in a partial reversal of the amortisation of the initial discount and transaction costs recognised in previous periods.

The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each annual reporting period in the scenario where the remaining cash flows are realised as expected in 2021 and 2022:

Figure 4.8

in €	(a) Amortised cost at the beginning of the reporting period	(b = a * 13.2%) Interest income to be recognised in P&L	(c) Cash flows	(d = a + b - c) Amortised cost at the end of the reporting period
2021	1,073	142	59	1,156
2022	1,156	153	1,309	0

4.8.3. Floating rate instrument without a prepayment option

Section 4.7 describes the principles for calculating the EIR for a floating rate instrument. The following example illustrates how entities may account for a floating rate debt instrument (this is one possible approach, other approaches may also be envisaged):

- On 1 January 2019, entity A purchases a non-amortising, non-callable debt instrument with five years remaining to maturity for its fair value of €995 and incurs transaction costs of €5. The instrument has a nominal value of €1,250 and carries floating rate of interest indexed to 12-month Euribor (not floored) plus a 2% credit margin payable annually at the end of each year. The instrument's redemption amount is equal to its nominal value plus accrued interest.
- The instrument qualifies for a measurement at amortised cost. As explained in **section 4.5**, its initial carrying amount / amortised cost is the sum of the initial fair value and of the transaction costs, i.e. €1,000.

² amortised cost as of year-end 2020 just before the revision of estimates, see table in **section 4.8.1**.

- At the beginning of 2019, the entity establishes a new timetable of the expected cash flows based on (a) the then applicable 12-month Euribor rate for year-end 2019 (as the contract specifies that the 12-month Euribor is observed at the beginning of the interest period) and (b) on market derived forward rates for the subsequent periods, as displayed in the table below:

Figure 4.9

in €	01/01/19	31/12/19	31/12/20	31/12/21	31/12/22	31/12/23
Euribor 12 months in % (1)	1.0%	1.5%	1.0%	2.0%	2.0%	NA
Acquisition cost (2)						
Undiscounted interest cash flows (3)	-1,000	38	44	38	50	50
Reimbursement of the principal at the maturity date (4)						1,250
Total expected cash flows	-1,000	38	44	38	50	1,300

(1) market derived forward interest rates:

- It is assumed that the forward interest rate at the end of a period is the same as the interest rate at the beginning of the following period
- Cash flows for period N are calculated based on the forward interest at the end of the preceding period N-1
 - e.g. for 2020, based on 2019 year-end forward rate: $44 = (1.5\% \text{ forward rate} + 2\% \text{ margin}) * 1,250$

(2) including transaction costs (commissions, fees...) to be included in the initial carrying amount of the asset

(3) $(\text{Euribor 12 months (1)} + 2\%) * €1,250$

(4) in our example, redemption price equals the nominal value

- Using an Excel formula, the entity determines that at initial recognition, the rate that exactly discounts the expected cash flows of this financial asset – as presented in the table below – to its initial gross carrying amount (i.e. the EIR) is 8.5%. The following table shows that the sum of the discounted cash flows amounts to zero:

Figure 4.10

in €	01/01/19	31/12/19	31/12/20	31/12/21	31/12/22	31/12/23	Total
Expected cash flows discounted at EIR (8.5%)	-1,000	35	37	29	36	863	0

- This EIR will be used by the entity to account for the debt instrument in the first year: the entity will recognise an interest revenue of €85 ($€1,000 * 8.5\%$) in profit or loss and the amortised cost at the end of the first year will amount to €1,048.

Figure 4.11

in €	(a)	(b = a * 13.2%)	(c)	(d = a + b - c)
	Amortised cost at the beginning of the reporting period	Interest income to be recognised in P&L	Cash flows	Amortised cost at the end of the reporting period
2019	1,000	85	38	1,048

- At the end of 2019, the entity establishes a new timetable of the expected cash flows based on (a) the then applicable 12-month Euribor rate for year-end 2020 (as the contract specifies that the 12-month Euribor is observed at the beginning of the interest period) and (b) on market derived forward rates for the subsequent periods, as displayed in the table below:

Figure 4.12

Cash flows in € million and interest rates in %	31/12/19	31/12/20	31/12/21	31/12/22	31/12/23
Euribor 12 months (1)	2,0%	2,0%	2,5%	3,0%	NA
Undiscounted interest cash flows (2)		50	50	56	63
Reimbursement of the principal at the maturity date (3)					1 250
Total expected cash flows	0	50	50	56	1 313

(1) market derived interest rates

(2) (Euribor 12 months (1) +2%) * €1,250

(3) in our example, redemption price equals the nominal value

- The entity then determines, using an Excel formula, a new EIR that exactly discounts these expected cash flows to the amortised cost of the debt instrument as of 31 December 2019 – the EIR equals 9.4%. The following table shows that this EIR discounts the new expected cash flows to the amortised cost of the debt instrument at the end of 2019:

Figure 4.13

in €	31/12/19	31/12/20	31/12/21	31/12/22	31/12/23	Total
Expected cash flows discounted at EIR (9.4%)	-1,048	46	42	43	918	0

- In 2020, the entity will use this EIR of 9.4%, to account for revenue interest and determine the amortised cost of the instrument at the end of the period.

Figure 4.14

in €	(a) Amortised cost at the beginning of the reporting period	(b = a * EIR) Interest income to be recognised in P&L	(c) Cash flows*	(d = a + b - c) Amortised cost at the end of the reporting period
2020	1,048	98	50	1,096

* Cash flow of 50 = (12-month Euribor at the beginning of 2020 + margin) * nominal value = (2% + 2%) * 1,250

- At the subsequent periods, the entity will duplicate the same process as the one described above, i.e.:
 - > determine the new EIR based on the newly expected cash flows (i.e. the EIR that discounts these cash flows to the amortised cost of the instrument at the end of the preceding period);
 - > use this EIR to recognise interest revenue and determine the amortised cost of the instrument at the end of the reporting period.

This floating EIR can be determined as being the then Euribor 12 Month interest curve that will be updated at each closing, plus a fixed margin determined initially. In practice entities may consider applying different types of shortcuts to simplify this mechanism provided that the actual outcome is not significantly different from the theoretical outcome.

4.8.4. Fixed-rate debt instrument with interest step-up

The following example aims to illustrate how a constant effective interest rate should be calculated for a debt with a contractually specified interest rate step-up.

Assume that on 1 January 2019, entity A issues a debt (the entity did not incur any transaction costs) for a price of €1,250 which is also its principal amount. The debt is repayable in total on 31 December 2023 (i.e. this is a non-amortising financial liability).

The rate of interest is specified in the contract as follows: 6% in 2019 (€75), 8% in 2020 (€100), 10% in 2021 (€125), 12% in 2022 (€150) and 16.4% in 2023 (€205).

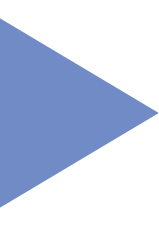
In this case, the EIR that exactly discounts the stream of the expected cash flows of the debt is 10%.

Thus, the entity will recognise interest expense based on the effective interest rate (10%) rather than the contractual interest rate with a step-up feature.

The table below provides information about the amortised cost, interest income and cash flows of the debt instrument in each annual reporting period:

Figure 4.15

in €	(a) Amortised cost at the beginning of the reporting period	(b = a * 10%) Interest income to be recognised in P&L	(c) Cash flows	(d = a + b - c) Amortised cost at the end of the reporting period	Interest using the facial rate
2019	1,250	125	75	1,300	75
2020	1,300	130	100	1,330	100
2021	1,330	133	125	1,339	125
2022	1,339	134	150	1,323	150
2023	1,323	132	1,455	0	205



CHAPTER 6

RECOGNITION AND INITIAL MEASUREMENT





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6.1. Introduction

Recognising a financial instrument means including it in the statement of financial position. The initial recognition date is the date on which the financial instrument is included in the statement of financial position for the first time.

This section first explains on which date financial assets should initially be recognised, and then describes the amount at which this instrument should be measured on the date of its initial recognition.

Upon initial recognition, a financial asset must be classified in accordance with the requirements presented in **chapter 7**, and financial liabilities in accordance with the requirements presented in **chapter 8**.

Derecognition is the reverse of the recognition and refers to the date on which a financial instrument must be removed from the statement of financial position. Derecognition requirements are presented in **chapters 10** and **11**.

6.2. Initial recognition of financial instruments

6.2.1. General requirements

6.2.1.1. Date of initial recognition

Financial instruments are recognised on the balance sheet when the entity becomes party to the contractual provisions of the instrument (IFRS 9.3.1.1).

There may be a lag of several days between the “trade date” and the “settlement date”. IFRS 9 allows for an accounting policy election consisting in considering that the “entity becomes party to a contract” either on the trade date or on the settlement date (see **section 6.2.2**).

6.2.1.2. Being a party to contractual provisions

The standard does not require a particular form of contract (e.g. written, oral). All legally binding declarations relating to the offer and the acceptance of that offer are taken into account for the purposes of recognition.

Planned future transactions never require recognition (IFRS 9.B3.1.2(e)), no matter how likely they are. If the entity is not yet party to a contract, the likelihood of it concluding a contract in the future is irrelevant.

6.2.1.3. Contracts excluded from the scope of IFRS 9

Some contracts, although meeting the definition of a financial asset or of a financial liability in IAS 32 (see **chapter 2**), are excluded from the scope of IFRS 9. These include most loan commitments, leases, insurance contracts and or some contracts to buy or sell a non-financial item that are qualified as “own use contracts”, etc. (see **chapter 1**). These contracts are initially recognised and measured applying the requirements set out in the relevant applicable standards, if any.



6.2.1.4. Illustrative examples

Examples of how to apply the recognition principles set out in **section 6.2.1.1** are provided in IFRS 9. B3.1.2:

Example 6.1

Unconditional receivables and payables are recognised when the entity becomes a party to the contract and, as a result, has a legal right to receive or a legal obligation to pay cash (IFRS 9.B3.1.2(a)).

Example 6.2

Firm commitments to purchase or sell goods or services are generally not recognised as assets until at least one of the parties has performed under the agreement, e.g. until the goods have been delivered or the services rendered. If a firm commitment to purchase or sell a non-financial item (such as commodities) can be settled net in cash or with another financial instrument, it falls within the scope of IFRS 9 (see **chapter 1**) and is recognised as an asset or a liability on the commitment date for its net fair value.

Example 6.3

Forward contracts that are within the scope of IFRS 9 are recognised as assets or liabilities on the commitment date. When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal, so that the net fair value of the forward is zero (the contract balances out) (IFRS 9.B3.1.2(c)).

Example 6.4

Option contracts that are within the scope of IFRS 9 (see **chapter 1**) are recognised as assets or liabilities when the holder or writer becomes a party to the contract (IFRS 9.B3.1.2(d)).

6.2.1.5. What if the purchased asset cannot be derecognised by the party selling it?

IFRS 9 prohibits an entity from recognising a purchased financial asset if its transfer does not qualify for derecognition from the point of view of the seller (IFRS 9.B3.1.1). In such case the buyer still has to account for the cash outflow (or other consideration transferred to the seller) by recognising a receivable from the seller (IFRS 9.B3.2.15).

6.2.1.6. Situations where the entity acts as an agent on behalf of another party

When an entity acts as an intermediary in a transaction involving a financial instrument, an analysis must be performed to determine whether the entity is to be considered as acting as an agent or as a principal. An agent may buy a financial instrument in the name and on behalf of another entity. An agent is not considered as an actual party to the contract and will not account for the instrument on its balance sheet. Only transactions where the entity is a party to the contract as a principal will have to be recognised on the entity's balance sheet.





This question frequently arises for brokerage and similar activities. If the broker is considered as acting as a principal, he will account for two back-to-back transactions on its balance sheet. However, if he is considered as acting as an agent, he will solely recognise its commission in profit or loss. IFRS 15 provides some guidance in this regard, but such analysis often requires the exercise of judgment. A legal opinion may also be necessary to support the agent vs. principal analysis applied to such transactions.

6.2.2. Regular way transactions: accounting policy election between accounting for financial assets on the trade date or on the settlement date

6.2.2.1. Overview

There is often a lapse of time between the moment the entity commits to buy or sell financial assets at a fixed price and the date when the effective delivery of these assets takes place (which, in general, corresponds to the date on which the cash flow / settlement takes place). An example is the purchase of a security where the parties agree on a price on a given day, but the delivery of the security and the payment of the agreed price occurs two business days later. Such a fixed price commitment to buy / sell a financial asset meets the definition of a derivative (see **chapter 13**). However, because of their short duration, commitments that are qualified as “regular way purchases” (see **section 6.2.2.2**) are not recognised as derivatives (IFRS 9.BA.4). IFRS 9 contains a specific accounting policy election for such transactions (see **section 6.2.2.3**).

Asset purchases that do not qualify as “regular way purchases” are subject to different rules, which are presented in **section 6.2.2.4**.

6.2.2.2. Definition of regular way contracts

Regular way purchases or sales are defined in IFRS 9 Appendix A as purchases or sales of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

In its implementation guidance (IFRS 9.IG.B.29), IFRS 9 gives an example of a forward contract to buy ordinary shares traded in an active public market. That contract does not qualify as a regular way purchase because the maturity of the forward is 2 months, whereas a regular way delivery of these shares in that particular market usually takes only three business days. Based on IFRS 9.IG.B.29, the conclusion would have been the same if the settlement date of the transaction were six days later than the trade date.

When a financial asset is traded in more than one active market and the settlement duration differs across these active markets, the entity should refer to the time frame that applies in the market in which the purchase actually takes place in identifying whether a commitment to buy that financial contract is a regular way purchase (IFRS 9.IG.B.30).

It is important to note that a regular way contract requires the **delivery** of an asset. Consequently, if the contract allows or requires a net settlement, it cannot be considered as a regular way contract and should rather be accounted for as a derivative instrument (IFRS 9.B3.1.4).



6.2.2.3. Accounting for regular way transactions

An entity may elect (IFRS 9.B3.1.3) to use either trade date accounting (IFRS 9.B3.1.5) or settlement date accounting (IFRS 9.B3.1.6) to recognise regular way purchases or sales of securities, currency and other financial assets.

The trade date is the date on which an entity commits to purchase / sell an asset (IFRS 9.B3.1.5) and the settlement date is the date on which an asset is delivered to the entity (IFRS 9.B3.1.6).

The **election is made separately** for each category of financial asset (e.g. financial assets measured at amortised cost, financial assets measured at fair value through other comprehensive income with subsequent recycling to profit or loss, equity instruments that are optionally designated as measured at fair value through other comprehensive income...) and is applied consistently to this category (IFRS 9.B3.1.3). The election made for a given financial asset category applies to both purchase and sale transactions.

If an entity elects to apply **trade date accounting** to a financial asset (IFRS 9.B3.1.5):

- the asset to be received upon settlement is recognised in the balance sheet on the trade date, against a payable on the liability side; and
- any change in the fair value of the asset between the trade date and the settlement date is accounted for in line with the general principles of the asset's subsequent measurement method. This means that, for assets that are measured at fair value through profit or loss, the change in fair value is recognised in profit or loss. For assets measured at fair value through other comprehensive income, the change in value is recognised in other comprehensive income. The change in fair value is not recognised for assets measured at amortised cost.

If the entity elects to apply **settlement date** accounting (IFRS 9.B3.1.6):

- the asset is only recognised in the balance sheet on the settlement date (i.e. when it is effectively received by the entity) against a cash outflow;
- any change in the fair value during the period between the trade date and the settlement date is accounted for in the same way as the entity would account for the acquired asset. For acquired assets that are measured at fair value through profit or loss, the change in fair value is recognised in profit or loss, and for assets measured at fair value through other comprehensive income, the change in fair value is recognised in other comprehensive income. The changes in fair value is not recognised for assets measured at amortised cost. This means that when an entity uses settlement date accounting for an asset that is subsequently measured at amortised cost, the asset is initially recognised on the settlement date for an amount equal to its fair value on the trade date (IFRS 9.5.1.2 and IFRS 9.IG.D.2.1).

For the purpose of impairment requirements, an entity should always consider the trade date of the transaction as the initial recognition date (IFRS 9.5.7.4).

In the end, this accounting policy election has an impact on the presentation of the statement of financial position (with the total balance sheet amount being "increased" earlier when trade date accounting is used), but has no impact on the statement of comprehensive income.



6.2.2.4. Accounting for transactions that are not regular way transactions

A contract for the sale or purchase of a financial asset is not a regular way contract if, for example:

- the terms permit or require net settlement, rather than the parties delivering the asset and the payment respectively; or
- the delay between the contractual trade date and the settlement date exceeds the customarily practice according to the established market practice.

Such contracts are accounted for as a derivative in the period between the trade date and the settlement date and are thus recognised at the trade date (IFRS 9.B3.1.4). This means that:

- this derivative is to be measured at fair value and that its change in value must be recognised through profit or loss during the period between the trade date and the settlement date; and
- it is to be derecognised at its fair value on the date of delivery of the asset resulting from the purchase commitment against:
 - > a cash outflow corresponding to the price stated in the purchase contract; and
 - > an initial recognition of the purchased financial asset at its fair value.

6.2.2.5. What about financial liabilities?

The implementation guidance of IFRS 9 (IFRS 9.IG.B.32) specifies that:

- IFRS 9 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of financial liabilities;
- the general recognition requirements in IFRS 9.3.1.1 apply (i.e. financial liabilities are recognised on the date when the entity becomes a party to the contract);
- financial liabilities are generally not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IFRS 9.

As a result, **section 6.2.2** must not be applied upon the initial recognition of financial liabilities.

6.3. Measurement of financial instruments upon their initial recognition

6.3.1. General requirements

The amount at which financial instruments are measured at their initial recognition depends on their nature and measurement category (see **chapter 7** for classification of financial assets and **chapter 8** for classification of financial liabilities):

- financial assets and financial liabilities that are subsequently **measured at fair value through profit or loss** (either optionally designated or mandatorily measured in such a way) are measured at their **fair value** on their initial recognition date (see **chapter 3** for more information on how fair value is determined). The transaction costs directly attributable to the acquisition of such financial assets or to the issue of such financial liabilities are immediately expensed to profit or loss (IFRS 9.5.1.1);



- **trade receivables** that do not contain a significant financing component (as defined by IFRS 15) are initially measured at their **transaction price** as defined in IFRS 15 (IFRS 9.5.1.3). This means that short term trade receivables (i.e. with initial maturity of less than 12 months) will generally be recognised for the amount indicated in the invoice;
- **all other** financial assets and financial liabilities are initially measured at their **fair value plus or minus transaction costs that are directly attributable** to the acquisition or issue of the financial asset or financial liability (IFRS 9.5.1.1).

Assets that are subsequently measured at amortised cost, and for which an accounting policy choice has been made to initially recognise them on their settlement date, are recognised initially at their fair value determined on the trade date (rather than at their fair value on settlement date) (IFRS 9.5.1.2).

Including transaction costs in the initial measurement means (IFRS 9.IG.E.1.1):

- for financial assets, that the transaction costs are added to the fair value at initial recognition;
- for financial liabilities, that the transaction costs are deducted from the fair value at initial recognition.

The subsequent recognition pattern of these costs depends on the instrument's measurement category (IFRS 9.IG.E.1.1):

- for financial assets and financial liabilities that are measured at amortised cost, as well as for financial assets that are measured at fair value through other comprehensive income with subsequent recycling to profit or loss, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method. As a result, they are amortised through profit or loss over the life of the instrument (see **chapter 4**);
- for equity financial instruments that are measured at fair value through other comprehensive income without subsequent recycling to profit or loss in accordance with IFRS 9.5.7.5 (see **sections 7.3.1 and 7.3.2**), transaction costs are recognised in other comprehensive income as part of a change in fair value at the next remeasurement date. As the realised gains or losses for this category are not subsequently transferred to profit or loss, any transaction costs incurred to purchase these instruments will never impact the profit or loss of the entity.

6.3.2. Situations where fair value equals transaction price

The fair value of a financial instrument at initial recognition is normally the transaction price, i.e. the fair value of the consideration given / received (IFRS 9.B5.1.1). IFRS 9.B5.1.2A further states that the best evidence of the fair value of a financial instrument at initial recognition is normally the transaction price.

However, if part of the consideration given or received is for something other than the financial instrument, it may indicate that the transaction price may be different from the fair value, and that therefore the fair value of the financial instrument must be measured (see **section 6.3.3**).



6.3.3. Situations where fair value is different from transaction price

6.3.3.1. Examples

One example of where the initial fair value may be different from the transaction price is **off-market interest rate** long-term loans (e.g. loans bearing a 5% rate whereas the prevailing market rate for similar loans is 8%), or long-term **interest-free** loans. Such situations may arise between entities under common control, or when the loan is one component of a larger transaction. For these loans, a valuation technique should be used (such as discounting the contractual cash flows at a market interest rate for a similar financial instrument (similar as to currency, term, type of interest rate and other factors) with a similar credit rating) to establish their initial fair value. Any difference between the transaction price and this initial fair value must follow the accounting treatment described in the following section, except for trade receivables initially recognised at their transaction price.

“Day one P&L” are typically more common in financial institution than in corporate treasury.

6.3.3.2. Accounting for the difference between the initial fair value and the transaction price (“Day one P&L”)

6.3.3.2.1. On initial recognition date

The difference between the transaction price and the initial fair value of a financial asset or a financial liability is generally referred to as “day one P&L” or “day one profit or loss”. This day one P&L may either be recognised in profit or loss immediately or deferred. The accounting treatment is not an accounting policy choice, it depends on whether the inputs used to estimate the instrument’s initial fair value are observable or not (IFRS 9.B5.1.2A). The two situations are presented below:

- **Situation 1:** the instrument’s valuation technique uses **only data from observable markets** (e.g. fair value is evidenced by a quoted price in an active market for an identical asset or is based on a valuation technique that uses only data from observable markets, i.e. Level 1 inputs):
 - > the instrument is recognised initially at its initial **fair value**, plus (if applicable to the instrument’s measurement category, as explained in **section 6.3.1**) transaction costs;
 - > the difference between the fair value at initial recognition and the transaction price is recognised immediately as a gain or loss (IFRS 9.B5.1.2A).
- **Situation 2:** in any other situation (i.e. the instrument’s valuation technique uses **one or more non-observable inputs**):
 - > the asset’s initial fair value is adjusted to defer the difference between the fair value at initial recognition and the transaction price;
 - > this means in practice that the instrument is recognised initially at its transaction price, plus (if applicable to the instrument’s measurement category, as explained in **section 6.3.1**) transaction costs;
 - > for subsequent accounting (see **section 6.3.3.2.2**) and disclosure purposes (see **chapter 16**), the amount of deferred day one P&L is identified separately from the instrument’s initial fair value.



To our knowledge, most entities confronted with the deferred day one P&L issue (in particular financial institutions) use separate accounts to distinguish the fair value of the instrument from the deferred day one P&L reserve. This facilitates the subsequent monitoring of the deferred day one P&L.

Consider the following example:

- an asset is purchased at CU 100 with no transaction costs;
- its initial fair value, determined based on a valuation technique using significant level 3 inputs, is CU 103;
- the day one P&L amounts to CU 3 (=103 – 100). This amount is deferred and monitored separately from the future change in value of the instrument.

The rationale behind the day one P&L accounting rule explained just above is that only the most “reliable” (i.e. fully observable) valuations may rebut the presumption that the transaction price is the best evidence of fair value (see **section 6.3.2**) and therefore imply a profit and loss impact.

Please refer to **chapter 3** for more information on valuation techniques and observability of inputs.

6.3.3.2.2. Subsequent accounting of deferred day one P&L

The deferred day one P&L (difference between the transaction price and the initial fair value) is recognised as a gain or loss only to the extent that it arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability.



Entities must exercise their judgment to identify whether there has been a “change in factors (including time)” that would justify partial or full recognition in profit or loss of the deferred day one P&L reserve.

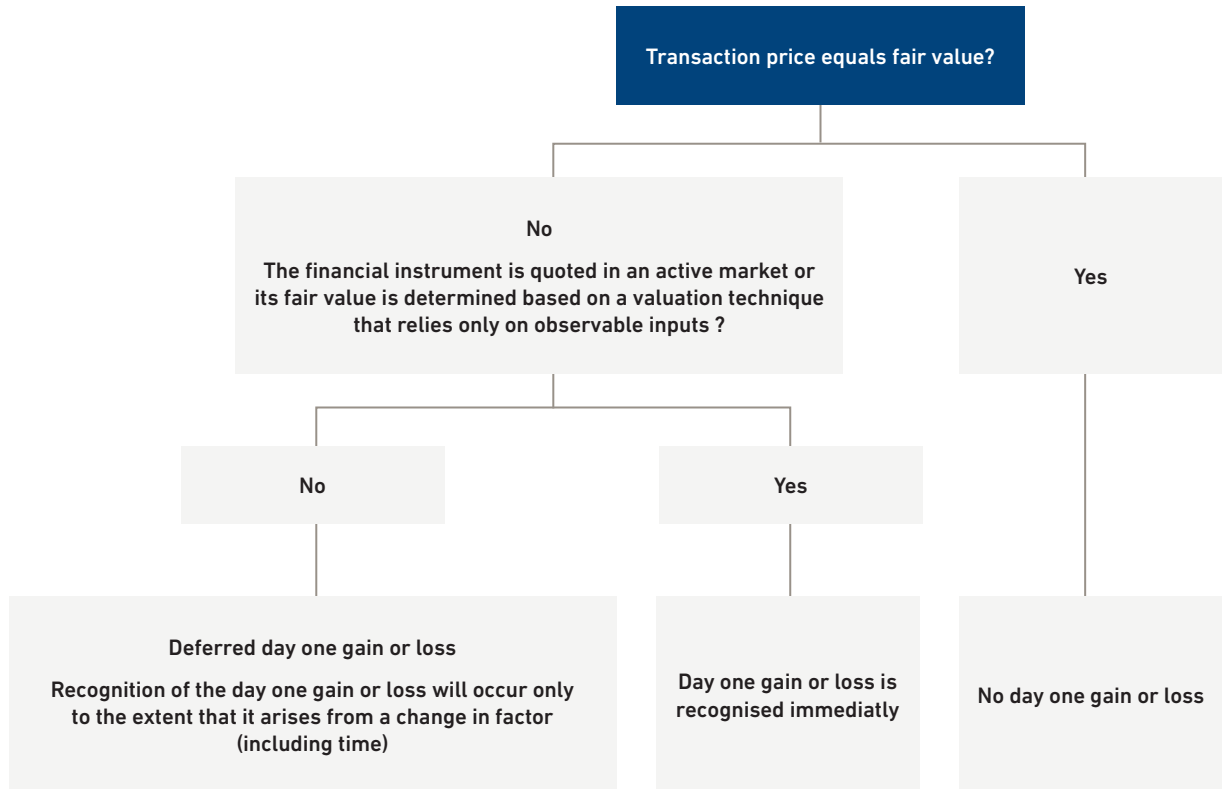
In practice, entities (and in particular financial institutions) may amortise the deferred day one P&L into profit or loss on a straight-line basis over the lifetime of the instrument. This accounting treatment may be an appropriate method in some cases where the passage of time is the driving factor, but it may not be appropriate in others.



6.3.4. Figure summarising the general approach

The following figure summarises the general approach of day one P&L accounting:

Figure 6.1



6.3.5. Transaction costs

Appendix A of IFRS 9 defines transaction costs as "Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability". An incremental cost is one that would not have been incurred, hadn't the entity acquired, issued or disposed of the financial instrument.

Transaction costs:

- **include** fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and security exchanges, and transfer taxes and duties (IFRS 9.B5.4.8).
- but they **do not include**:
 - > debt premiums or discounts, financing costs or internal administrative or holding costs (IFRS 9.B5.4.8); or
 - > transaction costs expected to be incurred on transfer or disposal of a financial instrument (IFRS 9.IG.E.1.1).



6.3.6. Specific cases

6.3.6.1. Assets and liabilities arising from loan commitments that are not in the scope of IFRS 9

As per the scope requirements in IFRS 9.2.1(g) (see **chapter 1**), most loan commitments issued are out of the scope of IFRS 9 (and in particular those that are not optionally designated by the entity as measured at fair value through profit or loss), i.e. they are not accounted for as derivatives. They only follow the impairment guidance of IFRS 9 until they are drawn down.

Once such loan commitments are drawn down, IFRS 9 is not very clear on the initial measurement of assets resulting from these commitments.

Example 6.5

A bank issued a commitment to lend to the company at 5%.

6 months later, when the entity draws down the loan, the applicable market rate would have been 7% (since both the interest free rate and the entity's credit spread have increased during that-time).

Although the bank has lent CU 100, the fair value of this loan on the day the funds are transferred is only CU 90, because of the higher discount rate ($x+2\%$ instead of $x\%$) used to determine the fair value of the loan.

Assuming there are no transaction costs, the question is whether the loan should be recognised at CU 100 (its transaction price and its fair value at the date of the loan commitment) or CU 90 (its fair value at the date of drawdown).



In our view, several interpretations are possible:

- **Approach 1:** if we apply the general requirements in IFRS 9.5.1.1 to initially measure financial assets at their fair value, it would seem reasonable to account for the loan at its fair value of CU 90;
- **Approach 2:** however, the basis for conclusions of IFRS 9.BCZ.2.3 explain that (a) the exclusion of loan commitments from the scope of IFRS 9 was supposed to simplify the accounting for these loan commitments and (b) that this scope exclusion is consistent with the measurement of the loan. Furthermore, IFRS 9.5.1.2 specifies that financial assets measured at amortised cost are to be measured at their fair value on trade date even when settlement date accounting is used. If we define trade date as the date the entity entered into a loan commitment, this would mean, in our example, that the loan must initially be measured at CU 100 and not CU 90.

To our knowledge, the second approach is the one frequently used in practice.



6.3.6.2. Initial recognition of financial guarantees issued

When financial guarantee contracts that fall within the scope of IFRS 9 are recognised in the financial statements of the issuer, this usually relates to situations in which the issuer is guaranteeing a debtor's obligation to a third party (the guarantee holder) and is thus required to make specified payments if the debtor defaults on the obligation or fails to comply with specified terms of a debt instrument.

At initial recognition, financial guarantee contracts must be accounted for in accordance with the general principles at fair value. If a financial guarantee contract is issued to an unrelated party in a standalone arm's length transaction, its fair value at inception is likely to equal the premium received (transaction price), unless there is evidence of the contrary (IFRS 9.B2.5(a)).

6.3.6.3. Financial instruments acquired via a business combination or as part of a portfolio that does not constitute a business

General recognition and measurement requirements apply to financial instruments acquired via a business combination or as part of a portfolio that does not constitute a business.

Indeed, for financial instruments acquired via a business combination the requirements in IFRS 3.18 are aligned with those in IFRS 9 regarding the fact that the acquirer of financial instruments must account for them at their fair value on acquisition date. The difficulties in practice may stem from the fact that the initial fair value must be assigned to each financial instrument acquired.

For financial instruments acquired as part of a portfolio that does not constitute a business, it may not be easy to allocate the global transaction price to individual instruments, when assessing whether a day one P&L must be recognised¹.

¹ For further detail on this topic, please refer to IFRIC Update November 2017.



CHAPTER 7

CLASSIFICATION OF FINANCIAL ASSETS



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7.1. Overview

Financial assets are classified into four distinct categories that reflect their measurement method:

- financial assets measured at fair value through profit or loss (FV-PL),
- financial assets measured at fair value through other comprehensive income **with** subsequent recycling to profit or loss (FV-OCI),
- financial assets measured at fair value through other comprehensive income **without** subsequent recycling to profit or loss (FV-OCINR), and
- financial assets measured at amortised cost.

Each of these categories has its own rules for classification and measurement. The rules for classification are set out in detail in this **chapter 7**, separately for equity instruments such as investments in shares (see **section 7.3**), and debt instruments such as loans and bonds or other debt securities held (see **section 7.4**), whereas the measurement-related aspects are covered in **chapters 3, 4** and **9**. **Section 7.5** deals with the reclassifications of financial assets between categories after their initial recognition.

The classification of financial assets is driven by two major criteria:

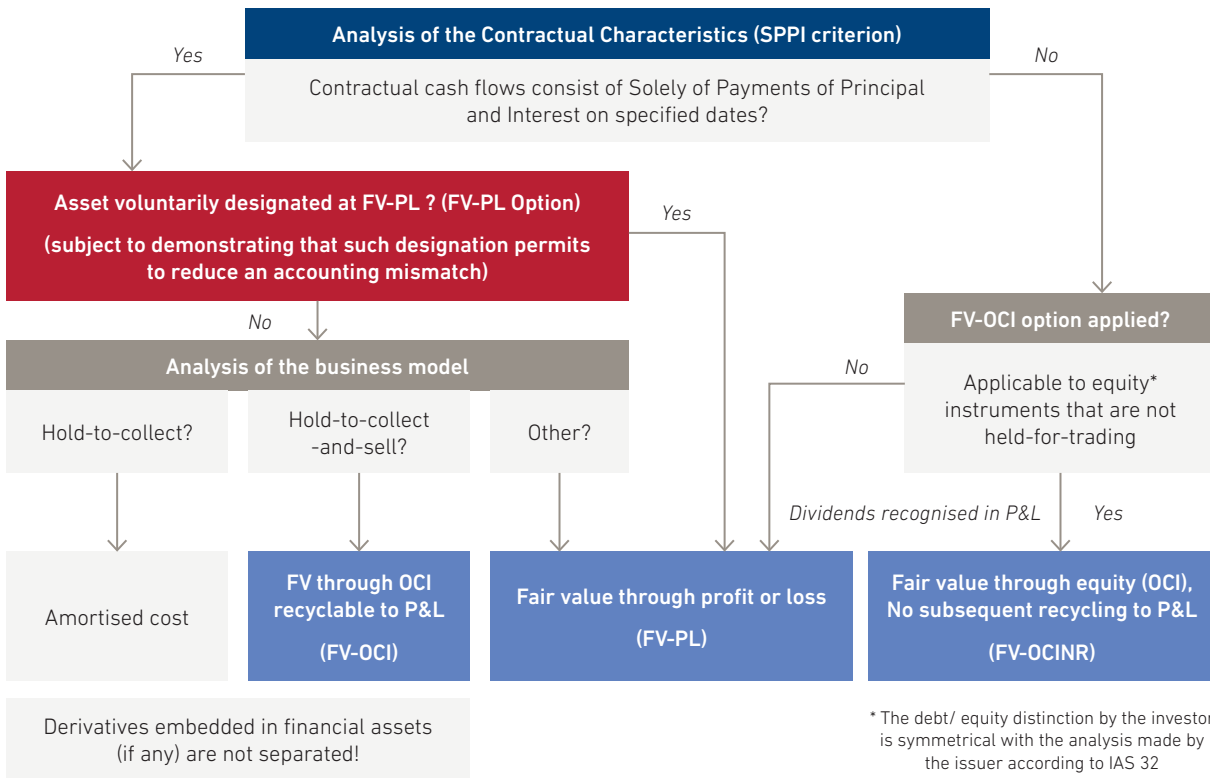
- the **business model** criterion, which refers to the way the cash flows of a financial asset are realised (through collection of contractual cash flows, through sales, or both); and
- the **contractual cash flows characteristics criterion** (also referred to as the “**SPPI**” / Solely Payments of Principal and Interest criterion), the aim of which is to ensure that only debt instruments that are basic lending transactions are eligible for amortised cost or FV-OCI measurement. Non-SPPI instruments are measured at FV-PL.

Irrespective of the business model under which they are managed and of their contractual cash flows characteristics, debt instruments held may be optionally designated as measured at FV-PL (subject to conditions).

Equity instruments will be measured at FV-PL as, by nature, they are non-SPPI. However, the entity has the irrevocable option to designate any equity instrument as measured at FV-OCINR upon initial recognition (noting that this option is not available for held-for-trading equity instruments).

The decision tree for the classification of financial assets can be summarised as follows:

Figure 7.1



7.2. Distinction between equity instruments and debt instruments

The contractual cash flows of **equity instruments** (such as ordinary shares that do not have a contractually due payment schedule) are of a different nature compared to the contractual cash flows of **debt instruments** (such as loans, receivables and bonds), contract of which in most cases contains a schedule with interest and principal payments which is set from the origination. As the contractual cash flows analysis is one of the key drivers of the classification of financial assets under IFRS 9, equity instruments and debt instruments will not be eligible to the same categories of financial assets. We have therefore opted to present in this chapter debt instruments separately from equity instruments.

Please note that the definition of equity instruments in IAS 32 will be used to operate this distinction:

- **equity instruments** (dealt with in **section 7.3**) are instruments that are classified fully as equity in the financial statements of the issuer in accordance with IAS 32. These instruments do not include any contractual obligation to deliver cash or another financial asset to another entity (IAS 32.16);
- other investments in financial assets will be considered as **debt instruments** in this chapter (including compound instruments such as bonds convertible into shares having both an equity and a financial liability component from the perspective of the issuer (IFRS 9.4.3.2)).

Stand-alone derivatives (as defined in **chapter 13**) do not have to undergo the decision tree above, as by definition:

- their cash flows do not meet the SPPI criterion; and
- they do not meet the definition of third party equity instrument either.

Their default classification is therefore FV-PL, unless (when specific conditions are met) they are documented as hedging instruments (please see **chapter 14** for more information on hedge accounting under IFRS 9).

7.3. Classification of equity instruments

The classification of investments in equity instruments such as common shares is quite straightforward under IFRS 9. It is described below. However, should such investments confer control, joint control or significant influence over the issuer of the instrument to the entity, the starting point for accounting for them would be the standards on consolidation (i.e. IAS 28, *Investments in Associates and Joint Ventures*, IFRS 10, *Consolidated Financial Statements* and IFRS 11, *Joint Arrangements*) rather than the provisions of IFRS 9 described below.

Given the nature of their cash flows, equity instruments do not meet the SPPI criterion. Their default classification will therefore be at Fair Value through Profit or Loss (FV-PL). However, most equity instruments are also eligible to the Fair Value through Other Comprehensive Income Without Recycling (FV-OCINR) category.

Two situations should be distinguished: equity instruments held for trading, and other equity instruments. They are detailed below.

7.3.1. Investments in equity instruments that are held for trading

Investments in equity instruments that are *held for trading* (see **section 7.4.2.4.1**) must be classified at FV-PL and measured accordingly. They are not eligible to the FV-OCINR category (IFRS 9.5.7.5).

7.3.2. Investments in equity instruments that are not held for trading

When an entity acquires an equity instrument that is neither held for trading nor contingent consideration in a business combination to which IFRS 3 applies (IFRS 9.5.7.5, IFRS 9.B5.7.1), it may at initial recognition make an irrevocable election (IFRS 9.4.1.4) to present its subsequent changes in fair value in **other comprehensive income** but without the possibility to later transfer the realised gain or loss into profit or loss (FV-OCINR). An entity may make this election separately for each new equity instrument (IFRS 9.B5.7.1).

Two options are thus available at initial recognition for any equity instrument that is not held for trading, on an instrument-by-instrument basis:

- FV-PL, or
- FV-OCINR. The accounting treatment of this category is explained in **chapters 9** and **12**. In a nutshell, the dividends are recognised in profit or loss (as long as they do not represent a recovery of part of the cost of the investment) but the realised gains and losses are never transferred from OCI to profit or loss, even upon the sale of the asset. As a result, this category is not subject to impairment calculations.

The option for a FV-OCINR classification is available only for instruments that meet the definition of equity instruments in accordance with IAS 32 from the perspective of the issuer (see **chapter 5**). Therefore,

financial instruments that are presented as equity instruments in accordance with IAS 32.16A to 16D following the amendment of IAS 32 for “Puttable financial instruments and obligations arising on liquidation”, but which do not meet the definition of equity instruments of IAS 32, are not eligible to the FV-OCI-NR classification (IFRS 9.BC5.21).

7.4. Classification of debt instruments

7.4.1. Main principles

Under IFRS 9, investments in debt instruments (such as loans, receivables, bonds and other debt securities) are classified into one of the following three measurement categories:

- financial assets measured at amortised cost (AC),
- financial instruments measured at fair value through profit or loss (FV-PL) or
- financial instruments measured at fair value through other comprehensive income with ulterior recycling to profit or loss (FV-OCI) (IFRS 9.5.2.1).

The following two criteria form the basis for classification amongst these three categories:

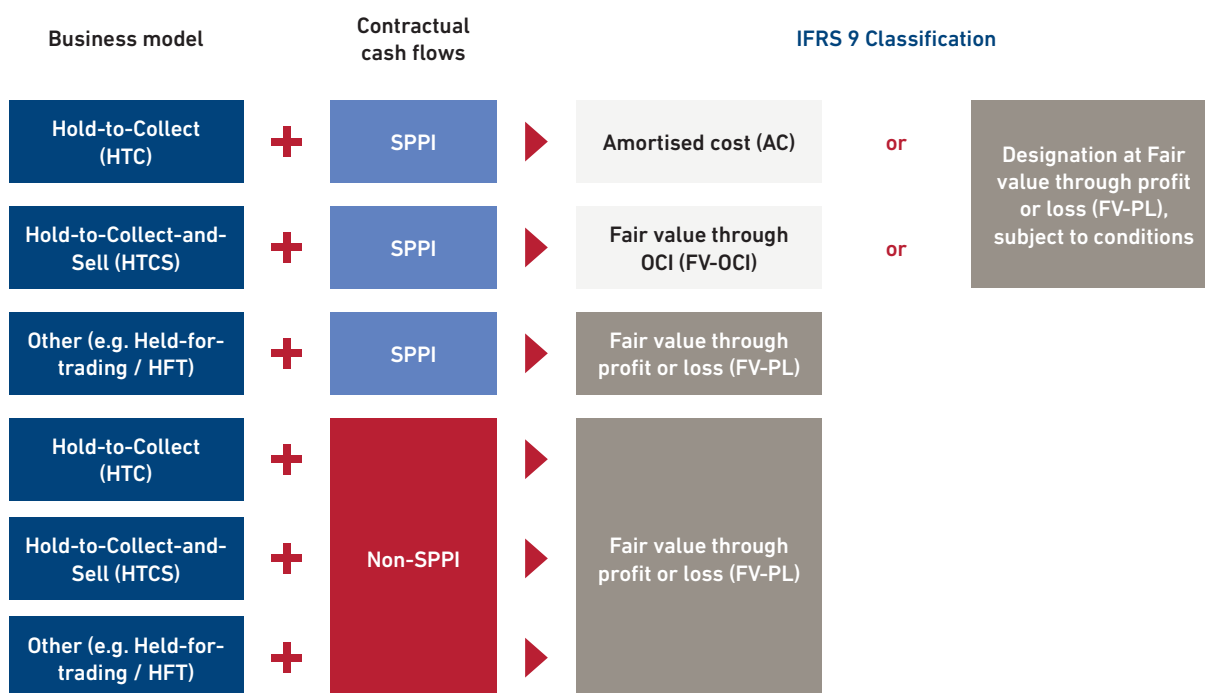
- **Criterion n° 1** (see **section 7.4.2**): the entity’s **business model** for managing the financial asset
 - > This notion refers to how an entity manages its financial assets in order to generate cash flows. In other words, the entity’s business model determines whether cash flows will result from collecting contractual cash flows, from selling financial assets or both.
 - > The standard defines 3 major business models, which are:
 - **Hold-to-Collect** business model (HTC): only assets held within a business model where the objective is to collect contractual cash flows may be measured at **amortised cost (AC)** subject to also meeting the contractual cash flows criterion, as described below.
 - **Hold-to-Collect-and-Sell** business model (HTCS): only assets held within a business model the objective of which is achieved by both collecting contractual cash flows **and** selling financial assets may be measured at **fair value through other comprehensive income with subsequent recycling to profit or loss (FV-OCI)** subject to also meeting the contractual cash flows criterion, as described below.
 - **Other** business models, such as held-for-trading: assets held within such business models are measured at **fair value through profit or loss (FV-PL)**; entities have no other classification alternative for such assets.
- **Criterion n° 2** (see **section 7.4.3**): the contractual cash flows characteristics of the financial asset
 - > This criterion is also called the “Solely Payments of Principal and Interest”, or the SPPI, criterion.
 - > Financial assets that do not meet this criterion (“non-SPPI” assets) are classified at **fair value through profit or loss (FV-PL)**.
 - > Financial assets that meet the SPPI criterion (“SPPI assets”) are classified according to the business model within which they are held (see).



An entity may choose to designate any financial asset as measured at FV-PL. This option is elected on an instrument by instrument basis, upon its initial recognition, and is irrevocable. This so called “**fair value option**” is applicable only when such designation helps to eliminate or significantly reduce an accounting mismatch that would otherwise arise (see **section 7.4.5** for more information on the fair value option).

The classification model applicable to investments in debt instruments can be summarised as follows:

Figure 7.2



7.4.2. The business model assessment

7.4.2.1. The general principles for the business model assessment

7.4.2.1.1. Three main business models

Financial assets are classified based on (a) the entity’s business model for managing its financial assets and (b) their contractual cash flows characteristics (the “Solely Payments of Principal and Interest” or “SPPI” criterion). This section describes how to assess the business model criterion, assuming the considered instruments have passed the SPPI test and the entity has not elected to classify the asset voluntarily at FV-PL to reduce an accounting mismatch (i.e. no use of the fair value option).

Business models (listed in Figure 7.2) refer to how the entity generates **cash flows** from the financial assets (by holding them, selling them or both). The business model is determined by key management personnel (as defined in IAS 24.9). The entity's management approach is assessed only on the basis of scenarios that the entity's key management personnel reasonably expects to occur, and not on the basis of so-called 'worst case' or 'stress case' scenarios (IFRS 9.B4.1.2A). Moreover, an entity's business model is not merely a matter of assertion (IFRS 9.B4.1.2B). It is typically observable through the activities that the entity undertakes to achieve the objective of the business model.

7.4.2.1.2. Indicators and evidence to consider when assessing a business model

Assessing an entity's business model(s) involves judgement. This assessment is not determined by a single factor or activity. Rather, the entity must consider all relevant facts and circumstances and all evidence available at the date of the assessment, including:

- how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel (IFRS 9.B4.1.2B(a));
- the type of risks that affect the performance of the business model, and the way in which these risks are managed (IFRS 9.B4.1.2B(b)); and
- how managers of the business are compensated (e.g. whether the compensation is based on the fair value of the financial assets managed, on the contractual cash flows collected, or on the basis of other criteria unrelated to the financial assets managed);
- the frequency, value and timing of sales in prior periods, as well as the reasons for those sales and expectations about future sales activity (IFRS 9.B4.1.2C). However, sales in themselves do not determine the business model and therefore cannot be considered in isolation from the three indicators listed above. Instead, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised.

A business model essentially based on fair value information, where the entity makes decisions based on the assets' fair values and manages the assets to realise those fair values, is not a Hold-to-Collect or Hold-to-Collect-and-Sell business model (see **sections 7.4.2.2** and **7.4.2.3**). Financial assets held within such a business model are measured at fair value through profit or loss.

7.4.2.1.3. Level of aggregation at which to assess a business model and number of business models within a reporting entity

The level at which the business model is determined depends on how, and for what purpose, the entity manages its business (i.e. its management approach) (IFRS 9.B4.1.2).

An entity's business model must **not** be assessed based on management's **intentions** for a single financial asset. The business model should be determined at a higher level of aggregation, i.e. the level at which the entity manages a particular portfolio of financial assets (IFRS 9.B4.1.2). **Portfolios** can also be divided into sub-portfolios to better reflect the entity's management approach. **The same business model** applies to all assets managed at this level.

An entity or group may have **more than one business model simultaneously** (IFRS 9.B4.1.2).

Example 7.1

An entity holds a trading portfolio of fixed-rate bonds with the objective of making a profit from short-term fluctuations in market interest rates (situation 1). In addition, it holds another portfolio of the same type of fixed-rate bonds, which are held over a longer term to generate a steady rate of interest income from the coupons and to permit the generation of additional returns from securities lending or to act as collateral for obtaining short-term liquidity (situation 2). In the first situation, the bond holdings are classified as financial assets measured at fair value through profit or loss (FV-PL) and in the second situation, as financial assets measured at amortised cost (AC) provided they meet the SPPI criterion.

Example 7.2

If an entity originates or purchases a portfolio of mortgage loans and manages some of the loans with an objective of collecting contractual cash flows (situation 1) and manages the other loans with an objective of selling them (situation 2), there is a minimum of two different business models within that entity (Hold-to-Collect for the assets under situation 1 and Held-for-Trading for the assets under situation 2). However, if the entity is unable to make a clear distinction between loans in situation 1 and loans in situation 2 but rather manages them all on a global basis, the whole portfolio is likely to meet the definition of a Held-to-collect-and-sell business model.

When determining the appropriate level of aggregation for assessing the business model of financial institutions such as **banks**, the following aspects should, in our opinion, be considered:

- the entity's organisational structure;
- internal reporting systems;
- investment policies;
- management compensation systems, etc.

7.4.2.1.4. Date at which the business model is to be assessed

The classification of a financial asset (and thus the assessment of the business model criterion) takes place at the date of its **initial recognition**. In practice however, given the level of aggregation of the business model assessment, a newly purchased or originated asset will generally belong to the business model attached to its portfolio or sub-portfolio upon its initial recognition.

7.4.2.2. Hold-to-Collect business model

Managing SPPI financial assets under the Hold-to-Collect business model is a pre-requisite for measuring them at **amortised cost**.

When an entity manages its financial asset in a Hold-to-Collect business model, it aims at earning the contractual return of the asset while managing the counterparty risk of the debtor. Thus, an amortised cost measurement method allows the user to have access to the most relevant information in this context: the interest rate return determined by the effective interest rate method, and the impairment allowance representing the credit loss expected by the entity. In this business model, the fair value of the asset is not crucial to understand the financial position of the entity as it does not help to predict its future cash flows.

Managing a financial asset within a “Hold-to-collect” business model does not necessarily mean that the asset must be **held to maturity**. The sale of a financial asset before it reaches maturity does not, in itself, automatically result in a change of business model for that portfolio. The facts and circumstances of the transaction must be taken into account.

In determining the business model of a portfolio, it is important to consider information about the entity’s past sales and expectations about its future sales. In this situation, it is necessary to consider the frequency, value and timing of such sales, and the reasons for the sales. The context of past sales, as compared to current conditions, should also be considered (IFRS 9.B4.1.2.C). In other words, past sales can affect future classification of financial assets.

However, if there is a large volume of sales, the entity must reassess whether it is still justifiable to consider the business model for that portfolio as being Hold-to-Collect (IFRS 9.B4.1.3). This means that a **detailed analysis** of the business model is required when assessing sales that have taken place¹ or that are planned in the future.

The following types of sales are consistent with a Hold-to-Collect business model, whatever their amount or frequency (“**permitted sales**”):

- **Sales due to an increase in the asset’s credit risk**, because (a) the credit quality of financial assets is relevant to the entity’s ability to collect contractual cash flows and (b) credit risk management activities that are aimed at minimising potential credit losses due to credit deterioration are integral to such a business model (IFRS 9.B4.1.3A).
 - > To determine whether there has been an increase in the assets’ credit risk, the entity considers reasonable and supportable information, including forward looking information.
 - > Selling a financial asset because it no longer meets the credit criteria specified in the entity’s documented investment policy is an example of a sale that has occurred due to an increase in credit risk. The investment policy credit quality requirements may not be aligned with the concept of “significant increase in credit risk” used by IFRS 9 for the impairment staging process (i.e. depending on the investment policy, a sale can be justified based on a change in the credit risk profile even if such change would not have qualified for a transfer from Stage 1 to Stage 2 in accordance with IFRS 9.5.5.3 and 5.5.5).
 - > The entity needs to demonstrate that the sale occurred following an increase in credit risk.
- **Sales made close to the maturity of the financial assets** where the proceeds from the sales approximate the collection of the remaining contractual cash flows (IFRS 9.B4.1.3B).

Furthermore, sales that occur for other reasons (such as sales to manage credit concentration risk) may also be consistent with a Hold-to-Collect business model according to IFRS 9.B4.1.3B if they are:

- **infrequent** (even if significant in value); or
- **insignificant in value** both individually and in aggregate (even if frequent).

If more than an infrequent number of sales - other than permitted sales (described) - are made out of a held-to-collect portfolio and those sales are more than insignificant in value (either individually or in aggregate), the entity needs to assess whether and how such sales are consistent with an objective of

¹ It is to be noted that only sales that lead to the derecognition of the financial asset are taken into account in the business model assessment. As a result, when from a legal point of view there has been a sale but not from an accounting point of view (as is the case for most sale and repurchase (repo) transactions of securities), this sale has no impact on the business model assessment.

collecting contractual cash flows (IFRS 9.B4.1.3B). An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the entity's business model.

Whether a third party imposes the requirement to sell the financial assets, or the decision to sell is at the entity's discretion, is not relevant to this assessment (IFRS 9.B4.1.3B).

7.4.2.3. Hold-to-Collect-and-Sell business model

Managing SPPI financial assets under the Hold-to-Collect-and-Sell (HTCS) business model is a prerequisite for measuring them at **fair value through OCI (FV-OCI)**.

The objective of the business model is to both hold financial assets to collect contractual cash-flows and sell them at a given point to realise capital gains. In other words, the entity's key management personnel have made a decision that **both** collecting contractual cash flows and selling financial assets are **integral** to achieving the objective of the business model (IFRS 9.B4.1.4A).

To provide all the relevant information, the Board chose to require a FV-OCI measurement method for this business model. Such measurement method provides the user with information on both the fair value of the asset on the statement of financial position, which is relevant if the instrument's cash flows are realised through the sale of the asset, and on the amortised cost performance in profit or loss (effective interest rate and expected credit loss impairment model).

IFRS 9 does not define the HTCS business model any further (i.e. no threshold is provided for the frequency or value of sales that should occur in this business model). In practice, it will be a matter of judgement. However, it is expected that it will typically involve greater frequency and value of sales compared to the Hold-to-Collect business model (IFRS 9.B4.1.4B). This is because selling financial assets is integral to achieving the business model's objective instead of being only incidental to it.

This business model should accommodate quite a large panel of situations as various objectives may be consistent with the Hold-to-Collect-and-Sell business model. The following business model objectives are cited as examples in IFRS 9 (IFRS 9.B4.1.4, IFRS 9.B4.1.4A and IFRS 9.B4.1.4C):

Example 7.3

A bank managing its everyday liquidity needs. The entity seeks to minimise the costs of managing those liquidity needs and therefore actively manages the return on the portfolio. That return consists of collecting contractual payments as well as gains and losses from the sale of financial assets. As a result, the entity holds financial assets to collect contractual cash flows and sells financial assets to reinvest in higher yielding financial assets or to better match the duration of its liabilities. In the past, this strategy has resulted in frequent sales activity and such sales have been significant in value. This activity is expected to continue in the future.

Example 7.4

An insurer holding financial assets to fund insurance contract liabilities. The insurer uses the proceeds from the contractual cash flows on the financial assets to settle insurance contract liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the insurer undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.

Example 7.5

A corporate investing its excess cash (aimed to fund future capital expenditure) in assets which it will hold to collect and, when an opportunity arises, it will sell the financial assets to re-invest the proceeds in financial assets with a higher return. The manager responsible for the portfolio is remunerated based on the overall return generated by the portfolio.

7.4.2.4. Other business models

Assets that are managed within business models other than Hold-to-Collect or Hold-to-Collect-and-Sell are to be fair-valued through profit or loss (IFRS 9.B4.1.5). This is the case of Held-for-Trading (HFT) activities as well as other business model based on fair value.

7.4.2.4.1. Held-for-Trading financial assets

Held for trading financial assets are to be fair-valued through profit or loss (IFRS 9.B4.1.6).

Non-derivative financial assets are held for trading when they are:

- acquired principally for the purpose of selling them in the near term;
- or when, on initial recognition, they are part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking (IFRS 9 Appendix A Defined terms).

7.4.2.4.2. Other fair value-based business models

One business model that results in measurement at fair value through profit or loss, in addition to the held-for-trading business model described above, is one in which a portfolio of financial assets is **managed and** where its performance is **evaluated on a fair value basis** (IFRS 9.B4.1.6).

Generally, an entity manages such financial assets with the objective of realising cash flows through the sale of the assets, often evidenced through active buying and selling of financial assets. The selling / no selling decisions are generally based on the assets' fair values.

The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. The fair value-based information is provided internally to the entity's key management personnel – for example, the entity's Board of Directors and Chief Executive Officer (IFRS 9.4.2.2(b)).

Even though the entity may collect some contractual cash flows while it holds the financial assets that are managed on a fair value basis, such way of managing financial assets is not consistent with a Hold-to-Collect or a Hold-to-Collect-and-Sell business model because the collection of contractual cash flows is only incidental to achieving the business model's objective rather than being integral to achieving it.



7.4.2.5. Illustrative examples

7.4.2.5.1. Liquidity portfolio of banks

Many banks are subject to regulations requiring them to hold liquidity buffers in order to reduce their liquidity risk, i.e. to prevent liquidity disruptions due to changing market conditions. Such buffers are also known as HQLA portfolios (high-quality liquid assets). The regulations also often impose to demonstrate on a regular basis the practical ability to generate liquidity from these financial assets (a) via sales or (b) by entering into sale and repurchase (repo) transactions.

The essential question when assessing the business model applicable to such portfolios is whether sales imposed by regulations on this portfolio prevent or not these HQLA assets from meeting the Hold-to-Collect criterion.

It is explicitly stated in IFRS 9.B.4.1.4, example 4, that in the situation where the sales imposed by the regulator would be frequent and significant in value, such a portfolio may not be measured at amortised cost because such sales are not compatible with the Hold-to-Collect business model. The fact that a sale is imposed by a regulator (rather than made at the entity's discretion) is not relevant for the business model assessment (IFRS 9.B.4.1.3B). However, only sales that lead to the derecognition of the assets sold are to be considered in this analysis. That assertion will exclude most repo (sale and repurchase) transactions as these often do not result in the derecognition of the security being sold (see **chapters 10** and **11**).

In practice the business model assessment for HQLA portfolios will therefore depend how the management of the bank elected to demonstrate the liquidity of this portfolio in the past and on how it plans to proceed in the future. For example:

- if liquidity is demonstrated only via repos, the portfolio should be eligible to a Held-to-Collect qualification;
- if liquidity is demonstrated via regular «true» sales of a portion of the portfolio, this could lead to the classification of the portfolio as Held-to-Collect-and-Sell. The frequency and volumes of sales as well as the expected level of sales is to be considered.

In some situations, to appropriately depict its actual management practice, a bank may have to break down HQLA portfolios into two sub-portfolios with different business models (e.g. Hold-to-Collect and Hold-to-Collect-and-Sell sub-portfolios).

Such business models may typically have to be reassessed in the future if the regulation were to change (by, for instance, no longer permitting demonstration based on repos but requiring only “true” sales).

7.4.2.5.2. Assets subject to securitisations or factoring

For cash management and balance-sheet management purposes, some entities may decide to sell their assets to banks (e.g. corporates selling their trade receivables to a factor) or to securitisation vehicles (e.g. a bank selling loans).

The impact of such sales on the business model assessment will depend on whether the sale leads to the derecognition² of these assets or not (i.e. on whether they remain or not on the consolidated statement of financial position of the reporting entity):

- sales that do not lead to derecognition are not to be considered as sales for the purpose of this chapter and therefore have no impact on the analysis of the business model;
- sales that lead to the derecognition of the sold financial assets are to be considered when assessing the entity's business model for such portfolios of assets. Even when there is no **past practice** of such sales, **any expected future factoring / securitisation** that leads to a derecognition of the financial assets sold is to be analysed. The consequence may vary depending on the ability of the entity to identify precisely the assets that will be sold in the future. If those assets can be isolated then the entity will probably distinguish two separate business models and assess them separately. However, if the entity is unable to isolate the assets that are expected to be sold, the business model assessment will have to be performed at the global portfolio level, taking into account the level of expected sale.

7.4.2.6. Changes in business models

Changes in business models may give rise to reclassifications of financial assets, but they are expected to be very rare in practice.

Section 7.5 provides some examples of changes in business model and describes the consequences of different types of reclassifications resulting from changes in business models.

7.4.2.7. What if the volume and frequency of sales differ from what was expected initially?

There may be cases where the reasonable scenarios envisaged by management when determining the applicable business model do not happen as planned, without there being any change in business model as defined in the standard (i.e. there has been no internal or external change significant to the entity's operations that is demonstrable to external parties). If cash flows are realised in a way that is different from the entity's expectations at the date that the entity assessed the business model (for example, if the entity sells more or fewer financial assets than it expected when it classified the assets), that does not give rise to a prior period error in the entity's financial statements (in accordance with IAS 8) as long as the entity considered all relevant information that was available at the time that it made the initial business model assessment for that portfolio (IFRS 9.B4.1.2A).

In such a scenario, all the existing assets of the portfolio should remain in their original measurement category (IFRS 9.B4.1.2A). However, the past sales level has to be taken into account in the assessment of the business model applicable to the new financial assets included in this portfolio, alongside with all other relevant information (IFRS 9.B4.1.2A).

² The principles in chapter 3 of IFRS 9 are to be applied to determine whether these assets should be derecognised following their sale (see **chapter 10**).



7.4.3. The SPPI test

7.4.3.1. The general principles

7.4.3.1.1. Why the SPPI criterion is important

The contractual terms of a financial asset must give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding for it to be eligible to amortised cost measurement (IFRS 9.B4.1.2) or to FV-OCI measurement (IFRS 9.B4.1.2) consistently with the business model in which the asset is managed. This is the so called “SPPI criterion” or the “SPPI test”. Financial assets that do not pass the SPPI test are to be fair-valued through profit or loss, irrespective of the entity’s business model for managing them.

7.4.3.1.2. Date of assessment

The SPPI assessment is made upon the initial recognition of a financial asset in the balance sheet (IFRS 9.3.1.1).

Some features may trigger a different SPPI conclusion depending on the market conditions existing on the SPPI test date. Therefore, the same asset purchased at two different dates may pass the SPPI test at one point in time and fail the same test at a later date (and vice-versa).

Example 7.6

Consider the instrument with an interest rate mismatch feature dealt with in **section 7.4.3.1.8**, requiring performing a benchmark test. This test will rely on the current market data available at the date of assessment. If the same test is carried out some years later, if market conditions changed significantly in the meantime, the conclusion of the benchmark test might be different. The outcome of the SPPI test could therefore be different for two instruments with exactly the same interest mismatch, but acquired at different dates.

Example 7.7

Consider a 10-year instrument with a structured non-SPPI coupon during the first two years and a vanilla fixed interest rate for years 3 to 10. All other characteristics of the instrument are SPPI. The entity that originates the instrument will have to classify it as non-SPPI because of the structured coupon in years 1 and 2. On the other hand, if the same instrument had been acquired in year 3 or subsequently, the entity would have performed the SPPI test upon the initial recognition of the purchased instrument. At that date the remaining cash flows being fully SPPI, the conclusion of the SPPI test would have been different from the one that would have been performed upon origination.

Off balance sheet commitments are not subject to the SPPI test. However, if they contain embedded derivatives, these derivatives must be analysed in accordance with the provisions of IFRS 9 on embedded derivatives (see **chapter 13**).

The initial conclusion with regards to the SPPI assessment shall not be revised for a given financial asset, unless that asset undergoes a contractual modification which leads to its derecognition.

7.4.3.1.3. Level of aggregation at which to assess the SPPI criterion

The SPPI criterion is assessed **at financial instrument level** (i.e. instrument by instrument), rather than at a more aggregated level such as portfolio level at which the business models are assessed (see **section 7.4.2.1.3**). This is because the SPPI analysis refers to contractual cash flows which may differ significantly from one instrument to another, even when included within the same portfolio.

The SPPI analysis is made for the instrument in its entirety, i.e. it is not possible to break down one contract into several components and to have an SPPI qualification for the “vanilla” component with basic / SPPI cash flows. Therefore, a structured feature will “penalise” the entire contract, as is the case with the conversion feature in investments in convertible bonds: convertible bonds will have to be classified as non-SPPI financial assets in their entirety in investors’ financial statements.

7.4.3.1.4. Objective of the SPPI test & concept of basic lending arrangement

When assessing whether contractual cash flows are SPPI, the entity must consider whether they are consistent with the cash flows of a so-called **basic lending arrangement**.

In a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. However, in such an arrangement, interest can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period of time. In addition, interest can include a profit margin that is consistent with a basic lending arrangement.

Contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices, do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. An originated or a purchased financial asset can be a basic lending arrangement irrespective of whether it is a loan in its legal form (IFRS 9.B4.1.7.A).

Some instruments, such as investments in shares, derivatives, convertible bonds or bonds redeemable in shares do not meet the SPPI criterion because of the nature of their cash flows.

Both principal and interest payments are cash flows of a financial asset and should therefore be considered when assessing the SPPI criterion. The notions of principal and interest are defined below. Even contractual cash flows that are not certain to occur are to be considered (e.g. cash flows – including any compensation for the early repayment – in the scenario where the issuer opts for the early repayment of the instrument), even when their probability of occurrence is low, as long as the clause is genuine.

It is to be noted that the following features are not to be considered in the SPPI analysis, in accordance with IFRS 9.B4.1.18:

- non-genuine contractual characteristics. A contractual cash flow characteristic is not genuine if it would affect the instrument’s cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur; or
- *de minimis* contractual characteristic (i.e. a feature that could have only a *de minimis* effect on the contractual cash flows, in each reporting period and cumulatively over the life of the instrument).

The SPPI analysis is performed:

- in the currency of the instrument (IFRS 9.B4.1.8). Thus, a debt instrument denominated in a foreign currency (which would generate volatility in the financial statements because of foreign exchange volatility in accordance with IAS 21, *The Effects of Changes in Foreign Exchange Rates*) may be SPPI as long as its cash flows provide only for a reimbursement of principal and interest in that currency.
- irrespective of whether the cash flows of the asset are qualified as principal and interest from a contractual point of view (IFRS 9.B4.1.15). The actual impact of a feature on the contractual cash flows of a financial asset is analysed regardless of its contractual denomination. To illustrate, cash flows indexed to the use of a particular toll road may be referred to as “interest” in the contract (where the “interest” increases as more automobiles use the road) but they do not meet the definition of interest in IFRS 9 (IFRS 9.B4.1.16).
- and irrespective of the legal form of the asset (IFRS 9.B4.1.7A): the SPPI assessment is to be conducted in the same way for loans, bonds, treasury bills, cash deposits, etc.

The credit quality of the counterparty does not, in itself, alter the outcome of the SPPI test. However, one can expect to have more complex features to analyse in a highly risky corporate loan structured in the context of a restructuring plan than in a vanilla bond issued by a sovereign.

7.4.3.1.5. Definition of principal

Principal is the fair value of a financial asset at the date of initial recognition (IFRS 9.4.1.3(a); IFRS 9.B4.1.7B). The principal amount is not the same as the nominal amount. The principal amount is generally equal to the amount for which the financial asset (e.g. a bond) was originally purchased.

Example 7.8

- > **Entity A** buys a security with a nominal value of €2m at the time of issue for €1.98m. In this case the principal amount of the security for Entity A is €1.98m.
- > At a later date **Entity B** buys this security from Entity A for €1.7m. This decline in the market value of the security is explained by a sharp rise in interest rates and a deterioration in the issuer’s credit rating. In this case the principal amount of the security for Entity B is €1.7m.

IFRS 9.B4.1.7B indicates that the principal amount may change over time (for example, it decreases if there are repayments of principal, or increases for a zero coupon bond for which interest payments are capitalised and only occur at the maturity of the instrument).

7.4.3.1.6. Definition of interest

Interest may consist only of the following components:

- consideration for the time value of money (i.e. consideration only for the passage of time) and
- for the credit risk
- that is associated with the principal amount outstanding
- in the currency in which the financial asset is denominated (IFRS 9.B4.1.8)
- during a particular period of time (IFRS 9.4.1.3(b)), as well as
- consideration for associated liquidity risk (IFRS 9.B4.1.7A).

- interest can also include consideration for other basic lending risks and costs, as well as a profit margin. This can include all costs associated with holding the financial asset for a particular period of time (e.g. processing charges, day-to-day administrative costs). For banks, this may also include regulatory capital requirements-related margin.

To illustrate the definition above, the following types of interest payments would be considered SPPI:

- floating interest composed of the benchmark interest index component and of a credit margin component where:
 - > the benchmark rate component is consistent both with the currency of the instrument and with its fixing frequency (i.e. 3-month Euribor reset quarterly on the basis of the 3-month Euribor prevailing at the beginning of the interest period for a contract denominated in EUR), and
 - > the credit margin is fixed and known from the initial recognition;
- fixed rate interest, known from the date of the initial recognition of the asset, without any uncertainty as to its amount over the life of the instrument (even if there is a predefined step-up or step-down scheduled).

In extreme economic circumstances **interest can be negative**. This may happen when, for example, the holder of a financial asset either explicitly or implicitly pays for the deposit of its money for a particular period of time (and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs). Negative interest does not prevent the asset from meeting the SPPI criterion (IFRS 9.B4.1.7A).

The fact that the instrument is originated or purchased at market conditions or not (potentially generating a day one gain or loss (see **chapter 6** Recognition and initial measurement) is not taken into account in the SPPI assessment. Indeed, as the principal is the initial fair value of the instrument, any “off market” feature will be neutralised by this definition of principal. For example, if an entity is providing an interest rate free loan to a counterparty the market rate for which would be 2%, the lender will recognise initially the loan at its fair value (below its nominal amount) and potentially a day one loss. Afterwards, this loan will behave like a vanilla zero-coupon loan that is consistent with the definition of a basic lending arrangement and will thus pass the SPPI Test.

7.4.3.1.7. Examples of non-SPPI features

The SPPI criterion is not met when the contractual terms introduce, for example, exposure to changes in equity prices, commodity prices (IFRS 9.B4.1.7A), or when the contractual interest rate is leveraged (IFRS 9.B4.1.9). See **section 7.4.3.4** for more examples of non-SPPI clauses.

7.4.3.1.8. Modified time value of money

In many cases the SPPI analysis will be rather straightforward, but there may be situations where entities have to apply judgement, namely when assessing whether the time value element provides consideration only for the passage of time. Judgement will be needed whenever the **time value of money element is modified** (IFRS 9.B4.1.9B), i.e. whenever it is inconsistent with the classical remuneration for the passage of time in a basic lending arrangement.

Examples of such modifications include **particular methods of determining interest rates for floating rate instruments**, such as resetting to an average value of the index over a given period (rather than the value of the index as observed at the beginning of the interest period), or an interest rate reset mismatch feature (whereby the tenor of the index used does not match the contractual frequency of interest fixing - e.g. Euribor 12 months that is reset quarterly instead of annually).

A modified time value of money element does not necessarily result in failing the SPPI test. Rather, the entity must assess the impact of the modification on the instrument's cash flows qualitatively and, where necessary, quantitatively.

Such assessment is referred to as the "benchmark test". The entity must compare

- the **undiscounted contractual cash flows** of the asset undergoing the SPPI assessment;
- with the undiscounted cash flows of the same financial asset for which the time value of money element is not modified (the "benchmark instrument").

If this difference is significant, the SPPI criterion is not met. Otherwise (i.e. in cases where the contractual cash flows do not differ significantly from those of the benchmark instrument), the modified time-value of money element meets the SPPI criterion (IFRS 9.B4.1.9C).

This assessment is made considering the effect of the modified time value of money element in each reporting period, and cumulatively over the life of the financial instrument. (IFRS 9.B4.1.9C).

If it is clear with little or no analysis whether the contractual (undiscounted) cash flows on a financial asset could be significantly different from the (undiscounted) benchmark cash flows, an entity need not perform a detailed assessment (IFRS 9.B4.1.9C). When assessing this criterion, factors and scenarios that could affect future cash flows should be taken into account (IFRS 9.B4.1.9D). Only reasonably possible scenarios must be considered; an entity need not consider each and every possible scenario of future interest rate changes.



IFRS 9 does not prescribe any precise methodology for performing the benchmark test. This analysis will therefore require judgement, in particular regarding:

- the type of assessment – qualitative or quantitative – to be performed. In practice, a qualitative assessment will be sufficient for very small or very significant mismatches;
- the way the quantitative test is performed in practice (dollar offset comparison, statistical regression analysis...);
- the materiality threshold to be set for what is to be considered a "significant" difference between the contractual cash flows and the benchmark / "perfectly SPPI" cash flows (that would result in the modified time value of money element failing the SPPI criterion);
- the data to be used to perform this comparison.

As regards the choice of the benchmark instrument in the case of an interest rate reset mismatch, IFRS 9 indicates that the benchmark instrument shall have the same fixing frequency as the instrument undergoing assessment. For example, for a loan paying a floating rate calculated on the basis of Euribor 3 months fixed every 6 months, the benchmark instrument would be a loan where interest is calculated on the basis of Euribor 6 months fixed every 6 months (and not on Euribor 3 months fixed every 3 months).

7.4.3.1.9. Contractual terms that change the timing or amount of contractual cash flows

If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows (for example, if the asset can be prepaid before maturity or its term can be extended), the entity must determine whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are SPPI (IFRS 9.B4.1.10).

To make this determination, the entity must assess the contractual cash flows that could arise both (a) before, and (b) after the change in contractual cash flows. The entity may also need to assess the nature of any contingent event (i.e. the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor, it may be an indicator. For instance, it is more likely that cash flows resulting from an “exotic” trigger³ will fail the SPPI criterion than cash flows resulting from a trigger that has a direct relationship with the basic components of interest such as credit risk⁴. Some examples of contractual features that change the timing or amount of contractual cash flows are analysed in **section 7.4.3.3**, namely prepayment features (see **section 7.4.3.3.2**) and extension features (see **section 7.4.3.3.3**).

7.4.3.2. Features and / or contracts that normally pass the SPPI test

We present below some examples of contractual features or instruments that usually meet the SPPI criterion. This list is not exhaustive.

7.4.3.2.1. Trade receivables

Trade receivables are financial assets resulting from contracts that transfer goods or services to customers. These are generally simple assets, with a single cash flow at the maturity of the related invoice. They therefore generally meet the SPPI criterion.

7.4.3.2.2. Fixed rate non-callable vanilla bonds

Supposing all the cash flows of a quoted bond are known when purchasing the bond and, putting aside the counterparty credit risk, certain to occur (meaning the interest rate is fixed and there are no optional features such as early prepayment option / call, interest deferral clauses, term extension features, etc.): it is likely that their contractual cash flows will represent solely payments of principal and interest. It can be noted that in some jurisdictions most bonds bear a fixed rate of interest and are not callable.

An interest rate can be contractually fixed at different levels depending on the period considered. For example, a 10-year bond may pay a fixed interest rate of 2% for the first 3 years, and a 5% fixed interest rate for the remaining life of the bond. This will be considered as a fixed rate instrument and will not alter the outcome of the SPPI test.

³ E.g. an interest rate that is reset to a higher rate if a specified equity index reaches a particular level.

⁴ E.g. an interest rate that is reset to a higher rate if the debtor fails to comply with a debt/equity covenant.

7.4.3.2.3. Floating rate instruments without mismatch features

For floating rate instruments, interest is often contractually defined as the sum of (a) a publicly observable floating rate (“the reference index”) and (b) a contractually specified margin. Their SPPI analysis is more complex than that of fixed rate instruments. The following contractual features in relation to interest rate determination have to be considered:

- contract currency,
- reference index (Euribor? Libor? etc.),
- tenor of the reference index (1 month? 3 months? 12 months? other?),
- date at which reference index value is observed at the beginning of the interest rate period (pre-fixed)? At the end of the period (post fixed or “in-arrears”)? Average over a predefined period?
- interest rate fixing frequency (monthly, quarterly? annual? etc.),
- interest margin, and whether it is fixed once and for all at the initial recognition of the asset, or whether it depends on any specific indicator / underlying.

An example of a perfectly SPPI floating rate would be that of a loan or a bond:

- for which the nominal amount and interest are denominated in EUR,
- indexed to Euribor 3 months,
- with a rate that is reset every three months to the current 3-month Euribor spot rate observed as of the beginning of the interest rate period,
- and where its contractual margin is fixed from the outset (e.g. 2%).

The cash flows of interest of such an instrument are SPPI as they reflect consideration for the time value of money and for the credit risk associated with the instrument. It is explicitly stated in IFRS 9.B4.1.11(a) that the consideration for credit risk may be determined at initial recognition only, and so may be fixed.

Of course, all the other contractual features (e.g. early prepayment amount, term extension options, etc.) would have to be further analysed before concluding that this loan / bond is SPPI. In many jurisdictions, floating interest is often set as described in the example above.

For less common instruments where the interest is not set as described in the example above, the floating interest rate clause may bear a modified time value of money element that could require the entity to perform a benchmark test (see examples in **sections 7.4.3.3.1** and **7.4.3.4.1**).

The fact that a contract’s floating-rate is **floored** or **capped** does not normally have any consequence whatsoever on the SPPI assessment, provided this cap / floor feature is “vanilla” (i.e. without any leveraged effect or other structured component). So, re-using the example above, capping the contractual reference rate at 5% whenever 3-month Euribor goes above 5% would still be compatible with the SPPI criterion. This is because such a contractual term can be viewed as simply reducing cash flow variability by setting a limit on a variable interest rate (IFRS 9.B4.1.13, example with Instrument C). A capped / floored floating rate may also be viewed as a simple combination of a floating rate (before the cap / floor is activated) and a fixed rate (after the cap / floor has been activated).

7.4.3.2.4. Inflation-linked instruments without leverage and without currency mismatch features

According to IFRS 9.B4.1.13 (example with instrument A), indexation of contractual cash flows to an inflation index (also referred to as consumer price index / CPI) is SPPI-compliant as long as:

- cash flows are indexed to the inflation rate of the currency in which the instrument is denominated (e.g. an instrument in euro indexed to the Euro zone inflation rate),
- **and** the inflation indexation formula is not leveraged.

This is because linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level. In other words, the interest rate on the instrument reflects “real” interest. Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.



Even though the example of Instrument A in IFRS 9.B4.1.13 mentions a capital-protected instrument, we consider that an inflation-indexed instrument **without capital protection** (in case of deflation) is SPPI-compliant as long as the two criteria described above are met. This is because, when the inflation rate is negative, having no floor on the inflation index simply allows to set the time value of money to a current level thus reflecting “real” interest. This is consistent with the fact that a negative interest rate environment does not impact the SPPI assessment (IFRS 9.B4.1.7A).

7.4.3.2.5. Subordination features in the event of debtor’s default

In almost every lending transaction the creditor’s instrument is ranked relative to the instruments of the debtor’s other creditors. For example, a trade receivable that ranks its creditor as a general creditor is subordinated to a loan issued by the same debtor that is collateralised. In the event of the debtor’s bankruptcy, the loan holder would have priority over the claims of the general creditor in respect of the collateral but the creditor of the trade receivable would still be entitled to get unpaid principal and other amounts due.

According to IFRS 9.B4.1.19, an instrument that is subordinated to other instruments may have contractual cash flows that are payments of principal and interest on the principal amount outstanding if:

- the debtor’s non-payment is a breach of contract, and
- the holder has a contractual right to unpaid amounts of principal and interest on the principal amount outstanding even in the event of the debtor’s bankruptcy.

If we revert to the example of the trade receivable presented above, that specific subordination feature is SPPI as it only defines the priority of payments in the event of default but does not affect the contractual right of the general creditor to unpaid amounts.

7.4.3.2.6. Collateralised full recourse vanilla loans

Consider a full recourse loan secured by collateral. The contractual cash flows of the loan are those of a basic lending arrangement. The fact that a full recourse loan is collateralized does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding (IFRS 9.B4.1.13 Instrument D).



For non-recourse loans the analysis is more complex, see **section 7.4.3.5.3**.

7.4.3.3. Features that may not pass the SPPI test

Below are some examples of contractual features or instruments that may or may not pass the SPPI criterion depending on how the cash flows resulting from specific clauses are determined in the contract. This list is not exhaustive.

7.4.3.3.1. Floating rates with interest rate mismatch(es)

Section 7.4.3.2.3 provides an example of a floating rate instrument that is considered as SPPI-compliant. Its reference index is 3-month Euribor and its fixing frequency is every three months to the current 3-month spot rate observed as of the beginning of the interest rate period.

Consider now the following two instruments with interest rate mismatch features:

Example 7.9

Instrument with a **refixing mismatch**: consider an instrument similar to that analysed in the example in **section 7.4.3.2.3**, also indexed to a 3-month Euribor index, but with a rate which is reset annually instead of quarterly:

- > such instrument includes a refixing mismatch,
- > refixing mismatches are situations where the time value of money element is modified and where a benchmark test has to be performed (IFRS 9.B4.1.9B, and B4.1.13 Instrument B).

Example 7.10

Instrument with an **averaged interest rate**: consider an instrument similar to that analysed in the example in **section 7.4.3.2.3**, also indexed to a 3-month Euribor index, but where the rate depends on an average of 3-month Euribor rates observed over a 3-month period preceding the reset date, instead of being fixed on the basis of the 3-month Euribor spot rate at the beginning of the interest rate period:

- > this is another example of a modified time value of money element (IFRS 9.B4.1.9B) that would require a benchmark test assessment.

Such “interest rate mismatches” require additional qualitative or quantitative analysis (IFRS 9.B4.1.13 Instrument B). Benchmark tests have to be performed to demonstrate that the cash flows of such instruments do not differ significantly from those of a basic lending transaction bearing a floating rate of interest without interest rate mismatch features (benchmark instrument). For more information on benchmark tests and modified time value of money, see **section 7.4.3.1.8**.

7.4.3.3.2. Prepayment clauses

Debt instruments often contain early prepayment clauses, meaning the instrument may be terminated before its contractual maturity by the issuer repaying the remaining amounts earlier than they were initially due. The contractual terms used to define this clause vary depending on the legal form of the instrument (bond vs. loan). This option is often at the hand of the borrower but can be at the hand of the lender, or even both as well. A wide range of prepayment feature exists.

It is quite common for the contract to stipulate that the party imposing early prepayment has to compensate the other party for the early termination of the contract. In less frequent cases the party exercising the early termination option may receive compensation for early prepayment as well.

Whatever the legal form of the instrument, the SPPI criterion will be met in cases where the prepayment amount **substantially represents unpaid amounts of principal and interest on the principal amount outstanding**, which may **include reasonable compensation** for the early termination of the contract (IFRS 9.B4.1.11(b)).

To illustrate the principle above, consider the following examples:

- A prepayment option for an amount equal to the **remaining unpaid principal amount and accrued interests** as of prepayment date, without any compensation for early prepayment is considered SPPI.
- In cases where a **lump-sum** type prepayment fee is included (e.g. 1,000 EUR or 5% of the principal amount that has been prepaid), **judgement** must be exercised to determine whether this compensation is “reasonable” as the standard does not include additional guidance or examples on this aspect. It is to be noted that the materiality of prepayment fees is to be assessed in respect of the principal amount of the instrument rather than its notional amount / par amount.
- In situations where the financial asset is pre-payable at an amount that includes the fair value **cost to terminate an associated hedging instrument**, such clause may or may not pass the SPPI test depending on the circumstances. For instance, when the calculation of the prepayment amount is intended to approximate unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate, such prepayment clause meets the SPPI criterion (IFRS 9.BC4.232).
- A prepayment option for an amount equal to the **present value of all the remaining cash flows** to be paid until maturity, **discounted** at a risk-free interest rate is considered SPPI. This is because the compensation included in the prepayment amount is in this case reasonable as it is equivalent to the cost of carry that the borrower would bear if he chose not to early reimburse and rather invest an amount of cash in a risk-free instrument.

IFRS 9 was amended in 2017 to state explicitly that a compensation does not contradict the SPPI criterion solely because it is received by the counterparty that exercises the option (IFRS 9.B4.1.12.A).

This amendment introduced as well in its basis for conclusions a sentence that states that there may be circumstances in which a **prepayment option at fair value** results in SPPI cash flows. (IFRS 9.BC4.232).

IFRS 9.B4.1.12 contains specific guidance for the analysis of early prepayment features in financial assets acquired or originated at a premium or discount to the contractual par amount. In this specific case, if:

- the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable compensation for the early termination of the contract; and
- when the entity initially recognises the financial asset the fair value of the prepayment feature is insignificant,

the prepayment option feature would meet the SPPI criterion irrespective of the fact that the existence of that discount / premium would have otherwise failed the SPPI criterion applying IFRS 9.B4.1.10 & B4.1.11(b).





This specific guidance in IFRS 9.B4.1.12 may apply for example to loans purchased at a premium / discount in the context of a separate loan portfolio purchase, or in the context of a business combination.

Given that the SPPI criterion and the “reasonableness” of any compensation for early prepayment has to be assessed against the principal amount (i.e. acquisition price, as described in **section 7.4.3.1.5**) rather than the nominal amount of a financial asset, even assets redeemable at par might have failed the SPPI criterion in IFRS 9.B4.1.11(b) had the guidance in IFRS 9.B4.1.12 not been included.

To illustrate further such situation, consider the following example:

- a non-amortising floating rate loan purchased at a discount (e.g. at 70 while its nominal amount is 100);
- the discount results from the fact that the creditworthiness of the issuer has deteriorated since the loan was originated;
- the loan contract states the loan may be early redeemed at its nominal amount (i.e. 100);
- assuming the loan is early redeemed for 100, the new lender (i.e. the party who purchased the loan on the secondary market) would in substance receive a compensation of 30 upon early repayment.

Should the entity’s accounting policy state that lump-sum prepayment penalties that are above 10% of the principal amount are not reasonable, the loan would have failed the SPPI test without the guidance in IFRS 9.B4.1.12, in accordance with IFRS 9.B4.11(b).

However, applying the principles in IFRS 9.B4.1.12 described above, the entity would probably conclude that this prepayment clause is SPPI as:

- the prepayment amount corresponds exactly to the contractual *par* amount, and
- the initial fair value of the prepayment feature upon initial recognition of the loan is likely to be insignificant.

7.4.3.3.3. Option to extend the contractual maturity

A contractual term that permits the issuer or the holder to extend the contractual maturity of a debt instrument (i.e. an extension option) will be considered to meet the SPPI criterion in cases where the terms of the extension option result in **SPPI contractual cash flows during the extension period**, which may include **reasonable additional compensation** for the extension of the contract.

In our opinion, regarding the 1st criterion above, the following two methods for determining interest during the extension period both meet the SPPI criterion:

- extension feature where post-extension interest rate is fixed and known from the outset⁵;
- extension feature where the initially set interest rate is adjusted upon extension to take account of market conditions observed when the term extension option is exercised.

⁵ The date of the initial recognition of the asset on the balance sheet.

The assessment of whether the extension fees, if any, are “reasonable” will require exercising judgement.

7.4.3.3.4. Option to switch from a floating rate to a fixed rate

Some contracts specify that the contract bears initially a floating interest rate but include an option to switch from this floating rate interest formula to a fixed rate interest formula at a later date. IFRS 9 does not contain any specific guidance as to how such clauses should be analysed.



In our opinion, the following two types of options to switch to a fixed rate both meet the SPPI criterion:

- the level of the fixed rate is known from the outset (as, in such case, this feature may be analysed by analogy to a vanilla cap that simply limits the variability of the instruments’ cash flows, as explained in **section 7.4.3.2.3**);
- the level of the fixed rate is not known initially but will be determined based on the current market conditions, taking into account the residual maturity of the instrument. For example, the reference rate used to fix the rate will be the then applicable:
 - > 10-year swap rate if the option is exercised when 10 years remain to the maturity of the contract,
 - > 5-year swap rate if the option is exercised when 5 years remain to the maturity of the contract, etc.

In situations where the rate is fixed in such a way that it refers to an interest rate index which tenor is fixed whatever the residual maturity of the contract upon exercise of the conversion option (e.g. reference to a 5-year swap rate even if 10 years remain to maturity), the feature contains a mismatch that must be assessed using a benchmark test (see **section 7.4.3.1.8**).

7.4.3.3.5. Write-down or conversion imposed by a regulator

Some instruments issued by regulated entities (such as banks) may be subject to a legislation that permits or requires a national resolving authority to impose losses on the holders of such instruments. For example, the national resolving authority may have the power to write down the par amount of that instrument or to convert it into a fixed number of the issuer’s ordinary shares if the national resolving authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is ‘failing’.

The holder would:

- analyse the **contractual terms** of the financial instrument to determine whether they give rise to SPPI cash flows,
- but **would not consider** the payments that arise only as a result of the national resolving authority’s power to impose losses on the holders of that instrument (IFRS 9.B4.1.13, Example with instrument E). That is because that power, and the resulting payments, are not contractual terms of the financial instrument.



7.4.3.3.6. Option to differ interest payment (coupon deferral)

Some financial assets provide the issuer with the right to defer the payment of coupons. This feature is considered SPPI only if the differed coupons are mandatory and accrue additional interests (IFRS 9. B4.1.14 Instrument H).

7.4.3.3.7. Perpetual bonds

Perpetual bonds are quite common financial instruments that do not have a stated maturity date, which means repayment of principal is not contractually due. This feature does not lead in itself to failing the SPPI test (IFRS 9.B4.1.13, example with Instrument H). This is because perpetual instruments have continuous (multiple) extension options. Such options may result in contractual cash flows that are payments of principal and interest on the principal amount outstanding if interest payments are mandatory and must be paid in perpetuity.

If the perpetual bond is callable (meaning the issuer may decide to prepay the instrument), the terms and conditions of the call – including any early termination fees / compensation – will have to be analysed as well (see **section 7.4.3.3.2**).

A perpetual instrument may also contain a coupon deferral mechanism (see **section 7.4.3.3.6**).

7.4.3.3.8. Regulated interest rate

In some jurisdictions, the government or a regulatory authority sets 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. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, a regulated interest rate is considered a proxy for the time value of money element 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 (IFRS 9.B4.1.9E).

In its basis for conclusions, IFRS 9 mentions the French interest rate applicable to “Livret A” saving accounts as an example of regulated interest rate that pass the SPPI test. The interest rate is determined by the central bank and the government according to a formula that reflects protection against inflation and an adequate remuneration that incentivises entities to use these particular savings accounts. This is because legislation requires a particular portion of the amounts collected by the retail banks to be lent to a governmental agency that uses the proceeds for social programmes. The IASB noted that the time value element of interest on these accounts may not provide consideration for only the passage of time; however, the IASB believes that amortised cost would provide relevant and useful information as long as the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement (IFRS 9.BC4.180).

7.4.3.4. Features that normally do not pass the SPPI test

Below are some examples of contractual features or instruments that usually do not meet the SPPI criterion. This list is not exhaustive.

7.4.3.4.1. Floating rate with a currency-index mismatch feature

The floating rate instrument described in **section 7.4.3.2.3** is considered as SPPI-compliant. That instrument is issued in EUR and its reference index is Euribor.

Consider however the following example: a loan is issued in EUR but it is indexed to a USD Libor, rather than Euribor. This instrument contains a currency-index mismatch. In our opinion, whenever the contractual terms include such a feature, the contract does not meet the SPPI criterion.

7.4.3.4.2. Leverage / multiple of a benchmark interest rate

Leverage is a contractual cash flow characteristic of some financial assets. Leverage may increase or modify the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest (IFRS 9.B4.1.9).

As a result, the following instruments are not SPPI-compliant:

- stand-alone derivatives (such as options, forwards and swaps) that by definition include such leverage;
- debt instruments with structured interest rate including a leverage factor in the interest formula.



In our opinion a leverage is identified when a coefficient > 1 is applied to an interest rate index (e.g. a floating rate instrument indexed to $1.5 \times$ Euribor).

7.4.3.4.3. Inverse floater

Some debt instruments pay an inverse floating interest rate: the interest rate has an inverse relationship to market interest rates. For example, a debt instrument paying interest equal to 5% minus Euribor is an inverse floater.

The contractual cash flows of such instruments are not SPPI as the interest amounts are not consideration for the time value of money on the principal amount outstanding (IFRS 9.B4.1.14, example with instrument G). The fact that the variability of such payoff may be limited by setting a cap or floor level in the contract has no impact on such conclusion.

7.4.3.4.4. Payoff indexed on commodities index, share price or stock market index

Contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices or commodity prices do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding (IFRS 9.B4.1.7A).

7.4.3.4.5. Debt instruments convertible or redeemable in shares

Instruments convertible into (or redeemable in) a fixed number of equity instruments of the issuer, or another entity, must undergo the SPPI analysis in their entirety. Their contractual cash flows are not SPPI



because they reflect a return that is inconsistent with a basic lending arrangement, i.e. the return is linked to the value of the equity of the issuer (IFRS 9.B4.1.7A and IFRS 9.B4.1.14, example with instrument F).

If, however, the number of shares delivered is variable to provide to the holder a value equal to a fixed amount of currency, then the instrument may pass the SPPI test. Indeed, in this case the holder is not exposed to the changes in the underlying share price over the life of the debt instrument.

7.4.3.5. Specific types of instruments subject to additional guidance

7.4.3.5.1. Contractually linked instruments (e.g. multi-tranche ABSs or CLOs)

In some transactions, an issuer may prioritise payments to the holders of financial assets using multiple Contractually Linked Instruments (CLI) that create concentrations of credit risk (tranches). Each has a subordination ranking tranche (e.g. senior, mezzanine or junior tranche) that specifies the order in which any cash flows generated by the issuer are allocated to the tranche (with senior tranches being paid first, then mezzanine tranches and junior tranches in the very end). In such situations, the holders of a tranche have the right to payments of principal and interest on the principal amount outstanding only if the issuer generates sufficient cash flows to satisfy higher-ranking tranches (IFRS 9.B4.1.20). In such structures, there is a reallocation of the credit risk of a portfolio of underlying loans or debt securities over several categories of instruments with different risk levels. Contractually Linked Instruments are commonly used in multi-tranche securitisation vehicles (e.g. ABS / asset backed securities, RMBS / residential mortgage backed securities, CLO / collateralised loan obligations).

IFRS 9 contains specific guidance for these instruments. Contractually linked instruments must satisfy all three criteria below to be considered SPPI:

- **criteria n° 1:** the contractual terms of the tranche being assessed are SPPI, e.g. the interest rate on the tranche is not linked to a commodity index (IFRS 9.B4.1.21(a)). This criterion is not specific to contractually linked instruments. As for any other financial asset, the entity must analyse the interest rate clauses, any prepayment and interest deferral clauses, etc.;
- **criteria n° 2:** the underlying pool of financial instruments also meets the SPPI criterion (IFRS 9.B4.1.21(b)). This criterion is further detailed below;
- **criteria n° 3:** the exposure to credit risk in the underlying pool of financial instruments inherent in the tranche is equal to or lower than the exposure to credit risk of the underlying pool of financial instruments (IFRS 9.B4.1.21(c)). This will be the case, for example, when the credit rating of the tranche being assessed for classification is equal to or higher than the credit rating that would apply to a single tranche that funded the underlying pool of financial instruments). This criterion is further detailed below.

Criteria n° 2 is in practice the most complex criterion to implement as it requires a “look-through” analysis of the underlying assets to make sure the pool contains only instruments that meet the SPPI criterion (IFRS 9.B4.1.23 and B4.1.25). An exception to this principle exists: derivatives by definition do not meet the SPPI criterion but some derivatives included in the pool may be disregarded in the analysis of criteria n° 2 (i.e. they do not make the tranche fail the SPPI criterion if they (a) reduce the cash flow variability of the final instrument (for example, a derivative hedging interest rate risk or foreign exchange risk, or a contract that reduces the credit risk on some or all of the instruments of the pool) or (b) align the cash flows of the underlying pool with those of the final instrument (IFRS 9.B4.1.24).



The underlying pool will not meet the “look through” criterion in the following situations (this list is not exhaustive):

- in the case of “*synthetic*” *securitisations* (where the issuer obtains exposure to the credit risk of selected counterparties by writing CDSs on these counterparties rather than investing in debt instruments issued by these counterparties),
- in the case of securities having lease contracts that expose the securitisation vehicle to the risk of the residual value of the leased property,
- or when the underlying pool contains non-SPPI financial investments such as equity instruments or funds shares.

The standard specifies that a detailed instrument-by-instrument analysis of the pool may not be necessary. This is crucial as the investor generally does not have the same level of information when investing in such structure than if he had purchased directly each asset individually. An entity must however perform sufficient analysis under IFRS 9 (including the provisions relating to de minimis features – see **section 7.4.3.1.4**) to determine whether the instruments in the pool meet the SPPI criterion (IFRS 9. B4.1.25). This will require a significant level of **judgement**.

Besides, all the possible changes to the underlying pool of financial instruments over the lifetime of the tranche must be considered. If the vehicle having issued the tranche is rechargeable in such a way that the underlying pool of instruments may include non-SPPI assets (other than derivative instruments used for risk management purposes by the securitisation vehicle as described) the tranche does not meet the SPPI criterion and must be fair-valued through profit or loss (IFRS 9.B4.1.26).

However, if the underlying pool includes instruments that are **collateralised** by assets that do not meet the SPPI criterion, the ability to take possession of such assets must be disregarded unless the entity acquired the tranche with the intention of controlling the collateral (IFRS 9.B4.1.26).

This analysis is to be carried out as of the date of the initial recognition of the tranche. Where the holder of the tranche is unable to conduct this “look-through” analysis, the instrument will be measured at fair value through profit or loss by default (IFRS 9.B4.1.26).

In the case of asset securitisations where the underlying pool of assets contains tranches resulting from other securitisations, the “look-through” analysis must make it possible to trace the underlying original assets of the initial securitisation. This is because IFRS 9 requires the entity to “look through” until it can identify the underlying pool of instruments that are creating (instead of passing through) the cash flows (IFRS 9.B4.1.22). Should such analysis not be possible, the asset will be measured at fair value through profit or loss (IFRS 9.B4.1.26).

Criterion n° 3 requires verifying whether the credit risk of the instruments is equal to or lower than the average risk of the underlying assets as a whole. The risk of the instrument in question must be compared with the rating that would have been obtained by the issued notes as a whole if no tranching had taken place, on the basis of the information available (e.g. probability of default, rating, etc.). This criterion would not be met, for instance, by most **subordinated / junior tranches** which absorb the first losses in the pool of the underlying assets. Investments in such tranches must be fair-valued through profit or loss. On the opposite end of the spectrum, this criterion will always be met for the most senior tranche of the issuing vehicle.



This analysis is to be carried out as of the date of the initial recognition of the tranche. It may be complex to implement for mezzanine tranches where the information of the risk level of the tranche and of the underlying is not available as of the initial recognition date. Where the holder of the tranche is unable to conduct this analysis, the instrument will be measured at fair value through profit or loss by default (IFRS 9.B4.1.26).

7.4.3.5.2. Instruments representing an investment in particular assets or cash flows

In some cases, a financial asset may have contractual cash flows that are described as principal and interest, but those cash flows do not represent the payment of principal and interest on the principal amount outstanding (IFRS 9.B4.1.15).

This may be the case if the financial asset **represents an investment in particular assets or cash flows and hence the contractual cash flows are not SPPI**:

- For example, if the contractual terms stipulate that the financial asset's cash flows increase as more automobiles use a particular toll road, those contractual cash flows are inconsistent with a basic lending arrangement (IFRS 9.B4.1.16).
- This could also be the case when a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a 'non-recourse' financial asset). Not all non-recourse assets are non-SPPI, see **section 7.4.3.5.3** for more information.

7.4.3.5.3. Non-recourse financial assets

Non-recourse financial assets are, for example, loans for which the lender's recourse is limited to an identified asset. A non-recourse loan always has an underlying project or asset (with or without the creation of an SPV⁶, a special purpose vehicle). In the case of a default of the debtor, the recourse of the lender is limited to the underlying asset or project. The lender has no recourse against the rest of the balance sheet of the debtor. Such situations can lead the lender to take a significant risk on the value of the underlying asset, which could prevent the loan from meeting the SPPI criterion.

A lending arrangement can be either explicitly non-recourse, or implicitly non-recourse. For example, a loan granted to a SPV that holds only one non-financial asset may be presented contractually "with recourse", but its risk profile may not be different from a loan granted to a large corporate with a recourse limited to a single asset. Therefore, judgement must be exercised on any lending arrangement granted to limited purpose entities (SPV, SPE...) to assess whether it is, in substance, a non-recourse lending transaction.

The fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from meeting the SPPI criterion. In such situations, the creditor is required to assess ("look through to") the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are SPPI.

⁶ Special Purpose Vehicles (SPV) / Special Purpose Entities (SPE) are entities that are created to accomplish a narrow and well-defined objective (e.g. to carry a lease, research and development activities, a securitisation of financial assets or carry out a project such as a windfarm). In SPV financing generally the underlying financed asset guarantees the loan / notes issued by the vehicle without any additional collateral and is often the only source of reimbursement in case of default of the SPV (as the activities of the entity are limited).

If the terms of a non-recourse financial asset:

- give rise to any other cash flows,
- **or** limit the cash flows in a manner inconsistent with payments representing principal and interest,

the financial asset does not meet the SPPI criterion. Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment (IFRS 9.B4.1.17).



In our opinion, the guidance in IFRS 9.B4.1.17 implies that a non-recourse financial asset will not pass the SPPI test if either of the following criteria are met:

- the lender can benefit from a positive performance of the financed asset (i.e. following the borrower's default, the sale of the assets received as a guarantee / collateral for the non-recourse asset can result in a profit for the lender, because the lender doesn't give back to the borrower the gain realised upon the sale), **or**
- the «non-recourse» nature of the instrument exposes the lender mainly to the asset's value risk rather than to a counterparty risk. The following factors must be considered in this assessment:
 - > Loan-To-Value ratio (the lower this ratio is the more likely it is that the non-recourse asset will pass the SPPI test) and loss-absorption mechanisms protecting the lender (equity tranche, guarantees received from third parties...), if any;
 - > the probability of default of the debtor (the lesser the probability of default the more likely it is that the non-recourse asset will pass the SPPI test);
 - > in the case of a non-recourse project financing loans: the technical feasibility of the project financed and its capacity to generate cash flows necessary to reimburse the non-recourse financing.

The analysis must be performed considering the global contractual arrangements together with an "in substance" analysis of the risk profile. For instance, where the non-recourse analysis is carried out for a financing to an SPV holding a single non-financial asset, this asset could be leased to a corporate which is committed to pay the rentals and provides strong guarantee to the SPV. In such situations, taking into account all the facts and circumstances of the transaction, the investor may conclude that the main risk he is exposed to is a basic lending risk with the corporate entity as counterparty and that the non-recourse feature meets the SPPI criterion.

It is to be noted that the analysis of non-recourse financial assets is to be carried out upon the initial recognition of a non-recourse asset and the initial conclusion is not reassessed subsequently, even upon a change in the facts and circumstances surrounding this financing. This analysis is often complex to implement and requires understanding the economic rationale and the viability of the financial set-up.

If the non-recourse financing takes the form of a contractually linked instrument (e.g. a multi-tranche ABS / CLO), more specific guidance on contractually linked instruments applies (see **section 7.4.3.5.1**).



7.4.4. Puttable mutual fund shares

Puttable mutual fund shares do not generally meet the core definition of an equity instrument provided by IAS 32 even if they may be presented within equity thanks to the presentation exception that exists in IAS 32 for puttable instruments. Therefore, puttable mutual fund shares are not eligible to the FV-OCINR category (see **section 7.3.2** regarding the eligibility criteria to the FV-OCINR category).

These puttable mutual fund shares will generally fail the SPPI test as well, as:

- the return paid to the investor is based on the change in the fund net asset value; and
- the fund manager generally has discretion on the amounts that are transferred by the fund to the shareholders (i.e. no pre-agreed schedule for payments of principal and interest).

As a result, the only possible category for classifying puttable mutual fund shares will normally be FV-PL, irrespective of the entity's business model applied for managing these shares.

7.4.5. Fair value option

Upon the **initial recognition** of a financial asset, an entity may make an **irrevocable** election to classify that asset (or a group of financial assets) as measured at fair value through profit or loss if and only if:

- such designation results in **more relevant information** (IFRS 9.B4.1.27)
- by **eliminating or significantly reducing a** measurement or recognition inconsistency (**accounting mismatch**) (IFRS 9.4.1.5). Such inconsistencies arise from measuring financial assets (or financial assets and liabilities) that are economically related on different bases.

The following are examples where the above conditions could be met (IFRS 9.B4.1.30):

Example 7.11

An entity has financial assets, financial liabilities, or both, that share a risk, such as interest rate risk, and that give rise to opposite changes in fair value that tend to offset each other. However, only some of the instruments would be measured at fair value through profit or loss (for example, those that are derivatives, or are classified as held for trading). It may also be the case that the requirements for hedge accounting are not met because, for example, the requirements for hedge effectiveness in IFRS 9.6.4.1 are not met.

Example 7.12

An entity has financial assets, financial liabilities, or both, that share a risk, such as interest rate risk, that gives rise to opposite changes in fair value that tend to offset each other and none of the financial assets or financial liabilities qualifies for designation as a hedging instrument because they are not measured at fair value through profit or loss. Furthermore, in the absence of hedge accounting there is a significant inconsistency in the recognition of gains and losses. For example, the entity has financed a specified group of loans by issuing traded bonds whose changes in fair value tend to offset each other. If, in addition, the entity regularly buys and sells the bonds but rarely, if ever, buys and sells the loans, reporting both the loans and the bonds at fair value through profit or loss eliminates the inconsistency in the timing of the recognition of the gains and losses that would otherwise arise from measuring them both at amortised cost and recognising a gain or loss each time a bond is repurchased.

This so-called 'fair value option' may only be applied at initial recognition of financial assets and cannot subsequently be reconsidered until the derecognition of the asset. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the measurement or recognition inconsistency at exactly the same time. A reasonable delay is permitted provided that each transaction is designated as at FV-PL at its initial recognition and, at that time, any remaining transactions are expected to occur (IFRS 9.B4.1.31).

It would not be acceptable to designate only some of the financial assets that **give rise to the inconsistency** as at FV-PL if doing so would not eliminate or significantly reduce the accounting mismatch and would therefore not result in more relevant information. However, it would be acceptable to designate as measured at FV-PL only some of a number of similar financial assets if doing so achieves a significant reduction (and possibly a greater reduction than other allowable designations) in the inconsistency. As designation as at FV-PL can be applied only to the whole of a financial instrument, the entity must designate one or more assets in their entirety. It may not designate either a component or a proportion of a financial asset (IFRS 9.B4.1.32).

If an entity elects to designate financial assets as at FV-PL, specific disclosures must be provided in the **notes** to financial statements (see **chapter 16**).

It is to be noted that chapter 6.7 of IFRS 9 permits in specific circumstances to designate a credit exposure as measured at fair value through profit or loss, as an alternative to hedge accounting. Such designation is described in **chapter 14**. It differs from the designation at FV-PL described in **section 7.4.5** in that it (a) can be elected after the initial recognition of the asset, and (b) is revocable or might have to be discontinued (subject to specific conditions). Entities that continue using the requirements on hedge accounting in IAS 39 (as permitted by IFRS 9.7.2.21) are not allowed to use this specific designation.

7.5. Reclassifications of financial assets

7.5.1. Main principles

Entities shall not subsequently reclassify investments in **equity instruments**, as their classification is determined once and for all at their initial recognition.

Financial assets that are **debt instruments** (loans, bonds...) meeting the SPPI criterion must be **reclassified only** when an entity changes its business model for managing these assets (IFRS 9.4.4.1). However, some debt instruments should never be reclassified, even following a change in their business model. These are:

- assets designated as measured at FV-PL (see **section 7.4.5**), as the fair value option is irrevocable;
- Assets initially measured at FV-PL because they do not meet the SPPI criterion.

The contractual cash flows (or the SPPI) criterion is assessed at initial recognition of a financial asset. This criterion is not reassessed later and consequently cannot give rise to reclassifications.

Changes in business model that require reclassification are expected to be very infrequent in practice as they only occur when an entity either begins or ceases to perform an activity that is significant to its operations (IFRS 9.B4.4.1). A **change in business model** occurs when all of the following criteria are met:

- the change in business model is determined by the entity's senior management as a result of external or internal changes;
- the change is significant to the entity's operations;
- the change is demonstrable to external parties; and
- the change in business model has already been agreed at the time of reclassification (IFRS 9.B4.4.1 and B4.4.2).

In the event of a change of business model, all the assets concerned should be reclassified as of the reclassification date (see **section 7.5.4**) into the category associated with the new business model. A reclassification of financial assets is applied **prospectively** (IFRS 9.5.6.1), without restating prior figures.

The consequences of reclassifications are detailed in **section 7.5.4**.

7.5.2. Examples

Examples of a **change in business model** include the following (IFRS 9.B4.4.1):

Example 7.13

An entity has a portfolio of commercial loans that it holds to sell in the short term. It acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer held for sale; it is now held to collect the contractual cash flows.

Example 7.14

An entity decides to shut down its retail mortgage business. It takes on no new business and actively markets its mortgage loan portfolio for sale.

The following situations **are not changes in business model** (IFRS 9.B4.4.3):

- a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);
- the temporary disappearance of a particular market for financial assets;
- a transfer of financial assets between parts of the entity with different business models.

7.5.3. Reclassification date

The **reclassification date** is the first day of the reporting period that follows the effective date of change in business model resulting in the reclassification (IFRS 9, Appendix A). In practice this may lead to a time-lag between the date on which the business model is modified and the date of accounting reclassification (IFRS 9.B4.4.2)

Example 7.15

Assume that:

- > the termination of a business line previously considered as managed under a Held-to-Collect model is announced on 18 November of year N,
- > management will from now manage the assets with a view to short-term disposal,
- > no new assets are acquired or originated between 18 November and 31 December,
- > the active search for buyers for the existing assets is in progress at 31 December.

The financial assets will still be accounted for and presented in the financial statements at 31 December in year N in accordance with the previous business model (i.e. at amortised cost if the SPPI criterion is satisfied). The provisions applicable to the accounting category under the new business model (and any impacts due to reclassification) will only take effect as of 1 January of the year N+1.

7.5.4. Accounting for a reclassification

The reclassification is carried out in accordance with the **general classification principles** set out in IFRS 9.4.1.1 - 4.1.4. Gains, losses and interest recognised prior to the reclassification date are not restated, as reclassifications are applied prospectively (IFRS 9.5.6.1).

The accounting impacts on the reclassification date depend on the type of reclassification:

- If a financial asset is reclassified from amortised cost (AC) to fair value through profit or loss (FV-PL), its fair value is measured at the reclassification date. The difference between the previous amortised cost (i.e. the carrying amount) and the fair value is recorded in profit or loss (IFRS 9.5.6.2).
- If a financial asset is reclassified from FV-PL to AC, its fair value at the reclassification date becomes its new amortised cost (i.e. its gross carrying amount) (IFRS 9.5.6.3).
- If a financial asset is reclassified from AC to FV-OCI, the fair value of the financial asset is measured at the reclassification date. Any gains or losses arising from the difference between the previous carrying amount (i.e. the amortised cost) and the fair value is recorded in other comprehensive income. Neither the effective interest rate nor the expected credit losses are adjusted as a result of the reclassification (IFRS 9.5.6.4).
- If a financial asset is reclassified from FV-OCI to AC, the financial asset is reclassified at its fair value at the reclassification date. The cumulative gains and losses previously recognised in other comprehensive income are removed from equity and adjusted against the fair value of the financial asset at the reclassification date. As a result, the financial asset is measured at the reclassification date as if it had always been measured at amortised cost. The adjustment only affects other comprehensive income, and not the profit or loss section of the statement of comprehensive income or the separate statement of profit or loss (if presented). In other words, this is not a reclassification adjustment (see IAS 1.40). The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification (IFRS 9.5.6.5).
- If a financial asset is reclassified from FV-PL to FV-OCI, the financial asset is reclassified at its fair value (IFRS 9.5.6.6).
- If a financial asset is reclassified from FV-OCI to FV-PL, the financial asset continues to be measured at fair value. The cumulative gains and losses previously recognised in other comprehensive income are reclassified from equity to the profit or loss section of the statement of comprehensive income or the separate statement of profit or loss (if presented) (IFRS 9.5.6.7).



The AC and FV-OCI categories require that interest revenue be accounted for using the effective interest rate method. Both of those measurement categories also require that an impairment allowance be recorded for expected credit losses. Thus, following a reclassification from AC to FV-OCI (or the other way around) there is no impact on (a) the recognition of interest revenue and (b) the amount of expected credit losses. However, the presentation of the impairment allowance changes:

- If a financial asset is reclassified from FV-OCI to AC, a loss allowance is recognised as an adjustment to the gross carrying amount of the financial asset (and no longer within OCI).
- If a financial asset is reclassified from AC to FV-OCI, the loss allowance recognised as an adjustment to the gross carrying amount is derecognised (IFRS 9.B5.6.1), and an identical accumulated impairment amount is instead recognised within OCI and disclosed in accordance with IFRS 7.

An entity is not required to separately recognise and update **interest revenue** or **impairment gains or losses** for financial assets measured at FV-PL. Consequently, when an entity reclassifies a financial asset out of the FV-PL category, the effective interest rate is determined based on the fair value of the asset at the reclassification date. In addition, the date of the reclassification is treated as the date of initial recognition for the purposes of measuring expected credit losses (IFRS 9.B5.6.2).

The **SPPI** criterion is assessed only upon initial recognition of a financial asset. Thus, the SPPI status of the instrument is not reconsidered upon reclassification.

The accounting impacts associated with each type of reclassification are summarised in the table below:

Figure 7.3

Initial business model and initial accounting category	New business model	New category	Consequences of the reclassification
Held-to-Collect / Amortised cost	Held-to-Collect-and-Sell	FV-OCI	<p>The difference between the measurement of the asset at amortised cost and at fair value must be accounted for in equity / OCI at the reclassification date (with no impact in profit or loss).</p> <p>The recognition of interest income does not change (the EIR is not modified).</p> <p>The measurement of credit losses does not change, as the same impairment approach is applied to both accounting categories. However, impairment is no longer entered as a deduction from the instrument's book value on the asset side but in a dedicated account within equity / OCI.</p>
Held-to-Collect / Amortised cost	"Other" business model (incl. Held-for-Trading)	FV-PL	<p>The difference between the measurement of the asset at amortised cost and at fair value must be accounted for in profit or loss at the reclassification date. The reclassified financial asset is no longer subject to IFRS 9 impairment rules (any previously booked impairment must be reversed).</p>

Initial business model and initial accounting category	New business model	New category	Consequences of the reclassification
Held-to-Collect-and-Sell / FV-OCI	Held-to-Collect	Amortised cost	<p>The unrealised gains and losses due to measurement at fair value that are booked in equity / OCI must be reversed against a fair value adjustment account on the B/S thus bringing its book value to the carrying amount that would have been obtained had the asset always been measured at amortised cost.</p> <p>The recognition of interest income does not change (the EIR is not modified).</p> <p>The measurement of credit losses does not change, as the same impairment approach is applied to both accounting categories. However, impairment is no longer entered in a dedicated account within equity / OCI but as a deduction from the instrument's book value on the asset side.</p>
Held-to-Collect-and-Sell / FV-OCI	"Other" business model (incl. Held-for-Trading)	FV-PL	<p>The unrealised gains and losses due to measurement at fair value that are booked in equity/OCI is recycled into profit or loss at the reclassification date.</p> <p>The reclassified financial asset is no longer subject to IFRS 9 impairment rules (any previously booked impairment allowance must be reversed). The instrument is subsequently subject to the accounting treatment applicable to financial assets measured at FV-PL.</p>
"Other" business model / FV-PL	Held-to-Collect-and-Sell	FV-OCI (if SPPI criterion met)	<p>At the reclassification date, an impairment allowance is recorded for 12-month expected credit losses.</p> <p>After reclassification, the instrument is subject to the accounting treatment applicable to financial assets measured at FV-OCI.</p>
"Other" business model / FV-PL	Held-to-Collect	Amortised cost (if SPPI criterion met)	<p>At the reclassification date, an impairment allowance is recorded for 12-month expected credit losses.</p> <p>The fair value at the reclassification date becomes the initial amortised cost of the instrument. The instrument is subsequently subject to the accounting treatment applicable to financial assets measured at amortised cost.</p>



CHAPTER 8

CLASSIFICATION OF FINANCIAL LIABILITIES





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8.1. Overview

As pointed out in **chapter 6**, when an entity first recognises a financial liability, it must classify it either at amortised cost or at fair value through profit or loss (IFRS 9.4.2.1). This chapter will present the principles that determine in which category a financial liability must be classified for subsequent measurement.

This chapter will also set out some cases that do not belong to the two categories above, for which specific measurement requirements apply and that are specifically addressed in IFRS 9. It will however not deal with financial liabilities in a context of hedge accounting issues as this topic is already covered by a dedicated chapter (see **chapter 14**).

It will also address the possibility (or not) to reclassify financial liabilities from one accounting category to another.

8.2. Financial liabilities measured at amortised cost

As a general principle, all financial liabilities are supposed to be classified initially and subsequently measured at amortised cost (IFRS 9.4.2.1 and IFRS 9.5.3.1), except those held for trading or voluntarily designated at FV-PL. Measurement of financial liabilities at amortised cost requires the use of the effective interest rate method in the same way as for financial assets measured at amortised cost (see **chapter 4**).

8.3. Financial liabilities measured at fair value through profit or loss

8.3.1. General principles

Any financial liability not classified by default in the amortised cost category is classified and subsequently measured at fair value through profit or loss (FV-PL).

This classification must be split into three different sub-categories that must be considered separately because their disclosure and presentation requirements are different (see **sections 16.6.1.1** and **16.6.1.2**):

- financial liabilities held for trading;
- financial liabilities designated at fair value through profit or loss (“fair value option”); and
- financial liabilities designated at fair value through profit or loss in the context of a credit risk management based on credit derivatives measured at FV-PL. This designation is further detailed in **section 14.1.2.3**.

Any change in fair value of a financial liability at FV-PL must be recognised in profit or loss. However, for financial liabilities designated at FV-PL by option, changes in fair value of the liability caused by changes in own credit risk may be recognised in other comprehensive income (IFRS 9.5.7.1). This exception is further detailed in **section 8.3.3.2**.

8.3.2. Financial liabilities held for trading

A financial liability must be classified and measured at fair value through profit or loss if it meets the definition of held for trading. Appendix A of IFRS 9 defines a financial instrument as held for trading if it meets one of the following conditions:

- the instrument is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- on initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - > the implementation guidance of IFRS 9 states that if there is evidence of a recent actual pattern of short-term profit-taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time (IFRS 9.IG.B.11);
- it is a derivative (except for a derivative that is a financial guarantee contract, see **section 8.4.2**, or a designated and effective hedging instrument, see **chapter 14**).

The fact that a liability is used to fund trading activities does not in itself make that liability one that is held for trading (IFRS 9.BA.8).

8.3.3. Designation of financial liabilities at fair value through profit or loss

8.3.3.1. Scope of the “fair value option” for financial liabilities

An entity has the possibility to voluntarily designate a financial liability at fair value through profit or loss that would have been classified at amortised cost otherwise. This fair value option can be applied only at initial recognition to the liability and is irrevocable (IFRS 9.4.2.2).

This option can be applied to the financial liability only in one of the following circumstances:

- it eliminates or significantly reduces a measurement or recognition inconsistency (*‘accounting mismatch’*) that would otherwise arise because assets or liabilities that are economically related are measured on different bases. This option is similar to the option applicable to financial assets. Please refer to **section 7.4.5** for more details; or
- a group of financial liabilities (or financial assets and financial liabilities) is managed and its performance is assessed on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity’s key management personnel (as defined in IAS 24 - *Related Party Disclosures*), for example, the entity’s board of directors and chief executive officer;
- the financial liability is a hybrid contract that contains a host that is not an asset within the scope of this standard unless:
 - > the embedded derivative does not significantly modify the cash flows of the contract; or
 - > It is clear with little or no analysis that the separation of the embedded derivative is prohibited (see **section 13.3.4** for more details on hybrid contracts and embedded derivatives).

The decision to designate a financial liability as at FV-PL is similar to an accounting policy choice, but is not required to be applied consistently to all similar transactions. In other words, it can be applied on an instrument-by-instrument basis. However, the application of the fair value option must result in reliable and more relevant information. This means that the entity must demonstrate that it falls within one or more circumstances mentioned above (IFRS 9.B4.1.28).

8.3.3.2. Presentation in OCI of the changes in fair value attributable to changes in credit risk

8.3.3.2.1. Main principle

As set out above, changes in the fair value of a financial liability at FV-PL are generally recognised in profit or loss.

The amount of changes in fair value that is attributable to changes in the credit risk of a liability for which the “fair value option” is applied stands as an exception because such changes must be recognised in other comprehensive income rather than in profit or loss. The remaining amount of changes in the fair value of the liability is still presented in profit or loss (IFRS 9.5.7.7).

8.3.3.2.2. Cases when the main principle isn't applied

Presentation in OCI of the amount of changes in fair value that is attributable to changes in the credit risk shall not be applied to financial liabilities for which the “fair value option” is applied if:

- it creates or increases an accounting mismatch: in such a situation, the entity must present all gains or losses on that liability in profit or loss, including the effects of changes in the credit risk of that liability (IFRS 9.5.7.8);
- the liability designated at FV-PL is either a loan commitment or a financial guarantee contract: for these financial instruments, all gains and losses must be presented in profit or loss (IFRS 9.5.7.9).

In such cases, the full change in fair value of the financial liability shall be recognised in the profit or loss of the period.

8.3.3.2.3. Definition of change in value attributable to change in credit risk

According to the definition provided by IFRS 7, credit risk is “the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation” (see section 16.7). For a financial liability, it relates to the risk that the issuer will fail to pay that specific liability. It does not necessarily relate to the creditworthiness of the issuer. For example, if an entity issues a collateralised liability and a non-collateralised liability that are otherwise identical, the credit risk of those two liabilities will be different, even though they are issued by the same entity. The credit risk on the collateralised liability will be less than the credit risk of the non-collateralised liability. The credit risk for a collateralised liability may be close to zero (IFRS 9.B5.7.13).

IFRS 9 makes the distinction between credit risk and asset-specific performance risk. Asset-specific performance risk is not related to the risk that an entity will fail to discharge a particular obligation but instead it is related to the risk that a single asset or a group of assets will perform poorly (or not at all)

(IFRS 9.B5.7.14). The following are examples of asset-specific performance risk (IFRS 9.B5.7.15):

- a liability with unit-linking features whereby the amount due to investors is contractually determined on the basis of the performance of specified assets;
- a liability issued by a structured entity with the following characteristics:
 - > the entity is legally isolated so the assets in the entity are ring-fenced solely for the benefit of its investors, even in the event of bankruptcy; and
 - > the entity enters into no other transactions and the assets in the entity cannot be mortgaged. Amounts are due to the entity's investors only if the ring-fenced assets generate cash flows. Thus, changes in the fair value of the liability primarily reflect changes in the fair value of the assets.

IFRS 9 provides additional guidance to determine whether the changes in the fair value of a liability are attributable to a change in the credit risk. According to IFRS 9.B5.7.16, an entity must determine this change either:

- as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk;
 - > changes in market conditions that give rise to market risk include changes in a benchmark interest rate, the price of another entity's financial instrument, a commodity price, a foreign exchange rate or an index of prices or rates (IFRS 9.B5.7.17); this definition is consistent with the definition of market risk given in IFRS 7 (see **section 16.7** for further details on market risk definitions);
 - > if the only significant relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate, the amount of the changes in credit risk can be estimated as follows (IFRS 9.B5.7.18):
 - first, the entity computes the liability's internal rate of return at the start of the period using the fair value of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return;
 - next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in the previous step;
 - the difference between the fair value of the liability at the end of the period and the amount determined in the second step is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate and is the amount to be presented in other comprehensive income.
- or using an alternative method the entity believes more representative of the changes in credit risk.

The first method assumes that changes in the fair value arising from factors other than changes in credit risk or changes in the observed (benchmark) interest rates are not significant. If this assumption is false, this first method is not appropriate, and the entity must use an alternative method to measure the changes in credit risk (IFRS 9.B5.7.19).

As with all fair value measurements, the method used by an entity to determine the portion of the change in a liability's fair value that is attributable to changes in its credit risk must make maximum use of observable inputs and minimum use of unobservable inputs (IFRS 9.B5.7.20).

The first method is illustrated by the following illustrative example (IFRS 9.IE1 to IFRS 9.IE5).

Example 8.1

On 1 January 20X1 an entity issues a 10-year bond with a par value of CU150,000 and an annual fixed coupon rate of 8%, which is consistent with market rates for bonds with similar characteristics.

The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5%. At the end of the first year:

- > LIBOR has decreased to 4.75%;
- > the fair value for the bond is CU153,811, consistent with an interest rate of 7.6%.

This reflects a shift in LIBOR from 5% to 4.75% and a movement of 0.15% which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.

The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.

The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

Step 1: at the start of the period of a 10-year bond with a coupon of 8%, the bond's internal rate of return is 8%. Because the observed (benchmark) interest rate (LIBOR) is 5%, the instrument-specific component of the internal rate of return is 3%.

Step 2: the contractual cash flows of the instrument at the end of the period are:

- > interest: CU12,000 per year for each of years 2–10 [CU150,000 × 8% = CU12,000];
- > principal: CU150,000 in year 10.

The discount rate to be used to calculate the present value of the bond is thus 7.75%, which is the end of period LIBOR rate of 4.75%, plus the 3% instrument-specific component.

This gives a present value of CU152,367:

$$PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}.$$

Step 3: the market price of the liability at the end of the period is,
 $CU153,811 = [CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}.$

Thus, the entity presents CU1,444 in other comprehensive income, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.



Benchmark interest rates are not defined by IFRS 9. In our view, it may concern risk free rates as well as interbank offered rates (“IBOR”) such as Libor, Euribor, or overnight interest rates (e.g. EONIA). This variety may lead to potential difficulties to isolate credit risk component in the changes of the fair value of a liability, because some interest rates may not include such a component (“risk free rates”) whereas others do (e.g. Libor or Euribor).

In our opinion, only the changes attributable to the credit risk that is specific to the issuer of the liability must be presented in OCI, which means that no specific restatement on benchmark interest rates should be performed, regardless of whether they already include another credit risk component that is entity-specific or not.

8.3.4. Contingent consideration recognised by an acquirer in a business combination

When a contingent consideration is recognised as a liability by an acquirer in a business combination (to which IFRS 3 applies), this liability must subsequently be measured at FV-PL (IFRS 9.4.2.1(e)).

This category of instrument is measured in the same way as a financial liability at FV-PL in IFRS 9, but is considered separately because such items may differ from a financial liability at FV-PL as defined in IFRS 9. The main differences with a financial liability at FV-PL that is in the scope of IFRS 9 are that (IFRS 3.58):

- changes in the fair value of a contingent consideration can occur after the acquisition date and result from facts and circumstances that existed at the acquisition date: such changes are in the scope of IFRS 3 as ‘measurement period adjustments’ and not covered in this handbook;
- contingent considerations can be classified as equity and thus do not fall into the scope of this chapter;
- contingent considerations, even if measured at FV-PL in accordance with IFRS 9, can be out of the scope of IFRS 9.

8.4. Specific cases

8.4.1. Financial liabilities arising from a transfer of a financial asset or a continuing involvement

When an entity transfers a financial asset but neither retains nor transfers substantially all risks and rewards, it must continue to recognise the asset to the extent of its continuing involvement if it retains control of that asset (IFRS 9.3.2.16).

When an entity continues to recognise an asset to the extent of its continuing involvement, it also recognises an associated liability and measures it in such a way that the net carrying amount of the transferred asset and the associated liability is (IFRS 9.3.2.17):



- the amortised cost of the rights and obligations retained by the entity, if the transferred asset is measured at amortised cost; or
- equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, if the transferred asset is measured at fair value.

The particularity of liabilities arising in the context of a continuing involvement is that the classification and measurement of such liabilities depend on the classification and measurement of the corresponding asset. Therefore, it is not possible to associate this category of liabilities either to amortised cost or to FV-PL as this classification may change according to the situation and the related asset that is accounted for as a continuing involvement. This connection between assets and liabilities, and the primacy of the measurement of the asset is underlined in IFRS 9.3.2.21: if a transferred asset is measured at amortised cost, the “fair value option” applicable to liabilities at FV-PL is not applicable to the liability part of the continuing involvement.

8.4.2. Financial guarantee contracts

In the case of a financial guarantee contract, the issuer of such a contract must, after its initial recognition (see **section 9.2.4.2**), subsequently measure it at the higher of (IFRS 9.4.2.1(c)):

- the amount of the loss allowance determined in accordance with impairment requirements of IFRS 9 (see **chapter 9**) and
- the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

This measurement requirement applies unless the issued financial guarantee contract is either:

- a financial liability at FV-PL (see **section 8.3**); or
- a financial liability arising because of a transfer of a financial asset or a continuing involvement (see **section 8.4.1**).

8.4.3. Commitments to provide a loan at a below-market interest rate

In the case of commitments to provide a loan at a below-market interest rate, the issuer of such a commitment must, after its initial recognition (see **section 9.2.4.1**), subsequently measure it at the higher of (IFRS 9.4.2.1(d)):

- the amount of the loss allowance determined in accordance with impairment requirements of IFRS 9 (see **section 9.4**); and
- the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

This subsequent measurement only applies if such commitments have not been classified as financial liabilities at fair value through profit or loss (IFRS 9.4.2.1(d)).

8.5. Reclassifications

It is not allowed to reclassify any financial liability as set out in IFRS 9.4.4.2, i.e. a financial liability classified and subsequently measured at amortised cost can never be transferred to the fair value category, and *vice versa*.

The following events or changes in circumstances would not be considered as reclassifications:

- if the fair value of a financial instrument (e.g. interest rate swap) previously classified as a financial asset at fair value through profit or loss becomes negative: in this situation, the financial asset becomes a financial liability at fair value through profit or loss (IFRS 9.B5.2.1);
- the designation as a hedging instrument (or the discontinuation of such designation) of derivatives that are financial liabilities at fair value through profit or loss in a cash flow hedge or net investment hedge (see **chapter 14**) (IFRS 9.4.4.3);
- changes in measurement if an entity chooses to apply the option to designate a credit exposure as measured at fair value through profit or loss (see **section 14.1.2.3**) (IFRS 9.4.4.3).





CHAPTER 9

SUBSEQUENT MEASUREMENT OF FINANCIAL INSTRUMENTS (INCLUDING IMPAIRMENT)



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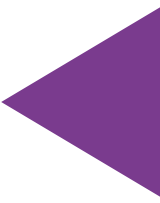


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9.1. Introduction

After having detailed the recognition, initial measurement (see **chapter 6**) and the classification requirements of financial assets (see **chapter 7**), and financial liabilities (see **chapter 8**), this chapter will present the subsequent measurement requirements of IFRS 9.

9.2. Subsequent measurement and recognition of gains and losses

After having addressed the initial measurement of financial instruments (see **section 6.3**) and their classification (see **section 7.4**), the objective of this section is to describe the principles which apply to their subsequent measurement. These principles differ based on the classification of financial assets and liabilities: fair value through profit or loss, fair value through other comprehensive income or amortised cost.

This section will not address the subsequent measurement modifications implied by hedge accounting (see **chapter 14**). Nor will it address the accounting treatment of reclassifications that is further developed in **section 7.5**.

9.2.1. Financial Instruments at FV-PL

9.2.1.1. Financial assets and derivatives at FV-PL

9.2.1.1.1. General principle

The following measurement principles must be applied to:

- debt instruments at FV-PL that encompass instruments which have failed the SPPI test (see **section 7.4.3**) or that have been documented in portfolios managed with “other business models” including held for trading but not only (see **section 7.4.2**);
- equity instruments that have not been designated as FV-OCI (see **section 7.3.2**);
- derivatives that are not documented in a hedging relationship (for those specific derivatives see **chapter 13**).

All financial assets classified in the FV-PL category are measured at their fair value at reporting date. This fair value is determined in accordance with the principles described in **chapter 3** (IFRS 9.5.2.1).

Changes in fair value of the financial asset are recognised in the profit or loss of the period. (IFRS 9.5.7.1).

When remeasuring the fair value of a financial asset, it can happen that this fair value becomes negative. In such a case, IFRS 9.B5.2.1 states that a financial asset measured at fair value through profit or loss whose fair value becomes negative is in fact a financial liability and is measured accordingly.

9.2.1.1.2. Unquoted equity instruments at FV-PL

Under IFRS 9, any financial asset classified as FV-PL is measured at fair value, even if it is an unquoted equity instrument for which fair value cannot be reliably estimated. The IAS 39 exemption for this kind of instrument was not retained in IFRS 9.

However, in limited circumstances, IFRS 9.B5.2.3 allows to retain the cost as “an appropriate estimate of fair value”. This means that, to measure such equity instrument at cost, the entity will have to demonstrate that the cost is the best estimate of its fair value.

IFRS 9 clarifies the expression “some limited circumstances” as follows:

- Cost will never be the best estimate of fair value for quoted equity instruments (IFRS 9.B5.2.6).
- Cost may be the best estimate of fair value when more recent information available is insufficient to measure fair value or when there is a wide range of possible fair values (IFRS 9.B5.2.3).

IFRS 9.B5.2.4 provides a non-exhaustive list of indicators that cost might not be the best estimate of the fair value:

- significant change in the performance of the investee compared with budgets, plans or milestones;
- changes in expectation that the investee’s technical product milestones will be achieved;
- a significant change in the market for the investee’s equity or its products or potential products;
- a significant change in the global economy or the economic environment in which the investee operates;
- a significant change in the performance of comparable entities, or in the valuations implied by the overall market;
- internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy;
- evidence from external transactions in the investee’s equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

9.2.1.2. Financial liabilities at FV-PL

9.2.1.2.1. General principle

Financial liabilities measured at FV-PL encompass those classified as held for trading (see **section 8.3.2**), those designated at FV-PL (see **section 8.3.3**), derivatives except for those documented in a hedging relationship (see **chapters 13** and **14**), and contingent consideration recognised in a business combination in accordance with IFRS 3 (IFRS 9.4.2.1).

Fair value is determined in accordance with IFRS 13.

Any gains and losses resulting from a change in fair value are recognised in the profit or loss of the period (IFRS 9.5.7.1) except for financial liabilities designated at FV-PL (see **section 8.3.3**).



Even if IFRS 9.B5.2.1 does not explicitly address this case, we think that by analogy with the accounting treatment of financial assets at FV-PL with a negative fair value, a financial liability with a positive fair value for the entity ought to be accounted for as a financial asset rather than as a negative liability.

9.2.1.2.2. Liabilities designated at FV-PL

When a financial liability is designated at FV-PL (see **section 8.3.3**), the gains and losses resulting from change in fair value is split between (IFRS 9.B5.7.5):

- those related to changes in own credit risk: these impacts are accounted for in other comprehensive income unless such presentation would create or enlarge an accounting mismatch (see **chapter 8**); and,
- the remaining amount of change in fair value that are recognised in profit or loss.

Example 9.1: Financial liabilities through profit or loss (IFRS 9.IE1-5)

On 1 January 20X1 an entity issues a 10-year bond with a par value of CU150,000¹ and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.

The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:

- > LIBOR has decreased to 4.75 per cent.
- > the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent²

The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.

The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

¹ In this guidance monetary amounts are denominated in 'currency units' (CU).

² This reflects a shift in LIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.



First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return. (IFRS 9.B5.7.18(a)).

At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent. Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.

Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph IFRS 9.B5.7.18(a). (IFRS 9.B5.7.18(b)).

The contractual cash flows of the instrument at the end of the period are:

- interest: CU12,000(a) per year for each of years 2–10.
- principal: CU150,000 in year 10.

The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is the end of period LIBOR rate of 4.75 per cent, plus the 3 per cent instrument-specific component. This gives a present value of CU152,367.(b)

The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph IFRS 9.B5.7.18(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with IFRS 9.5.7.7(a). (IFRS 9 B5.7.18(c)).

The market price of the liability at the end of the period is CU153,811.(c) Thus, the entity presents CU1,444 in other comprehensive income, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.

(a) $CU150,000 \times 8\% = CU12,000$.

(b) $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$.

(c) $market\ price = [CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}$.



9.2.2. Financial instruments at Amortised Cost

Financial assets and liabilities classified in this category are measured at their amortised cost determined using the effective interest rate method (see **chapter 4**).

For financial assets, amortised cost encompasses the credit loss allowance (see **section 9.4.9**).

Interest revenues or expenses of financial instruments carried at amortised cost are calculated by applying their effective interest rate to their gross carrying amount, except for:

- financial assets that becomes credit impaired subsequently to their acquisition or origination, for which the effective interest rate is applied to the amortised cost (i.e. an amount net of credit loss allowance); and
- purchased or originated credit-impaired financial assets for which the entity should apply the credit-adjusted effective interest rate to the amortised cost of the financial asset (see **section 9.4.5**).

Section 4.5 provides numerical examples of amortised cost and effective interest rate calculations.

9.2.3. Financial assets at FV-OCI

This financial asset category encompasses two types of instruments, respectively debt and equity instruments (see **chapter 7**), that are both measured at their fair value (determined in accordance with IFRS 13) in the statement of financial position. However, the impacts of the changes in such fair value in other comprehensive income and profit or loss will be different depending on the type of instrument.

9.2.3.1. Debt Instruments at FV-OCI Recyclable

In this measurement category, debt instruments are measured at their fair value, and any change in fair value is recognised in other comprehensive income except for (IFRS 9.5.7.10):

- interest revenues recognised in profit or loss, calculated using the effective interest rate method;
- impairment gains and losses that impact the profit or loss of the period.

When a debt instrument at FV-OCI is derecognised all gains or losses accumulated in other comprehensive income are recycled through profit or loss (IFRS 9.5.7.10) as a reclassification adjustment (see **section 16** on disclosures).



In practice, this FV-OCI category aims at recognising:

- the asset at fair value in the statement of financial position,
- the effect of amortised cost measurement in the profit or loss of the period, and
- any residual change in value recognised in other comprehensive income.

9.2.3.2. Equity instruments at FV-OCI Non-Recyclable

In accordance with the requirements specified in **section 7.3.2**, an entity can choose to classify an equity instrument at fair value through **other comprehensive income** but without the possibility to later transfer the gain or loss realised upon sale into profit or loss (FV-OCINR).

Therefore, changes in the fair value of the equity instrument will impact other comprehensive income (IFRS 9.5.7.5) without any possibility of subsequently being recycled through profit or loss (IFRS 9.B5.7.1). However, the accumulated gains or losses may be transferred to equity (IFRS 9.B5.7.1).



One possibility for an entity would be to maintain the equity instrument's accumulated gains or losses in other comprehensive income until the derecognition of the equity instrument. On derecognition, the entity could transfer the accumulated amount to equity. This could be a mean to continue to provide information on realised versus unrealised gains or losses.

Dividends received on equity instruments will impact the profit or loss of the period (IFRS 9.5.7.1; IFRS 9.5.7.6) unless they "clearly represent a recovery of part of cost of the investment" (IFRS 9.B5.7.1).

9.2.4. Specific financial commitments

9.2.4.1. Commitment to provide a loan at a below-market interest rate

As stated by IFRS 9.4.2.1(d), unless commitments to provide a loan at a below-market interest rate are measured at FV-PL, they are subsequently measured at the higher of:

- the amount of the loss allowance determined in accordance with **section 9.4.6**, and
- the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

9.2.4.2. Financial guarantee issued

Unless financial guarantees issued are measured at FV-PL or arise following a derecognition analysis, IFRS 9.4.2.1(c) requires to subsequently measure such contracts at the higher of:

- the amount of the loss allowance determined in accordance with **section 9.4.6**, and
- the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

9.3. Financial instruments denominated in Foreign Currencies

IAS 21 - *The effects of changes in foreign exchange rates* deals with the accounting consequences of changes of foreign exchange rates on financial instruments.

Any entity must first determine its functional currency in accordance with IAS 21. It follows that any currency which is different from the entity's functional currency is considered as a foreign currency.

IAS 21 defines two types of instruments to which different principles apply:

- **monetary instruments** that consist of cash in foreign currencies, assets and liabilities that are to be received or paid in a fixed or determinable number of units of currency (IAS 21.8 and IAS 21.16); and
- **non-monetary instruments** that do not meet the previous definition. Examples of non-monetary items are equity instruments, tangible and intangible assets, goodwill, etc.

Monetary instruments must be translated using the appropriate closing rate (IAS 21.28).

Non-monetary instruments are translated at their historical rate except when they are measured at fair value. In this last case, they must be translated at the exchange rates corresponding to the date of the fair value measurement i.e. the reporting date.

In practice, most financial instruments are monetary items, except equity instruments. However, all equity instruments held are measured at fair value under IFRS 9. Therefore, in practice, all financial instruments are translated at the closing rate at each reporting date.

At each reporting date financial instruments in foreign currencies are:

- initially accounted for in their foreign currency in accordance with their classification (i.e. Amortised Cost, FV-OCI or FV-PL), and
- subsequently translated in the entity's functional currency as follows:
 - > for monetary financial instruments measured at amortised cost and any financial instrument measured at FV-PL, through profit or loss;
 - > for monetary financial assets measured at FV-OCI, any exchange differences are split into:
 - the part related to the amortised cost measurement that will impact profit or loss, and
 - the residual foreign currency translation effect that will be recorded in other comprehensive income (IFRS 9.5.7.10 and IFRS 9.B5.7.2 – 2A).
 - > for equity instruments measured at FV-OCINR in accordance with IFRS 9.5.7.5 (see **section 7.3.2**), any exchange differences will impact other comprehensive income without any further recycling (IFRS 9.B5.7.3) and therefore will never impact profit or loss.

Example 9.2: IFRS 9.IG.E.3.2 IFRS 9 and IAS 21—financial assets measured at fair value through other comprehensive income: separation of currency component

A financial asset measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9 is treated as a monetary item. Therefore, the entity recognises changes in the carrying amount relating to changes in foreign exchange rates in profit or loss in accordance with paragraphs 23(a) and 28 of IAS 21 and other changes in the carrying amount in other comprehensive income in accordance with IFRS 9. How is the cumulative gain or loss that is recognised in other comprehensive income determined?

It corresponds to the difference between the amortised cost of the financial asset³ and the fair value of the financial asset in the functional currency of the reporting entity. For the purpose of applying paragraph 28 of IAS 21 the asset is treated as an asset measured at amortised cost in the foreign currency.

³ The objective of this example is to illustrate the separation of the currency component for a financial asset that is measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9. Consequently, for simplicity, this example does not reflect the effect of the impairment requirements in section 5.5 of IFRS 9.

To illustrate: on 31 December 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a contractual par amount of FC1,250, carries fixed interest of 4.7 per cent that is paid annually ($FC1,250 \times 4.7\% = FC59$ per year), and has an effective interest rate of 10 per cent.

Entity A classifies the bond as subsequently measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9, and thus recognises gains and losses in other comprehensive income. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 ($= FC1,000 \times 1.5$).

Dr Bond	LC1,500	
Cr Cash		LC1,500

On 31 December 20X2, the foreign currency has appreciated and the exchange rate is FC1 to LC2. The fair value of the bond is FC1,060 and thus the carrying amount is LC2,120 ($= FC1,060 \times 2$). The amortised cost is FC1,041 ($= LC2,082$). In this case, the cumulative gain or loss to be recognised in other comprehensive income and accumulated in equity is the difference between the fair value and the amortised cost on 31 December 20X2, i.e. LC38 ($= LC2,120 - LC2,082$).

Interest received on the bond on 31 December 20X2 is FC59 ($= LC118$). Interest revenue determined in accordance with the effective interest method is FC100 ($= FC1,000 \times 10$ per cent). The average exchange rate during the year is FC1 to LC1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (see paragraph 22 of IAS 21). Thus, reported interest revenue is LC175 ($= FC100 \times 1.75$) including accretion of the initial discount of LC72 ($= [FC100 - FC59] \times 1.75$). Accordingly, the exchange difference on the bond that is recognised in profit or loss is LC510 ($= LC2,082 - LC1,500 - LC72$). Also, there is an exchange gain on the interest receivable for the year of LC15 ($= FC59 \times [2.00 - 1.75]$).

Dr Bond	LC620	
Dr Cash	LC118	
Cr Interest revenue		LC175
Cr Exchange gain		LC525
Cr Fair value change in other comprehensive income		LC38

On 31 December 20X3, the foreign currency has appreciated further and the exchange rate is FC1 to LC2.50. The fair value of the bond is FC1,070 and thus the carrying amount is LC2,675 ($= FC1,070 \times 2.50$). The amortised cost is FC1,086 ($= LC2,715$). The cumulative gain or loss to be accumulated in other comprehensive income is the difference between the fair value and the amortised cost on 31 December 20X3, i.e. negative LC40 ($= LC2,675 - LC2,715$). Thus, the amount recognised in other comprehensive income equals the change in the difference during 20X3 of LC78 ($= LC40 + LC38$).

Interest received on the bond on 31 December 20X3 is FC59 ($= LC148$). Interest revenue determined in accordance with the effective interest method is FC104 ($= FC1,041 \times 10\%$). The average exchange rate during the year is FC1 to LC2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (see paragraph 22 of IAS 21). Thus, recognised interest revenue is LC234 ($= FC104 \times 2.25$) including accretion of the initial discount of LC101 ($= [FC104 - FC59] \times 2.25$). Accordingly, the exchange difference on the bond that is recognised in profit or loss is LC532 ($= LC2,715 - LC2,082 - LC101$). Also, there is an exchange gain on the interest receivable for the year of LC15 ($= FC59 \times [2.50 - 2.25]$).



Dr Bond	LC555	
Dr Cash	LC148	
Dr Fair value change in other comprehensive income	LC78	
Cr Interest revenue		LC234
Cr Exchange gain		LC547

9.4. Impairment

This section deals with the new impairment model introduced by IFRS 9. This impairment model relies on an expected credit losses approach, as opposed to the IAS 39 incurred credit losses approach. Under IFRS 9, an entity does not wait for an incurred loss event to recognise an impairment allowance. Instead, it generally recognises an impairment allowance upon initial recognition to reflect the fact that it expects to experience credit losses in the future.

It is important to note that IFRS 9 was developed just after a financial crisis that occurred in 2008. One of the lessons learnt from this crisis was that the incurred loss model of IAS 39 often resulted in provisions that were “too little, too late”. This led the G20 Leaders and the Basel Committee on Banking Supervision to recommend that accounting standard setters consider modifying provisioning standards to incorporate forward looking assessments in the estimation of credit losses⁴. In response to this recommendation, the International Accounting Standards Board (IASB) developed a provisioning standard (IFRS 9 impairment requirements) that require the use of Expected Credit Loss (ECL) models rather than incurred loss models. IFRS 9 was finalised in July 2014.

In 2014, the IASB decided to create an Implementation Transition Group (ITG) that met three times between April and December 2015 to address implementation issues faced by preparers upon the first application of IFRS 9. The ITG provided a summary of their discussions that have been referred to the IASB. These discussions are not authoritative but can be considered as educational guidance. ITG conclusions will be mentioned in this section.

IFRS 9 relies to a large extent on the actual risk management practice of the entity. For regulated entities such as banks, this practice is significantly influenced by regulatory constraints. Therefore, even if IFRS 9 does not explicitly refer to them, its implementation often interacts significantly with other regulation guidance or requirements.

This section will first present the scope definition, followed by an overview of the three models proposed by IFRS 9 (general, simplified, POCI), each of which will then be further detailed and the core principles of these approaches....

Presentation and disclosure requirements specific to credit impairment losses are dealt with in **chapter 16**.

⁴ <https://www.bis.org/bcbs/publ/d385.pdf>

9.4.1. Scope definition

9.4.1.1. SPPI financial asset measured at Amortised Cost, or at Fair Value through Other Comprehensive Income

The requirements of the credit risk impairment calculation detailed in this section apply to all SPPI financial assets classified at Amortised Cost of Fair Value through Other Comprehensive Income. This may encompass various debt instrument irrespective of their legal form (e.g. debt securities, credits, loans, receivables, deposits, customer overdrafts, etc.) (IFRS 9.5.5.1).

Financial assets classified in the FV-PL category (Fair Value through Profit or Loss) are excluded from the scope of the impairment requirements of IFRS 9.

9.4.1.2. Loan commitments and financial guarantees

IFRS 9 impairment requirements apply to all financial guarantees and loan commitments, except those that are measured at Fair Value through Profit or Loss. Note that this even includes financial guarantees and loan commitments that are not in the classification scope of IFRS 9 (IFRS 9.2.1(g)).

ITG Discussions⁵

Following its 22 April 2015 meeting, the ITG confirmed that commitments to extend credit are included in the impairment scope each time that:

- > the agreement that contains the commitment complies with the definition of a financial instrument, and
- > the agreement meets the definition of a loan commitment given by IFRS 9.BCZ.2.2: "a firm commitment to provide credit under pre-specified terms and conditions".

9.4.1.3. Other contracts in the scope of IFRS 9 impairment requirements

Although specific requirements apply which are detailed in **chapter 1**, the impairment scope of IFRS 9 also includes:

- lease receivables recognised by a lessor (IFRS 9.2.1(b)(i)); and
- contract assets as defined by IFRS 15 (IFRS 9.5.5.15(a)).

⁵ ITG 22 April 2015 Loan commitments - Scope (Agenda Paper 3).



Figure 9.1

Financial instruments	In the scope of IFRS 9 - Impairment
Debt instruments held at amortised cost	✓
Debt instruments held at fair value through OCI	✓
IFRS 15 trade receivables	✓
IFRS 16 lease receivables	✓
Issued loan commitments	✓
Issued financial guarantees	✓
Equity instruments held	✗
Derivatives	✗
Debt instruments at fair value through profit or loss	✗
Employer's rights under employee benefit plans (IAS 19)	✗

For further information about the scope of IFRS 9 in general, please refer to **chapter 1**.

9.4.2. IFRS 9 proposes three different impairment approaches

At each reporting date, an impairment is recorded for any financial instrument in the scope of IFRS 9 impairment requirements (please refer to **section 9.4.6.1.3**).

IFRS 9 defines three possible impairment models:

- the general approach that is applied by default (see **section 9.4.3**),
- the simplified approach, that is or may be applied subject to conditions (see **section 9.4.4**), and
- a third approach dedicated to Purchased or Originated Credit-Impaired (POCI) instruments (see **section 9.4.5**).

9.4.2.1. General approach

The general approach is the “by default” model that applies to financial instruments that neither qualify for the simplified approach nor for the definition of POCI.

This approach relies on a three-stage approach:

- Any instrument within the scope of the general approach is initially classified in Stage 1. Upon initial recognition, an impairment allowance is recognised for an amount equal to the 12-month expected credit losses (12MECL) (IFRS 9.5.5.5). 12MECL is the portion of lifetime expected credit losses that represents the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date (IFRS 9 Appendix A).
- Instruments are transferred to Stage 2 when a significant increase in credit risk has been identified since their initial recognition date (see **section 9.4.3.2**). In this case, the amount of credit impairment is equal to the expected credit loss that results from all possible default events over the expected life of the instrument (Lifetime Expected Credit Loss: LTECL) (IFRS 9.5.5.3).

- Instruments are classified in Stage 3 when they become credit-impaired. Their impairment allowance continues to be recorded up to their LTECL but their interest revenue is determined by applying their effective interest rate to their amortised cost (i.e. net of impairment allowance) instead of to their gross carrying amount (IFRS 9.5.4.1(b)).

If the conditions for a Stage 2 or Stage 3 classification are no longer met, the entity transfers the instrument back to Stage 1 and recognises an impairment allowance equal to the 12MECL. (IFRS 9 5.5.7).

An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition (and must therefore stay in Stage 1) if the financial instrument is determined to have low credit risk at the reporting date (IFRS 9.5.5.10, please refer also to **section 9.4.3.4.1**).

Guidance for calculation of expected credit loss allowance is further developed in **section 9.4.6**.

9.4.2.2. Simplified approach

The simplified approach consists in always recognising an impairment allowance up to the LTECL of the instrument. This conservative shortcut allows the entity to avoid having to monitor the change in credit risk of the instrument since its initial recognition.

The simplified approach is:

- Mandatory for trade receivables or contract assets that do not contain a financing component in accordance with IFRS 15;
- Offered as an option for trade receivables or contract assets that contain a financing component in accordance with IFRS 15, receivables arising from operating lease contracts, and receivables arising from finance lease contracts (IFRS 9.5.5.15). Applying this option is an accounting policy choice that the entity may select separately for each of these four types of financial assets.

The simplified approach is further detailed in **section 9.4.4**.

9.4.2.3. Purchased or Originated Credit-Impaired (POCI)

IFRS 9 defines a specific approach for instruments acquired or originated with an incurred loss of credit. Such instruments are named "Purchased or Originated Credit Impaired" (POCI) instruments (IFRS 9.5.5.13).



Purchasing or originating a credit impaired instrument is generally not common. But this occurs in situations such as a distressed asset activity (acquired or originated), a purchase of portfolio of existing debt instruments, or in a business combination that includes the acquisition of already credit impaired portfolios. Some debt restructuring may also trigger the derecognition of an existing debt and the recognition of a new debt that may be considered as POCI.

POCI instruments are excluded from the general approach. Their interest revenues are recognised based on a credit adjusted effective interest rate, and only cumulative changes in lifetime expected credit losses since initial recognition are recognised as a loss allowance (IFRS 9.5.5.13).

This approach is further detailed in **section 9.4.5**.

9.4.3. General approach

9.4.3.1. Core principles

9.4.3.1.1. An impairment approach based on the IFRS 9 unit of account

The general approach was designed by the IASB to apply to each financial instrument, i.e. at a contract level (IFRS 9.5.5.1): “An entity shall recognise a Loss Allowance for ECL on a financial asset”.

9.4.3.1.2. Impairment relies on expected credit losses

Instead of recognising an impairment when an event of default occurs, IFRS 9 requires accounting for a loss allowance immediately on the financial asset’s initial recognition date⁶.

This loss allowance is called Expected Credit Loss and reflects (IFRS 9.5.5.17):

- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- the time value of money; and
- reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

9.4.3.1.3. A three-stage approach

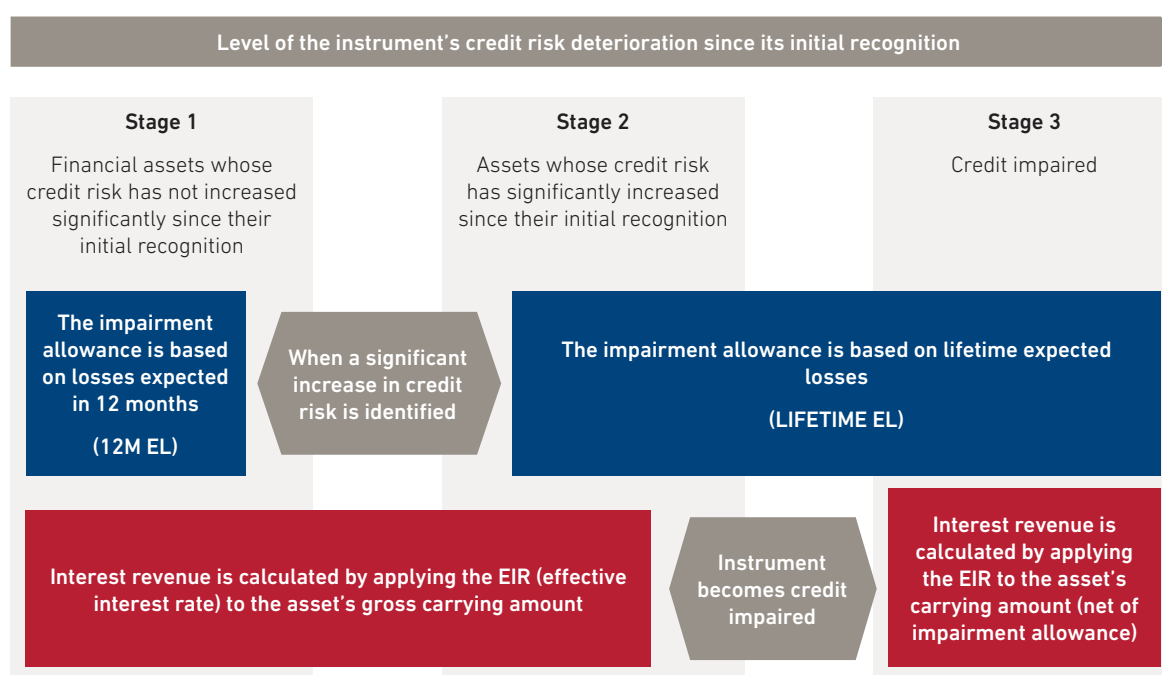
One of the core principles of the general impairment approach of IFRS 9 is the classification of financial assets in one of the three stages of the approach (“staging”). This classification drives the amount of impairment to be recognised.

Classification of a financial asset in one of the three stages is made on the basis of changes in its credit risk since its initial recognition date⁷. This assessment is therefore not an absolute but a relative approach (see **section 9.4.3.1.4**).

⁶ Note that for the purpose of impairment requirements, the initial recognition date of regular way transactions is always considered to be the trade date (IFRS 9.5.7.4)

⁷ Note that for the purpose of impairment requirements, the initial recognition date of regular way transactions is always considered to be the trade date (IFRS 9.5.7.4).

Figure 9.2



Stage 1: Any instrument within the scope of the general approach is initially classified in Stage 1. Upon initial recognition, an impairment allowance is recognised for an amount equal to the 12-month expected credit losses (12MECL) (IFRS 9.5.5.5). 12MECL is the portion of lifetime expected credit losses that represents the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date (IFRS 9 Appendix A). Interest income is calculated based on the gross carrying amount. In other words, interest is calculated by applying the effective interest rate to the carrying amount of the asset, before any impairment allowance.

Stage 2: Instruments are transferred to Stage 2 when a significant increase in credit risk (i.e. increase in probability of default) has been identified since their initial recognition date (see **section 9.4.3.2**). When assessing credit risk, an entity may use external ratings assigned by rating agencies and/or its own internal credit ratings (IFRS 9.B5.5.23). Collateral is not taken into account when assessing credit risk (IFRS 9.B5.5.22). For Stage 2 instruments, the amount of credit impairment equals the expected credit loss that results from all possible default events over the expected life of the instrument (Lifetime expected Credit Loss: LTECL) (IFRS 9.5.5.3). Interest income is calculated in the same way as for instruments in Stage 1.

Stage 3: Instruments are classified in Stage 3 when they become credit-impaired. Their impairment allowance continues to be recorded up to their LTECL (as in Stage 2) but their interest revenue is determined by applying their effective interest rate to their amortised cost (i.e. net of impairment allowance) instead of their gross carrying amount (IFRS 9.5.4.1(b)).

An asset is defined as being **credit-impaired** when one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred (IFRS 9 Appendix A: credit-impaired).

Such events that may evidence a credit -impaired asset include:

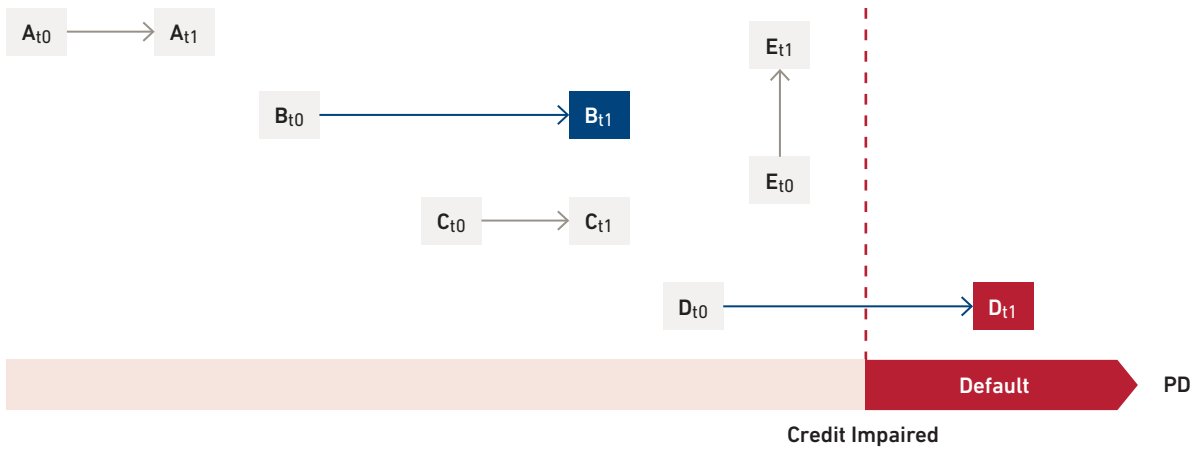
- significant financial difficulty of the issuer or the borrower;
- a breach of contract, such as a default or past due event;
- the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
- it is becoming probable that the borrower will enter bankruptcy or another financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

Even if it is not possible to identify one single event, the combined effect of several events may have caused financial assets to become credit-impaired.

9.4.3.1.4. Staging is based on a relative credit risk approach

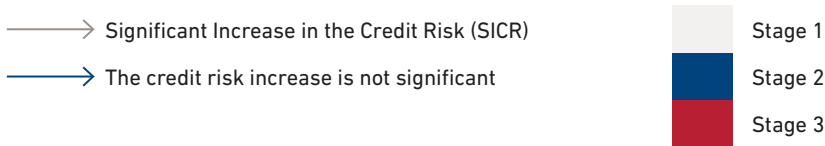
Instruments remain in Stage 1 from their origination date as long as a significant deterioration in their credit risk is not identified. This approach is a relative approach. Two similar instruments with exactly the same credit risk profile may be classified in different stages depending on their respective credit risk profile upon their acquisition (see instruments B and C in the figure below). The staging approach is not based on the absolute level of risk, but rather on the extent to which the risk profile has changed since its initial recognition. This relative approach requires to be able to follow the evolution of the credit quality over time.

Figure 9.3 Significant increase in credit risk: illustrative examples



Assumptions: t0: initial recognition date of a loan or a debt security
 A, B, C, D, E are loans t1: next reporting date

The credit risk of the loan E remains the same between t0 and t1.



When a financial asset is recognised following a drawdown on a loan commitment, the lender performs the SICR assessment considering the initial credit risk of the loan commitment from the date the entity became a party to the irrevocable commitment (IFRS 9.B5.5.47).

9.4.3.1.5. A symmetrical approach

The analysis of the change of the credit quality is symmetrical: when a significant increase in credit risk is identified, the asset is transferred from Stage 1 to Stage 2. If, later on, the asset credit quality improves in such a way that there is no longer any significant increase of the credit quality since its initial recognition, then the asset is transferred back to Stage 1 (IFRS 9.5.5.7).

IFRS 9.B5.5.27 specifies that a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed payments would not typically be erased by simply making one payment on time following a modification of the contractual term". Such period of time before effectively going back to Stage 1 is often called the **probationary period**.

9.4.3.2. Significant Increase in Credit Risk (SICR)

Identifying a Significant Increase in Credit Risk (SICR) on a financial asset will lead an entity to increase the asset impairment allowance from EL12M to LTEL. This may represent a significant jump in the impairment allowance. SICR is therefore a critical parameter of the IFRS 9 general impairment approach. Monitoring the credit quality of an instrument is therefore essential to a proper implementation of the IFRS 9 general impairment approach.

9.4.3.2.1. SICR is based on change in the risk of default occurring

An entity assesses whether a credit risk has increased significantly by comparing:

- the risk of a default occurring over the expected life of the financial instrument as **at the reporting date**; and
- the risk of a default occurring over the expected life of the financial instrument **at its initial recognition date**.

For the purposes of IFRS 9, an increase of credit risk is assessed on the basis of changes in the probability of default of the debtor since its initial recognition and over the estimated life of the contract. In practice this is performed based on change in the Lifetime probability of default (LT PD).

The SICR assessment must be performed by monitoring the change in the instrument's probability of default rather than the change in the ECL amount (IFRS 9.B5.5.9). For example, if a collateralised debt asset has a significant increase in its probability of default, without a significant change to its ECL because the collateral is valuable enough to protect the lender against any loss, the entity will have to consider that a significant increase in credit risk occurred for the purpose of the staging process.

In order to assess these changes in the probability of default, an entity considers the characteristics of the financial instrument (or group of financial instruments) and the default patterns in the past for comparable financial instruments (IFRS 9.B5.5.13).

9.4.3.2.2. Factors or indicators of change in credit risk

Credit risk analysis is a "multifactor and holistic analysis" that will depend on the type of product, the characteristics of the financial instrument, the borrower risk profile as well as the geographical region of the transaction (IFRS 9.B5.5.16).

That is why the standard does not prescribe a specific methodology but rather requires entities to exercise their judgement in assessing the SICR according to facts and circumstances. For example, qualitative and non-statistical quantitative information available may sometimes be sufficient whilst in other cases it may be needed to consider information from statistical models or both types of information may be needed (IFRS 9.B5.5.18).

Several approaches are therefore possible as long as they comply with the following main principles (IFRS 9 B5.5.12):

- they allow to isolate the evolution of the probability of default from other factors of changes of the expected loss of credit (e.g. value of the collateral);

- they are based on the evolution of the probability of default since the financial instrument's initial recognition date;
- they consider the expected maturity of the instrument;
- they are based on reasonable and supportable information (**section 9.4.6.5** , including forward-looking information - see **section 9.4.7.2.2**) obtained without undue costs or efforts and which may affect the credit risk of the instrument.

IFRS 9 provides a non-exhaustive list of information that may be relevant in the SICR assessment (IFRS 9. B5.5.17):

- significant changes in internal pricing indicators as a result of a change in the issuer's credit risk since the inception of the instrument, including (but not limited to) an increase in the credit spread that would be applied if a similar loan with the same conditions and with the same counterparty was originated on the reporting date;
- other changes in the rates or terms of a financial instrument which would be materially different if the instrument had been created or issued at the balance sheet date (for example, more stringent covenants, to require more collateral or a higher income coverage) due to changes in the credit risk of the financial instrument since its initial recognition;
- significant changes in external credit risk market indicators (for an identical financial instrument or similar financial instruments with the same expected life). These changes in credit risk market indicators may include:
 - > the credit spread,
 - > CDS prices for the borrower,
 - > the length of time or the extent of the decline in the fair value of the financial asset below its amortised cost,
 - > other market information about the borrower, such as price changes in the borrower's debt and equity instrument;
- a significant change, either occurred or expected, in the external credit rating of the financial instrument;
- an occurred or expected downgrade in the borrower's internal credit rating. Internal financial ratings are more reliable when they can be corroborated by external ratings or default studies;
- actual or anticipated adverse changes in business, financial or economic conditions that could result in a material change in the borrower's ability to meet its debt obligations, such as a known or expected increase in interest rates or a significant increase in expected or expected unemployment rates;
- a significant change, whether occurred or expected, in the borrower's operating results, such as a decrease in sales or margins, increased operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity or management problems, or changes in the scope of the business or organisational structure of the business, that result in a significant change in the borrower's ability to pay its debts;
- significant increases in credit risk on other financial instruments of the same borrower;
- a material adverse change (expected or occurred) in the regulatory, economic or technological environment of the borrower, which results in a significant change in the borrower's ability to



honor his debts. For example, it can be a technological shift that has led to a decreasing demand for products sold by the borrower;

- significant changes in the value of collateral or in the quality of credit of guarantees or enhancements received by third parties, which may reduce the borrower's economic motivation to make his contractual payments, or to influence the likelihood of failure. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages;
- a significant change in the quality of the guarantee provided by a shareholder (or by the parents of a borrower) if the shareholder has (or the parents) an incentive and financial ability to prevent default by capital or cash infusion;
- significant changes, such as a reduction in financial support from a parent or other affiliate, or a significant or expected change in the quality of credit enhancements, which may reduce the borrower's economic incentive to make the scheduled contractual payments. Credit enhancement or financial support implies taking into account the financial condition of the guarantor and/or, in the case of interest in a securitisation, the possible ability of subordinate interests to absorb expected credit losses (for example, on the loans underlying the security);
- expected changes in the loan documentation, including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument;
- significant changes in the expected performance and behaviour of the borrower, including changes in the payment situation of the borrowers included in the group (for example, an increase in the number or amount expected of delayed contractual payments or significant increases in the expected number of credit card holders who are expected to approach or exceed their credit limit or who are expected to be paying the minimum);
- changes in the entity's credit management approach dealing with the financial instrument, i.e. based on emerging indicators of changes in the credit risk of the financial instrument: this management practice is expected to become more active or to be focused on managing the instrument (more closely monitored or controlled) or the entity specifically intervening with the borrower;
- past due information.

The ITG members discussed how and to what extent behavioural measures of credit risk such as past due information could be taken into account in the SICR analysis.

ITG Discussions ⁸

Could some type of behavioural measures of credit risk (for example past due information) serve as a reasonable proxy for identifying SICR since initial recognition?

As a reminder, ITG members mentioned some principles among which the following principle: "a significant increase in credit risk is expected to occur prior to delinquency and consequently, when making this assessment, an entity is required to consider all reasonable and supportable information, including information that is forward-looking, that is available without undue cost and effort".

When considering the use of behavioural indicators, it was noted that an entity:

⁸ ITG 16 September 2015: Issue N°2 of Significant increase in credit risk (Agenda Paper 1)

- > focuses on identifying pre-delinquency behavioural indicators of increases in credit risk, for example increased utilisation rates or increased cash drawings on specific products;
- > only uses indicators that are relevant to the risk of default occurring;
- > establishes a link between the behavioural indicators of credit risk and changes in the risk of default occurring since initial recognition;
- > are mindful that while behavioural indicators are often predictive of defaults in the short term, they are often less predictive of defaults in the longer term; and
- > considers whether the use of behavioural indicators is appropriate for the type of product being assessed—for example, if a loan has only back-ended payments, behavioural indicators based on timeliness of payment will not be appropriate.

Some ITG members noted that when making the assessment of significant increases in credit risk, an entity considers the possibility of segmenting the portfolio into groups of financial instruments with shared credit characteristics in such a way that similar indicators of credit risk could be used to identify increases in credit risk for specific sub-portfolios.

9.4.3.2.3. The definition of “significant” is a relative definition

As seen previously in **section 9.4.3.1.3**, credit risk monitoring must be **relative** to its level at recognition date.

This principle implies that the determination of a significant increase in credit risk is going to be different for two financial instruments with different levels of credit risk at initial recognition. Thus, a given change in probability of default, in absolute terms, can be significant for a financial instrument with a low credit risk at initial recognition and not significant for another financial instrument with a higher credit risk at initial recognition. This implies also that, for two financial instruments with the same level of credit risk at a reporting date, one financial instrument can present a significant increase in credit risk whilst not the other: it will depend on their initial credit risk level (IFRS 9.B5.5.9).

The following example illustrates further this notion of “relative” (IFRS 9.IE12).

Example 9.3: No significant increase in credit risk

Company C is the holding company of a group that operates in a cyclical production industry. Bank B provided a loan to Company C. At that time, the prospects for the industry were positive, because of expectations of further increases in global demand. However, input prices were volatile and given the point in the cycle, a potential decrease in sales was anticipated.

In addition, in the past Company C had been focused on external growth, acquiring majority stakes in companies in related sectors. As a result, the group structure is complex and has been subject to change, making it difficult for investors to analyse the expected performance of the group and to forecast the cash that will be available at the holding company level. Even though leverage is at a level that is considered acceptable by Company C’s creditors at the time that Bank B originates the loan, its creditors are concerned about Company C’s ability to refinance its debt because of the short remaining life until the maturity of the current financing. There is also concern about Company C’s ability to continue to service interest using the dividends it receives from its operating subsidiaries.

At the time of the origination of the loan by Bank B, Company C’s leverage was in line with that of other customers with similar credit risk and based on projections over the expected life of the loan, the available capacity (i.e. headroom) on its coverage ratios before triggering a default event, was high. Bank B applies its own internal rating methods to determine credit risk and allocates a specific internal rating score to its



loans. Bank B's internal rating categories are based on historical, current and forward-looking information and reflect the credit risk for the tenor of the loans. On initial recognition, Bank B determines that the loan is subject to considerable credit risk, has speculative elements and that the uncertainties affecting Company C, including the group's uncertain prospects for cash generation, could lead to default. However, Bank B does not consider the loan to be originated credit-impaired because it does not meet the definition of a purchased or originated credit-impaired financial asset in Appendix A of IFRS 9.

Subsequent to initial recognition, Company C has announced that three of its five key subsidiaries had a significant reduction in sales volume because of deteriorated market conditions but sales volumes are expected to improve in line with the anticipated cycle for the industry in the following months. The sales of the other two subsidiaries were stable. Company C has also announced a corporate restructure to streamline its operating subsidiaries. This restructuring will increase the flexibility to refinance existing debt and the ability of the operating subsidiaries to pay dividends to Company C.

Despite the expected continuing deterioration in market conditions, Bank B determines that there has not been a significant increase in the credit risk on the loan to Company C since initial recognition. This is demonstrated by factors that include:

- > (a) Although current sale volumes have fallen, this was as anticipated by Bank B at initial recognition. Furthermore, sales volumes are expected to improve, in the following months.
- > (b) Given the increased flexibility to refinance the existing debt at the operating subsidiary level and the increased availability of dividends to Company C, Bank B views the corporate restructure as being credit enhancing. This is despite some continued concern about the ability to refinance the existing debt at the holding company level.
- > (c) Bank B's credit risk department, which monitors Company C, has determined that the latest developments are not significant enough to justify a change in its internal credit risk rating.

As a consequence, Bank B does not recognise a loss allowance at an amount equal to lifetime expected credit losses on the loan. However, it updates its measurement of the 12-month expected credit losses for the increased risk of a default occurring in the next 12 months and for current expectations of the credit losses that would arise if a default were to occur.

But the relative feature of this analysis was pushed one step further by IFRS 9: the determination of the SICR cannot be done only by comparing the change in the absolute risk of a default occurring over time (IFRS 9.B5.5.11). It means that, even if the probability of default remains the same, there may be an increase in credit risk. For example, if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is identical to the risk of a default occurring on that financial instrument when its expected life in a subsequent period is only five years, that may indicate an increase in credit risk. This is because the risk of a default occurring over the expected life usually decreases as time passes if the credit risk is unchanged and the financial instrument is closer to maturity. However, for financial instruments that only have significant payment obligations close to the maturity of the financial instrument the risk of a default occurring may not necessarily decrease as time passes.



The SICR definition is both a highly sensitive parameter of any IFRS 9 impairment approach and a significant area of judgement. The SICR methodology must therefore be duly documented.

To help users of financial statements understand the approach retained, IFRS 7 requires specific disclosures on the definition of SICR (see **chapter 16**).

9.4.3.2.4. The 30 days past due rebuttable presumption

Behavioural indicators like past due status (delinquency) will rarely be the only indicator analysed if other reasonable and supportable forward-looking information on the borrower's credit risk quality is available without undue cost and effort (IFRS 9.5.5.11).

However, IFRS 9.5.5.11 defines a presumption that the asset's credit risk quality has decreased significantly if the past due status lasts for more than 30 days.

This presumption may be rebutted if the bank has reliable and justifiable information demonstrating that the credit quality has not deteriorated significantly despite this delinquency.



The main purpose of this presumption is to ensure that, in most situations, a significant degradation of credit quality will be identified and the related asset classified in Stage 2 before the default of the asset. Situations of "jumped to default" i.e. when an asset classified in Stage 1 goes straight to Stage 3 (without transiting by Stage 2) should remain exceptional.

9.4.3.2.5. SICR of a highly collateralised asset

As the SICR assessment is focused on the change in risk of default rather than on ECL, the existence or not of a collateral or a guarantee will generally not impact the assessment of the SICR.

This was confirmed by an IFRS 9 illustrative example presented hereafter (IFRS 9.IE18).

Example 9.4: Highly collateralised financial asset

Company H owns real estate assets which are financed by a five-year loan from Bank Z with a loan-to-value (LTV) ratio of 50 per cent. The loan is secured by a first-ranking security over the real estate assets. At initial recognition of the loan, Bank Z does not consider the loan to be originated credit-impaired as defined in Appendix A of IFRS 9.

Subsequent to initial recognition, the revenues and operating profits of Company H have decreased because of an economic recession. Furthermore, expected increases in regulations have the potential to further negatively affect revenue and operating profit. These negative effects on Company H's operations could be significant and ongoing.

As a result of these recent events and expected adverse economic conditions, Company H's free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could become tight. Bank Z estimates that a further deterioration in cash flows may result in Company H missing a contractual payment on the loan and becoming past due.

Recent third party appraisals have indicated a decrease in the value of the real estate properties, resulting in a current LTV ratio of 70 per cent.

At the reporting date, Bank Z needs to assess whether there has been a significant increase in credit risk since initial recognition, irrespective of the value of the collateral it holds. It notes that the loan is subject to considerable credit risk at the reporting date because even a slight deterioration in cash flows could result in Company H missing a contractual payment on the loan. As a result, Bank Z determines that the credit risk (i.e. the risk of a default occurring) has increased significantly since initial recognition. Consequently, Bank Z recognises lifetime expected credit losses on the loan to Company H.



Although lifetime expected credit losses must be recognised, the measurement of the expected credit losses will reflect the recovery expected from the collateral (adjusting for the costs of obtaining and selling the collateral) on the property as required by paragraph B5.5.55 of IFRS 9 and may result in the expected credit losses on the loan being very small.

9.4.3.2.6. Collective assessment of SICR

The IFRS 9 unit of account is the contract. This means that each financial asset is accounted for individually and distinctly. According to that, the preferred conceptual approach for the IFRS 9 impairment approach relies in the first place on an individual basis.

However, IFRS 9 acknowledges that it may be necessary to apply analysis on a collective basis especially when information relevant for the assessment of the SICR is available only on a portfolio level. This could be the case for example, by considering information on the credit risk situation of a portfolio of loans sharing a common characteristic (a geographical area, a line of business, etc.).

This collective assessment also ensures that all available information is included in the process even if the information is not yet available on an individual basis (i.e. it is not yet known which contract in the portfolio will be impacted). For example, if the only information available on an individual basis is the “past due” indicator, it is essential to complement this individual analysis with collective indicators to be able to monitor the evolution of the credit risk quality of the portfolio and not unduly delay the recognition of LTECL.

This collective approach applies to portfolios of instruments that share credit risk characteristics (e.g. type of collateral, generation, industry, geographical area, etc.). Each time that information on a dedicated sub-portfolio becomes available, it may be necessary to split this sub-portfolio in order to take it into account.

The following illustrative example of IFRS 9 illustrates further this SICR assessment on a portfolio basis (IFRS 9.IE29).

Example 9.5: Responsiveness to changes in credit risk

Bank ABC provides mortgages to finance residential real estate in three different regions. The mortgage loans are originated across a wide range of LTV criteria and a wide range of income groups. As part of the mortgage application process, customers are required to provide information such as the industry within which the customer is employed and the post code of the property that serves as collateral on the mortgage.

Bank ABC sets its acceptance criteria based on credit scores. Loans with a credit score above the ‘acceptance level’ are approved because these borrowers are considered to be able to meet contractual payment obligations. When new mortgage loans are originated, Bank ABC uses the credit score to determine the risk of a default occurring as at initial recognition.

At the reporting date Bank ABC determines that economic conditions are expected to deteriorate significantly in all regions. Unemployment levels are expected to increase while the value of residential property is expected to decrease, causing the LTV ratios to increase. As a result of the expected deterioration in economic conditions, Bank ABC expects default rates on the mortgage portfolio to increase.

Individual assessment

In Region One, Bank ABC assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process. Its scoring models are based on current and historical past due statuses, levels of customer indebtedness, LTV measures, customer behaviour on other financial instruments with Bank ABC, the loan size and the time since the origination of the loan. Bank ABC updates the LTV measures on a regular basis through an automated process that re-estimates property values using recent sales in each post code area and reasonable and supportable forward-looking information that is available without undue cost or effort.

Bank ABC has historical data that indicates a strong correlation between the value of residential property and the default rates for mortgages. That is, when the value of residential property declines, a customer has less economic incentive to make scheduled mortgage repayments, increasing the risk of a default occurring.

Through the impact of the LTV measure in the behavioural scoring model, an increased risk of a default occurring due to an expected decline in residential property value adjusts the behavioural scores. The behavioural score can be adjusted as a result of expected declines in property value even when the mortgage loan is a bullet loan with the most significant payment obligations at maturity (and beyond the next 12 months). Mortgages with a high LTV ratio are more sensitive to changes in the value of the residential property and Bank ABC is able to identify significant increases in credit risk since initial recognition on individual customers before a mortgage becomes past due if there has been a deterioration in the behavioural score.

When the increase in credit risk has been significant, a loss allowance at an amount equal to lifetime expected credit losses is recognised. Bank ABC measures the loss allowance by using the LTV measures to estimate the severity of the loss, i.e. the loss given default (LGD). The higher the LTV measure, the higher the expected credit losses all else being equal.

If Bank ABC was unable to update behavioural scores to reflect the expected declines in property prices, it would use reasonable and supportable information that is available without undue cost or effort to undertake a collective assessment to determine the loans on which there has been a significant increase in credit risk since initial recognition and recognise lifetime expected credit losses for those loans.

Collective assessment

In Regions Two and Three, Bank ABC does not have an automated scoring capability. Instead, for credit risk management purposes, Bank ABC tracks the risk of a default occurring by means of past due statuses. It recognises a loss allowance at an amount equal to lifetime expected credit losses for all loans that have a past due status of more than 30 days past due. Although Bank ABC uses past due status information as the only borrower-specific information, it also considers other reasonable and supportable forward-looking information that is available without undue cost or effort to assess whether lifetime expected credit losses must be recognised on loans that are not more than 30 days past due. This is necessary in order to meet the objective in paragraph 5.5.4 of IFRS 9 of recognising lifetime expected credit losses for all significant increases in credit risk.

Region Two

Region Two includes a mining community that is largely dependent on the export of coal and related products. Bank ABC becomes aware of a significant decline in coal exports and anticipates the closure of several coal mines. Because of the expected increase in the unemployment rate, the risk of a default occurring on mortgage loans to borrowers who are employed by the coal mines is determined to have increased significantly, even if those customers are not past due at the reporting date. Bank ABC therefore segments its mortgage portfolio by the industry within which customers are employed (using the information recorded as part of the mortgage application process) to identify customers that rely on coal mining as the dominant source of employment (i.e. a 'bottom up' approach in which loans are identified based on a common risk characteristic). For those mortgages, Bank ABC recognises a loss allowance at an amount equal to lifetime expected credit losses while it continues to recognise a loss allowance at an amount equal to 12-month expected credit losses for



all other mortgages in Region Two⁹. Newly originated mortgages to borrowers who rely on the coal mines for employment in this community would, however, have a loss allowance at an amount equal to 12-month expected credit losses because they would not have experienced significant increases in credit risk since initial recognition. However, some of these mortgages may experience significant increases in credit risk soon after initial recognition because of the expected closure of the coal mines.

Region Three

In Region Three, Bank ABC anticipates the risk of a default occurring and thus an increase in credit risk, as a result of an expected increase in interest rates during the expected life of the mortgages. Historically, an increase in interest rates has been a lead indicator of future defaults on mortgages in Region Three—especially when customers do not have a fixed interest rate mortgage. Bank ABC determines that the variable interest-rate portfolio of mortgages in Region Three is homogenous and that unlike for Region Two, it is not possible to identify particular sub portfolios on the basis of shared risk characteristics that represent customers who are expected to have increased significantly in credit risk. However, as a result of the homogenous nature of the mortgages in Region Three, Bank ABC determines that an assessment can be made of a proportion of the overall portfolio that has significantly increased in credit risk since initial recognition (i.e. a ‘top down’ approach can be used). Based on historical information, Bank ABC estimates that an increase in interest rates of 200 basis points will cause a significant increase in credit risk on 20 per cent of the variable interest-rate portfolio. Therefore, as a result of the anticipated increase in interest rates, Bank ABC determines that the credit risk on 20 per cent of mortgages in Region Three has increased significantly since initial recognition. Accordingly, Bank ABC recognises lifetime expected credit losses on 20 per cent of the variable rate mortgage portfolio and a loss allowance at an amount equal to 12-month expected credit losses for the remainder of the portfolio¹⁰.

9.4.3.2.7. Use of multi-scenarios for SICR assessment

This topic was discussed during an IASB Webcast in July 2016¹¹.

A multiple scenario approach can be a relevant means to identify a deterioration in the credit risk of an asset. If we consider the figure below, an entity that would focus on the most likely scenario only may come to the conclusion that the probability of default has not changed whereas a multi-scenario analysis would reveal that the situation has deteriorated.

Figure 9.4

	Upside	Most likely	Downside
Probability of default in Year 0	10%	80%	10%
Probability of default in Year 1	10%	60%	30%

When performing a multi-scenario assessment, an entity may identify different scenarios leading to different SICR assessment outcomes. In such a case, if the scenarios are mutually exclusive (as it is generally the case), it is not possible to apply one scenario to part of an asset and another scenario to another part of the same asset. A single asset cannot be “split” between two different stages.

⁹ Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognised on those mortgages.

¹⁰ Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognised on those mortgages.

¹¹ Webcast “IFRS 9 forward-looking information and multiple scenarios” July 2016.

<https://www.ifrs.org/-/media/project/financial-instruments/webcast-july-2016/ifrs9-webcast-july-2016-slides.pdf?la=en>

The question could be raised however in situations where the SICR assessment is performed collectively on a portfolio basis. Consider a situation where an entity estimates that there is an 85% probability that the portfolio assets remains in Stage 1, and a 15% probability that it be classified in Stage 2.

This situation was discussed at an ITG meeting and the ITG came to the conclusion that where the range of possible scenarios is mutually exclusive, they cannot be applied to part of a portfolio of assets. Therefore, in such a situation it would be inappropriate to put 15% of the portfolio in Stage 2 and keep the remaining 85% in Stage 1 as it represents a scenario probability rather than the proportion of the assets in the portfolio that have SICR.

Transferring assets representing 15% of the portfolio in Stage 2 would however be relevant if the entity is able to demonstrate that there are specific assets in the portfolio that share a specific risk profile that makes them react differently to a given economic scenario.

9.4.3.3. Default definition

9.4.3.3.1. A definition that relies on a simple principle ...

The definition of default is a key element of any IFRS 9 impairment approach as it both interacts with the SICR assessment and the ECL calculation methodology (see **section 9.4.3.3**).

However, rather than providing a positive definition of what is a defaulted asset, IFRS 9.B5.5.37 states that an entity “shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate”.

This definition applies consistently to all financial instruments unless information becomes available that demonstrates that another definition of the default is more relevant for a particular financial instrument.



This definition of default allows entities to leverage on their actual and already implemented risk management policy. Most financial institutions will therefore leverage on the investments made to implement the regulatory definition of default by aligning, to the extent possible, its IFRS 9 definition of default to the regulatory definition.

IFRS 9 nevertheless defines a backstop to this principle that is further discussed in the next section.

9.4.3.3.2. ... with a backstop: the rebuttable presumption of 90 days past due

IFRS 9.B5.5.37 states that if an amount has been past due for more than 90 days, the financial asset is presumed to be defaulted unless the entity has reasonable and supportable information to demonstrate otherwise.



If the presumption is rebutted, this must be properly documented. It is important and relevant to note that this topic is one of the areas of focus of banking regulators in their assessment of IFRS 9 implementation by banks.

9.4.3.4. Simplification options offered by IFRS 9

9.4.3.4.1. The “low credit risk” status

By simplification, an entity **may** assume that the credit risk on a financial asset has not increased significantly since initial recognition as long as the financial instrument is determined to have low credit risk at the reporting date (IFRS 9.5.5.10; IFRS 9.B5.5.22).

This low credit risk threshold is an absolute level of credit risk. It must be seen as an exception to the relative level approach that prevails in the general SICR assessment.

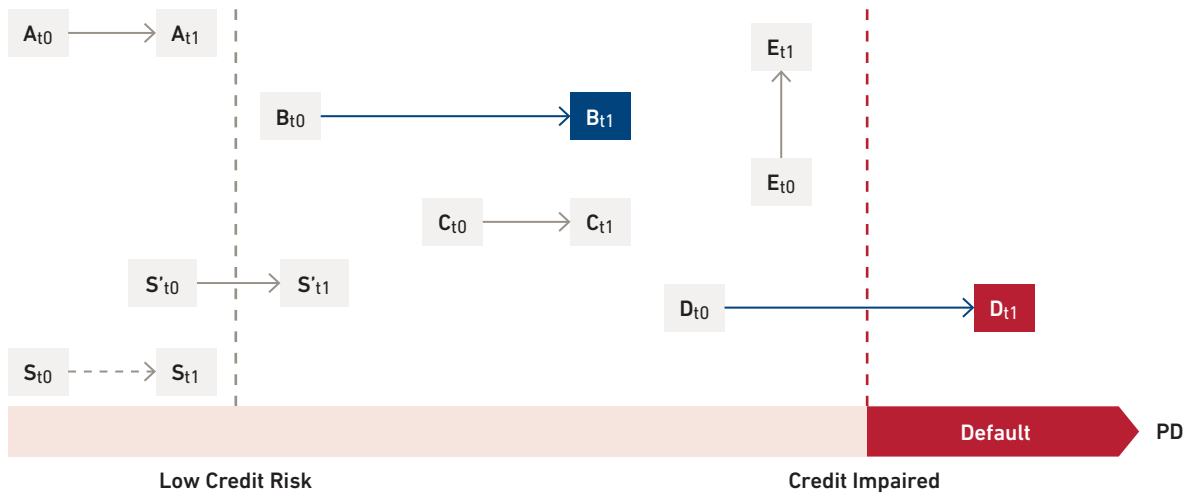
If an entity chooses to apply this simplification, no further analysis is required and the financial instrument is presumed not to be in a SICR situation. This simplification option can be applied instrument by instrument (IFRS 9.BC5.184).



The European Banking Authority considers that a high-quality application of the IFRS 9 impairment model by a bank would require not to apply this simplification to loans. This position is not an IFRS requirement. However, this probably explains why many European banks decided not to avail themselves of this option for their loan portfolios.

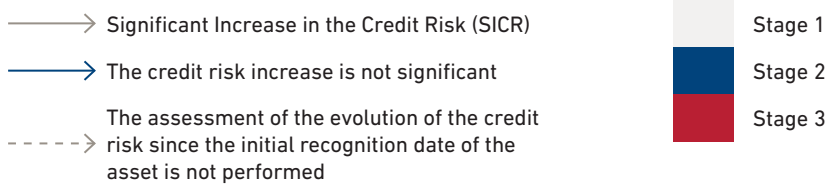
The figure below presents the consequences of the low credit risk simplification assuming that the entity elects to only apply it to debt securities.

Figure 9.5



Assumptions: t_0 : initial recognition date of a loan or a debt security
 S, S' are debt securities t_1 : next reporting date
 A, B, C, D, E are loans

The credit risk of the loan E remains the same between t_0 and t_1 .



To be determined to have low credit risk and thus be eligible to this simplification option, a financial asset must meet the following cumulative conditions (IFRS 9.B5.5.22):

- it has a low risk of default;
- the borrower has a strong capacity to meet its contractual cash flow obligations in the near term; and
- this capacity may but will not necessarily be reduced by adverse changes in the longer-term economic and business conditions.

The low credit risk analysis is performed on the basis of the characteristics of the instrument. The instrument may not be considered as having a low credit risk solely because of the value of a collateral.

An instrument cannot be considered as having low credit risk simply because its credit risk is lower than other similar financial instruments in the local area within which an entity operates. (IFRS 9 B5.5.22).

To determine whether a financial asset has low credit risk an entity may rely on internal scoring methodologies. However, the threshold retained must be consistent with what is generally accepted as low credit risk. Therefore IFRS 9 quoted as an example the case of an asset with an external investment grade rating that may be considered a low credit risk instrument. This does not mean that the instrument must have external ratings to qualify as a low credit risk, but that it is necessary for it to present a risk profile such that a market player would be likely to assign it that status taking into account all the terms and conditions of the asset as well as relevant available information. (IFRS 9.B5.5.23).

If an instrument no longer qualifies for the low credit risk simplification, it must be treated like any other instrument in the general approach and a Significant Increase Credit Risk assessment must be performed. An instrument is not presumed to bear a SICR simply because it becomes ineligible to the low credit risk simplification (IFRS 9.B5.5.24).

Example 9.6: Public investment-grade bond (IFRS 9.IE24)

Company A is a large listed national logistics company. The only debt in the capital structure is a five-year public bond with a restriction on further borrowing as the only bond covenant. Company A reports quarterly to its shareholders. Entity B is one of many investors in the bond. Entity B considers the bond to have low credit risk at initial recognition. This is because the bond has a low risk of default and Company A is considered to have a strong capacity to meet its obligations in the near term. Entity B's expectations for the longer term are that adverse changes in economic and business conditions may, but will not necessarily, reduce Company A's ability to fulfil its obligations on the bond. In addition, at initial recognition the bond had an internal credit rating that is correlated to a global external credit rating of investment grade.

At the reporting date, Entity B's main credit risk concern is the continuing pressure on the total volume of sales that has caused Company A's operating cash flows to decrease.

Because Entity B relies only on quarterly public information and does not have access to private credit risk information (because it is a bond investor), its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from rating agencies.

Entity B applies the low credit risk simplification. Accordingly, at the reporting date, Entity B evaluates whether the bond is considered to have low credit risk using all reasonable and supportable information that is available without undue cost or effort. In making that evaluation, Entity B reassesses the internal credit rating of the bond and concludes that the bond is no longer equivalent to an investment grade rating because:

- > The latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20 per cent and in operating profit by 12 per cent.
- > Rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade. However, at the reporting date the external credit risk rating was unchanged.
- > The bond price has also declined significantly, which has resulted in a higher yield to maturity. Entity B assesses that the bond prices have been declining as a result of increases in Company A's credit risk. This is because the market environment has not changed (for example, benchmark interest rates, liquidity, etc. are unchanged) and comparison with the bond prices of peers shows that the reductions are probably company specific (instead of being, for example, changes in benchmark interest rates that are not indicative of company-specific credit risk).

While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions have increased the risk of a default occurring on the bond. As a result of the factors described above, Entity B determines that the bond does not have low credit risk at the reporting date. As a result, Entity B needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, Company B determines that the credit risk has increased significantly since initial recognition and that a loss allowance at an amount equal to lifetime expected credit losses should be recognised in accordance with IFRS 9.5.5.3.

9.4.3.4.2. SICR assessment: the 12M PD can be retained as an approximation of the LT PD

An entity may use the changes in the risk of a default occurring in the next 12 months as a reasonable proxy of change in the lifetime probability of default in the context of the SICR assessment. However, this approximation is subject to the following cumulative conditions (IFRS 9.B5.5.13):

- based on its experience for comparable financial instruments, the entity is able to demonstrate that default patterns are not concentrated at a specific point during the expected life of the financial instrument; and
- there are no identified circumstances that indicate that the use of a lifetime assessment is necessary.
- IFRS 9 further specifies that the use of the probability of default at 12 months as a proxy for the probability of default over the estimated residual life of the instrument is not appropriate when, for example:
 - the financial instrument only has significant payment deadlines beyond the next 12 months (e.g., in fine);
 - changes in macroeconomic factors (or other relevant credit-related factors) are not adequately reflected in the risk of failure for the next 12 months;
 - changes in credit-related factors only have an impact (or a more pronounced effect) on the credit risk of the financial instrument beyond the next 12 months.



Considering the operational difficulties that may occur when assessing the probability of default over the expected life of an instrument for the SICR assessment, this simplification is often considered by financial institutions. This simplification is in practice all the more relevant as the bank will be able to leverage on available regulatory data that generally have a 12-month horizon.

ITG Discussions¹²

ITG members noted that they would expect an entity to complete a robust analysis up front to support the conclusion that changes in the 12-month risk of a default occurring is a reasonable approximation for the assessment of changes in the lifetime risk of default occurring.

The level of initial analysis required would normally depend on the specific type of financial instrument being considered. Consequently, in some cases, a qualitative analysis could be enough whereas in less clear-cut cases, a quantitative analysis may be necessary.

The ITG members also noted that it may be appropriate to segregate portfolios (for example by maturity) to facilitate the analysis for groups of similar financial instruments.

¹² ITG 16 September 2015: Use of changes in the risk of a default occurring over the next 12 months when assessing significant increases in credit risk (Agenda Paper 2)



9.4.3.5. Operational implementations

9.4.3.5.1. Assessment at counterparty level

The unit of account of IFRS 9 being the individual contract, the monitoring of credit quality is preferably carried out instrument by instrument rather than by counterparty. However, IFRS 9 does not prohibit the assessment of SICR at a counterparty level as long as it can be demonstrated that it leads to the same conclusion as an instrument by instrument assessment.

Example 9.7: Counterparty assessment of credit risk (IFRS 9.IE43)

Scenario 1

In 20X0 Bank A granted a loan of CU10,000 with a contractual term of 15 years to Company Q when the company had an internal credit risk rating of 4 on a scale of 1 (lowest credit risk) to 10 (highest credit risk). The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. In 20X5, when Company Q had an internal credit risk rating of 6, Bank A issued another loan to Company Q for CU5,000 with a contractual term of 10 years. In 20X7 Company Q fails to retain its contract with a major customer and correspondingly experiences a large decline in its revenue. Bank A considers that as a result of losing the contract, Company Q will have a significantly reduced ability to meet its loan obligations and changes its internal credit risk rating to 8.

Bank A assesses credit risk on a counterparty level for credit risk management purposes and determines that the increase in Company Q's credit risk is significant. Although Bank A did not perform an individual assessment of changes in the credit risk on each loan since its initial recognition, assessing the credit risk on a counterparty level and recognising lifetime expected credit losses on all loans granted to Company Q, meets the objective of the impairment requirements of IFRS 9. This is because, even since the most recent loan was originated (in 20X7) when Company Q had the highest credit risk at loan origination, its credit risk has increased significantly. The counterparty assessment would therefore achieve the same result as assessing the change in credit risk for each loan individually.

Scenario 2

Bank A granted a loan of CU150,000 with a contractual term of 20 years to Company X in 20X0 when the company had an internal credit risk rating of 4. During 20X5 economic conditions deteriorate and demand for Company X's products has declined significantly. As a result of the reduced cash flows from lower sales, Company X could not make full payment of its loan instalment to Bank A. Bank A re-assesses Company X's internal credit risk rating, and determines it to be 7 at the reporting date. Bank A considered the change in credit risk on the loan, including considering the change in the internal credit risk rating, and determines that there has been a significant increase in credit risk and recognises lifetime expected credit losses on the loan of CU150,000.

Despite the recent downgrade of the internal credit risk rating, Bank A grants another loan of CU50,000 to Company X in 20X6 with a contractual term of 5 years, taking into consideration the higher credit risk at that date.

The fact that Company X's credit risk (assessed on a counterparty basis) has previously been assessed to have increased significantly, does not result in lifetime expected credit losses being recognised on the new loan. This is because the credit risk on the new loan has not increased significantly since the loan was initially recognised. If Bank A only assessed credit risk on a counterparty level, without considering whether the conclusion about changes in credit risk applies to all individual financial instruments provided to the same customer, the objective of the SICR assessment would not be met.



Most financial institutions have been monitoring their credit risk exposure on a counterparty basis rather than on an instrument by instrument basis. The shortcut presented above therefore undeniably has significant operational merits. However, it should be used with caution, and documentation must be properly established to demonstrate that this approximation leads to outcomes similar to those of the IFRS 9 impairment requirements.

9.4.3.5.2. SICR: operational simplification to the relative assessment

One of the most complex operational issues in the implementation of IFRS 9 is to manage the relative feature of the SICR assessment. In fact, most financial institutions monitor their credit exposures on the basis of their absolute credit risk level. Therefore, the initial credit risk of a given contract is rarely stored in the IT systems so that a relative approach is operationally difficult to implement.

IFRS 9 does not prevent entities from using shortcuts in this regard. But they will have to demonstrate that the operational shortcut provides outcomes that are consistent with the IFRS 9 general impairment approach (e.g. recognising a LTECL for any instrument that has a SICR).

One of the commonly considered shortcuts is to leverage on the internal origination credit risk policy of the entity to demonstrate that, initially, loans that share specific characteristics also share a common initial credit risk. If this can be demonstrated, the SICR relative assessment may be approximated through an absolute threshold approach.

IFRS 9 provides an illustrative example to illustrate the benefits and the limits of such an approach (IFRS 9.IE40):

Example 9.8: Comparison to maximum initial credit risk (IFRS 9.IE40)

Bank A has two portfolios of automobile loans with similar terms and conditions in Region W. Bank A's policy on financing decisions for each loan is based on an internal credit rating system that considers a customer's credit history, payment behaviour on other products with Bank A and other factors, and assigns an internal credit risk rating from 1 (lowest credit risk) to 10 (highest credit risk) to each loan on origination. The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. Loans in Portfolio 1 were only offered to existing customers with a similar internal credit risk rating and at initial recognition all loans were rated 3 or 4 on the internal rating scale. Bank A determines that the maximum initial credit risk rating at initial recognition it would accept for Portfolio 1 is an internal rating of 4. Loans in Portfolio 2 were offered to customers that responded to an advertisement for automobile loans and the internal credit risk ratings of these customers range between 4 and 7 on the internal rating scale. Bank A never originates an automobile loan with an internal credit risk rating worse than 7 (i.e. with an internal rating of 8–10).

For the purposes of assessing whether there have been significant increases in credit risk, Bank A determines that all loans in Portfolio 1 had a similar initial credit risk. It determines that given the risk of default reflected in its internal risk rating grades, a change in internal rating from 3 to 4 would not represent a significant increase in credit risk but that there has been a significant increase in credit risk on any loan in this portfolio that has an internal rating worse than 5. This means that Bank A does not have to know the initial credit rating of each loan in the portfolio to assess the change in credit risk since initial recognition. It only has to determine whether the credit risk is worse than 5 at the reporting date to determine whether lifetime expected credit losses must be recognised.



However, determining the maximum initial credit risk accepted at initial recognition for Portfolio 2 at an internal credit risk rating of 7, would not meet the objective of IFRS 9 requirements. This is because Bank A determines that significant increases in credit risk arise not only when credit risk increases above the level at which an entity would originate new financial assets (i.e. when the internal rating is worse than 7). Although Bank A never originates an automobile loan with an internal credit rating worse than 7, the initial credit risk on loans in Portfolio 2 is not of sufficiently similar credit risk at initial recognition to apply the approach used for Portfolio 1. This means that Bank A cannot simply compare the credit risk at the reporting date with the lowest credit quality at initial recognition (for example, by comparing the internal credit risk rating of loans in Portfolio 2 with an internal credit risk rating of 7) to determine whether credit risk has increased significantly **because the initial credit quality of loans in the portfolio is too diverse**. For example, if a loan initially had a credit risk rating of 4 the credit risk on the loan may have increased significantly if its internal credit risk rating changes to 6.

This illustrative example thus explicitly acknowledges that, under certain circumstances, an absolute approach may provide similar outcomes than a relative approach. However, it is important to stress two key elements in the assessment of the portfolio A methodology:

- only loans with an initial credit grade of 3 or 4 were considered, so that their initial credit risk can be considered as homogeneous; and
- the entity demonstrated that a movement from grade 3 to grade 4 did not represent a significant increase in credit risk whereas a movement from grade 4 to grade 5 would.

Please note that the ITG also further discussed on this topic during its September 2015 meeting.

9.4.4. Simplified approach: scope and requirements

To facilitate the implementation of the impairment requirements of IFRS 9, the Board has proposed a simplified approach that, although simplified, is nevertheless based on the expected credit loss model. This simplified approach is either, required for some instruments, or offered as an option for others. We will first present the principles applicable to the simplified approach and then present its scope requirements and options.

9.4.4.1. Principles of the simplified approach

The simplified approach consists simply in calculating the impairment allowance of a financial asset, at any time, on the basis of its LTECL (IFRS 9.5.5.15b). Requirements for LTECL calculations are identical for both the general and the simplified approach.

The main benefit of this simplified approach is therefore that the entity does not have to monitor the change in credit risk of each asset from its initial recognition date. The staging process and its SICR threshold do not apply in the simplified approach. Disclosure requirements are also simplified.

At first glance, this simplified approach may seem rather conservative as it will likely lead to the recognition of a greater amount of impairment than what would have been obtained by applying the general approach. In fact, under the simplified approach any asset will bear a LTECL impairment allowance upon initial recognition whereas the same asset under the general approach would have been classified in Stage 1 and impairment calculated only up to its 12MECL.

However, we will see in the next sections that the simplified approach is required only for relatively short-term instruments (e.g. less than 12 month) for which the difference between LTECL and 12MECL is not expected to be significant. It is also offered as an option for instruments that may present a longer maturity.

9.4.4.2. Scope of the simplified approach

The **simplified approach is required** for trade receivables and contract assets that:

- result from transactions that are within the scope of IFRS 15 - *Revenue from contracts with customers*; and
- do not contain a significant financing component in accordance with IFRS 15.

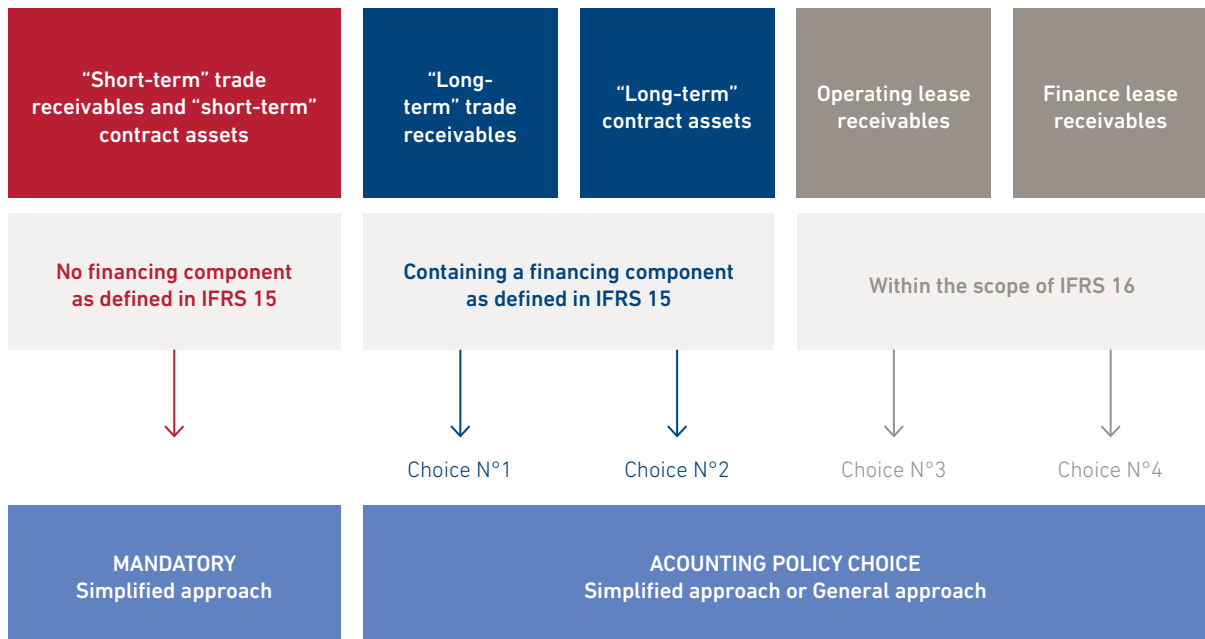
The **simplified approach is offered** as an accounting policy choice for:

- trade receivables arising from transactions that are within the scope of IFRS 15 and that contain a significant financing component in accordance with IFRS 15;
- contract assets arising from transactions that are within the scope of IFRS 15 and that contain a significant financing component in accordance with IFRS 15;
- operating lease receivables in the scope of IFRS 16 - *Leases*; and
- finance lease receivables in the scope of IFRS 16.

An entity will therefore potentially have four separate and independent accounting policy choices to perform. However, the accounting policy choice must be applied consistently to all financial assets that belong to the same above-mentioned category.

The figure below provides an overview of the scope of the simplified approach.

Figure 9.6



In practice, 12-month ECL and lifetime ECL are generally the same for such assets, as their maturity rarely exceeds 12 months.

Accounting policy choice applied consistently to each of the following:

- all "long-term" trade receivables,
- all "long-term" contract assets,
- all operating lease receivables,
- all finance lease receivables.

9.4.5. Purchased or Originated Credit Impaired assets (POCI)

9.4.5.1. When will an asset be considered as a POCI?

A Purchased or Originated Credit Impaired asset (POCI) is an asset that is already credit impaired at its initial recognition date whether it is originated or purchased (IFRS 9 Appendix A). A financial asset is credit impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred (see **section 9.4.2.3**).



Purchasing or originating a credit impaired instrument is generally not common. But this occurs in situations such as a distressed asset activity (acquired or originated), a purchase of a portfolio of existing debt instruments, or in a business combination that includes the acquisition of already credit impaired portfolios. Some debt restructuring may also trigger the derecognition of an existing debt and the recognition of a new debt that may be considered as POCI.

It is important to stress the fact that an asset may be considered as risky without necessarily meeting the definition of credit-impaired.

An asset acquired with a significant discount does not systematically bear credit losses. The significant discount can be caused by various other factors than credit risk, such as a bond paying a high fixed rate coupon in a decreasing interest rate environment (IFRS 9.B5.4.7).



9.4.5.2. Accounting for POCI instruments

The POCI accounting treatment is totally different from both the general and the simplified approaches for three main reasons:

- the amortised cost of POCI instruments is determined on the basis of a credit adjusted EIR (IFRS 9. B5.4.7);
- no impairment allowance is recognised upon initial recognition of the POCI instrument, only the cumulative change in the LTECL since initial recognition will be recognised as a loss allowance; and
- POCI are not subject to staging.

When calculating a credit-adjusted effective interest rate (CA EIR), an entity should consider all the contractual terms of the financial asset together with all expected credit losses (IFRS 9 Appendix A). This means that an entity must include the initially expected cash shortfall over the life of the contract in the cash flows used to calculate the CA EIR at its initial recognition (IFRS 9.B5.4.7 and IFRS 9.5.5.13).

Example 9.9: Calculation of a credit-impaired EIR

On 01/01/20X1, entity A buys a POCI asset for CU40. Its nominal is CU100 and its annual contractual interest rate is 5%.

The expected cash flows, taking into account the expected credit losses, are as presented hereunder:

		01/01/20X1	31/12/20X1	31/12/20X2	31/12/20X3
Contractual cash flows	(1)	-40	5	5	105
Expected cash flows	(2)		5	5	45
Credit loss expected at maturity date	(1) - (2)		0	0	60

In the case of a non-POCI asset, the calculation of the initial EIR would have relied on the contractual cash flows.

Here, in the case of a POCI asset, the calculation of the initial credit-adjusted EIR (or CA-EIR) relies on the expected cash flows considering the expected credit losses.

$$40 = 5 \times (1 + \text{CAEIR})^{-1} + 5 \times (1 + \text{CAEIR})^{-2} + 45 \times (1 + \text{CAEIR})^{-3}$$

Credit Adjusted EIR = 12,5 %

As required by IFRS 9.5.5.13, an entity **only** recognises as loss allowance the cumulative changes in LTECL since initial recognition. Moreover, this LTECL is discounted with the credit-adjusted EIR (IFRS 9.B5.5.45). Any change in the loss allowance, either positive or negative, will impact the profit or loss of the period similarly to any change in impairment allowance.

Example 9.10: Accounting treatments depending on the evolution of the LTECL for a POCI asset

Proceeding with the **example 9.9**, we will consider several scenarios:

Scenario 1: the expected cash flows remain unchanged over the life of the POCI asset

In such a case, the gross carrying amount and the amortised cost of this POCI asset are the same. This is because the amortised cost relies on the expected cash flows that encompass the initially expected credit losses.

If the expected cash flows remain unchanged at each reporting date (because the expected cash flows include contractual interests) :

		01/01/20X1	31/12/20X1	31/12/20X2	31/12/20X3
Contractual cash flows	(1)	-40	5	5	105
Expected cash flows	(2)		5	5	45
Credit loss expected at maturity date	(1) - (2)		0	0	60
Credit-Adjusted EIR			12,5%		

The figure below details the amortised cost :

	Gross carrying amount = Amortised Cost	Interests CA EIR = 12,50 %	Received cash flows = expected cash flows	Gross carrying amount End of period	Loss Allowance	Impact generated by the passage of time	Loss Allowance End of period	Amortised Cost end of period
31/12/20X1	40	5	-5	40	0,0	0,0	0,0	40,0
31/12/20X2	40	5	-5	40	0,0	0,0	0,0	40,0
31/12/20X3	40	5	-45	0	0,0	0,0	0,0	0,0

		Cash		POCI carrying amount = Amortised Cost	Loss Allowance		P&L	P&L Impairment gain or loss	
1/1/20X1	Acquisition of a POCI asset at 40 (LT ECL = CU 60)		40	40					
31/12/20X1	Expected cash flows unchanged	5		5			5		
31/12/20X2	Expected cash flows unchanged	5		5			5		
31/12/20X3	Expected cash-flows unchanged	45		5			5		
		55	40	55	55	0	0	0	15
						0	0		0

Scenario 2: As of 31/12/20X2, the expected cash flows have decreased

The credit risk has increased meaning that the expected cash flows at maturity have fallen to CU35.

As of 31/12/20X2 reporting, the expected cash flows are revised as follows (credit-risk increasing) :

		01/01/20X1	31/12/20X1	31/12/20X2	31/12/20X3
Contractual cash flows	(1)		5	5	105
Expected cash flows	(2)		5	5	35
Credit loss expected at maturity date	(1) - (2)		0	0	70
Credit-Adjusted EIR	12,5%				
Loss Allowance				8,9	10

Please note that the changes with the previous scenario are highlighted in **blue**.

The figure below details the amortised cost :

	Gross carrying amount = Amortised Cost	Interests CA EIR = 12,50 %	Received cash flows = expected cash flows	Gross carrying amount End of period	Loss Allowance	Impact generated by the passage of time	Loss Allowance End of period	Amortised Cost end of period
31/12/20X1	40	5	-5	40	0,0	0,0	0,0	40,0
31/12/20X2	40	5	-5	40	-8,9	0,0	-8,9	31,1
31/12/20X3	40	5	-35	10	-8,9	-1,1	-10,0	0,0

As of 31/12/20X2, a Loss Allowance of (CU8,9) is recognised. This corresponds to the decrease of the expected cashflows in year 20X3 (CU10 missing compared to the initial expected cashflows of CU45) discounted at the Credit Adjusted EIR.

In year 20X3, the expected losses are unchanged but the loss allowance discounting effect is reversed (i.e. the loss allowance is capitalised) generating an impact by the passage of time that increases the Loss Allowance (1,1 = 8,9 * 12,50 %).



		Cash		POCI carrying amount = Amortised Cost		Loss Allowance		P&L		P&L Impairment gain or loss	
1/1/20X1	Acquisition of a POCI asset at 40 (LT ECL = 60 CU)		40	40							
31/12/20X1	Expected cash flows unchanged	5		5	5			5			
31/12/20X2	Expected cash flows decreased	5		5	5		8,9	5		8,9	
31/12/20X3	Expected cash-flows unchanged			5			1,1	5		1,1	
		35			45	10					
		45	40	55	55	10	10	0	15	10	0

Scenario 3: As of 31/12/20X2, the expected cash flows have increased

As of 31/12/20X2 reporting, the expected cash flows are revised as follows (credit-risk decreasing) :

		01/01/20X1	31/12/20X1	31/12/20X2	31/12/20X3
Contractual cash flows	(1)		5	5	105
Expected cash flows	(2)		5	5	55
Credit loss expected at maturity date	(1) - (2)		0	0	50
Credit-Adjusted EIR	12,5%				
New gross carrying amount as at 31/12/20X2				48,9	

Please note that the changes with the previous scenario are highlighted in **blue**.

The figure below details the amortised cost :

	Gross carrying amount = Amortised Cost	Interests CA EIR = 12,50 %	Received cash flows = expected cash flows	Impairment gain or loss	Gross carrying amount End of period	Loss Allowance	Loss Allowance End of period	Amortised Cost end of period
31/12/20X1	40	5	-5		40	0,0	0,0	40,0
31/12/20X2	40	5	-5	8,9	48,9	0,0	0,0	48,9
31/12/20X3	48,9	6,1	-55		0	0,0	0,0	0,0

		Cash		POCI Gross carrying amount		Loss Allowance		P&L		P&L Impairment gain or loss	
1/1/20X1	Acquisition of a POCI asset at 40 (LT ECL = 60 CU)		40	40							
31/12/20X1	Expected cash flows unchanged	5		5	5			5			
31/12/20X2	Expected cash flows increased	5		5	5			5			
				8,9							8,9
31/12/20X3	Expected cash-flows unchanged	55		6,1	55			6,1			
		65	40	65	65	0	0	0	16,1	0	8,9



In the third scenario of **example 9.10**, when the LTECL decreases under its initial level (i.e. CU10 in the above example), we have presented the positive change in expected cash flows as a “negative” loss allowance. This accounting entry is in line with IFRS 9.5.5.14.

Another possible approach would be to adjust the gross carrying amount of the POCI asset. In fact, the LTECL used to determine the initial credit-adjusted EIR has been re-estimated. This change in estimates could be reflected as an adjustment to the gross carrying amount in accordance with IFRS 9.B5.4.6.

9.4.6. Measurement of ECL

9.4.6.1. Definitions and main principles

9.4.6.1.1. Definitions of Credit losses and Expected credit losses

Credit loss is defined as the present value of the difference between (i) the amount of contractual cash flows owed to an entity and (ii) the amount of cash flows that the entity expects to receive. This difference is discounted at the original effective interest rate of the instrument to obtain its present value (IFRS 9 Appendix A).

The cash flows that the entity expects to collect include the cash flows from the sale of collateral or other credit enhancements (example: sureties) that are integral to the contract.



To the extent that the definition of credit losses is sensitive both to default and payment dates (through the discount factor), an expected delay in payment will be included in the calculation of credit losses (IFRS 9. B5.5.28).

IFRS 9 impairment requirements are mainly principle-based. IFRS 9 is therefore not prescriptive in calculation methodology to be retained to determine a credit loss.

The Expected credit losses of an asset (ECL) are the average of the credit losses weighted by their probability of occurrence (IFRS 9 Appendix A).

The definition of ECL can be illustrated as shown in the figure below:

Figure 9.7

$$ECL_t = \left(\text{Contractual cash flows} - \text{Expected cash flows} \right) \times \text{Discount at EIR}$$

Weighted by probabilities and taking into account macroeconomic forecasts

9.4.6.1.2. Main principles

Expected Credit Losses are calculated in accordance with the following principles (IFRS 9.5.5.17):

- ECL is an unbiased amount determined on the basis of probability-weighted possible scenarios;
- ECL reflects the time value of money;
- ECL reflects reasonable and supportable information on past events, current circumstances and forecasts of future economic conditions (this last part is known as “forward looking information” and is further discussed in **section 9.4.7**), that is available, at the closing date, without having to incur undue cost or effort.

In the process of ECL calculation, an entity will have to use judgement based on relevant facts and circumstances. This judgement may have to be applied at several steps of the ECL calculation (probability of default, estimated recovery, information to take into account and its impact on the calculation...). It is important to keep in mind that all judgements and assumptions made in this ECL calculation process, taken as whole, must be internally consistent. Moreover, assumptions made, especially with regards to the general economic environment, must also be consistent with assumptions made by the entity in the general context of preparing its financial statements.

9.4.6.1.3. ECL is determined at each reporting date

The ECL calculation is required at each reporting date following the initial recognition of the financial instrument, up to its derecognition.

ITG Discussions¹³

As regards the requirement to re-measure expected credit losses at the date of derecognition of a financial asset, it was highlighted that:

- > IFRS 9.3.2.12 requires that expected credit losses must be re-measured at the date of derecognition in order to calculate the derecognition gain or loss; and
- > IAS 1.82(aa) et (ba) require that separate line items must be presented for gains and losses arising from derecognition and impairment losses and reversals.

Consequently, ITG members noted that there was a requirement to re-measure expected credit losses at the date of derecognition of a financial asset (including on a derecognition arising as a result of a modification). However, it was highlighted that, as with the requirements of any IFRS, considerations of materiality in accordance with IAS 8 - *Accounting Policies, Changes in Accounting Estimates and Errors* would need to be taken into account.

9.4.6.1.4. A multi-scenario approach

Expected credit losses of an asset, ECL, are the average of the credit losses weighted by their probability of occurrence. This definition implies that it is necessary to use several scenarios. However, an entity need not necessarily identify all possible scenarios (IFRS 9.5.5.18).

The purpose of estimating ECL is neither to estimate a worst-case scenario nor a best-case scenario. Instead, ECL must always reflect both the possibility that a credit loss occurs and the possibility that no credit loss occurs even if this last possibility is very low (IFRS 9.B5.5.41).

In practice, it is not necessarily a complex analysis. In some cases, it may be enough to use a relatively simple model, which does not require a simulation based on a great number of scenarios.

For example, the average ECL of a large portfolio of financial instruments with similar risk characteristics may be a reasonable estimate of the weighted average of ECL. In other cases, it will probably be necessary to establish scenarios that imply to detail the amounts and timing of expected cash flows, as well as the probability of occurrence of each scenario. In this case, it is necessary to use a minimum of two scenarios (default and no default) (IFRS 9.5.5.18 et B5.5.42).

9.4.6.1.5. Contractual life vs. expected life

Maturity is an important parameter to consider when calculating ECL. IFRS 9 defines Lifetime ECL as the “expected credit losses that result from all possible default events over the **expected** life of a financial instrument.”

This implies therefore that the expected life used for the ECL calculation must take into account every specific contractual term such as, for example, a prepayment option or an extension option. This is confirmed by IFRS 9.B5.5.51 which clearly requires the inclusion of expected prepayments.

The maximum period to consider when measuring expected credit losses is the maximum contractual period (including any extension option) over which the entity is exposed to credit risk. It cannot be a longer period, even if that longer period is consistent with business practice (IFRS 9.5.5.19). As a result, if an entity

¹³ ITG 22 April 2015: Expected Credit Losses – Measurement Date (Agenda Paper 7).



is in practice exposed over a longer period than the contractual period, this will not be considered in the ECL calculation. However, please note that revolving instruments may have to apply different principles (see **section 9.4.6.7**).

To achieve this analysis, the ITG considered that one must consider only the option at the hand of the borrower as identified in the ITG discussions reported here after.

ITG Discussions¹⁴

The question submitted to the ITG members on IFRS 9.5.5.19 requirements was about a portfolio composed of mortgage loans with the following features:

- > the loans have a stated maturity of 6 months but contain a contractual extension option that applies automatically subject to the lender's non-objection;
- > this portfolio is managed on a collective level and an individual credit review is not performed;
- > therefore, the lender will only object to the extension option when he has received a specific piece of information on the borrower.

In accordance with IFRS 9.5.5.19 requirements, 6 months should be considered as the maximum contractual period.

ITG members observed that IFRS 9 do not explain whether extensions options are analysed differently if they are at the hand of the borrower and/or of the lender. However, the standard requires entities to consider "the maximum contractual period (including extension options) over which the **entity is exposed** to credit risk". This wording implies that only the extension option at the borrower's hand is considered. In other words, if the lender cannot be forced to extend the credit, then the extension option is not taken into account in the maximum period of exposure to credit risk.

ITG members also clearly stated that it would not be appropriate to analyse this portfolio by analogy with the requirements that applies to certain revolving credit facilities that must be considered as an exception.

9.4.6.1.6. 12MECL vs Lifetime ECL

Under the general impairment approach, instruments for which there has been no significant deterioration of credit quality since their initial recognition date are classified in Stage 1 and their impairment allowance is calculated as the 12-month expected credit losses (12MECL).

Conversely, the instruments for which a significant deterioration in credit quality has been identified are classified in Stage 2 and must be impaired up to their Life Time expected Credit losses: LTECL. The LTECL will therefore correspond to the present value of all the credit losses the lender expects to bear until the maturity of the instrument.

12MECL is a portion of the LTECL. It represents the lifetime expected loss of credits due to a default event occurring within the next 12 months after the reporting date (IFRS 9.B5.5.43).

The main difference, on an operational level, between LTECL and 12MECL is therefore an adjustment of the probability of default parameter (PD). For LTECL the probability of default over the entire expected life of the instrument is considered, whereas for the purposes of calculating the 12MECL the probability of default will be limited to events expected to occur in the next 12 months.

¹⁴ ITG 22 April 2015: The maximum period to consider when measuring ECL (Agenda Paper 1).

12MECL calculation is however not limited to the contractual cash flows scheduled over the next 12 months as the entity assesses the consequences that an event of default, expected in the next 12 months, may have on the remaining expected lifetime cash flows.

Example 9.11

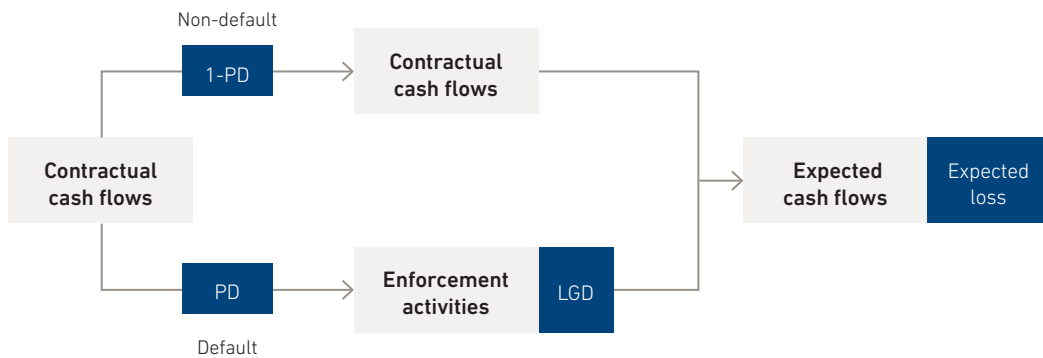
A bank carries a loan granted to entity A, with a nominal amount of CU100 and a residual maturity of 5 years. The principal of the loan will be repaid fully *in fine* at the end of year 5. Interests are paid at the end of each year. The bank believes that the probability that entity A default within the next 12 months is 1%. In case of default, the bank estimates its recovery at 50% of principal amount. In this case the 12MECL will be equal to $1\% \times 100 \times 50\% = \text{CU}0.5$. Thus, even if the analysis of the probability of default is limited to the next 12 months, the effect of this default on the final principal payment in year 5 is taken into account.

9.4.6.2. From IFRS 9 principles to most common ECL formulas

IFRS 9 does not prescribe a single methodology to determine ECL. In this section, we will illustrate how the IFRS 9 ECL calculation principles can be applied through the most common formula.

When measuring ECL, an entity need not identify every possible scenario (IFRS 9.5.5.18). However, at least two scenarios must be taken into account: one scenario reflecting the possibility of a credit loss occurring and one scenario reflecting the possibility of a credit loss not occurring.

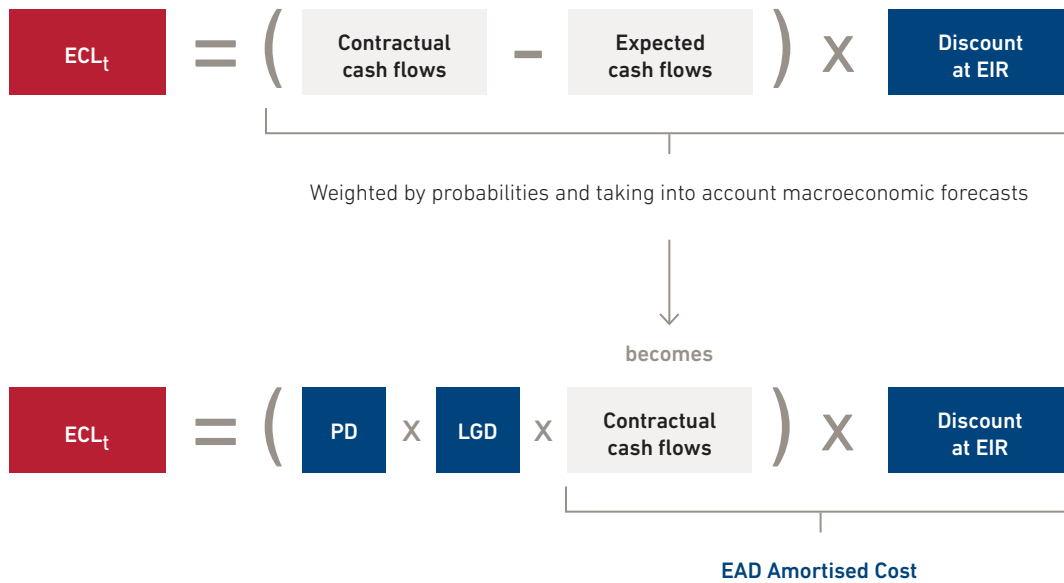
Figure 9.8



Where:
 PD : Probability of Default
 LGD : Loss Given Default

The next figure illustrates further how the ECL definition may be transposed into a more statistical approach.

Figure 9.9



Where:
 PD : Probability of Default
 LGD : Loss Given Default
 EAD : Exposure at Default

The last figure below presents an example of a formula that is commonly used for ECL calculation. The example is set for an instrument with a 3-year maturity.

Figure 9.10

That leads to the following common formula

$$ECL_{3 \text{ years}} = \sum_{i=1}^{3 \text{ years}} PD_i * LGD_i * \underbrace{EAD_i}_{CRD_i * (1 - Prep_i) * CCF_i} * \underbrace{FA_i}_{\frac{1}{(1 + EIR)^{i-1}}}$$

- PD_i : Probability of default of the year i
- LGD_i : Loss Given Default of the year i
- EAD_i : Amortised cost of the year i
 - > The amortised cost of the year i may be as at the mid-year or as at the beginning/end of the year
 - > The OSP (Out Standing Principal Amount) is modified by taking into account the prepayments (i.e. 1 - Prep)
 - > CCF or Credit Conversion Factor: it will be 100% for an asset and between 0 and 100% for an off-balance sheet instrument
- DF_i : Discounted Factor of the year i

The following example illustrates one way to calculate 12MECL using an explicit probability of default approach (IFRS 9.IE49).

Example 9.12

Scenario 1

Entity A originates a single 10-year amortising loan for CU1million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and the economic outlook for the next 12 months, Entity A estimates that the loan at initial recognition has a probability of default (PD) of 0.5 per cent over the next 12 months. Entity A also determines that changes in the 12-month PD are a reasonable approximation of the changes in the lifetime PD for determining whether there has been a significant increase in credit risk since initial recognition.

At the reporting date (which is before payment on the loan is due¹⁵), there has been no change in the 12-month PD and Entity A determines that there was no significant increase in credit risk since initial recognition. Entity A determines that 25 per cent of the gross carrying amount will be lost if the loan defaults (i.e. the LGD is 25 per cent)¹⁶. Entity A measures the loss allowance at an amount equal to 12-month expected credit losses using the 12-month PD of 0.5 per cent. Implicit in that calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12 month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

Scenario 2

Entity B acquires a portfolio of 1,000 five-year bullet loans for CU1,000 each (i.e. CU1million in total) with an average 12-month PD of 0.5 per cent for the portfolio. Entity B determines that because the loans only have significant payment obligations beyond the next 12 months, it would not be appropriate to consider changes in the 12-month PD when determining whether there have been significant increases in credit risk since initial recognition. At the reporting date Entity B therefore uses changes in the lifetime PD to determine whether the credit risk of the portfolio has increased significantly since initial recognition.

Entity B determines that there has not been a significant increase in credit risk since initial recognition and estimates that the portfolio has an average LGD of 25 per cent. Entity B determines that it is appropriate to measure the loss allowance on a collective basis in accordance with IFRS 9. The 12-month PD remains at 0.5 per cent at the reporting date. Entity B therefore measures the loss allowance on a collective basis at an amount equal to 12-month expected credit losses based on the average 0.5 per cent 12-month PD. Implicit in the calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12-month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

9.4.6.3. Focus on most commonly used parameters of ECL calculation**9.4.6.3.1. Probability of Default (PD)**

The probability of default is the probability that the debtor will:

- default in accordance with the definition retained by the entity (see **section 9.4.3.3**),
- within a given time horizon, usually, for IFRS 9 impairment purposes, over the next 12 months or over the lifetime of the instrument.

¹⁵ Thus for simplicity of illustration it is assumed there is no amortisation of the loan.

¹⁶ Because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money.



9.4.6.3.2. Exposure At Default (EAD)

The EAD to be considered is generally the amortised cost of the instrument at the date of default considered in the ECL measurement.

9.4.6.3.3. Loss Given Default (LGD), impact of collateral and guarantees

Even if it is certain that a debtor will default (PD = 100%) with an exposure of CU100 identified (EAD = 100), a lender may estimate that its expected credit loss is lower than CU100 either:

- because the lender expects to recover a portion of its exposure (rights upon liquidation of debtor, sale of the loan to a third party as a recovery method...); and/or
- because the loss is fully or partially compensated by a collateral mechanism or other kind of guarantee.

The aim of the Loss Given Default (LGD) is to capture the percentage of the exposure that will be lost if a default occurs.

The estimate of expected cash shortfalls on a collateralised financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable (i.e. the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Consequently, any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract should be included in this analysis. Any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset (IFRS 9.B5.5.55).

ECL must take into account the cash flows expected from collateral and other credit enhancements solely if they are:

- an integral part of the contractual terms of the instrument; and
- not separately recognised by the entity (to avoid any double counting).

Determining whether a collateral is an integral part of the contractual terms of the instrument may not be straightforward and will probably require to exercise judgement in many circumstances. An entity will also have to consider all relevant facts and circumstances.

Example 9.13

- > In January N a bank grants a loan to entity A. The contract does not require any specific guarantee mechanism.
- > In January N + 2, the bank chooses to purchase a credit protection against the risk of default of entity A (e.g. a financial guarantee). This credit protection is not disclosed to entity A and the contractual arrangement of the loan remains unchanged.
- > In this case, it will probably be difficult to establish that this protection is an integral part of the loan contract. Therefore, its accounting treatment will have to be implemented separately from the loan, and the calculation of the loan impairment allowance will not consider the existence of this protection.

IFRS 7 requires specific disclosure on the effect of collateral and other credit enhancement on ECL (see **chapter 16**).

9.4.6.3.4. Time value of money

ECL are discounted to the reporting date using the effective interest rate of the instrument, or an approximation of the latter (IFRS 9.B5.5.44).

In the case of leasing receivables, the ECL are discounted using the same discount rate as that for the measurement of lease receivables in accordance with IFRS 16 (IFRS 9.B5.5.45).

In the case of POCL assets, ECL calculation uses the credit adjusted effective interest rate of the instruments as discount factor (IFRS 9.B5.5.46).

If a financial instrument has a variable interest rate, its EIR may change from time to time depending on the change in interest rate market conditions. In such cases, the ECL are determined using the current EIR as discount factor. This ensures consistency between the rate used to determine both the interest rate income, the amortised cost of the instrument and its impairment allowance.

Determining the EIR of financial guarantee contracts or loan commitments may be challenging. When such EIR cannot be determined, the entity must apply a discount factor for ECL calculations that reflects the current market assessment of the time value of money (such as a benchmark interest rate) and the risks that are specific to the cash flows (such as a credit margin). However the entity should pay attention that if a given risk is reflected in the discount factor, it must not be taken twice into account by also adjusting the cash shortfall for the ECL calculation (IFRS 9.B5.5.48).

9.4.6.4. Interaction with regulatory data

Regulated financial institutions such as banks have already developed models and collected data for regulatory requirements. Most of these entities will thus be able to leverage on synergies between regulatory and IFRS requirements. However, the objective of the IFRS impairment approach is, to some extent, different from the objectives of banking regulatory requirements. The IASB mentioned in IFRS 9.BC5.286 that “the impairment requirement in IFRS 9 are based on the information available at the reporting date and are designed to reflect economic reality, instead of adjusting the assumptions and inputs applied to achieve a counter-cyclical effect”.

Therefore, if there is obviously an opportunity to leverage on the regulatory experience in credit risk data and monitoring, financial entities need to be aware of the need to include the relevant adjustments to regulatory data/parameters to meet the requirements of IFRS 9.

9.4.6.5. Information to be considered

9.4.6.5.1. All reasonable and supportable information must be considered

The ECL estimates must rely on **reasonable and supportable information** dealing with past events, current circumstances and forecasts of the future economic situation (Forward-looking information see **section 9.4.7.3**), that is **available at the closing date without having to incur unreasonable costs or efforts** (undue cost or effort) (IFRS 9.5.5.17(c)).

All information satisfying the above requirement is used both in the assessment of the occurrence of a SICR and the ECL estimation.

An entity may use several sources of data, internal sources (internal historical credit loss experience, internal ratings, etc.) as well as external sources (IFRS 9.B5.5.51).

9.4.6.5.2. Meaning of “without undue cost and effort”

This notion is repeatedly affirmed by IFRS 9 but is not clearly defined. It is legitimate to think that this notion of cost and effort will be appreciated with a higher level of requirement for a significant banking institution than for an industrial company whose credit risk management is not the most critical part of business. It is also likely that banking regulator requirements in credit risk monitoring will lead larger banks to have access to a larger range of qualitative and quantitative information.

Likely, banks will use the data present in their information systems. However, as sophisticated as its models may be, it should not disregard observable market information that is relevant for the IFRS 9 impairment requirements for a particular financial instrument or instruments with similar characteristics (IFRS 9.B5.5.54).

9.4.6.5.3. Historical information

As stated by IFRS 9.B5.5.52, historical data is an “important anchor or base” for the ECL estimation. Nevertheless, this historical information must be adjusted with current observable data or current forecast conditions. This process aims both at adjusting historical data for situations that are currently existing but did not exist in the past, and removing from historical data the effect of situations that do not exist anymore.

IFRS 9 explicitly mentions that, in some cases, unadjusted historical information may be the best reasonable and supportable information available.

9.4.6.5.4. Point In Time (PIT) information

The estimate of expected credit losses must reflect the economic situation existing at the closing date. Such an approach is often referred to as “Point In Time” approach.

On the opposite, approaches relying on averaged data determined over an economic cycle (Through The Cycle (TTC)) are often favoured for regulatory purposes.

The IASB considered TTC approaches but explicitly rejected them (IFRS 9.BC5.282 and following). Consequently, entities relying on regulatory data for IFRS 9 SICR assessment and ECL calculations may have to make some adjustments to the parameters to move from a TTC approach to a PIT approach.

9.4.6.5.5. Back-testing

A back-testing process and regular review of the methodology and assumptions used for estimating ECL must be implemented to reduce any differences between estimates and actual credit loss experience. This will also ensure that the overall methodology for calculating expected credit losses, including reprocessing of historical data or economic forecasts, allows a good quality of forecasts in accordance with the principles of the standard (IFRS 9.B5.5.52).

9.4.6.6. Examples of “non-PD approaches”

IFRS 9 does not require a specific ECL methodology. We have discussed in **sections 9.4.6.2 and 9.4.6.3** what we can call “PD-based” approaches. We will hereafter present examples of “non-PD approaches”.

9.4.6.6.1. A loss rate approach

Example 9.14: 12-month expected credit loss measurement based on a loss rate approach (IFRS 9.IE53)

Bank A originates 2,000 bullet loans with a total gross carrying amount of CU500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of CU200, for a total gross carrying amount of CU200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU300, for a total gross carrying amount of CU300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans. In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X’s loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss ^(a)	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	4	CU800	CU600	0.3%
Y	1,000	CU300	CU300,000	2	CU600	CU450	0.15%

(a) In accordance with paragraph 5.5.17(b) expected credit losses should be discounted using the effective interest rate. However, for purposes of this example, the present value of the observed loss is assumed.

At the reporting date, Bank A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Bank A estimates five defaults in the next 12 months for loans in Group X and three for loans in Group Y. It estimates that the present value of the observed credit loss per client will remain consistent with the historical loss per client.

On the basis of the expected life of the loans, Bank A determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios. On the basis of its forecasts, Bank A measures the loss allowance at an amount equal to 12-month expected credit losses on the 1,000 loans in each group amounting to CU750 and CU675 respectively. This equates to a loss rate in the first year of 0.375 per cent for Group X and 0.225 per cent for Group Y.

Group	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Expected defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	5	CU1,000	CU750	0.375%
Y	1,000	CU300	CU300,000	3	CU900	CU675	0.225%

Bank A uses the loss rates of 0.375 per cent and 0.225 per cent respectively to estimate 12-month expected credit losses on new loans in Group X and Group Y originated during the year and for which credit risk has not increased significantly since initial recognition.

9.4.6.6.2. Provision matrix for trade receivables

Example 9.15: Provision matrix

Company M, a manufacturer, has a portfolio of trade receivables of CU30 million in 20X1 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with IFRS 15 - *Revenue from Contracts with Customers*. In accordance with paragraph 5.5.15 of IFRS 9 the loss allowance for such trade receivables is always measured at an amount equal to lifetime time expected credit losses.

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 over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

On that basis, Company M estimates the following provision matrix:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

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

	Gross carrying amount	Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)
Current	CU15,000,000	CU45,000
1–30 days past due	CU7,500,000	CU120,000
31–60 days past due	CU4,000,000	CU144,000
61–90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	CU580,000

9.4.6.7. Revolving credit facilities and loan commitments specificities

9.4.6.7.1. SICR assessment, initial credit risk

When a financial asset is recognised following a draw-down on a loan commitment, the lender should perform the loan SICR assessment considering the initial credit risk of the loan commitment from the date that the entity became a party to the irrevocable commitment (IFRS 9.B5.5.47).

Revolving credit facilities may be partially drawn, reimbursed and then drawn again. Such agreement may also combine a drawn and an undrawn component. For the purpose of identifying the initial credit risk of both drawn and undrawn components, the entity applies the general principles mentioned above for loan commitments. Consequently, the initial credit risk of the contract is determined when the facility commitment becomes irrevocable; it will apply both to drawn and undrawn components, and should not change until the revolving facility is derecognised.

9.4.6.7.2. Estimating ECL beyond the maximum contractual period

When processing the ECL calculation, the general principle is to consider the maximum contractual period, including extension options, over which the entity is exposed to credit risk. Generally, this period cannot be longer than the contractual period even if the entity's practice is different. This means that if a lender has a contractual feature that allows him to withdraw his commitment with a short notice period, ECL estimation will be limited to such maximum contractual exposure period, even if the lender has a past practice of not using this feature (IFRS 9.5.5.19).

During the IFRS 9 consultation process, some respondents raised concerns about the consequences of this principle on ECL estimates for revolving facilities with a contractual right to cancel the commitment with a one-day prior notice. In practice, banks bearing such commitments rarely exercise their right before a significant increase in credit risk already exists. This practice exposes them over a period which is significantly longer than the "one-day period" used for ECL calculation.

The Board acknowledged this particularity by designing an exception for those very specific instruments. This exception requires to consider, for ECL estimates, the behavioural maturity (i.e. the period over which the lender is actually exposed) instead of the contractual maturity (IFRS 9.BC5.255).

However, the wording of this exception is not very clear and it has generated several ITG discussions and a webcast issued by some Board members¹⁷.

Scope of the exception:

This exception concerns financial instruments that meet both of the following conditions. They are instruments:

- that include both a loan and an undrawn component; and
- for which the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. (IFRS 9.5.5.20).

ITG members considered in April 2015 that the "the borrower has flexibility in how frequently they make drawdowns on the facility and consequently it is possible that the facility could be fully drawn or fully undrawn at the reporting date".

IFRS 9.B5.5.39 also lists characteristics **that are generally shared** by such instruments:

- the financial instruments do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day);
- the contractual ability to cancel the contract is not enforced in the normal day-to-day management of the financial instrument and the contract may only be cancelled when the entity becomes aware of an increase in credit risk at the facility level; and
- the financial instruments are managed on a collective basis.



Products that are commonly considered to be in the scope of this exception include credit card facilities and retail overdrafts. However, attention must be paid to such contract to ensure they meet the above-mentioned scoping conditions.

The exception affects the maturity to be considered, not the credit limit

It is important to underline that this behavioural exception will impact only the maturity parameter of the ECL calculation and not the amounts. This was discussed by ITG members in September 2015. ITG members noted that:

- the impairment approach in IFRS 9 is based on the contractual terms of a financial instrument;
- the exception for some types of revolving credit facilities set out in paragraph 5.5.20 of IFRS 9 relates **only to the contractual commitment period** and does not address the contractual credit limit. ITG members noted that the Standard was clear in this regard and consequently, it would not be appropriate to analogise this specific exception to the contractual credit limit.

¹⁷ <https://www.ifrs.org/webcast/?webcastid=1145211>

Determining the period to be retained for ECL estimation purposes

An entity applies IFRS 9.B5.5.40 requirements to determine the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions. An entity should consider factors such as historical information and experience about:

- the period over which the entity was exposed to credit risk on similar financial instruments;
- the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and
- the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

The figure below was presented during the IASB webcast to illustrate the relationship between management actions and the expected life to be considered for ECL estimation:

Figure 9.11

	Entity A	Entity B	Entity C
Resulting actions	No mitigation actions	Mitigation actions taken for some facilities that increase in credit risk	Mitigation actions taken for all increases in credit risk
Effect on the expected life	No limiting of the expected life	The expected life for some facilities shortened	The expected life shortened for all facilities expected to increase in credit risk

ITG members considered in December 2015 how to determine the ending-point of the maximum period to consider when measuring expected credit losses in accordance with IFRS 9.B5.5.40¹⁸ and more specifically which credit risk management actions are taken into account in making this determination.

An entity considers all credit management actions that the entity **expects** to really enforce and that serve to either **terminate** or **limit** the credit risk.

Therefore, it is not possible to consider all the legal or operationally possible actions if they are not enforced.

In determining which credit risk management actions an entity expects to take, ITG members observed that an entity's expected actions must be based on reasonable and supportable information. In this regard, consideration should be given to an entity's normal credit risk mitigation process, past practice and future intentions.

¹⁸ IFRS 9.B5.5.40 when determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity's normal credit risk management actions, ..."

They explain that the entity's next review process can be sustained as an expected limit only if the entity's normal practice is to take credit risk mitigation actions as part of this process.

As the estimation of the maximum period to consider in accordance with IFRS 9.B5.5.40 would require judgement, IFRS 7-related *disclosure requirements* (such as explaining inputs, assumption and estimation techniques in relation to ECL) would be important.

The following example from IFRS 9 illustrate further the principles mentioned in this section (IFRS 9.IE58).

Example 9.16

Bank A provides co-branded credit cards to customers in conjunction with a local department store. The credit cards have a one-day notice period after which Bank A has the contractual right to cancel the credit card (both the drawn and undrawn components). However, Bank A does not enforce its contractual right to cancel the credit cards in the normal day-to-day management of the instruments and only cancels facilities when it becomes aware of an increase in credit risk and starts to monitor customers on an individual basis. Bank A therefore does not consider the contractual right to cancel the credit cards to limit its exposure to credit losses to the contractual notice period.

For credit risk management purposes Bank A considers that there is only one set of contractual cash flows from customers to assess and does not distinguish between the drawn and undrawn balances at the reporting date. The portfolio is therefore managed and expected credit losses are measured on a facility level.

At the reporting date the outstanding balance on the credit card portfolio is CU60,000 and the available undrawn facility is CU40,000. Bank A determines the expected life of the portfolio by estimating the period over which it expects to be exposed to credit risk on the facilities at the reporting date, taking into account:

- > the period over which it was exposed to credit risk on a similar portfolio of credit cards;
- > the length of time for related defaults to occur on similar financial instruments; and
- > past events that led to credit risk management actions because of an increase in credit risk on similar financial instruments, such as the reduction or removal of undrawn credit limits.

On the basis of the information listed above, Bank A determines that the expected life of the credit card portfolio is 30 months.

At the reporting date Bank A assesses the change in the credit risk on the portfolio since initial recognition and determines that the credit risk on a portion of the credit card facilities representing 25 per cent of the portfolio, has increased significantly since initial recognition. The outstanding balance on these credit facilities for which lifetime expected credit losses should be recognised is CU20,000 and the available undrawn facility is CU10,000.

When measuring the expected credit losses in accordance with paragraph 5.5.20 of IFRS 9, Bank A considers its expectations about future drawdowns over the expected life of the portfolio (i.e. 30 months) in accordance with paragraph B5.5.31 and estimates what it expects the outstanding balance (i.e. exposure at default) on the portfolio would be if customers were to default. By using its credit risk models Bank A determines that the exposure at default on the credit card facilities for which lifetime expected credit losses should be recognised, is CU25,000 (i.e. the drawn balance of CU20,000 plus further drawdowns of CU5,000 from the available undrawn commitment). The exposure at default of the credit card facilities for which 12-month expected credit losses are recognised, is CU45,000 (i.e. the outstanding balance of CU40,000 and an additional drawdown of CU5,000 from the undrawn commitment over the next 12 months).

The exposure at default and expected life determined by Bank A are used to measure the lifetime expected credit losses and 12-month expected credit losses on its credit card portfolio.

Bank A measures expected credit losses on a facility level and therefore cannot separately identify the expected credit losses on the undrawn commitment component from those on the loan component. It recognises expected credit losses for the undrawn commitment together with the loss allowance for the loan component in the statement of financial position. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be presented as a provision (in accordance with IFRS 7 - *Financial Instruments: Disclosure*).

9.4.6.7.3. ECL calculation: drawdown expectations

Because the Board considers the consistency of application of the impairment approach as a priority, these instruments are analysed as “only one set of cash flows from the borrower that relates to both components” i.e. drawn and undrawn components (IFRS 9.BC244 & 259).

In other words, the ECL will be consistent with the entity’s expectations of drawdowns even if the Board acknowledged that it will comprise a certain level of complexity (IFRS 9.BC5.247).

Therefore, the credit loss will be the present value of the difference between (IFRS 9.B5.5.30):

- “the contractual cash flows that are due to the entity 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.”

For the 12 months ECL calculation, an entity estimates the expected drawdown within the next 12 months whereas for the Lifetime ECL, it estimates the expected drawdown over the expected life of the instrument (IFRS 9.B5.5.31).

Concerning the expectations of drawdowns, please note the approaches considered but rejected by the Board (IFRS 9.BC5.246):

- limiting the estimate of future drawdowns to the next 12 months;
- estimating the expected drawdowns only on the grounds of historical information. Relevant adjustments should be made for reflecting both the current and future economic conditions;
- using the credit conversion factor provided by prudential regulators as generally they are standardised parameters.

9.4.7. Forward-looking information

The use of forward-looking information is both a new concept and one of the most judgemental areas of the IFRS 9 impairment approach. The combination of these two facts explains why the implementation of this new concept has been largely discussed since the publication of IFRS 9. In this section, we present the main principles attached to this concept and some guidance on how to apply it. We refer for this to ITG discussions (April and September 2015) as well as to an IASB Webcast dedicated to this topic in 2016¹⁹.

¹⁹ webcast “IFRS 9 forward-looking information and multiple scenarios” July 2016.

<https://www.ifrs.org/-/media/project/financial-instruments/webcast-july-2016/ifrs9-webcast-july-2016-slides.pdf?la=en>

9.4.7.1. When forward-looking information is needed and why

All along its impairment approach, IFRS 9 requires the consideration of all reasonable and supportable information that includes forecasts of future economic conditions often referred to as “forward-looking information”. The objective of the Board in introducing this forward-looking information into the impairment approach is to ensure that losses will be considered soon enough by taking into account the future macroeconomic evolutions the entity expects will occur.

Forward-looking information is used both for:

- the Significant Increase in Credit Risk assessment (see **section 9.4.3.2**), and
- the ECL estimation (see **section 9.4.6**).

9.4.7.2. Implementation methodology

9.4.7.2.1. IFRS 9 does not prescribe a specific method

In its webcast²⁰, the Board clarified that IFRS 9 does not prescribe any specific approach to incorporate forward-looking scenarios in the SICR assessment process and ECL estimation.

Different approaches were mentioned. The list is not exhaustive, but it is interesting to note that not all are statistical approaches (no further details were provided):

- single scenario with a scalar adjustment,
- probability weighted ELC based on “n” number of scenarios,
- Monte Carlo simulation.

9.4.7.2.2. Differentiated incorporation of forward-looking information

ITG Discussions

The ITG considered in September 2015 whether forward-looking information, including macroeconomic information, should be incorporated into the determination of expected credit losses in a **differentiated way for example, country by country and/or portfolio by portfolio**.

ITG members confirmed that, as noted in (IFRS 9.B5.5.16), different factors may be relevant to different financial instruments depending on the specific drivers of credit relevant for this group.

For example, IFRS 9.IE29 and following, mentions a situation where expectations about future levels of unemployment in a specific industry and specific region are only relevant to a sub-portfolio of mortgage loans in which the borrowers work in that industry in that specific region.

Conversely, if different financial instruments or portfolios being assessed share some similar risk characteristics, then relevant forward-looking information is applied in a comparable and consistent manner to reflect those similar characteristics.

²⁰ Webcast “IFRS 9 forward-looking information and multiple scenarios” July 2016.
<https://www.ifrs.org/-/media/project/financial-instruments/webcast-july-2016/ifrs9-webcast-july-2016-slides.pdf?la=en>



9.4.7.2.3. Need for a multi-scenario approach

During its Webcast, the Board explicated that the need for a multiple scenario approach depends on an assessment that relies on the concept of non-linearity.

A single forward-looking scenario is not sufficient when the relationship is not linear. This could happen when:

- the relationship between the forward-looking scenarios and the changes in credit risk is not linear.

As an example, depending on the initial level of unemployment rate, an increase of 1 bp implies a different increase in the credit risk; or

- when the relationship between the forward-looking scenarios and the changes in ECL measurement is not linear.

This second relationship is more complex to analyse because the non-linearity could result from one or from several key parameters of the ECL. As an example, a non-linear relationship can exist between the risk of a default occurring and the unemployment rate, or between credit losses arising on default and the House price index.



IFRS 9 does not provide information about how many scenarios should be considered.

We have generally seen in practice a three-scenario approach (one unfavourable scenario, a base scenario and a favourable scenario). However, some entities consider up to five scenarios.

When a multi-scenario approach is relevant, preparers must pay specific attention to the following steps:

- selection of the scenarios; and
- assessment of the probability of occurrence of each scenario.

9.4.7.2.4. Application to a non-PD SICR assessment approach

A non-PD approach is a SICR assessment approach which relies on non-statistical and/or qualitative factors.

In the case of such an approach, the IASB noted during its Webcast²¹ that an entity does not exclude qualitative forward-looking information when assessing the occurrence of SICR. SICR assessment could rely both on quantitative and qualitative information.

9.4.7.3. Information to be considered

9.4.7.3.1. Time horizon of economic forecast

When taking into account forward-looking information, it is not necessary to integrate economic forecasts over the entire life of the instrument. In fact, the more the forecasts are for distant periods, the less detailed information is available, and the more important the use of judgement is (IFRS 9.B5.5.50).

²¹ Webcast "IFRS 9 forward-looking information and multiple scenarios" July 2016.

<https://www.ifrs.org/-/media/project/financial-instruments/webcast-july-2016/ifrs9-webcast-july-2016-slides.pdf?la=en>



In practice, forward-looking information may be “*observable*” (IFRS 9.B5.5.54) and reliably estimated over the next 3 to 5 years. But these figures are highly dependent on the fact and circumstances and the economic environment of the transaction. Beyond that time horizon, the entity will generally adjust the effect of forward-looking parameters to progressively revert to current long-term average parameters.

9.4.7.3.2. Reasonable and supportable

ITG Discussions

The ITG members discussed in September 2015 how to determine whether forward-looking information is sufficiently reasonable and supportable to be included in an IFRS 9 impairment approach. The question is particularly relevant within the context of information about emerging issues and uncertain future events that is usually not included in an entity’s current budgeting and forecasting processes.

ITG members acknowledge that identifying reasonable and supportable relevant information and determining its impact on ECL measurement requires a high level of judgement and could be a challenging area. However, a piece of information must not be excluded simply because it has a low probability to occur, or the effect of that information on the credit risk or the amount of ECL is uncertain.

ITG members emphasised that an entity must make an effort in good faith to estimate the impact of uncertain future events, including second-order effects, on the credit risk of financial instruments and the measurement of expected credit losses.

ITG members made several observations on the importance of disclosures on relevant forward-looking information (see **chapter 16**).

9.4.7.3.3. Cut-off requirements

Economic forecasts used to satisfy forward-looking requirements are generally prepared some weeks before the end of the reporting period. The ITG discussed whether and how to incorporate events and forecasts that occur:

- after economic forecasts were made but before the end of the reporting period;
- between the reporting period end, and the publication date of the financial statements (i.e. when the financial statements are authorised for issue).

ITG members considered this issue in April 2015 and noted that reasonable and supportable new information that becomes available before the end of the reporting period must be taken into account in any case.

The second issue relates more to IAS 10 - *Events after the Reporting Period*, requirements. However, ITG members considered that IFRS 9 ECL are a probability-weighted estimate of credit losses **at the reporting date**. Accordingly, the determination of ECL takes into consideration relevant possible future scenarios based on a range of expectations at the reporting date, using the information available at that date. Hence, the movements in interest rates (or outcome of a public vote) are taken into consideration but with the probabilities attached to them at that date. These probabilities will rely on information available at the end of the reporting period.

9.4.7.3.4. Consistency of assumptions made

It is important to keep in mind that all judgements and assumptions made in the IFRS 9 impairment approach, taken as whole, must be internally consistent. Therefore, forward-looking assumptions used for the SICR assessment must be consistent with those used for the ECL calculation. Nevertheless, some circumstances could exist in which a macroeconomic parameter might have an impact in the measurement of ECL and not on the assessment of SICR (or vice-versa).

Moreover, assumptions made, especially with regards to the general economic environment, must also be consistent with assumptions made by the entity in the general context of preparing its financial statements. Other estimations requiring significant areas of judgement that may be influenced by macroeconomic parameters are

- Impairment of goodwill impairment,
- asset-Liability Management particularly concerning interest rate provisions, and
- deferred tax.

9.4.8. Modified financial assets

Any modification performed on a financial asset may have consequences on its contractual cash flows as well as on the credit risk profile of an entity. Therefore, situations of financial asset modifications must be carefully analysed to determine the appropriate consequences on the impairment allowance to be recognised under IFRS 9.

The accounting consequences are very different depending on whether the modification triggers asset derecognition or not.

9.4.8.1. Determining whether a financial asset modification triggers its derecognition

When the cash flows of a financial asset are modified or renegotiated, a derecognition analysis must be performed. The driving principle is that a financial asset must be derecognised if the contractual rights to the cash flows expire or if the terms of the financial asset have substantially changed. This analysis requires judgement and is further discussed in **chapters 10** and **11**.

9.4.8.2. Impacts when the modified asset is not derecognised

9.4.8.2.1. Accounting Impact at the modification date

When the modified asset is not derecognised, a new gross carrying amount is calculated by discounting the new contractual cash flows with the original EIR.

Any cost or fees incurred by this modification are amortised over the remaining term (IFRS 9.5.4.3) and therefore consequently adjust the new gross carrying amount.

The difference between the former and the new gross carrying amounts is recognised in profit or loss as a modification gain or loss (IFRS 9.5.4.3).

9.4.8.2.2. Impact on the SICR assessment

As the original asset is retained on the balance sheet, the SICR assessment is performed in relation to its initial level of credit risk, i.e. at its origination date (and not at the modification date)



There are situations where due to the financial difficulties of the debtor, the amortisation profile of a debt instrument is modified to be more aligned to the debtor's repayment capacity. This type of renegotiation may help to limit the risk of default of the debtor in relation to the situation before renegotiation. However, this renegotiation alone is not enough to justify that the credit quality of this instrument has improved significantly to trigger change of impairment stage.

9.4.8.3. Impacts when the modified asset is derecognised

When a new asset is recognised on the balance sheet following a cash flow modification, a specific analysis dealing with the existence or not of incurred credit loss is performed at that date. In other words, is the new asset an Originated Credit-Impaired asset (POCI) or not (see **section 9.4.5**)?

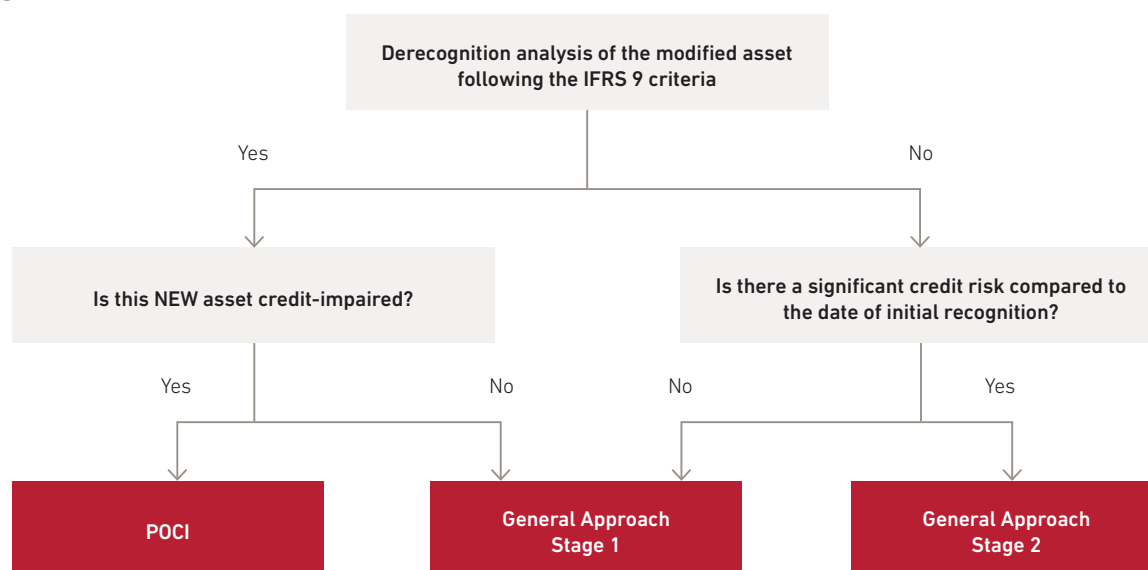
- If it appears that the new asset is not credit-impaired and therefore is not a POCI, then it will follow the rules of the general approach: The financial asset is classified in Stage 1 as any other newly recognised financial asset and the subsequent SICR analysis will be performed from the renegotiation date.
- If it appears that the new asset is credit-impaired (see **section 9.4.8.3** for the criteria to be applied), it is accounted for as a POCI (see **section 9.4.5**).



As stated by IFRS 9.B5.5.26, the recognition of a POCI following a debt restructuring is not expected to be a frequent scenario. It may however occur when a distressed asset is significantly modified.

9.4.8.4. In a nutshell, what is the methodology in the case of a modification of the cash flows?

Figure 9.12



9.4.8.5. Illustrative Example N° 11: modification of contractual cash flows

Example 9.17: Modification of contractual cash flows (IFRS 9.IE66)

Bank A originates a five-year loan that requires the repayment of the outstanding contractual amount in full at maturity. Its contractual par amount is CU1,000 with an interest rate of 5 per cent payable annually. The effective interest rate is 5 per cent. At the end of the first reporting period (Period 1), Bank A recognises a loss allowance at an amount equal to 12-month expected credit losses because there has not been a significant increase in credit risk since initial recognition. A loss allowance balance of CU20 is recognised.

In the subsequent reporting period (Period 2), Bank A determines that the credit risk on the loan has increased significantly since initial recognition. As a result of this increase, Bank A recognises lifetime expected credit losses on the loan. The loss allowance balance is CU30.

At the end of the third reporting period (Period 3), following significant financial difficulty of the borrower, Bank A modifies the contractual cash flows on the loan. It extends the contractual term of the loan by one year so that the remaining term at the date of the modification is three years. The modification does not result in the derecognition of the loan by Bank A.

As a result of that modification, Bank A recalculates the gross carrying amount of the financial asset as the present value of the modified contractual cash flows discounted at the loan's original effective interest rate of 5 per cent. In accordance with paragraph 5.4.3 of IFRS 9, the difference between this recalculated gross carrying amount and the gross carrying amount before the modification is recognised as a modification gain or loss. Bank A recognises the modification loss (calculated as CU300) against the gross carrying amount of the loan, reducing it to CU700, and a modification loss of CU300 in profit or loss. Bank A also remeasures the loss allowance, taking into account the modified contractual cash flows and evaluates whether the loss allowance for the loan must continue to be measured at an amount equal to lifetime expected credit losses. Bank A compares the current credit risk (taking into consideration the modified cash flows) to the credit risk (on the original unmodified cash flows) at initial recognition. Bank A determines that the loan is not credit-impaired at the reporting date but that credit risk has still significantly increased compared to the credit risk at initial recognition and continues to measure the loss allowance at an amount equal to lifetime expected credit losses. The loss allowance balance for lifetime expected credit losses is CU100 at the reporting date.



Period	Beginning gross carrying amount	Impairment (loss)/gain	Modification (loss)/gain	Interest revenue	Cash flows	Ending gross carrying amount	Loss allowance	Ending amortised cost amount
	A	B	C	D Gross: A × 5%	E	F = A + C + D - E	G	H = F - G
1	CU1,000	(CU20)		CU50	CU50	CU1,000	CU20	CU980
2	CU1,000	(CU10)		CU50	CU50	CU1,000	CU30	CU970
3	CU1,000	(CU70)	(CU300)	CU50	CU50	CU700	CU100	CU600

At each subsequent reporting date, Bank A evaluates whether there is a significant increase in credit risk by comparing the loan's credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows), in accordance with paragraph 5.5.12 of IFRS 9.

Two reporting periods after the loan modification (Period 5), the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. An assessment of all reasonable and supportable information that is available without undue cost or effort indicates that the overall credit risk on the loan has decreased and that the risk of a default occurring over the expected life of the loan has decreased, so Bank A adjusts the borrower's internal credit rating at the end of the reporting period.

Given the positive overall development, Bank A re-assesses the situation and concludes that the credit risk of the loan has decreased and there is no longer a significant increase in credit risk since initial recognition. As a result, Bank A once again measures the loss allowance at an amount equal to 12-month expected credit losses.

9.4.9. Presentation of Expected Credit Loss (ECL) in the financial statements

9.4.9.1. On the balance sheet, the presentation depends on the accounting category

The presentation of ECL on the balance sheet differs according to the accounting categories of the related financial instruments.

We recall some key definitions hereafter (IFRS 9 Appendix A):

— **Loss allowance:**

- > the allowance for ECL for instruments at amortised cost, lease receivables and contract assets;
- > the accumulated impairment amount for the instruments at FV-OCI; and
- > the provision for ECL on off-balance sheet items (loan commitments, financial guarantee contracts).

— **Gross carrying amount** is the amortised cost of a financial asset before adjustment for any loss allowance.

- > **Amortised cost** is the amount that is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the Effective Interest Method, **adjusted for any loss allowance** (see **chapter 2**).

9.4.9.1.1. Financial instruments at Amortised Cost (AC):

There is no requirement to present the loss allowance on a separate line in the statement of financial position. This was confirmed by the ITG discussions in December 2015.

ITG Discussions²²

The question submitted was whether it is required to present the loss allowance for financial assets measured at Amortised Cost (or trade receivables, contract assets or lease receivables) separately in the statement of financial position.

ITG members noted that neither IFRS 9 nor IFRS 7 contain any such requirement.

They noted also that IAS 1.54 does not list the loss allowance as an amount that is required to be separately presented on the face of the statement of financial position. Nevertheless, they insisted on the fact that the financial statements must present fairly the financial position of an entity.

9.4.9.1.2. Financial instruments at Fair Value Through OCI (FV-OCI)

The instruments recognised in this accounting category are measured at their fair value. Therefore, no loss allowance can reduce their carrying amount (IFRS 9.5.5.2). Instead, this loss allowance, so called “accumulated impairment amount” by IFRS 9, is recognised and presented separately in OCI.

Example 9.18: Debt instrument measured at fair value through other comprehensive income (IFRS 9. IE78)

An entity purchases a debt instrument with a fair value of CU1,000 on 15 December 20X0 and measures the debt instrument at fair value through other comprehensive income. The instrument has an interest rate of 5 per cent over the contractual term of 10 years. Its effective interest rate is also 5 per cent. At initial recognition, the entity determines that the asset is not purchased or originated credit-impaired.

	Debit	Credit
Financial asset—FVOCI(a)	CU1,000	
Cash		CU1,000

(To recognise the debt instrument measured at its fair value)

(a) FVOCI means fair value through other comprehensive income.

²² ITG 11 December 2015: Presentation of the loss allowance for financial assets measured at amortised cost (Agenda Paper 10)



On 31 December 20X0 (the reporting date), the fair value of the debt instrument has decreased to CU950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that expected credit losses should be measured at an amount equal to 12-month expected credit losses, which amounts to CU30. For simplicity, journal entries for the receipt of interest revenue are not provided.

	Debit	Credit
Impairment loss (profit or loss)	CU30	
Other comprehensive income ^(a)	CU20	CU1,000
Financial asset—FVOCI		CU50

(To recognise 12-month expected credit losses and other fair value changes on the debt instrument)

(a) The cumulative loss in other comprehensive income at the reporting date was CU20. That amount consists of the total fair value change of CU50 (ie CU1,000 – CU950) offset by the change in the accumulated impairment amount representing 12-month expected credit losses that was recognised (CU30).

Disclosure would be provided about the accumulated impairment amount of CU30.

On 1 January 20X1, the entity decides to sell the debt instrument for CU950, which is its fair value at that date.

	Debit	Credit
Cash	CU950	
Financial asset—FVOCI		CU950
Loss (profit or loss)	CU20	
Other comprehensive income		CU20

(To derecognise the fair value through other comprehensive income asset and recycle amounts accumulated in other comprehensive income to profit or loss)

9.4.9.1.3. Off-balance sheet (OBS)

According to IFRS 9 Appendix A, ECL on the off-balance sheet items (for instance, loan commitment or financial guaranty) must be presented as a provision.

This is consistent with IAS 1.54 l) that requires separate presentation of provisions explicitly.

IFRS 7.B8E adds that an entity should disclose information about the changes in the loss allowance for financial assets separately from those for loan commitments and financial guarantee contracts. However, if a financial instrument includes both a loan (i.e. financial asset) and an undrawn commitment (i.e. loan commitment) component and the entity cannot separately identify the expected credit losses on the loan commitment component from those on the financial asset component, the expected credit losses on the loan commitment should be recognised together with the loss allowance for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognised as a provision.

9.4.9.2. Presentation in Profit or Loss

IFRS 9.5.5.8 states that any increase or decrease in the ECL that is required to adjust the loss allowance at the reporting date is recognised in profit or loss as an impairment gain or loss.

According to IAS 1.82(ba) these ECL impacts are disclosed on a dedicated line of the profit or loss.



For the banking sector, this means that the ECL allowance is presented in the cost of credit risk (subpart of the profit or loss) whereas the interest income of the Amortised Cost of a FV-OCI instrument will be presented separately within Net Banking Interests.

9.4.9.3. Focus on assets classified in Stage 3

For financial instruments that become credit impaired (to be distinguished from the financial instruments that are credit-impaired since their initial recognition) and that are therefore transferred to Stage 3, IFRS 9.5.4.1(b) requires that their interest revenue be calculated by applying the EIR to the amortised cost (i.e. net of impairment allowance) of the instrument.

In December 2015, the ITG further discussed how this principle interacts with the definition of gross carrying amount and loss allowance.

ITG Discussions²³

The issue relates to the measurement of gross carrying amount and loss allowance for financial instruments that are measured at amortised cost and that are credit impaired (but not purchased nor originated credit-impaired).

On such specific case, the submitter raised a potential implementation issue about how the interest revenue recognised interacts with the calculation of the gross carrying amount and the loss allowance.

This potential issue submitted was illustrated by the following example:

- > An entity holds a financial asset (that is not a POCl) measured at amortised cost which the following characteristics:
 - Gross carrying amount (before deducting the ECL) = CU100 at 31 December 20X1
 - Its effective interest rate is 10%
 - On 31 December 20X1, this asset becomes credit-impaired and the ECL goes up to CU60
 - Accordingly, its amortised cost is CU40 at 31 December 20X1

At 31 December 20X2:

- There are no cash settlements, no changes in the expected cashflows
- In accordance with IFRS 9.5.4.1(b) the interest revenue for the year 20X2 is CU4 = CU40 x 10%
- Therefore, the amortised cost at 31 December 20X2 will be CU44 = CU40 x (1 + 10%)

²³ ITG 11 December 2015: Loss allowance for credit impaired financial assets (Agenda Paper 9)



Given all these elements, the calculation of the loss allowance and gross carrying amount at 31 December 20X2 can follow three possible approaches:

	Approach A	Approach B	Approach C
Gross carrying amount	110	104	100
Loss allowance	(66)	(60)	(56)
Amortised cost	44	44	44

In the view of the ITG members, Approach A is the only approach consistent with IFRS 9 on the following grounds:

- > the gross carrying amount reflects the contractual cash flows discounted by the original EIR;
- > the amortised cost reflects the expected cash flows discounted by the original EIR;
- > hence, the Lifetime ECL as the difference between the gross carrying amount and the amortised cost represents the expected cash shortfalls discounted by the original EIR.

9.4.10. Interaction with hedge accounting

9.4.10.1. Technical and complex interactions

IFRS 9 does not explicitly address the issues raised by the interaction between hedge accounting and impairment. However, as both relate directly to future cash flows of the entities they arguably interact. Without claiming to be exhaustive, we list below some examples of such interactions.

9.4.10.1.1. Credit risk of a hedged financial asset and hedge effectiveness criterion

One of the effectiveness criteria that IFRS 9 requires in applying hedge accounting is that the effect of credit risk must not dominate the value changes attributable to the hedged risk (see **section 14.5.3.2**).

Once a financial asset becomes credit impaired (enters stage 3), the entity considers that one or several events have a detrimental impact on the estimated cash flows. Even though there is no direct link between this staging process and the hedge effectiveness requirement within IFRS 9, entities may in practice consider that the hedge effectiveness requirements are no longer met once an asset is classified in Stage 3. However, one must pay attention to the following:

- there may be situations where an asset classified in Stage 2 could fail the effectiveness requirement of hedge accounting;
- conversely, the staging approach relies solely on the probability of default without considering the loss given default (LGD). Therefore, if the LGD is very low, it could be demonstrated that, even for a Stage 3 asset, the credit risk component does not dominate the value change attributable to the hedged risk.

9.4.10.1.2. Impact of a fair value hedge relationship on EIR and amortised cost

IFRS 9.6.5.8(b) indicates that, in a fair value hedge relationship, the hedging gain or loss on the hedged item adjusts its carrying amount. IFRS 9.6.5.10 explains further that any adjustment arising from paragraph 6.5.8(b) is amortised to profit or loss if the hedged item is a financial instrument. Amortisation may begin as soon as an adjustment exists and must begin no later than when the hedged item ceases to be adjusted for hedging gains and losses. The amortisation is based on a recalculated EIR at the date that amortisation begins.

As discussed in **section 9.4.6**, EIR and the carrying amount of a debt instrument that is subject to impairment are key factors for ECL computation.



The EIR of an asset hedged in a fair value hedge relationship must be adjusted no later than when the amortisation of the hedged item revaluation begins. The amortisation may begin only when the hedged item ceases to be adjusted for hedging gains or losses. Therefore, in our opinion, there is no need to adjust the EIR before then.

9.4.10.2. Interaction between the FV-OCI category and foreign currency denomination, fair value hedge accounting and impairment

The example below is based on illustrative example 14 of IFRS 9 (IFRS 9.IE82-102). It illustrates further the interaction between fair value hedge and impairment for a debt instrument denominated in a foreign currency, measured at fair value through other comprehensive income and designated in a fair value hedge accounting relationship.

Example 9.19: Interaction between the fair value through other comprehensive income measurement category and foreign currency denomination, fair value hedge accounting and impairment (IFRS 9.IE82)

An entity purchases a debt instrument (a bond) denominated in a foreign currency (FC) for its fair value of FC100,000 on 1 January 20X0 and classifies the bond as measured at fair value through other comprehensive income. The bond has five years remaining to maturity and a fixed coupon of 5 per cent over its contractual life on the contractual par amount of FC100,000. On initial recognition the bond has a 5 per cent effective interest rate. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1 on 1 January 20X0. At initial recognition the entity determines that the bond is not purchased or originated credit-impaired. In addition, as at 1 January 20X0 the 12-month expected credit losses are determined to be FC1,200. Its amortised cost in FC as at 1 January 20X0 is equal to its gross carrying amount of FC100,000 less the 12-month expected credit losses (FC100,000—FC1,200).

The entity has the following risk exposures:

- > (a) fair value interest rate risk in FC: the exposure that arises as a result of purchasing a fixed interest rate instrument; and
- > (b) foreign exchange risk: the exposure to changes in foreign exchange rates measured in LC.

The entity hedges its risk exposures using the following risk management strategy:

- > (a) for fixed interest rate risk (in FC) the entity decides to link its interest receipts in FC to current variable interest rates in FC. Consequently, the entity uses interest rate swaps denominated in FC under which it pays fixed interest and receives variable interest in FC; and



- > (b) for foreign exchange risk the entity decides not to hedge against any variability in LC arising from changes in foreign exchange rates.

The entity designates the following hedge relationship²⁴: a fair value hedge of the bond in FC as the hedged item with changes in benchmark interest rate risk in FC as the hedged risk. The entity enters into an on-market swap that pays fixed and receives variable interest on the same day and designates the swap as the hedging instrument. The tenor of the swap matches that of the hedged item (i.e. five years).

For simplicity, in this example it is assumed that no hedge ineffectiveness arises in the hedge accounting relationship. This is because of the assumptions made in order to better focus on illustrating the accounting mechanics in a situation that entails measurement at fair value through other comprehensive income of a foreign currency financial instrument that is designated in a fair value hedge relationship, and also to focus on the recognition of impairment gains or losses on such an instrument.

The entity makes the following journal entries to recognise the bond and the swap on 1 January 20X0:

	Debit LC	Credit LC
Financial asset—FVOCI	100,000	
Cash		100,000
(To recognise the bond at its fair value)		
Impairment loss (profit or loss)	1,200	
Other comprehensive income		1,200
(To recognise the 12-month expected credit losses)(a)		
Swap	0	
Cash		0
(To recognise the swap at its fair value)		
(a) In case of items measured in the functional currency of an entity the journal entry recognising expected credit losses will usually be made at the reporting date.		

As of 31 December 20X0 (the reporting date), the fair value of the bond decreased from FC100,000 to FC96,370 because of an increase in market interest rates. The fair value of the swap increased to FC1,837. In addition, as at 31 December 20X0 the entity determines that there has been no change to the credit risk on the bond since initial recognition and continues to carry a loss allowance for 12-month expected credit losses at FC1,200²⁵. As at 31 December 20X0, the exchange rate is FC1 to LC1.4. This is reflected in the following table:

²⁴ This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 6.4.1 of IFRS 9). The following description of the designation is solely for the purpose of understanding this example (i.e. it is not an example of the complete formal documentation required in accordance with paragraph 6.4.1 of IFRS 9).

²⁵ For the purpose of simplicity the example ignores the impact of discounting when computing expected credit losses.

	1 January 20X0	31 December 20X0
Bond		
Fair value (FC)	100,000	96,370
Fair value (LC)	100,000	134,918
Amortised cost (FC)	98,800	98,800
Amortised cost (LC)	98,800	138,320
Interest rate swap		
Interest rate swap (FC)	–	1,837
Interest rate swap (LC)	–	2,572
Impairment – loss allowance		
Loss allowance (FC)	1,200	1,200
Loss allowance (LC)	1,200	1,680
FX rate (FC:LC)	1:1	1:1.4

The bond is a monetary asset. Consequently, the entity recognises the changes arising from movements in foreign exchange rates in profit or loss in accordance with paragraphs 23(a) and 28 of IAS 21 - *The Effects of Changes in Foreign Exchange Rates*, and recognises other changes in accordance with IFRS 9. For the purposes of applying paragraph 28 of IAS 21 the asset is treated as an asset measured at amortised cost in the foreign currency.

As shown in the table, on 31 December 20X0 the fair value of the bond is LC134,918 (FC96,370 × 1.4) and its amortised cost is LC138,320 (FC(100,000–1,200) × 1.4).

The gain recognised in profit or loss that is due to the changes in foreign exchange rates is LC39,520 (LC138,320 – LC98,800), i.e. the change in the amortised cost of the bond during 20X0 in LC. The change in the fair value of the bond in LC, which amounts to LC34,918, is recognised as an adjustment to the carrying amount. The difference between the fair value of the bond and its amortised cost in LC is LC3,402 (LC134,918 – LC138,320). However, the change in the cumulative gain or loss recognised in other comprehensive income during 20X0 as a reduction is LC 4,602 (LC3,402 + LC1,200).

A gain of LC2,572 (FC1,837 × 1.4) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive income in the same period. For simplicity, journal entries for the recognition of interest revenue are not provided. It is assumed that interest accrued is received in the period.



The entity makes the following journal entries on 31 December 20X0:

	Debit LC	Credit LC
Financial asset—FVOCI	34,918	
Other comprehensive income	4,602	100,000
Profit or loss		39,520
(To recognise the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)		
Swap	2,572	
Profit or loss		2,572
(To remeasure the swap at fair value)		
Profit or loss	2,572	
Other comprehensive income		2,572
(To recycle the change in fair value of the swap)		

In accordance with paragraph 16A of IFRS 7, the loss allowance for financial assets measured at fair value through other comprehensive income is not presented separately as a reduction of the carrying amount of the financial asset. However, disclosure would be provided about the accumulated impairment amount recognised in other comprehensive income.

As at 31 December 20X1 (the reporting date), the fair value of the bond decreased to FC87,114 because of an increase in market interest rates and an increase in the credit risk of the bond. The fair value of the swap increased by FC255 to FC2,092. In addition, as at 31 December 20X1 the entity determines that there has been a significant increase in credit risk on the bond since initial recognition, so a loss allowance at an amount equal to lifetime expected credit losses is recognised²⁶. The estimate of lifetime expected credit losses as at 31 December 20X1 is FC9,700. As at 31 December 20X1, the exchange rate is FC1 to LC1.25. This is reflected in the following table:

²⁶ For simplicity this example assumes that credit risk does not dominate the fair value hedge relationship.

	31 December 20X0	31 December 20X1
Bond		
Fair value (FC)	96,370	87,114
Fair value (LC)	134,918	108,893
Amortised cost (FC)	98,800	90,300
Amortised cost (LC)	138,320	112,875
Interest rate swap		
Interest rate swap (FC)	1,837	2,092
Interest rate swap (LC)	2,572	2,615
Impairment – loss allowance		
Loss allowance (FC)	1,200	9,700
Loss allowance (LC)	1,680	12,125
FX rate (FC:LC)	1:1.4	1:1.25

As shown in the table, as at 31 December 20X1 the fair value of the bond is LC108,893 (FC87,114 × 1.25) and its amortised cost is LC112,875 (FC(100,000 – 9,700) × 1.25).

The lifetime expected credit losses on the bond are measured as FC9,700 as of 31 December 20X1. Thus the impairment loss recognised in profit or loss in LC is LC10,625 (FC(9,700 – 1,200) × 1.25).

The loss recognised in profit or loss because of the changes in foreign exchange rates is LC14,820 (LC112,875 – LC138,320 + LC10,625), which is the change in the gross carrying amount of the bond on the basis of amortised cost during 20X1 in LC, adjusted for the impairment loss. The difference between the fair value of the bond and its amortised cost in the functional currency of the entity on 31 December 20X1 is LC3,982 (LC108,893 – LC112,875). However, the change in the cumulative gain or loss recognised in other comprehensive income during 20X1 as a reduction in other comprehensive income is LC11,205 (LC3,982 –

LC3,402 + LC10,625).

A gain of LC43 (LC2,615 – LC2,572) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive income in the same period.



The entity makes the following journal entries on 31 December 20X1:

	Debit LC	Credit LC
Financial asset—FVOCI		26,025
Other comprehensive income	11,205	
Profit or loss	14,820	
(To recognise the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)		
Swap	43	
Profit or loss		43
(To recycle the change in fair value of the swap)		
Profit or loss	43	
Other comprehensive income		43
(To recycle the change in fair value of the swap)		
Profit or loss (impairment loss)	10,625	
Other comprehensive income (accumulated impairment amount)		10,625
(To recognise lifetime expected credit losses)		

On 1 January 20X2, the entity decides to sell the bond for FC87,114, which is its fair value at that date and also closes out the swap at fair value. The foreign exchange rate is the same as at 31 December 20X1. The journal entries to derecognise the bond and reclassify the gains and losses that have accumulated in other comprehensive income would be as follows:

	Debit LC	Credit LC
Cash	108,893	
Financial asset—FVOCI		108,893
Loss on sale (profit or loss)	1,367 ^(a)	
Other comprehensive income		1,367
(To derecognise the bond)		
Swap		2,615
Profit or loss	2,615	

(To close out the swap)

(a) This amount consists of the changes in fair value of the swap, the accumulated impairment amount and the changes in foreign exchange rates recognised in other comprehensive income (LC2,572 + LC1,200 + LC43 + LC10,625 – LC4,602 – LC11,205 = -LC1,367, which is recycled as a loss in profit or loss).

9.4.11. Write off

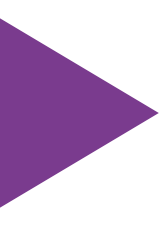
The write off is defined by IFRS 9.5.4.4 as a derecognition event that consists in reducing the gross carrying amount of the financial asset. It happens when an entity has “no reasonable expectations” of recovering the contractual cash flows in its entirety or a portion thereof.



Estimating the moment when there are no reasonable expectations any longer is a judgemental area. Diversity may arise in practice, especially taking into account the specificities of the legal environment of transactions.

IFRS 9 explicitly permits partial write off. IFRS 9.B5.4.9 describes a situation where an entity expects to recover only 30% of the asset by selling its collateral, but has no reasonable prospects of recovering any further cash flows from the financial asset. In that situation, IFRS 9 requires writing off the remaining 70% of the financial asset.





CHAPTER 13

DERIVATIVES AND EMBEDDED DERIVATIVES



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13.1. General principles of accounting for derivatives

IFRS 9 requires that all stand-alone financial instruments that meet the definition of a derivative (see **section 13.2.2**) and that are in the scope of IFRS 9 (see **chapter 1**) be measured at fair value. There are however several exemptions from this requirement. They are dealt with in **section 13.2.4**.

Derivatives that are within the scope of IFRS 9 are initially recognised as an asset or a liability on the commitment date, i.e. when an entity becomes a party to the contract. For non-optional derivatives, the initial fair value is often equal to zero, whereas option-type derivatives have an initial fair value (option premium) that is different from zero. When the transaction price of a derivative does not correspond to its initial fair value, this may give rise to a gain or loss upon the initial recognition of that derivative (the so called “day one gain or loss”), as described in **chapter 6**.

Fair value changes of derivatives between two reporting dates are recognised in profit or loss unless the entity has elected to apply hedge accounting by designating the derivative as a hedging instrument (see **chapter 14**).

Example 13.1

Consider a **purchased option**. In most cases the entity purchasing the option must pay the price of this option, the option premium, to its seller (“writer”) at the inception of the contract. The option premium generally corresponds to the option’s initial fair value. Therefore, option premiums paid are not expensed in profit or loss directly, the corresponding entry upon the initial recognition of a purchased option (financial asset) will generally be simply a cash out entry. Supposing the option purchased is not documented as a hedging derivative (see **chapter 14**), it is subsequently measured at fair value through profit or loss until its maturity date. Only the changes of fair value of the option during the accounting period are recognised in profit or loss. Options are presented in more detail in **section 13.2.1.3.3**.

Example 13.2

Consider an interest rate swap (IRS), a common instrument that can be used to hedge, for instance, the interest rate risk of a financial debt bearing a floating interest rate. Generally, the initial fair value of an IRS is equal to zero. As a result, its initial recognition does not give rise to a specific accounting entry on the balance-sheet. Subsequently to its initial recognition, the fair value of an interest rate swap may be below or above zero. An interest rate swap with a fair value above zero is accounted for as a financial asset. An interest rate swap with a fair value below zero is accounted for as a financial liability. From one reporting date to another the same IRS may switch from an asset position to a liability position, and vice-versa. Whatever its balance sheet presentation, all changes in the fair value of the interest rate swap are recognised in profit or loss (unless the IRS is documented as a hedging instrument, as per **chapter 14**). Interest rate swaps are presented in **section 13.2.1.3.2**.

Example 13.3

Some swaps include an upfront or balloon cash payment, when at inception one of the “legs” of the swap is at off-market conditions. Upfront or balloon payments generally represent the initial fair value of the swap and must be accounted for as a financial asset (if upfront payment paid), or as a financial liability (if upfront payment received), and normally do not give rise to an immediate gain or loss. In case market conditions and other inputs considered in the valuation of the swap change subsequently, a swap with an initial upfront payment **paid** and therefore initially recognised as a financial asset may become a financial liability. Similarly, a swap with an initial upfront payment **received** initially recognised as a financial liability may become subsequently a financial asset.

This requirement of FV-PL measurement extends to embedded derivatives accounted for separately from a hybrid contract (see **section 13.3**). A hybrid contract combines both a non-derivative host contract and an embedded derivative component. Any embedded derivative must be accounted for separately from its host contract if it meets the conditions in IFRS 9.4.3.3 (see **section 13.3.3**). However, separate accounting of embedded derivatives is prohibited for hybrid instruments measured at FV-PL. Hybrid contracts whose host contract is a financial asset are not subject to the embedded derivatives analysis as they undergo a specific test, the SPPI test (see **section 7.4.3**).

Section 13.2 will present stand-alone derivatives and **section 13.3** will focus on embedded derivatives. Derivatives on own equity instruments, and compound instruments (instruments embodying both a debt component and an equity component) are addressed in **chapter 5**.

13.2. Stand-alone derivatives

Derivative contracts are not always well known and understood. The specific vocabulary for these instruments is often an additional hurdle to properly understand their features and behaviours. In **section 13.2.1**, we will first present common derivative transactions, their uses, purposes and characteristics. We will then focus on the IFRS 9 definition of derivatives (see **section 13.2.2**), their accounting treatment (see **section 13.2.3**) and finally present some exceptions (see **section 13.2.4**).

13.2.1. Common derivatives, their uses and characteristics

13.2.1.1. Typical uses of derivatives

Derivatives can be used to hedge against risks to which the entity is exposed (hedging) (see **chapter 14**), to speculate on price changes (trading) or to take advantage of price differences between markets (arbitrage).

13.2.1.2. Economic characteristics of derivatives

13.2.1.2.1. Value derived from a reference variable

In the banking language, the term “derivative” is used for financial instruments the price of which depends on the price movements in a reference variable, known as the underlying. There is a wide range of possible underlyings. Examples are shares, equity indices, government bonds, credit risk, currencies, interest rates, commodities like gold, copper, etc., or also other derivatives such as swaps. Changes in the price / level of the underlying lead to changes in the fair value of the derivative.

Example 13.4

The income of a farmer is generated from selling corn. His income is directly influenced by the change in the corn market price. To reduce uncertainty, the farmer could, for example, consider entering into a derivative contract whereby he will commit to deliver, in the future, a specified quantity of corn against a fixed price. However, there will be no physical delivery of the corn. Instead, the value of the contract will be calculated (applying the difference between the contractually agreed fixed price and the then current market price of corn to the agreed quantity of corn) and the farmer will receive any positive difference if the fixed price is

higher than current market conditions, or pay a negative difference if the fixed price is lower than the current market conditions.

Such contract economically reduces the farmer's exposure to change in the underlying of the derivative contract: the corn market price. However, one can see that this contract remains "generic" as it will not take into account the actual quantity of corn that the farmer will be able to crop and sell. The derivative rather refers to a "notional" quantity of corn. Notional amount is another specificity of derivative further detailed in the next section.

13.2.1.2.2. Notional amount

The value of a derivative contract generally depends not only on the underlying variable(s) but also on the derivative's notional amount. The notional amount is the basis on which the derivative's value is calculated.

The notional amount may be expressed in units of a given currency, a number of shares, a number of units of weight or volume or other units specified in the contract (e.g. tons of wheat), etc. For most simple derivatives, the notional amount is the quantity applied to the change in value of the underlying to determine the contract value.

Everything being equal, if a derivative has a value of 10 for a notional amount of 2, the same derivative with a notional amount of 8 will generally have a value of 40.

13.2.1.2.3. Settlement provisions (net vs. gross settlement)

Depending on contractual provisions, a derivative can be:

- net-settled; or
- gross settled; or
- both, with a settlement option at the hand of one of the parties.

A net settlement is a one-way transfer of an asset, usually cash (in such case the term "net cash settlement" will be used), from the party in a liability position to the party in an asset position, settling the obligation.

A gross settlement consists in each party paying its obligation. Referring to example 13.1, a gross settlement would have consisted in the farmer delivering the agreed quantity of corn, and the counterparty paying the agreed fixed price in cash.

13.2.1.2.4. Where derivatives may be traded

Derivatives are traded either on futures and options exchanges on standardised terms, or over-the-counter (OTC) on freely negotiated terms. The exchange traded derivatives are often more liquid than OTC derivatives, and their market prices are directly observable.

Many OTC derivatives are documented using an ISDA (International Swaps and Derivatives Association) master agreement, which means their contractual terms are rather standardised even when treated over-the-counter.

13.2.1.3. Examples of commonly used derivatives

Typical examples of derivatives are forwards, futures, swaps and options. They are briefly described in this section.

13.2.1.3.1. Forwards and futures

Forwards are contracts entered into between two parties that require both parties to transact in the future at a pre-specified price known as the forward price. Forward contracts may relate both to financial or non-financial assets. The parties, the underlying and quantity of underlying are specified in the contract as well as the date of the future transaction (termination date) and the settlement options (in net, in gross / physically, or both). The payoff profiles of forward commitments are linear in nature and move upwards or downwards in direct relation to the price of the underlying asset. The fair value of a forward contract (as defined in **chapter 3** Fair value measurement) is affected by changes in the spot rate and changes in the forward points.

On commitment date, the fair values of the rights and obligations of both parties are often equal and as a result the net fair value of the forward is equal to zero. If the net fair value of the right and obligation is not equal to zero, the contract is recognised as an asset or liability (IFRS 9.B3.1.2(c)).

Forward contracts are similar to futures contracts. The key difference between the two is that forward contracts are not traded on an exchange, they are transacted over-the-counter (i.e. directly between two parties) on freely negotiated terms. Being over-the-counter type contracts, forwards are less standardised than exchange-traded futures.

13.2.1.3.2. Swaps

A swap is a contract whereby two parties agree to exchange different payment flows (e.g. foreign currency or interest payments) during a specific term on fixed dates in the future.

Common swaps are interest rate swaps and foreign exchange swaps.

When an entity becomes a party to a swap contract, the fair values of the rights and obligations under the swap contract are often equal, so that the net fair value of the swap is equal to zero. If the net fair value of the rights and obligations is not equal to zero, the swap contract is initially recognised as an asset or liability (IFRS 9.B3.1.2(c)).

Example 13.5

Consider an interest rate swap (IRS). An IRS is an exchange of a fixed rate stream of payments (like a fixed rate bond) for a floating rate stream of payments (like a floating rate bond).

Suppose Entity A enters into an interest rate swap with a counterparty B that requires A to pay a fixed rate of 8 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined based on a CU100 million notional amount. A and B do not exchange the notional amount. A pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

13.2.1.3.3. Options

An option is the right to purchase (call option) or sell (put option) the underlying asset (e.g. shares, bonds, commodities, foreign currency, etc.) from / to a counterparty at a previously agreed fixed price (**strike**). European options can be exercised only at a specified date (maturity date). American options can be exercised at any time over a defined period.

An option transaction is a **conditional forward** transaction in which the buyer acquires an optional right (option) with respect to an underlying.

A **call** option gives the holder the right to buy the underlying asset at a fixed price.

A **put** option provides the holder with the right to sell the underlying position at a fixed price.

The **buyer** of the call or put option must pay the seller of the option a **premium** (either immediately or, at some later point in time as is the case at some marketplaces where the premium payment is deferred until the expiration date). Buyers can decide not to exercise this right if this seems more favourable.

By contrast, the **seller** of a call or put option does not have the right to choose: as the option “seller”, the seller must carry out the transaction if the buyer exercises its option.

The risk profile of an option is very different depending on whether the option is purchased or sold:

- the maximum risk of a purchased option is limited to the premium paid and there may be no cap to the maximum potential gain;
- the maximum risk of a written option may not be capped. However, the maximum gain is capped to the premium received.

Options may be combined to get the risk profile desired by an entity. Some combinations may rely on a purchased option and a written option. The characteristics of such strategy may be fine-tuned in order to have a zero-cost strategy (the premium received on the written option equals the premium to be paid on the purchased option).

When it comes to their **exercise date**, there are different types of options:

- with a “European option”, buyers can exercise their optional right only at the end of the agreed term of the option transaction;
- with an “American option” this right can be exercised at any time over a specified period;
- a “Bermuda” option is a blend between an American option and a European option. The Bermuda option is exercisable at the expiration date, and on certain specified dates that occur between the purchase date and the date of expiration.

Option contracts are traded for a range of underlyings, such as shares, equity index futures, bond futures and commodities.

The table below provides a non-exhaustive list of examples of options and non-optional derivatives:

Figure 13.1

Non-optional transactions	Options
Futures	Options on interest rates: floors, caps, collars, options to buy or sell stocks or foreign currency, etc.
Swaps (Interest rates swaps, Cross Currency swaps, Total return swaps, etc.)	Options on credit risk: Credit Default Swaps
Forwards to buy or sell an underlying (currency, commodities, securities, etc.)	Options to buy or sell an underlying: calls and puts
	Options on derivatives: swaptions

Example 13.6

An **interest rate cap** is an option with interest rate underlying that gives the buyer the right to receive a cash amount from the seller when a particular benchmark rate increases to a specified level (strike) at a point in time.

An interest rate cap is frequently purchased by entities to fix a maximum interest rate level for floating rate borrowings over a given period.

Assume that an entity has a floating rate borrowing with a nominal amount of CU1,000, paying Euribor 3 months every quarter, and with a maturity of 5 years. The entity purchased a cap the characteristics of which perfectly match those of the borrowing (nominal amount, currency, date of cash flow payment, etc.), with a strike of 5%. At a given quarter, the spot Euribor 3-month level is 6%. On the borrowing, the entity must pay an interest rate expense of 15 ($6\% \times 1,000 \times 90/360$). The entity will receive from the seller of the cap a cash amount of 2.5 ($(6\% - 5\%) \times 1,000 \times 90/360$). The net interest cost of the borrowing, taking into account the effect of the cap, will then be an expense of 5% even if the current market rate has risen to 6%.

If interest rates fall to 5%, the cap will not be exercised by the holder.

13.2.2. The IFRS 9 definition of a derivative

A derivative is any contract within the scope of IFRS 9 which meets all the three following features (IFRS 9 Appendix A):

- **its value changes in response to the change in a specified underlying** that can be an interest rate, the price of a financial instrument, a commodity price, a foreign exchange rate, an index of prices or rates, a credit rating or a credit index, or other variables, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (see **section 13.2.2.1**);
- **it requires no initial net investment** or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors (see **section 13.2.2.2**); and
- **it is settled at a future date** (see **section 13.2.2.3**).

An entity must assess a contract to determine whether it presents all the features of a derivative (IFRS 9.IG.B.2). Most typical derivatives traded under an ISDA master agreement (e.g. swaps, options, futures, forwards, etc.) will meet the IFRS 9 definition of a derivative. But there may be exceptions (see for instance the example of a prepaid forward in **section 13.2.2.2.4** which does not meet the “initial net investment” criterion). Contracts that do not have the legal form of a derivative instrument (e.g. loan commitments or financial guarantees, or contracts to purchase non-financial instruments at a future date, etc.) may also meet the accounting definition of a derivative.

IFRS 9 provides specific exemptions for some contracts that meet the derivative definition, but that are nevertheless accounted for differently under IFRS 9 (see **section 13.2.4**).

13.2.2.1. The underlying variable

13.2.2.1.1. Value derived from an underlying variable

Derivative instruments are contracts the value of which is derived from changes in a specific variable.

Many contracts that have an underlying, whatever their legal form (e.g. forward purchase contracts, guarantees, loan commitments, etc.) may meet the definition of a derivative (IFRS 9.IG.B.2). Not all such instruments are however in the scope of IFRS 9 (see **chapter 1**).

An underlying is a variable that, along with other parameters such as a notional amount or a payment provision, determines the settlement of a derivative instrument. Its changes in value cause the fair value of a derivative to fluctuate (e.g. the 3-month Euribor index in an interest rate swap).

An underlying can also be binary / digital in its nature, acting as an “on / off” switch, as in the occurrence or non-occurrence of a specified event. The occurrence or non-occurrence of an event can trigger a fixed or a formula-driven payment.

13.2.2.1.2. Non-financial variable specific to a party of the contract

To meet the definition of a derivative, IFRS 9 requires that a non-financial underlying to not be specific to a party to the contract (this does not apply to a financial underlying). Examples of a non-financial underlying include, for instance, an index of earthquake losses in a specific region and an index of temperatures in a given city.

However, if the contract refers to a non-financial variable that is specific to a party to the contract, this contract is not a derivative. Examples of non-financial variables specific to a party to the contract include:

- cash flows indexed to the financial ratios of one of the parties (e.g. EBITDA);
- the occurrence or non-occurrence of a fire that damages or destroys an asset of a party to the contract (IFRS 9.BA.5);
- a change in the fair value of a non-financial asset where the fair value reflects not only changes in market prices for such assets (a financial variable) but also the condition of the specific non-financial asset held (a non-financial variable). Such underlying is specific to the parties to the contract. For example, if a guarantee of the residual value of a specific car exposes the guarantor to the risk of changes in the car’s physical condition, the change in that residual value is specific to the owner of the car (IFRS 9.BA.5).

13.2.2.2. Initial investment

13.2.2.2.1. General principle

One of the defining characteristics of a derivative is that it has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors (IFRS 9.BA.3).

Derivatives are unique in that the counterparties to the contract generally do not have to initially invest in, own or exchange an associated asset or liability. Therefore, there is commonly no exchange of cash (or a relatively small investment) at the date the counterparties enter into the contract. Most derivatives do not require any initial investment. For instance:

- swaps or forward contracts generally do not require an initial net investment unless the terms favour one party over the other, or unless they contain a financing element and as such are prepaid (see below);
- commodity futures contracts generally require no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. Both contracts reflect changes in the price of the commodity in the same way (similar gains or losses will be incurred).

The relationship between this nil or small initial net investment compared to the underlying price is often referred to as a leverage. Any derivative instrument under IFRS 9 will provide such leverage to the parties to the contract.

Some derivatives require an initial net investment as a compensation for the time value (e.g. a premium on an option, because that party has a right under the contract and the other party has an obligation). Other derivatives have terms that are more or less favourable than market conditions (e.g. a premium on a forward contract to buy shares with a forward price that is lower than the current forward price). In addition, derivatives could require a mutual exchange of currencies or other assets at inception, in which case it is the amount of the net investment that must be analysed (i.e. the difference between the fair values of the assets exchanged).

13.2.2.2.2. Currency swaps

Currency swap contracts can require an exchange of the underlying currencies not only at maturity but also at inception. The initial exchange of currencies typically occurs at fair value (at spot exchange rates). This exchange is considered to be the exchange of one kind of cash for another kind of cash at the same value. The initial investment is, therefore, considered to be the difference in the values, if any, that are exchanged.

A currency swap that requires an initial exchange of different currencies of equal fair values meets also the definition because it has a zero-initial net investment (IFRS 9.BA.3).

13.2.2.2.3. Options

When an entity purchases an option it generally pays a premium for the right it obtains to exercise the option. Whether or not the option meets the definition of a derivative under IFRS 9 will depend on the amount of the premium compared to the price of the underlying.

Example 13.7

If an entity pays CU10 to purchase a call on a security the fair value of which is 100, the call may be qualified as a derivative. However, if the entity purchases the call at a price of 90, the leverage provided by the option will not be sufficient to meet the definition of a derivative.

In practice however, option contracts generally meet the definition of a derivative because the premium is less than the investment that would be required to obtain the underlying financial instrument to which the option is linked (IFRS 9.BA.3).

13.2.2.2.4. Prepaid derivative instruments

Forward contracts which require an upfront cash prepayment of the forward purchase or sale price (prepaid forward) do not meet the definition of a derivative under IFRS 9 as they do not meet the initial net investment criterion. Prepaid contracts do not have an initial nil net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in the test of the market factors for a derivative.

Example 13.8

An entity enters into a prepaid forward contract to purchase, for instance, shares of entity A in one year at the forward price. The current market price (€2.000) is less than the one-year forward price (€2.099) of these shares. The entity is required to prepay the forward purchase price at inception at an amount equal to the current market price of the shares. The initial investment in the forward contract at its spot market price is less than the forward price but it approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors, because the shares of entity A could be purchased at inception for the current market price (IFRS 9.IG.B.9).



In situations where only part of the forward price is prepaid at inception by one of the parties to the contract, entities should exercise judgement to assess whether the initial net investment is smaller or not than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

IFRS 9 does not provide guidance on how to account for prepaid forwards that do not meet the definition of a derivative.

In our opinion, these transactions should be treated as hybrid financial assets or liabilities. The accounting treatment will depend on whether the party prepays or receives the prepayment:

- the party that pays the prepayment amount will have to account for a hybrid asset which, given the exposure to the contractually specified underlying variable, in many cases will not meet the SPPI criterion described in **section 7.4.3**;
- the party that receives the upfront payment will have to account for a hybrid financial liability containing an embedded derivative, as per **section 13.3.5.3**.

Example 13.9

Consider a pay-fixed, receive-variable interest rate swap where the entity prepays its obligations under the fixed leg of the swap at inception (IFRS 9.IG.B.4).

Entity A enters into a CU100 million notional amount five-year pay-fixed, receive-variable interest rate swap with entity B. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month Libor. The interest rate of the fixed leg of the swap is 10 % per year. Entity A prepays at inception its fixed leg payments under the swap for the total amount of CU50 million (CU100 million × 10 per cent × 5 years), discounted using market interest rates, while retaining the right to receive floating interest rate payments on the CU100 million notional amount over the life of the swap, with the floating rate being reset quarterly based on three-month Libor.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than what would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfils the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” provision of IFRS 9. Even though entity A has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the Libor index. Accordingly, the contract is accounted for as a derivative contract.

A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows (see **section 13.2.2.2**). The prepaid amount fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” criterion of a derivative.

Example 13.10

Now consider a pay-variable, receive-fixed interest rate swap where the entity prepays its obligations under the variable leg of the swap at inception (IFRS 9.IG.B.5).

An entity A enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with entity B. The variable leg of the swap is reset on a quarterly basis to 3-month Libor. The fixed interest payments under the swap are calculated as 10 % x the swap’s notional amount, e.g. CU10 million per year.

Entity A prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 % on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since entity A knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment of this prepaid interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” criterion of IFRS 9. Therefore, the contract is not accounted for as a derivative under IFRS 9.

By discharging the obligation to pay variable interest rate payments, entity A in effect provides a loan to entity B (IFRS 9.IG.B.5).



13.2.2.3. Future settlement

13.2.2.3.1. Settlement at a future date

As explained, the third part of the definition of derivatives is that they should be settled at a future date. So, spot transactions (e.g. spot purchases of currency) are not derivatives. The spot market is a financial market in which financial instruments or commodities are traded for immediate delivery. It contrasts with a forward (or future) market, in which delivery is due at a later date.

13.2.2.3.2. Settlement provisions

As explained in **section 13.2.1.2.3**, many derivatives may be settled gross (by physical delivery of the underlying against cash) or net (where only the net difference between the then-observed market value of the underlying and the pre-determined / forward price is exchanged). The contract may also offer the choice of settlement to one party of the contract.

The IFRS 9 definition of a derivative does not depend on the settlement pattern of the contract. However, the settlement mode (net or gross) is an essential feature of a derivative and will impact the eligibility or not of the contract for specific treatments under IFRS 9 / exceptions:

- **Regular-way purchases / sales** of financial assets (see **section 13.2.2.3.3**): contracts which require or permit net settlement of the change in the value of the contract are not regular way transactions. They are accounted for as derivatives in the period between the trade date and the settlement date (IFRS 9.B3.1.4). Regular way contracts are further defined in **chapter 6**.
- **Own-use derivatives** contracts to buy or sell non-financial assets that can only be net cash-settled do not qualify for the own-use exception and must be accounted for as derivatives. Own-use contracts are further defined in **chapter 1**.
- **Own equity instruments**: derivative contracts on own equity instruments that are not settled only on a gross physical settlement basis cannot be qualified as equity instruments. Derivatives on own equity instruments are further defined in **chapter 5**.

13.2.2.3.3. Regular way purchases and sales of financial assets

Some transactions relating to financial assets (e.g. purchases of bonds) may take several days to be settled, i.e. there is a several-day lag between the trade date (on which the contract is entered into) and the settlement date (on which the bonds are received for a cash payment). Suppose that this bond purchase is a "regular-way" purchase of bonds in the marketplace concerned (i.e. the delivery of the asset is required within the time frame established generally by regulation or convention in that marketplace) and that the entity opts for settlement date accounting for such financial assets (see **chapter 6**). No derivative will be recognised during this short period between the trade date and the settlement date, despite the fact that:

- the transaction is settled at a (close) future date,
- it has an underlying (bond price) that drives its value
- and it requires no initial net investment (no payment before the settlement date).

This is because of the initial recognition requirements in IFRS 9 for regular way purchases and sales of financial assets (see **chapter 6**).

However, when the settlement of such a purchase takes more time than commonly established by regulation or convention in the marketplace concerned, the bond purchase may not be qualified as a regular-way purchase and a derivative (forward to buy bonds) will have to be accounted for until the settlement date.

13.2.3. General principles of accounting for stand-alone derivatives that are not documented as hedges

A derivative in the scope of IFRS 9 is recognised as an asset or a liability on the commitment date (IFRS 9. B3.1.2(c)).

When an entity becomes a party to a forward contract, the fair values of the right and obligation are often equal. The net fair value of the forward is zero. If the net fair value of the right and obligation is not zero, the contract is recognised as an asset or a liability (IFRS 9.B3.1.2(c)).

An entity must initially measure a derivative at its fair value. Transaction costs that are directly attributable to the acquisition or issue of the derivative are recognised in profit or loss when incurred.

All derivatives that are within the scope of IFRS 9, but not documented in a hedging relationship, are classified as **Held for Trading** (IFRS 9 appendix A) and measured at fair value through profit or loss (see **section 13.2.4** for more details on derivative scope exemptions). The changes in the fair values of derivatives are accounted for in profit or loss at each reporting date.

IFRS fair value measurement is explained in **chapter 3**.

For derivatives documented in a hedging relationship, specific treatment may apply (see **chapter 14**).

13.2.4. Exemptions

Not all derivatives (even when they have all the typical characteristics of a derivative) are to be measured at FV-PL. IFRS 9 contains the following derivative specific scope exemptions (see **chapter 1**):

- contracts to buy or sell non-financial assets that are entered into for the receipt of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements ("own-use" contracts);
- insurance contracts;
- some financial guarantees;
- loan origination commitments for borrowers and certain loan origination commitments for lenders;
- some derivatives on own equity instruments that meet the definition of equity instruments;
- forward contracts between an acquirer and a selling shareholder to buy or sell an acquiree that will result in a business combination at a future acquisition date.

Besides, specific requirements exist for "Regular-way" purchases and sales of financial assets (see **section 13.2.2.3.3**).

13.3. Embedded derivatives

13.3.1. Introduction

Most stand-alone derivatives within the scope of IFRS 9 and not documented in a hedging relationship are measured at fair value through profit or loss. Entities might be tempted to avoid recording in profit or loss the volatility resulting from derivatives by hiding them into non-derivative host contracts.

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

As an anti-abuse measure, the IASB introduced the embedded derivatives requirements to IAS 39, to make sure most “hidden” derivatives give rise to the same impacts in profit or loss as stand-alone derivatives. The rationale for the requirement to separate particular embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract, for example, by embedding a commodity forward in a debt instrument (IFRS 9.BCZ4.102).

This concept of embedded derivative is carried forward under IFRS 9 for hybrid contracts containing a host non-financial contracts or a host financial liabilities. However, as financial assets are subject to a dedicated characteristics test under IFRS 9 (the “Solely payments of principal and interest” test), hybrid contracts containing a host financial asset are not subject to the embedded derivatives requirements.

13.3.2. Definitions

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative contract (IFRS 9.4.3.1).

An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (IFRS 9.4.3.1).

An embedded derivative is a derivative that is attached to the host contract and is not contractually transferable independently. It always has the same counterparty as the host contract. A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument (IFRS 9.4.3.1).

It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument (“synthetic instrument” accounting) for the purpose of applying IFRS 9, in particular when each of these financial instruments has its own terms and conditions and may be transferred or settled separately. Therefore, as a general principle non-derivative financial instruments and derivatives are classified separately (IFRS 9.IG.C.6). Please refer also to **section 13.4**.

Example 13.11

Consider an entity A investing in a convertible bond issued by entity B. The bond pays a fixed interest rate on a yearly basis. Upon bond maturity, the holder has the possibility either to be reimbursed from B the nominal amount of the bonds, or to receive in cash an amount equal to the fair value of entity C shares.

This convertible bond meets the definition of a hybrid contract. The host contract is a vanilla fixed rate bond, and the embedded derivative is a call option on entity C shares. The strike of the call is the redemption price of the bond.

Example 13.12

Consider the same fact pattern as in example 13.11, except that the holder of the convertible bond has the right to sell separately the conversion option (call) to a third party.

In such case, the convertible bond will not be considered as a hybrid contract. Entity A and entity B will account for this transaction by recognising separately the fixed rate bond, and a stand alone call option.

13.3.3. Hybrid contracts – when must embedded derivative requirements be applied?

When an entity becomes a party to a hybrid contract the host contract of which is not a financial asset (such as hybrid contract with financial liability host, non financial contract host, etc.), the entity has to assess whether any embedded derivatives contained in the contract are required to be separated from the host contract and accounted for as stand-alone derivatives under IFRS 9.

When an entity becomes a party to a hybrid contract with a host that is a financial asset within the scope of IFRS 9, the entity must apply the classification requirements of IFRS 9 for financial assets (see **chapter 7**) to the entire hybrid contract (IFRS 9.4.3.2). Derivatives embedded in financial asset host contracts are never bifurcated. However, the impact of the embedded derivative on the hybrid contract cash flows will be captured within the characteristics test of the financial asset classification procedure (SPPI Test).

The figure below summarises the scope of the embedded derivative analysis.

Figure 13.2

Hybrid contracts	
Hybrid contracts with financial asset hosts (IFRS 9.4.3.2)	Other hybrid contracts (IFRS 9.4.3.3)
<p>If a hybrid contract contains a host that is an asset within the scope of IFRS 9, the entity must apply the requirements on classification of financial assets (see chapter 7), including the SPPI characteristic test, to the entire hybrid contract.</p>	<p>If the host contract is a financial liability, a loan commitment excluded from the scope of the classification requirements in IFRS 9, an insurance contract or a non-financial host contract, the entity will have to assess the terms of the hybrid contract to establish whether the embedded derivative must be bifurcated.</p>

Example 13.13

Entity A invests in a convertible bond issued by entity B. The convertible bond pays a fixed-rate annual coupon and has a maturity of three years. At any point prior to the bond's maturity, entity A has the option to convert the bond into a fixed number of shares of entity C.

The host-contract being a financial asset, entity A would analyse the convertible bond in its entirety. The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding because they reflect a return that is inconsistent with a basic lending arrangement (IFRS 9. B4.1.7A), i.e. the return is linked to the value of the change in value of entity C shares.

This asset does not meet the SPPI criterion, so the convertible bond should be classified at FV-PL in its entirety.

13.3.4. Accounting for hybrid contracts subject to the embedded derivative requirements

13.3.4.1. General principles

For all hybrid contracts that are not financial assets within the scope of IFRS 9, the entity must apply the following 3-step approach upon initial recognition of the contract:

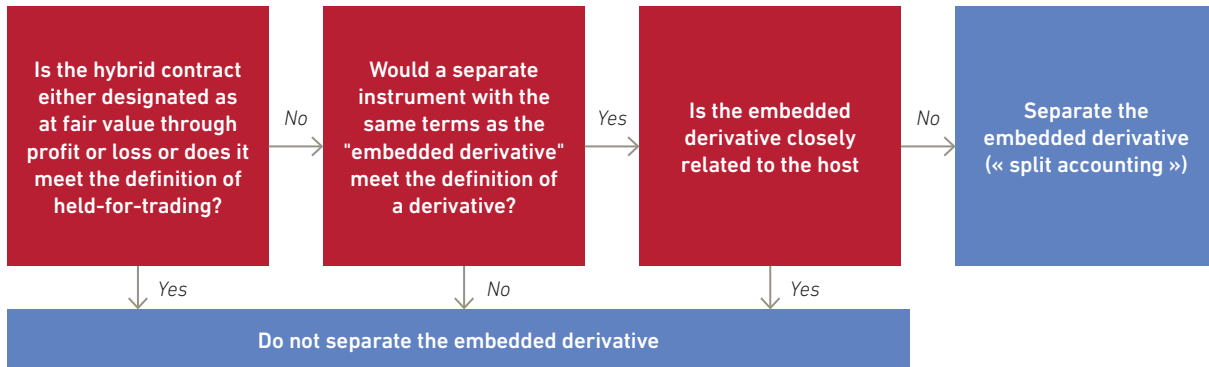
- identify the embedded derivative(s) (see **section 13.3.2**);
- for each embedded derivative identified, determine whether it is required to be bifurcated from the host contract (see below); and
- for those embedded derivatives that are required to be accounted for separately, measure the derivatives at fair value at initial recognition and subsequently at fair value through profit or loss (IFRS 9.B4.3.1, see **section 13.3.6**).

The assessment of whether an embedded derivative is required to be separated from the host contract and accounted for as a derivative should be made on the basis of the circumstances that existed when the entity first becomes a party to the contract.

An embedded derivative must be separated from the host contract (that is not a financial asset) and accounted for as a stand alone derivative under IFRS 9 if, and only if:

- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see **section 13.3.5**);
- a separate instrument with the same terms as the embedded derivative would meet the definition of a (stand-alone) derivative (see **section 13.3.2**); and
- the hybrid contract is not measured at fair value with changes in fair value recognised in profit or loss (IFRS 9.4.3.3). For instance, a derivative that is embedded in a financial liability measured at FV-PL must not be bifurcated.

Figure 13.3



If an embedded derivative meets the three criteria for bifurcation, the hybrid contract, a single contract from the legal documentation standpoint, must be “split” into two units of account:

- the host contract, which is accounted for in accordance with the appropriate standards (IFRS 9.4.3.4), and
- the separated embedded derivative, which is accounted for as a stand-alone derivative (see **section 13.2.3**). This means generally that, unless it is documented as a hedge in accordance with hedging requirements explained in **chapter 14**, the embedded derivative that has been separated will be measured at fair value, with the changes from one reporting date to another being reported in profit or loss.

IFRS 9 does not address whether a bifurcated embedded derivative should be presented separately in the balance-sheet (IFRS 9.4.3.4).

However, split accounting in such situations is not required if the entity designates the entire hybrid contract as measured at FV-PL, as explained in the following section.

13.3.4.2. Hybrid instruments designated as measured at FV-PL

The requirements for separating non-closely-related embedded derivatives presented on the preceding section can be complex to implement or potentially result in less reliable measures (IFRS 9.B4.3.9). That is why IFRS 9 permits (or in some cases requires) designating the entire hybrid contract as measured at fair value through profit or loss.

Designation at FV-PL is **required** if an entity is required by IFRS 9 to separate an embedded derivative from its host contract but is **unable to measure** the embedded derivative separately either at acquisition or at the end of a subsequent financial reporting period (IFRS 9.4.3.6). For more complex instruments, the fair value of the combined contracts may be significantly easier to measure and hence be more reliable than the fair value of only those embedded derivatives that are required to be separated (IFRS 9.BCZ.4.69).



An entity is unable to measure the embedded derivative when both:

- the entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, **and**
- the entity is unable to measure the fair value of the embedded derivative as a difference between the fair value of the hybrid contract and the fair value of the host contract (IFRS 9.4.3.7).

Designation at FV-PL of a hybrid contract to avoid the bifurcation of the embedded derivative is **permitted** except in the following two scenarios, where measurement at FV-PL would not reduce complexity or would not increase reliability (IFRS 9.B4.3.10):

- the embedded derivative(s) do(es) not significantly modify the cash flows that otherwise would be required by the contract (IFRS 9.4.3.5); or
- it is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative(s) is prohibited (IFRS 9.4.3.5 and IFRS 9.BCZ.4.70).



To reliably identify and measure the separate components, an entity that enters into sophisticated investment and funding strategies such as structured notes or other contracts with embedded derivatives should obtain the information necessary to perform separate valuation. As such information may not always be easy to obtain in practice, some entities opt for a systematical designation at FV-PL in their entirety for eligible hybrid instruments with complex embedded derivatives.

13.3.5. Determining whether the embedded derivative is “closely-related”

13.3.5.1. Presentation of the “closely-related” criterion

One of the most critical parts of the embedded derivative analysis process consists in determining whether the embedded derivative is “closely-related” to the host contract. Indeed, IFRS 9.4.3.3 states that an embedded derivative must be bifurcated if, and only if, its economic characteristics and risks are **not** closely related to the economic characteristics and risks of the host contract.

IFRS 9 do not provide a clear definition of what is meant by “closely-related”. However, it provides several examples of closely-related embedded derivatives and non-closely-related embedded derivatives.

In analysing these examples, we note that two main principles are consistently applied. An embedded derivative cannot be closely-related to its host contract each time that:

- it brings to the hybrid contract an underlying that does not exist in the host contract, or
- it introduces to the contract a leverage effect that did not exist in the host contract.

However, given the lack of clear guidance, judgement is often required to perform this “closely-related” analysis.

We will first look at the range of host contracts that can be identified (see **section 13.3.5.2**) and then illustrate this closely-related concept further through several illustrative examples.

13.3.5.2. Identifying host contracts

Host contracts can be a financial instrument or a non-financial instrument.

13.3.5.2.1. Financial instrument host contract

Hybrid instruments that have financial asset host contracts that are within the scope of IFRS 9, are not subject to the embedded derivatives assessment (see **section 13.3.3**).

If a financial instrument host contract has no stated or predetermined maturity and represents a residual interest in the net assets of an entity, then its economic characteristics and risks are those of an equity instrument, and an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related (IFRS 9.B4.3.2).

If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a **debt** instrument (IFRS 9.B4.3.2). Debt instruments in practice often correspond to instruments having the legal form of borrowings (loans or quoted debt securities such as bonds / notes). Such instruments are naturally exposed to risks typically present in financing transactions, such as interest rate risk and credit risk of the borrower.

Some financial instruments are excluded from the scope of IFRS 9, but the standard states explicitly that the embedded derivative guidance is nevertheless applied to (IFRS 9.2.1):

- host **lease** contracts in the scope of IAS 17 / IFRS 16, and
- host contracts (mainly **insurance** contracts) in the scope of IFRS 4 / IFRS 17.

13.3.5.2.2. Non-financial host contract

IFRS standards do not limit the scope of non-financial contracts that are subject to the embedded derivative requirement.

In practice, an embedded derivative feature may thus be identified in any type of contract to deliver service or goods.

13.3.5.3. The “closely-related” criterion – debt host contracts

13.3.5.3.1. Interest rate leverage features

IFRS 9.B4.3.8(a) states that an embedded derivative in which the underlying is an interest rate or interest rate index that can change the amount of interest that would otherwise be paid or received on an interest-bearing host debt contract is generally **closely** related to the host contract, but it will be regarded as **not closely** related in the following situations:

- when the hybrid contract can be settled in such a way that the holder would not recover substantially all of its recognised investment, **or**
- when the embedded derivative could at least:
 - > **double the holder's initial rate** of return on the host contract; **and**
 - > result in a rate of return that is at least **twice what the market return would be** for a contract with the same terms as the host contract. (These criteria are sometimes referred as the “double-double test”).

This example typically illustrates the concept of leverage effect introduced in a debt instrument by an embedded derivative. While IFRS 9 is mainly principle-based, this example provides clear thresholds to determine the level from which the leverage introduced is considered as too significant to consider that the embedded derivative is closely-related to its host contract.

The condition that “the holder would not recover substantially all of its recognised investment” applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder to not recover substantially all of its recognised investment (IFRS 9.IG.C.10). If, for example, the terms of a hybrid contract permit, but do not require, the holder to settle the hybrid contract in a way that causes the holder not to recover substantially all of its recognised investment and the issuer does not have such a right (for example, when this is a puttable debt instrument), the feature is considered closely related to the host contract. This is because the issuer does not have a right to oblige the holder to lose its investment.



IFRS 9 does not define the term “substantially all of its recognised investments”. An entity must consider all relevant facts and circumstances in its judgement.

The analysis focuses on the situation where the holder would not recover substantially all of its investment as a consequence of the interest rate embedded derivative. The possibility that recovery may not occur due to credit or default risk must not be considered in this analysis.

“Substantially all” in IFRS 9.B4.3.8(a) implies that embedded clauses that may lead to a slight negative yield or an insignificant failure to recover principal do not fail the “closely-related” criterion.

Regarding the 2nd criterion (not closely related if it may double the rate of return), to be considered as not closely related to the host contract, the embedded derivative must (over the life of the contract) be able to **both** double the initial rate of return **and** result in a rate of return that is at least twice what would otherwise be expected for a similar host contract at the time it takes effect (same terms as the host contract and same credit risk as the issuer's).

IFRS 9 thus considers that if an interest rate embedded derivative leads a debt contract to bear an interest rate that is significantly different both from a fixed interest rate (first condition) and a floating interest rate (second condition), then it cannot be considered as closely related to the debt host contract.



A common example of such notes where the “double-double” test is often met at inception is indexation on CMS (constant maturity swap) rates. Should a bond with a 15-year maturity be indexed to, say, a CMS 10-year rate, the double-double condition would not be met and the embedded indexation to the CMS 10-year rate would not be considered closely related to the host debt contracts in the issuer’s statements. This is because, supposing a comparable fixed rate for the 15-year period is 5%, **both** of the following scenarios may not be ruled out at inception:

- the possibility that the CMS 10-year rate, over the 15-year term, reaches or exceeds 10% (i.e. it could double the initial fixed-rate of return), and
- the possibility that the CMS 10-year rate, over the 15-year term, reaches or exceeds twice the level of a comparable vanilla floating rate, such as Euribor 12-months, supposing the coupon on this bond is reset every 12 months.

In practice, a cap to the CMS indexation (say at 9.5% in the example) is generally introduced in the contractual interest rate formula. This cap grants that the instrument cannot double the initial rate of return of a fixed rate debt instrument with similar characteristics. Consequently, the leveraged effect is capped below the bifurcation threshold of IFRS 9 and the embedded derivative must not be bifurcated.

13.3.5.3.2. Interest rates caps and floors

An embedded floor or cap on the interest rate in a debt host contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest when the contract is issued, and the cap or floor is not leveraged in relation to the host contract (IFRS 9.B4.3.8(b)).

13.3.5.3.3. Interest step-up / step-down features

IFRS 9 does not specifically deal with contingent step-up features.





To determine the accounting qualification of a contingent step-up or step-down feature, the nature of the interest revision trigger should first be carefully analysed.

Triggers that are **specific to the parties to the contract** (such as breach of a contractual covenant by the borrower or the borrower's default on its contractual payment obligations), do not meet the definition of a derivative (see **section 13.2.2**). As a result, these triggers do not constitute an embedded derivative, and do not have to be separated from the host debt contract.

Example 13.14

A common example of a contingent interest feature is one requiring additional interest on a failure to comply with a debt contractual covenant. Such feature does not meet the definition of a derivative as the covenant is a non-financial variable that is specific to a party to the contract. It therefore cannot be qualified as an embedded derivative.

Triggers that refer to **observable market variables that are not specific to parties** to the contract: provided the trigger meets the definition of an embedded derivative, a case-by-case analysis should be performed to assess whether the trigger may be considered as closely related to the host debt instrument. For instance, triggers that do not directly relate to the credit worthiness of the borrower may need to be separated. In our opinion, a reset based on a change in another entity's credit default spread or a change in an equity index should not be considered as closely related.

Example 13.15

A contingent interest feature that increases the interest rate of the instrument if the market price of the issuer's ordinary shares falls (or rises) to a specified level should be bifurcated and separately accounted for. The equity underlying is not closely related to the host debt contract.

13.3.5.3.4. Embedded inflation-related derivatives

The primary purpose of inflation derivatives is the transfer of inflation risk. Inflation derivatives may be embedded in debt instruments such as bonds. The derivative component and the host debt financial instrument form together a hybrid instrument, a so-called inflation-linked bond. The inflation indexation may be introduced in different ways (interest indexed to inflation, fixed rate of interest applied to an inflated nominal, etc.).

IFRS 9 does not contain any specific guidance on how inflation-linked bonds should be analysed by their issuer (for the analysis in the financial statements of the investor, please refer to **chapter 7** Classification of financial assets).



In our opinion, the inflation-related derivative embedded in inflation-linked bonds should be analysed by analogy to the principles set out in IFRS 9 for inflation-indexed lease payments (see **section 13.3.5.5**).

As a result, such derivatives would be considered as closely related to the host debt contract when both conditions are met:

- the inflation-linking feature is not leveraged, **and**
- the index relates to inflation in the entity's own economic environment.

In our opinion, a leverage is observed when a coefficient > 1 is applied to the contractual inflation index (e.g. 1.5 x yearly CPI level for an instrument with yearly coupons).

13.3.5.3.5. Embedded credit derivatives

The initial step when analysing embedded credit risk-related features is to analyse whether they relate to the credit risk of the borrower or to a third party / a reference asset.

Embedded credit-risk features that relate to the **borrower** generally may not require bifurcation as the derivative shares the same credit risk underlying as the debt host contract. Attention would have to be paid nevertheless to the existence of any significant leverage.

Embedded credit risk features that relate to a **third party or a specific asset** will generally not be considered as closely related to the host debt contract because it introduces a new underlying to the host debt contract. IFRS 9.B4.3.5(f) indicates that credit derivatives that allow one party (the "beneficiary") to transfer the credit risk of a particular reference asset, which it may not own, to another party (the "guarantor") are not closely related to the host debt instrument. This is because such credit derivatives allow the guarantor to assume the credit risk associated with the reference asset without directly owning it.

Consider an instrument such as an ABS (asset-backed-security) or a CLO (collateralised loan obligation) resulting from a securitisation. Such investments, which introduce a tranching of credit risk of the underlying assets via the waterfall structure of cash flows, allow investors to gain exposure to the underlying assets without owning them. The waterfall feature itself does not normally result in the separation of an embedded credit derivative. However, the ownership by the issuer of the reference asset is a key element in determining whether the embedded credit derivative is closely linked to the host debt contract or not. Therefore, synthetic CLOs (where the issuer gains exposure to the reference assets by writing CDSs on these assets instead of investing in them) contain non-closely related credit derivatives that are to be bifurcated by the issuer, unless the issuer measures the entire hybrid instrument at FV-PL.

13.3.5.3.6. Embedded equity derivatives

The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (IFRS 9.4.3.3(a)). We illustrate hereafter this principle using examples from IFRS 9:

- A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in an equity price or index is not closely related to a host debt instrument (IFRS 9.B4.3.5(a)). This is because the principal payment may increase or decrease depending on the change in the underlying equity price or index (IFRS 9.B4.3.6).
- Equity-indexed interest or principal payments embedded in a host debt instrument – by which the amount of interest or principal is indexed to the value of equity instruments – are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar (IFRS 9.B4.3.5(c)).

Example 13.16

Consider an Equity-Linked Note (ELN). An equity-linked note combines the risk and return characteristics of a debt instrument and an equity derivative providing a performance based on the change in common stock prices or a specified equity index. The embedded equity derivative and the debt host instrument are not closely related.

Example 13.17

Consider a bond with a step-up that is contingent on equity returns. The contingency basis for determining the step-up could be any variable but, in this example, the step-ups are indexed to the rate of return earned on a selected portfolio of 30 equity securities. The step-up feature embedded in this contract is indexed to equity prices, and as a result the host debt contract and the embedded derivative are not closely related.

13.3.5.3.7. Embedded commodity derivatives

Embedded derivatives introducing exposure to changes in prices of non-financial assets such as commodities are not closely related to the host debt contract.

IFRS 9 contains the following examples of host debt contracts where the embedded commodity derivatives are not closely related:

- A put option embedded in an instrument that enables the holder to require the issuer to reacquire the instrument for an amount of cash or other assets that varies on the basis of the change in a commodity price or index is not closely related to a host debt instrument (IFRS 9.B4.3.5(a)).
- Commodity-indexed interest or principal payments embedded in a host debt contract – by which the amount of interest or principal is indexed to the price of a commodity (such as gold) are not closely related to the host instrument because the risks inherent in the host and the embedded derivative are dissimilar (IFRS 9.B4.3.5(d)).

13.3.5.3.8. Embedded currency derivatives

An embedded foreign currency derivative that provides a stream of principal or interest payments that are denominated in a foreign currency and is embedded in a host debt instrument (for example, a dual currency bond) is closely related to the host debt instrument. Such a derivative is not separated from the host instrument because *IAS 21, The Effects of Changes in Foreign Exchange Rates*, requires foreign currency gains and losses on monetary items to be recognised in profit or loss (IFRS 9.B4.3.8(c)).

13.3.5.3.9. Call, put and prepayment options

Callable bonds¹ are securities consisting of a host debt instrument and an option granting the issuer the right to redeem the instrument before maturity under specified conditions. In general, the contractual interest rate is higher for callable bonds compared to similar non-callable bonds because the issuer pays investors a price for obtaining the right to redeem the debt instrument before maturity. Puttable bonds are securities consisting of a host debt instrument and an option granting the holder / investor the right to redeem or retire the financial instrument before maturity under specified conditions. The contractual prepayment terms must be carefully analysed to assess whether they are closely related or not to the host debt contract.

IFRS 9.B4.3.5(e) states that embedded call or put options that can accelerate the repayment of principal on debt are considered to be **not** closely related to the host debt contract or host insurance contract, **unless** the call / put feature meets one of the two conditions:

- the option's exercise price is approximately equal on each exercise date to the amortised cost of the host debt instrument; **or**
- the exercise price of the prepayment option reimburses the lender for an amount up to the approximate present value of lost interest for the remaining term of the host contract. Lost interest is the product of the principal amount prepaid multiplied by the interest rate differential. The interest rate differential is the excess of the effective interest rate of the host contract over the effective interest rate the entity would receive at the prepayment date if it reinvested the principal amount prepaid in a similar contract for the remaining term of the host contract.

The assessment of whether the call or put option is closely related to the host debt contract is made before separating the equity element of a convertible debt instrument in accordance with IAS 32 (IFRS 9. B4.3.5(e)).

Paragraph B4.3.5(a) of IFRS 9 further requires that the put / call feature must not be indexed to "exotic" underlying variables (such as equity or commodity price or index) for that calls or put to be considered as "closely related" to the host debt contract.

Example 13.18

Consider a debt instrument that has been issued at par and is callable at any time during its 10-year term (it contains the so-called "American-style" option). If the debt instrument is called, the investor receives the par value of the debt instrument and the unpaid and accrued interest. No significant issue costs have been incurred initially (i.e. Initial amortised cost equals the par value).

The embedded call option is closely related to the debt instrument host contract because (a) the payoff is not indexed (i.e. the repayment amount does not depend on a commodity or an equity index) and (b) the call option's exercise price is approximately equal on each exercise date to the amortised cost.

Example 13.19

Consider another debt instrument that is issued at par and callable at any time during its term. If the debt instrument is called, the investor receives the greater of the par value of the debt instrument or the market value of 10 shares of a third party.

¹ This section only deals with callable bonds issued. Callable/ puttable bonds held are to undergo the SPPI analysis and IFRS 9 contains specific guidance for such bonds, as specified in **section 7.4.3.3.2**.

The embedded call option is not closely related to the debt instrument host contract because the payoff is indexed to an equity price.

13.3.5.3.10. Term-extending options

According to IFRS 9.B4.3.5(b), an option or automatic provision to extend the remaining term to maturity of an issued debt instrument is **not** closely related to the host debt instrument **unless** there is a concurrent adjustment to the approximate current market rate of interest at the time of the extension.

13.3.5.4. The “closely-related” criterion – equity host contracts

Hybrid instruments with equity host contracts are much less common than hybrid instruments with debt host contracts.

IFRS 9 does not provide any example of derivatives embedded in an equity host contract. The standard simply states that an embedded derivative would need to possess equity characteristics related to the same entity to be regarded as closely related to its host equity contract (IFRS 9.B4.3.2).

13.3.5.5. The “closely-related” criterion - lease host contracts

IFRS 9 paragraph B4.3.8(f) provides three examples of features that would not trigger the bifurcation of an embedded derivative from a host lease contract:

- the feature is an **inflation-related index**, such as an index of lease payments to a consumer price index, provided that the lease is not leveraged **and** the index relates to inflation in the entity's own economic environment;



Entities may have to use judgement in assessing whether lease payments indexed to a CPI contain leverage.

In our opinion, a leverage is observed when a coefficient > 1 is applied to the contractual inflation index (e.g. 1.5 x yearly CPI level for an instrument with yearly coupons).

- **the feature is contingent rentals based on lessee related sales.** This is because under IFRS 9, specified lessee volumes of sales is a non-financial variable specific to a party to the contract. Therefore, this feature does not meet the definition of an embedded derivative;
- Or the feature is **contingent rentals based on variable interest rates.**

13.3.5.6. The “closely-related” criterion – non-financial host contracts

13.3.5.6.1. Purchase / sale price denominated in a foreign currency

Purchase / sale contracts frequently contain **foreign currency** features, for instance where the purchase / sale price for the non-financial asset is denominated in a foreign currency.

IFRS 9.B4.3.8(d) indicates that such an embedded foreign currency derivative is **closely** related to the host contract provided it meets all of the 3 criteria :

- it is **not leveraged**;
- it **does not contain an option** feature; and
- it **requires payments denominated in one of the following currencies**:
 - > the functional currency of any substantial party to that contract;
 - > the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in (international) commercial transactions around the world (such as the US dollar for crude oil transactions);
 - The “routinely” used currency cannot be a currency that is used for a certain product or service in commercial transactions only within the local area of one of the substantial parties to the contract.
 - This is a currency that is used for similar transactions all around the world, not just in one local area.
 - **Example 13.24** , based on paragraph IG.C.9 of IFRS 9, further illustrates this criterion.
 - > **or** a currency that is commonly used in contracts to purchase or sell non-financial items in the (primary) economic environment in which the transaction takes place and in which the party operates (e.g. a relatively stable and liquid currency that is commonly used in local business transactions or external trade). The basis for conclusions of IFRS 9 (IFRS 9.BCZ.4.94-95) provides some additional explanations on the rationale of this criterion:
 - Entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) instead of the local currency of any of the parties to the transaction.
 - In addition, an entity operating in a hyperinflationary economy may use a price in a “hard” currency to protect against inflation (for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent).
 - The IASB has therefore decided that a foreign currency derivative should be viewed as closely related to the host contract if that foreign currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a relatively stable foreign currency, and prices may be quoted in that foreign currency.

We provide hereafter several examples on how the 3rd criterion relating to the “eligibility” of the contractual currency should be analysed.

Example 13.20

Consider a situation where the reporting entity, Entity A with US dollar as functional currency, enters into a contract to take delivery in one month of a collection of model dresses made of silk from a French manufacturer, Entity B with euro as functional currency. The purchase price will be paid in euros. The main elements to carry out the analysis of the 3rd criterion in IFRS 9.B4.3.8(d) are summarised hereafter:

- > Entity A's functional currency: US dollar
- > Entity B's functional currency: euro
- > Contract currency: euro

This contract does not contain a foreign currency derivative requiring bifurcation because it is denominated in the functional currency of one of the parties.

Example 13.21

Now consider an example similar to the previous one but where the functional currency of the seller of the goods is not EUR. Suppose the same Entity A (the functional currency of which is the US Dollar) entered into a contract to take delivery of a collection of model dresses from Entity C, a British distributor the functional currency of which is GBP, for delivery in one month. The contract is denominated in euro. The main elements to carry out the analysis of the 3rd criterion in IFRS 9.B4.3.8(d) are summarised below :

- > Entity A's functional currency: US dollar
- > Entity C's functional currency: GB Pound
- > Contract currency: euro

Here the foreign currency derivative is not closely related to the host purchase contract because (a) the payment is not denominated in either of the parties' functional currencies, (b) model dresses sales contracts are not routinely denominated in EUR in (international) commercial transactions around the world and (c) EUR is not a currency that is commonly used in contracts to purchase or sell non-financial items in the (primary) economic environment of Entity A (i.e. neither of the 3 currency eligibility conditions in IFRS 9.B4.3.8(d) are met). Even though the British distributor must acquire the collection of model dresses made of silk from the German manufacturer in euros, the German manufacturer is not a party to the British distributor's contract with Entity A.

Example 13.22

Consider another example where the contractual currency is not considered to be closely related to the host sale / purchase contract, based on an example in the Implementation Guidance of IFRS 9 (IFRS 9.IG.C.7).

A Norwegian entity, Entity D, agrees to sell oil to an entity in France, Entity F. The host oil contract is not within the scope of IFRS 9 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (IFRS 9.2.4 and IFRS 9.BA.2) and the entity has not irrevocably designated it as measured at fair value through profit or loss in accordance with IFRS 9.2.5. The oil sale / purchase contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian kroner are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contact as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in profit or loss, unless they designate this bifurcated derivative as a cash flow hedging instrument, if appropriate.

Example 13.23

Consider another example where the embedded currency-related provisions are not considered to be closely related to the host sale / purchase contract, based on an example in the Implementation Guidance of IFRS 9 (IFRS 9.IG.C.8).

Entity L, the functional currency of which is the euro, enters into a contract with Entity N, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IFRS 9 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (IFRS 9.2.4 and IFRS 9.BA.2) and the entity has not irrevocably designated it as measured at fair value through profit or loss in accordance with IFRS 9.2.5. The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars.

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity L's nor Entity N's functional currency. This foreign currency derivative would not be separated because it follows from paragraph IFRS 9.B4.3.8(d) that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is an addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under IFRS 9.4.3.3 (IFRS 9.IG.C.8).

Example 13.24

This example aims to illustrate the "globally routinely used currency" criterion in paragraph B4.3.8(d) of IFRS 9. It is based on the Implementation Guidance of IFRS 9 (IFRS 9.IG.C.9).

If cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

13.3.5.6.2. Price caps and floors in sale / purchase contracts

Similarly to the guidance applicable to interest rate caps or floors, IFRS 9.B4.3.8(b) indicates that provisions included in a contract to purchase or sell an asset (e.g. a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the money at inception and are not leveraged.

Example 13.25

Entity A enters into a long-term purchase contract for a specified quantity of commodity. The pricing terms call for the goods to be delivered at the then-current spot price but within a specified range. For instance, the goods must be sold at a price not lower than 37€ per ton and not higher than 75€ per ton, no matter what the current spot price might be. From the perspective of the entity A, this contract essentially contains two embedded options: a purchased call at 75€ per ton and a written put at 37€ per ton. However, these options, that are not leveraged, would not need to be bifurcated and accounted for separately if they are both out of the money at inception.

13.3.5.7. The “closely-related” criterion - insurance host contracts

IFRS 9 specifically states that part of the guidance on embedded derivatives already analysed above also applies to insurance host contracts, in particular principles for assessing:

- embedded indexations to floating interest rate (IFRS 9.B4.3.8(a) – see **section 13.3.5.3.1**);
- embedded caps and floors (IFRS 9.B4.3.8(b) – see **section 13.3.5.3.2**);
- embedded equity-indexation features (IFRS 9.B4.3.5(c) – see **section 13.3.5.3.6**);
- embedded commodity price indexation features (IFRS 9.B4.3.5(d) – see **section 13.3.5.3.7**);
- embedded calls and puts (IFRS 9.B4.3.5(e) – see **section 13.3.5.3.9**);
- embedded currency features (IFRS 9.B4.3.8(d) – see **section 13.3.5.6.1**).

IFRS 9 also contains two paragraphs dealing with insurance contract-specific embedded derivative issues.

13.3.5.7.1. Unit-linked contracts

A unit-linking feature is a contractual term that requires payments denominated in units of an internal or external investment fund.

IFRS 9.B4.3.8(h) states that a unit-linking feature embedded in a host insurance contract or a host financial liability is closely related to the host contract if the unit-denominated payments are measured at current unit values that reflect the fair values of the assets of the fund.

13.3.5.7.2. The embedded feature and the host insurance contract are inter-dependent

IFRS 9.B4.3.8(h) indicates that a derivative embedded in an insurance contract is **closely** related to the host insurance contract if the embedded derivative and host insurance contract are so interdependent that an entity cannot measure the embedded derivative separately (i.e. without considering the host contract).

13.3.6. Bifurcating an embedded derivative

13.3.6.1. Splitting a hybrid contract into the host contract and a stand-alone derivative

The term “bifurcation” refers to the separation of the instrument into its components. A hybrid instrument contains a host contract and one or more embedded derivatives.

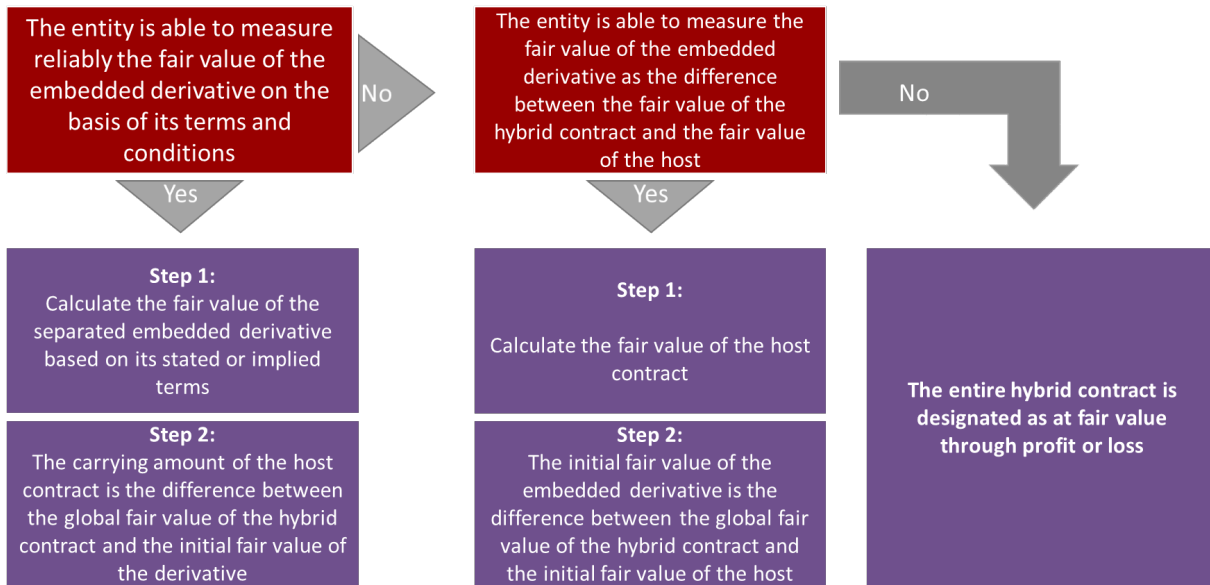
The general principle in IFRS 9 for the initial bifurcation is that:

- embedded derivatives are separated from their host contract on the basis of their stated (or implied substantive) terms; and
- the initial carrying amount of the host instrument is determined as the residual amount after separating the embedded derivative (IFRS 9.B4.3.3).

If, however, the entity is unable to measure reliably the fair value of an embedded derivative on the basis of its terms and conditions, the fair value of the embedded derivative can be calculated indirectly as the difference between the fair value of the hybrid contract and the fair value of the host (IFRS 9.4.3.7).

If the entity is unable to measure the fair value of the embedded derivative indirectly (i.e. as the difference between the value of the hybrid contract and that of the host), the entire hybrid contract is designated as at fair value through profit or loss (IFRS 9.4.3.7).

Figure 13.4



This decision tree must be applied at each reporting date. If an entity is no longer able to determine the fair value of a bifurcated embedded derivative either directly or indirectly, the entire hybrid contract is designated as at fair value through profit or loss even if the entity did not do so previously (IFRS 9.4.3.6). This process relates, however, only to measurement issues. The assessment of whether an embedded derivative must be bifurcated is performed once for all upon initial recognition (see **section 13.3.7**).

IFRS 9 also includes specific guidance regarding the initial carrying amount of the embedded derivative component, depending on the optional (see **section 13.3.6.3**) or non-optional (see **section 13.3.6.2**) nature of the embedded derivative.

13.3.6.2. Separating an embedded non-option derivative

A non-option embedded derivative should be determined in a manner that results in its **fair value being equal to zero** at the initial recognition of the hybrid instrument (IFRS 9.4.3.3).



This means, for example, that if the non-option embedded derivative has stated terms that are off-market at inception, the “off-market” component should be quantified and allocated to the host contract so that the derivative’s initial fair value will be equal to zero.

One situation where the terms of the embedded non option derivative could be off-market is where the entity has contracted a hybrid instrument in a secondary market after the inception of this instrument. The general principle should still apply, meaning the terms of the embedded derivative at the initial recognition of the hybrid instrument should be determined by the entity in such way as to result in the bifurcated embedded derivative having a fair value equal to zero.

The Implementation Guidance of IFRS 9 (IFRS 9.IG.C.1) further details the principles for allocating contractual cash flows between the host contract and the embedded derivative in situations where the host contract is a financial liability which contains a non-option embedded derivative.

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgement on the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in the separation of an embedded derivative that is not already clearly present in the hybrid contract.

The entity cannot create a cash flow that does not exist. Artificial terms must not be created to introduce leverage, asymmetry, or some other risk exposure not already present in the hybrid instrument. If the appropriate terms for the non-option derivative are readily apparent (pursuant to documented legal terms), an entity cannot make its own judgement on these terms.

If entities were permitted to separate embedded non-option derivatives on other terms, a single hybrid contract could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid contract.

Entities should establish a notional amount and an underlying consistent with the terms of the hybrid instrument. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

The allocation of cash flows according to the requirements above may impact the financial statements in different ways:

- they determine the measurement of the separated derivative, and thus profit or loss of the entity (unless the derivative is documented as a hedge); and
- the cash flows attributed to the host contract will also impact financial statements via the requirements applicable to the host contract according to the relevant IFRS standard. For instance, if the host contract is a financial liability, the interest expense recorded in profit or loss will directly result from the portion of contractual cash flows attributed to the host contract.

Example 13.26

If this five-year debt instrument has fixed interest payments of CU40,000 annually and a contractual payment at maturity of CU1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays CU40,000 annually because there are no floating interest rate cash flows in the hybrid contract (IFRS 9.IG.C.1).

13.3.6.3. Separating an embedded option-based derivative

An embedded option-based derivative (such as an embedded put, call, cap, floor or swaption) is separated from its host contract **on the basis of the stated terms of the option feature** (IFRS 9.B4.3.3). As a result, contrary to embedded non-optional derivatives, the embedded option-based derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract (IFRS 9.IG.C.2).

The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid contract. Therefore, the separation of an option-based derivative should be based on the stated terms of the option feature as stated in the contract. At the initial recognition of the contract embedded options could have a positive or negative fair value that includes both intrinsic value and time value (these notions are defined further in **chapter 14**).

13.3.6.4. Multiple embedded derivatives

Some hybrid contracts may contain more than one embedded derivative (e.g. a put or a call feature in addition to the cash flows being indexed to a specific underlying variable).

Generally, multiple embedded derivatives in a single hybrid contract are treated as a single compound embedded derivative (IFRS 9.B4.3.4).

However, separation of different embedded derivatives will be required in one of the following situations:

- embedded derivatives that are classified as equity according to IAS 32 are accounted for separately from other embedded derivatives classified as assets or liabilities (see **chapter 5**); or
- if a hybrid contract has more than one embedded derivative and those derivatives relate to different risk exposures and are readily separable and independent of each other, they are accounted for separately from each other (IFRS 9.B4.3.4).

13.3.7. Reassessment of embedded derivatives

An entity should assess whether an embedded derivative should be separated from the host contract when the entity first becomes a party to the hybrid contract (IFRS 9.B4.3.11).

Subsequent reassessment is prohibited unless there is a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required under the contract, **in which case reassessment is required** (IFRS 9.B4.3.11).

If there is a modification of the contractual terms that significantly modifies the cash flows, the features embedded in the debt instrument according to its modified terms would have to be assessed for bifurcation by the issuer at the modification date.

An entity determines whether a modification to cash flows is significant by considering the extent to which the expected future cash flows associated with the embedded derivative, the host contract or both have changed and whether the change is significant relative to the previously expected cash flows on the contract.

If there is no subsequent modification in the contractual cash flows, the conclusion on bifurcating or not the embedded derivative(s) reached at the initial recognition of the hybrid instrument will remain valid. This holds even in situations where, for example, market conditions change since the initial recognition date and considering these new market conditions would lead (supposing reassessment was permitted) to a different conclusion on whether the embedded derivative is closely related or not to the host contract. Should a reassessment be required even without a change in contractual terms, frequent monitoring of market conditions and other factors relevant for the assessment would be required (IFRS 9.BCZ.4.103). The prohibition to reassess embedded derivatives in such situations aims thus, among other things, at reducing the costs of implementing IFRS 9.

13.4. In-substance analysis of linked transactions and "synthetic instruments"

It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ("synthetic instrument" accounting) (IFRS 9.IG.C.6).

However, entities may enter into two or more legally separate transactions that, if combined, generate a result that is economically similar to entering into a single transaction. Depending on facts and circumstances, such operations may be requalified as being a derivative "in substance". In such case the entity will have to account for a derivative under IFRS 9 rather than for several separate instruments.

The following indicators should be considered when assessing if separate transactions should be accounted for as one unit of account, in accordance with IFRS 9.IG.B.6:

- the transactions were entered into at the same time and in contemplation of one another;
- the transactions were executed with the same counterparty;
- the transactions relate to the same risk;
- there is no apparent economic need, or substantive business purpose, for structuring the transactions separately that could not also have been accomplished in a single transaction.

Conversely, the fact that each transaction has its own terms and conditions and each may be transferred or settled separately are indicators that the transactions have to be classified separately (IFRS 9.IG.C.6).



Determining whether two or more contracts should be combined is a matter of facts and circumstances requiring the use of professional judgement.

The accounting should follow the substance of the arrangements, especially if there is no apparent economic need or substantive business purpose for structuring a transaction.

In our opinion, even if the example provided by IFRS 9 is applied to a derivative transaction, the above analysis and related indicators provide guidance that is also relevant for any transactions involving non-derivative financial instruments.

Example 13.27

Let's consider an example with two offsetting loans. Entity A has granted a five-year fixed rate loan to another Entity B. Entity B has granted a five-year variable rate loan for the same amount to Entity A at the same time. The entities agreed that there will be no transfers of principal at inception of the two loans, since the entities have a netting agreement.

This combined transaction meets the definition of a derivative (i.e. there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and settlement at a future date, as per **section 13.3.2**). The contractual effect of the loans is the equivalent of an interest rate swap arrangement (see **section 13.2.1.3.2**) with no initial net investment.

The IASB noted that the same answer would apply even if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IFRS 9 does not require a net settlement.

Example 13.28

Let's assume a structured repo trade consisting of several transactions:

- > Transaction 1 (bond purchase): Entity A purchases a bond (the bond) from another entity (Entity B).
- > Transaction 2 (interest rate swap): Entity A enters into (an) interest rate swap contract(s) with Entity B. Entity A pays a fixed rate of interest equal to the fixed coupon rate of the purchased bond in Transaction 1 and receives a variable rate of interest.
- > Transaction 3 (repurchase agreement): Entity A enters into a repurchase agreement with Entity B, in which Entity A sells the bond in Transaction 1 on the same day it purchases this bond from Entity B and agrees to buy back the bond at the maturity date of the bond.

This transaction was analysed by the IFRS Interpretations Committee in the March 2014 IFRIC Update. The Interpretations Committee noted that application of the guidance in IFRS 9.IG.B.6 requires judgement. It also noted that the indicators in IFRS 9.IG.B.6 may help an entity to determine the substance of the transaction, but that the presence or absence of any single specific indicator alone may not be conclusive.





CHAPTER 14

HEDGE ACCOUNTING UNDER IFRS 9



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14.1. Introduction

14.1.1. Need for hedging & economic vs accounting hedge

14.1.1.1. Need for hedge accounting

IFRS 9 relies on a dual measurement model. Financial instruments are measured either at fair value or at amortised cost depending on their contractual characteristics and the business model in which they are managed.

An entity is commonly exposed to different kinds of financial risks such as changes in interest rates, foreign currency rates, commodity prices, etc. Financial instruments, and more specifically derivatives, are the most common means used by entities in their hedging strategies of financial risks.

Under IFRS 9, all derivative instruments are measured, by default, at fair value through profit or loss (FV-PL) whereas a lot of other financial instruments are measured at amortised cost (most financial liabilities, basic loans held within a Held-to-Collect business model, etc.) or Fair Value through Other Comprehensive Income (basic loans held within a Held-to-Collect-and-Sell business model). Therefore, even if a derivative perfectly matches the exposure borne by another financial instrument, this may not be appropriately reflected in the profit or loss of the entity because the derivative hedging instrument will be measured at FV-PL whereas the exposure may be measured on a different basis. This difference in measurement methodology will result in a profit or loss volatility that does not reflect the actual economic situation of the entity.

The aim of the hedge accounting requirements is to provide an overriding accounting treatment to allow the economic hedging strategy to be better reflected in the profit or loss of the entity.

14.1.1.2. Economic vs. accounting hedge

As explained above, hedge accounting is an overriding and optional accounting treatment. Any entity can choose not to apply hedge accounting to risk management transactions even if they are fully efficient from an economic standpoint and managed internally as pure hedging strategies.

As any overriding treatment, hedge accounting is subject to several conditions which are organised as shown below:

Figure 14.1



These criteria and other features of hedge accounting will be further addressed in the rest of this chapter.

14.1.2. Alternatives to hedge accounting

The conditions required to apply hedge accounting (see **section 14.5**) are not always straightforward and may necessitate significant effort from entities (documentation, measurement of effectiveness, etc.). Thus, some entities may consider applying alternative accounting treatments that may lead to “similar” outcomes.

There are situations where the hedging instrument and the hedged exposure are measured in a similar way so that their economic offset is directly reflected in the profit or loss of the entity. These situations are often named “natural hedge” (see **section 14.1.2.1**).

IFRS 9 also offers options to account for some financial assets and liabilities (see **section 14.1.2.2**), contracts to sell or buy non-financial instruments (see **section 14.1.2.4**) and exposures to credit risk (see **section 14.1.2.3**) at fair value under some conditions.

14.1.2.1. Natural hedge

As explained previously the aim of hedge accounting is to minimise profit or loss volatility generated by offsetting positions that are measured on a different basis for accounting purposes (e.g. cost vs. fair value).

There are situations where a derivative may not need to be documented in a hedging relationship to offset the accounting impact of the economically hedged exposure. This is the case of a foreign exchange (FX) basis swap hedging a foreign currency financial liability. The derivative is by default measured at fair value through profit or loss, and the financial liability is remeasured at each reporting date at the closing spot rate through profit or loss as well in accordance with IAS 21 requirements for monetary items. Therefore, their change in value according to the change in the FX spot rate naturally offset in profit or loss without the need for hedge accounting.

Even in this situation, hedge accounting has some merits as it aligns the financial reporting with the actual management of the entity. Hedge accounting may also allow the entity to achieve a better outcome in terms of profit or loss volatility. But the existence of a “natural hedge” effect may lead some entities to consider that the constraints of applying hedge accounting in such a situation outweigh its benefits.

14.1.2.2. Optional designation as at fair value through profit or loss to reduce an accounting mismatch

As explained in **section 14.1.1.1**, the dual measurement method in IFRS 9 may lead to some profit or loss volatility between two instruments that fully offset economically. This situation is often referred to as an “accounting mismatch”.

IFRS 9 (IFRS 9.4.1.5 and IFRS 9.4.2.2(a)) permits entities to designate at fair value through profit or loss financial assets and liabilities that would not be measured that way, if such designation would eliminate or significantly reduce an accounting mismatch. This election (the “fair value option for accounting mismatch”) is available at initial recognition and is irrevocable. See **section 7.4.5** for more details on the fair value option and some examples of situations where an accounting mismatch may arise.

IFRS does not permit the designation of only a part of a financial asset or a financial liability at fair value through profit or loss. The designation of only some of the financial assets and liabilities that generate the accounting mismatch is prohibited as well, if doing so would not eliminate or significantly reduce the accounting mismatch.

Example 14.1

Entity A issues a single €500 million fixed rate debt liability and uses the cash received to purchase a vanilla financial fixed rate debt asset for €450 million that is managed on a fair value basis. Applying the general requirements of IFRS 9 for classification and measurement, the entity would recognise the financial debt at amortised cost and the financial asset at fair value through profit or loss. To reduce the accounting mismatch, the entity may consider applying the fair value option to its financial liability. However, the entity cannot designate only €450 million out of the €500 million of the financial liability at fair value through profit or loss.

Applying this fair value option permits to reduce the volatility in profit or loss but does not replicate the hedge accounting outcome. Indeed, the election needs to be done upon initial recognition (unlike hedge accounting) and the 'hedged item' must be remeasured at fair value for all its attributes which could lead to some volatility in profit or loss (unlike hedge accounting where entities could hedge only some risk components for a given hedged item under some conditions - see **section 14.3.2.1**). In the above example where the entity elects to design a fixed rate debt at fair value to reduce the accounting mismatch with the fixed rate asset measured at fair value, the offsetting positions on interest rates will be better reflected in profit or loss. But the entity will have to remeasure its financial liability fully at fair value, triggering changes in value from other risk components such as own credit risk¹.

14.1.2.3. Credit risk exposures

14.1.2.3.1. A dedicated approach is needed for credit risk management based on credit derivatives

Many financial institutions use credit derivatives to manage their credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer the risk of credit loss on a loan or on a loan commitment to a third party. This might also reduce the regulatory capital requirements of the bank for these credit exposures.

However, the credit risk component of a financial item does not meet the eligibility criteria for hedged items (IFRS 9.BC6.470). One of the hedge accounting requirements is that the hedged risk must be separately identifiable to be able to isolate its impact on the change in fair value of the hedged instrument. The IASB considered that it is not the case for the credit risk component of a loan because, if it is obvious that it is a component of a spread between the risk-free rate and the market interest rate for a given debt instrument, it is not possible to isolate it within this spread from other risks such as liquidity risk, funding risk, etc.

We presented in the previous section the principles of the fair value option for accounting mismatch. This could have been a potential solution to solve this issue. However, it has many limits as:

- it applies only to financial instruments that are within the scope of IFRS 9, excluding for example loan commitments;
- it has to be designated upon initial recognition of the instrument and is irrevocable; and
- it has to be applied to the instrument as a whole (not a proportion of it).

¹ Note that the own credit risk component of the change in fair value of a financial liability designated at FV-PL is recognised in Other Comprehensive Income. Please refer to **chapter 8** Classification of financial liabilities for more information.

These limits do not enable entities to adequately reflect the credit risk management based on credit derivatives that financial institutions often implement. Therefore, the Board introduced with IFRS 9 a new mechanism to address these situations.

14.1.2.3.2. Principles and conditions of the approach

An entity that uses a credit derivative to manage the credit risk of all, or part of, a financial instrument, may designate that financial instrument as measured at FV-PL if (IFRS 9.6.7.1):

- the name of the credit exposure of the hedged financial instrument matches the reference entity of the credit derivative; and
- the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

This designation has to be done to the extent that the credit risk is so managed (e.g. only for a proportion of the financial instrument if the credit derivative only hedges a proportion of it).

This designation may apply to any financial instrument, even if it is not within the scope of IFRS 9 (including loan commitments for example).

This designation may be made upon initial recognition, subsequently, or even while the financial instrument is unrecognised (e.g. loan commitments).

This designation must be accompanied by a related documentation that explains the risk management link between the credit derivative and the financial instrument, and documents the date of initial designation at FV-PL of the financial instrument.

Upon initial designation at FV-PL, any difference between the carrying amount, if any, of the financial instrument and its fair value is recognised in profit or loss. Any change in value accumulated in other comprehensive income has to be immediately reclassified from equity to profit or loss as a reclassification adjustment (IFRS 9.6.7.2).

The designation at FV-PL must be discontinued if the situation does not meet the requirement described above anymore, for example:

- the credit derivative is sold, terminated or settled; or
- the credit risk of the financial instrument is no longer managed using a credit derivative.

When such designation is discontinued, the fair value of the instrument at the date of discontinuation becomes its new carrying amount. Subsequently, the instrument is subject to the same measurement methodology that was used before designating the financial instrument at FV-PL (IFRS 9.6.7.4). For example, if the instrument was measured at amortised cost, the entity will have to determine a new effective interest rate based on the new gross carrying amount of the instrument.

14.1.2.4. Own use contracts

Contracts to buy or sell a non-financial item that can be settled net in cash (including net settlement in another financial instrument or by exchanging financial instruments) are accounted for in accordance with IFRS 9 requirements as if these contracts were financial instruments unless they are entered into

and continue to be held for the purpose of receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (IFRS 9.2.4). These contracts that are excluded from the scope of IFRS 9 are often referred to as 'own use' contracts. This concept is mostly applied to contracts to buy or sell commodities. They are accounted for as executory contracts, and as a result their accounting treatment falls within other applicable IFRS standards (Please refer to **chapter 1** for more information on this scoping issue).

When a contract to buy or sell a non-financial item is within the scope of IFRS 9, it is accounted for as a derivative at fair value through profit or loss, unless it is documented as a hedging instrument.

Note that IFRS 9 allows entities to irrevocably designate their own use contracts (that would otherwise be out of scope of IFRS 9) as measured at fair value through profit or loss. This designation is available only at inception of the contract, and only if it eliminates or significantly reduces an accounting mismatch that would otherwise arise (IFRS 9.2.5).

14.1.3. IFRS 9 hedge accounting approach & changes vs. IAS 39

IAS 39 hedge accounting requirements were largely criticised as being rule-based and not reflecting the risk management activities of entities. The outcome in the financial statements was sometimes prejudicial and did not reflect the economic substance of these types of relationships leading to a limitation of the use of hedging instruments by many entities.

The IASB had these criticisms in mind when defining the IFRS 9 hedge accounting requirements and decided to move hedge accounting from rule-based requirements to more principle-based requirements reflecting the risk management activities of the entities. The Board notably did so by introducing two notions in the standard: risk management strategy and risk management objective which are fundamental in the new hedge accounting model (see **section 14.2**). The objective is to link hedge accounting entries and the related information disclosed in the financial statements to the way entities manage their risks.

Moving from a rule-based approach to a principle-based approach for hedge accounting, IFRS 9 softens some of the qualifying criteria and proposes more favourable accounting treatments for some of the hedging relationships. This will normally lead to more hedging relationships being eligible to hedge accounting even if the basics of hedge accounting were not modified.

Some of the main changes brought by IFRS 9 are summarised below (this list is not exhaustive):

- Eligibility of hedged items:
 - > IFRS 9 permits, under some conditions, the designation of components of a non-financial instrument as a hedged item (see **section 14.3.2**).
 - > IFRS 9 expands the eligibility to some net positions (see **section 14.3.4.2**).
 - > Unlike IAS 39, IFRS 9 permits the designation of an aggregated exposure that is a combination of eligible non-derivative items and derivatives as hedged items (see **section 14.3.4.3**).
- Effectiveness: IFRS 9 replaces the 80-125 per cent effectiveness threshold with a more qualitative requirement reflecting the risk management purposes (see **section 14.5.3**). Ineffectiveness will continue to be monitored and recognised directly in profit or loss when it occurs (except for hedging equity instruments for which the entity elected to recognise fair value changes in OCI).

- Accounting for time value of options and forward points: IFRS 9 introduce a new accounting treatment which is more consistent with the economic substance of these elements often considered as “cost of hedging” (see **section 14.8**).
- Discontinuation: entities no longer have the possibility to voluntarily de-designate a hedging relationship if its risk management is unchanged (see **section 14.10.1**). Hedge accounting continues to be optional (i.e. entities can choose not to apply hedge accounting even if they enter into hedging relationships (regardless of their effectiveness)).

Most of the changes introduced by IFRS 9 on hedge accounting are driven by the objective of a better alignment with the hedging strategy of the management. Those changes come with new disclosure requirements to enable users of financial statements to have a clear view of the entity’s hedging strategy and its implications for future cash flows (see **chapter 16**).

14.1.4. IFRS 9, Macro-hedging, and related transition options

The new hedge accounting model introduced by IFRS 9 does not address the dynamic risk management implemented mostly by financial institutions to manage the risk related to their asset and liability management. These strategies are often named “macro hedging” activities.

The Board has launched a project to provide users of financial statements with better information about a company’s dynamic risk management activities.

Meanwhile, the Board decided to grant any preparer with the option to differ the application of the new IFRS 9 hedge accounting requirements until the project on accounting for macro hedging is completed. In this case, the entity continues to apply IAS 39 hedging requirements.

The standard does not indicate whether it is possible to apply IFRS 9 for example in 2018, electing the option to differ the application of the new hedging requirements of IFRS 9, and to apply these new hedging requirements in 2021 even if the IASB project on macro hedging is not yet finalised. Doing this would, in our opinion, be possible, as nothing in the standard seems to prevent it. However, once an entity elects to apply IFRS 9 hedge accounting requirements, it cannot revert back to IAS 39 afterwards.

14.2. Risk management: strategy vs. objective

As mentioned above, IFRS 9 aims at reflecting risk management activities in the financial statements.

Risk management activities are the implementation of the risk management strategies of the entity. IFRS 9.B6.5.24 makes a distinction between risk management strategy and risk management objective.

A risk management strategy is established at the highest level at which an entity determines how it manages its risks. A risk management strategy is generally maintained over a relatively long period of time. Risk management strategies typically identify the risks to which the entity is exposed and set out how the entity responds to them (for example, which risks are being hedged and if relevant, to which extent, using which instruments, over which period(s)...). Generally, they are flexible to react to changes in circumstances.

In contrast, the risk management objective is related to a given hedging relationship and reflects how the entity implements the risk management strategy at this level (i.e. how the particular hedging instrument that has been designated is used to hedge the particular risk that has been designated as the hedged item to satisfy the risk management strategy).

Example 14.2

For example, an entity may have as a risk management strategy for the management of the interest rate exposure to keep its net indebtedness at floating rate at or below 60 per cent of its total indebtedness. The entity decides from time to time at which proportion to keep the floating rate indebtedness depending on the market interest rates (on 1 January 202X, given the market interest rates and the entity's expectation for their evolution, the entity sets this level at 50 per cent).

On 1 January 202X, the entity issues a debt (assume there is no cash, and this is the only debt in the balance sheet of the entity) for €100 million at floating rate. To comply with its management risk strategy the entity decides to contract at the same time an interest rate swap (pay fixed / receive variable) for €50 million. After this transaction, the entity's net indebtedness at floating rate amounts to €50 million and fixed rate indebtedness amounts to €50 million.

- > The hedge objective is to hedge against the variability in interest rate for 50% of the future interest rates of the issued debt.
- > Floating rate net indebtedness amounts to 50 per cent of the total net indebtedness of the entity which is compliant with the risk management strategy of the entity.

Three months later (on 31 March 202X), the entity takes advantage of the low level of interest in the market and issues a new debt for €50 million at fixed rate. The new net indebtedness (considered hedging transactions) profile is thus composed of:

- > €100 million (€50 million corresponding to the fixed rate leg of the interest swap entered into on 1 January 202X and €50 million corresponding to the new fixed rate debt issued on 31 March 202X) at fixed rate; and
- > €50 million (€100 million corresponding to the floating rate debt issued as 1 January 202X reduced for €50 million by the received floating rate of the interest rate swap entered into by the entity at the same date) at floating rate.

Floating rate net indebtedness amounts to 33.3 per cent of the total net indebtedness of the entity which is compliant with its risk management strategy.

The entity decided given the market interest rates to put the level of floating rate at 60 per cent of the total indebtedness and thus decided to change the hedge objective of the hedging relationship described above to comply with this new level. To do so, the entity now designates as the hedge objective to hedge against variability of 10 per cent of the future interest payments of the debt issued in January 202X. The entity then uses only a proportion of the interest rate swap entered into in January 202X corresponding to €10 million as the hedging instrument, the other €40 million are now excluded from the hedging relationship and could either be used in another hedging relationship or considered as a trading position.

In this example, the risk management strategy (to keep the floating rate indebtedness at a level below 60 per cent) did not change. However, the risk management objective did change as the entity no longer hedges against the variability of 50 per cent of the future interest payments of the floating rate debt issued in January 202X but rather hedges against variability of 10 per cent of the future interest payments of the same debt.

These two concepts are very important under IFRS 9 for hedge accounting. They will interact with the hedging documentation of the entity (see **section 14.5.2**), the ability to discontinue a hedging relationship (see **section 14.10.1**), and the disclosure requirements (see **chapter 16**).

14.3. Hedged items

14.3.1. Introduction to eligible hedged items

14.3.1.1. Why is it important to appropriately design the hedged item?

The correct designation of the hedged item is of crucial importance as it will:

- allow the application of hedge accounting or not depending on its eligibility;
- have to be described in the hedging documentation;
- impact the possibility to maintain or not an existing hedging relationship; and
- drive potentially significant impacts in profit or loss.

For example, it is on the basis of the documented hedged item that the entity will perform:

- the hedge ineffectiveness measurement that will impact the profit or loss of the period; and
- the assessment of whether the hedged item disappeared or is no more likely to occur, to determine whether the discontinuation of an existing hedging relationship is required.

14.3.1.2. General principles governing eligible hedged items

Under IFRS 9.6.3.1, a hedged item could be:

- a recognised asset or liability;
- an unrecognised firm commitment;
- a **highly probable** forecast transaction; or
- a net investment in a foreign operation.

A hedged item can be a single item or a group of items.

A hedged item can also be a component of such item or group of items (specific cash flows, proportion or layer of a nominal amount, a net position, an aggregated exposure...).

A hedged item can also relate to a risk component, that can be explicit or implicit, and that can be hedged fully or partially.

By combining the two above concepts (hedging an item in its entirety or a component of it, fully or partially hedging a risk component...) there are numbers of ways to determine what the hedged item will exactly be. But in any case, such designation is only possible provided the hedged risk is separately identifiable and reliably measurable (IFRS 9.6.3.2, i.e. it must be possible to clearly identify and quantify the change in value attributable to the risk(s) being hedged). This applies to financial and non-financial instruments.

As a general principle, a hedged item has an impact on the profit or loss of the entity entering into the hedging relationship (IFRS 9.6.5.2, see **section 14.3.5**).

All these concepts will be explained in more details below.



14.3.2. A hedged item can be a component

Under IFRS 9 (IFRS 9.6.3.7) an entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship.

IFRS 9.6.3.7 specifies that an entire item comprises all changes in the cash flows or fair value of an item. A component comprises less than the entire fair value change or cash flow variability of an item. In that case, an entity may designate only the following types of components (including combinations) as hedged items:

- only changes in the cash flows or fair value of an item attributable to a specific risk or risks provided this risk is separately identifiable and reliably measurable. Risk components include a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or other variable (commonly known as “one-sided risk”), of a hedge of an exposure for only a partial term for which it is outstanding (see **section 14.3.2.1**);
- one or more selected contractual cash flows (see **section 14.3.2.2**);
- components of a nominal amount: there are two types of nominal amounts that can be designated as the hedged item in a hedging relationship:
 - > a component that is a proportion of an entire item (e.g. when an entity hedges only 50 per cent of the interest cash flows of a floating rate debt) (see **section 14.3.2.3.1**), or
 - > a layer component (see **section 14.3.2.3.2**).

Finally, an entity can designate as the hedged item all the cash flows of an eligible item, or only a given risk component provided that this does not result in hedging more than the total cash flows of the hedged item (see **section 14.3.3**).

14.3.2.1. Hedging a risk component of a hedged item

Under IFRS 9.6.3.7, entities can designate any risk component as a hedged item for financial and non-financial items provided this risk is **separately identifiable** and **reliably measurable**.

14.3.2.1.1. Explicit and implicit risk components

The two conditions mentioned above (separately identifiable and reliably measurable) have to be analysed for the specific risk in the context of the particular market structure. These conditions can be satisfied for risks that are contractually specified and those that are not (the risk component is implicit) (IFRS 9.6.3.7).

Example 14.3

(IFRS 9.B6.3.10(a)) An example of a contractually specified risk is when an entity A enters into a long term supply contract for natural gas that is priced using a contractually specified formula that references commodities and other factors (for example, gas oil, fuel oil and other components such as transport charges). Entity A hedges the gas oil component in that supply contract using a gas oil forward contract. Because the gas oil component is specified by the terms and conditions of the supply contract it is a contractually specified risk component. Because of the pricing formula, the entity concludes that the gas oil price exposure is separately identifiable. At the same time, there is a market for gas oil forward contracts. Hence, Entity A concludes that the gas oil price exposure is reliably measurable. Consequently, entity A concludes that the gas oil price exposure in the supply contract is a risk component that is eligible for designation as a hedged item.

Example 14.4

(IFRS 9.B6.3.10(c)) An example of an implicit risk component is when Entity C hedges part of its future jet fuel purchases on the basis of its consumption forecast up to 24 months before delivery and increases the volume that it hedges over time. Entity C hedges this exposure using different types of contracts depending on the time horizon of the hedge, which affects the market liquidity of the derivatives. For the longer time horizons (12–24 months) Entity C uses crude oil contracts because only these have sufficient market liquidity. For time horizons of 6–12 months Entity C uses gas oil derivatives because they are sufficiently liquid. For time horizons up to six months Entity C uses jet fuel contracts. Entity C's analysis of the market structure for oil and oil products and its evaluation of the relevant facts and circumstances is as follows:

- > Entity C operates in a geographical area in which Brent is the crude oil benchmark. Crude oil is a raw material benchmark that affects the price of various refined oil products as their most basic input. Gas oil is a benchmark for refined oil products, which is used as a pricing reference for oil distillates more generally. This is also reflected in the types of derivative financial instruments for the crude oil and refined oil products markets of the environment in which Entity C operates, such as:
 - the benchmark crude oil futures contract, which is crude oil for Brent; the benchmark gas oil futures contract, which is used as the pricing reference for distillates—for example, jet fuel spread derivatives cover the price differential between jet fuel and that benchmark gas oil; and
 - the benchmark gas oil crack spread derivative (i.e. the derivative for the price differential between crude oil and gas oil—a refining margin), which is indexed to Brent crude oil.
- > the pricing of refined oil products does not depend on which particular crude oil is processed by a particular refinery because those refined oil products (such as gas oil or jet fuel) are standardised products.

Hence, Entity C concludes that the price risk of its jet fuel purchases includes a crude oil price risk component based on Brent crude oil and a gas oil price risk component, even though crude oil and gas oil are not specified in any contractual arrangement. Entity C concludes that these two risk components are separately identifiable and reliably measurable even though they are not contractually specified. Consequently, Entity C may designate hedging relationships for forecast jet fuel purchases on a risk components basis (for crude oil or gas oil). This analysis also means that if, for example, Entity C used crude oil derivatives based on West Texas Intermediate (WTI) crude oil, changes in the price differential between Brent crude oil and WTI crude oil would cause hedge ineffectiveness.



Permitting the designation of risk components as hedged items for hedge accounting purposes leads to an accounting treatment that reflects more accurately the risk management activities of the entities. It also facilitates the demonstration of the existence of the economic relationship between the hedging instrument and the hedged item.

If entities could not designate risk components as hedged items for hedge accounting purposes, they would have to demonstrate the existence of an economic relationship between the hedging instrument and all (or a proportion of) the hedged item. This would lead to some ineffectiveness that may limit the cases when entities use hedge accounting or alter the performance of the hedging relationship communicated to users.

14.3.2.1.2. Inflation as an implicit risk component

IFRS 9 (IFRS 9.B6.3.13) considers there is a presumption that unless inflation risk is contractually specified, it is not a separately identifiable and reliably measurable risk component and hence cannot be designated as a risk component of a financial instrument. However, in limited cases, it is possible to identify a risk component for inflation risk that is separately identifiable and reliably measurable because of the particular circumstances of the inflation environment and the relevant debt market.



Example 14.5

IFRS 9.B6.3.14 takes the example of an entity which issues debt in an environment in which inflation-linked bonds have a volume and term structure that results in a sufficiently liquid market that allows constructing a term structure of zero-coupon real interest rates. This means that for the respective currency, inflation is a relevant factor that is separately considered by the debt markets. In those circumstances the inflation risk component could be determined by discounting the cash flows of the hedged debt instrument using the term structure of zero-coupon real interest rates (i.e. in a manner similar to how a risk-free (nominal) interest rate component can be determined).

However, in an environment where the inflation-linked bonds market is not sufficiently liquid to determine a term structure of zero-coupon real interest rates, the analysis of the market structure would not support the entity concluding that inflation is a relevant factor that is separately considered by debt markets. Therefore, the entity cannot overcome the rebuttable presumption that inflation risk that is not contractually specified is not separately identifiable and reliably measurable.

14.3.2.1.3. Hedging a one-sided risk

Once an entity has identified which risk component it wishes to hedge, it has to decide whether it will hedge the risk in full or only a portion of it.

For example, an entity may consider hedging the change in interest rate cash flows of a floating rate liability against the risk of an increase of the benchmark rate above 4% with a cap. In this case the entity is only hedging a “one-sided risk” and not the full exposure of its future cash flows to the interest rate volatility (IFRS 9.6.3.7).

14.3.2.1.4. Partial term hedging

It is possible to document a hedging relationship on a hedged risk for only a partial term for which it is outstanding. This was explained in the Implementation Guidance of IAS 39 and remains relevant under IFRS 9.

This kind of documentation applies both to financial and non-financial instruments and requires that the hedged risk components meets the usual eligibility conditions and in particular that the hedged risk is separately identifiable and reliably measurable.

Example 14.6

Entity A acquires a 10 per cent fixed rate government bond with a remaining term to maturity of ten years. Entity A classifies the bond as measured at FV-OCI. To hedge itself against fair value exposure on the bond associated with the present value of the interest rate payments until year 5, Entity A acquires a five-year pay-fixed, receive-floating swap.

The swap may be designated as hedging the fair value exposure of the interest rate payments on the government bond until year 5 and the change in value of the principal payment due at maturity to the extent affected by changes in the yield curve relating to the five years of the swap (IAS 39.IG.F.2.17).

14.3.2.2. Hedging specific contractual cash flows

An entity has the possibility to document only one or several specific contractual cash flows as a hedged item.

Example 14.7

An entity may choose to implement a hedge against the impact of the change in interest benchmark rates on the interest cash payments only for the first 3 years of a 5-year floating rate debt.

Example 14.8

An entity issued a 5-year foreign currency bond. Interests are paid each year but the principal repayment is *in fine*. The entity may document a foreign currency hedge only on the final redemption cash payment in year 5 without hedging the foreign currency exposure related to the interest payments.

14.3.2.3. Hedging a proportion or a layer of a nominal amount**14.3.2.3.1. Hedging a proportion of a nominal amount**

An entity has the possibility to hedge a strict proportion of an instrument's contractual cash flows. For example, it can hedge 50% of all the cash flows of a debt instrument (IFRS 9.B6.3.17).

14.3.2.3.2. Hedging a layer component

A layer component can be specified from a defined, but open, population or from a defined nominal amount.

Example 14.9

Below are examples of layer components that may be documented as a hedged item:

- > a part of a monetary transaction volume: such as the first \$10 million cash inflows from sales to customers in March 202X (for an entity the functional currency of which is euro);
- > a part of a physical volume: such as 100 tons bottom layer of rubber inventory in a specified location;
- > a part of a physical or other transaction volume: such as the first 200 oil barrel purchases in March 202X or the first 200 MWh of electricity sales in June 202X;
- > a layer from the nominal amount of the hedged item: such as the last €80 million of a €100 million firm commitment or the bottom layer of €20 million of a €100 million fixed-rate bond.

It is important to note that a layer has to be identifiable so that it is possible to identify the hedged exposure or cash flow when it occurs.

Example 14.10

Consider an entity frequently selling goods in a foreign currency. The entity would like to document a foreign currency hedge on the last 100 units of goods sold on a given period. In practice, the entity will only be able to identify those "last sales" at the end of the period as additional transactions may occur by the end of the period. In such situation the entity will not be allowed to document the 100 units sold as a hedged item because it is unable to identify the transaction when it occurs. The identification can only be performed afterwards.

Similarly, when a layer component is designated in a fair value hedge, an entity must specify it from a defined nominal amount. To comply with the requirements of fair value hedge accounting, an entity hedging a layer component must re-measure it for fair value changes attributable to the hedged risk and

the resulting adjustment must be recognised in profit or loss no later than when the item is derecognised. Therefore, it is necessary to track the nominal amount from which the layer is defined to track the designed layer and, when relevant (e.g. the hedged layer is derecognised), amortise the accumulated adjustment.

IFRS 9.B6.3.20 states that a layer component that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the prepayment option's fair value is affected by changes in the hedged risk, unless the designated layer includes the effect of the related prepayment option when determining the change in the fair value of the hedged item.

14.3.3. Relationship between components and the total cash flows of a hedged item

IFRS 9.B3.21 states that if a component of the cash flows of a financial or a non-financial item is designated as the hedged item, that component must be less than or equal to the total cash flows of the entire item.

This type of situation, often referred to as the "Sub-LIBOR" issue, may seem to be counterintuitive at first sight but actually occurs in various circumstances.

Example 14.11

Some financial institutions and sovereigns are able to raise funding at an interest rate that is below the benchmark interest rate (e.g. LIBOR – 20 bp). In such a situation the standard would not allow the entity to document as a hedged item the LIBOR component as, given the negative spread of -20, this component may be more than the total cash flows of the entire item.

In the example of a floating rate debt paying LIBOR – 20bp, one solution to consider would be to document the whole instrument (and not just the LIBOR component) as being hedged against the change in value of the LIBOR index.

Such situation may also occur in the commodity environment as mentioned by IFRS 9.B6.3.25. For example, for quality, storage or transportation reasons, negative spreads applied to index prices are common.

Example 14.12

Consider a specific type of crude oil from a particular oil field that is priced off the relevant benchmark crude oil. If an entity sells that crude oil under a contract using a contractual pricing formula that sets the price per barrel at the benchmark crude oil price minus CU10 with a floor of CU15, the entity can designate as the hedged item the entire cash flow variability under the sales contract that is attributable to the change in the benchmark crude oil price. However, the entity cannot designate a component that is equal to the full change in the benchmark crude oil price.

14.3.4. Group of items

For a group of items to be eligible as a hedged item for hedge accounting purposes, IFRS 9.6.6.1 requires that:

- the individual items constituting the group are eligible as hedged items under IFRS 9 (see sections above); and
- for risk management purposes, the items in the group are managed together on a group basis.

The items composing the group being managed together on a group basis for risk management purposes is a matter of facts and not documentation (it depends on the entity's behaviour).

The standard provides additional requirements for situations where:

- the hedged item is a component of a group (see **section 14.3.4.1**);
- the items composing a group have offsetting impact so that they constitute net positions, including nil net positions (see **section 14.3.4.2**); and
- the items hedged consist in an aggregated exposure (see **section 14.3.4.3**).

14.3.4.1. Component of a group of items

IFRS 9 permits not only a component of a single item to be designated as a hedged item for hedge accounting purposes under some conditions (see **section 14.3.2**) but also components of a group of items that is eligible as a hedged item.

Under IFRS 9, entities can hedge a proportion or a layer component of a group of items eligible as hedged items (see conditions in **section 14.3.4**) if the hedge is consistent with the entity's risk management objective and, as for any eligible hedged item, if it is separately identifiable and reliably measurable.

Authorising layer components for a group of items to be eligible as hedged items is supported by all the reasons that support the eligibility of layer components of a single item but also because (IFRS 9.BC6.439):

- uncertainties relating to the transactions (e.g. breach of contracts or prepayment options) can be better modelled when considering a group of items;
- in practice, hedging layers of groups of items is a common risk management strategy; and
- arbitrarily identifying and designating specific items from a group of items that are exposed to the same hedged risk can:
 - > give rise to arbitrary accounting results if the designated items do not behave as originally expected (while other items, sufficient to cover the hedged amount, do behave as originally expected); and
 - > can provide opportunities for earnings management (for example, by choosing to transfer and derecognise particular items from a homogeneous group of items when only some were specifically designated into a fair value hedge and therefore have fair value hedge adjustments attached to them).

Hedging a layer component of an eligible group of items is subject to additional specific requirements (IFRS 9.6.6.3):

- the items in the overall group from which the layer is identified are exposed to the same hedged risk (so that the measurement of the hedged layer is not significantly affected by which particular items from the overall group form part of the hedged layer);
- for a hedge of existing items (for example an unrecognised firm commitment or a recognised asset) an entity can identify and track the overall group of items from which the hedged layer is defined (so that the entity is able to comply with the requirements for the accounting for qualifying hedging relationships); and
- any items in the group that contain prepayment options meet the requirements for a layer component of a nominal amount (see **section 14.3.2.3.2**).

Example 14.13

Consider a hedge of a proportion of a group of items. Entity A issues a group of 1.000 loans in March 202X at fixed rates and with similar characteristics. The loans cannot be early repaid. Entity A's risk management strategy consists in hedging 50% of the group of loans against changes in fair value due to changes in interest rates. Thus, the entity enters in a hedging derivative to hedge 50% of the changes in fair value related to the 1.000 loans issued in March 202X. This proportion is eligible as a hedged item under IFRS 9.

14.3.4.2. Net positions

14.3.4.2.1. General requirements for hedges of net positions

Under IFRS 9, net positions can be a hedged item only if the entity hedges on a net basis for risk management purposes. Whether an entity hedges in this way is a matter of fact. Hence, an entity cannot apply hedge accounting on a net basis solely to achieve a particular accounting outcome if that would not reflect its risk management approach. Net position hedging must form part of an established risk management strategy.

14.3.4.2.2. Specific requirements for cash flow hedges of net positions

Net positions are common situations in many segments of activities, but the most common is probably the situation where foreign currency exposures of an entity with offsetting impacts are managed and hedged on a net basis. This is generally achieved with a cash flow hedge relationship.

IFRS 9.6.6.1 and IFRS 9.B6.6.7 permit that net positions be designated as hedged items for hedge accounting purposes under a cash flow hedge relationship if:

- it is a hedge of a foreign currency risk; and
- the designation of the net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

The requirement for specifying the reporting periods on which the expected transactions impact profit or loss was set by the IASB to avoid the selection effect (which would lead to earnings management).

14.3.4.2.3. Presentation requirements for hedging relationships on net positions

For a hedge of a group of items with offsetting risk positions (i.e. a hedge of a net position) where hedged risk affects different line items in the statement of profit or loss and other comprehensive income, any hedging gains or losses in that statement is to be presented in a separate line from those affected by the hedged items (IFRS 9.6.6.4 and BC6.4.5.8).

Hence, in the income statement, the amount in the line item that relates to the hedged item itself remains unaffected by hedging gains and losses.

For asset and liabilities that are hedged together as a group in a fair value hedge, the individual items composing the group will be adjusted for the changes of the hedged risk in the financial position (for example when the group of items includes assets and liabilities with offsetting positions, the individual assets and liabilities will be adjusted for the change in the hedged risk) as for hedging single items (see **section 14.7.2.1**). If these items do not impact the same line of the income statement, the hedging gains and losses will be presented on a separate line as for cash flow hedge relationships.

Example 14.14

An entity, the functional currency of which is EUR, is hedging the foreign currency risk of a net position of foreign currency sales of USD 100 and a foreign currency expense of USD 80 using a forward exchange contract for USD 20. Both the sales and the expenses will be recognised in profit or loss as if they were not hedged, and the performance of the forward exchange contract will be presented in a separate line item. The benefit from the hedging strategy will be effective on the bottom line of the profit or loss statement (or on an intermediate level such as EBIT), but the sales and the expenses will be presented without the benefit of hedge accounting.

The Board decided to require such presentation principles because it considers that recognising the benefit of the hedge on each line item of the profit or loss affected by the hedged item would be tantamount to recognising gross gains and losses that do not exist. In the example above, it would have been “as if” two derivatives were implemented for a respective gross amount of USD 100 and USD 80 whereas the entity actually entered a USD 20 forward only. The IASB thus considered that hedging gains and losses for cash flow hedges of a net position are to be recognised in a separate line within profit or loss or other comprehensive income to avoid recognising “fictitious” gains and losses.

Additionally, IFRS 9.B6.6.9 requires that, if the hedged items of a group hedged on a net basis will not impact the profit or loss during the same period, the entity has to recognise the changes in value of the items in the net position that have a similar effect as the hedging instrument only once the transactions that they relate to are recognised.

Example 14.15

Consider the same fact pattern as for Example 14.14 above except that the expenses of USD 80 are expected to occur in year N+1, and the sales of USD 100 are expected in year N+2. The entity enters a USD 20 forward having the same maturity as the expected sales in year N in order to hedge its net position in a cash flow hedge relationship.

At the end of year N, the entity recognises the change in value of the forward in other comprehensive income. No additional entries are recognised related to the future expected transactions as they have not yet occurred.

At the end of year N+1, the entity will recognise the expenses of USD 80 at the spot rate applicable upon the expense recognition date, and recognise on a separate line item of the profit or loss statement the change in value of these expenses attributable to the change in the foreign exchange rate between the designation of the hedging relationship and the recognition of expenses. The offsetting entry of this cumulative change in value will be recognised in other comprehensive income as a cash flow hedge reserve together with the performance of the hedging derivative.

In year N+2, the entity will recognise the sales at the spot rate applicable upon the revenue recognition date and transfer in a separate line of the profit or loss statement the amount accumulated in the cash flow hedge reserve within other comprehensive income.

14.3.4.2.4. Nil net positions

IFRS 9.6.6.6 states that when the hedged item is a group that is a nil net position (i.e. the hedged items among themselves fully offset the risk that is managed on a group basis), an entity is permitted to designate it in a hedging relationship that does not include a hedging instrument, provided that:

- the hedge is part of a rolling net risk hedging strategy, whereby the entity routinely hedges new positions of the same type as time moves on (for example, when transactions move into the time horizon for which the entity hedges);



- the hedged net position changes in size over the life of the rolling net risk hedging strategy and the entity uses eligible hedging instruments to hedge the net risk (i.e. when the net position is not nil);
- hedge accounting is normally applied to such net positions when the net position is not nil and it is hedged with eligible hedging instruments; and
- not applying hedge accounting to the nil net position would give rise to inconsistent accounting outcomes, because the accounting would not recognise the offsetting risk positions that would otherwise be recognised in a hedge of a net position.

14.3.4.3. Aggregated exposures

Entities can designate as hedged item an aggregated exposure that is a combination of an exposure eligible as a hedged item under IFRS 9 and a derivative (IFRS 9.6.3.4). To be eligible as a hedged item, the aggregated exposure must be managed as one exposure for a particular risk by the entity.

Example 14.16

An example of an aggregated exposure is combination of a floating rate debt denominated in USD (the entity functional currency is euro) and an interest rate swap (pay fixed / receive variable) denominated in USD. Economically, the aggregated exposure in this case corresponds to a fixed rate debt denominated in USD that the entity can hedge under IFRS 9 against changes in the exchange rates between USD and the functional currency of the entity.

An aggregated exposure can be a forecast transaction (i.e. uncommitted but anticipated future transaction that would give rise to an exposure and a derivative) provided that it is highly probable and, once it has occurred, is eligible as a hedged item.

Example 14.17

At 1 January 202X, entity A, the functional currency of which is EUR, expects (transaction is highly probable) to issue a fixed rate debt denominated in USD in 12 months. The entity's strategy is to have all its indebtedness in its functional currency, so it is highly probable that when the debt will be issued, entity A will transact a cross-currency interest rate swap converting the fixed rate debt denominated in USD to a fixed rate debt denominated in EUR.

To hedge against the evolution of interest rates between 1 January 202X and the debt issuance date, entity A decides to contract a forward starting interest rate swap (pay fixed / receive variable).

Under IFRS 9, entity A can designate this forward starting interest rate swap as hedging the forecast aggregated exposure against changes in EUR interest rates over the next 12 months. This hedging relationship will qualify as a cash flow hedge.

Hedging an aggregated exposure does not mean that the combination of the exposure and the derivative composing this aggregated exposure are no longer accounted for following the relevant requirements of IFRS 9. Both the exposure and the derivative constituting the aggregated exposure will continue to be accounted for following the relevant IFRS 9 requirements.

When designating an aggregated exposure as a hedged item, an entity considers the combined effect of the items that constitute the aggregated exposure for the purpose of assessing hedge effectiveness and measuring hedge ineffectiveness.

14.3.5. A hedged item must be exposed to a risk that could affect profit or loss

The definition of fair value hedge and cash flow hedge (IFRS 9.6.5.2) explicitly states that they aim at hedging a risk that could affect the profit or loss of the entity. This is also the case for a net investment hedge as IAS 21 stipulates that the foreign currency risk hedged in such a hedging relationship will impact the profit or loss upon disposal of the net investment.

Example 14.18

A EUR functional entity is considering issuing a new USD debt in 3 months. The transaction is highly probable. The entity would like to enter a foreign currency derivative to hedge the change in the EUR/USD spot rate between the derivative transaction date and the USD debt origination date. This derivative cannot benefit from a hedge accounting treatment in such a situation because the profit or loss of the entity will never be impacted by the change in the spot rate occurring between the trade date of the derivative and the date of the USD debt origination.

In practice this condition is often related to the counterparty of the hedged transaction. IFRS 9.6.3.5 states that only assets, liabilities, firm commitments or highly probable forecast transactions with a party external to the reporting entity can be designated as hedged items.

Intragroup transactions fully eliminated through the consolidation process have no impact on the consolidated profit or loss and cannot therefore be documented as a hedged item in the group consolidated account. Royalty payments, interest payments and management charges between members of the same group will not generally affect the consolidated profit or loss and consequently cannot qualify as hedged items in a cash flow hedge unless there is a related external transaction (IFRS 9.B6.3.5).

Hedge accounting can however be applied to transactions between entities in the same group in the individual or separate financial statements of those entities.

There are however several exceptions to this principle on intragroup transactions:

- In the consolidated financial statements of an investment entity as defined in IFRS 10, transactions between the investment entity and its subsidiaries measured at fair value through profit or loss will not be eliminated and are therefore eligible as hedged items.
- IFRS 9 provides a specific exception for equity investments classified at FV-OCI-NR. Even if the gain or loss realised upon the sale of the equity instrument will never impact the profit or loss, IFRS 9 explicitly allows entities to document them as a hedged item provided that the hedged exposure could affect other comprehensive income (IFRS 9.6.5.3).
- The foreign currency risk of an intragroup monetary item may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation in accordance with IAS 21. This will occur when an intragroup monetary item exists between two entities having different functional currencies (e.g. a USD payable / receivable between a USD functional currency entity and a EUR functional currency entity).
- The foreign currency risk of a highly probable forecast intragroup transaction may qualify as a hedged item in consolidated financial statements provided that the transaction is denominated in a currency other than the functional currency of the entity entering that transaction and the foreign currency risk will impact profit or loss.



Example 14.19

Entities A and B belong to the same group. Entity A's functional currency is EUR, Entity B's functional currency is USD. Entity A manufactures equipment and sells it to the other entities of the group to be used in their industrial process.

Entity B expects to buy equipment from entity A in 9 months for €5 million.

Entity B wants to hedge its exposure against changes in the EUR/USD spot rate on the highly probable forecast intragroup transaction with entity A. Entity B enters a forward contract to buy EUR / sell USD.

The highly probable intragroup transaction is eligible as a hedged item as the changes in the EUR/USD spot rate will impact the consolidated financial statements of the group in the future through the depreciation of the purchased equipment (the basis for calculation of the depreciation expense will depend on the exchange rate at the date entity B recognises the equipment in its balance sheet).

Example 14.20

Entities A and B belong to the same group. Entity A is a manufacturing entity based in Europe and its functional currency is EUR. Most of the costs of Entity A are denominated in EUR. Entity A sells its goods only to intragroup commercial entities. The sales are denominated in the functional currency of the intragroup commercial entity. Entity B is a commercial entity, based in the United States, in charge of selling the goods produced by Entity A to local external parties. Entity B has a USD functional currency and buys goods from Entity A in USD.

Entity A has an exposure to changes in the EUR/USD spot rate as most of its expenses are in EUR whereas its sources of income are in USD. To hedge the forecast highly probable sale of goods to Entity B, Entity A enters a forward to sell USD / purchase EUR. The forecast intragroup transaction can be a hedged item in this situation as it is highly probable, denominated in a currency other than the functional currency of Entity A, and there is a related external transaction (the sale of the goods in USD by Entity B to external clients).

14.4. Hedging instruments

14.4.1. Hedging with derivatives

14.4.1.1. General principle

IFRS 9 does not restrict the use of derivative instruments that are measured at fair value through profit or loss as hedging instruments for hedge accounting purposes (provided the hedge accounting criteria are met) except for some written options (see **section 14.4.1.2**) and some intragroup transactions.

14.4.1.2. Written options

Written options are not eligible as hedging instruments under IFRS 9 except in the following two situations:

- when the hedging written option is documented as a hedge of a purchased option, including one that is embedded in another instrument (IFRS 9.B6.2.4);
- when the written option is combined with one or several purchased options so that the net position of the combined hedging instruments, at the date of designation, does not result in a net written position (IFRS 9.6.2.6).

Example 14.21

To minimise the cost of hedging instruments, entities in practice often use tailored solutions to meet their hedging requirements. As a result, such solutions may include written options. IFRS 9 permits entities to combine several hedging instruments, and such combinations may include written options provided that the combination is not in effect a net written option (IFRS 9.6.2.5). An interest rate collar is an example of a combination of hedging instruments including a written option. This type of combination provides a tailored solution to the entity's hedging needs. It also reduces costs for the entity: by combining a purchased call option with a written put option in this way, an entity can hedge against rising interest rates without having to pay an option premium (a zero-cost collar).

14.4.2. Hedging with non-derivative financial instruments**14.4.2.1. Financial instruments accounted for at fair value through profit or loss**

IFRS 9 permits non-derivative financial instruments to be designated as hedging instruments provided they are accounted for at fair value through profit or loss (IFRS 9.6.2.2).

Financial liability designated as at fair value through profit or loss for which the amount of change in fair value that is attributable to changes in the credit risk of that liability is presented in other comprehensive income (see **chapter 8**), is not considered to meet the above-mentioned requirement and is therefore not eligible as a hedging instrument.

14.4.2.2. Hedge of a foreign currency risk with non-derivative financial instruments

For hedges of foreign currency risk, the foreign currency risk component of a non-derivative financial instrument can be designated as a hedging instrument. In this case, its foreign currency risk component is determined in accordance with IAS 21 (IFRS 9.B6.2.3).

However, an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income without recycling (see **chapter 7**) cannot be documented as a hedging instrument as its changes in value related to the foreign currency risk component will never impact profit or loss.

14.4.2.3. Own equity instruments

An entity's own equity instruments are not financial assets or financial liabilities of the entity and therefore cannot be designated as hedging instruments (IFRS 9.B6.2.2).

14.4.3. Hedging with a combination of financial instruments

An entity may view in combination, and jointly designate as the hedging instrument, any combination of the following (including those circumstances where the risk arising from one hedging instrument offsets the risk arising from others):

- derivatives or a proportion of derivatives; and
- non-derivative or a proportion of them.

This possibility is subject to the fact that the combination of instruments does not result in a net written option position (IFRS 9.6.2.56).

The use of proportions of instruments is further detailed in the next section.

14.4.4. Portions and proportions of hedging instruments

14.4.4.1. General principle

As a general principle, a qualifying instrument must be designated in its entirety as a hedging instrument. (IFRS 9.6.2.4). For example, it is prohibited to document as a hedging instrument only a portion of the remaining time period during which the instrument remains outstanding at the designation date.

Example 14.22

An entity has entered a 10-year swap. At the end of year 2, the entity has the possibility to designate this swap as a hedging instrument for the remaining 8 years. However, at the end of year 2, the entity is not allowed to designate only a portion of these 8 remaining years as a hedging instrument.

Derivatives embedded in hybrid contracts, but that are not separately accounted for, cannot be designated as separate hedging instruments (IFRS 9.B6.2.1).

However, this general principle comes with several exceptions:

- documenting a proportion of an instrument (see **section 14.4.4.2**);
- separating the hedging instrument into several risk components and document each of them in a hedging relationship (see **section 14.4.4.3**);
- separating the forward element from the spot element of a forward contract (see **section 14.4.4.4**);
- separating the currency basis spread (see **section 14.4.4.5**);
- separating the time value component from the intrinsic value component of an option (see **section 14.4.4.6**);
- separating the foreign currency component of a non-derivative financial instrument (see **section 14.4.4.7**).

14.4.4.2. Proportions of hedging instruments

A proportion of an eligible hedging instrument, such as 50% of its notional amount, may be designated as the hedging instrument in a hedging relationship (IFRS 9.6.2.4(c)).

The proportion not designated as a hedging instrument in this hedging relationship can either be:

- designated in one or several other hedging relationships, or
- classified in accordance with the general classification requirements of IFRS 9.

14.4.4.3. Separating the hedging instrument into several risk components

A single hedging instrument can be split into several risk components provided each of them is documented in a hedging relationship.

The risk components can be documented in hedging relationships of different nature (cash flow hedge, fair value hedge...) (IFRS 9.B6.2.6).

Example 14.23

A EUR functional currency entity bears a EUR floating rate loan asset, and a USD fixed rate financial liability. The entity enters a cross-currency interest rate swap paying EUR floating interest rate and receiving USD fixed interest rate. The entity may separate this derivative into two risk components:

- > a EUR interest rate component hedging the floating interest rate asset in a cash flow hedge relationship; and
- > a foreign currency component hedging the USD financial liability in another cash flow hedge relationship.

14.4.4.4. Separating the spot element and the forward element of a forward contract

IFRS 9.6.2.4(b) permits the separation of the spot element and of the forward element of a forward contract and the designation of only the change in the spot element as a hedging instrument (instead of the change in value of the whole forward contract).

This possibility applies to hedges of foreign currency exposure as well as to hedges of commodity risk.

See **section 14.8.2** for additional guidance on the accounting treatment of forward elements excluded from the hedging relationship.

14.4.4.5. Separating the currency basis spread

The currency basis spread of a foreign currency hedging instrument may be separated and excluded from the designation of a financial instrument as the hedging instrument.

See **section 14.8.3** for additional guidance on the accounting treatment of currency basis spreads excluded from the hedging relationship.

14.4.4.6. Separating the time value element and the intrinsic value element of an option

IFRS 9.6.2.4(a) permits the separation of the intrinsic value element and of the time value element of an option contract and the designation as the hedging instrument of only the change in the intrinsic value of an option and not of the change in its time value.

See **section 14.8.1** for additional guidance on the accounting treatment of the time value of options excluded from the hedging relationship.



14.4.4.7. Separating the foreign currency component of a non-derivative financial instrument

IFRS 9.6.2.2 permits the documentation of only the foreign currency component of a non-derivative financial instrument as a hedging instrument.

See **section 14.4.2.2** for more guidance.

14.5. Qualifying criteria

14.5.1. General requirements

Hedge accounting is an optional accounting treatment (i.e. an entity has the possibility to choose transaction by transaction to apply hedge accounting requirements or not), but in order to apply hedge accounting, the following cumulative criteria must be met (IFRS 9.6.4.1):

- the hedging relationship consists only of eligible hedging instruments (see **section 14.4**) and eligible hedged items (see **section 14.3**);
- at the inception of the hedging relationship there is a formal designation and documentation of the hedging relationship and of the entity's risk management objective and strategy for undertaking the hedge (see **section 14.5.2**);
- the hedging relationship meets all hedge effectiveness requirements (see **section 14.5.3**); and
- the hedging relationship meets the definition of at least one of the following three kinds of hedging relationships: fair value hedge, cash flow hedge or net investment hedge (see **section 14.7.1**).

A hedging relationship is discontinued if the qualifying criteria cease to be met (IFRS 9.6.5.6) (see **section 14.10.1**). In practice this will require to monitor the qualifying criteria of each hedging relationship at each reporting date.

14.5.2. Documenting a hedging relationship

IFRS 9 requires a formal designation and documentation of the hedging relationship at its inception. This documentation must contain each of the following (IFRS 9.6.4.1(b)):

- documentation of the entity's risk management objective and strategy for undertaking the hedge (see **section 14.2**);
- identification of the hedging instrument (see **section 14.4**);
- identification of the hedged item(s) (see **section 14.3**);
- the nature of the risk(s) being hedged; and
- how the entity will assess whether the hedging relationship meets the hedge effectiveness requirements (including its analysis of the sources of hedge ineffectiveness and how it determines the hedge ratio).

Hedge accounting may only be applied when all qualifying criteria are met, including this documentation set up. In the absence of formal documentation, hedge accounting cannot be applied. Accordingly, hedge accounting can only start from the date the required documentation is completed. Furthermore, hedge accounting is applicable only prospectively, hedge accounting cannot be designated retrospectively. Therefore, the date of designation must be explicitly mentioned in the documentation.



The designation of the hedged item is of crucial importance as changes in the hedged item (included timing, and disappearance) may have very significant impacts on the hedging relationship. Therefore, the hedged item must be designated in a way that leaves no doubt on the ability of the entity to identify it when it occurs.

14.5.3. Hedge effectiveness criteria

14.5.3.1. Effectiveness assessment vs. ineffectiveness measurement

Hedge effectiveness of a hedging relationship under IFRS 9 (IFRS 9.B6.4.1) corresponds to the extent to which changes in the fair value or the cash flows of the hedging instrument offset changes in the fair value or the cash flows of the hedged item.

Hedge effectiveness **assessment** is different from hedge ineffectiveness **measurement**.

Hedge effectiveness **assessment** is a qualifying criterion for a hedging relationship to be accounted for following hedge accounting requirements (if a hedging relationship is not effective, hedge accounting cannot be applied).

Hedge ineffectiveness **measurement** aims at measuring the ineffectiveness of a qualifying hedging relationship to be recognised in profit or loss (a hedging relationship being effective does not mean it is 100% effective but just that it meets the qualifying criteria).

14.5.3.2. Criteria for hedge effectiveness assessment

To qualify for hedge accounting, a hedging relationship has to comply with the following hedge effectiveness requirements:

- there is an economic relationship between the hedged item and the hedging instrument (see **section 14.5.3.2.1**);
- the effect of credit risk does not dominate the value changes that result from that economic relationship (see **section 14.5.3.2.1**), and
- the hedge ratio (see **section 14.5.3.2.3**) of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item. However, such ratio may not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would in turn create hedge ineffectiveness (irrespective of whether recognised or not).

14.5.3.2.1. Economic relationship

For a hedging relationship to qualify for hedge accounting, there is an expectation that the changes in values of the hedging instrument and of the hedged item will generally move in the opposite directions because of the same risk, which is the hedged risk, during the term of the hedging relationship. This is known as the “economic relationship” under IFRS 9.

Example 14.24

For example, when an entity hedges a fixed rate bond against changes in fair value using an interest rate swap (pay variable / receive fixed), the hedged risk or the underlying is “interest rate”. In this case and provided the hedged item and the hedging instrument have similar main characteristics, their values will usually be expected to move in the opposite directions and offset each other and the existence of the economic relationship is easily demonstrated.

IFRS 9 does not provide any “bright line” and the use of quantitative techniques to demonstrate the existence of an economic relationship is not mandatory for all hedging relationships. For example, for non-sophisticated hedging relationships where the main characteristics of the hedged item and the hedging instrument are the same (see the example above), a qualitative demonstration is sufficient. In some circumstances, the existence of a statistical correlation is a good starting point to demonstrate the existence of an economic relationship.

However, an economic relationship does not exist (IFRS 9.B6.4.6) only as a consequence of the existence of a statistical correlation between the changes in values of the hedging instrument and the hedged item. An economic relationship is usually based either on a kind of receipt (e.g. the use of crude oil to produce jet fuel), or an economic rationale (e.g. existence of a peg between two currencies, link between the share price of a mining entity and the spot price of the underlying commodity...).

An economic relationship may exist even if it is expected that in some situations the hedging instrument’s and the hedged item’s respective values move in the same direction. This is for example the case when the underlying items are not the same but are economically related and the price differential between the two related underlying items moves while the underlying items themselves do not move significantly (IFRS 9.B6.4.5).

14.5.3.2.2. The effect of credit risk

IFRS 9 requires that entities take into account the credit risk associated with the hedging instrument and with the hedged item in assessing the hedge effectiveness of a hedging relationship.

Credit risk has always been identified as a source of ineffectiveness as it alters the change in fair value of the hedging instrument without a corresponding change in the hedged item. However, its importance in the effectiveness assessment is emphasised in IFRS 9, probably because this standard was written by the IASB shortly after a significant financial crisis.

Taking into account the credit risk movements (gains or losses) in the hedge effectiveness assessment could give rise to some ineffectiveness even when the main characteristics of the hedging instrument and the hedged item match as the credit risk movements will not be the same for the hedging instrument and the hedged item. Entities can exclude the credit risk associated to the hedged instrument from the hedging relationship to avoid some unintended movements in value of the hedged item. But they cannot

do the same for the hedging instrument the change in fair value of which will always come with a credit risk component (as required by IFRS 13, including adjustments for credit risk such as CVA, DVA...).

When credit risk movements dominate the changes in values of the hedging instrument or of the hedged item related to the economic relationship, hedge effectiveness requirements are not met and thus hedge accounting cannot be used. IFRS 9 does not specify thresholds to assess whether such domination exists for a hedging relationship, but entities must monitor the evolution of the credit risk on both the hedging instrument and the hedged item to ensure that there is no significant deterioration that could cause the hedge relationship to not be effective.

The domination mentioned above does not exist (see IFRS 9.B6.4.7) when accidentally the changes associated with the credit risk dominate the changes in values of the hedging instrument or of the hedged item associated with the hedged risk. This could occur for example if there is little change in value in the hedged underlying item. Conversely such a domination exists when the credit risk gains / losses dominate significant changes in values of the hedging instrument or the hedged item associated with the hedged underlying.



In our opinion, the assessment of the effect of credit risk on the effectiveness of a hedging relationship should mainly be a **qualitative** one. In most cases entities apply general counterparty risk limits, general counterparty selection guidelines (such as a minimum rating, etc.), and other credit risk mitigation tools such as collateral agreements. Therefore, in most cases, taking into account such credit risk management mechanisms largely facilitates the assessment of the impact of credit risk on hedge effectiveness.

14.5.3.2.3. Hedge ratio

IFRS 9 in its Appendix A defines the hedge ratio as the relationship between the quantity of the hedging instrument and the quantity of the hedged item in terms of their relative weighting.

In most situations, the hedge ratio is 1:1. However, a hedge ratio is frequently used when the hedging relationship is based on a proxy hedge (i.e. when the underlying item of the hedging instrument is not identical to the underlying item of the hedged item).

Requiring the hedge ratio to be derived from the quantity of the hedged item and of the hedging instruments an entity actually uses aims at aligning the hedge ratio used in the documentation of the hedging relationship with the actual risk management strategy / objective.

The requirement to avoid any imbalance in the weightings of the hedging instrument and of the hedged item is not aimed at authorising only perfect hedging relationships to be accounted for using hedge accounting but to ensure that entities do not use hedge ratios that are not consistent with their risk management strategies / objectives to merely achieve an accounting outcome (by introducing or avoiding accounting ineffectiveness).

Example 14.25

As explained in **section 14.7.3**, in a cash flow hedge relationship, under-effectiveness will not impact profit or loss whereas over-effectiveness will impact profit or loss. Consider an entity that chooses to document a given



quantity of a hedging instrument as hedging a greater quantity of the hedged item than the quantity it uses for risk management strategy / objective to create a relationship that will always be in an under-effectiveness position. By doing so the entity aims at avoiding the recognition of any ineffectiveness thanks to the cash flow hedge mechanism for effectiveness mentioned above. This situation would fail the “hedge ratio” requirement of effectiveness assessment under IFRS 9. To apply hedge accounting, IFRS 9.B6.4.10 would require the hedge ratio to be adjusted to avoid such imbalance.

The hedge ratio is determined upon the original hedging relationship designation. It must be monitored by the entity and, when relevant, be adjusted to reflect changes in the relationship between the hedging instrument and the hedged item. This mechanism known as “rebalancing” under IFRS 9 is further explained in **section 14.9**.

14.6. Methods for hedge effectiveness assessment and ineffectiveness measurement

14.6.1. Hedge effectiveness assessment vs. hedge ineffectiveness measurement

As mentioned in **section 14.5.3.1**, hedge effectiveness assessment is different from hedge ineffectiveness measurement as:

- the former is required by IFRS 9 as a qualifying criterion for hedge accounting. It consists in documenting an existing economic relationship between the hedging instrument and the hedged item, taking into account the effect of credit risk and the use of the hedge ratio (see **section 14.5.3.2.3**); whereas
- hedge ineffectiveness corresponds to the extent to which the changes in the fair value of the hedging instrument actually match those on the hedged item. With limited exceptions, hedge ineffectiveness will always impact the profit or loss of the period (see **sections 14.7.2.1** and **14.7.3**).

14.6.2. Assessment of hedge effectiveness

IFRS 9 does not prescribe a single method for the assessment of hedge effectiveness. Any method used by entities to assess the hedge effectiveness must take into account the main characteristics of the hedging instrument and of the hedged item and any expected sources of ineffectiveness.

The sophistication of the method to be used to assess the hedge effectiveness of a hedging relationship depends on the extent to which the main characteristics of the hedging instrument and of the hedged item match one each other:

- when the critical characteristics of the hedging instrument match (or are closely aligned to) the characteristics of the hedged item, a qualitative analysis of those critical terms may be sufficient to assess whether the hedge is effective (IFRS 9.B6.4.15).
- when the critical characteristics of the hedging instrument do not match (or are not closely aligned to) the critical characteristics of the hedged item, there will be a higher uncertainty on the ability of the hedging instrument to offset the change in value of the hedged item. In such situation, the entity may have to perform a quantitative analysis to conclude on its effectiveness assessment (IFRS 9.B6.4.16).

14.6.3. Measurement of hedge ineffectiveness

Hedge ineffectiveness measurement aims at determining the amount of ineffectiveness that must be recognised. With limited exceptions this ineffectiveness will be recorded in the profit or loss of the period.

When measuring hedge ineffectiveness, IFRS 9 requires entities to consider the time value of money. Consequently, the entity determines the value of the hedged item on a present value basis and therefore the change in the value of the hedged item also includes the effect of the time value of money.

The most common sources of ineffectiveness are:

- a mismatch in the critical terms of the hedging instrument compared to the hedged item (timing, fixing, index...);
- the credit risk borne by the hedging instrument;
- a change in the hedged item's risk profile occurring after the initial designation of the hedging relationship (e.g. a cash flow occurring later than initially expected);
- a financing component embedded in the hedging instrument that is not replicated in the hedged item (e.g. interest rate swap with a fair value different from zero at the date of initial designation of the hedging relationship).

14.6.4. Methods for hedge effectiveness assessment / ineffectiveness measurement

IFRS 9 does not prescribe a specific method for hedge effectiveness assessment whereas the ineffectiveness measurement must be performed in accordance with the Dollar offset method.

The next sections will present this Dollar offset method that must be used for ineffectiveness measurement and may be used for effectiveness assessment, as well as the main principle of linear regression that can be used for effectiveness assessment.

As a reminder, the methods applied by the entity for effectiveness assessment and measurement are to be mentioned and explained in the documentation of the hedging relationship.

14.6.4.1. Dollar offset method

The Dollar offset method involves comparing the change in fair values of the hedged item and of the hedging instrument.

One of the well-known approaches of the Dollar offset method is the **hypothetical derivative method** which compares the change in the fair value or cash flows of the actual hedging instrument with the changes in the fair value or cash flows of a "hypothetical" derivative that replicates the critical characteristics of the hedged item. IFRS 9.B6.5.5 considers that the hypothetical derivative is not a method in its own right but rather a mathematical expedient that can only be used to calculate the change in value of the hedged item. Consequently, it cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (conversely, a hypothetical derivative has to include all the critical characteristics of the hedged item).



Example 14.26

An entity issued a floating rate debt to Bank A. At the same time the entity enters a non-collateralised interest rate swap with a different counterparty to hedge its cash flow exposure related to the change in the floating rate. The entity documents this swap in a cash flow hedge relationship and will use the hypothetical derivative method to measure the hedge ineffectiveness of this hedging relationship. The entity bears a credit risk on the derivative counterparty. This risk may have an impact on the change in fair value of the hedging derivative. Even if all the derivative's other critical terms match those of the hedged item, the hypothetical derivative cannot include this counterparty risk as it is specific to the hedging derivative and not embedded in the hedged item.

The hypothetical derivative method can also be used to analyse the sources of ineffectiveness.

The Dollar offset method (and its hypothetical derivative practical expedient) is commonly used for retrospective hedge effectiveness tests. It can also be used for prospective hedge effectiveness assessment if the entity is able to simulate the changes in the fair value of the hypothetical derivative and compare them with expected changes in fair value of the hedging instrument.

14.6.4.2. Regression analysis method

Regression analysis is a statistical process aiming at estimating the relationship / correlation between variables.

In the context of hedge accounting, entities may use the regression analysis to:

- demonstrate that an economic relationship between the hedging instrument and the hedged item (i.e. the hedging instrument and the hedged item move in the opposite directions and offset each other) exists; and
- choose the best hedge ratio before entering a hedging relationship.

Regression analysis is commonly based on historical data but can also be performed on forecast scenarios.

14.7. Accounting for qualifying hedging relationships

14.7.1. Three kinds of hedging relationships

Under IFRS 9, there are three types of hedging relationships, the accounting treatment of which is detailed in the next sections:

- **Fair value hedge:** this type of hedging relationship corresponds to a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss (see **section 14.7.2** for the accounting treatment of such hedging relationships).

Example 14.27

An entity has issued a fixed rate bond. The entity enters a pay floating / receive fixed interest rate swap. The floating rate index paid on the swap is consistent with the yield curve used to calculate the fair value of the fixed rate bond. The other characteristics of the swap are aligned with those of the bond (nominal, maturity, coupon payment date, etc.). The entity's hedging strategy is to hedge its exposure to the changes in fair value

of the bond caused by changes in interest rates. This hedging relationship is consistent with the definition of a fair value hedge.

- **Cash flow hedge:** this type of hedging relationship corresponds to a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component, of a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or of a highly probable forecast transaction, and could affect profit or loss (see **section 14.7.3** for the accounting treatment of such hedging relationships).

Example 14.28

An entity plans to purchase a piece of equipment in 12 months for an amount denominated in a foreign currency. This transaction is considered as highly probable. The entity is exposed to the change in the foreign currency rate that could increase or decrease the price to be paid in its functional currency. The entity enters a foreign currency forward contract. The resulting net economic position is that the price to be paid is now a fixed amount of its functional currency. This kind of hedging strategy meets the definition of a cash flow hedge.

- **Net investment hedge:** this type of hedging relationship aims to hedge the net investment in a foreign operation as defined in IAS 21 (see **section 14.7.4** for the accounting treatment of such hedging relationships).

It is interesting to note that hedging a risk of change in fair value may expose the entity to a cash flow risk and reciprocally. In the above **Example 14.28**, the entity is hedging the change in value of the fixed rate bond by swapping it into a floating rate instrument. But, doing so, it creates an exposure to change in cash flows indexed to this floating rate.

There are some situations where the hedging strategy may meet both the fair value hedge and the cash flow hedge definitions. In such situations the entity is free to choose which kind of hedging relationship it wishes to apply.

Example 14.29

An entity issued a foreign currency zero-coupon bond. To hedge the related foreign currency risk the entity enters a foreign currency forward receiving the foreign currency amount to pay the final redemption cash payment of the bond and paying a fixed amount of functional currency. This strategy can be documented either as a fair value hedge of the bond, or as a cash flow hedge of the final redemption cash payment.

14.7.2. Accounting for Fair Value Hedge

14.7.2.1. General principle

Subject to a fair value hedge relationship meeting the qualifying criteria, the hedging relationship is accounted for as follows (IFRS 9.6.5.8):

- the gains or losses on the hedging instrument are recognised in profit or loss (A);
- the carrying amount of the hedged item is adjusted to reflect gains or losses related to the changes in fair value according to the hedged risk (B);
- any ineffectiveness (i.e. difference between (A) and (B) above) is recognised in the profit or loss of the period.



In practice a fair value hedge relationship has generally little impact on the accounting treatment of the hedging instrument but modifies the accounting treatment of the hedged item so that their change in value offset one another in the profit or loss of the period. However, this principle comes with some exceptions.

Any adjustment to the carrying amount of a financial instrument measured at amortised cost is amortised to profit or loss. This amortisation may begin as soon as an adjustment exists and may not begin later than when the hedged item ceases to be adjusted (IFRS 9.6.5.10). This amortisation is performed by adjusting the effective interest rate of the hedged item when the amortisation begins.

14.7.2.2. Fair value hedge of an equity instrument classified as fair value through other comprehensive income

As explained in **chapter 7**, an entity may classify any equity instrument, at its initial recognition date, as fair value through other comprehensive income. In such case, any change in value accumulated in other comprehensive income will never impact the profit or loss of the entity.

As an exception to the definition of a fair value hedge that requires that a hedged risk must have an impact in profit or loss, an entity has the possibility to document a hedging relationship on such equity instruments.

In such case, the fair value hedge relationship must be accounted for as follows (IFRS 9.6.5.8):

- gains or losses on the hedging instrument are recognised in other comprehensive income;
- gains or losses on the equity instrument classified as fair value through other comprehensive income remain in comprehensive income;
- any ineffectiveness is thus recognised in other comprehensive income.

Example 14.30

At 1 January 202X, Entity A, the functional currency of which is euro, buys a share of Company X for €100. The entity elects to recognise the changes in the fair value of this share through other comprehensive income.

To hedge against changes in the fair value of the share, Entity A contracts a forward to sell the share at €100. To simplify this illustrative example, assume that the spot price of the share is always equal to its forward price. The forward maturity is 1 April 202X. The entity documents this forward as a hedge of the share in a fair value hedge relationship.

At 31 March 202X, the fair value of the share is €130. Entity A recognises the change in the fair value of the share through other comprehensive income for €30. At the same date, the fair value of the forward contract amounts to €-30 which Entity A recognises in other comprehensive income (the net impact on other comprehensive income is thus nil).

14.7.2.3. Fair value hedge of an SPPI financial asset classified as fair value through other comprehensive income

When the hedged item is an “SPPI” instrument for which the changes in fair value are recognised in other comprehensive income (i.e. it is an “SPPI” instrument managed in a “held to collect cash flows and sell” business model), the fair value hedge relationship is accounted for as follows:

the gains or losses on the hedging instrument are recognised in profit or loss;

- the gains or losses of the hedged instrument according to the hedged risk are recognised in profit or loss, any remaining change in fair value of the hedged instrument remains in other comprehensive income;
- any ineffectiveness of the hedging relationship is thus recognised in the profit or loss of the period.

Example 14.31

At 1 January 202X, Entity A, the functional currency of which is euro, purchases a non-amortising, non-callable debt instrument for €100. The instrument carries fixed interest of 5%, will mature in 3 years and meets the conditions to be accounted for at fair value through other comprehensive income.

At the same date, Entity A contracts an interest rate swap (pay variable / receive fixed) with the same main characteristics as the debt instrument to hedge against fluctuations in fair value of the debt instrument related to changes in interest rates. The swap is therefore documented in a fair value hedge relationship.

At 31 March the fair value of the debt instrument increased to €130, €25 due to changes in interest rates and 5€ due to changes in the credit risk of the instrument. Applying IFRS 9 requirements for fair value hedges, Entity A recognises the change in the fair value of the debt instrument related to interest rates (the hedged risk component) of €25 in profit or loss. The remaining change in value of the debt remains recorded in other comprehensive income for €5. At the same date, the change in fair value of the hedging instrument (interest rate swap) amounts to €-24 and is recorded in the profit or loss of the period. The net impact in profit or loss is €1 for the first quarter of 202X and reflects that the hedging relationship bears some ineffectiveness.

Even if the carrying amount of the hedged item is not adjusted by the hedging relationship (as the hedged instrument is already measured at fair value), its impact in profit or loss is the same as for any instrument measured at amortised cost. Therefore, the adjustment mechanism of the effective interest rate that exists for instruments classified at amortised cost being hedged in a fair value hedge relationship to amortise the fair value hedge adjustment to their carrying amount is applied. The offsetting entry of the effect of the adjusted effective interest rate in profit or loss will be other comprehensive income (instead of the amortisation of the adjustment to the carrying amount of amortised cost instruments).

14.7.2.4. Fair value hedge of an unrecognised firm commitment

When the hedged item is an unrecognised firm commitment (or a component thereof), a fair value hedge relationship is accounted for as follows:

- the gains or losses on the hedging instrument are recognised in profit or loss;
- the cumulative change in value of the hedged item since the initial designation of the hedging relationship is recognised as an asset or a liability with a corresponding gain or loss recognised in profit or loss;
- any ineffectiveness is thus recognised in the profit or loss of the period.

When the firm commitment leads to the recognition of an asset or a liability, the amount accumulated in the financial position for changes in the values of the hedged item adjusts the initial carrying amount of the asset or liability generated by the settlement of the firm commitment (IFRS 9.6.5.8).

Example 14.32

At 1 January 202X, Entity A, the functional currency of which is euro, enters a firm commitment to purchase equipment for £10 million the delivery of which is planned in 9 months. At the same date, Entity A enters a forward contract to buy £10 million against €12 million in 9 months (payment of the equipment is expected to occur at the delivery date).

Entity A uses only the spot element of the forward contract as the hedging instrument and recognises the changes in forward points directly in profit or loss (see **section 14.8.2**).

The table below summarises the evolution of the exchange rates and the total fair value of the forward contract:

Figure 14.2

Date	01/01/202X	31/03/202X	30/06/202X	30/09/202X
£/€	1,10	1,15	1,00	1,30
Forward contract fair value (in € million)	-	1,0	-1,0	1,0
o/w spot element	-	0,5	-1,0	2,0
o/w forward element	-	0,5	0,0	-1,0

At 1 January 202X, Entity A does not recognise any journal entry as the forward contract was entered into at market conditions (i.e. with a nil fair value).

At 30 March 202X, Entity A recognises a liability for the changes of the value of the hedged item for €0.5 million ($(1.15\text{€}/\text{£} - 1.10\text{€}/\text{£}) * \text{£}10 \text{ million}$) with a corresponding impact in profit or loss and an asset for €1 million corresponding to the fair value of the forward contract. The profit or loss impacts of the hedged item and of the spot element are presented within the same line and lead to a nil impact. The total profit or loss impact corresponds to the forward element value change (€0.5 million).

At 30 June 202X, Entity A reverses the liability recognised in the first quarter (for €0.5 million) and recognises an asset for €1 million corresponding to the value of the hedged item. This leads to a profit or loss impact of €1.5 million. At the same date, the forward contract corresponds to a liability of €1 million thus entity A reverses the asset recognised in the first quarter for €1 million and recognises a liability for the same amount leading to a profit or loss impact of €-2 million of which €-1.5 million recognised in the same line as the hedged item (leading to a nil impact in this line) and €-0.5 million corresponding to the change in the value of the forward element.

At 30 September 202X, Entity A reverses the asset corresponding to the value of the hedged item recognised at the end of the second quarter and recognises a liability for €2 million corresponding to the value of the hedged item at the end of the third quarter. This leads to a profit or loss impact of €-3 million. At the same time, Entity A reverses the liability recognised in the second quarter related to the fair value of the forward contract and recognises an asset for €1 million which leads to a profit or loss impact of €2 million of which €3 million corresponding to the change in the value of the spot element and €-1 million corresponding to the change in the value of the forward element.

At the same date, Entity A receives the equipment and recognises it in the financial position at the exchange rate at this date for €13 million ($\text{£}10 \text{ million} * 1.3\text{€}/\text{£}$). The entity then applies the requirements of IFRS 9.6.5.8 and reverses the liability (€2 million) corresponding to the value of the hedged item and incorporates its amount in the carrying amount of the equipment. Consequently, the equipment is recognised in the financial position for a value of €11 million consistent with the hedged level of the spot rate at the hedging relationship inception date.

14.7.3. Cash Flow Hedge

Subject to a cash flow hedge relationship meeting the qualifying criteria, the hedging relationship is accounted for as follows (IFRS 9.6.5.11):

- the accounting treatment of the hedged item over the life of the hedging relationship remains unaffected;
- a cash flow hedge reserve is created in other comprehensive income and dynamically adjusted to the lesser of the following:
 - > the cumulative gain or loss on the hedging instrument from inception of the hedging relationship; and
 - > the cumulative change in fair value of the hedged item from inception of the hedge.
 - > This is frequently referred to as the “lower of” accounting of cash flow hedges. The amount recorded in other comprehensive income is considered to be the effective part of the hedging relationship;
- any remaining gain or loss on the hedging instrument is considered as ineffectiveness and is recognised in profit or loss.

It can be noted that the “lower of” approach is not symmetrical so that in practice, only over-effectiveness (i.e. when the change in value of the hedging instrument in absolute terms exceeds the change in value of the hedged item) will impact profit or loss whereas under-effectiveness will not.

The accounting treatment of the amount accumulated in the cash flow hedge reserve within other comprehensive income depends on the nature of the hedged item:

- If the hedged item subsequently leads to the recognition of a non-financial asset or non-financial liability, the entity removes it from the cash flow hedge reserve and incorporates it directly in the cost or other initial carrying amount of the non-financial asset or liability. This mechanism is often called “basis adjustment”.
- If the hedged forecast transaction subsequently becomes a firm commitment for which fair value hedge accounting is applied, the amount accumulated in the cash flow hedge reserve is removed and incorporated in the asset / liability resulting from the firm commitment.
- In any other situation the amount accumulated in the cash flow hedge reserve is reclassified to the profit or loss as a reclassification adjustment in the same period or periods during which the hedged expected future cash flows affect profit or loss (e.g. when the hedged foreign currency cash inflow impacts profit or loss as revenue in accordance with IFRS 15).



This latter accounting treatment illustrates the importance of the clear and precise designation of the hedged item in order for the entity to be able to perform the reclassification from other comprehensive income to profit or loss with the right timing to match the hedged exposure.

However, if the amount accumulated in the cash flow hedge reserve is a loss which the entity will not recover in full or in part in one or more future periods, the entity immediately reclassifies this loss to profit or loss as a reclassification adjustment.

14.7.4. Net Investment Hedge

14.7.4.1. What is a net investment hedge?

IAS 21.8 defines net **investment in a foreign operation** as the amount of the reporting entity's interest in the net assets of that operation. This includes monetary items for which settlement is neither planned nor likely to occur in the foreseeable future (e.g. some long-term receivables or intragroup loans). IFRIC 16.1 specifies that the foreign operation could be a subsidiary, an associate, a joint venture or a branch.

A net investment is generally a long-term investment in an entity the functional currency of which is different from that of the holding company, which creates an exposure to the changes in foreign currency rates. This risk ultimately impacts the profit or loss of the group upon the disposal of the foreign operation. IAS 21 requires the reporting entity's net investment in a foreign operation to be translated into the parent's functional currency at the closing exchange rate and all exchange differences to be recognised in other comprehensive income until the reporting entity disposes of the foreign operation (IAS 21.48-49). Upon disposal of the foreign operation, the amount accumulated in other comprehensive income is reclassified to profit or loss.

Entities may have as risk strategy to hedge their net investment against foreign currency risk using derivative and non-derivative financial instruments.

14.7.4.2. Hedged item in a net investment hedge

IFRIC 16.10 stipulates that hedge accounting may be applied only to the foreign exchange differences arising between the functional currency of the foreign operation and the parent entity's functional currency. Hedging exchange differences arising between the functional currency of the foreign operation and the reporting entity's presentation currency is not permitted.

This position can be explained by the fact that, unlike the functional currency for which IAS 21 details how it is determined, there is no restriction on the presentation currency that an entity can use for the presentation of its financial statements. Thus, economically, there is not always a real exposure to this currency as it is the case for the functional currency. In practice, when the group presentation currency is identical to the functional currency of the group's parent company, this prohibition of hedging net investment against the presentation currency will not be a constraint for the group.

Entities may qualify as a hedged item the net investment in the reporting entity's financial statements for an amount equivalent to its carrying amount or less.

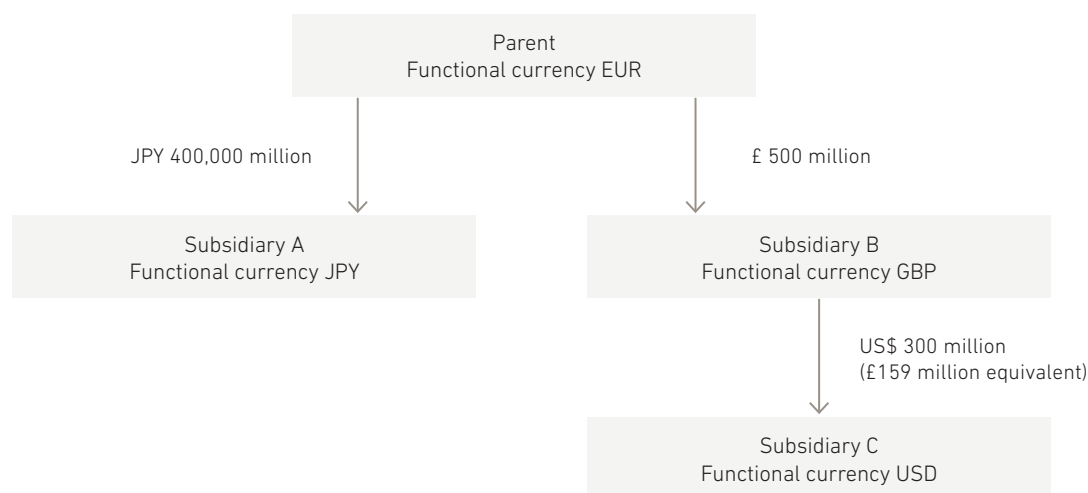
A foreign operation may be held by intermediate parent(s). The hedged exchange differences do not need to relate to the ultimate parent's functional currency but may relate to any intermediate parent's functional currency.

Example 14.33

The following example (extracted from IFRIC 16.AG2) shows how to apply IFRS 9 requirements for a net investment hedge in a group situation:

A parent entity wholly owns (directly and indirectly) 3 subsidiaries for which the net investment is reported in the following figure:

Figure 14.3



In this case, the group presented above can hedge any of the following:

- > the parent can hedge its net investment in each of the subsidiaries A, B and C for the foreign exchange risk between their respective functional currency and its functional currency (EUR);
- > the parent can hedge the USD / GBP foreign exchange risk between the functional currencies of subsidiaries B and C.

Besides, subsidiary B can document a hedging relationship for the foreign exchange risk arising between the functional currency of subsidiary C (USD) and its functional currency (£) in its own consolidated financial statements.

14.7.4.3. Hedging instruments in a net investment hedge

There is no restriction on the use of eligible hedging instruments (see **section 14.4** for eligible hedging instruments) for net investment hedges: entities may use derivative and financial non-derivative instruments to hedge the exchange differences arising from foreign operations. Hedging instruments may be held by any entity within the group as long as the documentation of the hedging relationship permits the tracking of these hedging instruments and the accounting for the hedging gains and losses correctly.

14.7.4.4. Accounting treatment

The accounting treatment of net investment hedging relationships is similar to the accounting treatment applicable for cash flow hedging relationships except that the amounts accumulated in other comprehensive income are reclassified to profit or loss only when the investment is disposed of or liquidated.



14.8. Time value of options and forward elements of forward contracts

IFRS 9 introduced new accounting requirements that are specific to hedging relationships based on options and forward contracts.

14.8.1. Time value of options

14.8.1.1. Time value vs. intrinsic value

The fair value of an option consists of two components:

- the **intrinsic value** which represents the value of the option if it were to be exercised at the date of valuation. Consider the following example:

Example 14.34

At 1 January 2018, Entity A buys a call option to buy 1 share of Entity B for €30 any time until 31 December 2018. The price at which an option can be exercised is called the “strike” (here it is €30). The market price of the share at 1 January 2018 is €29.

At this date the intrinsic value of the put option is nil as the market price is lower than the strike price. At 30 June 2018, the market price of the share increases to €32 thus the intrinsic value of the option at this date amounts to €2 (if Entity A chooses to exercise its put option it would buy the share at a price which is €2 lower than market price).

An option is said “in the money” when the intrinsic value is positive for the buyer of the option so that he has a financial interest to exercise the option. An option is said “at the money” when the spot price of the underlying equals the strike price. An option is said “out of the money” in any other situation.

- the **time value** which is generally measured by difference between the fair value of the option and its intrinsic value. The time value has a probabilistic nature and economically represents the probability that an “out of the money” option becomes “in the money” or that an “in the money” option becomes “out of the money”. As options are generally purchased out of the money, a simplified way to explain the time value of an option is to consider that it represents the probability that the buyer of the option will have a financial interest to exercise the option.
 - > Time value is mainly influenced by the time left to maturity (the longer the period, the higher the time value), the difference between the spot price and the strike (the closest the spot price is to the strike, the higher the probability for the option to become in the money, the higher the time value), the volatility of the underlying item...
 - > Thus, economically, the time value corresponds to an “insurance” premium paid by the investor to hedge against unfavourable evolutions of the price of an underlying item.

Generally, an option is purchased when it is “out of the money” so that its intrinsic value is nil and the whole fair value of the option contract consists in its time value. The buyer of the option pays a premium (equivalent to the time value of the option) to be protected against the unfavourable evolutions of the spot price of the underlying. This mechanism is, from an economic point of view, pretty similar to the premium payment of an insurance contract.

The time value component of an option at maturity is always zero. Therefore, when an entity purchases an out of the money option, the entity knows that the premium paid (which represents the initial time value of the contract) represents the cost of the hedge.

14.8.1.2. Documentation of options as hedging instruments

Options can be designated as a hedging instrument under IFRS 9 (see **section 14.4.1.2** for limitations regarding written options). An entity can elect to document an option as a hedging instrument either:

- **only for the intrinsic value** of the designated option. This is generally the best way to maximise the effectiveness of the hedging relationship. In this case IFRS 9 provides a specific accounting treatment for the time value component, excluded from the hedging relationship, that is explained further in the next section; or,
- **in its entirety**. In this case, all changes in fair value of the option will be considered in the effectiveness assessment and measurement of the hedging relationship.

When an entity designates all the fair value of an option as the hedging instrument in a hedge relationship, the changes in the time value component of the option's fair value result in ineffectiveness as this component is not offset by similar changes in the fair value of the hedged item (unless the hedged item contains optionality). Entities using all the fair value of an option as the hedging instrument have to monitor the level of ineffectiveness during the life of the hedge relationship and recognise its impacts in profit or loss. Under some circumstances (for example, if the ineffectiveness is so important that it is not possible to demonstrate the existence of an economic relationship between the hedged item and the hedging instrument), the entity may be obliged to discontinue the hedge relationship.

14.8.1.3. Accounting treatment of time value of option when it is excluded from the hedging relationship

14.8.1.3.1. General principles

When an entity separates the intrinsic value and the time value component of an option to document only the intrinsic value as a hedging instrument, it accounts for the time value component as follows (IFRS 9.6.5.15):

Step 1: determine whether the time value is fully aligned with the hedged item. The non-aligned portion will have its change in fair value recognised in profit or loss, and the aligned portion will be treated in accordance with step 2 (see **section 14.8.1.3.3** for further guidance on aligned time value).

Step 2: determine whether the option hedges a time period-related hedged item (go to step 3) or a transaction-related hedged item (go to step 4) (see **section 14.8.1.3.2** for further guidance on the distinction between time period and transaction-related hedged item).

Step 3: the aligned time value component of an option hedging a time period-related hedged item is accounted for as follows:

- any change in fair value of the aligned time value component is recognised in other comprehensive income and accumulated in a separate component of equity;

14.8.1.3.2. Distinction between transaction-related hedged item and time period-related hedged item

IFRS 9 provides some guidance on the distinction between a transaction-related hedged item and a time period-related hedged item (IFRS 9.B6.5.29). This distinction is important as it directly impacts the way the initial time value of the option is accounted for as explained in **section 14.8.1.3.1**.

For transaction-related hedged items, the time value of the option is considered as part of the cost of the transaction. This is for example the case when an entity hedges an expected purchase of inventory or a future sale in a foreign currency.

For time-period related hedged items, the time value of the option is considered as the cost of protection against risk during a given period. This is for example the case when an entity hedges a commodity inventory against changes in fair value over one year.

In practice this distinction is sometimes difficult to apply and qualifying a hedged item may need the use of judgement.

14.8.1.3.3. Situation where the time value is not aligned with the hedged item

The accounting treatments described in step 3 and 4 above apply to the entire time value component only when the critical terms of the option designated as the hedging instrument and the hedged item are aligned. When this is not the case, and thus, the actual time value of the option differs from that of an aligned option, entities must determine the amount to accumulate in a separate component of equity as follows (IFRS 9.B6.5.33):

- If, at inception of the hedging relationship, the actual time value is higher than the aligned time value, entities have to:
 - > determine the amount that is accumulated in a separate component of equity on the basis of the aligned time value; and
 - > account for the differences in the fair value changes between the two time values in profit or loss.
- If, at inception of the hedging relationship, the actual time value is lower than the aligned time value, entities must determine the amount to be accumulated in a separate component of equity by reference to the lower of the cumulative change in fair value of:
 - > the actual time value; and
 - > the aligned time value.

14.8.1.4. Illustrative examples

The figures below present examples of how to account for the time value of an option applying hedge accounting.

Figure 14.5

Accounting treatment of the time value of an option with a hedged item related to a time period

- Hedged risk: value of nickel inventory recorded in the company's balance sheet
- Hedging instrument: purchase of a put at T0
- Time value at inception (premium): €10
- Duration of the hedge: 10 reporting periods

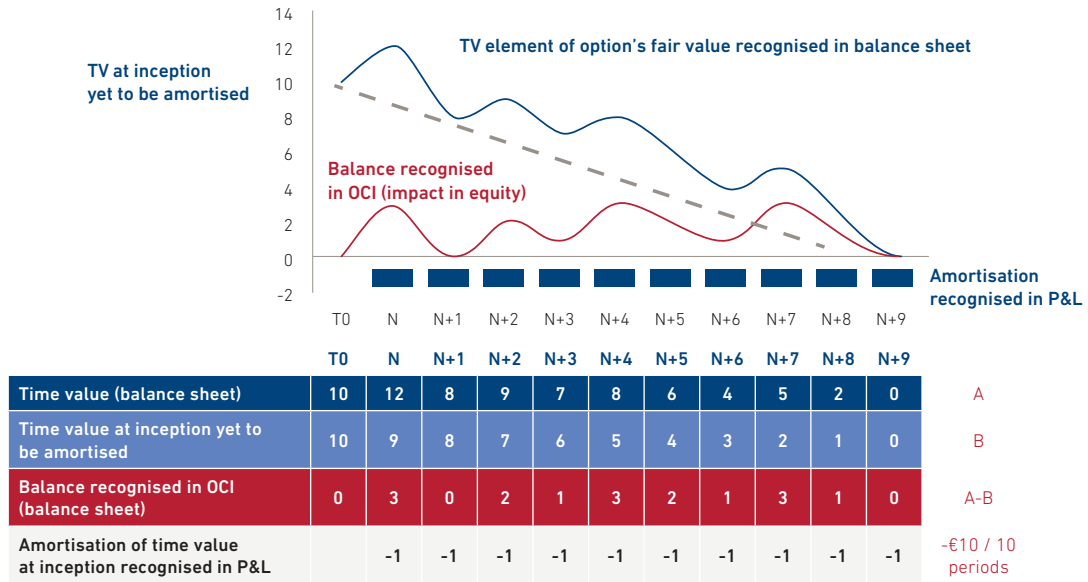
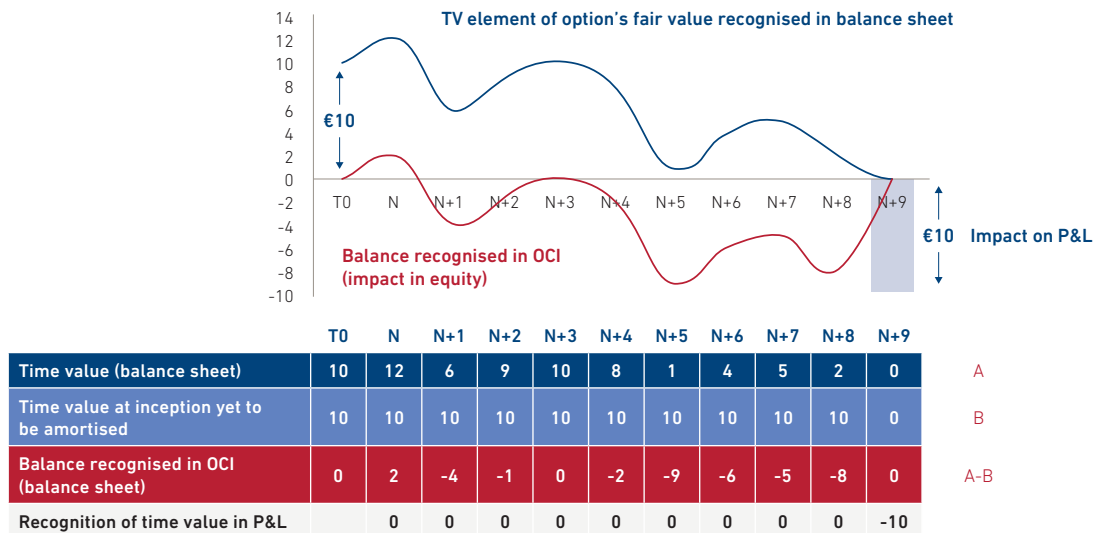


Figure 14.6

Accounting treatment of the time value of an option with a hedged item related to a transaction

- Hedged risk: sales in USD in N+9
- Hedging instrument: purchase of a EUR call / USD put at T0
- Time value at inception: €10
- Duration of the hedge: 10 reporting periods



14.8.2. Forward element of a forward contract

The fair value of forward contracts is not only impacted by changes in the spot rates of the underlying item but also by changes in the forward elements.

The difference between the spot rate and the forward rate is explained by various factors that are specific to each underlying item. For example, the forward element of a foreign currency forward will be mainly driven by the change in the interest rate curve of each currency whereas the forward element of a commodity forward contract may be driven by interest rate, transportation and storage cost.

Under IFRS 9 (IFRS 9.6.5.16), entities hedging with forward contracts can choose between three different ways to document the forward instrument as hedging instrument:

- documenting the forward contract in its entirety as a hedging instrument (including the forward elements);
- documenting only the change in the spot rate element as a hedging instrument and recognising any change in the forward element directly in the profit or loss; or
- documenting only the change in the spot rate element as a hedging instrument and applying to the change in value of the forward element the same accounting treatment as that described above for the changes in the time value of options (see **section 14.8.1.3**).

This choice is made freely by the entity, hedging relationship by hedging relationship. The entity's decision is mentioned in the hedging documentation.

Example 14.35

At 1 January 202X, Entity A, the functional currency of which is euro, expects to buy some equipment in 12 months for £10 million (the transaction is highly probable). Entity A's foreign currency risk management strategy is to hedge all transactions in foreign currency that amount to the equivalent of €2 million or above. Hence, at the same date (1 January 202X), Entity A enters a forward contract to buy £10 million in exchange for €14 million in 12 months to hedge against unfavourable exchange rates changes. Entity A designates only the spot element as the hedging instrument and considers the forward element as a hedge cost. In this case, the hedge concerns a transaction (equipment purchase) and not a period, thus both the changes in the value of the spot element and the forward element are accumulated in a separate component of equity until the recognition of the equipment in the financial position. At 1 January 202(X+1), Entity A receives the equipment and recognises in the financial position at the exchange rate prevailing at this date. The spot exchange rate is £1 = €1.3. The equipment is recognised in the financial position for €13 million. The amount accumulated in the separate component of equity for changes in the value of the forward contract is €-1 million. This corresponds to the gain or loss on the differential between the forward rate of the forward contract and the spot exchange rate at the date of the transaction. This amount is removed from the separate component of equity to adjust the initial carrying amount of the equipment. Ultimately, the equipment is recognised in Entity A's financial position at the forward rate of the forward contract.

14.8.3. Foreign currency basis spread of financial instruments

Foreign currency basis spread is a component of a financial instrument that reflects the market's appetite difference for a currency relatively to another. This element is generally relatively small when two "strong" currencies are compared. But it can be quite significant when a strong currency such as EUR or USD is compared to the currency of an emerging country.



For example, if an entity is considering exchanging USD against the currency of an emerging country, the entity that will sell USD and receive the emerging currency will be “receiving” the foreign currency basis spread from the counterparty. This foreign currency basis spread between two currencies may change overtime and thus influence the market price of a financial instrument.

IFRS 9 explicitly addresses the accounting treatment of this foreign currency basis spread of financial instruments when it is embedded in a hedging instrument. IFRS 9.6.5.16 states that the requirements described in **section 14.8.2** for the forward component of a forward contract are also applicable to the foreign currency basis spread of financial instruments documented as hedging instruments.

14.9. Rebalancing

14.9.1. Definition

The concept of rebalancing is directly connected to the concept of hedge ratio explained in **section 14.5.3.2.3**.

A rebalancing refers to the adjustment made to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge effectiveness requirement presented in **section 14.5.3.2.3** (IFRS 9.B6.5.7).

A rebalancing of the hedging relationship must occur each time that:

- it is related to a change in the relationship between the hedging instrument and the hedged item;
- without any change to the risk management; and
- the change aims to maintain a hedge ratio that complies with the hedge effectiveness requirements.

In most situations, rebalancing will be a matter of fact based on actual risk management decisions. Rebalancing is not optional and should occur each time the above conditions are met.

Entities may change the quantities designated as hedging instruments or hedged items for other reasons than those mentioned above (for example because part of a forecast transaction is no longer expected to occur or the credit risk of the counterparty to the hedging instrument is significantly deteriorated...). In these cases, “rebalancing” is not applicable and entities would apply other requirements of IFRS 9. For example, if an entity decreases the quantity of designated hedging instruments because a part of a future transaction is no longer expected to occur, the hedge relationship is to be partially discontinued (see **section 14.10**).

14.9.2. Accounting for rebalancing

When rebalancing is required, entities measure and account immediately for any ineffectiveness that arose before the adjustment of the hedge ratio (IFRS 9.B6.5.8).

Subsequent consequences of rebalancing depend on the way the hedge ratio is adjusted. The impacts are limited to the consequences described below (all other accounting treatments of the hedging relationship remains unaffected) (IFRS 9.B6.5.17-20):

- The hedge ratio is adjusted by increasing the volume of the hedged item: from the date of the rebalancing, the changes in the value of the hedged item also include the changes in value of the additional volume of the hedged item.
- The hedge ratio is adjusted by decreasing the volume of the hedged item: from the date of the rebalancing, the volume by which the hedged item was decreased is no longer part of the hedging relationship.
- The hedge ratio is adjusted by decreasing the volume of the hedging instrument: from the date of the rebalancing, the volume by which the hedging instrument was decreased is no longer part of the hedging relationship.
- The hedge ratio is adjusted by increasing the volume of the hedging instrument: from the date of the rebalancing, the changes in the fair value of the hedging instrument also include the changes in the value of the additional volume of the hedging instrument.

Finally, a rebalancing will also trigger the need to update the analysis of the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its remaining term. The hedging documentation is updated accordingly (new hedge ratio, new effectiveness assessment...) (IFRS 9.B6.5.21).

14.9.3. Illustrative example

Example 14.36

The example below explains how to apply IFRS 9's rebalancing requirements.

An entity, the functional currency of which is EUR, is considering a highly probable future revenue arising from the sale of equipment in 12 months. The revenue will be denominated and paid in Currency X (CX100 million). There is no traded derivative to hedge against fluctuations in the exchange rates EUR/CX. The entity decides to hedge the expected revenue using a currency derivative denominated in a currency CY that is well correlated with the currency CX and for which derivatives are traded in the market.

The entity performed statistical analysis and established that the current relationship between CY and CX remained stable around 1 CX = 1.1 CY. The entity uses a derivative with a nominal of CY91 million (100 /1.1) to hedge the revenue denominated in CY. A cash flow hedge relationship is documented between this CY derivative and the CX highly probable cash inflow.

Six months after the initial designation, the entity updates its statistical analysis and realises that the hedge ratio changed to 1 CX = 1.05 CY. The entity decides to adjust the quantity of CY hedging instrument used to hedge its CX exposure. The quantity of hedging instrument documented in the hedging relationship is increased so that from now on, a derivative of CY 95 million is documented as a hedge of a future cash inflow of CX 100 million.

This adjustment reflects a change in the relationship between CX and CY and it is consistent with the actual risk management of the entity (i.e. the risk strategy remained unchanged). By increasing the quantity of hedging instrument in the relationship, the entity will avoid remaining in an imbalanced situation under which the hedging relationship could remain constantly in an under-effectiveness situation where economic ineffectiveness would not have been recognised due to the "lower of" test of the cash flow hedge accounting (see **section 14.7.3**). Therefore, the entity treats it as a rebalancing. The accounting of the hedged item, and the previously designated part of the hedging instrument remain unaffected. From the rebalancing date onwards, an additional quantity of CY4 million will be documented as hedging instrument.

The entity will update its hedging documentation accordingly, mentioning that the new hedge ratio is now 1 CX = 1.05 CY.



14.10. Hedge discontinuation

14.10.1. When to discontinue a hedging relationship

A hedging relationship has to be discontinued prospectively when and only when the qualifying criteria are no longer met (after taking into account the effect of rebalancing when applicable) (IFRS 9.6.5.6).

This is, for example the case when:

- the hedging instrument expires or is sold, terminated or exercised. For the purpose of hedge relationship discontinuation, the replacement or rollover of a hedging instrument is not an expiration or a termination if such a replacement or rollover is part of, and consistent with, the risk management objective.
- the hedged item is sold, extinguished or no longer expected to occur;
- the hedge effectiveness requirements are no longer met (see **section 14.5.3.2**);
- the entity changed its risk management objective (see **section 14.2**).

Discontinuing hedge accounting can either affect a hedging relationship in its entirety or only a part of it (IFRS 9.6.5.6).

Voluntary discontinuation of hedge accounting relationships that still meet the qualifying criteria, and for which the risk management objective is unchanged, is not permitted under IFRS 9 (IFRS 9.B6.5.23).

For the purpose of hedge discontinuation, a hedging instrument is not expired or terminated if:

- as a consequence of laws or regulations, the parties to the hedging instrument agree that one or more clearing counterparties replace their original counterparty to become the new counterparty to each of the parties. When the parties to the hedging instrument replace their original counterparties with different counterparties the requirement above is met only if each of those parties effects clearing with the same central counterparty; and
- other changes, if any, to the hedging instrument are limited to those that are necessary to perform such a replacement of the counterparty (IFRS 9.6.5.6).

14.10.2. Accounting for hedging relationship discontinuation

14.10.2.1. General principle

A hedging relationship must be discontinued from the date where the conditions mentioned in the precedent sections are met. The effect of the hedge accounting relationship has to be applied until that date, including any ineffectiveness measurement and recognition.

The effects of hedge accounting discontinuation are always prospective only.

14.10.2.2. Discontinuing a fair value hedge

When discontinuing a fair value hedge relationship (IFRS 9.6.5.8):

- the hedging instrument continues to be measured at fair value with changes in fair value recognised in profit or loss, unless it is derecognised or used in another hedging relationship; and
- the hedged item ceases prospectively to be adjusted for changes in its fair value attributable to the hedged risk.

The hedged item accounting treatment reverts to the measurement method that applies to its classification. Any adjustment created by the fair value hedge relationship on the hedged item's carrying amount of instruments measured at amortised cost has to be amortised to profit or loss in accordance with the treatment described in **section 14.7.2**.

Example 14.37

At 1 January 202X, Entity A issues a fixed rate debt for €100 million repayable in five years. At the same date, Entity A enters an interest rate swap (pay variable / receive fixed) with the same maturity and designates it as a fair value hedge of the debt.

At the end of 202(X+2), Entity A changes its risk management objective and decides to stop hedging its debt. The entity cancels the swap at market conditions. The fair value hedge relationship is discontinued.

The cumulative adjustment to the debt at the end of 202(X+2) amounts to €4 million. The entity will amortise this amount to profit or loss over the remaining life of the debt by using an adjusted effective interest rate.

14.10.2.3. Discontinuing a cash flow hedge

When discontinuing a cash flow hedge relationship (IFRS 9.5.12):

- the cash flow hedge reserve created in other comprehensive income ceases to be adjusted by the change in value of the hedging instrument;
- if the hedged future cash flows are still expected to occur, that amount remains in the cash flow hedge reserve until the future cash flows occur, and then the accounting treatment described in **section 14.7.3** is applied consistently with the nature of the hedged transaction;
- if the hedged future cash flows are no longer expected to occur, that amount is immediately reclassified from the cash flow hedge reserve to profit or loss as a reclassification adjustment.

Example 14.38

At 1 January 202X, Entity A, the functional currency of which is euro, expects (the transaction is highly probable) that it will disburse \$500 million to acquire a new business in 6 months.

Entity A enters at the same date into a forward contract to receive \$500 million and pay €490 million in 6 months to hedge against unfavourable changes in the exchange rates. Entity A designates as a hedging instrument only the spot element of the forward contract (the spot exchange rate amounts at 1 January 202X to €1 = \$1).

At 31 March 202X (the spot rate at this date amounts to €1 = \$1.05), the transaction is still highly probable but the acquisition price is modified and reduced to \$450 million. Entity A decides to stop hedging the acquisition



price and cancels the forward at market conditions. Assuming that the hedging relationship had been fully effective, the accumulated cash flow hedge reserve amounted to €24 million ($500 * (1 - 1 / 1.05)$).

The initially hedged cash flows are separated in two parts:

- > \$50 million that are no longer expected to occur. The accumulated cash flow hedge reserve related to this part is immediately recorded in profit or loss for €2.4 million ($24 * 50 / 500$).
- > \$450 million that are still expected to occur. The accumulated cash flow hedged reserve related to this part remains in other comprehensive income until the acquisition occurs.

It is interesting to note that, although an expected cash flow that is no longer highly probable triggers the discontinuation of the hedging relationship as the qualifying criteria for cash flow hedge are no longer met, it may still be expected to occur.

There are situations where the hedged risk ceases to exist, but the hedged cash flow is still expected to occur.

Example 14.39

An entity is considering issuing a new fixed rate debt in 12 months. The bond issue is considered as highly probable but its interest rate will only be fixed 1 month before the issue. To hedge the risk of increase in interest rate over the first 11 months, the entity enters a forward starting interest rate swap and documents the swap in a cash flow hedge relationship of the bond. The risk being hedged is the change in the future interest rate expense of the entity on the future Bond, according to changes in benchmark interest rate.

At the end of the 11th month, the entity will discontinue its hedging relationship because the hedged risk will cease to exist as the rate of the bond will be fixed and determined. The hedging relationship will have to be discontinued at that date. However, the performance accumulated in the cash flow hedge reserve will remain in other comprehensive income as the hedged cash flows (the interest payment of the bond) will still be highly probable. The amount accumulated in the cash flow hedge reserve will impact the profit or loss in the same periods during which the hedged interest expenses will impact profit or loss, i.e. over the life of the bond.

CHAPTER 16

DISCLOSURES ABOUT FINANCIAL INSTRUMENTS



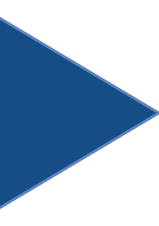


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16.1. Introduction

Disclosures about financial instruments is an intricate and vast topic, because these specific disclosure requirements, although included in a dedicated standard (IFRS 7), depend on other standards that may relate to financial instruments among other items. Disclosures also represent the “end of the journey” in the preparation of financial statements process of an entity: for that reason, disclosure-oriented standards are often considered as “checklist” standards that only require quantitative or qualitative information to report. In practice, this topic is however much more complex because when preparing financial reports entities have to understand all the underlying concepts that are needed to produce the required information and to structure this information in a relevant way and format.

We have sought to present in the first section of this chapter, **section 16.2**, the objectives of IFRS 7, and we also briefly touch upon the information that can be required on financial instruments by IFRS standards other than IFRS 7 to enable the reader to consider financial instruments in the general context of the financial reporting of an entity. In **section 16.3** we have included a brief overview of the scope of instruments to which the requirements in IFRS 7 apply whereas in **section 16.4** we bring readers' attention to the different levels of aggregation that may exist for providing disclosures under IFRS 7.

As most disclosure requirements for financial instruments are presented in IFRS 7, we have then chosen to follow the structure of this standard for **sections 16.5 to 16.8**, as the thematic approach of IFRS 7 (e.g. significance of financial instruments for financial position and performance, hedge accounting, nature and extent of risks arising from financial instruments, transfers of financial assets, etc.) seemed relevant and self-supporting for the reader of this publication.

In some sections though, we have sometimes brought items extracted from other standards to clarify some specific topics (e.g. scope of fair value disclosures and interactions between IFRS 7 and IFRS 13), or to bring in requirements on financial instruments that are present in other standards (e.g. IAS 1).

In **section 16.9**, the last section of this chapter, we focus on the specific requirements for the interim financial statements under IAS 34.

Given the overall scope of our publication, we do not present the disclosure requirements relating to the first-time application of IFRS 9.

16.2. Objectives of disclosure requirements relating to financial instruments (IFRS 7)

The objective of IFRS 7 is to require entities to provide disclosures in their financial statements that enable users to evaluate (IFRS 7.1):

- the significance of financial instruments for the entity's financial position and performance; and
- the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period and how the entity manages those risks.

Beyond those objectives specifically set out in IFRS 7, financial information on financial instruments should also meet overall objectives that are required in other relevant standards and must be considered together with IFRS 7.

Although most of the disclosure requirements for financial instruments are included in IFRS 7, some other standards relating to overall financial information or specifically to fair value measurement also apply. The table below summarises the differences between those standards, their scope of application and the main topics that are dealt within.

Figure 16.1

Standard	Objective	Scope	Main topics covered
IAS 1 <i>Presentation of financial instruments</i>	Prescription of the basis for presentation of general purpose financial statements to ensure comparability	All entities applying the IFRS (both in annual and interim statements)	<ul style="list-style-type: none"> — Definition of items that constitute financial statements (statement of financial position, profit or loss, OCI...) — Information required on accounting policies — Definition of the general purpose for the preparation of financial statements (fair representation, going concern...) — Minimum comparative information, etc.
IAS 8 <i>Accounting policies, changes in accounting estimates and errors</i>	Prescription of criteria, accounting treatment and disclosures, for accounting policies, changes in accounting estimates and corrections of errors	When an entity is facing changes in its accounting policies, accounting estimates or should correct errors for prior periods	<ul style="list-style-type: none"> — Guidelines on selection, application of and changes in accounting policies — Accounting treatment and disclosures requirements for changes in accounting policies or estimates — Accounting treatment and disclosures requirements for corrections of errors
IAS 34 <i>Interim financial reporting</i>	Prescription of the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period.	Any entity that must or chooses to publish an interim financial report in accordance with IFRS	<ul style="list-style-type: none"> — Minimum content of an interim financial report — Interactions between IAS 1 and IAS 34 — Information to disclose specifically for interim closing (e.g. revenues received seasonally), or in the same way as an annual closing — Significant events and transactions — Etc.

Standard	Objective	Scope	Main topics covered
IFRS 7 <i>Financial instruments : disclosures</i>	Enable users of the financial statements to evaluate the significance of financial instruments for the entity's financial position and performance and the nature and extent of risks arising from financial instruments	Any entity that records financial instruments (as defined in IAS 32) in its annual financial statements	<ul style="list-style-type: none"> — Classes of financial instruments — Impairment methodology and breakdown of financial instruments by stage — Nature and extent of risks arising from financial instruments — Hedge accounting — Transfers of financial assets — First time application (FTA) of IFRS 9 disclosures — Etc.
IFRS 13 <i>Fair value measurement</i>	<ul style="list-style-type: none"> — Defining fair value — Setting out in a single IFRS a framework for measuring fair value — Requiring disclosures about fair value measurements 	When another IFRS requires or permits fair value measurements or disclosures about fair value measurements (with some scope exclusions specified in the standard, such as share-based payment transactions in the scope of IFRS 2, etc.)	<ul style="list-style-type: none"> — Definition and principles of fair value measurement — Application of the definition to specific assets or liabilities (e.g. an entity's own equity instruments) — Valuation techniques and inputs used — Fair value hierarchy — Disclosures about fair value measurements

A focus on IAS 34 *Interim Financial Reporting* is made in **section 16.9** with examples of disclosures about financial instruments that are required in the interim financial reports.

16.3. Scope of IFRS 7

The scope of instruments to which IFRS 7 applies is presented in detail in **chapter 1**.

It is important to note that the scope of IFRS 7 includes more items than the sole financial instruments that are within the scope of IFRS 9 (including contracts to buy or sell a non-financial item in the scope of IFRS 9) (IFRS 7.4-5). The additional items in the scope of IFRS 7 include, for example, unrecognised financial instruments that meet the definition of a financial instrument according to IAS 32 but are specifically excluded from the scope of IFRS 9 (e.g. lease liabilities or certain loan commitments, or regular way sales and purchases that are accounted for using settlement date accounting) (see **chapter 1**).

16.4. Aggregation level required for presenting disclosures about financial instruments: by class vs by measurement category

IFRS 7 requires the disclosure of some pieces of information by measurement category of financial instruments and of some others by class of financial instruments.

The **measurement categories** of financial instruments are specified in IFRS 9 (IFRS 7.B3). They determine how financial instruments are measured and where changes in fair value are recognised. Financial instruments may have the following measurement categories, the classification criteria of which are described in **chapter 7** Classification of financial assets and **chapter 8** Classification of financial liabilities:

- financial assets measured at fair value through profit or loss (FV-PL);
- financial liabilities measured at fair value through profit or loss (FV-PL);
- financial assets measured at amortised cost (AC);
- financial liabilities measured at amortised cost (AC);
- financial assets measured at fair value through other comprehensive income (FV-OCI).

The disclosures required by measurement category mainly relate to:

- the carrying amounts of financial instruments (see **section 16.6.1.1**);
- reclassifications of financial assets (see **section 16.6.1.4**);
- and items of income, expenses, gains and losses (see **section 16.6.2**).

The **classes** of financial instruments are determined by the entity and are distinct from the measurement categories of financial instruments (IFRS 7.B1). IFRS 7 does not define exactly what a class of financial instruments is but provides guidance on how the groupings into classes should be performed.

According to IFRS 7.6, the classes in which financial instruments are grouped should:

- be appropriate to the nature of the information disclosed (e.g. fair value of financial instruments, specific risks such as credit or market risk arising from them...);
- consider the characteristics of those financial instruments (maturity, category of loan, fixed or variable rate...);
- provide sufficient information to permit reconciliation to the line items presented in the statement of financial position (IFRS 7.6).

Even if classes and accounting categories are distinct from each other, IFRS 7.B2 indicates that in determining classes of financial instrument, entities must, at a minimum:

- distinguish instruments measured at amortised cost from those measured at fair value;
- treat as a separate class or classes those financial instruments outside the scope of IFRS 7.

IFRS 7.B3 further indicates that when determining the appropriate classes of financial instruments entities:

- should decide, in the light of its circumstances, how much detail they provide to satisfy the requirements of this IFRS, how much emphasis it places on different aspects of the requirements and how they aggregate information to display the overall picture without combining information with different characteristics;
- should strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation;
- should not obscure important information by including it among a large amount of insignificant detail; and

- they should not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks



Entities will have to use **judgement** to appreciate the relevance of classes identified with respect to their activities and the characteristics of financial instruments.

Classes of financial instruments will often be more granular than the financial categories defined by IFRS 9 (amortised cost, financial assets or liabilities measured at FV-PL...). For example, for assets at amortised cost, classes could be defined based on the economic characteristics of the assets included in this classification: home loans, revolving facilities, consumer loans...

The illustrative examples of IFRS 7 (e.g. IFRS 7.IG.21) seem to indicate that the classes, in relation to credit risk disclosures, should be **quite granular** (e.g. residential mortgages, unsecured consumer loans and commercial loans are presented as distinct). However, judgement will be needed to assess the specific circumstances of the entity and the shared risk characteristics of the instruments it holds.

One should also keep in mind that classes of financial instruments may vary from one disclosure to another to provide more relevant information: the entity can for example define one set of classes of financial instruments for disclosures about credit risk and another set of classes for disclosures about fair value (day one gain or loss) or about items presented in the statement of financial position.

The table below provides some examples of disclosures that should be given by **class** of financial instruments:

Figure 16.2

Topic to which the disclosure requirements relate	Specific aspects to consider in determining the appropriate aggregation level when grouping financial instruments into classes	Section
Fair value	<ul style="list-style-type: none"> — Nature, characteristics and risks of assets and liabilities — Level in the fair value hierarchy 	16.6.4
Credit risk	<ul style="list-style-type: none"> — Economic characteristics of financial instruments 	16.7.2
Transfers of financial assets	<ul style="list-style-type: none"> — N/A 	16.8



Although IFRS 7 does not require entities to disclose all of the information by classes of financial instruments, in practice entities may choose to go further than the minimum requirements of the standard, as long as this provides relevant information without overburdening financial statements with excessive detail obscuring important information. For example, disclosures about the statement of financial position and the statement of comprehensive income may also be broken down by classes of financial instruments, even if IFRS 7 only requires those pieces of information to be given by categories of financial instruments in accordance with IFRS 9.

16.5. Accounting policies

The general requirements regarding accounting policies of an entity are in the scope of standards IAS 1 and IAS 8. IFRS 7.21 makes a reference to the principles of IAS 1.117 and requires entities to disclose the **significant accounting policies** that are relevant to an understanding of the financial statements, including the measurement bases used for their preparation. The reference to “significant” accounting policies also means, in our opinion, that accounting policies related to non-significant items should not be detailed to make the information more relevant and understandable.

IFRS 7.B5 provides more details to illustrate the requirements in IFRS 7.21 on significant accounting policies for financial instruments. This guidance is summarised in the table below:

Figure 16.3

Type of financial instrument to which the accounting policies relate	Relevant accounting policies
Financial assets and liabilities designated at FV-PL (subject to the fair value option)	<ul style="list-style-type: none"> — Nature of the financial instruments optionally designated at FV-PL. — How the entity has satisfied the conditions for applying this option, that are specified: <ul style="list-style-type: none"> > in IFRS 9.4.1.5 for financial assets (i.e. in our opinion, entities should explain to what extent such designation permits to reduce or eliminate an accounting mismatch and also provide a narrative description of the inconsistency that would otherwise arise) (see section 7.4.5); > and in IFRS 9.4.2.2 for financial liabilities (i.e. (a) if the designation is related to a reduction of an accounting mismatch, the same information should be provided as for financial assets thus designated, as explained above, and (b) if the designation relates to a group of financial liabilities managed on a fair value basis, entities should, in our opinion, provide a description of the management and / or investment strategy that justifies such designation) (see section 8.3.3).
Financial assets – regular way purchases or sales (see section 6.2.2)	<ul style="list-style-type: none"> — Explain whether those financial assets are accounted for at trade date or at settlement date. As a reminder, under IFRS 9 the choice between these two dates of initial recognition / derecognition must be made by category of financial instruments.
All financial instruments	<ul style="list-style-type: none"> — Information about determination of net gains or net losses for each category. <ul style="list-style-type: none"> > Example: whether the net gains or net losses on items at FV-PL include interest or dividend income.

IFRS 7 also reminds entities that they must disclose, in accordance with IAS 1.122, the **judgements** that management has made for the preparation of financial statements in their accounting policies. Those judgements do not include the uncertainties and assumptions involving estimations, that must be disclosed separately.

Regarding financial instruments, the main judgement areas explicitly mentioned in IAS 1 are (IAS 1.123):

- the way the entity determines when substantially all the significant risks and rewards of ownership of financial assets and lease assets are transferred to other entities (in relation to the derecognition analysis);
- the way the entity determines for a financial asset whether cash flows that arise from contractual terms at specified dates meet the SPPI criterion (see **section 7.4.3**).

The disclosures about uncertainties and assumptions involving estimations are detailed in IAS 1.125-133. These requirements of IAS 1 are adapted to the most significant estimations resulting from the requirements of the relevant standards. When it comes to financial instruments, in our view such estimations include, but are not limited to:

- fair value measurement (see **section 16.6.4**): significant assumptions, inputs and valuation techniques used when measuring the fair values of financial assets and liabilities;
- key assumptions and parameters for calculation of expected credit losses (see **section 16.7.2**);
- methods used to assess the effectiveness in hedge accounting relationships, needing assumptions on change in the hedged risks, and their impact on the hedging relationship (see **section 16.6.3**).

16.6. Significance of financial instruments for financial position and performance

As pointed out in **section 16.2**, one of the main objectives of IFRS 7 is to enable users of the financial statements to evaluate the significance of financial instruments for the entity's financial position and performance. To achieve this goal, specific disclosures are required relating to the statement of financial position and to the statement of comprehensive income.

It is also important to keep in mind the requirements and objectives of IAS 1 regarding the financial statements, as a lot of other general requirements that must be satisfied may relate to financial instruments (e.g. compliance of the disclosures about the statement of comprehensive income with the classification required in IAS 1.82 and IAS 1.82A).

16.6.1. Statement of financial position

16.6.1.1. Categories of financial assets and financial liabilities

IFRS 7.8 requires for an entity to disclose the **carrying amount**, either on the face of the statement of financial position or in the notes, for each financial instrument category (as defined by IFRS 9) listed below:

- financial assets measured at FV-PL, showing separately:
 - > those optionally designated as at FV-PL (see **section 7.4.5**);
 - > those mandatorily measured at FV-PL¹ according to IFRS 9 (see **chapter 7**);
- financial liabilities measured at FV-PL (see **chapter 8**), showing separately:
 - > those optionally designated as at FV-PL (see **section 8.3.3**);
 - > those that meet the definition of held for trading in IFRS 9 (see **section 8.3.2**);

¹ These include:

- derivatives that are assets,
- Non-SPPI debt instruments (irrespective of their business model),
- debt instruments (SPPI or Non-SPPI) managed under business models (such as Held-for-trading) other than HTC or HTCS
- equity instruments that are not designated as measured at FV-OCINR

- financial assets measured at AC (see **section 7.4**);
- financial liabilities measured at AC (see **section 8.2**);
- financial assets measured at FV-OCI, with the carrying amounts presented separately between:
 - > assets that meet the SPPI criterion and have a HTCS business model (see **section 7.4**);
 - > equity investments designated as at FV-OCINR (see **section 7.3.2**).

16.6.1.2. Financial assets or financial liabilities optionally designated at fair value through profit or loss

If an entity has elected to measure at FV-PL **financial assets** that would otherwise be measured at FV-OCI or AC, it has to disclose the following information (IFRS 7.9):

- the maximum exposure to credit risk (see **section 16.7.2.6.2**) at the end of the reporting period;
- the amount by which any related credit derivatives (e.g. credit default swaps) or similar instruments mitigate that maximum exposure to credit risk;
- the amount of change, **during the period and cumulatively** since initial recognition, in the fair value of assets that is attributable to changes in the credit risk of the financial asset (i.e. the spread of the financial asset). This amount can be determined either:
 - > as the amount of change in its fair value that is not attributable to changes in market conditions that give rise to market risk; or
 - > using an alternative method, the entity believes more faithfully represents the amount of change in its fair value that is attributable to changes in the credit risk of the asset.

Changes in market conditions that give rise to market risk include changes in an observed (benchmark) interest rate, commodity price, foreign exchange rate or index of prices or rates;

- the amount of the change in the fair value of any related credit derivatives or similar instruments, over the period and since the financial asset was designated as at FV-PL.

When it comes to **financial liabilities** designated as at FV-PL, the disclosure requirements will depend on whether all the fair value gains or losses are recognised in profit or loss, or if a part of these changes that relates to the changes in the liability's credit risk is recognised in OCI:

- if an entity has designated a financial liability as at FV-PL and is required by IFRS 9.5.7.7 (see **section 8.3.3**) to present changes in its credit risk in OCI, it has to disclose (IFRS 7.10):
 - > the cumulative amount of change in the fair value of the liability that is attributable to changes in the credit risk of that liability (i.e. the amount that is recorded in OCI at the end of the reporting period);
 - > the difference between the financial liability's carrying amount, and the amount the entity would be contractually required to pay at maturity to the holder of the obligation;
 - > any transfers of the cumulative gain or loss within equity (in accordance with IFRS 9.B5.7.9, e.g. from OCI to retained earnings) during the period, including the reason for such transfers (repayment, disposal, etc.);
 - > if a liability is derecognised during the period, the amount presented in OCI that was realised at derecognition;

- if an entity has designated a financial liability as at FV-PL and is required by IFRS 9.5.7.8 (see **section 8.3.3**) to present all changes in the fair value of that liability (including the effects of changes in the credit risk of the liability) in profit or loss, it must disclose (IFRS 7.10A):
 - > the amount of change, **during the period and cumulatively**, in the fair value of the financial liability that is attributable to changes in the credit risk of that liability;
 - > the difference between the financial liability's carrying amount and the amount the entity would be contractually required to pay at maturity to the holder of the obligation.

In addition to the specific requirements described above, entities are also required to provide the following narrative disclosures (IFRS 7.11):

- for financial **assets and financial liabilities** designated at FV-PL:
 - > a detailed description of the methods used to measure the amount of change in the fair value of assets and liabilities attributable to changes in their credit risk, and an explanation of why these methods were deemed to be appropriate;
 - > where relevant, the reasons why the entity believes that the disclosures provided do not faithfully represent the changes in the fair value of an instrument attributable to changes in its credit risk, and the factors it believes are relevant;
- for financial **liabilities** designated at FV-PL:
 - > the methods used to determine whether presenting the effects of changes in a liability's credit risk in OCI would create or enlarge an accounting mismatch in profit or loss;
 - > if an accounting mismatch is created or enlarged (which results in the entity being required to present in profit or loss – rather than in OCI – the effects of changes in a liability's credit risk), an explanation of this mismatch, with particular attention to any economic relationship (described in paragraph IFRS 9.B5.7.6) that would enable the entity to expect a compensation between the above changes, and changes in another financial instrument measured at FV-PL (see **chapter 8**).

16.6.1.3. Investments in equity instruments designated at fair value through other comprehensive income

If an entity has designated investments in equity instruments as measured at FV-OCINR (see **section 7.3.2**) it has to disclose (IFRS 7.11A):

- which instruments it has designated as measured at FV-OCINR;
- the reasons for using this presentation alternative;
- the fair value of each such investment at the end of the reporting period;
- dividends recognised during the period, showing separately:
 - > those related to investments derecognised during the reporting period; and
 - > those related to investments held at the end of the reporting period;
- any transfers from OCI to other consolidated reserves during the period, including the reason for such transfers.

In addition, the following disclosures are required in case of derecognition during the reporting period of investments in equity instruments measured at FV-OCINR (IFRS 7.11B):

- the reasons for disposing of the investments;
- the fair value of the investments at the date of derecognition;
- the cumulative gain or loss on disposal.

16.6.1.4. Reclassification of financial assets

The conditions for reclassifying financial assets that are debt instruments are presented in **section 7.5**. As explained in **section 7.5** and in **section 8.5**, financial assets that are equity instruments and financial liabilities may not be subsequently reclassified to a different measurement category: their initial classification is irrevocable.



It is to be noted that some of the disclosures about reclassified assets presented below are required only in the reporting period during which the reclassification took place, whereas others will have to be provided until the derecognition of the reclassified assets.

If an entity has reclassified any financial assets due to a change in business model **in the current or previous reporting periods**, it must present the following for **each** reclassification (IFRS 7.12B):

- the date of reclassification;
- a detailed explanation of the change in business model and a qualitative description of its effect on the entity's financial statements;
- the amount reclassified into and out of each category (FV-PL, AC, FV-OCI).

For reclassifications of assets from FV-PL to AC or from FV-PL to FV-OCI in the current or previous reporting periods, specific information must be provided **for each reporting period following reclassification until derecognition** (IFRS 7.12C), namely:

- the effective interest rate determined on the date of reclassification;
- the interest revenue recognised.

If an entity has reclassified financial assets from FV-OCI to AC, from FV-PL to AC or from FV-PL to FV-OCI **in the current reporting period**, it must disclose the following information on the reporting date following the reclassification (IFRS 7.12D):

- the fair value of the financial assets at the end of the reporting period;
- the fair value gain or loss that would have been recognised in profit or loss or OCI during the reporting period if the financial assets had not been reclassified.

16.6.1.5. Offsetting financial assets and financial liabilities

As a general principle of presentation, IAS 1 does not allow to offset assets and liabilities or income and expenses, unless required or permitted by an IFRS (IAS 1.32).

IAS 32 contains specific criteria for offsetting financial assets against financial liabilities. Entities must offset financial assets and liabilities when the two criteria specified in IAS 32.42 are met:

- the entity currently has a legally enforceable right to set off the recognised amounts; and
- it intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.



It is to be noted that the disclosure requirements on offsetting financial assets and financial liabilities presented in this section go beyond the sole recognised financial instruments that are set off in the statement of financial position in accordance with paragraph 42 of IAS 32. These disclosures also apply to recognised financial instruments that are subject to enforceable master netting arrangements or similar agreements that do not meet the criteria for offsetting in IAS 32.42.

To provide these disclosures, entities will therefore need to use contractual data (which is not necessarily easily available in their accounting systems) and make a detailed inventory of their netting agreements.

The objective of the disclosures about offsetting financial assets and financial liabilities in IFRS 7 is to enable users of the financial statements to evaluate the effect **or potential effect** of netting arrangements on the entity's financial position (IFRS 7.13B). To comply with this objective, entities must disclose information both on (IFRS 7.13A and IFRS 7.B40):

- recognised financial instruments that have been **set off** (i.e. presented in net) in their statement of financial position in accordance with IAS 32.42, **and**
- recognised financial instruments **subject to an enforceable master netting arrangement** or *similar agreement*, that covers *similar financial instruments* and transactions, irrespective of whether they are set off in the statement of financial position or not in accordance with IAS 32.42. IFRS 7.B41 provides additional guidance on how the terms in italic should be interpreted:
 - > the "*similar agreement*" include derivative clearing agreements, global master repurchase agreements, global master securities lending agreements, and any related rights to financial collateral;
 - > the "*similar financial instruments*" covered by such agreement include derivatives, sale and repurchase agreements, reverse sale and repurchase agreements, securities borrowing, and securities lending agreements.

Examples of financial instruments that should not be included in the disclosures about offsetting are loans and customer deposits at the same institution (unless they are set off in the statement of financial position), and financial instruments that are subject only to a collateral agreement (IFRS 7.B41).

The following **quantitative** information has to be disclosed to meet the objective described above, **separately** for recognised financial assets and recognised financial liabilities:

- the gross carrying amounts of assets and liabilities concerned **[a]**;
- the amounts set off in accordance with the criteria set out in IAS 32.42 **[b]**;
 - > the disclosure of these amounts must be limited to the amounts that meet the offsetting criteria, and not include the integral amounts of the financial assets and liabilities (IFRS 7.B44). For example, if a derivative asset of EUR 100 and a derivative liability of EUR 150 are eligible to offsetting, only EUR 100 will be disclosed as offset amounts for both the derivative asset and the derivative liability;

- the net amounts **[c]** presented in the statement of financial position **[c] = [a] - [b]**;
 - > in the case of financial instruments that are not eligible to offsetting but are included in the scope of offsetting disclosures, the net amounts of the financial assets and liabilities should be equal to their gross carrying amounts (IFRS 7.B45), i.e. **[c] = [a]**;
 - > these amounts must be reconciled to the individual line items amounts presented in the statement of financial position (IFRS 7.B46);
- the amounts subject to an enforceable master netting arrangement or similar agreement **[d]** that are not set off as above, including:
 - > amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in IAS 32;
 - > amounts related to financial collateral (including cash collateral);
 - i.e. the fair value of actual financial collateral both received and pledged, and not the amounts related to any resulting payables or receivables recognised to return or receive back such collateral (IFRS 7.B48);
- the net amount **[e]** resulting from the difference between **[c]** and **[d]** (positive or equal to 0 (IFRS 7.13D));
 - > calculation of this net amount has to be made in a specific order to take into account the effects of over-collateralisation by financial instruments (IFRS 7.B49):
 - it is first necessary to deduct the amounts related to financial instruments that do not meet the offsetting criteria in IAS 32 from the net amounts in **[c]**;
 - the entity must then limit the amounts related to financial collateral in **[d]** to the remaining amount above for the related financial instrument;
 - however, if rights to collateral can be enforced across financial instruments, such rights can be included in the disclosure of the net amounts provided in accordance with IFRS 7.13D.

A **tabular format** is recommended but it is allowed to use another format if it is appropriate (IFRS 7.13C).

The application guidance of IFRS 7 specifies the level of aggregation in which this information on offsetting should be disclosed:

- the quantitative disclosures described above may be grouped by type of financial instrument or transaction (for example, derivatives, repurchase and reverse repurchase agreements or securities borrowing and securities lending agreements) (IFRS 7.B51);
- alternatively, an entity may group the quantitative disclosures of the amounts **[c]**, **[d]** and the net amount **[e]** by counterparty instead of by type of financial instrument (IFRS 7.B52).
 - > If an entity provides this information by counterparty, the entity is not required to identify the counterparties by their name. However, designation of counterparties (Counterparty A, Counterparty B, Counterparty C, etc.) must remain consistent from one year to another to permit comparability.
 - > Additional qualitative disclosures may need to be provided about the types of counterparties.
 - > Amounts that are individually significant in terms of total counterparty amounts must be separately disclosed and the remaining individually insignificant counterparty amounts must be aggregated into a one-line item.



In addition to the quantitative information above, an entity must also include in the disclosures a **description** of the rights of set-off associated with the recognised financial assets and liabilities that are subject to an enforceable master netting arrangement or similar agreement (including the nature of those rights) (IFRS 7.13E). According to the application guidance of IFRS 7 (IFRS 7.B50), this description should include:

- a mention of the entity's conditional rights to set off amounts (if any);
- for instruments subject to rights of set-off that are not contingent on a future event but that do not meet the remaining criteria in IAS 32.42, the reason(s) why the criteria are not met;
- for any financial collateral received or pledged, the terms of the collateral agreement (for example, when the collateral is restricted).

If all the information required on offsetting is disclosed in more than one note to the financial statements, entities have to add **cross-references** between those notes (IFRS 7.13F).

In case of a discrepancy due to different measurement requirements in IFRS 9 between financial instruments that must be offset (e.g. between a payable related to a repurchase agreement measured at AC and a derivative measured at fair value), an entity must include instruments at their recognised amounts and describe any resulting measurement differences in the related disclosures (IFRS 7.B42). In practice, it means that the entity will potentially offset "amortised cost amounts" with "fair value amounts" and highlight those discrepancies in the related note.

The specific disclosures set out in this section are **minimum** requirements. To meet the objective in IFRS 7 an entity may need to supplement them with additional (**qualitative**) disclosures, depending on the

terms of the enforceable master netting arrangements and related agreements, including the nature of the rights of set-off, and their effect or potential effect on the entity's financial position (IFRS 7.B53).

The implementation guidance of IFRS 7 provides illustrative examples of the disclosures about offsetting (IFRS 7.IG.40D):

Example 16.1

Background

An entity has entered into transactions subject to an enforceable master netting arrangement or similar agreement with the following counterparties.

The entity has the following recognised financial assets and financial liabilities resulting from those transactions that meet the scope of the disclosure requirements in IFRS 7.13A.

Counterparty A:

The entity has a derivative asset (fair value of CU100 million) and a derivative liability (fair value of CU80 million) with Counterparty A that meet the offsetting criteria in IAS 32.42. Consequently, the gross derivative liability is set off against the gross derivative asset, resulting in the presentation of a net derivative asset of CU20 million in the entity's statement of financial position. Cash collateral has also been received from Counterparty A for a portion of the net derivative asset (CU10 million). The cash collateral of CU10 million does not meet the offsetting criteria in IAS 32.42, but it can be set off against the net amount of the derivative asset and derivative liability in the case of default and insolvency or bankruptcy, in accordance with an associated collateral arrangement.

Counterparty B:

The entity has a derivative asset (fair value of CU100 million) and a derivative liability (fair value of CU80 million) with Counterparty B that do not meet the offsetting criteria in IAS 32.42, but which the entity has the right to set off in the case of default and insolvency or bankruptcy.

Consequently, the gross amount of the derivative asset (CU100 million) and the gross amount of the derivative liability (CU80 million) are presented separately in the entity's statement of financial position. Cash collateral has also been received from Counterparty B for the net amount of the derivative asset and derivative liability (CU20 million). The cash collateral of CU20 million does not meet the offsetting criteria in IAS 32.42, but it can be set off against the net amount of the derivative asset and derivative liability in the case of default and insolvency or bankruptcy, in accordance with an associated collateral arrangement.

Counterparty C:

The entity has entered into a sale and repurchase agreement with Counterparty C that is accounted for as a collateralised borrowing. The carrying amount of the financial assets (bonds) used as collateral and posted by the entity for the transaction is CU79 million and their fair value is CU85 million. The carrying amount of the collateralised borrowing (repo payable) is CU80 million.

The entity has also entered into a reverse sale and repurchase agreement with Counterparty C that is accounted for as a collateralised lending. The fair value of the financial assets (bonds) received as collateral (and not recognised in the entity's statement of financial position) is CU105 million. The carrying amount of the collateralised lending (reverse repo receivable) is CU90 million.

The transactions are subject to a global master repurchase agreement with a right of set-off only in default and insolvency or bankruptcy and therefore do not meet the offsetting criteria in IAS 32.42. Consequently, the related repo payable and repo receivable are presented separately in the entity's statement of financial position.



Example 16.1

Illustrating the application of paragraph 13C(a)–(e) by type of financial instrument

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)	(d) Related amounts not set off in the statement of financial position		(e)=(c)-(d)
Description	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral received	Net amount
Derivatives	200	(80)	120	(80)	(30)	10
Reverse repurchase, securities borrowing and similar agreements	90	–	90	(90)	–	–
Other financial instruments	–	–	–	–	–	–
Total	290	(80)	210	(170)	(30)	10



Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a)	(b)	(c)=(a)-(b)	(d) Related amounts not set off in the statement of financial position		(e)=(c)-(d)
Description	Gross amounts of recognised financial liabilities	Gross amounts of recognised financial assets set off in the statement of financial position	Net amounts of financial liabilities presented in the statement of financial position	(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral pledged	Net amount
Derivatives	160	(80)	80	(80)	-	-
Reverse repurchase, securities borrowing and similar agreements	80	-	80	(80)	-	-
Other financial instruments	-	-	-	-	-	-
Total	240	(80)	160	(160)	-	-



Illustrating the application of paragraph 13C(a)–(c) by type of financial instrument and paragraph 13C(c)–(e) by counterparty

Financial assets subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a) Gross amounts of recognised financial liabilities	(b) Gross amounts of recognised financial assets set off in the statement of financial position	(c)=(a)-(b) Net amounts of financial liabilities presented in the statement of financial position
Description			
Derivatives	200	(80)	120
Reverse repurchase, securities borrowing and similar agreements	90	–	90
Other financial instruments	–	–	–
Total	290	(80)	210

Net financial assets subject to enforceable master netting arrangements and similar agreements, by counterparty

CU million

As at 31 December 20XX	(c) Net amounts of financial assets presented in the statement of financial position	(d) Related amounts not set off in the statement of financial position		(e)=(c)-(d) Net amount
		(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral pledged	
Counterparty A	20	–	(10)	10
Counterparty B	100	(80)	(20)	–
Counterparty C	90	(90)	–	–
Other	–	–	–	–
Total	210	(170)	(30)	10

Financial liabilities subject to offsetting, enforceable master netting arrangements and similar agreements

CU million

As at 31 December 20XX	(a) Gross amounts of recognised financial liabilities	(b) Gross amounts of recognised financial assets set off in the statement of financial position	(c)=(a)-(b) Net amounts of financial liabilities presented in the statement of financial position
Description			
Derivatives	160	(80)	80
Reverse repurchase, securities borrowing and similar agreements	80	–	80
Other financial instruments	–	–	–
Total	240	(80)	160

*Net financial liabilities subject to enforceable master netting arrangements and similar agreements,
by counterparty*

CU million

As at 31 December 20XX	(c) Net amounts of financial liabilities presented in the statement of financial position	(d) Related amounts not set off in the statement of financial position		(e)=(c)-(d) Net amount
		(d)(i), (d)(ii) Financial instruments	(d)(ii) Cash collateral pledged	
Counterparty A	20	–	(10)	10
Counterparty B	100	(80)	(20)	–
Counterparty C	90	(90)	–	–
Other	–	–	–	–
Total	210	(170)	(30)	10

16.6.1.6. Collateral

If an entity has **pledged financial assets** as collateral for liabilities or contingent liabilities, it should disclose the following information (IFRS 7.14):

- the carrying amount of financial assets pledged as collateral (including collateral that may be sold or repledged by the holder and that is presented separately in the statement of financial position);
- the terms and conditions of the pledge.

When an entity **holds collateral** (of financial or non-financial assets) and is **permitted to sell or repledge** it in the absence of default by the owner of the collateral, it has to disclose (IFRS 7.15):

- the fair value of the collateral held;
- the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it;
- the terms and conditions associated with its use of the collateral.

Specific disclosures, as per IFRS 7.35K and IFRS 7.36, are also required on how collateral held reduces the entity's expected credit losses or credit exposure. These disclosures are detailed in the credit risk section (see **section 16.7.2**).

16.6.1.7. Allowance account for credit losses

For assets that are debt instruments measured at FV-OCI with ulterior recycling to profit or loss (see **section 7.4**), the carrying amount is equal to fair value and is not reduced by a loss allowance. Although the loss allowance of such assets is not presented separately in the statement of financial position as a reduction of the carrying amount of the financial asset, it has to be disclosed in the notes to the financial statements (IFRS 7.16A).

16.6.1.8. Compound financial instruments with multiple embedded derivatives

If an entity has issued an instrument that contains both a liability and an equity component, and the instrument has multiple embedded derivatives (see **chapter 13**) for which values are interdependent (such as a callable convertible debt instrument), it must disclose the existence of those features (IFRS 7.17).

16.6.1.9. Defaults and breaches

Loans payable are defined as "*financial liabilities, other than short-term trade payables on normal credit terms*" (IFRS 7 Appendix A).

For loans payable recognised at the end of the reporting period, an entity has to disclose (IFRS 7.18):

- details of any default during the period of principal, interest, sinking fund or redemption terms of those loan payable;
- the carrying amount of the loans payable in default at the end of the reporting period;
- whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issues.

If, during the period, there were breaches of loan agreement terms, other than those described above (i.e. other than default of principal, interest, sinking fund or redemption terms), which permitted the lender to demand accelerated repayment (e.g. breach of covenant), and the entity did not remedy these breaches or renegotiate the terms of the loan at or before the end of the reporting period (in which case the following information is not required), the entity is required to disclose (IFRS 7.19):

- detailed information on the breaches;
- the carrying amount of the loans concerned.

Any defaults or breaches may affect the classification of the liability as current or non-current in accordance with IAS 1 (IFRS 7.IG.12).

16.6.2. Statement of comprehensive income

16.6.2.1. Interactions between IAS 1 and IFRS 7

As a reminder, IAS 1.10A allows entities to present either a single statement of profit or loss and other comprehensive income, with two separate sections (profit or loss and OCI), or two separate statements (statement of profit or loss and statement of comprehensive income).

Most of the information required under IFRS 7 on the statement of comprehensive income relates to the profit or loss section. It should be noted that some other general disclosure requirements that are specified in IAS 1 also apply to financial instruments in the scope of IFRS 7 (e.g. disclosure requirements regarding the reclassification adjustments relating to components of OCI in IAS 1.90-96). The latter disclosures stemming from IAS 1 are not detailed in this section which only focuses on the specific disclosure requirements in IFRS 7 on items of income, expense, gains or losses relating to financial instruments.

16.6.2.2. Net gains or net losses

Net gains and losses on financial instruments must be presented separately in the statement of comprehensive income or in the notes, according to the applicable measurement categories as defined in IFRS 9 (IFRS 7.20(a)) and as follows:

- financial assets and liabilities measured at FV-PL, with a separate presentation of net gains and losses between:
 - > those optionally designated as at FV-PL (see **section 7.4.5**);
 - for liabilities optionally designated at FV-PL, a separate presentation of the amounts of net gains and losses recognised in OCI and those recognised in profit or loss is also required;
 - > those mandatorily measured at FV-PL;
- financial assets measured at AC;
- financial liabilities measured at AC;
- financial assets measured at FV-OCI, showing separately:
 - the net gains and losses recognised in OCI during the period;
 - the amounts recycled upon derecognition from OCI to profit or loss as a reclassification adjustment over the period;

- and financial assets that are equity instruments measured at FV-OCI/NR.

16.6.2.3. Interest income and interest expenses

An entity must disclose total interest income and total interest expense, determined using the effective interest method, separately for **each** of the following measurement categories (IFRS 7.20(b)):

- financial assets measured at AC;
- financial assets at FV-OCI;
- financial liabilities that are not measured at FV-PL.

16.6.2.4. Fees income and expenses

IFRS 7.20(c) requires disclosing fee income and expenses that are not included in determining the effective interest rate, arising from:

- financial assets and liabilities that are not measured at FV-PL;
- trust and other fiduciary activities that result in the holding or investing of assets on behalf of individuals, trusts, retirement benefit plans, and other institutions.

16.6.2.5. Derecognition of financial assets measured at amortised cost

If an entity has derecognised any financial assets at amortised cost over the period, it must disclose the following items (IFRS 7.20A):

- gains or losses (to be presented separately) arising from derecognition of such assets; and
- an explanation of the reasons for derecognising these assets.

IAS 1.82(aa) also requires disclosing in a separate line in the statement of profit or loss² the total amount of gains and losses arising from the derecognition of financial assets. Unlike IFRS 7.20A, IAS 1 does not require to disclose separately the amounts of gains and losses upon derecognition.

16.6.3. Hedge accounting

IFRS 9 allows entities to choose between applying the requirements for hedge accounting in IFRS 9 or continuing to apply those in IAS 39. For the main changes in IFRS 9 compared to IAS 39 regarding hedge accounting and the related transition options, please refer to **sections 14.1.3** and **14.1.4**.

Even if an entity still applies IAS 39 for its hedging relationships, the new disclosure requirements on hedge accounting in IFRS 7, modified by IFRS 9, now equally apply to that entity, even though it does not yet apply the new hedge accounting requirements in IFRS 9. The amended IFRS 7 requires both qualitative and quantitative information, and some of that information only applies to specific designation options introduced by IFRS 9.

For more details about hedge accounting under IFRS 9, see **chapter 14**.

² or in the in the profit or loss section if a single statement of comprehensive income is presented.

It should be noted that the disclosure requirements on hedging presented in **section 16.6.3** apply **only** to those risk exposures that an entity hedges (mainly using derivatives) **and for which it elects to apply hedge accounting** (IFRS 7.21A).



Hedge accounting being optional, entities with hedging strategies that are not documented in an accounting hedging relationship are not required to provide the full set of IFRS 7 hedging disclosures presented in this section. However, in our opinion, providing some of this information (such as the description of the entity's risk management strategy) would be relevant even for the undocumented hedging strategies.

16.6.3.1. Objectives of disclosures about hedges

The disclosure requirements in IFRS 7 on hedge accounting aim at providing information about (IFRS 7.21A):

- the entity's risk management strategy and how it is applied to manage risk;
- how the entity's hedging activities may affect the amount, timing and uncertainty of its future cash flows; and
- the effect that hedge accounting has had on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.

16.6.3.2. Level of detail and of aggregation in the disclosures about hedging

A large part of these disclosures must be provided by **"risk category"**. In the same way as for the concept of "classes of financial instrument", IFRS 7 does not define precisely what a risk category is but specifies that it is determined based on the risk exposures the entity decides to hedge and **for which hedge accounting is applied**. The entity must determine risk categories consistently for all hedge accounting disclosures (IFRS 7.21C). Although the determination of how much detail to disclose and the appropriate level of aggregation depend on the entity's **judgement**, the level of aggregation or disaggregation should be consistent with that used for related information in other parts of IFRS 7 and IFRS 13 (IFRS 7.21D):

- for example, users should be able to make comparisons between the fair value disclosures and the hedge accounting disclosures (IFRS 7.BC35FF);
- the goal of this same level of aggregation or disaggregation is to make it possible for the users of the financial statements to identify, thanks to the disclosures, financial instruments measured at fair value that are not designated as hedging instruments (IFRS 7.BC35MM).





In practice, risk categories are generally based on the underlying risks that drive the value of the hedging instrument, such as interest rate risk, foreign currency change risk, equity price risk, commodities price risk, etc.

However, when one derivative is used to hedge several risks, entities may need to define even more granular risk categories. The following example is provided in the basis for conclusions of IFRS 7 (IFRS 7.BC350):

- suppose an entity that manages its **floating interest rate risk** using interest rate swaps (to change it to a fixed interest rate) for some hedging relationships (cash flow hedges), while it also uses cross-currency interest rate swaps to manage both the **floating interest rate** and **foreign exchange risk** of other hedging relationships (cash flow hedges).
- This entity would have one risk category for floating interest rate risk and another risk category for foreign exchange risk combined with floating interest rate risk.

16.6.3.3. Where in the financial communication should disclosures about hedging be provided?

IFRS 7.21B requires that all disclosures about hedge accounting should be presented in a **single** note or separate section of the financial statements. It is however possible to incorporate this information by **cross-reference** from the financial statements to some other statement that is available on the same terms and at the same time for the users of the financial statements (e.g. a management commentary or risk report). Without the information incorporated by cross-reference, the financial statements are incomplete.

16.6.3.4. Qualitative disclosures about risk management strategy and sources of ineffectiveness

The entity should explain its risk management strategy **for each risk category** of risk exposures that it decides to hedge **and for which hedge accounting is applied**, which implies to give enough details so that the user can evaluate for example (IFRS 7.22A):

- how each risk arises;
- how the entity manages each risk; this includes whether the entity hedges an item in its entirety for all risks or hedges a risk component (or components) of an item and why;
- the extent of risk exposures that the entity manages.

To meet these requirements, the information should include (but is not limited to) a **description** of (IFRS 7.22B):

- the **hedging instruments** that are used (and how they are used) to hedge risk exposures;
- how the entity determines the **economic relationship** between the hedged item and the hedging instrument for the purpose of assessing hedge effectiveness;

- how the entity establishes the **hedge ratio** and what the **sources of ineffectiveness** are. In particular, when it comes to sources of ineffectiveness, the entity should describe, by risk category:
 - > the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term, for all types of hedging (i.e. fair value hedge, cash flow hedge and net investment hedge) (IFRS 7.23D);
 - > if other sources of hedge ineffectiveness emerge in a hedging relationship, those sources and the resulting hedge ineffectiveness (IFRS 7.23E).

IFRS 7.22C contains additional disclosure requirements on **hedged risk components** for entities applying the new requirements on designated risk components as hedged items under IFRS 9³ (see **section 16.6.3.7**).

16.6.3.5. Quantitative hedge accounting disclosures

Besides the new narrative descriptions of the entity's risk management strategy and other qualitative information presented above, IFRS 7 also brings new requirements related to the quantitative effect of hedge accounting on the entity's statement of financial position, statement of comprehensive income and statement of changes in equity.

16.6.3.5.1. Format of quantitative disclosures about hedging

Entities are required to provide most quantitative disclosures about hedging in a **tabular** format (IFRS 7.24A, 24B and 24C), and often they need to provide this information by hedging relationship type (FVH, CFH, NIH) and by risk category.

16.6.3.5.2. Disclosures about the amount, timing and uncertainties of future cash flows relating to hedging instruments

To allow users of financial statements to evaluate the terms and conditions of **hedging instruments** and how they affect the amount, timing and uncertainty of future cash flows of the entity (IFRS 7.23A), entities are required to provide the following quantitative information, broken down by risk category (IFRS 7.23B):

- a profile of the **timing of the nominal amount** of the hedging instrument; and
- if applicable, the **average price or rate** (for example strike or forward prices, etc.) of the hedging instrument.

Note that, should the entity frequently reset its hedging relationships (case of dynamic hedging strategies, see **section 16.6.3.6.1**), this quantitative information is not required (IFRS 7.23C).



In our view, as no further guidance on the profile of the timing of the hedging instrument's nominal amount is provided in IFRS 7, entities should determine relevant maturity buckets according to their judgement and the economic characteristics of their hedging instruments.

³ See **section 14.3.2.1**

16.6.3.5.3. The effects of hedge accounting on financial position and performance

IFRS 7 requires detailed quantitative information, broken down by risk category (and, when relevant, by type of hedging relationship), separately for:

- hedging instruments, and
- hedged items.

These requirements are presented hereafter.

For each risk category and for each type of hedge (i.e. FVH, CFH and NIH), an entity is required to disclose the following amounts related to **hedging instruments** (IFRS 7.24A):

- the **carrying amount** of the hedging instruments, presenting financial assets separately from financial liabilities;
- the **line item** in the statement of financial position that includes the hedging instrument;
- the **change in fair value** of the hedging instrument used as the basis for recognising hedge ineffectiveness for the period; and
- the **nominal amounts** (including quantities such as tonnes or cubic metres) of the hedging instruments.

The following table extracted from the implementation guidance of IFRS 7 illustrates how these requirements may be complied with IFRS 7.IG.13C:

Figure 16.4

	Nominal amount of the hedging instrument	Carrying amount of the hedging instrument		Line item in the statement of financial position where the hedging instrument is located	Changes in fair value used for calculating hedge ineffectiveness for 20X1
		Assets	Liabilities		
Cash flow hedges					
Commodity price risk					
Forward sales contracts	xx	xx	xx	Line item XX	xx
Fair value hedges					
Interest rate risk					
Interest rate swaps	xx	xx	xx	Line item XX	xx
Foreign exchange risk					
Foreign currency loan	xx	xx	xx	Line item XX	xx

Furthermore, an entity should disclose the following amounts related to **hedged items**, for each risk category and by type of hedging relationship (IFRS 7.24B):

- for **fair value hedges**:
 - > the **carrying amount** of the hedged item recognised in the statement of financial position (presenting assets separately from liabilities);

- > the **accumulated amount of fair value hedge adjustments** on the hedged item included in the carrying amount of the hedged item recognised in the statement of financial position (presenting assets separately from liabilities);
 - > the **line item** in the statement of financial position that includes the hedged item;
 - > the **change in value** of the hedged item used as the basis for recognising hedge ineffectiveness for the period; and
 - > the accumulated amount of fair value hedge adjustments remaining in the statement of financial position for any hedged items that have **ceased to be adjusted** for hedging gains and losses (see **section 14.10.2.2**);
- for **cash flow hedges** and **hedges of a net investment in a foreign operation**:
- > the **change in value** of the hedged item used as the basis for recognising hedge ineffectiveness for the period;
 - > the **balances** in the cash flow hedge reserve and the foreign currency translation reserve for **continuing hedges**; and
 - > the **balances** remaining in the cash flow hedge reserve and the foreign currency translation reserve from any hedging relationships for which hedge accounting **is no longer applied**.

The following table extracted from the implementation guidance of IFRS 7 illustrates could these requirements may be complied with IFRS 7.IG.13D:



Figure 16.5

	Carrying amount of the hedged item		Accumulated amount of fair value hedge adjustments on the hedged item included in the carrying amount of the hedged item		Line item in the statement of financial position in which the hedged item is included	Change in value used for calculating hedge ineffectiveness for 20X1	Cash flow hedge reserve
	Assets	Liabilities	Assets	Liabilities			
Cash flow hedges							
Commodity price risk							
Forecast sales	n/a	n/a	n/a	n/a	n/a	xx	xx
Discontinued hedges (forecast sales)	n/a	n/a	n/a	n/a	n/a	n/a	xx
Fair value hedges							
Interest rate risk							
Loan payable	–	xx	–	xx	Line item XX	xx	n/a
Discontinued hedges (Loan payable)	–	xx	–	xx	Line item XX	n/a	n/a
Foreign exchange risk							
Firm commitment	xx	xx	xx	xx	Line item XX	xx	n/a

In addition to the disclosure requirements on hedging instruments and hedged items presented above, IFRS 7 requires specific information on amounts recognised in relation to **each type of hedge**, mainly on hedge ineffectiveness and reclassifications from reserves to profit or loss in respect of cash flow hedges and net investment hedges.

The following amounts should be presented by risk category and for each type of hedge (even if cash flow hedges and net investment hedges are grouped in the requirements below) (IFRS 7.24C):

— for **fair value hedges**:

- > hedge ineffectiveness - i.e. the difference between the hedging gains or losses of the hedging instrument and the hedged item - recognised in profit or loss (or OCI for hedges of a financial asset measured at FV-OCI-NR); and
- > the line item in the statement of comprehensive income that includes the recognised hedge ineffectiveness;

- for **cash flow hedges** and **hedging of a net investment in a foreign operation**:
 - > hedging **gains or losses** of the reporting period that were recognised in **OCI**;
 - > hedge **ineffectiveness** recognised in **profit or loss**;
 - > the **line item** in the statement of comprehensive income that includes the recognised hedge ineffectiveness;
 - > the **amount reclassified** from the cash flow hedge reserve or the foreign currency translation reserve **into profit or loss** as a reclassification adjustment (differentiating between amounts for which hedge accounting had previously been used, but for which the hedged future cash flows are no longer expected to occur, and amounts that have been transferred because the hedged item has affected profit or loss);
 - > the **line item** in the statement of comprehensive income that includes the reclassification adjustment; and
 - > for **hedging of net positions** only (see **section 14.3.4.2**), the hedging gains or losses recognised in a separate line item in the statement of comprehensive income. This line should be disclosed only if the entity applies IFRS 9 to hedge accounting and has such hedges (please refer to **section 16.6.3.7** for further details on disclosure requirements regarding hedge accounting that apply only under IFRS 9, not under IAS 39).

IFRS 7 also makes the link between the primary financial statements according to IAS 1 and the effects of hedge accounting in the notes, as it requires to provide a **reconciliation** (in the primary financial statements or in the notes) **of each component of equity** and an analysis of OCI in accordance with IAS 1 that, taken together (IFRS 7.24E):

- differentiates, at a minimum, between:
 - > the amounts that relate to the **hedging gains or losses** of the reporting period recognised in **OCI**, and **amounts reclassified** from the cash flow hedge reserve or the foreign currency translation reserve into profit or loss as a reclassification adjustment (in the meaning of IAS 1) (IFRS 7.24C(b)(i) and IFRS 7.24C(b)(iv)); and
 - > the **amounts removed from the cash flow hedge reserve** and either included in the initial cost or other carrying amount of the asset / liability (in the case of a hedged forecast transaction subsequently resulting in the recognition of a non-financial asset or non-financial liability, see **chapter 14**), or reclassified immediately from the cash flow hedge reserve to profit or loss due to an expected loss on the hedged transaction;
- differentiates between:
 - > the amounts associated with the **time value of options** that hedge transaction related hedged items; and
 - > the amounts associated with the time value of options that hedge time-period related hedged items.

This line should be disclosed only by entities that apply IFRS 9 to hedge accounting and have chosen to separate the intrinsic value and time value of an option contract and designate as the hedging instrument only the change in intrinsic value of the option⁴;

⁴ See **sections 14.4.4.6** and **14.8.1**

- differentiates between:
 - > the amounts associated with **forward elements of forward contracts** and the foreign currency basis spreads of financial instruments that hedge transaction related hedged items; and
 - > the amounts associated with forward elements of forward contracts and the foreign currency basis spreads of financial instruments that hedge time-period related hedged items.

This line should be disclosed only by entities that apply IFRS 9 to hedge accounting and have chosen to separate the forward element and the spot element of a forward contract and designate as the hedging instrument only the change in the value of the spot element of the forward contract⁵, or when an entity separates the foreign currency basis spread from a financial instrument and excludes it from the designation of that financial instrument as the hedging instrument⁶.

As the information above is required by risk category (IFRS 7.24F), it may be easier to provide this disaggregation by risk in the notes to the financial statements related to hedge accounting rather than overburden the OCI and / or the statement of changes in equity in the primary financial statements with too much details or disaggregation.

The following table extracted from the implementation guidance of IFRS 7 illustrates how these requirements may be complied with IFRS 7.IG.13E:

Figure 16.6

Cash flow hedges ^(a)	Separate line item recognised in profit or loss as a result of a hedge of a net position ^(b)	Change in the value of the hedging instrument recognised in other comprehensive income	Hedge ineffectiveness recognised in profit or loss	Line item in profit or loss (that includes hedge ineffectiveness)	Amount reclassified from the cash flow hedge reserve to profit or loss	Line item affected in profit or loss because of the reclassification
Commodity price risk						
Commodity X	n/a	xx	xx	Line item XX	xx	Line item XX
- Discontinued hedge	n/a	n/a	n/a		xx	Line item XX

(a) The information disclosed in the statement of changes in equity (cash flow hedge reserve) should have the same level of detail as these disclosures.

(b) This disclosure only applies to cash flow hedges of foreign currency risk.

Fair value hedges	Ineffectiveness recognised in profit or loss	Line item(s) in profit or loss (that include(s) hedge ineffectiveness)
Interest rate risk	xx	Line item XX
Foreign exchange risk	xx	Line item XX

⁵ See sections 14.4.4.4 and 14.8.2

⁶ See sections 14.4.4.5 and 14.8.3

16.6.3.6. Specific disclosures about particular hedging designations

16.6.3.6.1. Specific disclosure requirements for dynamic hedging strategies

In situations in which an entity frequently resets (i.e. discontinues and restarts) hedging relationships because both the hedging instrument and the hedged item frequently change (i.e. the entity uses a dynamic process in which both the exposure and the hedging instruments do not remain the same for long), the entity is required to disclose (IFRS 7.23C):

- information about what the ultimate risk management strategy is in relation to those hedging relationships;
- a description of how it reflects its risk management strategy by using hedge accounting and designating those particular hedging relationships; and
- an indication of how frequently the hedging relationships are discontinued and restarted as part of the entity's process in relation to those hedging relationships.

In practice such dynamic hedging relationships, where the entity assesses its overall exposure to a particular risk, particularly concern open portfolios.

Because the designated hedging relationships change frequently, the specific relationships at the reporting date might not be representative of the normal volumes during the period. For that reason, when the volume of hedging relationships is unrepresentative of normal volumes during the period (i.e. the volume at the reporting date does not reflect the volumes during the period), IFRS 7 requires the entity to disclose that fact and the reason it believes the volumes are unrepresentative (IFRS 7.24D).

16.6.3.6.2. Specific disclosure requirements for cash flow hedges in relation to the hedged forecast transaction

For cash flow hedges, the entity should describe any forecast transaction for which hedge accounting has been used in the previous period, but which is no longer expected to occur (IFRS 7.23F).

16.6.3.7. Other specific disclosures that may apply under IFRS 9 only

In addition to the requirements above, specific disclosures are required for entities that have chosen to apply one of the following options under IFRS 9 hedge accounting:

- when an entity **designates a specific risk component** as a hedged item⁷ it must provide, in addition to the disclosures about the risk management strategy (see **section 16.6.3.1**), qualitative or quantitative information about (IFRS 7.22C):
 - > how the entity determined the risk component that is designated as the hedged item (including a description of the nature of the relationship between the risk component and the item as a whole); and
 - > how the risk component relates to the item in its entirety (for example, the designated risk component historically covered on average 80% of the changes in fair value of the item as a whole).

⁷ See **section 14.3.2.1**



- If an entity **designated** a financial instrument, or a proportion of it, as measured at fair value through profit or loss because it uses a **credit derivative to manage the credit risk** of that financial instrument⁸ it must disclose (IFRS 7.24G):
 - > for credit derivatives that have been used to manage the credit risk of these financial instruments, a reconciliation of each of the nominal amount and the fair value at the beginning and at the end of the period;
 - > the gain or loss recognised in profit or loss on designation of a financial instrument, or a proportion of it, as measured at fair value through profit or loss; and
 - > on discontinuation of measuring a financial instrument, or a proportion of it, at fair value through profit or loss, that financial instrument's fair value that has become the new carrying amount and the related nominal or principal amount (except for providing comparative information in accordance with IAS 1, an entity does not need to continue this disclosure in subsequent periods).

16.6.4. Fair value

Fair value disclosure requirements are set out in IFRS 7 and IFRS 13. IFRS 13 is primarily a standard on measurement (i.e. it defines fair value and provides guidance for measuring it) and it contains specific disclosure requirements on fair value, for instruments for which other IFRS standards require to include a fair value either in the statement of financial position or in the notes. It also defines the fair value hierarchy in three levels 1, 2 and 3 based on the observability of inputs used to measure fair value.

While IFRS 7 is focused on financial instruments and only contains specific disclosures about fair value, the scope of IFRS 13 is broader. The scope of fair value disclosures under IFRS 13 includes non-financial assets and liabilities (such as investment properties measured at fair value in accordance with IAS 40) in addition to financial instruments.

IFRS 7 mainly requires disclosures of fair value (including financial instruments that are not carried at fair value in the statement of financial position) and specific disclosures in the case of a deferred recognition of a day one gain in profit or loss. It also contains several exemptions regarding the presentation of fair values of financial instruments.

IFRS 13 requires, among other things, much more detailed disclosures about measurement techniques, inputs, level in the 3-level hierarchy of IFRS 13 attached to each fair value measurement (by class of financial instruments), detailed information on Level 3 measurements, etc.

16.6.4.1. Disclosures of fair value required by IFRS 7

16.6.4.1.1. Fair value by class of financial instruments

IFRS 7 requires for an entity to present the fair value of the assets and liabilities **for each class** of financial assets and financial liabilities (as defined by the entity in accordance with the principles set out in **section 16.4**). This information must be provided in a way that permits a comparison between the fair values and the related carrying amounts of the financial assets and liabilities (IFRS 7.25). In disclosing fair values, an entity must group financial assets and financial liabilities into classes, but has to offset

⁸ See **section 14.1.2.3**

them only to the extent that their carrying amounts are offset in the statement of financial position (see **section 16.6.1.5**) (IFRS 7.26).

16.6.4.1.2. Exemption from disclosures of fair values of financial assets and liabilities

IFRS 7 does not require disclosures of fair value in the following situations:

- when the carrying amount is a **reasonable approximation of fair value**, for example, for financial instruments such as short-term trade receivables and payables (IFRS 7.29(a)); and
- for contracts containing a discretionary participation feature (as described in IFRS 4 if the fair value of that feature cannot be measured reliably (IFRS 7.29(c)).

However, in the latter case (i.e. **contracts containing discretionary participation features**), additional information must be disclosed by the entity to help users of the financial statements make their own judgements about the extent of possible differences between the carrying amount of those contracts and their fair value, including (IFRS 7.30):

- the fact that fair value information has not been disclosed for these instruments because their fair value cannot be measured reliably;
- a description of the financial instruments, their carrying amount, and an explanation of why fair value cannot be measured reliably;
- information about the market for the instruments;
- information about whether and how the entity intends to dispose of the financial instruments; and
- if financial instruments for which fair value previously could not be reliably measured are derecognised, that fact, their carrying amount at the time of derecognition, and the amount of gain or loss recognised.

16.6.4.1.3. Specific disclosure requirements on deferred day one gain or loss

In the event of a deferred recognition of a day one gain or loss in profit or loss in accordance with IFRS 9. B5.1.2A, resulting from the difference between the transaction price and the initial fair value of a financial asset or a financial liability upon its initial recognition (see **chapter 6**), an entity must disclose **by class** of financial asset or financial liability (IFRS 7.28):

- its accounting policy for recognising the day one gain or loss resulting from the difference between the fair value at initial recognition and the transaction price to reflect a change in factors (including time) that market participants would take into account when pricing the asset or liability;
- the aggregate difference yet to be recognised in profit or loss at the beginning and end of the period, and a reconciliation of changes in the balance of this difference;
- why the entity concluded that the transaction price was not the best evidence of fair value, including a description of the evidence that supports the fair value.

Implementation guidance of IFRS 7 provides additional information with an illustrative example on this topic (IFRS 7.IG.14):

Example 16.2

Background

On 1 January 20X1 an entity purchases for CU15 million financial assets that are not traded in an active market. The entity has only one class of such financial assets.

The transaction price of CU15 million is the fair value at initial recognition.

After initial recognition, the entity will apply a valuation technique to measure the financial assets' fair value. This valuation technique uses inputs other than data from observable markets.

At initial recognition, the same valuation technique would have resulted in an amount of CU14 million, which differs from fair value by CU1 million.

The entity has existing differences of CU5 million at 1 January 20X1.

Application of requirements

The entity's 20X2 disclosure would include the following:

Accounting policies

The entity uses the following valuation technique to measure the fair value of financial instruments that are not traded in an active market:

[description of technique, not included in this example]. Differences may arise between the fair value at initial recognition (which, in accordance with IFRS 13 and IFRS 9, is generally the transaction price) and the amount determined at initial recognition using the valuation technique. Any such differences are [description of the entity's accounting policy].

In the notes to the financial statements

As discussed in note X, the entity uses [name of valuation technique] to measure the fair value of the following financial instruments that are not traded in an active market. However, in accordance with IFRS 13 and IFRS 9, the fair value of an instrument at inception is normally the transaction price. If the transaction price differs from the amount determined at inception using the valuation technique, that difference is [description of the entity's accounting policy].

The differences yet to be recognised in profit or loss are as follows:

	31 Dec X2	31 Dec X1
	CU million	CU million
Balance at beginning of year	5.3	5.0
New transactions	–	1.0
Amounts recognised in profit or loss during the year	(0.7)	(0.8)
Other increases	–	0.2
Other decreases	(0.1)	(0.1)
Balance at end of year	4.5	5.3

16.6.4.2. Disclosure requirements in IFRS 13

As explained above, the disclosure requirements in IFRS 13 cover a wider range of instruments than those in IFRS 7.

In this section, we focus mainly on specific disclosure requirements that apply to financial instruments.

16.6.4.2.1. Objective of IFRS 13 disclosures about fair value

The objective of IFRS 13 disclosures is to help users of the financial statements to assess (IFRS 13.91):

- for assets and liabilities that are measured at fair value on a recurring or non-recurring basis (see the following section) in the statement of financial position after initial recognition, the valuation techniques and inputs used to develop those measurements;
- for recurring level 3 fair value measurements, the effect of the measurements on profit or loss or OCI for the period.

16.6.4.2.2. Recurring vs non-recurring fair value measurements

IFRS 13 makes a distinction in its disclosure requirements between:

- assets and liabilities that are measured at fair value on a **recurring basis**;
 - > recurring fair value measurements of assets or liabilities are those that other IFRSs require or permit in the statements of financial position at the end of **each** reporting period (IFRS 13.93);
- assets and liabilities that are measured at fair value on a **non-recurring basis**;
 - > non-recurring fair value measurements of assets or liabilities are those that other IFRSs require or permit in the statement of financial position **in particular circumstances** (e.g. for a non-financial asset held for sale measured at fair value less costs to sell in accordance with IFRS 5) (IFRS 13.93).



Applying the definitions above, most of the IFRS 9 measurement categories, except for financial instruments measured at amortised cost, will give rise to recurring fair value measurements on the statement of financial position. More extensive disclosures will be required for instruments measured at fair value on a recurring basis.

In our opinion, financial instruments measured at amortised cost are generally not subject to disclosures about recurring or non-recurring fair value measurements. This is because the disclosure requirements in IFRS 13.91 and IFRS 13.93 apply to assets and liabilities measured at fair value **after their initial recognition**. As generally financial instruments subsequently measured at amortised cost are measured at fair value only at their initial recognition, they are excluded from the scope of these disclosures.

Figure 16.7

IFRS 9 measurement category	Disclosures about recurring fair value measurements (IFRS 13 full disclosures scope)	Disclosures about non-recurring fair value measurements (IFRS 13 reduced disclosures scope)	Only some selected disclosures for items not measured at fair value in the statement of financial position
Financial assets and financial liabilities measured at FV-PL (mandatory classification / optional designation)	X		
Financial assets measured at FV-OCI (with and without ulterior recycling to profit or loss)	X		
Financial assets and financial liabilities measured at AC (amortised cost)			X (General case, including financial assets and liabilities hedged under FVH type relationships and subject to fair value hedge adjustments (see section 14.7.2)) The IFRS 13 disclosures about fair value that are applicable to financial assets measured at amortised cost are marked by the "X" sign in the penultimate column in the table provided in section 16.6.4.2.5 below.

Given the scope of our publication, we have chosen to not reproduce the disclosure requirements on fair value in IFRS 13 relating to non-financial assets and liabilities.

16.6.4.2.3. Format of quantitative disclosures under IFRS 13

IFRS 13.99 specifies that quantitative disclosures required by IFRS 13 must be presented in a **tabular** format, unless another format is more appropriate.

16.6.4.2.4. Level of aggregation for disclosures under IFRS 13

IFRS 13.93 requires that the disclosures listed in **section 16.6.4.2.5** be provided for **each class** of assets and liabilities. Determining appropriate classes of assets and liabilities for which disclosures about fair value measurements should be provided requires judgement, as explained in **section 16.4**.

It should be noted that IFRS 13 contains additional guidance to that in IFRS 7 (presented in **section 16.4**) on determining the appropriate classes, specifically when it comes to disclosures about fair value. IFRS 13.94 indicates that appropriate classes of assets and liabilities should be determined on the basis of the following:

- the nature, characteristics and risks of the asset or liability; and
- the level of the fair value hierarchy within which the fair value measurement is categorised.

IFRS 13.94 also states that:

- The number of classes may need to be greater for fair value measurements categorised within **level 3** of the fair value hierarchy because those measurements have a greater degree of uncertainty and subjectivity.
- A class of assets and liabilities will often require **greater disaggregation** than the line items presented in the statement of financial position. However, entity should provide information sufficient to permit reconciliation to the line items presented in the statement of financial position.

16.6.4.2.5. Main disclosure requirements in IFRS 13

IFRS 13 classifies the fair value measurements in 3 levels, depending on how the fair value measurement has been established:

- **Level 1:** inputs that are **quoted prices** (unadjusted) in active markets for **identical** assets or liabilities that the entity can access at the measurement date (IFRS 13.76);
- **Level 2: inputs** other than quoted prices included within Level 1 that are **observable** for the asset or liability, either directly or indirectly (IFRS 13.81). Level 2 inputs include the following (IFRS 13.82):
 - > quoted prices for similar assets or liabilities in active markets;
 - > quoted prices for identical or similar assets or liabilities in markets that are not active;
 - > inputs other than quoted prices that are observable for the asset or liability, for example:
 - interest rates and yield curves observable at commonly quoted intervals;
 - implied volatilities; and
 - credit spreads.
 - > market-corroborated inputs.
- **Level 3: inputs** that are **unobservable** for the asset or the liability.

As a general rule, the higher the fair value hierarchy level, the less reliable the fair value measurement is supposed to be. For instance, Level 3 measurements are considered to be less objective than Level 2 measurements.

IFRS 13 requires specific disclosures about valuation techniques and inputs used to establish measurements in levels 1, 2 and 3, as well as transfers between levels and extensive disclosures about level 3 measurements, namely because there is more judgement and subjectivity involved.

The nature and level of detail of information to be disclosed (see column n° 2 in the table below) depends on the level of fair value measurement (1, 2 or 3 – see the column n° 1 in the table below) and also on its nature (recurring or non-recurring). However, as all fair value measurements, in the case of financial assets measured at fair value, are recurring fair value measurements, we have chosen to not reproduce here the specific requirements in IFRS 13 for non-recurring fair value measurements. It should be noted that some of these disclosure requirements apply even to assets and liabilities that are not presented at fair value in the statement of financial position (i.e. in the case of financial instruments, for assets and liabilities that are measured at amortised cost (see the penultimate column in the table below)).

The table below summarises the major disclosure requirements in IFRS 13 for financial instruments, but it does not include disclosures that apply only to level-3 measurements which are presented in a separate subsequent section.

Figure 16.8

Level of fair value measurement	Required disclosures about financial assets and liabilities measured at fair value (recurring fair value measurements)	Financial assets and liabilities measured at AC	Reference
Levels 1, 2 and 3	<ul style="list-style-type: none"> — Fair value at the end of reporting period. 	X	IFRS 13.93(a)
Levels 1, 2 and 3	<ul style="list-style-type: none"> — Level of fair value hierarchy. 	X	IFRS 13.93(b) IFRS 13.97
Levels 1 and 2	<ul style="list-style-type: none"> — Amounts of any transfers between levels 1 and 2 (separately for transfers into and out of each level). — Reasons for those transfers. — Entity's policy for determining when transfers are deemed to have occurred. 		IFRS 13.93(c)
Levels 1, 2 and 3	<p>Timing of transfers between levels of the fair value hierarchy: an entity must disclose and consistently follow its policy for determining when such transfers are deemed to have occurred. The policy about the timing of recognising transfers must be the same for transfers into the levels as for transfers out of the levels. Examples of policies for determining the timing of transfers include the following:</p> <ul style="list-style-type: none"> — the date of the event or change in circumstances that caused the transfer; — the beginning of the reporting period; — the end of the reporting period. 		IFRS 13.95
Levels 2 and 3	<ul style="list-style-type: none"> — Description of the valuation technique(s) and the inputs used in the fair value measurement. — Any change in valuation technique (e.g. changing from a market approach to an income approach) and the reason(s) for making it. 	X	IFRS 13.93(d) IFRS 13.97

IFRS 13.IE60 provides an illustrative example on how to disclose the information required in IFRS 13.93(a) and IFRS 13.93(b). The example includes both financial and non-financial items:

Figure 16.9

Description	31/12/X9	Fair value measurements at the end of the reporting period using			Total gains (losses)
		Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Recurring fair value measurements					
Trading equity securities: ^(a)					
— Real estate industry	93	70	23		
— Oil and gas industry	45	45			
— Other	15	15			
> Total trading equity securities	153	130	23		
Other equity securities: ^(a)					
— Financial services industry	150	150			
— Healthcare industry	163	110		53	
— Energy industry	32			32	
— Private equity fund investments ^(b)	25			25	
— Other	15	15			
> Total other equity securities	385	275		110	
Debt securities:					
— Residential mortgage-backed securities	149		24	125	
— Commercial mortgage-backed securities	50			50	
— Collateralised debt obligations	35			35	
— Risk-free government securities	85	85			
— Corporate bonds	93	9	84		
> Total debt securities	412	94	108	210	
Hedge fund investments:					
— Equity long/short	55		55		
— Global opportunities	35		35		
— High-yield debt securities	90			90	
> Total hedge fund investments	180		90	90	



(CU in millions)	Description	31/12/X9	Fair value measurements at the end of the reporting period using			Total gains (losses)
			Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)	
Derivatives:						
	— Interest rate contracts	57		57		
	— Foreign exchange contracts	43		43		
	— Credit contracts	38			38	
	— Commodity futures contracts	78	78			
	— Commodity forward contracts	20		20		
	> Total derivatives	236	78	120	38	
Investment properties:						
	— Commercial—Asia	31			31	
	— Commercial—Europe	27			27	
	> Total investment properties	58			58	
	Total recurring fair value measurements	1,424	577	341	506	
Non-recurring fair value measurements						
	— Assets held for sale ^(c)	26		26		15
	Total non-recurring fair value measurements	26		26		15

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

(a) On the basis of its analysis of the nature, characteristics and risks of the securities, the entity has determined that presenting them by industry is appropriate.

(b) On the basis of its analysis of the nature, characteristics and risks of the investments, the entity has determined that presenting them as a single class is appropriate.

(c) In accordance with IFRS 5, assets held for sale with a carrying amount of CU35 million were written down to their fair value of CU26 million, less costs to sell of CU6 million (or CU20 million), resulting in a loss of CU15 million, which was included in profit or loss for the period.

16.6.4.2.6. Specific disclosures for level-3 fair value measurements

The table below summarises the specific disclosures that are only required for level-3 fair value measurements. These disclosure requirements supplement the general disclosures required for instruments that can be classified in level 3 but also in other levels of fair value measurements which are presented in **section 16.6.4.2.5**.

Figure 16.10

Required disclosures about level-3 financial assets and liabilities measured at fair value (recurring fair value measurements)	Reference
<ul style="list-style-type: none"> — Quantitative information about the significant unobservable inputs used in the fair value measurement⁹ 	IFRS 13.93(d) IFRS 13.97
<p>Reconciliation from the opening balances to the closing balances, disclosing separately changes during the period attributable to the following:</p> <ul style="list-style-type: none"> — total gains or losses for the period recognised in profit or loss, including the reference to related line item(s) in profit or loss; — total gains or losses for the period recognised in OCI, including the reference to related line item(s) in OCI; — purchases, sales, issues and settlements (each disclosed separately); — the amounts of any transfers into or out of level 3 of the fair value hierarchy (disclosed separately), the reasons for those transfers and the entity's policy for determining when transfers between levels are deemed to have occurred 	IFRS 13.93(e)
<p>The amount of the total gains or losses in profit or loss attributable to the change in unrealised gains or losses relating to those assets and liabilities held at the end of the reporting period (including the reference to related line item(s) in profit or loss)</p>	IFRS 13.93(f)
<p>Description of the valuation processes used by the entity (including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value measurements from period to period).</p> <p>IFRS 13.IE65 provides further guidance on information that could be disclosed to comply with this qualitative disclosure requirement:</p> <ul style="list-style-type: none"> — for the group within the entity that decides the entity's valuation policies and procedures: <ul style="list-style-type: none"> > its description; > to whom that group reports; and > the internal reporting procedures in place (e.g. whether and, if so, how pricing, risk management or audit committees discuss and assess the fair value measurements); — the frequency and methods for calibration, back testing and other testing procedures of pricing models; — the process for analysing changes in fair value measurements from period to period; — how the entity determined that third-party information, such as broker quotes or pricing services, used in the fair value measurement was developed in accordance with the IFRS; and — the methods used to develop and substantiate the unobservable inputs used in a fair value measurement. 	IFRS 13.93(g)

⁹ if quantitative unobservable inputs are not developed by the entity when measuring fair value (e.g. when an entity uses prices from prior transactions or third-party pricing information without adjustment), **an entity is not required to create quantitative information on significant unobservable inputs**. However, an entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the entity (IFRS 13.93(d)).

-
- **Narrative description** of the **sensitivity of the fair value measurement to changes in unobservable inputs**, if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement.
 - > NB: to comply with this disclosure requirement in IFRS 13.93(h), the narrative description of the sensitivity to changes in unobservable inputs has to include, at a minimum, the unobservable inputs disclosed when complying with IFRS 13.93(d) (see above).
 - If there are interrelationships between those inputs and other unobservable inputs used in the fair value measurement, an entity must also provide a **description of those interrelationships** and of how they might magnify or mitigate **the effect of changes in the unobservable inputs** on the fair value measurement. IFRS 13.93(h)
 - for financial assets and financial liabilities, if changing one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly:
 - > an entity must state that fact and disclose the effect of those changes.
 - > The entity has to disclose how the effect of a change to reflect a reasonably possible alternative assumption was calculated.
 - > For that purpose, significance has to be judged with respect to profit or loss, and total assets or total liabilities, or, when changes in fair value are recognised in OCI, total equity.
-

IFRS 13.IE61 provides an illustrative example to comply with the requirement of IFRS 13.93(e) and IFRS 13.93(f) to disclose a reconciliation from the opening balances to the closing balances for each class of assets and liabilities with level-3 fair value measurements:

Fair value measurements using significant unobservable inputs (Level 3)												
(CU in millions)	Other equity securities			Debt securities			Hedge fund investments		Derivatives		Investment properties	
	Health-care industry	Energy industry	Private equity fund	Residential mortgage-backed securities	Commercial mortgage-backed securities	Collateralised debt obligations	High-yield debt securities	Credit contracts	Asia	Europe	Total	
Opening balance	49	28	20	105	39	25	145	30	28	26	495	
— Transfers into Level 3				60 ^{(a)(b)}							60	
— Transfers out of Level 3				(5) ^{(b)(c)}							(5)	
— Total gains or losses for the period included												
> Included in profit or loss			5	(23)	(5)	(7)	7	5	3	1	(14)	
> Included in other comprehensive income	3	1										



IFRS 13.IE63 provides an illustrative example complying with the requirements of IFRS 13.93(d) on the significant unobservable inputs used in level-3 fair value measurements:

Fair value measurements using significant unobservable inputs (Level 3)										
— Purchases, issues, sales and settlements										
> Purchases	1	3		16	17		18			55
> Issues										
> Sales				(12)			(62)			(74)
> Settlements							(15)			(15)
Closing balance	53	32	25	125	35	50	38	90	31	506
Change in unrealised gains or losses for the period included in profit or loss for assets held at the end of the reporting period										
			5	(3)	(7)	(5)	2	(5)	3	(9)

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

(a) Transferred from Level 2 to Level 3 because of a lack of observable market data, resulting from a decrease in market activity for the securities.

(b) The entity's policy is to recognise transfers into and transfers out of Level 3 as of the date of the event or change in circumstances that caused the transfer.

(c) Transferred from Level 3 to Level 2 because observable market data became available for the securities.



Figure 16.12

Quantitative information about fair value measurements using significant unobservable inputs (Level 3)

(CU in millions)

Description	Fair value at 31/12/X9	Valuation technique(s)	Unobservable input	Range (weighted average)	
Other equity securities:					
Healthcare industry	53	Discounted cash flow	weighted average cost of capital	7%–16% (12.1%)	
			long-term revenue growth rate	2%–5% (4.2%)	
			long-term pre-tax operating margin	3%–20% (10.3%)	
			discount for lack of marketability(a)	5%–20% (17%)	
			control premium(a)	10%–30% (20%)	
			Market comparable companies	EBITDA multiple(b)	10–13 (11.3)
			revenue multiple(b)	1.5–2.0 (1.7)	
			discount for lack of marketability(a)	5%–20% (17%)	
			control premium(a)	10%–30% (20%)	
			Energy industry	32	Discounted cash flow
long-term revenue growth rate	3%–5.5% (4.2%)				
long-term pre-tax operating margin	7.5%–13% (9.2%)				
discount for lack of marketability(a)	5%–20% (10%)				
control premium(a)	10%–20% (12%)				
Market comparable companies	EBITDA multiple(b)	6.5–12 (9.5)			
revenue multiple(b)	1.0–3.0 (2.0)				
discount for lack of marketability(a)	5%–20% (10%)				
control premium(a)	10%–20% (12%)				
Private equity fund investments	25	Net asset value(c)			
Debt securities:					
Residential mortgage-backed securities	125	Discounted cash flow	constant prepayment rate	3.5%–5.5% (4.5%)	
			probability of default	5%–50% (10%)	
			loss severity	40%–100% (60%)	



Quantitative information about fair value measurements using significant unobservable inputs (Level 3)

(CU in millions)

Description	Fair value at 31/12/X9	Valuation technique(s)	Unobservable input	Range (weighted average)
Commercial mortgage-backed securities	50	Discounted cash flow	constant prepayment rate	3%–5% (4.1%)
			probability of default	2%–25% (5%)
			loss severity	10%–50% (20%)
Collateralised debt obligations	35	Consensus pricing	offered quotes	20–45
			comparability adjustments (%)	-10% – +15% (+5%)
Hedge fund investments:				
High-yield debt securities	90	Net asset value(c)	n/a	n/a
Derivatives:				
Credit contracts	38	Option model	annualised volatility of credit(d)	10%–20%
			counterparty credit risk(e)	0.5%–3.5%
			own credit risk(e)	0.3%–2.0%
Investment properties:				
Commercial—Asia	31	Discounted cash flow	long-term net operating income margin	18%–32% (20%)
			cap rate	0.08–0.12 (0.10)
Commercial—Europe	27	Market comparable approach	price per square metre (USD)	\$3,000–\$7,000 (\$4,500)
		Discounted cash flow	long-term net operating income margin	15%–25% (18%)
			cap rate	0.06–0.10 (0.08)
			Market comparable approach	price per square metre (EUR)

(Note: A similar table would be presented for liabilities unless another format is deemed more appropriate by the entity.)

- (a) Represents amounts used when the entity has determined that market participants would take into account these premiums and discounts when pricing the investments.
- (b) Represents amounts used when the entity has determined that market participants would use such multiples when pricing the investments.
- (c) The entity has determined that the reported net asset value represents fair value at the end of the reporting period.
- (d) Represents the range of the volatility curves used in the valuation analysis that the entity has determined market participants would use when the pricing contracts.
- (e) Represents the range of the credit default swap spread curves used in the valuation analysis that the entity has determined market participants would use when pricing the contracts.



IFRS 13.IE66 provides the following illustrative example focused on residential mortgage-backed securities. It is an example of compliance with the requirement in IFRS 13.93(h) of providing a narrative description of the sensitivity of the fair value measurement to changes in significant unobservable inputs, and a description of any interrelationships between those unobservable inputs.

'The significant unobservable inputs used in the fair value measurement of the entity's residential mortgage-backed securities are prepayment rates, probability of default and loss severity in the event of default. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, a change in the assumption used for the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.'

16.6.4.2.7. Specific disclosures for specific cases of financial assets and liabilities with offsetting or credit enhancement features

If an entity holds financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk and makes an accounting policy decision to use the exception provided in IFRS 13.48¹⁰, it must disclose that fact (IFRS 13.96).

This disclosure is required for both recurring and non-recurring fair value measurements, but in practice will only apply to recurring fair value measurements when it comes to financial instruments (for the reasons explained in **section 16.6.4.2.2**).

If an entity has issued liabilities measured at fair value with an inseparable third-party credit enhancement, it is required to disclose (IFRS 13.98):

- the existence of that credit enhancement and
- whether it is reflected in the fair value measurement of the liabilities

This disclosure is required for both recurring and non-recurring fair value measurements, but in practice will only apply to recurring fair value measurements when it comes to financial instruments (for the reasons explained in **section 16.6.4.2.2**).

16.6.4.2.8. Additional information that may need to be disclosed in addition to the minimum disclosure requirements in IFRS 13

To meet the objective presented in **section 16.6.4.2.1**, judgement is required as the entity has to consider, for example, the level of detail necessary to satisfy the disclosure requirements, or whether users of financial statements need additional information compared to the minimum requirements of the standard (IFRS 13.92).

Examples of such additional information are presented in IFRS 13.IE64. An entity might need to disclose some or all of the following:

- the nature of the item being measured at fair value, including the characteristics of the item being measured that are taken into account in the determination of relevant inputs. For example, for residential mortgage-backed securities, an entity might disclose the following:

¹⁰ Fair value is measured on the net risk exposure of the group of financial assets and liabilities

- > the types of underlying loans (e.g. prime loans or sub-prime loans);
 - > the collateral;
 - > the guarantees or other credit enhancements;
 - > the seniority level of the tranches of securities;
 - > the year of issue;
 - > the weighted-average coupon rate of the underlying loans and the securities;
 - > the weighted-average maturity of the underlying loans and the securities;
 - > the geographical concentration of the underlying loans;
 - > information about the credit ratings of the securities.
- how third-party information such as broker quotes, pricing services, net asset values and relevant market data was taken into account when measuring fair value.

16.7. Nature and extent of risks arising from financial instruments

IFRS 7 requires providing general quantitative and qualitative disclosures for each type of risk that arises from financial instruments, both assets and liabilities. These are presented in **section 16.7.1**.

IFRS 7 also contains specific disclosure requirements for the following types of risks: credit risk, liquidity risk and market risk. They are presented in dedicated **sections 16.7.2 to 16.7.4**.

16.7.1. General qualitative and quantitative disclosures applicable to all risks arising from financial instruments

16.7.1.1. Objectives of these disclosures

The qualitative and quantitative disclosures about risks arising from financial instruments aim to achieve the second main goal set by IFRS 7.1, i.e. enable users of financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period (IFRS 7.31). These disclosures include a description of risks and how they are being managed (IFRS 7.32).

Such risks typically include, but are not limited to, credit risk, liquidity risk, and market risk (IFRS 7.32). The main risks that are directly linked to financial instruments are defined as follows in IFRS 7 Appendix A:

- **credit risk:** the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation;
- **liquidity risk:** the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset;
- **market risk:** the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: **currency risk**, **interest rate risk** and **other price risk**. These three risks are also defined by IFRS 7:

- > **currency risk:** the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. Currency risk (or foreign exchange risk) arises on financial instruments that are denominated in a foreign currency, i.e. in a currency other than the functional currency in which they are measured. For the purpose of IFRS 7, currency risk does not arise from financial instruments that are non-monetary items or from financial instruments denominated in the functional currency (IFRS 7.B23);
- > **interest rate risk:** the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. Interest rate risk arises on interest-bearing financial instruments recognised in the statement of financial position (e.g. debt instruments acquired or issued) and on some financial instruments not recognised in the statement of financial position (e.g. some loan commitments) (IFRS 7.B22);
- > **other price risk:** the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer or by factors affecting all similar financial instruments traded in the market. Other price risk arises on financial instruments because of changes in, for example, commodity prices, equity prices (IFRS 7.B25), prepayment risk (i.e. the risk that one party to a financial asset will incur a financial loss because the other party repays earlier or later than expected), and residual value risk (e.g. a lessor of motor cars that writes residual value guarantees is exposed to residual value risk) (IFRS 7.IG.32). Two examples of financial instruments that give rise to equity price risk are (IFRS 7.B26):
 - a holding of equities in another entity and
 - an investment in a trust that in turn holds investments in equity instruments.
 - Other examples include forward contracts and options to buy or sell specified quantities of an equity instrument and swaps that are indexed to equity prices. The fair values of such financial instruments are affected by changes in the market price of the underlying equity instruments.

16.7.1.2. Where in the financial communication should these disclosures be provided?

All the required disclosures have to be either provided in the financial statements or incorporated by cross-reference from the financial statements to some other statement, such as a management commentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete (IFRS 7.B6).

16.7.1.3. Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose (IFRS 7.33):

- the exposure to risk and how they arise **[a]**;
- its objectives, policies and processes for managing the risk and the methods used to measure the risk **[b]**; and
- any changes in **[a]** or **[b]** from the previous period. Such changes may result from changes in exposure to risk or from changes in the way those exposures are managed (IFRS 7.IG.17).



The type of qualitative information that could be disclosed to meet the requirements above includes, but is not limited to, a **narrative description** of (IFRS 7.IG.15):

- **[a]** the entity's exposures to risk and how they arose. Information about risk exposures might describe exposures both gross and net of risk transfer and other risk-mitigating transactions;
- **[b]** the entity's policies and processes for accepting, measuring, monitoring and controlling risk, which might include:
 - > the structure and organisation of the entity's risk management function(s), including a discussion of independence and accountability;
 - > the scope and nature of the entity's risk reporting or measurement systems;
 - > the entity's policies for hedging or mitigating risk, including its policies and procedures for taking collateral; and
 - > the entity's processes for monitoring the continuing effectiveness of such hedges or mitigating devices;
- **[b]** the entity's policies and procedures for avoiding excessive concentrations of risk.

16.7.1.4. Quantitative disclosures

For **each type of risk** arising from financial instruments, an entity must disclose (IFRS 7.34):

- **summary quantitative data** about its exposure to that risk at the end of the reporting period, based on the information provided internally to key management personnel of the entity (as defined in IAS 24 *Related Party Disclosures*), for example the entity's board of directors or chief executive officer;
 - > IAS 24.9 defines key management personnel as those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.
- **specific** disclosures required for **credit** risk, **liquidity** risk and **market** risk, to the extent not provided in within the summary quantitative data mentioned above (see **sections 16.7.2 to 16.7.4**);
- **concentrations of risk** if not apparent from the disclosures made in accordance with the requirements on summary quantitative data and specific disclosures about credit risk, liquidity risk and market risk presented in the two preceding paragraphs (see **section 16.7.1.5**).

When an entity uses several methods to manage a risk exposure, the entity must disclose information using the method or methods that provide the most relevant and reliable information. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* discusses relevance and reliability (IFRS 7.B7).

If the quantitative data disclosed as at the end of the reporting period are unrepresentative of an entity's exposure to risk during the period, an entity has to provide further information that is representative (IFRS 7.35).

To meet this requirement, an entity might disclose the highest, lowest and average amount of risk to which it was exposed during the period. For example, if an entity typically has a large exposure to a particular currency, but at year-end unwinds the position, the entity might disclose a graph that shows the exposure at various times during the period, or disclose the highest, lowest and average exposures (IFRS 7.IG.20).

16.7.1.5. Disclosures about concentrations of risk

Concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions. The identification of concentrations of risk requires judgement taking into account the circumstances of the entity.

Disclosure of concentrations of risk must include (IFRS 7.B8):

- a description of how management determines concentrations;
- a description of the shared characteristic that identifies each concentration (e.g. counterparty, geographical area, currency or market);
 - > for example, the shared characteristic may refer to geographical distribution of counterparties by groups of countries, individual countries or regions within countries (IFRS 7.IG.19);
- the amount of the risk exposure associated with all financial instruments sharing that characteristic.

IFRS 7.IG.18 provides further guidance on the concentrations of **credit** risk specifying that they may arise, for example, from:

- industry sectors,
 - > thus, if an entity's counterparties are concentrated in one or more industry sectors (such as retail or wholesale), it would disclose separately exposure to risks arising from each concentration of counterparties;
- credit rating or other measure of credit quality,
 - > for example, if an entity's counterparties are concentrated in one or more credit qualities (such as secured loans or unsecured loans) or in one or more credit ratings (such as investment grade or speculative grade), it would disclose separately exposure to risks arising from each concentration of counterparties;
- geographical distribution,
 - > for example, if an entity's counterparties are concentrated in one or more geographical markets (such as Asia or Europe), it would disclose separately exposure to risks arising from each concentration of counterparties;
- or from a limited number of individual counterparties or groups of closely related counterparties.

Specific disclosure requirements for credit risk concentrations are detailed in **section 16.7.2.6**.

Similar principles apply to identifying concentrations of other risks, including **liquidity** risk and **market** risk. For example, concentrations of liquidity risk may arise from the repayment terms of financial liabilities, sources of borrowing facilities or reliance on a particular market in which to realise liquid assets.

Concentrations of **foreign exchange** risk may arise if an entity has a significant net open position in a single foreign currency, or aggregate net open positions in several currencies that tend to move together.

16.7.2. Credit risk: specific qualitative and quantitative disclosures

Credit risk is one of the major risks exposing many entities, financial institutions in particular, and therefore many qualitative and quantitative disclosures are required by IFRS 7 on this risk to help users of the financial statements assess its impacts and extent.

16.7.2.1. Scope and objectives

The disclosure requirements detailed below apply to financial instruments in the scope of impairment in IFRS 9 (including those rights that IFRS 15 *Revenue from Contracts with Customers* specifies are accounted for in accordance with IFRS 9 for the purposes of recognising impairment gains or losses) (see **section 9.4.1.3**) (IFRS 7.5A). Exceptions to this scope will be detailed in each relevant section. For more details on the scope of impairment in IFRS 9, please refer to **section 9.4.1**.

Credit risk disclosures should enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, disclosure requirements focus on the three following areas (IFRS 7.35B):

- **credit risk management practices**, including inputs, methods, assumptions and information used to apply IFRS 9 impairment model based on expected credit losses;
- quantitative and qualitative information about **amounts arising from expected credit losses**, including changes in those amounts and the reasons for those changes;
- entity's **credit risk exposure** (i.e. the credit risk inherent in an entity's financial assets and commitments to extend credit) including significant credit risk concentrations.

Credit risk disclosures detailed below are only minimum requirements that should be completed by the entity if such disclosures are not sufficient to comply with these objectives (IFRS 7.35E).

In providing these disclosures, an entity should consider (IFRS 7.35D):

- how much detail to disclose, how much emphasis to place on different aspects of the disclosure requirements;
- the appropriate level of aggregation or disaggregation; and
- whether users of financial statements need additional explanations to evaluate the quantitative information disclosed.

16.7.2.2. Level of aggregation for disclosures about credit risk

A lot of disclosures about credit risk must be provided by class of financial instruments. **Section 16.4** provides guidance on how a class of financial instrument is determined, including specific aspects to consider for credit risk.

16.7.2.3. Where in the financial communication should these disclosures be provided?

As for other risks arising from financial instruments, this information can be incorporated by cross-reference from the financial statements to other statements, such as a management commentary or risk

report that is available to users of the financial statements on the same terms as the financial statements and at the same time (see **section 16.7.1.2**) (IFRS 7.35C).

16.7.2.4. Credit risk management practices

An entity should explain its credit risk management practices and how they relate to the recognition and measurement of expected credit losses. To meet this objective, the entity should provide information that enable users to understand and evaluate (IFRS 7.35F):

- how it determined whether the credit risk of financial instruments has increased significantly since initial recognition (see **section 9.4.3.2**), including, if and how:
 - > financial instruments are considered to have **low credit risk** (see **section 9.4.3.4.1**), and the classes of financial instruments to which it applies;
 - > the **presumption** has been **rebutted** that there have been significant increases in credit risk since initial recognition when financial assets are more than **30 days past due** (see **section 9.4.3.2.4**);
- the entity's **definitions of default** (see **section 9.4.3.3**), including the reasons for selecting those definitions. Such information may include (IFRS 7.B8A):
 - > the qualitative and quantitative factors considered in defining default;
 - > whether different definitions have been applied to different types of financial instruments; and
 - > assumptions about the cure rate (i.e. the number of financial assets that return to a performing status) after a default occurred on the financial asset;
- how the instruments were grouped if expected credit losses were measured on a **collective basis**;
- how an entity determined that financial assets are **credit-impaired** financial assets (i.e. classified in stage 3, see **section 9.4.3.1.3**);
- an entity's **write-off policy**, including the indicators that there is no reasonable expectation of recovery and information about the policy for financial assets that are written-off but are still subject to enforcement activity (see **section 9.4.11**);
- how the entity assessed whether there was a significant increase in credit risk on financial assets that were **modified or renegotiated** but not derecognised (see **section 9.4.8**), including:
 - > how it assesses whether the credit risk of the modified financial assets has improved, for financial assets that were modified while they were in stage 2 or stage 3 and that have been transferred to stage 1 since then;
 - > how it monitors the extent to which such modified assets that have been transferred from stage 2 or stage 3 to stage 1 are subject again to lifetime expected credit loss measurement because of a subsequent significant increase in their credit risk;
 - for example, entities could provide quantitative information (e.g.a deterioration rate) about modified financial assets transferred from stage 2 to stage 1 which have been subsequently transferred back to stages 2 or 3 (IFRS 7.B8B).

An entity should also disclose the **inputs, assumptions and estimation techniques** used to apply the impairment requirements of IFRS 9. For this purpose, the following disclosures about the measurement bases of the loss allowance for expected credit losses should be provided (IFRS 7.35G):



- the basis of inputs and assumptions¹¹ and the estimation techniques used to:
 - > measure the 12-month and lifetime expected credit losses (see **chapter 9**);
 - > determine whether the credit risk of financial instruments has increased significantly since initial recognition (i.e. describe the criteria applied for transfers from stage 1 to stage 2); and
 - > determine whether a financial asset is a credit-impaired financial asset;
- how **forward-looking information** (see **section 9.4.7**) has been incorporated into the estimation of expected credit losses, including the use of macroeconomic information



In our opinion, such information could include:

- information about the use of multiple economic scenarios and their weighting when integrating forward-looking information into the calculation of the expected credit losses; or
- the list of macroeconomic factors, such as GDP, used;
- any other relevant quantitative or qualitative information that may have a significant impact on the estimation of the expected credit losses. The more significant the impact of forward-looking information on the expected credit losses is, the more detailed the disclosures explaining the effect of forward-looking information should be (e.g. providing a description of macroeconomic factors by geographical area may be necessary).

- **changes** in the estimation techniques or significant assumptions made during the reporting period and the reasons for those changes.

16.7.2.5. Quantitative and qualitative disclosures about the amounts resulting from expected credit losses

16.7.2.5.1. Reconciliation of changes in the loss allowance

IFRS 7 requires entities to provide detailed information regarding the changes in loss allowance during the reporting period, but also to consider these changes together with the changes in the gross carrying amounts of related financial instruments.

To explain the changes in the loss allowance and the reasons for those changes, an entity should provide, **by class** of financial instrument (see **section 16.4** for guidance on classes of financial instruments), a **reconciliation from the opening balance to the closing balance of the loss allowance**, in a table, showing separately the changes during the period for (IFRS 7.35H):

- the amount of changes in the loss allowance for 12-month expected credit losses (stage 1);

¹¹ IFRS 7.B8C indicates that the data used by the entity to measure expected credit losses or determine the extent of increases in credit risk since initial recognition may include internal **historical information** or rating reports, and **assumptions about the expected** life of financial instruments and the timing of the sale of collateral

- the amount of changes in the loss allowance for lifetime expected credit losses, distinguishing between:
 - > financial instruments for which credit risk has increased significantly since their initial recognition but that are not credit-impaired (i.e. stage 2 instruments);
 - > financial assets that are credit-impaired at the reporting date, but that are not purchased or originated credit-impaired (i.e. stage 3 instruments);
 - > and trade receivables, contract assets and lease receivables subject to the simplified impairment approach (see **section 9.4.4**);
- the amount of changes in the loss allowance for financial assets that are POCI, i.e. purchased or originated credit-impaired assets (see **section 9.4.5**);
 - > in addition, the total amount of undiscounted expected credit losses at initial recognition on new POCI financial assets initially recognised during the reporting period.

In addition to this reconciliation table, an entity should disclose a **narrative explanation** of the changes in the loss allowance, which may include an analysis of these changes during the period and focus particularly on the following information (IFRS 7.B8D):

- the portfolio composition;
- the volume of financial instruments purchased or originated;
- the severity of the expected credit losses.

If an entity has recognised **loan commitments or financial guarantee contracts**, it should disclose the loss allowance (recognised as a provision on the statement of financial position) in the reconciliation table separately from the loss allowance for financial assets (IFRS 7.B8E) (see **section 9.4.9.1.3** for further details).

16.7.2.5.2. Explanation of how significant changes in the gross carrying amount contributed to changes in the loss allowance

In addition to the loss reconciliation table, to enable users of financial statements to understand the changes in the loss allowance, an entity should provide an **explanation** on how significant **changes in the gross carrying amount** of financial instruments during the period contributed to changes in the loss allowance. Similarly to what is required for the reconciliation of the change in the loss allowance amount, this information should be presented separately for stage 1 instruments, stage 2 instruments, stage 3 instruments, assets subject to the simplified approach and POCI. The information on changes in the gross carrying amount should include relevant qualitative and quantitative information, which may include for example (IFRS 7.35l):

- changes because of financial instruments originated or acquired during the reporting period;
- the impacts of modification of contractual cash flows on financial assets that have been modified during the reporting period but were not derecognised at the modification date;
- changes because of financial instruments that were derecognised (including those that were written-off) during the reporting period;
- changes arising from whether the loss allowance is measured at an amount equal to 12-month (i.e. stage 1 instruments) or lifetime expected credit losses (i.e. stage 2 and stage 3 instruments).

16.7.2.5.3. Illustrating disclosures described in the previous two sections

The following example, extracted from the implementation guidance of IFRS 7, illustrates how the requirements in IFRS 7.35H-I could be complied with (this example illustrates how (a) quantitative reconciliation of changes in the loss allowance, (b) narrative explanation of how the gross carrying amount contributed to changes in the loss allowance and (c) quantitative reconciliation of changes in the gross carrying amount could be presented for mortgage loans that are not POCL and that are considered as a separate class of financial assets) (IFRS 7.IG.20B):

Example 16.3

Significant changes in the gross carrying amount of mortgage loans that contributed to changes in the loss allowance were:

- > The acquisition of the ABC prime mortgage portfolio increased the residential mortgage book by x%, with a corresponding increase in the loss allowance measured on a 12-month basis.
- > The write off of the CUXX DEF portfolio following the collapse of the local market reduced the loss allowance for financial assets with objective evidence of impairment by CUX.
- > The expected increase in unemployment in Region X caused a net increase in financial assets whose loss allowance is equal to lifetime expected credit losses and caused a net increase of CUX in the lifetime expected credit losses allowance.

The significant changes in the gross carrying amount of mortgage loans are further explained below:

Mortgage loans–loss allowance	12-month expected credit losses	Lifetime expected credit losses (collectively assessed)	Lifetime expected credit losses (individually assessed)	Credit-impaired financial assets (lifetime expected credit losses)
CU'000				
Loss allowance as at 1 January	X	X	X	X
Changes due to financial instruments recognised as at 1 January:				
— Transfer to lifetime expected credit losses	(X)	X	X	–
— Transfer to credit-impaired financial assets	(X)	–	(X)	X
— Transfer to 12-month expected credit losses	X	(X)	(X)	–
— Financial assets that have been derecognised during the period	(X)	(X)	(X)	(X)
New financial assets originated or purchased	X	–	–	–
Write-offs	–	–	(X)	(X)
Changes in models/risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31 December	X	X	X	X

Mortgage loans—gross carrying amount	12-month expected credit losses	Lifetime expected credit losses (collectively assessed)	Lifetime expected credit losses (individually assessed)	Creditimpaired financial assets (lifetime expected credit losses)
CU'000				
Gross carrying amount as at 1 January	X	X	X	X
Individual financial assets transferred to lifetime expected credit losses	(X)	–	X	–
Individual financial assets transferred to credit-impaired financial assets	(X)	–	(X)	X
Individual financial assets transferred from credit-impaired financial assets	X	–	X	(X)
Financial assets assessed on collective basis	(X)	X	–	–
New financial assets originated or purchased	X	–	–	–
Write-offs	–	–	(X)	(X)
Financial assets that have been derecognised	(X)	(X)	(X)	(X)
Changes due to modifications that did not result in derecognition	(X)	–	(X)	(X)
Other changes	X	X	X	X
Gross carrying amount as at 31 December	X	X	X	X

16.7.2.5.4. Disclosures about the nature and effects of modifications of contractual cash flows that do not result in the derecognition of the modified assets

Given the potential effect of a modification of contractual cash flows on the amount of expected credit losses, specific disclosures are required for financial assets that have been **modified but have not been derecognised**. These disclosures aim at enabling users of the financial statements to understand the nature and effect of such modifications on financial assets and on the measurement of expected credit losses (IFRS 7.35J):

- the **amortised cost** before the modification and the net **modification gain or loss** recognised for financial assets modified during the reporting period and allocated to stage 2 or stage 3 (and are thus subject to lifetime expected credit losses);
 - > when an entity has trade receivables, contract assets or lease receivables to which the simplified approach in IFRS 9 is applied (see **section 9.4.2.2**), this requirement only applies to those financial assets that are modified while more than 30 days past due (IFRS 7.35A);
- the **gross carrying amount** at the end of the reporting period of all such modified financial assets (including assets modified in previous reporting periods) that have been transferred back to stage 1 during the reporting period (and are thus subject to 12-month expected credit losses).





In our opinion, these disclosure requirements do not apply to POCI financial assets as the loss allowance for such financial assets is equal to the amount of lifetime expected credit losses since initial recognition, and never reverts to a loss allowance based on 12-month expected credit losses.

16.7.2.5.5. Disclosures about the effect of collateral held and other credit enhancements on the expected credit losses

To enable users of financial statements to understand the effect of collateral and other credit enhancements on the amounts arising from expected credit losses, an entity should disclose by class of financial instrument (IFRS 7.35K):

- the amount that best represents the entity's **maximum exposure** to credit risk at the end of the reporting period **without taking account of any collateral held** or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with IAS 32);
 - > for a financial asset, this amount is typically the gross carrying amount, net of (IFRS 7.B9):
 - any amounts offset in accordance with IAS 32; and
 - any loss allowance recognised in accordance with IFRS 9;
- a **narrative description of collateral held** as security and other credit enhancements, including¹²:
 - > a description of the nature and quality of the collateral held;
 - > an explanation of any significant changes in the quality of that collateral or credit enhancements as a result of deterioration or changes in the collateral policies of the entity during the reporting period;
 - > information about financial instruments for which an entity has not recognised a loss allowance because of the collateral.
- This narrative description could include information about (IFRS 7.B8G):
 - > the main types of collateral held as security and other credit enhancements (guarantees, credit derivatives and netting agreements that do not qualify for offset in accordance with IAS 32);
 - > the volume of collateral held and other credit enhancements and its significance in terms of the loss allowance;
 - > the policies and processes for valuing and managing collateral and other credit enhancements;
 - > the main types of counterparties to collateral and other credit enhancements and their creditworthiness;
 - > information about risk concentrations within the collateral and other credit enhancements;
- **quantitative information about the collateral held** as security and other credit enhancements for financial assets that are credit-impaired at the reporting date (i.e. allocated to stage 3);
 - > for example, a quantification of the extent to which collateral and other credit enhancements mitigate credit risk could be provided.

¹² Please note that this requirement does not apply to lease receivables, in accordance with IFRS 7.35A.

An entity is neither required to disclose information about the fair value of collateral and other credit enhancements nor is it required to quantify the exact value of the collateral that was included in the calculation of expected credit losses (i.e. the loss given default) (IFRS 7.B8F).

16.7.2.5.6. Disclosures of amounts written-off

If financial assets have been written-off during the reporting period and are still subject to enforcement activity, an entity should disclose the contractual amount outstanding on these assets (IFRS 7.35L).

16.7.2.6. Credit risk exposure

16.7.2.6.1. Credit risk exposure and significant credit risk concentrations for financial instruments that are in the scope of the impairment requirements of IFRS 9

The following specific disclosure requirements on credit risk exposure and credit risk concentrations supplement the general disclosure requirements presented in **section 16.7.1.5** for financial instruments that are in the scope of IFRS 9 impairment requirements.

To enable users of financial statements to assess an entity's credit risk exposure and understand its significant credit risk concentrations, an entity should disclose, **by credit risk rating grades** (IFRS 7.35M):

- the gross carrying amount of financial assets; and
- the exposure to credit risk on loan commitments and financial guarantee contracts.

Credit risk rating grades are defined as rating of credit risk based on the risk of a default occurring on the financial instrument (IFRS 7 Appendix A). The number of credit risk rating grades should be consistent with the number that the entity reports to key management personnel for credit risk management purposes.

This information must be provided separately for:

- financial instruments allocated to stage 1 (and thus subject to 12-month expected credit losses);
- financial instruments for which the loss allowance is measured at an amount equal to lifetime expected credit losses, distinguishing between:
 - > financial instruments allocated to stage 2 (for which there has been a significant increase in credit risk since initial recognition);
 - if past due information is the only borrower-specific information available and an entity uses past due information to assess whether credit risk has increased significantly since initial recognition, an entity must provide an analysis by past due status for those financial assets (IFRS 7.B8I);
 - > financial instruments allocated to stage 3 (financial assets that are credit-impaired at the reporting date but that are not POCI);
 - > trade receivables, contract assets and lease receivables to which the simplified approach in IFRS 9 is applied (see **section 9.4.2.2**);

- disclosures according to IFRS 7.35M relating to these assets may be based on the provision matrices used, if any (see **section 9.4.6.6.2**) (IFRS 7.35N);
- > POCI financial assets.

The Appendix B of IFRS 7 provides further guidance and describes situations where credit risk concentration may occur. For instance, a concentration of credit risk exists when a number of counterparties are located in a geographical region or are engaged in similar activities and have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions.

An entity should provide information that enables users of financial statements to understand whether there are groups or portfolios of financial instruments with particular features that could affect a large portion of that group of financial instruments such as concentration to particular risks. This could include, for example, loan-to-value groupings, geographical, industry or issuer-type concentrations (IFRS 7.B8H).

When an entity has measured expected credit losses on a **collective basis** and is unable to allocate the gross carrying amount of individual financial assets (or the exposure to credit risk on loan commitments and financial guarantee contracts) to the credit risk rating grades for which lifetime expected credit losses are recognised, it should:

- apply the requirement above to those financial instruments that can be directly allocated to a credit risk rating grade; and
- disclose separately the gross carrying amount of financial instruments for which lifetime expected credit losses have been measured on a collective basis (IFRS 7.B8J).

The following example illustrates how the requirements in IFRS 7.35M might be complied with (IFRS 7.IG.20C):

Example 16.4

20XX CU'000	Consumer loan credit risk exposure by internal rating grades			
	Consumer—credit card Gross carrying amount		Consumer—automotive Gross carrying amount	
	Lifetime	12-month	Lifetime	12-month
Internal Grade 1–2	X	X	X	X
Internal Grade 3–4	X	X	X	X
Internal Grade 5–6	X	X	X	X
Internal Grade 7	X	X	X	X
Total	X	X	X	X

Corporate loan credit risk profile by external rating grades

20XX CU'000	Corporate-equipment Gross carrying amount		Corporate-construction Gross carrying amount	
	Lifetime	12-month	Lifetime	12-month
AAA-AA	X	X	X	X
A	X	X	X	X
BBB-BB	X	X	X	X
B	X	X	X	X
CCC-CC	X	X	X	X
C	X	X	X	X
D	X	X	X	X
Total	X	X	X	X

Corporate loan risk profile by probability of default

20XX CU'000	Corporate-unsecured Gross carrying amount		Corporate-secured Gross carrying amount	
	Lifetime	12-month	Lifetime	12-month
0.00 – 0.10	X	X	X	X
0.11 – 0.40	X	X	X	X
0.41 – 1.00	X	X	X	X
1.01 – 3.00	X	X	X	X
3.01 – 6.00	X	X	X	X
6.01 – 11.00	X	X	X	X
11.01 – 17.00	X	X	X	X
17.01 – 25.00	X	X	X	X
25.01 – 50.00	X	X	X	X
50.01+	X	X	X	X
Total	X	X	X	X

The example below, extracted from the implementation guidance of IFRS 7, shows specifically how to disclose information about an entity's credit exposure for trade receivables to which simplified approach to impairment is applied (IFRS 7.IG.20D):

Example 16.5

Entity A manufactures cars and provides financing to both dealers and end customers. Entity A discloses its dealer financing and customer financing as separate classes of financial instruments and applies the simplified approach to its trade receivables so that the loss allowance is always measured at an amount equal to lifetime expected credit losses. The following table illustrates the use of a provision matrix as a risk profile disclosure under the simplified approach:



20XX CU'000	Trade receivables days past due				
	Current	More than 30 days	More than 60 days	More than 90 days	Total
Dealer financing					
Expected credit loss rate	0.10%	2%	5%	13%	
Estimated total gross carrying amount at default	CU20,777	CU1,416	CU673	CU235	CU23,101
Lifetime expected credit losses—dealer financing	CU21	CU28	CU34	CU31	CU114
Customer financing					
Expected credit loss rate	0.20%	3%	8%	15%	
Estimated total gross carrying amount at default	CU19,222	CU2,010	CU301	CU154	CU21,687
Lifetime expected credit losses—customer financing	CU38	CU60	CU24	CU23	CU145

16.7.2.6.2. Credit risk exposure arising from financial instruments that are excluded from the scope of the impairment requirements of IFRS 9

For financial instruments giving rise to credit risk that fall within the scope of IFRS 7 but not within the scope of the impairment requirements of IFRS 9 (i.e. namely derivatives on the asset side, investments in debt instruments and financial guarantee contracts and loan commitments issued **that are measured at FV-PL**), it is also required to disclose the following information about their credit risk exposure, **by class** of financial instrument (see **section 16.4**) (IFRS 7.36):

- the amount that best represents its **maximum exposure** to credit risk at the end of the reporting period without taking account of any collateral held or other credit enhancements (e.g. netting agreements that do not qualify for offset in accordance with IAS 32);
 - > this disclosure is not required for financial instruments for which carrying amount best represents the maximum exposure to credit risk;
- a **description of collateral held** as security and other credit enhancements, and their financial effect (e.g. quantification of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk;
 - > an entity might meet this requirement by disclosing (IFRS 7.IG.22):
 - the policies and processes for valuing and managing collateral and other credit enhancements obtained;
 - a description of the main types of collateral and other credit enhancements (examples of the latter being guarantees, credit derivatives, and netting agreements that do not qualify for offset in accordance with IAS 32);

- the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and
- information about risk concentrations within the collateral or other credit enhancements.

Activities that give rise to credit risk and the associated maximum exposure to credit risk include, but are not limited to (IFRS 7.B10):

- granting loans to customers and placing deposits with other entities;
 - > in these cases, the maximum exposure to credit risk is the carrying amount of the related financial assets;
- entering into derivative contracts, e.g. foreign exchange contracts, interest rate swaps and credit derivatives;
 - > when the resulting asset is measured at fair value, the maximum exposure to credit risk at the end of the reporting period will equal the carrying amount;
- granting financial guarantees;
 - > in this case, the maximum exposure to credit risk is the maximum amount the entity could have to pay if the guarantee is called on, which may be significantly greater than the amount recognised as a liability;
- making a loan commitment that is irrevocable over the life of the facility or is revocable only in response to a material adverse change;
 - > if the issuer cannot settle the loan commitment net in cash or another financial instrument, the maximum credit exposure is the full amount of the commitment. This is because it is uncertain whether the amount of any undrawn portion may be drawn upon in the future. This may be significantly greater than the amount recognised as a liability.

16.7.2.7. Assets recognised as a result of taking possession of collateral or other enhancements held as security

When an entity has recognised financial or non-financial assets during the period as a result of taking possession of collateral it holds as security or calling on other credit enhancements (e.g. guarantees), it should disclose for such assets held at the reporting date (IFRS 7.38):

- the nature and carrying amount of the assets; and
- when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

16.7.3. Liquidity risk: specific qualitative and quantitative disclosures

As explained in **section 16.7.1.1, liquidity risk** is the risk that an entity will encounter difficulties in meeting obligations associated with its financial liabilities that are settled by delivering cash or another financial asset.

In relation to this risk, IFRS 7 requires quantitative disclosures (namely the maturity analysis for the financial liabilities) and a description of how entities manage their liquidity risk.

16.7.3.1. Financial instruments for which disclosures about their liquidity risk should be provided

Given the definition of liquidity risk presented above, only liabilities (as opposed to financial assets) are subject to these disclosure requirements, and not all financial liabilities but only those that are settled by delivering cash or another financial asset, whatever their measurement category under IFRS 9 is.



IFRS 7.39 does not explicitly say whether the financial liabilities in question are necessarily in the scope of IFRS 9 (as a reminder, some instruments while meeting the definition of a financial instrument have been scoped out of IFRS 9). However, in accordance with the scope of IFRS 7, and on the basis of the examples provided in its application guidance, we consider that the scope of such disclosures is broader than the sole liabilities in the scope of IFRS 9: for example, items such as financial guarantees issued and loan commitments issued are also in the scope of disclosures about liquidity risk.

Furthermore, as the definition of liquidity risk only refers to financial liabilities that are settled by delivering cash or another financial asset, the following liabilities (and mainly derivatives) would seem de facto out of the scope of such disclosures (IFRS 7.BC58A):

- when the issuer can only settle a financial liability in its own equity instruments; or
- when the issuer has the possibility to settle a financial liability by delivering its own equity instruments rather than by delivering cash or another financial asset.

In such cases the issuer is not exposed to liquidity risk as it can avoid the delivery of cash or another financial asset.

16.7.3.2. Summary quantitative data

As set out in **section 16.7.1**, an entity must comply with the general disclosure requirements (both qualitative and quantitative) for all risks arising from financial instruments. Those general requirements are emphasised in IFRS 7.B10A which indicates that an entity discloses summary quantitative data about its exposure to liquidity risk on the basis of the information provided internally to key management personnel. An entity must explain how such data is determined.

If the outflows of cash (or another financial asset) included in those data could either:

- occur significantly earlier than indicated in the data, or
- be for significantly different amounts from those indicated in the data (e.g. for a derivative that is included in the data on a net settlement basis but for which the counterparty has the option to require gross settlement),

the entity must disclose that fact and provide quantitative information that enables users of its financial statements to evaluate the extent of this risk unless that information is included in the contractual maturity analysis (see below).

16.7.3.3. Remaining contractual maturity analysis

An entity is required to disclose (IFRS 7.39):

- a maturity analysis for **non-derivative** financial liabilities (including issued financial guarantee contracts) that shows the remaining contractual maturities;
 - > in case of a hybrid (combined) financial instrument, an entity does not separate an embedded derivative and applies this requirement to the whole instrument (IFRS 7.B11A);
- a maturity analysis for **derivative** financial liabilities. The maturity analysis must include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows, which would be the case for example (IFRS 7.B11B):
 - > for an interest rate swap with a remaining maturity of five years in a cash flow hedge of a variable rate financial asset or liability;
 - > or all loan commitments;

The determination of **appropriate time bands** depends on the entity's **judgement** (IFRS 7.B11). For example, the following time bands could be considered relevant by an entity:

- [0-1 month];
-]1-3 months];
-]3 months-1 year];
-]1-5 years], etc.

IFRS 7.B11C provides additional guidance regarding the determination of the remaining contractual maturities:

- when a counterparty has a choice of when an amount is paid, the liability is allocated to the earliest period in which the entity can be required to pay;
 - > for example, financial liabilities that an entity can be required to repay on demand (e.g. demand deposits) are included in the earliest time band;
- when an entity is committed to make amounts available in instalments, each instalment is allocated to the earliest period in which the entity can be required to pay;
 - > for example, an undrawn loan commitment is included in the time band containing the earliest date it can be drawn down;
- for issued financial guarantee contracts the maximum amount of the guarantee is allocated to the earliest period in which the guarantee could be called.

The application guidance of IFRS 7 (IFRS 7.B11D) also provides further guidance on the **amounts to be disclosed** in the contractual maturity analysis:

- The contractual amounts disclosed in the maturity analyses are the **contractual undiscounted cash flows** (and not for example the carrying amount of the related liability recognised on the statement of financial position), for example:
 - > gross finance lease obligations (before deducting finance charges);
 - > prices specified in forward agreements to purchase financial assets for cash;



- > net amounts for pay-floating / receive-fixed interest rate swaps for which net cash flows are exchanged;
 - > contractual amounts to be exchanged in a derivative financial instrument (e.g. a currency swap) for which gross cash flows are exchanged; and
 - > gross loan commitments.
- When the amount payable is not fixed, the amount disclosed is determined by reference to the conditions existing at the end of the reporting period. For example, when the amount payable varies with changes in an index, the amount disclosed may be based on the level of the index at the end of the period (e.g. Euribor 6 months forward curve applicable at the reporting date).

The following example, extracted from the implementation guidance of IFRS 7, illustrates how the maturity analysis could be presented for non-derivative financial liabilities (IFRS 7.IG.31A):

Example 16.6

Undiscounted cash flows: Non-derivative financial liabilities							
	Maturity						
	Total	less than 1 month	1–6 months	6 months–1 year	1–2 years	2–3 years	more than 3 years
Bonds	2,100	7	34	40	79	1,940	
Lease liabilities*	4,970			340	310	290	4,030
Trade and other payables	980	280	700				

*Further information about the maturity of lease liabilities is provided in the table below:

	Maturity						
	Total	less than 1 year	1–5 years	5–10 years	10–15 years	15–20 years	20–25 years
Lease liabilities	4,970	340	1,200	1,110	1,050	970	300

16.7.3.4. Description of how liquidity risk is managed

- Entities are also required to provide a description of how they manage the liquidity risk inherent in their derivative and non-derivative financial liabilities.
- Specifically, they should disclose a maturity analysis of **financial assets they hold** for managing liquidity risk (e.g. financial assets that are readily saleable or expected to generate cash inflows to meet cash outflows on financial liabilities), **if** that information is necessary to enable users of the financial statements to evaluate the nature and extent of liquidity risk (IFRS 7.B11E).
- Other factors that an entity might consider in providing this disclosure include, but are not limited to, whether the entity (IFRS 7.B11F):
- > has committed borrowing facilities (e.g. commercial paper facilities) or other lines of credit (e.g. stand-by credit facilities) that it can access to meet liquidity needs;
 - > holds deposits at central banks to meet liquidity needs;
 - > has very diverse funding sources;

- > has significant concentrations of liquidity risk in either its assets or its funding sources;
- > has internal control processes and contingency plans for managing liquidity risk;
- > has instruments that include accelerated repayment terms (e.g. on the downgrade of the entity's credit rating);
- > has instruments that could require the posting of collateral (e.g. margin calls for derivatives);
- > has instruments that allow the entity to choose whether it settles its financial liabilities by delivering cash (or another financial asset) or by delivering its own shares; or
- > has instruments that are subject to master netting agreements.

16.7.4. Market risk: specific qualitative and quantitative disclosures

As set out in **section 16.7.1**, an entity must comply with the general disclosure requirements (both qualitative and quantitative) for all risks arising from financial instruments. Such requirements also apply to market risks before the application of specific disclosures about this risk that are detailed below.

The specific requirements on market risk mainly consist of a sensitivity analysis. When presenting this sensitivity analysis, an entity may choose one of the following options:

- **option 1:** a sensitivity analysis for each type of market risk to which the entity is exposed; or
- **option 2:** a sensitivity analysis, such as value-at-risk (VaR), that reflects interdependencies between risk variables (e.g. interest rates and exchange rates).

The disclosure requirements differ depending on the methodology applied. They are presented hereafter separately for option 1 and option 2. Besides, an entity must provide sensitivity analyses for the whole of its business, but may provide different types of sensitivity analysis for different classes of financial instruments (IFRS 7.B21).

It should be noted that no sensitivity analysis is required for financial instruments classified as the entity's **own equity instruments**, as such instruments are not remeasured: neither profit or loss nor equity will be affected by equity price risk of those instruments (IFRS 7.B28).

16.7.4.1. Disclosing sensitivity analysis by type of market risk (option 1)

Using this approach, an entity must disclose (IFRS 7.40):

- a sensitivity analysis for each type of market risk to which the entity is exposed at the end of the reporting period, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
- the methods and assumptions used in preparing the sensitivity analysis; and
- changes from the previous period in the methods and assumptions used, and the reasons for such changes.

16.7.4.1.1. Effect on profit or loss or equity of changes in the relevant risk variables

When showing the effect on profit or loss and equity of reasonably possible changes in the relevant risk variable (e.g. prevailing market interest rates, currency rates, equity prices or commodity prices), entities are not required (IFRS 7.B18):

- to determine what the profit or loss for the period would have been if relevant risk variables had been different. Instead, entities disclose the effect on profit or loss and equity at the end of the reporting period assuming that **a reasonably possible change** in the relevant risk variable had occurred at the end of the reporting period and had been applied to the risk exposures in existence at that date.
 - > For example, if an entity has a floating rate liability at the end of the year, the entity would disclose the effect on profit or loss (i.e. interest expense) for the current year if interest rates had varied by reasonably possible amounts;
- to disclose the effect on profit or loss and equity for each change within a range of reasonably possible changes of the relevant risk variable. Disclosure of the effects of the changes at the limits of the reasonably possible range would be sufficient.

In determining what a reasonably possible change in the relevant risk variable is, an entity should consider (IFRS 7.B19):

- the **economic environments in which it operates**. A reasonably possible change should not include remote or 'worst case' scenarios or 'stress tests'. Moreover, if the rate of change in the underlying risk variable is stable, the entity need not alter the chosen reasonably possible change in the risk variable.
 - > For example, if interest rates are 5% and an entity determines that a fluctuation in interest rates of ± 50 basis points is reasonably possible, it would disclose the effect on profit or loss and equity if interest rates were to change to 4.5% or 5.5%.
 - > In the next period, interest rates have increased to 5.5%. The entity continues to believe that interest rates may fluctuate by ± 50 basis points (i.e. that the rate of change in interest rates is stable). The entity would disclose the effect on profit or loss and equity if interest rates were to change to 5% or 6%. The entity would not be required to revise its assessment that interest rates might reasonably fluctuate by ± 50 basis points, unless there is evidence that interest rates have become significantly more volatile.
- and the **time frame over which it is making the assessment**. The sensitivity analysis must show the effects of changes that are considered to be reasonably possible over the period until the entity will next present these disclosures, which is usually its next annual reporting period.

Risk variables that are relevant to disclosing market risk include but are not limited to (IFRS 7.IG.32 & (IFRS 7.IG.33):

- the yield curve of market interest rates. It may be necessary to consider both parallel and non-parallel shifts in the yield curve;
- foreign exchange rates;
- prices of equity instruments;
- market prices of commodities;

- prevailing market interest rates, for interest-sensitive financial instruments such as a variable-rate loan; or
- currency rates and interest rates, for foreign currency financial instruments such as foreign currency bonds.

An extract from IFRS 7.IG.36 provided below illustrates how the sensitivity analysis required by IFRS 7.40 could be disclosed.

Example 16.7

Interest rate risk

At 31 December 20X2, if interest rates at that date had been 10 basis points lower with all other variables held constant, post-tax profit for the year would have been CU1.7 million (20X1—CU2.4 million) higher, arising mainly as a result of lower interest expense on variable borrowings. If interest rates had been 10 basis points higher, with all other variables held constant, post-tax profit would have been CU1.5 million (20X1—CU2.1 million) lower, arising mainly as a result of higher interest expense on variable borrowings.

Profit is more sensitive to interest rate decreases than increases because of borrowings with capped interest rates. The sensitivity is lower in 20X2 than in 20X1 because of a reduction in outstanding borrowings that has occurred as the entity's debt has matured (see note X).

Foreign currency exchange rate risk

At 31 December 20X2, if the CU had weakened 10% against the US dollar with all other variables held constant, post-tax profit for the year would have been CU2.8 million (20X1—CU6.4 million) lower, and other comprehensive income would have been CU1.2 million (20X1—CU1.1 million) higher. Conversely, if the CU had strengthened 10% against the US dollar with all other variables held constant, post-tax profit would have been CU2.8 million (20X1—CU6.4 million) higher, and other comprehensive income would have been CU1.2 million (20X1—CU1.1 million) lower. The lower foreign currency exchange rate sensitivity in profit in 20X2 compared with 20X1 is attributable to a reduction in foreign currency denominated debt. Equity is more sensitive in 20X2 than in 20X1 because of the increased use of hedges of foreign currency purchases, offset by the reduction in foreign currency debt.

16.7.4.1.2. Level of aggregation for disclosing this information

When disclosing the sensitivity analysis, an entity should not aggregate information about exposures to risks from significantly different economic environments, for example (IFRS 7.B17):

- an entity that trades financial instruments might disclose this information separately for financial instruments held for trading and those not held for trading;
- an entity would not aggregate its exposure to market risks from areas of hyperinflation with its exposure to the same market risks from areas of very low inflation.

In contrary, if an entity has exposure to only one type of market risk in only one economic environment, it would not show disaggregated information.

The sensitivity of profit or loss (that arises, for example, from instruments measured at FV-PL) is disclosed separately from the sensitivity of OCI (that arises, for example, from investments in equity instruments for which changes in fair value are presented in OCI) (IFRS 7.B27).

16.7.4.1.3. Specific disclosures about each market risk

The appendix B of IFRS 7 contains additional guidance on sensitivity analysis separately by type of risk:

Market risk	Applicable disclosure	Reference
Interest rate risk	<p>The sensitivity analysis might show separately the effect of a change in market interest rates on:</p> <ul style="list-style-type: none">— interest income and expense;— other line items of profit or loss (such as trading gains and losses); and— when applicable, equity. <p>An entity might disclose a sensitivity analysis for interest rate risk for each currency in which the entity has material exposures to interest rate risk (for example: LIBOR USD, LIBOR GBP, EURIBOR...).</p>	IFRS 7.IG.34
Currency risk	<p>A sensitivity analysis is disclosed for each currency to which an entity has significant exposure.</p>	IFRS 7.B24
Other price risk	<p>An entity might disclose the effect of a decrease in a specified stock market index, commodity price, or other risk variable.</p> <p>For example, if an entity gives residual value guarantees that are financial instruments, the entity could disclose an increase or decrease in the value of the assets to which the guarantee applies.</p>	IFRS 7.B25

16.7.4.2. Disclosing sensitivity analysis prepared using “Value-at-risk” type methods (option 2)

If an entity prepares a sensitivity analysis, such as value-at-risk, that **reflects interdependencies** between risk variables (e.g. interest rates and exchange rates) and uses it to manage financial risks, it may disclose that sensitivity analysis in place of the analysis specified above under option 1. In this case, disclosure of the effect on the profit or loss and equity is not required. The entity using option 2 must also disclose (IFRS 7.41):

- an explanation of the method used in preparing such a sensitivity analysis, and of the main parameters and assumptions underlying the data provided;
- an explanation of the objective of the method used and of limitations that may result in the information not fully reflecting the fair value of the assets and liabilities involved.

This applies even if such a methodology measures only the potential for loss and does not measure the potential for gain (IFRS 7.B20).

Such an entity might comply with these disclosure requirements by disclosing (IFRS 7.B20):

- the type of value-at-risk model used (e.g. whether the model relies on Monte Carlo simulations);
- an explanation about how the model works and the main assumptions (e.g. the holding period and confidence level).

Entities might also disclose (IFRS 7.B20):

- the historical observation period and weightings applied to observations within that period;
- an explanation of how options are dealt with in the calculations; and
- which volatilities and correlations (or, alternatively, Monte Carlo probability distribution simulations) are used.

16.7.4.3. Other market risk disclosures

When the sensitivity analyses disclosed above are unrepresentative of a risk inherent in a financial instrument, the entity is required to disclose that fact and the reason it believes the sensitivity analyses are unrepresentative (IFRS 7.42). This situation may occur because for example:

- the year-end exposure does not reflect the exposure during the year (IFRS 7.42);
- a financial instrument contains terms and conditions for which effects are not apparent from the sensitivity analysis, e.g. options that remain out of (or in) the money for the chosen change in the risk variable (IFRS 7.IG.37);
 - > additional disclosure in this case might include (IFRS 7.IG.38):
 - the terms and conditions of the financial instrument (e.g. the options);
 - the effect on profit or loss if the term or condition were met (i.e. if the options were exercised); and
 - a description of how the risk is hedged.
 - > Example: an entity may acquire a zero-cost interest rate collar that includes an out-of-the-money leveraged written option (e.g. the entity pays ten times the amount of the difference between a specified interest rate floor and the current market interest rate);
 - the entity may regard the collar as an inexpensive economic hedge against a reasonably possible increase in interest rates;
 - However, an unexpectedly large decrease in interest rates might trigger payments under the written option that, because of the leverage, might be significantly larger than the benefit of lower interest rates;
 - neither the fair value of the collar nor a sensitivity analysis based on reasonably possible changes in market variables would indicate this exposure. In this case, additional information described above could be provided by the entity;
- financial assets are illiquid, e.g. when there is a low volume of transactions in similar assets and an entity finds it difficult to find a counterparty (IFRS 7.IG.37);
 - > additional disclosure in this case might include the reasons for the lack of liquidity and how the entity hedges the risk (IFRS 7.IG.39);
- an entity has a large holding of a financial asset that, if sold in its entirety, would be sold at a discount or premium to the quoted market price for a smaller holding (IFRS 7.IG.37);
 - > In this situation, additional disclosure might include:
 - the nature of the security (e.g. entity name);
 - the extent of holding (e.g. 15% of the issued shares);
 - the effect on profit or loss;
 - how the entity hedges the risk.



16.8. Transfers of financial assets

Specific disclosures are required for transfers of financial assets. Such disclosures apply to:

- financial **assets transferred that have not been derecognised**, existing at the reporting date, irrespective of when the related transfer transaction occurred,
- and any **continuing involvement** (this notion is defined in **section 16.8.2.1**) in a transferred asset, existing at the reporting date, irrespective of when the related transfer transaction occurred.

For the purposes of applying the disclosure requirements in those paragraphs, an entity transfers all or a part of a financial asset (the transferred financial asset) if, and only if, it either (IFRS 7.42A):

- transfers the contractual rights to receive the cash flows of that financial asset; or
- retains the contractual rights to receive the cash flows of that financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement.

It should be noted that the notion of “transfer” in IFRS 7 is broader than the one used in IFRS 9.3.2.4 when determining whether the transferred asset should be derecognised, and also includes “pass-through” arrangements. Pass-through arrangements are not transfers of financial assets strictly speaking (as the initial holder remains their owner) but they may qualify for a derecognition of the financial assets subject to that arrangement if specific requirements in IFRS 9 are met.

The **objectives** of these disclosures are to enable users of the financial statements (IFRS 7.42B):

- to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and
- to evaluate the nature of, and risks associated with, the entity’s continuing involvement in derecognised financial assets.

If these objectives cannot be met through the minimal disclosures that are required below, an entity should disclose any **additional** information that it considers necessary to meet the disclosure objectives (IFRS 7.42H).

An entity must present those disclosures in a **single note** in its financial statements (IFRS 7.42A).

16.8.1. Transferred financial assets that are not derecognised in their entirety

In case of financial assets that have been transferred but continue to be recognised in part or in their entirety, an entity must disclose at each reporting date, separately for each class of such transferred assets (IFRS 7.42D):

- the nature of the transferred assets;
- the nature of the risks and rewards of ownership to which the entity is exposed;
- a description of the nature of the relationship between the transferred assets and the associated liabilities, including restrictions arising from the transfer on the reporting entity’s use of the transferred assets;

- a schedule that sets out the fair value of the transferred assets, the fair value of the associated liabilities and the net position, but this information is required only if the counterparties to the associated liabilities have recourse only to the transferred assets;
- when the entity continues to recognise all of the transferred assets, the carrying amounts of the transferred assets and the associated liabilities;
- when the entity continues to recognise the assets to the extent of its continuing involvement, the total carrying amount of the original assets before the transfer, the carrying amount of the assets that the entity continues to recognise, and the carrying amount of the associated liabilities.

Those disclosures are required at each reporting date at which the entity continues to recognise the transferred financial assets, regardless of when the transfers occurred (IFRS 7.B32).

IFRS 7.IG.40B illustrates how an entity applying IFRS 9 might meet the quantitative disclosure requirements in IFRS 7.42D presented above:

Figure 16.13

Illustrating the application of paragraph 42D(d) and (e)

	Financial assets at fair value through profit or loss		Financial assets at amortised cost		Financial assets at fair value through other comprehensive income
	CU million		CU million		CU million
	Trading assets	Derivatives	Mortgages	Consumer loans	Equity investments
Carrying amount of assets	X	X	X	X	X
Carrying amount of associated liabilities	(X)	(X)	(X)	(X)	(X)
For those liabilities that have recourse only to the transferred assets:					
Fair value of assets	X	X	X	X	X
Fair value of associated liabilities	(X)	(X)	(X)	(X)	(X)
Net position	X	X	X	X	X

16.8.2. Transferred financial assets that are derecognised in their entirety

16.8.2.1. Definition of and guidance on “continuing involvement”

For the purposes of applying the disclosure requirements on transfers of financial assets in IFRS 7, an entity has continuing involvement in a transferred financial asset if, as part of the transfer, the entity **retains any of the contractual rights or obligations** inherent in the transferred financial asset **or obtains any new contractual rights or obligations** relating to the transferred financial asset.

The following **do not constitute** continuing involvement (IFRS 7.42C):

- normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action;
- forward, option and other contracts to reacquire the transferred financial asset for which the contract price (or exercise price) is the fair value of the transferred financial asset; or
- an arrangement whereby an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more entities and the three “pass-through” conditions in IFRS 9.3.2.5(a)–(c) are met.

An entity **does not have** a continuing involvement in a transferred financial asset (IFRS 7.B30):

- if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the transferred financial asset nor acquires any new contractual rights or obligations relating to the transferred financial asset; or
- if it has neither an interest in the future performance of the transferred financial asset nor a responsibility under any circumstances to make payments in respect of the transferred financial asset in the future. The term ‘payment’ in this context does not include cash flows of the transferred financial asset that an entity collects and is required to remit to the transferee.

When an entity transfers a financial asset, the entity may retain the right to service that financial asset for a fee that is included in, for example, a servicing contract. The entity assesses the **servicing contract** in accordance with the guidance above to decide whether the entity has continuing involvement as a result of the servicing contract for the purposes of the disclosure requirements. IFRS 7.B30A provides some specific guidance on how servicing contracts should be assessed:

- for example, a servicer will have continuing involvement in the transferred financial asset if the servicing fee is dependent on the amount or timing of the cash flows collected from the transferred financial asset;
- similarly, a servicer has continuing involvement if a fixed fee would not be paid in full because of non-performance of the transferred financial asset;
- in both examples above, the servicer has an interest in the future performance of the transferred financial asset;
- this assessment is independent of whether the fee to be received is expected to compensate the entity adequately for performing the servicing.

IFRS 7.B31 explains **which contracts** may give rise to continuing involvement in a transferred financial asset by indicating that continuing involvement may result from contractual provisions in the **transfer agreement or** in a **separate agreement** with the transferee or a third party entered into in connection with the transfer.

According to IFRS 7.B29, the **assessment** of continuing involvement in a transferred financial asset is made **at the level of the reporting entity**.

- For example, if a subsidiary transfers a financial asset to an unrelated third party in which the parent of the subsidiary has continuing involvement, the subsidiary does not include the parent's involvement in the assessment of whether it has continuing involvement in the transferred asset in its separate or individual financial statements (i.e. when the subsidiary is the reporting entity).
- However, a parent would include its continuing involvement (or that of another member of the group) in a financial asset transferred by its subsidiary in determining whether it has continuing involvement in the transferred asset in its consolidated financial statements (i.e. when the reporting entity is the group).

An entity has to **aggregate** its continuing involvement into types that are representative of the entity's exposure to risks (IFRS 7.B33).

- For example, an entity may aggregate its continuing involvement by type of financial instrument (e.g. guarantees or call options) or by type of transfer (e.g. factoring of receivables, securitisations and securities lending).



Entities should be careful when defining the scope of disclosure requirements regarding continuing involvement, as the definition of this notion in IFRS 7 (see above) differs from that in IFRS 9:

- the term “continuing involvement” in IFRS 9 is used in situations where financial risks and rewards have been neither transferred nor retained, meaning part of the transferred asset (corresponding to the entity's continuing involvement) needs to be maintained on the statement of financial position;
- in IFRS 7 the notion of continuing involvement is different and the disclosures about continuing involvement apply to situations where the derecognition criteria in IFRS 9 are met, meaning the transferred asset has been derecognised in its entirety.

To sum up, the disclosure requirements on transferred assets in IFRS 7 apply as follows:

- if the financial asset is not derecognised in its entirety in accordance with IFRS 9, the entity should comply with the disclosure requirements set out in IFRS 7.42D presented in **section 16.8.1**;
- however, if a financial asset is derecognised in its entirety but the transferor retains some continuing involvement (as defined in IFRS 7), it should comply with the disclosure requirements in IFRS 7.42E presented in the following section.



16.8.2.2. Disclosure requirements on transferred financial assets that are derecognised in their entirety

When an entity derecognises transferred financial assets in their entirety but has continuing involvement in them, the entity must disclose, as a minimum, **for each type of continuing involvement** and at each reporting date (IFRS 7.42E):

- the **carrying amount** of the assets and liabilities that are recognised in the entity's statement of financial position and represent the entity's continuing involvement in the derecognised financial assets, and the line items in which the carrying amount of those assets and liabilities are recognised (IFRS 7.42E(a));
- the **fair value** of the assets and liabilities that represent the entity's continuing involvement in the derecognised financial assets (IFRS 7.42E(b));
- the **amount that best represents the entity's maximum exposure to loss** from its continuing involvement in the derecognised financial assets, and information showing how the maximum exposure to loss is determined (IFRS 7.42E(c));
- the **undiscounted cash outflows** that would or may be required to repurchase derecognised financial assets (e.g. the strike price in an option agreement) or other amounts payable to the transferee in respect of the transferred assets (IFRS 7.42E(d));
 - > if the cash outflow is variable then the amount disclosed should be based on the conditions that exist at each reporting date;

The figure below, extracted from the implementation guidance of IFRS 7, shows how an entity could comply with the disclosure requirements in IFRS 7.42E(a)-(d) presented above (IFRS 7.IG.40B):

Figure 16.14

	Cash outflows to repurchase transferred (derecognised) assets	Carrying amount of continuing involvement in statement of financial position			Fair value of continuing involvement		Maximum exposure to loss
	CU million	CU million			CU million		CU million
Type of continuing involvement		Financial assets at fair value through profit or loss	Financial assets at fair value through other comprehensive income	Financial liabilities at fair value through profit or loss	Assets	Liabilities	
Written put options	(X)			(X)		(X)	X
Purchased call options	(X)	X			X		X
Securities lending	(X)			(X)	X	(X)	X
Total		X		(X)	X	(X)	X

- a **maturity analysis of the undiscounted cash outflows** detailed in the previous paragraph, showing the remaining contractual maturities of the entity's continuing involvement (IFRS 7.42E(e));
 - > this analysis distinguishes between cash flows that are required to be paid (e.g. forward contracts), cash flows that the entity may be required to pay (e.g. written put options) and cash flows that the entity might choose to pay (e.g. purchased call options) (IFRS 7.B34);
 - > an entity has to use its judgement to determine an appropriate number of time bands in preparing the maturity analysis. For example, an entity might determine that the following maturity time bands are appropriate (IFRS 7.B35):
 - [0-1 month];
 -]1-3 months];
 -]3-6 months];
 -]6-12 months];
 -]1-3 years];
 -]3-5 years]; and
 - more than 5 years;
 - > if there is a range of possible maturities, the cash flows are included on the basis of the earliest date on which the entity can be required or is permitted to pay (IFRS 7.B36);
 - > IFRS 7.IG.40B provides an illustrative example, extracted below, of how entities could comply with the requirement for disclosing the maturity analysis of the undiscounted cash flows relating to the continuing involvement in the transferred assets:

Figure 16.15

Undiscounted cash flows to repurchase transferred assets								
Type of continuing involvement	Maturity of continuing involvement CU million							
	Total	less than 1 month	1–3 months	3–6 months	6 months –1 year	1–3 years	3–5 years	more than 5 years
Written put options	X		X	X	X	X		
Purchased call options	X			X	X	X		X
Securities lending	X	X	X					



- **qualitative information** that explains and supports the quantitative disclosure requirements presented above, in accordance with IFRS 7.42E(f) and IFRS 7.B37:
 - > the qualitative information includes a **description of the derecognised financial assets and the nature and purpose of the continuing involvement** retained after transferring those assets;
 - > it also includes a **description of the risks to which an entity is exposed**, including:
 - a description of how the entity manages the risk inherent in its continuing involvement in the derecognised financial assets;
 - whether the entity is required to bear losses before other parties, and the ranking and amounts of losses borne by parties whose interests rank lower than the entity's interest in the asset (i.e. its continuing involvement in the asset);
 - a description of any triggers associated with obligations to provide financial support or to repurchase a transferred financial asset.

An entity may aggregate the information required by IFRS 7.42E in respect of a particular asset if the entity has more than one type of continuing involvement in that derecognised financial asset, and report it under one type of continuing involvement (IFRS 7.42F).

In addition, an entity must disclose¹³ for each type of continuing involvement (IFRS 7.42G):

- the **gain or loss recognised at the date of transfer** of the assets;
 - > the entity is required to disclose if a gain or loss on derecognition arose because the fair values of the components of the previously recognised asset (i.e. the interest in the asset derecognised and the interest retained by the entity) were different from the fair value of the previously recognised asset as a whole;
 - > in that situation, the entity must also disclose whether the fair value measurements included significant inputs that were not based on observable market data (see **section 16.6.4.2.5**) (IFRS 7.B38);
- **income and expenses recognised**, both in the reporting period and cumulatively, **from the entity's continuing involvement** in the derecognised financial assets (e.g. fair value changes in derivative instruments);
- if the total amount of **proceeds from transfer** activity (that qualifies for derecognition) in a reporting period is **not evenly distributed** throughout the reporting period (e.g. if a substantial proportion of the total amount of transfer activity takes place in the closing days of a reporting period):
 - > when the greatest transfer activity took place within that reporting period (e.g. the last five days before the end of the reporting period),
 - > the amount (e.g. related gains or losses) recognised from transfer activity in that part of the reporting period, and
 - > the total amount of proceeds from transfer activity in that part of the reporting period.

¹³ This information should be provided for each period for which a statement of comprehensive income is presented.

16.9. Focus on information required for interim financial reporting (IAS 34)

IAS 34 – *Interim Financial Reporting* prescribes the minimum content of an interim financial report and the principles for recognition and measurement in complete or condensed financial statements for an interim period.

If events or transactions that are significant to an understanding of the changes in financial position and performance of the entity since the end of the last annual reporting period occurred, an entity should explain them and update the relevant information presented in the most recent annual financial report accordingly (IAS 34.15).

We present hereafter some selected disclosure requirements in IAS 34 that specifically mention financial instruments and that seem the most relevant to us. Entities should also carefully read the other more generic requirements in IAS 34 and use judgement when determining whether they apply to their financial instruments.

For instance, IAS 34 contains an indicative list of **events or transactions** for which disclosures would be required if they are **significant** (IAS 34.15B). Here are some examples of events or transactions relating to financial instruments extracted from that list:

- recognition of a loss from the impairment of financial assets and the reversal of such an impairment loss;
- changes in the business or economic circumstances that affect the fair value of the entity's financial assets and financial liabilities, whether those assets or liabilities are recognised at fair value or amortised cost;
- any loan default or breach of a loan agreement that has not been remedied on or before the end of the reporting period;
- transfers between levels of the fair value hierarchy used in measuring the fair value of financial instruments;
- changes in the classification of financial assets as a result of a change in the purpose or use of those assets.

For ease of reference, we included a table below that provides a link between the events and transactions listed in IAS 34.15B and the related parts of IFRS 7 and / or IFRS 13 regarding disclosures in the annual financial statements that could be used as a basis for related disclosures in the interim financial reporting:

Figure 16.16

Event / transaction	IFRS reference	Section
Impairment loss / reversal	IFRS 7.35H to IFRS 7.38	16.7.2
Loan default or breach of a loan agreement	IFRS 7.18 to IFRS 7.19	16.6.1.9
Transfers between levels of the fair value hierarchy	IFRS 13.93(c), IFRS 13.93(e), IFRS 13.95	16.6.4.2
Changes in the classification of financial assets	IFRS 7.12B to IFRS 7.12D	16.6.1.4

IAS 34 also adds other disclosures that are required in interim financial reports even if no significant event or transaction occurred (unless such information is not material). The information must normally be reported on a financial year-to-date basis. The disclosure requirements related to financial instruments concern the fair value disclosures required by IFRS 7 and IFRS 13, as detailed in **section 16.6.4** (IAS 34.16A).

In addition, if an entity changes its accounting policies regarding financial instruments during the interim period, it should provide a description of the nature and effect of the change (IAS 34.16A).



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