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**"THE TRANSITION FROM IAS 39 TO IFRS 9: MAIN IMPACTS ON THE
BANKING INDUSTRY"**

RELATORE:

CH.MO PROF. FRANCESCO ZEN

LAUREANDO/A: FEDERICA BOTTARO

MATRICOLA N. 1082475

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Abstract

I principi contabili “*International Accounting Standards no. 39*” sono l’insieme di principi che sono stati realizzati dall’organismo “International Accounting Standards Board” negli anni 2000. L’organismo ha voluto creare tali principi come linee guida per analizzare gli strumenti finanziari, conosciuti come “*financial instruments*”, che costituiscono i bilanci finanziari delle imprese, delle banche e degli istituti finanziari. I principi contabili IAS 39 si focalizzano in specifiche fasi, come la fase di rilevazione, di riconoscimento, di misurazione degli strumenti finanziari.

Con l’avvento della crisi finanziaria che ha afflitto gran parte del sistema bancario, a partire dal crollo del gruppo di banche del sistema bancario americano, “Lehman Brothers”, l’applicazione e l’implementazione dei principi contabili IAS 39 hanno subito, sin dall’inizio, rallentamenti dovuti alle difficoltà riscontrate dagli analisti e dai revisori contabili. Di conseguenza, l’organismo IASB ha deciso di agire in modo da poter migliorare le debolezze e le difficoltà riscontrate. L’organismo IASB ha così collaborato con altre istituzioni, come Financial Accounting Standards Board e la Commissione Europea, con l’obiettivo di progettare e realizzare un nuovo insieme di principi contabili volto a migliorare i vecchi principi contabile IAS 39, ad eliminare le difficoltà nell’implementazione e nell’applicazione di tali principi contabili e a riempire le lacune riscontrate nell’analisi dei vecchi principi. Sono stati creati così i principi contabili “*International Financial Reporting Standards no. 9*” basati sul miglioramento dei principi contabili IAS 39. Il processo di sostituzione avviato dall’organismo International Accounting Standards Board è strutturato nelle seguenti tre fasi: *Fase 1 - Classification and Measurement, Fase 2 - Impairment methodology e Fase 3 - Hedge Accounting.*

Il seguente documento è volto ad analizzare, nel Capitolo 1, i principi contabili International Accounting Standards no. 39. Nel Capitolo 2, vengono illustrati i nuovi principi contabili, International Financial Reporting Standards no. 9, analizzati nelle tre principali sezioni. Infine, dopo un confronto tra i principi contabili International Accounting Standards no. 39 ed i principi contabili International Financial Reporting Standards no. 9, il Capitolo 3 si focalizza nelle varie regolamentazioni che hanno caratterizzato l’introduzione dei principi contabili e vengono analizzati i principali impatti nel settore bancario nelle fasi di classificazione e di misurazione degli strumenti finanziari e il processo di impairment.

Introduction

The International Accounting Standards Board, IASB, is the independent organization of International Financial Reporting Standards foundation: this organization is responsible for the introduction, the development and the implementation of accounting standards, as International Accounting Standards (known as IAS) or International Financial Reporting Standards (known as IFRS).

From 2000, the standard-setting organization IASB has introduced different IAS and IFRS necessary for the constitution and the formation of financial statements of banks, financial institutions and entities. These accounting standards are created by the IAS Board with the collaboration of IFRS Foundation and other organizations and are seen as a sort of guidelines during the preparation of financial statements on each financial reporting year.

With the happening of the recent financial crisis, for auditors and analysts, the interpretation of the accounting standards, IAS and IFRS, became more difficult; the main difficulty emerged during the understanding and the interpretation process of International Accounting Standards 39 whose accounting standards focus on the analysis of financial assets and financial liabilities. These accounting standards are collected in the financial document known as "*International Accounting Standards 39 – Financial Instruments*" and this document is one of the main sets of accounting standards created by the IAS Board. Due to the difficulties and the misunderstandings, the Board has decided to analyze the matters and the problems that are emerged during the analysis of auditors and analysts. This analysis has conducted the Board to revise these standards IAS 39 with the purpose to replace them.

The work that the Board has undertaken at the end of 2000s is the replacement of International Accounting Standards 39; the replacement phase conducts to the realization, the introduction and the implementation of a new set of accounting standards that will be linear with the requests of auditors and analysts and will improve the weaknesses emerged in the previous analysis. The elaboration of this new set of standards is a simplification of accounting requirements by following the three sections that are already mentioned and analyzed in the accounting standards IAS 39: the IAS Board has decided to improve and to simplify classification and measurement of financial instruments, to replace the previous impairment methodology with a new impairment model necessary for analyzing and discovering in time possible credit losses and to reorganize hedge accounting process.

The replacement project of the accounting standards IAS 39 is elaborated in works and teamwork focused on improvements of the following stages identified inside the financial documentation related to the identification of financial assets and financial liabilities.

1. *Classification and Measurement of Financial Instruments*: the replacement of IAS 39 has implied the reduction of classification categories in order to classify financial assets and financial liabilities in the correct financial groups; through the reduction of classification categories, the IAS Board has decided to explain precisely the measurement methods in order to make them more understandable.
2. *Impairment Methodology*: the IAS Board has decided to replace the incurred credit losses model that will be explained in the accounting standards IAS 39 (Chapter 1) and consequently to introduce a new model: the expected credit losses that will be explained in IFRS 9 (Chapter 2).
3. *Hedge accounting*: in the third section of International Accounting Standards 39, the International Accounting Standard Board explains the hedge accounting process that is seen difficult and less understandable for auditors and analysts; in the replacement of these accounting standards, the International Accounting Standards Board has tried to formulate, as better as possible, an hedge accounting process linear to the risk management process adopted by banks, financial institutions and entities.

From November 2009, the International Accounting Standards Board has introduced the new set of accounting standards with the publication of the first exposure draft related to the classification and the measurement. In the following years, after several works and analysis, the IAS Board has published other exposure drafts related to the other two sections, as the impairment process and the hedge accounting. All these exposure drafts are contained in a unique documentation that is known as “*International Financial Reporting Standards 9 – Replacement of IAS 39*”.

Corresponding to the elaboration of the new set of accounting standards, the European Commission has emanated some directives and regulations necessary to regulate the formation and the realization of financial statements of financial institutions, banks and entities. The main regulation that helps banks and financial institutions in the preparation of financial statements is no. 1606/2002 that has been approved, emanated and published on September 11, 2002 and this regulation focuses on the requirements for European listed companies for the preparation of financial statements by using International Accounting Standards and International Financial Reporting Standards. After this amendment, the European Commission has emanated other requirements and regulations in order to make perfect, as possible, the preparation process.

The present documentation focuses on the analysis of the financial exposure draft, *International Financial Reporting Standards 9 – Replacement of International Accounting Standards 39*. This exposure draft has been emanated from the International Accounting Standards Board with the collaboration of European Commission, IFRS Foundation and other organizations.

The documentation is divided in three main chapters. Before to focus our attention on the analysis and the understanding of the accounting standards IFRS 9 that will enter into force on January 1st, 2018, it is necessary to know the basis and the reasons that have led IAS Board to replace completely the International Accounting Standards 39. In Chapter 1 there is an analysis of the previous accounting standards IAS 39 that has been emanated from the International Accounting Standards Board and has been collected in the documentation “*International Accounting Standards 39 – Financial Instruments*”. These accounting standards have been emanated during 2000. From their implementation, auditors and analysts have found difficulties to apply financial requirements of these standards. Consequently, the IAS Board and the European Commission have emanated several amendments and regulations in order to have a solid basis to create new accounting standards, as known IFRS 9.

The Chapter 2 is an in-depth analysis of the three main sections of International Financial Reporting Standards 9; more precisely, the analysis focuses in the differences between the previous accounting standards, International Accounting Standards 39 and the new accounting standards, International Financial Reporting 9.

The Chapter 3 is a focus, firstly, on the main directives, regulations, amendments that have formed the accounting standards IFRS 9. Then, the analysis pays attention on the impact of these accounting standards in banks’ financial statements related to the classification and measurement of financial instruments and the impairment methodologies.

Chapter 1 – INTERNATIONAL ACCOUNTING STANDARDS 39: Recognition and Measurement of Financial Instruments

The International Accounting Standards 39 - *Financial Instruments: Recognition and Measurement*, was composed and emanated in March 1999 in order to have standards and financial rules necessary to recognize and to evaluate financial instruments (assets and liabilities). In the past, financial instruments were seen as a category of assets and liabilities that began to be important for the main economic system, like United States or Europe; this importance and relevance increased a lot and the main institutions analyzed that it was necessary to create and to emanate a set of accounting principles for the recognition and the measurement of financial instruments.

During the following years, the document enclosing the accounting principles IAS 39 has been one of the first financial paper that received ideas, relations, comments but also critics from analysts and auditors in relation to the discussed items. Consequently, the International Accounting Standards Board, IASB, has decided to review many parts of the written principles and the IAS no. 39 were subjected to numerous modifications and changes. These modifications were related to different factors: the growth of financial markets in the last years, the fluctuations of the main rates, the disclosure of new financial instruments, etc. Different rules and standards have been eliminated or modified by improving them in a better way. In fact, new financial rules have been introduced to improve the IAS no. 39. The accounting principles IAS 39 have been applied in the balance sheet of entities, banks, companies and institutions by also considering the continued modifications.

The decisive choice was after the regulation n° 1004 emanated on 2008 where the IAS Board decided to eliminate completely the International Accounting Standards 39 and to create a new set of accounting principles by respecting the correct guidelines. The completed works have conducted to the creation of a new set of accounting standards, collected in the financial document known as “*International Financial Reporting Standards 9 – Replacement of IAS 39*”.

The main purpose of the accounting principles IAS 39 is the recognition and the valuation of financial instruments (financial assets and liabilities) and financial contracts that are used to sell or buy non-financial items¹. Financial instruments have been introduced by the set of

¹ International Accounting Standards Board (IASB), “*International Accounting Standards 39 Financial Instruments: Recognition and Measurement*”, 18th February 2011, Paragraph 1

financial principles, known as International Accounting Standards no. 32, that explain this category of contracts. As already mentioned in the International Accounting Standard 32 from the International Accounting Standards Board, a financial instrument² is a category of financial contracts that is composed of financial assets of a bank or a financial institution with the respective financial liabilities of another entity³. An example of financial instruments, that will be explained in the following paragraphs, is the financial loan where there is a credit of the household that obtains the loan and there is a debt for the bank.

The International Accounting Standards 39 have established two main phases for identifying financial instruments that are defined in the International Accounting Standards 32: *recognition* and *measurement*. The accounting principles IAS 32 define the basic standards and rules for the representation of financial instruments in the balance sheets of entities. Furthermore, these accounting standards help entities to define the main phases necessary for the recognition and the measurement of financial instruments that are also explained in the IAS 39.

The International Accounting Standards 39 and the International Accounting Standards 32 can be applied for all types and categories of financial instruments with some exceptions, like joint ventures, investments in subsidiaries or in associates, etc., that are subjects to other

2 International Accounting Standards Board (IASB), “*International Accounting Standards 39 Financial Instruments: Recognition and Measurement*”, 2011, Paragraph 11, Definition of financial instrument: “[...] A financial instrument is any contract that gives rise to a financial asset to an entity and a financial liability or an equity instrument to another entity.”

3 International Accounting Standards Board (IASB), “*International Accounting Standards 32 - Financial Instruments: Presentation*”, 2005, Paragraph 11:

[...] 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 liabilities with another entity under conditions that are potentially favorable to the entity;
- A non-derivative or derivative contract that will or may be settled in the entity’s own equity instruments.

[...] 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 liabilities with another entity under conditions unfavorable to the entity;
- A non-derivative or derivative contract that will or may be settled in the entity’s own equity instruments.

accounting principles (for example the accounting principles IAS 27 or IAS 28 that focus in other important topics of financial statements).

As mentioned before, the International Accounting Standards 39 focus on significant phases necessary to identify and to analyze financial instruments: the IAS Board has tried to explain how to classify, to recognize and to measure financial assets and financial liabilities that compose the financial statements of entities, financial institutions and banks.

The IAS no. 39 define the financial instrument in four “life phases”, that are named:

- Phase 1: *Recognition*;
- Phase 2: *Initial measurement*;
- Phases 3: *Subsequent measurement*;
- Phase 4: *Elimination or Reclassification*.

These phases are, then, categorized in three main stages:

- 1) *Classification and Measurement of Financial Instruments*;
- 2) *Impairment methodology*;
- 3) *Hedge Accounting*.

Recognition is the initial phase where entities recognize financial assets or financial liabilities on its balance sheet only if, as mentioned from IASB in the accounting standards no. 39, they take part to the contractual provisions of the financial instruments⁴.

After the *recognition* (Phase 1), financial assets and financial liabilities are measured initially at *fair value* or at *amortized cost* and the measurement could be also associated, in specific categories of financial instruments, with transaction costs. This is the second life phase of a financial instruments, known as “*initial measurement*”.

After the *initial measurement* (Phase 2), there is the third “life phase” where financial instruments continue to be analyzed, evaluated and measured at *fair value* for specific categories, explained in the IAS 39, or at *amortized cost* for other categories. This financial measurement is characterized mainly from these two evaluation criteria and depends on the balance sheet data.

In the fourth phase, financial instruments can be eliminated from the balance sheet of entities, financial institutions and banks for different reasons: one of the main reasons is that the contractual provisions of the financial instruments have reached their maturity. But entities

⁴ PricewaterhouseCoopers (PwC), “*Financial Instrument under IFRS: A guide though the maze*”, June 2009 (Third Edition)

can also decide to de-recognize financial instruments because they don't represent the belonging category but represent the main characteristics of another category. In this way, if the financial instrument presents characteristics in line with another category, entities can remove the financial instrument from the initial category and allocate it in the other category. This is the *elimination* and the *reclassification* of financial instruments (Phase 4).

These four life phases of financial instruments will be thoroughly analyzed and discussed in the following paragraphs, starting from the classification of financial assets and financial liabilities.

1.A – Classification and Recognition of Financial Instruments

Financial instruments are recognized in different categories, necessary for the identification and measurement. The International Accounting Standard 39 identifies and recognizes financial assets in four main categories:

- *Financial Assets and Liabilities at Fair Value Through Profit and Loss (FVTPL) and Financial Assets and Liabilities at Fair Value Option (FVO);*
- *Held-to-maturity investments (HTM);*
- *Loans and Receivables (L&R);*
- *Available-for-Sale Financial Assets (AFS).*

In the first category, there are financial assets that are measured *At Fair Value Through Profit And Loss* (FVTPL). Financial assets are held for the short-term trading and are non-derivative contracts. The trading is related to the purchase of a financial asset or a financial liability that has been occurred in the short term in order to have a profit from it. In this way, the financial asset and the financial liability take part in a portfolio of financial instruments whose purpose is to obtain a short-term profit.

In this category, the International Accounting Standards 39 also take into account financial assets and financial liabilities that are firstly considered in FVTPL category and measured at *fair value* through the *fair value option*. Firstly, in the accounting principle IAS 39, the *fair value option* was applied to all financial assets and financial liabilities but this created several problems in the valuation of financial instruments. During the following years, the International Accounting Standard Board decided to take a set of modifications and consequent changes related to the application of the *fair value option*. The FVO criteria has been eliminated but in 2005 the IASB decided to include again the application of the measurement through *fair value option* in the accounting principle.

In this category, the accounting principles IAS 39 also consider derivatives⁵, without taking into account hedging instruments⁶.

The second classification is related to *Held-to-maturity Investments* (HTM). These are financial instruments (assets and liabilities) with fixed or determinable payments that entities and banks decide and intend to hold until their maturity⁷. The international accounting principle IAS 39 identify three main characteristics of these financial instruments:

- 1) they have fixed or determinable payments;
- 2) they have a determinate maturity;
- 3) entities have the intention and they are able to maintain them until the maturity.

These financial assets are effectively included in HTM category when entities intend to maintain them if they go until the maturity and they don't sell them before. Furthermore, entities must be able to maintain them until maturity. This capacity is ascertained if entities have financial sources for sustaining investments or if they have legal limitations that limit the support of financial instruments until their maturity.

If an entity decides to sell an amount of the HTM investment before the conclusion of its maturity, this investment has not to be considered in *Held-to-Maturity Investments* category.

These financial instruments that should be supported until they expire must be analyzed and considered during the initial recognition and at the closing date of each financial year⁸.

⁵ International Accounting Standards Board (IASB), "*International Accounting Standards 39 - Financial Instruments: Recognition and Measurement*", 2011, Paragraph IAS 39.9: "[...] A derivative is a financial instrument:

- whose value changes in response to the change in an underlying variable such as an interest rate, commodity or security price or index;
- that requires no initial investment, or one that is smaller than would be required for a contract with similar response to changes in market factors;
- that is settled at a future date.

⁶ International Accounting Standards Board (IASB), "*International Accounting Standards 39 - Financial Instruments: Recognition and Measurement*", 2011, Paragraph IAS 39.9: "[...] A hedging instrument is an instrument whose fair value or cash flows are expected to offset changes in the fair value or cash flows of a designated hedged item."

⁷ Sogefi Group, "*Consolidated Financial Statements: Explanatory and Supplementary Notes*", 2011

⁸ International Accounting Standards Board (IASB), "*International Accounting Standards 39 - Financial Instruments: Recognition and Measurement*", 2011, Paragraph 39.9

Loans and Receivables, as mentioned in IAS 39, are non-derivative financial assets that have fixed or determinable payments and belong to an active market. This third category doesn't belong to the previous category of HTM investments because there is no requirements for entities to maintain and hold loans and receivables until their maturity⁹.

The last category is constituted from *Available-For-Sale Financial Assets* (AFS). These financial instruments are described in International Accounting Standard 39 as non-derivative financial assets that are designated for sale and are not classified in “*Loans and Receivables*” category, “*Held-to-Maturity investments*” category or “*Financial Assets at Fair Value through Profit and Loss*” category, explained before. Entities don't have the intention to sell them but these financial instruments are recognized as “*available for sale*”. These instruments have different characteristics and conditions necessary for the classification for the previous categories.

Table 1 summarizes the main characteristics of financial assets categories:

Table 1 – Analysis of Financial Assets Categories

Financial Assets Category	Name	Main Characteristics
FVTPL	<i>Fair Value Through Profit and Loss of Financial Assets</i>	<ul style="list-style-type: none"> – A type of a financial contract whose purpose is to obtain profits in price and market margins; – Part of a portfolio of financial instruments that is managed jointly and manifested the attainment of profits in the short term; – Derivatives considered in this category but not hedging derivatives.
HTM	<i>Held to Maturity Financial</i>	– Financial assets with fixed

⁹ International Accounting Standards Board (IASB), “*International Accounting Standards 39 - Financial Instruments: Recognition and Measurement*”, 2011, Paragraph 39.9

	<i>Assets</i>	<p>or determinable payments that are different from FVTPL assets and L&R;</p> <ul style="list-style-type: none"> – Effective intention of entities to hold this type of financial assets to maturity; – Ability to hold financial assets to maturity with a strong financial capability.
L&R	<i>Loans and Receivable</i>	<ul style="list-style-type: none"> – Loans and Receivable generated or acquired by entities by providing cash or goods and services to a specific subject (debtor); – Financial assets that are not quoted in an active market.
AFS	<i>Available for Sale Financial Assets</i>	<ul style="list-style-type: none"> – Residual category that considers all financial assets that are not described in previous categories (FVTPL, HTM and L&R).

The International Accounting Standards 39, also, have classified financial liabilities in two main categories:

- financial liabilities measured at *Fair Value Through Profit and Loss (FVTPL)* that are defined by IAS 39 as financial contracts necessary for obtaining a profit through the continuous increase and decrease of their value. This category is also composed by liabilities held for trading for the purpose of future negotiation and financial liabilities measured through *fair value option*.
- financial liabilities at *amortized cost* that are related to the business structure of entities.

1.B – Initial and Subsequent Measurement of Financial Instruments

In the paragraphs of the financial document, *International Accounting Standards no. 39*, the IAS Board defines the recognition of financial assets and financial liabilities that must be recognized initially in the balance sheet of entities through the *fair value* criteria and only if entities are subjected to the contractual rights and obligations under the financial instruments. A financial asset is recognized in the balance sheet only if an entity does its obligation and a financial liability is recognized only if the corresponding entity does its obligation. The accounting principles IAS 39 explain the initial recognition through *fair value* method.

The accounting standards IAS 32 associated with the accounting standards IAS 39 define *fair value* as “the amount for which a financial asset could be exchanged or a financial liability could be settled, between knowledgeable, willing parties in an arm’s length transaction”¹⁰. If there is an active market, the *fair value* is equal to the market value. If there is a market but is not active, financial instruments must be evaluated at *fair value*. Mainly, financial assets are measured initially at *fair value* whose value corresponds to the amount paid and financial liabilities are also measured at *fair value* whose amount corresponds to the amount received. In other words, the amount paid or received is equal to the market value of financial instruments.

Furthermore, financial instruments can be recognized at trading date or at settlement date. In fact, entities that make the initial recognition must decide if to recognize the financial instruments at trading date or settlement date.

The trading date is when the entity signs the financial contract of sale or purchase of a financial instrument. In case of purchase, entities account the acquired financial instrument at trading date by recognizing the financial asset that they receive and the consequent financial liability that they pay. In case of sale of a financial instrument, entities account this transaction at trading date by eliminating the financial instrument and by creating a new credit.

The settlement date is, instead, related to the moment that entities receive the financial instrument that acquire or when entities sell and consequently eliminate their financial instrument to other entities that receive it. Entities can decide to apply one of the two dates to

¹⁰ International Accounting Standards Board (IASB), “*International Accounting Standards 32 - Financial instruments: Disclosure and Presentation*”, June 1995

account their financial instrument but they have to apply the chosen account date for all the categories that the acquired or sold financial instrument belongs.

Financial assets recognized at *fair value through profit and loss* (FVTPL) are initially measured at fair value. After the initial recognition, these financial instruments continue to be measured at fair value but their possible variations are recognized in the income statement.

Financial assets *held to maturity* (HTM) are measured and recognized firstly at fair value by considering also transaction costs. The International Accounting Standards no. 39 define transaction costs as all incremental costs that are directly attributable to the purchase or the sale of financial assets or financial liabilities. After this measurement, this category of financial assets is measured at *amortized cost* and possible increases or decreases of their value are recognized in the income statement.

The accounting standards IAS 39 define the meaning of *amortized cost* criteria as “a measurement method that considers the initial value of financial assets or financial liabilities that is recognized by entities and subtracts any eventual repayments or any possible impairment losses; this method adds/subtracts positive/negative variations of the difference between the initial value and the value close to maturity on the effective interest basis. *Amortized cost* is composed in the following calculation:

Formula of Amortized Cost
– Refunds
– +/- Amortization resulting from the difference between the initial value and the final value of the financial instrument based on the effective interest criteria
– Permanent depreciation due to decrease of value
– Payments
= <i>AMORTIZED COST</i>

Amortized cost is measured through the effective interest method. In the International Accounting Standards 32, the IAS Board explains the effective interest rate as “*the interest rate used for the calculation of the present value of the financial instrument that allows to determine the carrying amount*”. In the International Accounting Standards IAS 39, the

effective interest rate is also considered as “*the interest rate that discounts estimated future cash payments or revenues through the expected life of a financial instrument*”.

Loans and Receivables (L&R) are firstly measured at fair value by taking into account the transaction costs. Then, any eventual variations, named also incurred losses, of these financial instruments are considered in the income statement and are recognized at amortized cost by using the effective interest rate criteria.

Finally, there are financial assets *available for sale (AFS)* that are measured at fair value at first time. After this initial measurement, these financial instruments continue to be evaluated at fair value that is recognized in the Income Statement. If there are fluctuations of fair value, these instruments and their variations are considered directly in net assets; in case of high and durable decreases of fair value, these financial instruments, including variations, return to be considered in the income statement.¹¹

In the following table (Table 2), there is a short analysis of the recognition of financial instruments, explained in the paragraph 1.B).

Table 2 – Analysis of Recognition of Financial Assets

Category of financial instrument	Initial Recognition of financial instrument	Subsequent measurement of financial instrument
Fair Value Through Profit and Loss (FVTPL)	<ul style="list-style-type: none"> – measured at <i>fair value</i>; – recognized in Balance Sheet. 	<ul style="list-style-type: none"> – measured at <i>fair value</i>; – recognized in Income Statement, especially in the profit or loss section.
Held to Maturity (HTM)	<ul style="list-style-type: none"> – measured at <i>fair value</i> associated to transaction costs; – recognized in Balance Sheet. 	<ul style="list-style-type: none"> – measured at <i>amortized cost</i> through effective interest rate criteria; – recognized in Income Statement.
Loans and Receivables (L&R)	<ul style="list-style-type: none"> – measured at <i>fair value</i> associated to transaction costs; 	<ul style="list-style-type: none"> – measured at <i>amortized cost</i> through effective interest rate criteria;

¹¹ International Accounting Standard Board (IASB), International Account Standards 39 “*Financial Instruments: Recognition and Measurement*”

	– recognized in Balance Sheet.	– recognized in Income Statement.
Available for Sale (AFS)	– measured at <i>fair value</i> associated to transaction costs; – recognized in Balance Sheet.	– measured at <i>fair value</i> ; – recognized in Income Statement; – recognized in net assets, in case of variations of value.

Financial liabilities, as mentioned in the Paragraph 1.A, are divided in two main categories: financial liabilities that are recognized initially at *fair value through profit and loss* (FVTPL) and all the other financial liabilities that are not considered in the FVTPL category and are initially recognized at *fair value* (associated with transaction costs). The first category of financial liabilities continues to be measured at fair value. Any possible variations are considered in the Income Statement. Instead, the second category is recognized at amortized cost and as the first class of financial instruments, any difference is recognized in the Income Statement.

In the following Table 3, there is a summary of the recognition of financial liabilities:

Table 3 – Recognition of Financial Liabilities

Category of financial instrument	Initial Recognition of financial instrument	Subsequent recognition of financial instrument
Financial liabilities measured at FVPTL	– measured at <i>fair value</i> ; – recognized in the Balance Sheet.	– measured at <i>fair value</i> ; – recognized in the Income Statement, especially in the profit or loss section.
Other financial liabilities	– measured at <i>amortized cost</i> ; – recognized in the Balance Sheet.	– measured at <i>amortized cost</i> ; – recognized in the Income Statement.

1.C – De-recognition/Elimination of Financial Instruments

A financial instrument, as mentioned before, has mainly four phases. Firstly, a financial asset or a financial liability must be recognized and identified in the balance sheet of the entity or the bank or the financial institution. Consequently, there is the classification of the financial instrument that depends on the categories mentioned in the previous paragraph 1.B). In this way, a financial instrument is classified in FVTPL category, HTM category, L&M category or AFS category. After the classification, the financial instruments is measured through a financial criteria, *fair value* or *amortized cost* criteria.

During the lifetime of a financial instrument or a set of financial instruments, a bank or a financial institution or an entity can decide to derecognize or to eliminate financial instruments from their financial statements. The institutions derecognize and eliminate a financial instrument for different situations and reasons. The common situation where there is a de-recognition and an elimination of a financial instrument is when an entity has no more control of about contractual rights that characterize the financial instruments.

The loss of the control of contractual rights of a financial instrument depends on different situations, as when an entity can decide to get its rights or profits that derive from this financial contract. So, an entity loses its control of contractual rights if they reach their maturity or if the entity sells to another entity its contractual rights; a consequence is the de-recognition and the elimination of financial instrument.

If a financial instrument reaches its maturity, an entity gets the financial instrument. If an entity decides, instead, to sell the financial instrument to another entity, the other entity has to receive all the profits and the risks that have this financial contract.

1.C.1 - Elimination of financial instruments

The de-recognition process of a financial instrument is the elimination of this instrument that can be eliminated entirely or partially. In fact, a financial instrument can be derecognized and eliminated partially when a part of this instrument is transferred to another entity and the other part is owned by the entity. The transferred part is recognized at the present value at the sale date and the entity maintains the owned part of financial instrument.

The International Accounting Standards no. 39 collocate and selects two main situations, as mentioned in the previous paragraph, that explain the elimination of financial instruments and the transfer from an entity to another. The entity must account the transfer of financial assets

in order to stabilize the de-recognition of financial instruments. The two main cases of this de-recognition phases are the following:

- *Complete elimination of financial assets*: in this transaction, as mentioned before, an entity transfers completely a financial instrument to another entity without owning any parts of the financial instrument. In this way, in the income statement, the transferor entity will recognize the difference between the carrying amount of the financial instrument and the value paid by the other entity for obtaining the instrument. Furthermore, the entity that transfers its financial asset also recognizes the profit or the loss of financial instrument deriving from the difference.
- *Partial elimination of financial assets*: in this transaction, instead, an entity transfers partially the financial instrument to another entity. The transferor entity must remove its contractual rights, risks and profits of the transferred part of the financial instrument and its relative cash flows in order to transfer them to the other transferee entity. As the complete elimination of financial assets, also in this case, the transferor entity will recognize the difference between the carrying amount and the value paid by the transferee for the transferred part of the financial instrument in its income statement¹².

It could happen that the transfer of a financial instrument doesn't correspond to the consequent elimination of the instrument in the balance sheet of the transferor entity because it has not transferred all the risks and the profits that derive from the financial instrument. In this way, the transferor entity doesn't transfer the financial instrument and has the obligation to maintain it. The transferee entity pays the amount for acquiring the financial instrument that will be recognized.

Beyond the elimination of financial assets, there is also the de-recognition of financial liabilities. In this phase, an entity eliminates a financial liability in its balance sheet if and only if this financial instrument has been welded. This means three possible cases:

- the financial liability is extinguished because the entity has paid its possible debts through money or in other payment way;
- the financial liability is closed because the entity decides to eliminate it by not having the obligation to pay;
- the financial liability is welded if it has reached its maturity.

¹² International Accounting Standard Board (IASB), “*International Account Standards 39 “Financial Instruments: Recognition and Measurement”*”, 2011

In this operation, the entity must cancel from its balance sheet the carrying amount of the financial liability and recognize the amount paid in order to extinguish it.

There is also the case where the bank or the entity eliminates its financial liability and assumes another financial liability as substitute. In this way, the bank or the entity has to recognize the new financial instruments at *fair value* and the profit/loss that derives from the difference between the eliminated financial liability and the new financial instrument.

In conclusion, the International Accounting Standard no. 39 explain the life phases of a financial instrument that are divided in four phases. It is necessary, firstly, to recognize the financial instrument, to collocate it in the correct financial category, to evaluate it firstly and during its life. The derecognition and elimination are the last phases that are not obligatory and not necessary to actuate. But during the life phase of a financial instrument, it is possible that the financial instrument is classified in the wrong financial category. That's why there is also the *reclassification* of financial instruments.

1.D – Reclassification of Financial Instruments

In the paragraph 50 of “International Accounting Standard no. 39”, emanated by International Accounting Standards Board (IASB), “[...] *an entity shall not reclassify a financial instrument into or out of its fair value category recognized in the income statement while it is held or issued.*”

In the paragraphs that characterize the accounting principles IAS 39, the IAS Board allows entities the possibility to transfer and to reclassify financial assets from a category to another category in unusual circumstances¹³. This decision has been confirmed with the recent financial crisis in order to allow the reclassification of financial instruments. An entity decides to change the category for different reasons. Mainly an entity could identify in the financial asset a set of characteristics that are not compatible with the characteristics that represent the initial category. In this way, when the entity decides to reclassify the financial assets, this instrument will be recognized at *fair value* in the reclassification date.¹⁴

There are mainly three possible reclassifications of financial assets from a category to another category:

¹³ International Accounting Standard Board (IASB), “*International Accounting Standard IAS 39 - Financial instruments: Recognition and Measurement*”, 2011, Paragraph 50(b)

¹⁴ International Accounting Standard Board (IASB), “*International Accounting Standard IAS 39 - Financial instruments: Recognition and Measurement*”, 2011, Paragraph 50(c)

- 1) an entity that owns a financial investment that is classified in “*Held to Maturity*” category can decide to transfer this instrument in the “*Available-for-Sale*” category because it prefers not to reach its maturity and it intends to sell it before its maturity. The financial asset presents characteristics more compatible with AFS category than HTM category. In this reclassification, possible profits and losses that derive from this financial asset must be recognized in net assets;
- 2) an entity that has a financial asset, instead, that is *available for sale* (AFS category) can decide to hold it until it reaches its maturity and to classify it in HTM investments category. In this way, the entity can decide not to sell it but to transfer and hold it in its financial statements. In this case, eventual profit or loss are also recognized in net assets¹⁵;
- 3) An entity that owns financial assets that are *available for sale* can be reclassified in *Loans and Receivables* category (L&R) only if the identified characteristics of these instruments are compatible with L&R category. If these characteristics are compatible with the chosen category, the financial assets are classified and recognized at *fair value* at the reclassification date.¹⁶

So, the International Accounting Standards IAS 39 don't allow reclassifications for financial instruments from all the categories to all the others, as financial assets identified in *fair value through profit and loss* (FVTPL) but there is a limited range of reclassification of financial instruments. All the reclassifications of financial instruments are recognized, as mentioned before, at the date of this financial procedure that is named the reclassification date.

The accounting principles IAS 39 stabilize, instead, that it is difficult and unusual the reclassification of financial liabilities and for this reason the IAS Board doesn't allow entities to reclassify financial liabilities that are recognized at *fair value* in their income statement by emanating IAS 39 principles.

1.E – Hedge accounting

The International Accounting Standards 39 explain and identify criteria necessary to account financial instruments in relation to hedging instruments. The accounting principles introduce, in this way, the hedge accounting. Hedging is defined by IAS 39 as an identification of

¹⁵ International Accounting Standard Board (IASB), “*International Accounting Standard IAS 39 - Financial instruments: Recognition and Measurement*”, 2011, Paragraph 50(d)

¹⁶ International Accounting Standard Board (IASB), “*International Accounting Standard IAS 39 - Financial instruments: Recognition and Measurement*”, 2011, Paragraph 50(e)

instruments necessary to cover the variation of future *fair value* or future cash flows of hedging instruments with the fluctuations of *fair value* or cash flows of financial instruments. The “*hedge accounting*” is a set of accounting operations that are necessary to control risks that threaten the regular life of an entity. In fact, during its economic and financial business cycle, an entity or a bank is influenced from continuous possible risks that can be seen as a threaten for a better business. In addition to the normal practices of *risk management* necessary to control and to monitor any possible risks, the international accounting principles IAS 39 identify and analyze hedging instruments. These instruments are necessary to decrease the level of these possible risks and, if it is necessary, to eliminate them. In this way, these instruments are used to help entities, banks and financial institutions to mitigate the continuous risks that they are exposed. Risks are represented from the possible changes in economic variables like exchange rate that continues to vary in relation to the market trend, interest rate and other variables.

IAS 39 define derivatives as hedging instruments when possible variations, fluctuations and changes of *fair value* or future cash flows related to these instruments are compensated and so covered by the *fair value* or future cash flows of a identified hedging item. This hedging item is a financial asset or a financial liability or an irrevocable financial commitment or a net investment in a foreign entity that is designated as “hedging” and exposes the entity to a level of risk in terms of *fair value* or future cash flows¹⁷.

In this way, the International Accounting Standards 39 identify three main categories of hedge accounting: *fair value hedge*, *cash flow hedge* and *a net investment hedge in a foreign entity*. These three accounting methods that are explained in the following table (Table 4) are:

- “*fair value hedge*” that is a hedge method for possible variations and changes of *fair value* in relation to financial assets and financial liabilities that present a level of risks that could influence net income of an entity;
- “*cash flow hedge*” that is another hedge method used for possible fluctuations of future cash flows related to the risk that derives from financial assets and financial liabilities. In this case, this risk influences the net income of an entity.

¹⁷ Alessio Iannucci, Principi Contabili, “IAS 39: *Strumenti finanziari derivati – La contabilizzazione dei derivati di negoziazione (speculativi) e di copertura*”, 11 giugno 2007, pag. 59

- “*net investment hedge in a foreign entity*” that is the third hedge method for the risk of exchange rate fluctuations.¹⁸

Table 4 – Hedge Accounting Methods¹⁹

Hedge Accounting Methods	Description	Example
Fair value hedge	The <i>fair value</i> hedge is a typical hedge method that permits entities to account and to compensate the variation in <i>fair value</i> of a financial instrument with the corresponding variation in <i>fair value</i> of the hedging instrument. This hedge method is used for covering financial assets at fixed rate, financial liabilities at fixed rate and irrevocable commitments. These are hedging operations necessary to reduce the variability of <i>fair value</i> of financial assets and liabilities.	<ul style="list-style-type: none"> – Fixed rate financial receivables. – Fixed rate financial loans and investments.
Cash flow hedge	The cash flow hedge is another hedge method characterized by the variability of cash flows. This variability causes risks and is related to a variable-rate financial asset or financial liabilities. This hedge method is characterized by hedge	<ul style="list-style-type: none"> – Variable rate financial receivables. – Variable rate financial loans and investments.

¹⁸ Università degli Studi di Macerata, “Analisi dei bilanci bancari: principi contabili internazionali – Principali “IAS” di impatto per le banche”, 6 marzo 2012

¹⁹ Alessio Iannucci, Principi Contabili, “IAS 39: Strumenti finanziari derivati – La contabilizzazione dei derivati di negoziazione (speculativi) e di copertura”, 11 giugno 2007, pag. 58-63

	methods like cash flow method at variable rate. This represents a set of variations that is generated from hedging instruments.	
Net investment hedge in a foreign entity	The net investment hedge in a foreign entity is explained in the International Accounting Standard 21 as an amount of net assets less or equal to the carrying amount of net assets in a foreign financial operation ²⁰ . This hedging operation is related to fluctuations of exchange rate of a foreign instrument.	– Derivatives evaluated at <i>fair value</i>

For having a full coverage of risks, financial instruments and hedging instruments have a correlated evaluation. But it is possible to have discrepancies between financial instruments and hedging instruments. These discrepancies are identified in different criteria used for the evaluation of these instruments due to wrong information, different moment of initial recognition in the balance sheet or others.

1.F – Critical points of IAS 39 and evolution to IFRS 9

The 2008 financial crisis is not forgotten by banks, markets, companies and institutions as the worst financial period and the beginning of a long recovery. This financial crisis has affected the main and important economic system, like United States and European countries, by infecting entities, banks, small companies and so on. This collapse happened when a set of banks declared to be insolvent; this insolvency derived from *subprime mortgages*. Subprime mortgages are recognized as a type of several loans issued to individuals or businesses with a

²⁰ International Accounting Standard Board (IASB), “*International Accounting Standard 21 - The Effects of Changes in Foreign Exchanges Rates*”, 2003

low confidence level and so they represent a high level of risk because individuals and businesses have an unreliable credit history and unreliable guarantees.

During the financial crisis, the mentioned insolvency derived from the failure to pay these mortgages of debtors and the increase of households' debts. In this way, financial assets owned by financial institutions and banks were considered as contagious instruments. Consequently, no healthy bank was going to help troubled banks and this situation forced most of them to appeal to voluntary liquidation. The first case of this liquidation happened on September 15th, 2008 with the liquidation of one of American banks, Lehman Brothers.

Against this serious events and future events, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) decided to modify international accounting principles, especially the accounting standards IAS 39, in order to have a better method to review the financial situation of entities by simplifying the audit review and considering new elements.

1.F.1 – Changes of IAS 39

Since 1973, the International Accounting Standards Committee, IASC, has tried to individuate and consequently to emanate accounting principles necessary to standardize the accounting rules applied all over the world. The continuing research to individuate such financial rules has obtained some results in the 2000s when the International Accounting Standards Board introduced different accounting principles necessary to regulate the accounting system: one of these principles was IAS 39. But after the evaluation and the application of auditors and analysts and their critics, it was necessary to modify most of these accounting principles. In a communication done in March 23rd and 24th, 2000 the European Commission decided to introduce the main plans necessary to simplify and to improve the reporting of financial instruments explained in IAS 39.

From the introduction of International Accounting Standards 39, the IASB decided to review this accounting principle for different reasons. IAS 39 was “*complex and difficult to apply*” in the financial statements of entities; it was affected by multiple impairment models and complicated reclassification rules that could be difficult to understand²¹. Due to these critical points, the IASB has been stressed to modify the accounting principle IAS 39 for its complexity. On 17th December 2003, the IAS Board published the financial document known as “*International Accounting Standards (IAS) 39 – Financial Instruments: Recognition and*

²¹ Bankpedia, Giovanni Aversa, “*IFRS 9: Un nuovo approccio per gli strumenti finanziari*”, 2008

Measurement” in a revised version but still not satisfactory for auditors; as mentioned initially, these accounting standards are a set of fundamental rules for the recognition and valuation of financial assets and liabilities and only through improvements and simplifications, auditors have better instruments for an optimal recognition and valuation of financial instruments. This set of principles was adopted on November 19th, 2004 from European Commission with all the changes adopted by IASB, with the exception of certain provisions regarding the *fair value option* and *hedging operations*. On 17 December 2004, the IASB emanated another amendment about IAS 39: “*Transition and Initial Recognition of Financial Assets and Financial Liabilities*”. This regulation was done in order to give more flexibility to European entities²².

One of the main problems notified by auditors and analysts, as already mentioned previously, is the complex initial recognition of financial instruments. This initial phase is structured by a set of multiple classification criteria and valuation methods. In this way auditors and entities have underlined problems related to the choice about which is the better method or criteria necessary to recognize, to classify and to evaluate a financial instrument. So, in the application of IAS 39, entities and banks have found a wide selection of methods that have caused difficulties. These difficulties are connected to the classification of a financial instrument in a category even if it was much more compatible with another category. It could also happen that two financial instruments with same characteristics are classified in different financial categories. These problems have caused a negative impact in the balance sheet of different entities and their comparability. This critical point has been exposed to IASB to improve it.

Another critical point of IAS 39 is the valuation of financial instruments through fair value with the application of several financial categories. For having a better valuation through fair value and for obtaining reliable results, it will be necessary that there is an active market but in 2008 the world economy was affected by the financial crisis. This event has caused the creation of illiquid markets that never guarantees reliable results about valuations through fair value.

Auditors have identified the accounting principles IAS 39 like possible causes for the coming and the effects of financial crisis. This accusation derives from the high use of fair value method in order to evaluate financial instruments. Fair value is connected with continuous fluctuations where the value of financial instruments could have a drastic decrease.

²² Gazzetta ufficiale dell’Unione Europea, Regolamento (CE) N. 1751/2005 della Commissione” del 25 ottobre 2005, Par. 2-3

Consequently auditors, entities, banks and other institutions have seen many difficulties in the analysis and the valuation of financial instruments.

During the financial crisis, the IAS Board has emanated several documents and regulations necessary to revise the accounting standards IAS no. 39. In the following table, Table 5, there is a chronology of the amendments done in 2008:

Table 5 – Chronology of 2008 amendments (IASB)

Date	Amendments
March, 2008	<p>The International Accounting Standards Board emanated a document, “<i>Reducing complexity in reporting financial instruments</i>”.</p> <p>This document underlines the complexity deriving from the analysis of a financial instrument or the application of the correct and fair valuation method done by auditors. This complexity derives mainly from the variety of valuation methods. To International Accounting Standards Board, reducing complexity has different directions, as reducing the variety of valuation methods and evaluating financial instruments with the same method (<i>fair value</i>); but this choice, as mentioned by <i>PriceWaterHouse auditors</i>, could create problems due to the continuous fluctuations of <i>fair value</i>. The IAS Board individuates, in this document, a set of proposals to improve and to simplify the measurement of financial instruments and hedge accounting but doesn’t eliminate drastically the valuation methods. So, through this document, the IAS Board wanted to provide less complex accounting standards because economic agents have</p>

	<p>difficulties to understand and to interpret the accounting principle IAS 39.</p> <p>This is the first step done by the IASB in order to review and to replace the accounting principles IAS 39²³.</p>
October 3, 2008	<p>This was a revision phase instituted by the International Accounting Standards Board which in one hand helped entities to identify and define financial assets in order to get up from the financial crisis and in the other hand continued to revise IAS 39 by providing better classification models and valuation criteria for financial instruments for the future.</p>
October 7-8, 2008	<p>The European Commission, especially the organism ECOFIN (Economy and Finance) defined measurement criteria to get up from the financial crisis and expressed the exigency to have better valuation rules necessary to evaluate financial assets. This happened for increasing the confidence among investors, households, banks, companies and institutions.</p>
October 10, 2008	<p>The Financial Accounting Standard Board, FASB, emanated another document, named – “<i>FASB Statement No. 157 – Section 3</i>” that took part of the main document, <i>the FASB Statement No. 157</i> emanated in 2008.</p> <p>This document defined the <i>fair value</i> and identified <i>fair value measurements</i> in generally accepted accounting principles. The <i>Section 3</i> of this document was applied</p>

²³ PricewaterhouseCoopers, “*Banking and Capital Markets: Can financial instrument accounting be simplifying?*” Introduction, 2008

	<p>in October 10, 2008 in a situation where the market for the financial assets is not active and FASB decided to provide new proposals to entities.²⁴</p>
October 13, 2008	<p>The IAS Board analyzed the option to apply an amendment about IAS 39 that reduce the application of <i>fair value</i> method for illiquid financial assets. This amendment would have cancelled the prohibition to transfer financial assets valued at <i>fair value through profit and loss</i> to another financial category²⁵.</p>
October 16, 2008	<p><u><i>Emanation of 1004/2008 regulation.</i></u></p> <p>Due to the financial crisis that brought down economically and financially many countries, like Europe and United States, the International Accounting Standard Board decided to emanated the <i>regulation no. 1004/2008</i> concerning the valuation of financial instruments.</p> <p>This amendment focuses on the re-classification of financial instrument in rare and exceptional circumstances. This regulation cancels, especially, the prohibition to re-classify a financial asset (like loans and receivables) from the <i>fair value through profit and loss</i> (FVTPL) to another category that classifies financial instruments at <i>fair value</i> or <i>amortized cost</i>. In this way, the cost of financial assets begins to be equal to the <i>fair value</i> at the date of transfer from a category to another category and eventual</p>

²⁴ FASB, FASB STAFF POSITION NO. 157-3, “*Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*”, October 10, 2008

²⁵ Il Sole 24 Ore, Mauro Bini, “*The Fair Value Obtain the Derogation*”, October 14, 2008

profit or loss obtained in the previous category are not considered in the new financial category from the moment where the financial instrument is transferred. The IAS Board decided to emanate the *1004/2008 regulation* in order to give to European countries more flexibility in the classification and re-classification of financial instruments, as United States.²⁶ This amendment was effective from July 1st, 2008. This means that any re-classification done after the emanation of the *1004/2008 amendment* was effective at execution date; any re-classification executed before the publication of the regulation, the reference date was 1st July 2008.

The *regulation no. 1004/2008* establishes the re-classification of financial instruments: it is possible to re-classify financial instruments from a category to another category. Especially it allows to re-classify financial instruments that have linear characteristics with other financial category from their belonging category if the entity has the ability to maintain the financial instruments in the future or until its maturity (for example from *Loans* and *Receivables* category to another category). Furthermore, entities can also reclassify financial instruments classified in *Available for Sale* category that presents characteristics in line with another financial category, as L&R category.

With the *1004/2008 regulation*, the IASB allows to reclassify financial instruments belonging to FVTPL (*Fair Value Through Profit and Loss*) category to other categories like HFT (*Held To Maturity*) category, with the exception of derivatives and financial assets evaluated at FVO (*Fair Value Option*). Instead, the regulation doesn't permit to re-classify financial instruments from any financial category to FVTPL category. The re-classification is regulated at fair value at the re-classification date and the value of the financial instruments corresponds to fair value or amortized cost of the instrument.

²⁶ Giorgio Raviolo, "*Global crisis: from Bretton Woods to subprime*", 2009, EDIZIONI UNIVERSITARIE ROMANE, pages 205-217

As mentioned by Ernst Young, the *1004/2008 amendment* has been also emanated for banks in order to allow them to classify and evaluate financial instruments that are not listed in active market but in illiquid market or financial instruments that are not *held for trading* (HFT) by using *amortized cost* criteria. Any financial instrument that doesn't belong to HFT category means that they are not held for trading purposes and can be re-classified in other categories. The amendment doesn't allow to re-classify derivatives and financial instruments evaluated at *fair value option* method (FVO).

For the reclassification entities have to communicate the following data:

- the total amount of the financial instrument that is reclassified;
- the value and the *fair value* of the reclassified financial instrument during its financial life until its elimination or its maturity;
- profit or loss deriving from any possible variation of *fair value* of reclassified financial instrument;
- the effective interest rate at the reclassification date and an estimate of about future cash flows.²⁷

These elements are necessary to show the financial effects of reclassification process in relation to the failure to make this reclassification.

Furthermore, the amendment 1004/2008 has provided paths and guidelines necessary to recognize the *fair value* of financial instruments, especially in illiquid and inactive market where there are not sufficient cash flows in order to eliminate debts or financial obligations. Related to this measurement, as mentioned in the previous paragraphs, the IASB has also tried to improve the recognition of financial instruments in the balance sheets of entities, due to the multiplicity of valuation methods through *fair value*.

1.F.2 – Replacement process of IAS 39

At the end of 2008, after these amendments, especially the *1004/2008 regulation*, the IAS Board decided to eliminate IAS 39 by actuating an elimination process. Next to this elimination, the Board has identified a substitute document that covers the complex IAS 39 accounting principles with a new set of international accounting principles. The IASB wanted to produce a complete version easy to understand that faced all the items traced in the IAS 39: a version that should substitute the accounting principle IAS 39 in all its topics.

²⁷ ERNST & YOUNG, Stefano Grumolato, “IAS 32, IAS 39 and IFRS 7 - Financial Instruments: Recognition, Measurement, Presentation and Disclosure”, pages 42-43, April 2009, Ernst & Young

These new international accounting principles take part of the document, named “*International Financial Reporting Standards 9 (IFRS 9): Financial Instruments – Replacement of IAS 39*” that will be applicable from January 1st, 2018. The introduction of IFRS 9 was fixed at January 1st, 2013 but with the publication of an exposure draft on August 4th, 2013 the IAS Board postponed the entry of international accounting principles in 2015. In the end, the effective data is in January 1st, 2018.

The International Accounting Standards Board decided to structure the elaboration of International Financial Reporting Standards 9 by dividing in three main phases that will be analyzed more detail in the Chapter 2 (Table 6).

Table 6 – Three replacement phases of IAS 39

Periods	Actions
Phase 1 – Classification and Measurement (November 2009 – October 2010)	The IAS Board introduced the first version of IFRS 9 characterized by an analysis about the classification and the measurement of financial assets. The Board discussed the main issues reported in the discussion paper “ <i>Reducing complexity in reporting financial instruments</i> ” in relation to the classification and the evaluation of these financial assets. The IASB emanated a second version where it considered the first version related to financial assets by proposing a single evaluation method as a long-term solution for financial instruments and introduced this phase for financial liabilities. The Board considered the same issues explained in IAS 39 about financial liabilities with specific changes in <i>fair value option (FVO)</i> . At the end of 2010, the IAS Board introduced the complete version of <i>IFRS 9: Financial Instruments – Classification and Measurement</i> .
Phase 2 – Impairment methodology (November 2009 – September 2014)	In 2009, the IAS Board introduced an <i>exposure draft</i> , named “ <i>Financial instruments: Amortized cost and Impairment</i> ” that modifies the impairment process explained in the IAS 39. With this regulation, the

	IASB decided that it is necessary to account immediately the possible future losses of financial instruments. In the following years, furthermore, the board published a document “ <i>Financial Instrument: Impairment</i> ” that was connected with the previous <i>exposure draft</i> . At the end of 2014, after other modifications, it was introduced the complete second document, <i>IFRS 9: Financial Instruments – Impairment</i> ”.
Phase 3 – Hedging Accounting (December 2010 – November 2013)	The IASB emanated in December 2010 the <i>exposure draft</i> , named “ <i>Hedging Accounting</i> ” where it identified the <i>risk management</i> of entities related to continuous fluctuations of <i>fair value</i> and it analyzed the impact in the balance sheets. The main purpose of IASB was to identify a simple and understandable accounting method related to hedging instruments based on cash flow hedging process. The complete version of “ <i>Hedging Accounting</i> ” was published on November 2013.

Source: PricewaterhouseCoopers, “*International Accounting Standards: Interpretations and comparisons with national accounting standards*”, 2015, Edition VII, IPSOA

These three phases continue to be improved in order to have a complete version on January 1st, 2018. The accounting standards IFRS 9 will be discussed in a detailed way in the “*Chapter 2 – International Financial Reporting Standards 9: Financial instruments - Replacement of IAS 39*”.

1.G – Conclusions

The International Accounting Standards 39 are a set of accounting principles defined by the IAS Board in the 2000s. From their introduction, the accounting principles have been seen as a crucial point of several discussions because there were many issues necessary to be solved. The accounting standards no. 39 were considered by banks, auditors, institutions and entities like a set of complex principles which were difficult to understand and to apply in the balance sheets. Due to these complexities, the IAS Board was stressed to attenuate them by changing,

modifying and improving the accounting principles. The improvement process of IAS 39 was done for helping auditors and entities to understand easily the international accounting principles and consequently to apply them in their balance sheets.

One of the main critics that has affected IAS 39 accounting principles, as mentioned before, is related to the recognition and the classification of financial instruments: in the IAS 39 document, the International Accounting Standards Board has identified a set of several financial instruments categories and this has created many problems to auditors. In fact, they have met difficulties to classify financial instruments with the category that presents similar characteristics and this has complicated the correct classification of a financial instrument. This difference can have repercussions in the balance sheets of entities because this multiplicity of financial categories can bring to different balance sheets for the same entity that are created by different vision of auditors. With the replacement of the IAS 39, the IASB is arranged to identify a small set of categories that presents the main features of financial instruments.

Another problem that critics have found in the International Accounting Standards 39 is the complexity of the measurement phase of a financial instrument. The Board puts more attention to this complexity in relation to the fair value method which has been considered, from economic agents, as the main intensification lever of the recent financial crisis due to the continuous fluctuations of fair value of financial instruments.

A further problem that has signed the replacement of the accounting standards IAS no. 39 was the impairment process: in the IAS 39 the initial expected losses are disclosed with the initial recognition but the future expected losses of financial instruments value that derived from future events are not considered and the impairment test is not reported. So, in the replacement of IAS 39, the IAS Board puts attention into the impairment methodology in order to consider all possible losses that derived from future events like fluctuations of fair value or variations of effective interest rate.

This set of motivations associated with many others reasons have aroused more critics from the main economic agents and have induced the IAS Board to take a definitive decision. So, the Board decided to replace IAS 39 definitively and to develop a better set of accounting principles with the correct, easy and understandable characteristics, instructions and standards for entities, banks, institutions and auditors.

This is the official decision of IASB, done after the *1004/2008 regulation*, which led to the development of International Financial Reporting Standards 9.

Chapter 2 – INTERNATIONAL FINANCIAL REPORTING STANDARDS 9: Financial instruments (Replacement of IAS 39)

At the end of December 2008, the world financial market and financial system were affected by the financial crisis that started in United States with the failure of financial markets, especially with the failure of one of the banks of American banking system, Lehman Brothers. The International Accounting Standards Board (IASB) with the agreement of the Financial Accounting Standards Board (FASB) and IFRS Foundation decided to eliminate the International Accounting Standards 39 (IAS 39) by substituting these standards with the development and the creation of a complete set of accounting principles and standards. Their purpose was and continues to be the replacement of IAS 39 with the introduction of new accounting standards, known as International Financial Reporting Standards 9 (IFRS 9).

The main objectives that the organizations have established are:

- the development of a new set of standards that are less difficult to apply because the accounting standards no. 39 were difficult to understand, to interpret and to apply;
- the creation of an understandable criteria for classification and measurement of financial instruments in order to allow auditors or analysts or other users to identify the right ways to realize cash flows from financial instruments;
- a better measurement criteria through amortized cost in relation to credit losses;
- a modification on impairment methodologies;
- the improvement of hedging accounting.

Before the advent of 2008 financial crisis, the accounting standards IAS 39 have suffered much criticism, especially in relation to fair value method: auditors thought that profits were overestimated by using this method. Instead, after the advent of financial crisis, it happened the opposite: losses increased and there was an aggravation in relation to the use of fair value method.

As early as 2009, the IASB published the first exposure draft of accounting standards IFRS 9 that focused on the *recognition* and the *measurement* of financial instruments. After the publication of the first part, the Board focused on the development of two more other chapters: *impairment methodologies* and *hedge accounting* that the IAS Board decided to publish the following years.

Firstly, the deadline of the creation of the accounting standards IFRS 9 was at the end of 2010 and its application was fixed on January 1st, 2013; but the Accounting Regulatory Committee

with the agreement of International Accounting Standards Board and other organizations decided to postpone the deadline to 2015 in order to evaluate and to create accounting principles in a basis of integrity and completeness. At 2015, the IAS Board decided to postpone again the final date in order to prepare economic agents, companies, banks, financial institutions and other institutions to apply the new accounting standards. In this way, during a meeting, the International Accounting Standards Board with the agreement of European Commission, Financial Accounting Standards Board, IFRS Foundation and other committees announced the effective and official application date, by fixing on January 1st, 2018. In the following table, Table 7, there is a chronology about the development of IFRS 9:

Table 7 – Development of IFRS 9

Phase 1 – Classification and Measurement of financial instruments²⁸	
March 2008	The IAS Board and the FAS Board published a document “ <i>Reducing complexity in Reporting Financial instrument</i> ” that was a discussion paper related to the weaknesses and the problems verified in IAS 39 document. From this discussion, the IASB decided to create and to develop the IFRS 9.
July 2009	The IASB published the first <i>exposure draft</i> related to the classification and the measurement of financial instruments: “ <i>Financial instruments: Classification and Measurement</i> ”. Classification and Measurement were the first part defined in IFRS 9 project.
November 2009	The IASB published the requirements related to the classification and the measurement of financial assets.
October 2010	The IASB included the requirements related to the classification and the measurement of financial liabilities in the IFRS 9.
July 2014	The IASB published the final version of the

²⁸ www.ifrs.org Section: Projects – Work plan for IFRS – Financial instruments (replacement of IAS 39)

	<i>classification and measurement phase.</i>
Phase 2 – Impairment process²⁹	
November 2009	The IASB published the exposure draft related to the impairment of financial assets by using a different approach: cash flow approach.
January 2011	The IAS Board and the FAS Board also published another document in relation to the impairment process. This was a supplement to the official exposure draft, “Financial instruments: Amortized Cost and Impairment”.
March 2013	The IASB introduced again another document characterized by a set of proposals for the impairment accounting. In this document the board develops the expected credit loss model.
July 2014	The IASB published the final version of <i>impairment accounting</i> section in the official exposure draft.
Phase 3 – Hedge Accounting³⁰	
March 2008	The IAS Board shared the discussion document, <i>Reducing Complexity in Reporting Financial Instruments</i> , where it discussed new proposals about a simpler method of hedge accounting.
December 2010	The IASB elaborated another exposure draft, named <i>Hedge Accounting</i> where it has been identified a model that combined a management view and an accounting view in relation to the risk management.
September 2011	The section <i>Hedge Accounting</i> has been

²⁹ www.ifs.org Section: Projects – Work plan for IFRS – Financial instruments (replacement of IAS 39)

³⁰ www.ifs.org Section: Projects – Work plan for IFRS – Financial instruments (replacement of IAS 39)

	completed and published in the exposure draft.
September 2011 – November 2013	The IASB decided to revise the exposure draft by making changes and improvements and it was completed in November 2013.
July 2014	The IASB issued the final version of <i>hedge accounting</i> section.

Source: www.ifrs.org

2.A – Analysis of IFRS 9

The International Financial Reporting Standards 9 is a replacement of International Accounting Standards 39 where the International Accounting Standards Board has made a deep and intense revision, works and teamwork with other organization about of the main issues, weaknesses and problems underlined and found by auditors, analysts, entities or banks.

2.A.1 – Classification and measurement

The International Accounting Standards 39 are accounting standards that are characterized by a set of several classification categories related to their impairment models. This set has been one of the main issues discussed among auditors, institutions and banks because more categories means more difficulties to choose the correct category.

With the introduction of the first exposure draft about classification and measurement of financial assets and financial liabilities, the International Accounting Standards Board has decided to eliminate definitely the accounting principles no. 39 by introducing and establishing new accounting rules and requirements necessary for a better classification and a linear measurement of financial assets and financial liabilities. The exposure draft and the final version of IFRS 9 is integrated with the rules adopted in the accounting standards IAS 32, IAS 37 and IFRS 7.³¹

The IASB has decided to eliminate the classification categories adopted in IAS 39 by creating a small set of financial categories. This decision is translated in the passage from four classification categories to two classification categories. Firstly, before to conduct to the

³¹ International Accounting Standards Board (IASB), “*IFRS 9 Financial Instruments*”, July 2014, Par. 1

classification of financial instruments and in order to simplify the classification and the measurement, the IAS Board has determined two significant requirements necessary to classify financial assets:

1. *the entity's business model* for managing the financial assets like financial instruments held to maturity or available for sale;
2. *the contractual cash flows* that characterize financial assets.

As mentioned in IFRS 9 Financial Instruments (July 2014), “[...] A business model refers to how an entity manages its financial assets in order to generate cash flows by collecting contractual cash flows, selling financial assets or both”.³² These actions are related to the assessment of banks or entities about the future scenario that allows them to collect contractual cash flows or to sell financial instruments. The first requirement related to the business model, instead, has been affected by criticism due to the difficulty in the identification of the business model of entities or banks. In Chapter 3, there will be an analysis of the impact on banking system in relation to the business model.

In the previous accounting standards IAS 39, as mentioned in the Chapter 1, the classification of financial instruments are divided in four main categories: financial instruments measured at *fair value through profit and loss* (FVTPL), financial instruments *held to maturity* (HTM), *loans and receivables* (L&R) and financial instruments *available for sale* (AFS). Classification is necessary to determine how financial assets are incorporated in financial statements of entities and the Board has decided to simplify the classification by defining two main measurement categories necessary for calculating financial instruments:

- financial instruments measured at *amortized cost*: in this category, the IAS Board considers financial assets and financial liabilities that guarantee cash flows in a definite timeline like, for example, loans and receivables that banks want to maintain until their maturity;
- financial instruments measured at *fair value*: in this category, instead, it is considered a set of financial assets and financial liabilities used for trading and that don't guarantee certain and stable cash flows and consequently banks won't maintain them until their maturity. The results of the measurement of these financial instruments are, then, attributable to balance sheet.

³² International Accounting Standards Board (IASB), “*IFRS 9 Financial Instruments – Project summary*, July 2014, pages 8-10

After having identified these two categories, financial assets are measured in the following measurement methods in relation to the previous mentioned categories (amortized cost and fair value):

- *amortized cost (Held to Collect)*: in this measurement category, there are financial assets that are linear to the business model of the entity and are held to collect contractual cash flows. So, these assets are used to realize cash flows by collecting contractual payments. For determining cash flows, entities have to analyze the frequency and the amount of past sales in order to define expectations about future cash flows.³³
- *fair value through other comprehensive income (Held to Collect and Sell)*: in this category, financial assets are used by banks for collecting cash flows or for selling them in a better future situation. As mentioned in the IFRS 9, these financial assets are “*held within the business model of the entity and are held to collect contractual cash flows and to sell financial assets*”³⁴.
- *fair value through profit and loss (Held for Trading)*: financial assets are classified here if they don’t belong to the previous categories (debt instruments, derivatives or equity instruments). IFRS 9 define these financial assets as instruments that are not held within the business model of the entity and held to collect contractual cash flows or held to both collect contractual cash flows and selling financial assets; these financial instruments are held for trading³⁵.

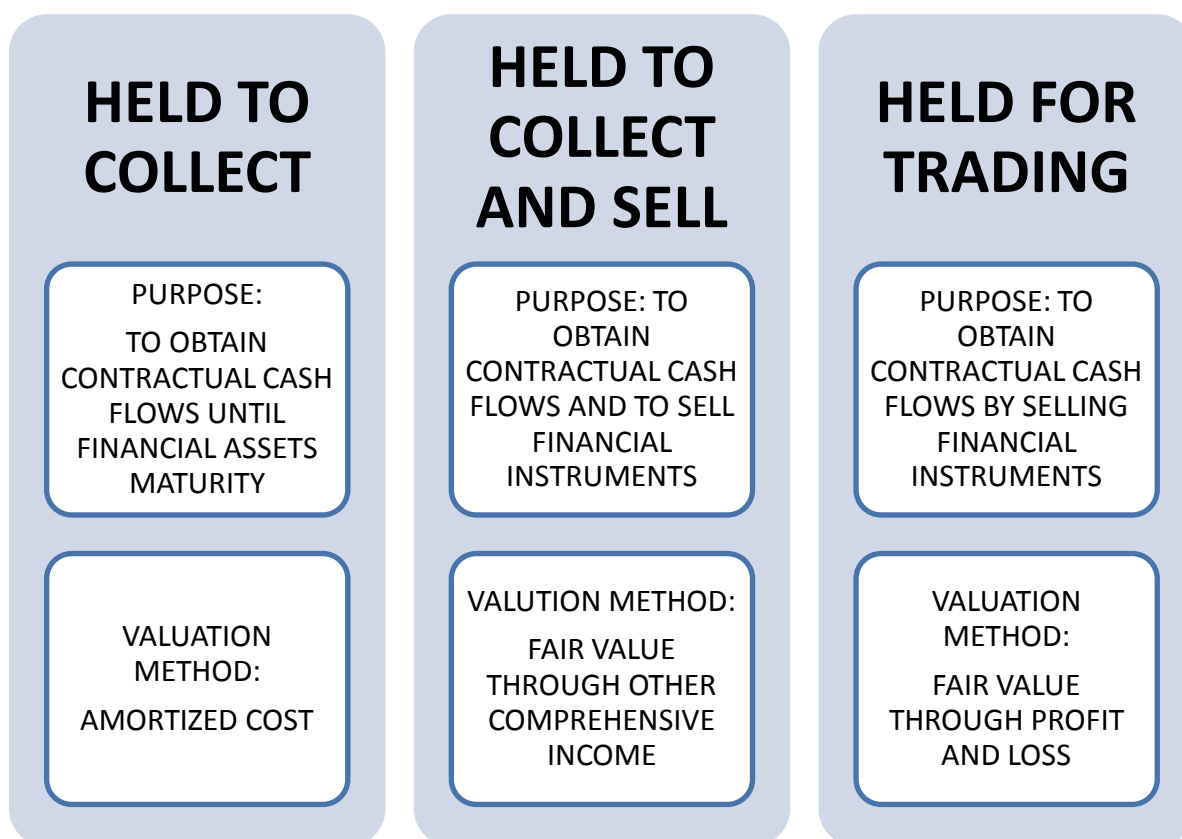
In the following graph 1, there is a summary of classification of financial assets:

Graph 1 – Classification of financial assets

³³ EY, “*Applying IFRS: Classification of financial instruments under IFRS 9*”, May 2015, Paragraph 3.1

³⁴ EY, “*Applying IFRS: Classification of financial instruments under IFRS 9*”, May 2015, Paragraph 3.2

³⁵ EY, “*Applying IFRS: Classification of financial instruments under IFRS 9*”, May 2015, Paragraph 3.3



Source: KPMG, “IFRS 9 – Implications for Banks”, 20 June 2013

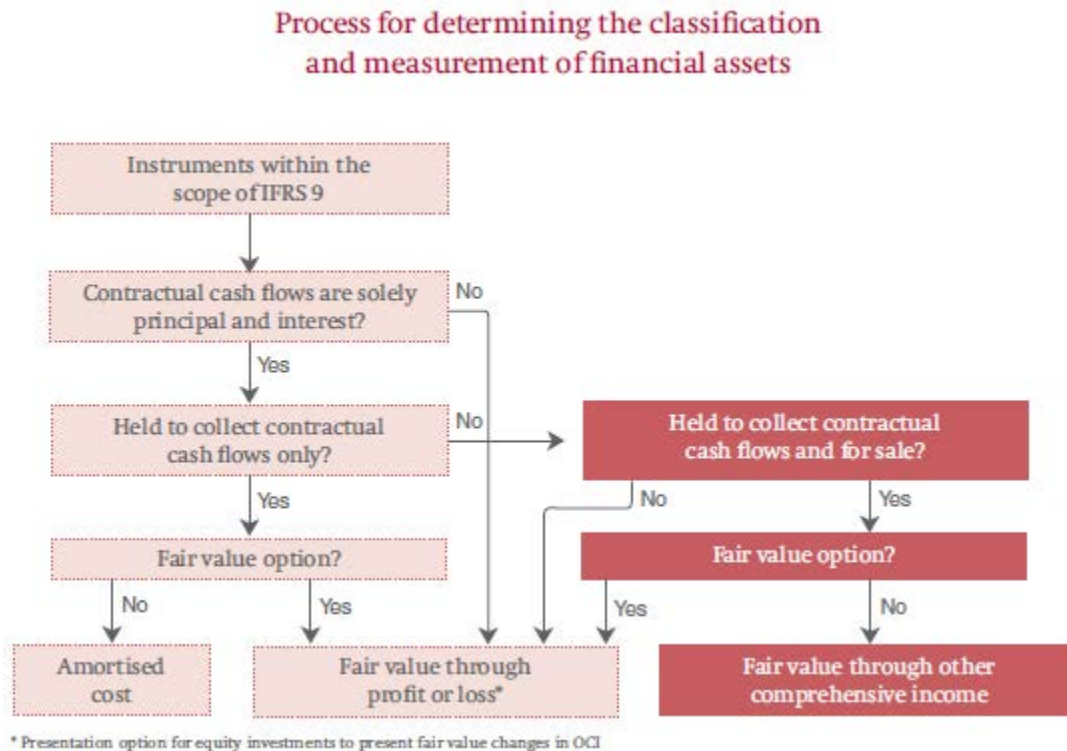
The classification of financial instruments in the mentioned categories is related to the characteristics of financial instruments and the business model that an entity and its management decide to follow. For classifying a financial asset, banks or financial institutions analyze why the financial instrument is in their financial statements and if it has had a positive trend in their balance sheet. From this analysis, banks decide if it is possible to classify them in order to maintain it until their maturity or to sell it before. If a financial asset has had a negative trend in their financial statements, banks prefer to sell it in order not to have continuous negative impact in future cash flows or in the financial situation.

Possible cash flows derive from the payment of interests or the repayment of financial capital and financial instruments are, consequently, measured at amortized cost. Instead, it is possible that cash flows can derive from other components and automatically financial assets are not evaluated at *amortized cost* but at *fair value*.

In the following chart (Chart 1), taken out of the project summary of “*IFRS 9: Financial Instruments (July 2014)*”, the International Accounting Standards Board summarizes the process necessary to determine the classification and the measurement of financial assets: this process is less complex than the process identified in the IAS 39. In the accounting standards

no. 39, there were more classification categories and so more several requirements for each category.

Chart 1 – Determination process of classification and measurement of financial assets



Source: IASB, IFRS 9: Financial instruments – Project Summary (July 2014)

The classification of financial liabilities is different from the classification of financial assets and doesn't follow the same process. In fact, financial liabilities are measured with the same methods underlined and described in the financial document that contains the accounting standards IAS 39: banks measure these liabilities through amortized cost method or at fair value through profit and loss (FVTPL), unless derivatives or collateral liabilities that are measured at fair value. Financial liabilities that are measured at FVTPL are held for trading and their variations are recognized in the balance sheet. Instead financial liabilities that are measured at amortized cost aren't held for trading as FVTPL and they are measured through the effective interest method. The accounting standards IFRS 9 allow banks and entities to measure financial liabilities at fair value, instead at amortized cost, if it is the better method to measure them in its entirety.

After the classification and the measurement of financial instruments, banks or entities continue to evaluate the instrument at fair value or at amortized cost by following the criteria

expressed in the IFRS 9. In comparison of IAS 39, the accounting standards IFRS 9 don't allow the reclassification of financial assets or financial liabilities from a category at fair value to a category at amortized cost or the contrary. The accounting standards IFRS no. 9 allow entities and banks to reclassify financial assets between two different measurement categories only if the entity or the bank changes its business model. This is the exception of the prohibition of IFRS 9 about the reclassification of financial instruments and this is an uncommon event that permits entities to take more attention in the initial recognition of financial assets. Instead, for financial liabilities the Board prohibits completely the reclassification. The initial classification is important for realizing future contractual cash flows.

So, the classification of financial assets and financial liabilities is defined at the initial recognition and banks and entities cannot modify the classification category of the considered financial instruments, except in rare cases mentioned before provided for the reclassification.

2.A.2 – Impairment methodology

In the first stage, the International Accounting Standards 39 analyze the recognition and the measurement of financial instruments; in addition to the first step, the International Accounting Standards Board fixes its attention in the impairment methodologies necessary to evaluate the variations of financial instruments, in terms of value.

The IAS Board has elaborated the accounting standards IFRS 9 in order to make the application of accounting standards less complex than the previous accounting standards IAS 39. The Board has decided to make also a set of changes and improvements in the second step of the new accounting standards: the impairment methodology. It introduces a new impairment method, known as *expected credit losses method*, that replaces the previous impairment method, known as *incurred credit losses model*, and permits to recognize impairment losses as soon as possible. This is related to variations recognized in credit risks that are translated, for banks and entities, as an increase or a decrease of the probability that a default event could happen since initial recognition.

The IAS Board defines, initially, the impairment methodology in the accounting standards IAS 39 as “*an incurred credit losses model*”; this *incurred loss model* is based on the assumption that “*all loans will be repaid until evidence to the contrary is identified (loss or trigger event)*”. *Only at this point, the entity has to write down the lower value of impaired loan.*”

Through the incurred loss model, banks and entities identify the impairment losses but these losses are recognized only if there is evidence that these losses exist. As mentioned in the discussion paper, “*Impairment of Financial Assets – The Expected Loss Model*” (December 2009), during the financial crisis, the incurred credit losses model began one of the main discussed issues that have conducted the IAS Board to take a decision: to create another impairment method, known as *expected credit loss model* that is included and defined in the appropriate exposure draft and then in the official International Financial Reporting Standards 9.

These new accounting standards allow all financial instruments to be submitted to the impairment test, unless financial instruments measured at *fair value through profit and loss*. So, financial assets that are submitted to the impairment test are those that are measured at amortized cost like loans and receivables but also debt instruments and trade receivables.³⁶

The expected credit losses model is defined, in the discussion paper of European Financial Reporting Advisory Group, as a model completely different from the incurred losses model. The Board has qualified the expected credit losses method as a method that recognizes expected credit losses and possible changes to a sort of financial assets portfolio. In one hand, in the International Accounting Standards 39, the Board bases the incurred credit losses model on the perspective allocation of credit losses to the period when these losses are incurred and recognized. In the other hand, in the International Financial Reporting Standards 9, the Board bases the expected credit losses method on the allocation of the initial expected credit losses when revenues are recognized in relation to the financial asset.³⁷ So, the first goal underlined by the International Accounting Standards Board in the exposure draft about impairment methodology and in the official IFRS 9 documentation is to recognize expected credit losses during and over the life of financial assets.

As mentioned in the page 4 of the abstract realized from *PricewaterhouseCooper (PwC)*, “*In depth: A look at current financial reporting issues*”, the accounting standards IFRS 9 underline “[...] *the application of the expected credit loss model to:*

- *investments in debt instruments that are measured at amortized cost;*
- *investments in debt instruments that are measured at fair value through other comprehensive income (FVOCI);*

³⁶ European Financial Reporting Advisory Group, “*Impairment of Financial Assets – The Expected Loss Model*”, December 2009, Paragraphs 1-10

³⁷ European Financial Reporting Advisory Group, “*Impairment of Financial Assets – The Expected Loss Model*”, December 2009, Paragraphs 24-30

- *all loan commitments that are not measured at fair value through profit and loss;*
- *financial guarantees that are not measured at fair value through profit and loss;*
- *lease receivables.*”³⁸

The IAS Board defines in the IFRS 9 the credit losses as “*the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive.*” These credit losses are defined in relation to possible future events (known as default events) that could affect the life and the nature of financial instruments. In this way entities have to analyze and to estimate possible risks to worst events that could influence the value of financial instruments by decreasing dramatically.

The accounting standards IFRS 9 individuate three main stages of impairment process that describe the deterioration of financial instruments over time:

1. Stage 1: *12 Month Expected Credit Loss;*
2. Stage 2: *Significant Increase in Credit Risk;*
3. Stage 3: *Credit Impaired Assets.*

The second and the third stages are also known as “*Lifetime Expected Credit Losses*”. These three stages are connected in relation to the credit quality of financial assets: financial assets that present a high credit quality are collocated in 12 Month Expected Credit Loss thanks to their low level of credit risk. As soon as financial assets present the initial deterioration of credit quality that becomes significant and there is an increase of the credit risk (where the Stage 2 takes the name), the financial instruments are collocated in the second stage. But the deterioration could become more significant over time and it could reach a level that affects completely the financial assets. This high deterioration brings to credit losses, called *lifetime expected credit losses* and financial assets become *credit impaired assets*, collocated in Stage 3.

In Stage 1, named *12 Month Expected Credit Loss*, the accounting standards consider all types of financial assets that have not suffered significant losses in terms of value over time. In fact, in this phase of the impairment process, the Board considers the financial assets that have two main characteristics:

- financial assets still present a high and important credit quality that is significant for their nature;

³⁸ PricewaterhouseCooper, “In depth: A look at current financial reporting issues”, 2014, pages 1-4

- if, however, financial assets begin to register a little impairment of their credit quality, for remaining in Stage 1 it is necessary to maintain a low level of credit risk.

In this stage, banks and entities have to measure the expected credit losses within a time horizon of about 12 months; in this way, they also calculate interests of financial assets measured at amortized cost by using the effective interest rate method and by considering all the losses of the analyzed instruments.

When financial assets have to be evaluated over time, the instruments could present an increase in the credit risk that results significant and this increase induces banks and entities to classify them in the second phase of impairment process, characterized by “*significant increase in credit losses*”. The main characteristic of financial assets that are considered in this stage (Stage 2) is the decrease of the level of the credit quality and the major impairment of credit risk that sets the instrument in an even lower level.

As mentioned in the previous stage, banks and entities have to measure the expected credit losses but within a different time horizon: in this case the time horizon goes until the maturity of the financial instrument in order to cover it for its entire life. The measurement of expected credit loss is, also in this case, done by applying the effective interest method on the amortized cost of the financial asset and it considers all its losses.

All the financial instruments that flow in the last stage, Stage 3, known for the classification of *credit impaired assets*, are characterized by the suffering of a significant loss of value that is associated to a loss in terms of credit quality and a deep increase in terms of credit risk. So, these financial assets are affected by the major loss.

The expected credit loss is measured by considered a time horizon until its maturity. The difference from the previous stage (Stage 2) is that banks and entities measure interests by applying the effective interest rate method on the amortized cost of the instruments.

The following table, Table 8, summarizes the deterioration stages of financial assets explained in the previous paragraphs. This summary is extracted from the document “*Exposure Draft ED/2013/3 – Financial Instruments: Expected Credit Losses*” (March 2013) written by the International Accounting Standard Board,).

Table 8 – Three Stage of Expected Credit Loss Model

Stages	Description
--------	-------------

Stage 1 – 12 Month Expected Credit Loss	This stage considers financial instruments that have not significant deterioration in credit quality since initial recognition or that have low credit risk level at the reporting data. 12-month expected credit losses are measured and recognized and interest revenue is calculated on the gross carrying amount of the asset. ³⁹
Stage 2 – Significant Increase in Credit Risk	This stage considers financial instruments that have registered a significant deterioration in credit quality since initial recognition but they don't have evidence of a significant credit loss event. It is recognized, for these instruments, the lifetime expected credit loss (a time horizon until their maturity) and interest revenue is calculated as in the previous stage: on the gross carrying amount of the asset. ⁴⁰
Stage 3 – Credit Impaired Assets	The last stage combines financial assets that are characterized by an objective evidence of a credit loss event at the reporting date. In this stage, there is the recognition of lifetime expected credit loss, as in the second stage but interest revenue is measured on the net carrying amount of the financial asset that doesn't consider expected credit losses. ⁴¹

Source: IASB, “*Exposure Draft ED/2013/3 – Financial instruments: Expected Credit Losses*”, March 2013, page 6, Paragraph (a), (b) and (c)

³⁹ International Accounting Standards Board (IASB), “*Exposure Draft ED/2013/3 – Financial instruments: Expected Credit Losses*”, March 2013, page 6, Paragraph (a)

⁴⁰ International Accounting Standards Board (IASB), “*Exposure Draft ED/2013/3 – Financial instruments: Expected Credit Losses*”, March 2013, page 6, Paragraph (b)

⁴¹ International Accounting Standards Board (IASB), “*Exposure Draft ED/2013/3 – Financial instruments: Expected Credit Losses*”, March 2013, page 6, Paragraph (c)

In the *incurred loss model* that is described in the International Accounting Standards 39, financial assets are depreciated only when there is real evidence that financial assets will never be repaid for the total amount. The expected credit losses are only considered and registered in the balance sheet of entities when it happens a trigger event⁴² (for example endogenous or exogenous turmoil of markets, technological shake out, severe macroeconomic scenario, etc.). Auditors and analysts have found a weakness of this expected credit losses: these credit losses are recognized too late and so they lose their value.

In the following table, Table 9, there is a summary of the differences between *incurred credit loss model* and *expected credit loss model* that will be underlined in Paragraph 2.A.2.

Table 9 – Incurred Credit Loss Vs. Expected Credit Loss

INCURRED CREDIT LOSS	EXPECTED CREDIT LOSS
<ul style="list-style-type: none"> – The model is introduced and defined in the International Accounting Standards 39; – the model recognized credit losses only when the entity is affected by a negative effect that has negative influence in the future cash flows or in the balance sheet of the entity; – the entity calculates an estimate about the credit loss in relation to the probability of this negative event; – the model prohibits the consideration of the effects of expected credit losses. 	<ul style="list-style-type: none"> – The model is introduced and defined in the International Financial Reporting Standards 9; – entities and banks make continuous evaluation and recognition about expected credit losses in relation to the advent of trigger events.

In the passage from the previous accounting standards IAS 39 to the new accounting standards IFRS 9, the IAS Board proposes, in the exposure draft, a substitute model that eliminate the *incurred loss model*. As mentioned before, this model will be substituted by the *expected loss model*. There is not a standard measurement of *expected credit loss*; the

⁴² A trigger event is an event that put banks or entities in a situation of high difficulty and they have to search a solution in order to get out of the bad situation.

International Financial Reporting Standards 9 underline the guidelines that help banks and entities to adopt them in order to measure possible losses.

So, in relation to the mentioned stages of the impairment process, there are different methods to recognize the expected credit loss:

- the expected loss can be recognized at an amount equal to 12-month expected credit losses;
- the expected loss can be recognized as “*lifetime expected credit loss*”.

These two methods are related to different timing horizon in terms of recognition: the first is 12-month timing horizon and the second is until the maturity of the financial instrument or the happening of a default event. The expected credit losses until the maturity and the lifetime of the financial asset are an estimate measured in relation to the probability that possible losses could derive until the maturity of the financial instrument. When entities and banks measure an estimate of expected credit losses, it is necessary that they estimate in a realistic scenario related to its probability to happen. It is not important to find different estimates related to different probabilities but it is necessary to have an estimate that is more probable to happen thanks to information and data owned by entities.

In conclusion, the accounting standards IFRS 9 define the expected credit losses as the averaged amount of credit losses weighted by taking account the possible risks of default events. As mentioned before, entities and banks have to consider the possible scenario related to the occurring of default events.

For the measurement of the expected credit losses, it is necessary that entities and banks should consider several conditions and variables: for example, banks or entities must take into account reasonable and understandable information about past events that have affected the entity, the current financial and economic situation and the possible future forecasts about the financial and economic condition of the entity. This information is useful for measuring the expected credit losses.

The IFRS 9 implementation is seen as an improvement process for the previous accounting standards, IAS 39: the improvement is better related to the impairment process and the introduction of expected credit loss model. The new accounting standards IFRS 9 will replace the old accounting standards IAS 39, with a particular attention to the measurement of impairment losses by using the new model, the expected credit losses process.

2.A.3 - Hedging accounting

The International Accounting Standard Board published in December 9, 2010 the exposure draft about the *hedge accounting*. The purpose of the Board is to maintain the section already discussed in the International Accounting Standards 39 by continuing to distinguish the *fair value hedge* and the *cash flow hedge* in a better way in order to match it with the risk management system of entities and by improving the explanations and the illustrations of hedge accounting. These intentions of the Board are significant for banks in terms of covering risks: this leads banks and entities to introduce internal valuation models.

In the accounting standards IAS 39, the Board doesn't underline indications and characteristics about the hedge accounting in a depth way but only define the methods and the rules to apply the hedge procedure.

In the new accounting standards IFRS 9, instead, the Board has decided to pay more attention in the definition of the hedge accounting. As we can understand in the following paragraphs, the International Accounting Standards Board has tried to create a connection between the hedge accounting and the risk management of entities with the purpose to allow entities to understand easily the discussed theme by reducing its complexity and so by facilitating the application of this hedge procedure in relation to its principle-based approach.

The objective defined by the IAS Board in the new accounting standards is to represent the effect of risk management system defined by entities in their financial statements: entities use financial instruments in order to manage and control exposures that arise from specific risks (defined in the following paragraphs) that could affect the income and the revenues of entities (known as profit or loss).⁴³

Hedging is defined, in the accounting standards IFRS 9, as “[...] *an instrument that an entity or a bank uses to mitigate the risk that cannot be mitigated in a complete way. Hedging is necessary for mitigating this risk.*” Hedging is a process necessary to individuate and to find different hedging instruments that are necessary to compensate the variation of fair value or expected cash flows of the financial instrument. The hedged item is considered an asset or a liability that is affected by continuous variations in terms of fair value or expected cash flows; in this way, the banks or entities resort to the application of the hedging instrument. The hedging instrument is considered like a derivative or a financial asset or a financial liability that

⁴³ International Accounting Standards Board (IASB), “*Exposure Draft: Hedge Accounting – Comments to be received by 9 March 2011*”, Paragraph IN12

banks use for covering and compensating the variations of the hedged instrument. Hedged item and hedging instrument will be defined in the following paragraph.

The first important characteristic that the IAS Board defines on the exposure draft of the accounting standards IFRS 9 about the hedge accounting application is the definition of the instruments that are used for hedging. In its document, the Board mentions the use of any kind of derivative instruments that are measured at fair value through profit or loss. The exception identified in the IFRS 9 by the IAS Board are the same defined in the IAS 39, as net issued options. As in the IAS 39, the accounting standards IFRS 9 take into account both financial instruments and non-financial instruments. But in comparison with the IAS 39, the new standards don't consider the distinction between financial and non-financial items but pay more attention in the identification and the measurement of a risk component.

Both in IAS 39 and in IFRS 9, the definition of hedged item remains the same and “[...] *it can be considered as:*

- *a recognized asset or liability;*
- *an unrecognized firm commitment;*
- *a highly probable forecast transaction that must be highly probable; or*
- *a net investment in a foreign operation.”*⁴⁴

The hedged item must be reliably measured because entities must designate it in its entirety in a hedging relationship with the hedging instrument. As mentioned by the IAS Board in the paragraphs of “*Exposure draft: Hedge Accounting*”, it is appropriate to designate risk components as hedged items only if they are separately identifiable and reliably measurable and only if entities consider circumstances and facts that could affect them. This principle is used to relate hedge accounting with risk management system.

Instead, in the definition of hedging instruments, the IAS Board restricts the classification of these instruments in order to have a better valuation about the business risks. In the exposure draft about hedging accounting, the IASB also proposes as hedged item an aggregate exposure composed by an exposure and a derivative. In the new accounting standards IFRS 9, the Board has decided to take a different approach: it permits to define both derivatives and non-derivative financial assets or non-derivative financial liabilities⁴⁵ as hedging instruments. Derivatives are measured at *fair value through profit and loss* and, as already mentioned, are designated as hedging instruments; non-derivative financial assets or non-derivative financial

⁴⁴ EY, “*Applying IFRS: Hedge Accounting under IFRS 9*”, February 2014, paragraph 2

⁴⁵ These financial instruments are measured at fair value through profit and loss.

liabilities are, now, designated as hedging instruments and are measured at fair value through profit and loss as derivatives. In this way, as mentioned in the exposure draft, the IASB introduces non-derivative instruments (measured at fair value through profit and loss) as hedging instruments, only if they are designated in their entirety and don't bring entities to change their measurement method of financial instruments.

As mentioned in the Chapter 1 about hedge accounting, the value of hedged item is subjected to variations in relation to the recognition of possible risks. These variations are recognized in the profit or loss of financial statements of the entity or the bank. Instead, the hedging instrument continues to be measured at fair value and any possible changes are equally recognized in the profit and loss. However, in the new accounting standards, every possible variations in fair value about hedging instrument are identified in the other comprehensive income section in order not to affect the profit or loss of the entity or the bank. If changes in the hedging instrument, in terms of value, are greater or lower than changes in the hedged item, in terms of value, the Board has decided to recognize the ineffectiveness in both cases.⁴⁶ The main requirement established by the Board is that the hedging instruments and hedged items must be designated by entities and banks *in its entirety* in order to have a better and effective hedging relationship between them.

As noted in the accounting standards IAS 39, the hedging accounting rules are characterized by the relationship between the hedged item and the hedging instrument. Banks and entities focus their attention in the possible economic and financial risks that could affect their business; through their *risk management* strategies and application, they want to reduce these risks. In relation to the type of the risk, entities have different method to cover the risk; there could be non-financial risks (for example risk of theft that bring entities or banks to cover the risk though, for example, insurance policies or there could be financial risks that are seen more complex to manage. There are several categories of financial risk and the main categories are: *interest rate risk*, *exchange rate risk* or *credit risk*.

Interest rate risk is a risk that derives from the change of an investment's value: there is a change in the level of interest rates due to the spread among them. This risk can be reduced through the application of hedging accounting by applying an interest rate swap. This allows "*an exchange of future interest receipts*".⁴⁷

⁴⁶ PricewaterhouseCoopers, "*Practical guide: General Hedge Accounting*", December 2013, pages 3

⁴⁷ www.investopedia.com/terms/i/interstraterisk.asp

Exchange rate risk is another type of risk that could affect companies and banks: this risk derives from the fluctuations of the exchange rate related to foreign transactions or foreign economic relations among entities or banks. The risk is related to the obtained cash flows deriving from the foreign transactions that don't compensate the liabilities at domestic currency.

Credit risk is the risk where the debtor is not able to fulfill, also in part, its obligations in terms of credit. Credit risk can be a risk of default or a risk of recovery. This type of risk is considered in the evaluation of a financial instrument in relation to the stages of hedge accounting procedure.

In the IAS 39 documentation, the risk analyzed by the IAS Board could affect the financial situation of entities and banks and is the exchange rate risk; instead, with the introduction of the international accounting standards IFRS 9, as mentioned in the previous paragraphs, the Board decides to consider other categories of risk, as *credit risk* or *interest rate risk*.

As mentioned in IFRS 9 exposure draft, the main purpose of the IAS Board is to introduce new hedge accounting rules and to incorporate, in this application, new requirements and improvements. In the exposure draft of the hedge accounting, the Board defines its object as “*the representation of the effect of an entity’s risk management activities that use financial instruments to manage exposures arising from particular risk that could affect profit or loss or other comprehensive income.*”⁴⁸

This introduction is necessary for the Board in order to establish and to manage the risk management system of entities and banks in relation to the financial instruments. Financial instruments are used by entities and banks for regulating risks that could affect the business of entities or banks and their profit or loss. The Board also decides to reduce the complexity to apply this phase in the financial statements of entities and banks.

The hedge accounting application is important for banks because it helps them to analyze and correctly understand the impact of possible risks that could affect their business in relation to the applied risk management strategies. The IAS Board notices the limitations of the hedge accounting expressed in the accounting standards IAS 39 and for this reason it introduces new requirements:

⁴⁸ International Accounting Standard Board (IASB), “Exposure draft of IFRS 9: Hedge Accounting”, 2016, paragraph 6

- *the Board has decided to associate the hedge accounting with the risk management system; so, the hedge relationship is designated to be aligned with the risk management strategies;*
- *the hedge is effective if banks and entities achieve offsetting changes in terms of fair value and cash flows;*
- *the effectiveness of the hedge is the necessary criteria for having an effective hedge relationship and must be reliably measured.*

In November 19, 2013, the International Accounting Standards Board publishes a new version of *Part 3 – Hedge Accounting* where it considers the steps for improving the application of this complex section. In the issued press release, the IASB announces the introduction of the new hedge accounting procedure associated “*[...] together with corresponding disclosures about risk management activity. The changes to hedge accounting and the associated disclosures were developed for helping preparers of financial statements in relation to the difficulty of appropriately reflecting their risk management activities with the hedge accounting. The new model represents a substantial overhaul of hedge accounting that will enable entities to better reflect their risk management activities in their financial statements.*”⁴⁹

In the International Accounting Standards 39, the Board identifies three types of hedging process: the *fair value hedge*, the *cash flow hedge* and *hedge of a net investment in a foreign operation* that is especially defined in the International Accounting Standards 21.

As mentioned in the Chapter 1, the *fair value hedge* is a hedge created for the coverage of the risk referring to the variations and the changes in the current value of an asset or a liability: these variations could have effect in the revenues of the considered bank or the considered entity. Instead, the *cash flow hedge* is another type of hedge that is necessary for the coverage of the risk referring to the variability of the future cash flows. These expected cash flows are designated by entities as future instruments necessary for the payment of debts. As for the fair value hedge, the variability could have impact in the income of the entity. The third type of hedge is designated in the *hedge of a net investment in a foreign operation* that is analyzed in the IAS 21. As mentioned in that accounting document, “*an entity with many foreign operations could be exposed to a number of foreign currency risks. The accounting standards*

⁴⁹ International Accounting Standard Board (IASB), “IFRS Press Release”, November 2013, Pages 1-2

*IAS 21 provide guidance on identifying the foreign currency risks that qualify as a hedged risk in the hedge of a net investment in a foreign operation.”*⁵⁰

In the passage from the International Accounting Standards 39 to the International Financial Reporting Standards 9, the IAS Board has decided to maintain these three categories of hedges that characterize hedging accounting procedure in the new accounting standards IFRS 9 by changing and improving them.

The first hedge defined by the IASB in the new accounting standards remains the *fair value hedge*. This type of hedge accounting is characterized by the change in terms of fair value of an asset or a liability; this change is related to a particular risk that could affect the financial situation of the entity or the bank (profit or loss). The variation could derive from changes in interest rates or foreign exchange rates.⁵¹

The second hedge that has been underlined in the International Accounting Standards 39 and caught again in the International Financial Reporting Standards 9 is the *cash flow hedge*.⁵² This method is connected to the changes in the fair value of an asset or a liability or a forecast transaction in term of cash flows and this variation could affect, as in the fair value hedge, the profit or loss of the financial statements of entities and banks.

Any changes of the value in the hedged item is correlated with changes of the value in the hedging instrument. If changes in the hedging instrument are greater than changes in the hedged item, the entity or the bank has to recognize the ineffectiveness of the hedging accounting. Instead if variations in the hedging instrument are lower than variations in the hedged item, there is not the recognition of the ineffectiveness.⁵³

The third hedge reported in IFRS 9 is *hedge in a net investment in a foreign operation*⁵⁴. This model is applied in order to control the currency risk referring to the assets of foreign

⁵⁰ International Financial Reporting Interpretations Committee, “*Hedges of a Net Investment in a Foreign Operation*”, 2008, pages 3-4

⁵¹ International Accounting Standards Board (IASB), “*Exposure Draft: Hedge Accounting - Comments to be received by 9 March 2011*”, pages 25-29, “[...] Fair value hedge is a hedge of the exposure to changes in fair value of a recognized asset or a recognized liability or an unrecognized firm commitment or a component of any such item, that is attributable to a particular risk and could affect profit and loss.”

⁵² International Accounting Standards Board (IASB), “*Exposure Draft: Hedge Accounting - Comments to be received by 9 March 2011*”, Pages 25-29, “[...] Cash flow hedge is a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognized asset or a recognized liability or a highly probable forecast transaction and could affect profit or loss.”

⁵³ PricewaterhouseCoopers, “*Practical guide: General Hedge Accounting*”, December 2013, pages 3-4

⁵⁴ The hedge of a net investment in a foreign operation is defined and discussed in the International Accounting Standards 21.

operations. Exchange differences that derive from these foreign operations are recognized in profit or loss (active or passive differences). Instead, the foreign currency gains or losses related to the hedging instrument is recognized in the other comprehensive income. With the passage from the accounting standards 39 to the accounting standard 9, the IASB hasn't carried other changes or improvements.⁵⁵

Following the International Accounting Standards 39, the IAS Board defines the hedging accounting as an optional treatment. Therefore, in one hand, entities and banks are not obliged to apply the hedge accounting procedure; in the other hand, they can apply the accounting method by making hedging operations. These operations are necessary to cover the imminent risks and banks or entities have to associate the hedge accounting procedure with the risk management but it is difficult for them due to the rule-based structure of the IAS 39.

Another difficulty recognized in the accounting standards 39 is the inability to cover specific components of non-financial items. Another problem found by the IAS Board is the difficulty to create sets of hedged item because of the multiplicity of criteria to follow. For assembling hedge items, it is necessary that are similar, with similar level of risk and similar level to be affected. In this way, many hedged items cannot be designated in a specific hedging group although they have real and clear links.

With the introduction of International Accounting Standards IFRS 9 - Financial instruments, entities and banks prefer to use and not to do unless about hedge accounting because every entity could be exposed to business risks (interest rate risk, credit risk, exchange rate risk, etc.) that derive from operations and transactions. As mentioned before, these risks could have impact in the cash flows of entities and consequently in their profit or loss. In this way, the IAS Board has made decisions and amendments in order to improve the control and the hedge of these risks. First, in the new accounting standards, the IAS Board has decided to use a valuation model where instruments are measured at amortized cost or fair value. Entities and banks prepare their financial statements and consequently, it is necessary to use hedge accounting in order not to have mismatches in the valuation model. Furthermore, hedge accounting and its procedure are necessary for entities in order to hedge future cash flows that are not recognized in the financial statements yet. In this way, the hedge accounting is used to represent the effects of management activities in relation to the particular and possible risks that could affect and have a potential impact in the financial statement of entities.⁵⁶

⁵⁵ PricewaterhouseCoopers, "*Practical guide: General Hedge Accounting*", December 2013, page 5

⁵⁶ Ambrogio Virgilio, "*La contabilizzazione delle relazioni di copertura: possibili impatti dallo IASB*", May 2011, pages 159-162

For hedge accounting, it is necessary that exists a relationship between eligible hedged items and eligible hedging instruments. In 2012, the new accounting standards stabilize requirements for the effectiveness criteria that is important of this relationship, as mentioned in the paragraphs of the exposure draft of IFRS 9 – Financial instruments: “[...]”

1. *the Board comprehensively reviewed the hedge accounting requirements in IAS 39 and replaced them with the requirements in IFRS 9;*
2. *the hedge accounting requirements in IFRS 9 have the purpose to align hedge accounting more closely with risk management system that results in more useful information to users of financial statements. The requirements also establish a more principle-based approach than the rule-based approach of the IAS 39 and notices inconsistencies and weaknesses in the hedge accounting model in IAS 39.*
3. *The Board doesn't address specific accounting for open portfolios or macro hedging as part of the general hedge accounting requirements in IFRS 9. The Board has discussed proposals for accounting for open portfolios and macro hedging.*⁵⁷

One of the main requirements that characterizes hedge accounting procedure is the hedge effectiveness that is necessary for having an appropriate hedging relationship between a hedged item and a hedging instrument. This effectiveness is defined in the accounting standards IAS 39 with an offset linear to the range of 80-125 per cent: in fact, the accounting standards IAS 39 stabilize that an hedged item is effective if its compensation is near to the limit range of about 80-125 per cent. Instead, with the introduction of new accounting standards, the Board has decided to eliminate this range in order to have more freedom in the relationship and to strengthen the relation between the hedge accounting and the risk management strategies.

The effectiveness becomes one of the main pillars of hedge accounting and the Board stabilizes that a hedging relationship between hedging instrument and hedged item has to reach the hedge effectiveness assessment in order *to limit and minimize expected hedge ineffectiveness* and to reach *optimal offsetting*. It is possible that the hedging relationship is not compensated equally and for having a better hedge effectiveness assessment, entities and banks can rebalance the hedging relationship in order to reach its objective.⁵⁸ The meaning of

⁵⁷ International Accounting Standards Board (IASB), “*IFRS Financial Instruments: Hedge Accounting*”, December 2010, Chapter 6, paragraph IN8

⁵⁸ International Accounting Standards Board (IASB), “*Exposure draft: Hedge Accounting - Comments to be received by 9 March 2011*”, Paragraph IN23-IN26: Hedge effectiveness requirements to qualify for hedge accounting and Rebalancing of a hedging relationship

hedge effectiveness and hedge ineffectiveness is defined, in the Appendix B of the exposure draft “Hedge Accounting” as “[...] *the extent to which changes in fair value or cash flows of the hedging instrument offset changes in fair value or cash flows of the hedged item (when the hedged item is a risk component, the change in fair value or cash flows of an item is attributable to the hedged risk). Hedge ineffectiveness is the contrary and is defined as the extent to which there is no such offset or changes in fair value or cash flows of the hedging instrument are greater than those on the hedged item*”.⁵⁹ As defined in this appendix of the exposure draft, hedge effectiveness become for entities and banks a method to qualify and evaluate hedge accounting process.

In conclusion, as underlined by the International Accounting Standards Board and in the previous paragraphs, for having a better hedging relationship between the hedged item and the hedging instrument it is necessary that hedge accounting is related to the risk management strategy and its activities. In this way entities individuate and decides which items have necessity to be hedged.

2.B – Differences between International Accounting Standards 39 and International Financial Reporting Standards 9

The processing and the realization of the new accounting standards IFRS 9 have the purpose to substitute and to help entities and banks in the preparation of their financial statements at the end of every financial year. The objective of the IAS Board is to simplify, as possible, these accounting standards. International Financial Reporting Standards 9 is a set of accounting standards designated by the International Accounting Standards Board that are easy to understand and to use in the financial and economic situations of entities and banks.

The main differences between International Accounting Standards 39 and International Financial Reporting Standards 9 have been exposed in the discussion papers of the new accounting standards; the following paragraphs will summarize these differences in order to underline the improvements and the changes that have been decided and applied by the Board during the realization of the accounting standards IFRS 9.

⁵⁹ International Accounting Standard Board (IASB), “*Exposure draft: Hedge Accounting – Comments to be received by 9 March 2011*”, Appendix B, Paragraph B27-B31

Firstly, the Board has noticed that the previous accounting standards IAS 39 was a rules-based set of reporting standards that defines rules for accounting and reporting financial instruments. The accounting standards IFRS 9, instead, is known as a principle-based set of accounting principles that uses a simplified classification and measurement criteria for evaluating financial assets and financial liabilities. In this way, for classifying and measuring financial instruments it is important to consider and to satisfy two main conditions: it is necessary to consider the business model individuated by entities and banks and financial instruments are characterized by contractual cash flows.

Another important discordance between the accounting standards IAS 39 and IFRS 9 is related to the classification and its categories. As mentioned in Chapter 1, the Board individuated in IAS 39 four categories necessary to classify financial assets: *financial assets classified at fair value through profit and loss* or *financial investments held to maturity* or *loans and receivables* or *financial assets available for sale*. In IFRS 9, the Board has identified two main macro classification categories related to their measurement method: *financial assets measured at amortized cost* or *financial assets measured at fair value (that are divided in two categories: financial assets measured at fair value through other comprehensive income or financial assets measured at fair value through profit and loss)*. The following table, Table 10, summarizes the classification differences of IAS 39 and IFRS 9:

Table 10: Classification differences of IAS 39 and IFRS 9

INTERNATIONAL ACCOUNTING STANDARDS 39 (IAS 39)	INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS 9)
1) <u><i>Financial assets classified at fair value through profit and loss</i></u> : financial assets that are held for trading and, after its initial recognition, continue to be measured at fair value through profit and loss.	1) <u><i>Financial assets measured at amortized cost</i></u> whose objective is to collect contractual cash flows by holding these financial assets.
2) <u><i>Financial investments held for trading</i></u> : non-derivative financial assets that are characterized by fixed and determinable payments and entities want to hold them until their maturity.	
3) <u><i>Loans and receivables</i></u> : non-derivative	2) <u><i>Financial assets measured at fair value</i></u> :

financial assets that are characterized by fixed and determinable payments (as the previous category) but are not quoted in an active market.	- <i>through other comprehensive income</i> whose purpose is to collect contractual cash flows and to sell by holding these instruments but not until its maturity;
4) <i>Financial assets available for sale</i> : the remaining non-derivative financial assets that are available for sale and are not classified in the previous three categories.	- <i>through profit and loss</i> that are not used to collect contractual cash flows or to sell financial instruments (as derivatives).

As it regards, instead, the classification of financial liabilities, IAS 39 defines two main categories: *at fair value* and *at amortized cost* by using the *effective interest method*. IFRS 9 prefers to classify and to measure, generally, financial liabilities at *amortized cost* or at *fair value through profit and loss*.

In relation to the classification of financial assets and financial liabilities, it is important to underline that in IAS 39, the International Accounting Standards Board permits entities and banks to reclassify financial instruments because of the several classification categories. In fact, entities or banks have, initially, classified financial instruments in the wrong category and after a closer inspection, they notice that financial instruments present characteristics more similar to another category than to the initial category.

In IFRS 9, instead, the IAS Board doesn't permit to reclassify financial assets, in particular when entities or banks make a selection in order to classify them; the lonely situation where the Board permits the reclassification is when entities and banks changes their business model that constitutes one of the main requirements for the classification of financial assets and financial liabilities. The Board, instead, doesn't permit to reclassify financial liabilities without considering any possible and particular situations.

Beside the reclassification, entities and banks have the possibility to derecognize financial assets if the derecognition respects the following requirements: *the contractual rights related to cash flows from financial assets are expired or are going to expire* or *there is a transfer of a financial assets that is qualified as derecognition*. This process is permitted in the accounting standards IAS 39 but the Board also permits this procedure in the accounting standards IFRS 9. In particular, in the new accounting standards, the IAS Board specifies that the transfer of financial assets brings to the transfer of all risks that trouble financial instruments.

These are the main recognized differences of the Part 1 – *Classification and Measurement* between the past represented by the accounting standards IAS 39 and the future represented by the accounting standards IFRS 9.

In the Part 2 – *Impairment methodology*, the IAS Board adopts two different methods in the accounting reporting IAS 39 and in the accounting reporting IFRS 9.

In IAS 39, entities and banks have to assess financial assets at the end of each reporting period if they present impairment. In this way, entities or banks must calculate the eventual impairment loss that represents the difference between “*the carrying amount of the financial asset and the present value of expected credit losses less the effective interest rate*”. This impairment loss is, then, recognized in the financial statement, in profit or loss section. The adopted impairment method is known as *incurred credit losses model*.

The accounting standards IFRS 9, instead, establish another type of impairment methodology in another way. Firstly, the IAS Board recognizes future expected credit losses that are not considered in the previous accounting standards. From this consideration, the adopted method is also known as *expected credit losses method*. There are three main stages for the calculation of expected credit losses.

Stage 1 – *12 months expected credit losses* is the phase of impairment that is considered at initial recognition where banks estimate expected contractual cash flows. If the expected cash flows are less than those in the contractual terms, these losses are immediately recognized in the profit or loss of financial statements. This stage is characterized by a high level of credit quality and a low level of credit risk that must be evaluated at each financial reporting period. If the level of credit risk remains low, financial assets continue to be impaired in the first stage and at each financial reporting period expected credit losses are evaluated by entities. Interest revenues are calculated by considering the gross carrying amount.

Stage 2 – *Significant increase in credit risk* is the phase of impairment process where entities and banks register a significant increase in the level of credit risk that is higher than the level in Stage 1 and the corresponding decrease of the level of credit quality. In this way, financial assets are recognized in the second stage; here, expected credit losses are considered and recognized in profit or loss of financial statements, as in the mentioned Stage 1. Furthermore, full lifetime expected credit losses are recognized. If the level of credit risk significantly increases but remains at the same level without having anymore increases over time, entities can decide to transfer financial assets in the previous stage with the risk that could happen sudden increases. Interest revenues are calculated on the carrying amount, as in Stage 1.

These two stages, 1 and 2, are similar phases of impairment model but the main difference between them is related to the level of credit risk.

The third stage, Stage 3 – *Credit impaired*, is characterized by the achievement of an higher level of credit risk and consequently credit risk is impaired by entities and banks. As in Stage 2, entities and banks recognize full lifetime expected credit losses at each financial reporting period. Unlike Stage 1 and Stage 2, interest revenue will be calculated on the net carrying amount that derives from the difference between the gross carrying amount and any possible impairment loss. In the following table, Table 11, the differences between IAS 39 and IFRS 9 about the impairment methodology are schematically listed:

Table 11 – Impairment methodology differences between IAS 39 and IFRS 9

INTERNATIONAL ACCOUNTING STANDARDS 39	INTERNATIONAL FINANCIAL REPORTING STANDARDS 9
<p><u><i>Incurred credit losses model</i></u>: a model where impairment losses are measured in the following calculation:</p> <p>+ <i>carrying amount of financial asset</i></p> <p>- <i>present value of expected credit losses less effective interest rate</i></p>	<p><u><i>Expected credit losses</i></u>: a model divided in three stages:</p>
	<p>Stage 1: a stage where there is a low level of credit risk, 12-month expected credit losses are recognized and interest rate is calculated on the carrying amount.</p>
	<p>Stage 2: a stage where there is a significant increase on the level of credit risk, full lifetime expected credit losses are recognized and interest revenues are calculated on the carrying amount.</p>
<p>Stage 3: a stage where credit risk achieves an higher level (credit is impaired), full lifetime expected credit losses are recognized and interest revenues are measured on net carrying amount:</p> <p>+ <i>gross carrying amount</i></p> <p>- <i>any possible impairment loss</i></p>	

In the Part 3 – *Hedge Accounting*, the accounting standards IAS 39 and IFRS 9 define the hedge accounting in similar way. International Accounting Standards no. 39 permit to use

hedge accounting process if the following main requirements, mentioned by the IAS Board, are satisfied:

- *hedge relationship is designated and related to the risk management system;*
- *the hedge is expected to be effective if entities or banks achieve offsetting changes in terms of fair value or cash flows;*
- *the effectiveness of the hedge must be reliably measured.*

After the identification of the requirements, the Board designates three main types of hedge accounting: *fair value hedge*, *cash flow hedge* and *hedged of a net investment in a foreign operation*.

If hedge accounting begins to be not clear and discontinued, it means that:

- the hedging instruments is sold or expired;
- the hedging relationship between the hedging instruments and the hedge item doesn't satisfy the effectiveness criteria;
- the bank or the entity decides not to manage hedge accounting.

Regarding the International Financial Reporting Standards 9, the IAS Board has decided to create a less complex procedure in order to manage hedge accounting of financial instruments by taking important decisions and by making changes and improvements to the procedure designated in the accounting standards IAS 39. The first change adopted by the Board is to align more closely the hedge accounting procedure with the internal risk management strategies. In respect with IAS 39, the Board has decided to eliminate the restrictions designated in the previous practice that have limited many entities and banks to appeal to hedge accounting procedure. This disposal has brought entities and banks to use more flexibly the accounting practice.

The IAS Board, also, specifies that the adoption of hedge accounting is optional but the application of this procedure helps entities and banks to reduce and to eliminate possible accounting mismatches. This practice also helps entities and banks to manage risks that could affect their financial situation: interest rate risk, credit risk, exchange rate risk and so on.

Unlike IAS 39, IFRS 9 define hedging instruments and hedged item in order to make more understandable these categories.

The common characteristic between IAS 39 and IFRS 9 is that the Boards also maintains standards the three types of hedges in new accounting: *fair value hedge*, *cash flow hedge* and *hedged of a net investment in a foreign operation*, as summarized in Table 12.

Table 12– Three types of hedges

INTERNATIONAL ACCOUNTING STANDARDS 39	INTERNATIONAL FINANCIAL REPORTING STANDARDS 9
<i><u>FAIR VALUE HEDGE</u>: is a hedge of the exposure related to changes in fair value of a hedged item that is attributable to a particular risk and could affect profit and loss.</i>	
<i><u>CASH FLOW HEDGE</u>: is a hedge of the exposure related to variability in cash flows that is associated with a particular risk of hedged item and could affect profit and loss.</i>	
<i><u>HEDGE OF A NET INVESTMENT IN A FOREIGN OPERATION</u>: is a hedge of an equity investment (a subsidiary, an associate or a joint venture) through derivatives or non-derivative contract. The changes correspond to the amount of the reporting entity's interest in the net assets of the operation.</i>	

Source: extracted definitions from “Exposure Draft: Hedge Accounting” and “IAS 21: The Effects of Changes in Foreign Exchange Rates”

Other differences underlined in the comparison between IAS 39 and IFRS 9 are related to the new requirements adopted in the accounting standards IFRS 9:

- *the hedging relationship must be between an eligible hedging instrument and an hedged item and must respect the effectiveness criteria;*
- *hedge accounting must be aligned with the internal risk management strategies in order to effectively hedge risks;*
- *the hedging relationship is anticipated to be effective throughout the life of the hedge.*

Despite the amendments, the changes and the improvements adopted by the Board in the hedge accounting section, some auditors and analysts continue to consider the IFRS 9 documentation and procedures more complex in their rules.

The official date for the introduction of International Accounting Standards 9 – Financial Instruments is on January 1st, 2018.

2.C – Conclusions

With the advent of the financial crisis that firstly affected United States and then Europe and consequently their entities and banks, the International Accounting Standards 39 began not to be linear with the financial and economic situation and the market trend. The International Accounting Standards Board has decided to introduce a new set of accounting standards by following two main requirements:

- *less complex in order to be easy to apply;*

– *more understandable in order to apply accounting standards in the better way.*

The first purpose of the IAS Board was to simplify, as possible, these accounting standards in order to help entities and banks. Consequently, the Board has decided to revise the previous accounting standards and to change and to improve specific sections. The Board proposes a revision of the various sections that constitute the accounting reporting IAS 39 by dividing the new accounting standards, International Financial Reporting Standards 9 in three parts:

- Part 1: Classification and Measurement;
- Part 2: Impairment methodology;
- Part 3: Hedge Accounting.

The Board has worked, for much time, by making specific changes and improvements for these sections, as mentioned in the previous paragraphs of Chapter 2. Firstly, the IASB has solved the problem about the classification of financial instruments by reducing the classification categories, as mentioned in Paragraph 2.A.1. and it has related the classification to the business model adopted by entities and banks. This decision has been criticized from auditors and analysts because it is difficult to individuate the correct business model.

Then, the International Accounting Standards Board has paid more attention in the impairment methodology by passing from incurred credit loss method to expected credit loss method (as mentioned in Paragraph 2.A.2). The third part has been completely revised by the IASB and the lonely part that the Board has decided to take account only the three types of hedges, mentioned in Paragraph 2.A.3.

After having postponed for different times the introduction date, the effective date has been decided for January 1st, 2018; however, the new accounting standards may be freely consulted.

Chapter 3 – Impact of International Financial Reporting Standards 9 in banks’ financial statements

The evolution of financial markets characterized by the globalization and the advent of financial crisis have conducted the European Commission to appeal to International Accounting Standards Board for creating a new set of rules, amendments, regulations, standards easy to apply and necessary for creating and preparing the financial statements of entities and banks and for guaranteeing their comparability.

3.A – Regulations and requirements

The European Commission has emanated the regulation no. 1606, approved and then published, on September 11, 2002; the Commission began with this amendment in order to create or lead to the creation of accounting standards necessary for the preparation of financial statements of banks and entities. Especially, the regulation no. 1606/2002 requires all European listed companies to prepare their balance sheet and their income statements (that constitute their financial statements) by following the International Accounting Standards or the International Financial Reporting Standards. This requirement bases its purpose in the increase of transparency and comparability of financial statements; furthermore, another objective of the Commission is to increase the efficiency of financial accounts and to improve the trend of financial markets. In other words, the regulation no. 1606/2002 requires the European listed companies (including banks and insurance companies) to create consolidated financial statements by considering IAS and IFRS accounting standards since January 1st, 2005. Furthermore, Member States have also the possibility to permit the application of IAS or IFRS to individual financial statements. After the regulation no. 1606/2002, the European Commission has introduced another amendment, the regulation no. 1126/2008, that identifies a set of accounting standards necessary for drawing up the consolidated financial statements. In this regulation, the Commission has listed all the International Accounting Standards and the International Financial Reporting Standards related to the drafting of financial reports.⁶⁰ Listed companies, banks or financial intermediaries must apply IAS and IFRS accounting standards in order:

- to protect and to increase the transparency and the comparability;
- to maintain and to increase the efficiency of financial markets.

⁶⁰ www.eur-lex.europa.eu – Regulation no. 1606/2002

The regulation no. 1606/2002 has been applied in Italy and since January 1st, 2005, EU listed companies must draw up their consolidated financial statements through the accounting standards IAS and IFRS. In section no. 5 of the regulation no. 1606/2002, the European Commission specifies the option of Member States to authorize or to oblige the use of International Accounting Standards to:

- listed companies in relation to their financial statements;
- non-listed companies in relation to their financial statements or consolidated financial statements.

In Italy, the legislature has also adopted the community law no. 306/2003 that establishes the obligation of banks or entities to adopt the International Accounting Standards in the preparation of the following types of financial statements:

- financial statements of listed companies;
- financial statements and consolidated financial statements of companies characterized by financial instruments “*widely distributed among the public subjects*”;
- consolidated financial statements of insurance companies;
- financial statements of insurance companies if they are listed companies and they don’t draw up the consolidated financial statements.

The application of International Accounting Standards and International Financial Reporting Standards is not obligatory for not-listed companies in the preparation of financial statements or consolidated financial statements; the application of these International Accounting Standards is excluded for non-listed insurance companies and for companies that use the abbreviate structure⁶¹.

Through these regulations, the European Union has decided to apply an important process of accounting harmonization in order to regulate, in an easy and understandable way, the preparation of financial statements of entities, banks, financial companies and so on. The purpose of European Union is to focus the development of financial statements to the use of International Accounting Standards (IAS and IFRS). The focus is also to guarantee a high level of comparability and transparency⁶².

⁶¹ Italian Civil Code, art. 2435-bis

⁶² The financial statements of entities or banks or financial institutions should be comparable: this means that the evaluation criteria should not be changed from a financial year to another financial year in order to make comparable the different budgets over time. The financial statements should be transparent: this means that financial statement must represent all relevant information and data necessary for their preparation and avoid misleading interpretations of these data.

The main regulations related to the preparation of financial statements of banks and financial companies are the following:

- the mentioned regulation no. 1606/2002;
- the legislative decree no. 38 emanated on February 28, 2005;
- Communication no. 262 emanated by Bank of Italy on December 22nd, 2005.

The regulation no. 1606/2002, as mentioned in the previous paragraphs, is related to the obligation of listed companies belonging to regulated markets in the European Union to draw up and to prepare the consolidated financial statements by applying the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRS). These accounting standards have been created and emanated by the International Accounting Standards Board and approved by the European Commission.

After this regulation, the legislator has decided to emanate a legislative decree, known as decree no. 38 published on February 28, 2005, in application with the previous regulations⁶³.

With the legislative decree no. 38/2005, the Italian financial system has decided to apply the obligation or the possibility to apply the International Accounting Standards or the International Financial Reporting Standards necessary for the preparation of financial statements, as mentioned in section no. 5 of the regulation no. 1606/2002. The decree has also made available the use of these International Accounting Standards to banks and financial companies that are steadily under control of Bank of Italy.

Firstly, the application of IAS and IFRS accounting standards was, only, for the preparation of consolidated financial statements of banks and financial companies; from 2006, the legislator decided also to apply these accounting standards for the preparation of financial statements. The Bank of Italy has the obligation to control and to verify the proper use of the accounting standards IAS and IFRS from banks and financial companies.

On December 22nd, 2005, the Bank of Italy emanated another communication, known as communication no. 262/2005, that obliges the financial institutions and banks⁶⁴ to follow the regulation no. 1606/2002. From this communication, the selected banks have to draw up and to prepare financial statements and/or consolidated financial statements through the application of International Accounting Standards (IAS and IFRS). The communication, also, underlines and provides significant information related to the several sections of the balance

⁶³ Regulation no. 1606/2002

⁶⁴ The financial entities considered in the communication no. 262/2005 are Italian banks, financial companies that represent parent companies of banking groups, Italian banking branched of foreign banks.

sheet, the income statement (profit and loss account), the notes and the management report. In the following years, the legislator has added other financial entities for the preparation of financial statements through the application of IAS/IFRS. On November 2009, the communication of Bank of Italy should conform with the adopted changes of several International Accounting Standards, like the changes adopted in International Accounting Standards 39.

Through the legislative decree no. 38/2005, the Bank of Italy provides the instructions and the structure for the preparation of financial statements:

1. firstly, it is necessary to prepare and to draw up the financial statements in order to be clear, easy to understand and easy to use for auditors, users, analysts and others;
2. then, financial statements must be prepared by using assumptions, procedures, accounting criteria in order to be easy to evaluate during the accounting period and to have a clear vision about the economic situation and result;
3. finally, financial statements are characterized from the following prospects:
 - a. balance sheet;
 - b. income statement;
 - c. statement about comprehensive income;
 - d. statement about changes in shareholders' equity;
 - e. cash flow statement;
 - f. notes.

The balance sheet is structured in two sections: assets and liabilities. As mentioned in Chapter 1, the International Accounting Standards 39 identify four categories of financial assets that are included in the section "Assets": financial assets measured *at fair value through profit and loss (Item 30)*, financial assets *held to maturity (Item 50)*, *loans and receivables (Item 20)* and financial assets *available for sale (Item 40)*.⁶⁵ In this section, the International Accounting Standards also consider hedging derivatives (*Item 80*) that are financial derivatives or credit derivatives used for hedging operations which have positive fair value. Related to this item, any possible negative or positive variations of the value of financial assets that are submitted to hedging accounting are recognized in *Item 90*. In the second section, "Liabilities", there are two categories of financial liabilities: financial liabilities measured *at fair value through profit and loss (Item 50)* and financial liabilities measured *at amortized cost (Item 40)*. There are, also, in this section hedging derivatives (*Item 60*) that are financial derivatives or credit derivatives which have negative fair value. As mentioned for the section "Assets", *Item 70*

⁶⁵ Balance Sheet – Sections: Assets and Liabilities

recognizes possible negative or positive variations of financial liabilities classified in IAS 39 that are submitted to hedging accounting.

In the following table, Table 13, the Bank of Italy summarizes the financial institutions, banks and entities that are obliged to pass from National Accounting Standards to International Accounting Standards and International Financial Reporting Standards:

Table 13 – Passage from National Accounting Standards to International Accounting Standards and International Financial Reporting Standards

Types of Entities	Preparation of financial statements	Preparation of consolidated financial statements
Banks and financial institutions	In 2005 these entities could adopt International Accounting Standards (IAS-IFRS) but from 2006 they are obliged to apply them.	From 2005 they are obliged to adopt International Accounting Standards (IAS-IFRS), as underlined in the regulation no. 1606/2002).
Listed companies that issue financial instruments	In 2006 these companies could adopt International Accounting Standards (IAS-IFRS) but from 2006 they are obliged to apply them.	From 2005 they are obliged to adopt International Accounting Standards (IAS-IFRS), as mentioned in the regulation no. 1606/2002).
Insurance companies	This type of entities is obliged to adopt International Accounting Standards (IAS-IFRS) if they are not listed and they don't draw up financial statements,	From 2005, it is obligatory to adopt International Accounting Standards (IAS-IFRS).
Other entities that prepare consolidated financial statements	From 2005 this type of entities could adopt and apply International Accounting Standards for the drawing up of financial statements and consolidated financial statements.	
Other entities that don't have to prepare consolidated financial statements	From 2005 these entities have the possibility to adopt and to use International Accounting Standards.	
Other companies that use the abbreviated structure to draw	These companies have not to adopt these International	From 2005 they could adopt International Accounting

up financial statements or not-listed insurance entities	Accounting Standards (IAS-IFRS).	Standards.
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As mentioned in the previous table, all the obligations are related to the regulation no. 1606/2002. With the introduction of International Accounting Standards and International Financial Reporting Standards, for the preparation of financial statements of banks and other entities, it has been introduced a new measurement criteria of financial assets and financial liabilities: *fair value method* that is identified as “*the amount for which an asset could be exchanged or a liability could be settled between knowledgeable, willing parties in an arm’s length transaction*“, as mentioned in paragraph 9 of International Accounting Standards 39 (IAS 39.9).

Another organization, the European Securities and Markets Authority (ESMA), has issued its evaluation about the implementation of International Financial Reporting Standards 9. The ESMA confirms that the accounting standards IFRS 9 will replace many parts of the previous accounting standards IAS 39 by modifying the classification and the measurement of financial assets and financial liabilities and by establishing a new impairment model, known as “*expected credit losses model*”. New requirements have been introduced in the new accounting standards but in the meantime, these rules will be not applied yet in the financial statements of banks and financial institutions. The ESMA has established that the introduction and the following implementation of IFRS 9 accounting standards will have a significant and an important impact for banks and financial institutions; instead, other entities (for example small companies) will be not hit from this introduction and as mentioned by the EBA, “[...] *can also benefit from the new requirements adopted for the hedge accounting from the International Accounting Standards Board*”. This is due to the association of risk management system that entities implement in their structure with the hedge accounting rules. The ESMA organization has decided to analyze and to better estimate changes in the new accounting rules and the policies adopted in the accounting standards IFRS 9. It analyzes the impacts on the banks’ financial statements; the impacts depend on the date and the composition of financial instruments and portfolios. For having a good implementation of IFRS 9, the Authority has driven to a high-quality process: it has launched a guidance for having a better application of impairment process and an evaluation of credit risks that will characterize financial situations of banks and financial institutions. In its surveys, the objective of European Securities and Market Authority is to provide better, understandable

and clear instructions, rules and information necessary for implementing the accounting standards IFRS 9.⁶⁶

3.B – Implementation of IFRS 9: European Banking Authority assessments

With the realization and the introduction of the new accounting standards *International Financial Reporting Standards 9*, the International Accounting Standards Board needs to understand if banks, financial institutions and entities have correctly applied these accounting standards internally and if they have problems during the implementation. With the introduction of these accounting standards, the IAS Board has introduced and applied a set of several changes, especially for financial institutions: the European Banking Authority (EBA) and the International Accounting Standards Board (IASB) have adopted improvement procedures for banks necessary for having a better classification and measurement system for financial instruments and they have implemented the transition from *incurred credit loss model* to *expected credit loss model*. For these reasons, on January 2016, the European Banking Authority has decided to conduct an evaluation testing exercise related to the implementation of accounting standards IFRS no. 9 in order to understand their impact in the financial statements of banks and financial institutions. For conducting this procedure, the EBA has considered a sample of about 50 financial institutions and has focused its attention in order:

- to understand, in a better way, the positive or negative impacts in the implementation process of IFRS 9;
- to understand the interaction of IFRS 9 with financial statements of banks and financial institutions considered in the sample;
- to understand the way in which financial institutions and banks are implementing the new accounting standards, IFRS 9.

From the point of qualitative aspects, in the considered sample of 50 financial institutions, the EBA considers both smaller banks and larger banks: in respect to larger banks, smaller financial institutions have spent more time in the implementation of IFRS 9 due to the lack of resources necessary for this process. In the survey published on 10 November 2016, “*Report: on results from the EBA impact assessments of IFRS 9*”, the European Banking Authority believes that for the introduction of IFRS 9 accounting standards in banks and financial

⁶⁶ European Securities and Markets Authority (ESMA), “PUBLIC STATEMENT - *Issues for consideration in implementing IFRS 9: Financial Instruments*”, 10 November 2016, Paragraphs 1-25

institutions, it is necessary to involve the departments within them (auditors and board of directors): this collaboration is done for better implementing the new accounting standards.⁶⁷ From the point of quantitative aspects, the European Banking Authority has conducted a preliminary procedure in order to obtain estimates related to the impact of accounting standards IFRS 9. These estimates are related to the classification and measurement phases and the impairment methodology explained in the sections of International Financial Reporting Standards 9. During the implementation of new accounting standards, the impact observed by European Banking Authority is influenced from the business model that is chosen and decided internally by banks and financial institutions and from how financial statements are composed. These estimates procedure, as mentioned before, are the first preliminary EBA testing exercise: in fact, the banking authority has planned that will conduct further exercises, as a second testing exercise, in order to have reliable and accurate estimates, data and information about the impact of IFRS 9. This second stage of the testing exercise will be implemented when banks and financial institutions have already introduced and put into effect the accounting standards IFRS 9 with their accounting methodologies and their financial statements structure⁶⁸.

The European Banking Authority conducts a testing exercise that consists in a set of 34 qualitative questions and a set of quantitative questions. Qualitative questions are “[...] related to:

- a) *International Financial Reporting Standards 9: the project, the status and the governance;*
- b) *Classification and Measurement;*
- c) *Impairment methodology: the requirements of expected credit loss model;*
- d) *Hedge accounting;*
- e) *Regulatory own funds;*
- f) *Others.*”⁶⁹

Instead, the quantitative questions are related to estimates of financial statements’ data and an analysis of changes on the banking financial statements: there is an analysis of the impact on

⁶⁷ European Banking Authority, “*Report: On result from the EBA impact assessments of IFRS 9*”, 10 November 2016, pages 4-6

⁶⁸ European Banking Authority, “*Report: On results from EBA impact assessments of IFRS 9*”, 10 November 2016, pages 7-10

⁶⁹ European Banking Authority, “*Report: On result from the EBA impact assessment of IFRS 9*”, 10 November 2016, pages 16-26

the balance sheet of banks from the point of view of classification and measurement phase and impairment phase.⁷⁰

These sets of qualitative and quantitative questions have been applied at the reference date, on December 31st 2015, except for some smaller banks that participate to the testing exercise. A sample of 58 banks and financial institutions are requested to answer about qualitative and quantitative questions and to provide significant and relevant information and data in order to understand the impact during the application of IFRS 9 in the financial statements. To do this procedure, banks and financial institutions must change the accounting standards from IAS 39 to IFRS 9 in order to implement the new accounting standards no. 9.

When the European Banking Authority began the testing exercise, some of banks' respondents were at the *initial phase* of the implementation where they began to identify classification and measurement section and impairment methodology because they were lagged in the application of IFRS 9. Instead, a small set of banks have already implemented these accounting standards and are at the *building phase*. The testing survey conducted by EBA is related to the two stages, the *classification and measurement* and the *impairment methodology*. For the third stage, banks and financial institutions are requested to continue to apply the hedge accounting explained in the IAS 39 because the International Accounting Standards Board prefers to work a little bit in order to make the hedging section most simply. So, the IAS Board with the agreement of EBA, IFRS Foundation and other organizations has decided not to apply IFRS 9 hedge accounting rules and explanations.

More than 50% of banks and financial institutions that have answered to qualitative and quantitative survey are classified, as mentioned in the European Banking Authority, "*in a design phase*" in the implementation of the classification and the measurement of financial instruments and the impairment methodology; these banks are mainly smaller banks that have "[...] *the lack of historical data and capabilities, limited IT and human resources.*" The EBA, also, has individuated larger banks that are in an advanced step for the implementation of the accounting standards IFRS 9.

In relation to the implementation of new accounting standards, the sample of 58 banks and financial institutions have to answer to the mentioned questions but at the same time they have to provide information and data that are relevant and necessary to have a complete vision about the impact of IFRS 9.

⁷⁰ European Banking Authority, "*Report: On result from the EBA impact assessments of IFRS 9*", 10 November 2016, paragraphs 16-26

3.B.1 – Qualitative questions

At the qualitative point of view, in its financial survey, the European Banking Authority wants to receive information from the surveyed banks and financial institutions about:

- in which phase they are involved in order to introduce and to implement the IFRS 9;
- in which way they are facing the implementation.

As mentioned before, a part of 58 respondents is in the initial phase of this process: in fact, they are introducing the first steps of classification and measurement phase and of impairment methodology. Instead, a small part of surveyed banks and financial institutions is in the next advanced step that permits banks to apply, deeply, the accounting standards IFRS 9 to their financial statements.

In the passage from International Accounting Standards 39 to International Financial Reporting Standards 9, the changes adopted by the International Accounting Standards Board haven't had a relevant and a significant impact on the major part of 58 surveyed banks and financial institutions and on their financial statements because the IAS Board has decided to reduce the classification categories of financial assets from 4 to 2 classes while the classification categories of financial liabilities remain the same. The methods necessary to measure financial assets and financial liabilities remain almost the same: the Board has adopted two main measurement methods: amortized cost and fair value. It is necessary, however, to say that “[...] *many banks have not finalized IFRS 9 classification and measurement [...]*” to their financial statements and so, they will have the real impact only when IFRS 9 accounting standards are implemented.⁷¹

The European Banking Authority has observed in its survey that the changes applied by the International Accounting Standards Board in the classification and measurement of financial instruments have not had a significant impact on banks' financial statements because this section depends on the business model chosen by banks and financial institutions and on their financial products that they own. With the new accounting standards IFRS 9, the IAS Board has decided not to permit the reclassification, only in limited and specific cases, as mentioned in Chapter 2. In the EBA survey, banks and financial institutions have analyzed possible reclassification that are not prohibited in the previous accounting standards IAS 39.

⁷¹ European Banking Authority, “*Report: On result from the EBA impact assessment of IFRS 9*”, 10 November 2016, paragraphs 39-42

In the second stage of financial instruments, there is the application of impairment methodologies: in the European Banking Authority analysis, banks and financial institutions are at the initial phase of the application and the development of impairment methodologies: they have to implement and to use the important and significant data and information necessary to the application of new accounting standards.

The EBA has stabilized a set of guidelines, policies and methods necessary to implement in a correct and a high-quality way: these guidelines are designated for banks and financial institutions that should apply the new impairment model, the *expected credit losses model*. As mentioned by the EBA, this model depends on three main factors:

- 1) the type of exposure;
- 2) the materiality of exposure;
- 3) the stage at which the exposure is classified under IFRS 9.

3.B.2 – Quantitative questions

The European Banking Authority also conducts quantitative questions in order to estimate the effective impact that derives from the implementation of IFRS 9 in the financial statements. The introduction of new accounting standards IFRS 9 has a significant impact in the classification and the measurement of financial instruments and in the impairment methodologies.

The financial statements of banks and financial institutions are characterized from financial instruments; through the analysis of banks' situations, their balance sheets are characterized by loans and receivables and debt securities. Loans and receivables are owned by the majority of surveyed banks and financial institutions: firstly, these financial instruments are measured at *fair value* (FVTPL category⁷²) and banks and institutions continue to measure them through this method. But, through the implementation of IFRS 9, loans and receivables are classified and measured at amortized cost. For debt securities, banks and financial institutions are requested to measure them at amortized cost. In addition to loans and receivables and debt securities, there are, also, equity instruments that are measured at FVOCI category⁷³ (as decided in IAS 39) but with the implementation of IFRS 9 these instruments could be measured at FVTPL category.⁷⁴

⁷² Fair Value Through Profit and Loss

⁷³ Fair Value Through Other Comprehensive Income

⁷⁴ European Banking Authority, "Report: On result from the EBA impact assessment of IFRS 9", 10 November 2016, paragraphs 73-76

The index CET 1, known as *Common Equity Tier 1*, is an index necessary for measuring the strength of banks or financial institutions, especially after the 2008 financial crisis that hit the financial banking system. This capital ratio is the ratio of banks' equity capital related to its risk-weighted financial assets. With the introduction and the implementation of the new accounting standards IFRS 9, from the quantitative point of view, the CET 1 ratio is estimated “to decrease on average by 59 bps”, as mentioned in the study conducted by EBA and published on November 11, 2016. In the mentioned survey, the European Banking Authority also measures the *Total Capital ratio* that is the ratio between the banks' equity capital and loans that banks and financial institutions have guaranteed to their customers, weighted with their risks. Besides of CET 1, the European Banking Authority estimates that the Total Capital Ratio is expected “to decrease on average by 45 bps”.

In the surveyed document published by EBA on November 2016, the authority also conducts and estimates the impact of impairment rules and methodologies during the implementation of IFRS 9. In the quantitative questions delineated by EBA, banks and financial institutions have provided quantitative data necessary to estimate, as possible, the new impairment model (the *expected credit losses model*). As for the classification and the measurement of financial instruments, the EBA also estimates and measures *CET 1 ratio* and *Total Capital ratio*: CET 1 index is expected to decrease “on average by 75 bps” and this decrease hits 85% of surveyed banks and financial institutions. The same decrease is estimated for the Total Capital Ratio but it will have a lower impact due to the *excess of accounting provisions* of IFRS 9.⁷⁵

The analyzed estimates that are explained in the previous paragraphs, are summarized in the following table, Table 14: these data are extracted and explained from the European Banking Authority in its financial document, “*Report: On result from the EBA impact assessment of IFRS 9*” (November 2016). In the following table, the EBA uses specific measures and, as explained in its document, specifies them:

- *median* is of 75th percentile of surveyed banks and financial institutions referred to the upper limit of a range selected from the survey;
- *mid of estimated range* is the value between the lowest and highest values within a bank's estimated range of impact;
- *weighted average* is calculated on the basis of the percentage of the total assets under IAS 39 of each bank to the sample: this average is calculated on *conservative estimation* that is

⁷⁵ European Banking Authority, “*Report: On result from the EBA impact assessment of IFRS 9*”, 10 November 2016, paragraphs 77-86

the highest value within a bank's estimated range of impact and on the *mid of estimated average*.

Table 14 – Summary of IFRS estimates

ESTIMATED INCREASE OF PROVISIONS OF IFRS 9*	
Median	20%
Mid of estimated data	18%
Weighted Average of Conservative estimation in range	26%
Weighted Average of estimated data	21%

*expressed in %

ESTIMATED IMPACT OF CET 1 RATIO IN THE IMPLEMENTATION OF IFRS 9*	
	TOTAL IMPACT OF IFRS 9
Median	-50
Mid of estimated data	-59
Weighted Average of Conservative estimation in range	-55
Weighted Average of estimated data	-42

*expressed in bps

ESTIMATED IMPACT OF CET 1 RATIO IN THE IMPLEMENTATION OF IFRS 9: Classification and Measurement and Impairment*		
	Classification and Measurement	Impairment
Median	-25	-50
Mid of estimated data	-59	-59
Weighted Average of Conservative estimation in range	-55	-55
Weighted Average of estimated data	-42	-42

*expressed in bps

ESTIMATED IMPACT OF TOTAL CAPITAL RATIO IN THE

IMPLEMENTATION OF IFRS 9*	
	TOTAL IMPACT OF IFRS 9
Median	-25
Mid of estimated data	-45
Weighted Average of Conservative estimation in range	-43
Weighted Average of estimated data	-30

*expressed in bps

ESTIMATED IMPACT OF TOTAL CAPITAL RATIO IN THE IMPLEMENTATION OF IFRS 9: Classification and Measurement and Impairment*		
	Classification and Measurement	and Impairment
Median	-25	-25
Mid of estimated data	-45	-45
Weighted Average of Conservative estimation in range	-43	-43
Weighted Average of estimated data	-30	-30

*expressed in bps

Source: European Banking Authority, “*Report: On result from the EBA impact assessment of IFRS 9*”, 10 November 2016

After having conducted the survey in a sample of 58 banks and financial institutions and having collected information and data, the EBA has decided to launch another exercise necessary to have a better and understandable vision about the implementation of IFRS 9.

3.C – Impacts of International Financial Reporting Standards 9: Classification and Measurement

The new requirements of the first section, “*Classification and Measurement of Financial Instruments*”, that are underlined in the International Financial Reporting Standards 9, focus on two main classes of classification and measurement of financial assets and financial liabilities:

- 1) the classification and measurement process of debt instruments depends on the chosen business model of banks or financial institutions and on the test results obtained in the SPPI (*Solely Payment of Principal and Interest*) test;
- 2) the classification and the measurement phase of equity instruments is done *at fair value through profit and loss* (FVTPL), unless the case where banks or financial institutions prefer to adopt the FVOCI method (*fair value through other comprehensive income*) in order to classify and to measure financial instruments held for trading.

For the two distinguished classes, the classification and the measurement of financial instruments are based, mainly, on the business model: for defining precisely what it means, it is necessary to distinguish two main and important categories of financial instruments:

- 1) *loans portfolios* that is a set of loans issued by a lender, assembled together with other types of loans and sold at a secondary time through the “*securitization process*”⁷⁶. In this case, the business model is unique and is referred to held to collect;
- 2) *securities portfolios* whose business model attribution should be related to the management level of banks or financial institutions; these portfolios should have homogenous management standards for financial instruments in order to have a direct link with the organizational structure of banks or financial institutions.

As mentioned in Section B4 - Paragraph 1.2.C of the financial document “*International Financial Reporting Standards 9 – Replacement of IAS 39*”, the International Accounting Standards Board defines financial assets that are *held to collect* (HTC) by considering the business model chosen by banks or financial institutions: “[...] *Financial assets that are held to collect are related to the business model and are held to realize financial cash flows by collecting interest and capital throughout the life cycle of considered financial instruments. It is necessary to consider the frequency, the value and the timing of previous sales, the reasons and future expectation in terms of sales. But sales are not the main instrument necessary for determining the business model but previous sales and future expected sales are important information necessary for the determination of main object of entities and banks: this purpose is based on the management of financial instruments and it pays attention on the realization*

⁷⁶ Definition of securitization: “*Securitization is a financial process through which a bank or a financial institution or an entity or a company creates a set of financial instruments, as loans portfolio, for several characteristics (time remained for the conclusion of the loan, the level of risk, etc.) and consequently the sale of these financial instruments create liquidity.*”

of financial cash flows.”⁷⁷ So, previous sales and future expected sales of financial assets or financial liabilities should be linear and compatible with the business model of financial instruments that are *held to collect*. Before to associate sales transaction with the decision of business model, banks and financial institutions should consider specific factors as:

- the level of credit risk;
- the frequency of sales transactions in relation to the level of credit risk;
- the importance of sales transactions for determining the business model;
- the maturity of financial instruments.

In the Section B4 - Paragraph 1.4.B of the published documentation IFRS 9, there is an explanation of financial instruments that are *held to collect and to sell*: “[...] *In the business model of financial instruments held to collect and to sell, sales and, consequently, contractual cash flows are a significant part for the determination and the achievement of the purpose of business model chosen by banks and financial institutions. However, there is no threshold for the frequency and the importance of financial instruments.*”⁷⁸ Possible examples of the business model of financial instruments *held to collect and to sell* could include the following cases:

- a financial institution that holds financial assets in order to satisfy daily cash requirements;
- an insurance institution that holds financial assets in order to cover, as possible, eventual liabilities that derives from insurance contracts;
- a financial entity that assigns a financial asset or a set of financial assets which constitutes a portfolio to the chosen business model in order to manage it and to achieve its purpose.

The observed frequency of sales of financial assets that are *held to collect and to sell* in a chosen business model is more than the frequency of sales of financial assets that are only *held to collect* in a specific business model. It is possible that the frequency of sales of financial assets can affect a part of financial assets’ portfolio and consequently it is possible to separate these financial assets in sub-portfolio.

In addition to the mentioned business model, other financial assets are held from banks or financial institutions in relation to other types of business model: in this case they are

⁷⁷ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9 – Replacement of IAS 39*”, Section B4, Paragraph 1.2.C

⁷⁸ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Section B4, Paragraph 1.4.B

measured *at fair value through profit and loss* (as for equity instruments). This category includes financial assets' portfolios that:

- are managed and held in order to obtain and to realize financial cash flows through sales;
- are measured and evaluated at fair value;
- are available for sale and held for trading; they are classified in the HFT category (*Held for Trading* financial assets).

As mentioned in the International Financial Reporting Standards 9, contractual cash flows are significant but not essential for the achievement of the purpose of the chosen business model of banks and financial institutions.⁷⁹

The business model is uniquely identified in the commercial product level. Any eventual changes with regards to the chosen business model should create a new product and should attribute a new business model.

In the following table, Table 15, there is a summary of various types of business models that banks and financial institutions decide to apply, linear with owned financial instruments or financial assets' portfolios.

Table 15 – Types of Business Model

Types of Financial Assets' Portfolios	Types of Business Model
Investment debt financial assets	Held to Collect method (HTC)
Marketable debt securities	Held to Collect and to Sell method (HTC&S)
Investments (considered with Other Comprehensive Income exercise)	Other Comprehensive Income method (OCI)
Investments (without Other Comprehensive Income exercise)	Fair Value through Profit and Loss method (FVTPL)
Trading financial assets	Held for Trading method (HFT)
Others	Fair Value Option for accounting mismatches Fair value method

As mentioned in the previous paragraphs of this Section, the International Financial Reporting Standards 9 have introduced new requirements for the classification and the measurement of financial instruments. These requirements suggest the following categories:

⁷⁹ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Section B4, Paragraph 1.5

- for debt instruments, the classification is done by following the business model (*Held to Collect or Held to Collect and to Sell*) or the results obtained in the SPPI test which will be discussed in Section 3.C.1. Financial instruments can be measured *at amortized cost* or *at fair value (through profit and loss or through other comprehensive income)*;
- for equity instruments, the classification and measurement are done *at fair value through profit and loss* (FVTPL) or *through other comprehensive income* (FVOCI).

A financial asset could be measured at amortized cost and this measurement happens if the following conditions are satisfied:

- the financial asset is held within a business model “*Held-to-Collect*” whose goal is to hold the financial instrument in order to collect the contractual cash flows;
- the contractual terms of the financial asset provide an amortization plan characterized by specific dates and the contractual cash flows are only the payment of principal and interests.⁸⁰

An entity has also to classify financial liabilities that are measured at amortized cost, except of the following categories:

- financial liabilities measured *at fair value through profit and loss* (FVTPL);
- financial liabilities that come from the transfer of a financial asset without the use of de-recognition phase;
- financial guarantee contracts;
- financial liabilities that are commitments deriving from the provision of a loan at a lower interest rate.⁸¹

According to IFRS 9, financial assets and financial liabilities are measured at amortized cost in the same way required in the previous accounting standards IAS 39. The new accounting standards IFRS 9 also introduces the concept of “*gross carrying amount*” that represents the amortized cost before the adjustment on the “*loss allowance*”. At initial recognition, the gross carrying amount or the amortized cost of financial instruments are equal to the fair value of financial instrument added or less transaction costs.⁸² For calculating the amortized cost of a financial asset or a financial liability and for recognizing interests on the basis of the *effective*

⁸⁰ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Section 4, Paragraph 1.2

⁸¹ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Section 4, Paragraph 2.1

⁸² International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Appendix A

interest rate method, banks or financial institutions must determine the effective interest rate and individuate the changes in expected cash flows. Through the gross carrying amount, the accounting standards IFRS 9 adopt an approach necessary to calculate interests and separate them from credit losses.

In addition to the amortized cost, such as in the International Accounting Standards no. 39, the International Financial Reporting Standards no. 9 have introduced the method of *effective interest rate* (EIR) that is calculated by applying the gross carrying amount of financial assets, unless financial assets that are credit-impaired or are not initially credit-impaired but become later.⁸³ The effective interest rate method is a method that discounts estimated future cash flows, payments and receipts throughout the life of the financial instrument. The effective interest rate is the interest rate that derives from the sum of gross carrying amount used for financial assets and the amortized cost used for financial liabilities. The EIR is calculated at initial recognition of financial assets or financial liabilities at the original interest rate; for each financial period, the bank or the financial institution must apply the gross carrying amount for financial assets and the amortized cost for financial liabilities relative to the previous reporting period to the EIR calculation. As mentioned in Appendix A of International Financial Reporting Standards 9, the estimates relative to expected cash flows should consider all possible contractual terms, without taking into account expected losses: in this way, the contractual cash flows should not be reduced by the amount of expected losses. In addition to consider the carrying amount and the amortized cost, the bank or the financial institution should also consider these following elements:

- commissions that derive from financial assets (creation or acquisition of financial assets);
- commissions that derive from financial liabilities (creation or acquisition of financial liabilities);
- commitment fees that the bank or the financial institution receive in order to originate a loan if the loan commitment is not measured *at fair value through profit and loss*. These fees are considered as a compensation for the continued involvement to the acquisition of the financial instrument.

⁸³ From “*International Financial Reporting Standards 9: Replacement of IAS 39*”: For financial assets that are credit-impaired, the bank or the financial institution has to apply the effective interest rate to the adjusted amortized cost of the financial assets at the initial recognition. Instead for financial assets that initially are not credit-impaired but become later, the bank or the financial institution has to apply the effective interest rate on the basis of the amortized cost of the financial assets in subsequent reporting periods.” Section 5, Paragraph 4.1

The gross carrying amount can be modified in relation to the expected cash flows: this process is often known as “*modification without de-recognition*”⁸⁴. In case of modification or re-negotiation of contractual terms, the bank or the financial institution must verify and check if the new determined contractual terms are significantly different from the original terms, in qualitative and quantitative terms. This check is significant in order to involve or not the de-recognition process. If the changes don’t involve the de-recognition, the accounting standards state the following conditions:

- the gross carrying amount is calculated again by taking into account the new contractual cash flows; differences between the re-calculated gross carrying amount and the previous gross carrying amount are recognized in the income statement of the bank or the financial institution and costs or expenses incurred in the “*modification without de-recognition*” are included in the new contractual cash flows and amortized over the remaining life of the financial instrument;
- significant increase in credit risk is evaluated by taking into account the *default risk* at the reporting date (based on the modified contractual terms) and the *default risk* at the initial recognition (based on the original contractual terms).⁸⁵

Therefore, banks or financial institutions will have affected their income statements due to the differences deriving from the modified carrying amount and the original carrying amount and the changes on credit risk.

3.C.1 – Analysis of SPPI test

The “*Solely Payment of Principal and Interest*” test, known as SPPI test, has been explained in Chapter 2 with the explanation of new accounting standards IFRS 9. According with these accounting standards, banks and financial institutions have to analyze the main characteristics of contractual cash flows in order to be linear with the business model that they have chosen and to verify the correct application and the respect of SPPI test. This analysis is necessary in order to control and to recognize contractual cash flows that could lead to failure of SPPI test.

⁸⁴ In case of derecognition, the bank or the financial institution consider the modified financial instrument as a new financial product because the previous instrument is cancelled. Therefore, this implies the application of accounting requirements and rules at initial recognition. The economic effects that derives from the derecognition process are given by the difference between the carrying amount at the date of derecognition and the obtained compensation.

⁸⁵ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Section 5, Paragraph 4.3-4.5

The SPPI analysis is explained in the paragraphs of the financial document, “*International Financial Reporting Standards 9 – Replacement of IAS 39*”: firstly, an entity should assess if contractual cash flows are solely payments of principal and interest on the principal amount with the currency in which the financial asset is measured.

Leverage is a contractual cash flow characteristic that owns some types of financial assets. This characteristic is translated for financial assets as the variability of contractual cash flows and this means that financial assets will not have economic characteristics of interest. Some example of financial assets with the leverage characteristics are *stand-alone option*, *forward contracts* and *swap contracts*. If a financial asset contains a section where could change the timing or the amount of the contractual cash flows, it is necessary to determine if the contractual cash flows of the financial asset represent solely payments of principal and interests of the outstanding principal. This case happens when, for example, the financial assets can be repaid before the maturity or if the maturity date may be extended. So, it is necessary that banks or financial institutions conduct an evaluation process in order to understand the variation of contractual cash flows. Another example is when a bank or a financial institution decides to reset a financial instrument with a specific interest in order to put the interest rate at a higher level because the debtor doesn’t comply several payments: contractual cash flows are seen by banks or financial institutions as solely payment of principal and interest of the outstanding principal due to the non-payments of debtor and the increase of credit risk.⁸⁶

If, instead, a financial instrument is an investment in specific assets or specific financial cash flows, contractual cash flows are not only the solely payment of principal and interests on the outstanding principal. This could be the case of creditors that are limited with specific assets or specific financial cash flows of debtor, also known as “*non-recourse debt*⁸⁷”. If a financial asset is non-recourse, it is not necessary to apply SPPI test steps but it is recommended to banks and financial institutions to analyze assets and contractual cash flows in order to

⁸⁶ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Section B4, Paragraph 1.7-1.10

⁸⁷ A “non-recourse debt” is a type of loan that is protected by a collateral guarantee: if the debtor fails in its payments, the creditor (a bank or a financial institution) can recourse to the collateral guarantee without asking any other compensation to the debtor. This process guarantee the creditor to use the collateral guarantee in order to cover the owned debt.

determine and classify if contractual cash flows of the financial asset represents the solely payment of the principal and interests on the outstanding principal.⁸⁸

If a financial instrument is subordinated to other financial instruments, the instrument could have contractual cash flows that are solely payments of principal and interest; if the debtor fails the payment by violating the contractual terms, the creditor can request the unpaid amount of principal and interest. This requirement is applied if the financial instrument is not covered by collateral guarantees or if the debtor has acquired unsecured loans that give anyway the right of the creditor to receive the amount that the debtor fails to pay.⁸⁹

Examples of contractual conditions that lead to rise of contractual cash flows represent solely payments of principal and interests of the outstanding principal:

- a variable interest rate that represents the compensation for the time value of money, the credit risk associated with the residual capital credit; the compensation for the credit risk can be determined at the initial recognition;
- a contractual requirement that allows the debtor to repaid a debt instrument in advance or permits the creditor to ask the repayment of a debt instrument before the maturity date that represent the non-paid total amount of principal and interests of the outstanding principal;
- a contractual requirement that permits the debtor or the creditor to extend the contractual term of a debt instrument and this creates contractual cash flows that represent solely payments of principal and interest on the outstanding principal.⁹⁰

In the following Table, Table 16, there are some examples of financial instruments in a financial banking contest with the implementation of International Financial Reporting Standards 9 and the application of SPPI test.

Table 16 – Examples of financial instruments with IFRS 9 application in a financial banking contest

Examples of financial instruments	Application of SPPI test
Bonds at a current currency (Euro) which	With these financial instruments, there is the

⁸⁸ International Accounting Standards Board (IASB), “International Financial Reporting Standards 9: Replacement of IAS 39”, Section B4, Paragraph 1.16-1.17

⁸⁹ International Accounting Standards Board (IASB), “International Financial Reporting Standards 9: Replacement of IAS 39”, Section B4, Paragraph 1.19

⁹⁰ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Section B4, Paragraph 1.11

<p>have the ability to convert payments of cash flows of principal and/or interests to another currency (US Dollar) at a fixed exchange rate</p>	<p>option to convert payments from a current currency (Euro) to another currency (US Dollar) at a predefined exchange rate. This option has a negative influence with the SPPI test that fails. This failure happens because the bank or the financial institutions assumes the risk of variations of exchange rates and this risk is not consistent with the assumptions and the requirements of IFRS 9 in terms of SPPI test: the time value and the credit risk.</p>
<p>Loans considered at a specific currency (for example US Dollar) whose payments are based on the EURIBOR indexes⁹¹.</p>	<p>These financial instruments are not consistent with the chosen currency and this inconsistency consequently causes the failure of SPPI test because the time value of the reference currency is not remunerated. There is a misalignment of currencies.</p>
<p>Loans at “zero rates” that are an agreement between a final consumer and a dealer that facilitate the sale of his products through interest-free rates loans (known as TAEG 0%).</p>	<p>With these financial instruments, the bank or the financial institution receives the remuneration of these loans through the payment of bank commissions from the dealer. In this case the SPPI test can pass or can fail. If the bank fees that are paid by the dealer are proportional with the length of the loans and the credit risk of the bank, the SPPI test goes well. Instead, if the bank fees are not proportional with the time value and the credit risk, the SPPI test fails completely.</p>

⁹¹ From EURIBOR website, “it.euribor-rates.eu”: “EURIBOR indexes are known as Euro Interbank Offered Rates and are a set of rates that are used 40 European financial banking institutions that are necessary for doing interbank exchange operation in Euro. [...] EURIBOR indexes are seen that are necessary to be applied for financial instruments that are characterized from interests’ payments (saving deposits and mortgages, and so on). There are 8 different indexes.”

Loans at a specific currency (for example Euro) at a fixed rate with the application of inflation index (provided by ISTAT). The currency is related to the inflation rate.	In this case the SPPI test passes because the reference currency (Euros) is aligned with inflation index (provided by ISTAT) and the index remunerates the time value.
Loans at another currency, as US Dollar, at a fixed exchange rate with the application of inflation index (provided by ISTAT). The currency is not related to the inflation rate.	In this case, instead, the SPPI test fails due to the missing alignment between the reference currency (US Dollar) and the inflation index (provided by ISTAT). So, the time value is not remunerated and there is a risk of exchange rate.
Unilateral changes of interest rates in relation to loans that state possible unilateral changes of interest rates applied by bank ⁹² .	The SPPI test is compliant if the changes adopted by the bank is linear with risk elements admitted by IFRS 9 (increase of credit risk, increase of operating costs and administrative costs); if these elements are not linear, the SPPI test fails.
Loans with an interest rate like NASDAQ or price of gold	In this case, interests are measured in relation to prices (as NASDAQ or price of gold) that are not linear with the requirements of SPPI test.
Loans provided by banks or financial institutions that expect the increase of the spread if there is an increase of EBITDA index or there is the sale of strategic assets of the counterparty.	Loans are debt instruments and these instruments are characterized by payments of interests from the debtor. The payment of interest involves to take the credit risk from the bank that releases the loan. If the increase of the spread or the sale of strategic assets compensates the credit risk taken by the bank at a higher level, the SPPI test passes.

⁹² From art. 18 2.bis of Banking ACT (TUB): “*If the customer is not a consumer or a micro-company [...], in contracts different from permanent contracts [...], the bank can insert clauses, expressly approved by the customer, that underline the possibility to change interest rates if specific events and conditions happen.*”

By summarizing, the implementation of International Financial Reporting Standards 9 introduces, in the financial statements of banks and financial institutions, the concept of *business model* for the classification of financial assets and financial liabilities. The International Accounting Standards Board lists, in the accounting standards IFRS 9, the possible business models:

- 1) *held-to-collect* (also known as HTC);
- 2) *held-to-collect-and-to-sell* (also known as HTC&S);
- 3) *others*.

For classifying financial assets and financial liabilities through “*held-to-collect*” or “*held-to-collect-and-to-sell*” business model, the IAS Board prescribes the application of SPPI test for financial instruments: this test is done in order to understand whether these instruments are consistent with the “*basic lending arrangement*”. This means basic loan transactions that involve only the reimbursement of principal and interests.

The IAS Board’s goal is to define a fully operational model for implementing the SPPI test and consequently for distinguishing financial instruments between loans and securities portfolio. The SPPI test is a fully operational test that should be performed firstly, prior the classification and the measurement. So, there are two cases:

- 1) in case of loans, the application and the execution of SPPI test happens before the approval phase of these financial instruments;
- 2) in case of securities, the application and the execution of SPPI test happens before the negotiation phase.

In the first case, there is the *origination* phase where the bank creates loans and the *post-origination phase* where existing loans are modified. For having a precise and correct execution of SPPI testing model, it is necessary to distinguish the financial instruments (loans) in the following way:

- *standard products*: these are standard contracts that are applied to standard customers; for loans that are categorized here, the execution of SPPI model is an obligatory step necessary during the creation of the standard products. The SPPI test could pass or fail and the result is an important parameter for approving the standard products. If SPPI test fails, the condition adopted in the standard product will be changed and improved in order not to permit another failure. Once the changes are made, it is necessary to identify them in order to associate SPPI test outcomes to each applied change.
- *non-standard products*: these are contracts different from the previous products due to the bargaining power. These contracts can be distinguished in two more other categories:

- 1) tailor-made contracts: contracts that come through the *one-to-one trading* and for which they haven't the obligation to apply the SPPI test. With the implementation of the new accounting standards IFRS 9, the execution of this test will become one of the most important parameters necessary for approving the products and their characteristics.
- 2) contracts characterized by standard products that have had several changes: contracts that are created firstly in the standard category but then have suffered several changes that have not been identified before. These instruments become non-standards contracts and the SPPI test becomes obligatory. If the outcomes of the SPPI test remain the same after changes, it is necessary to return to the standard contract without the applied changes. If, instead, the SPPI test obtains another outcome, the bank or the financial institution can add changes with the previous identified changes or can create a new product/financial instrument.

In addition to the origination phase, banks or financial institutions can apply changes in loans (post-origination phase) and consequently it is necessary, as mentioned in IFRS 9, to control the results obtained in the SPPI test.

As for loans, the International Financial Reporting Standards 9 have applied the previous considerations also for securities.

In addition to the application of SPPI test, the International Accounting Standards Board introduces another test in the new accounting standards 9: the *benchmark test*. The new accounting standards IFRS 9 require banks and financial institutions to analyze the contractual cash flows of financial instruments and its characteristics based on *held-to-collect* or *held-to-collect-and-to-sell* business model: this analysis is important in order to verify the correct application of SPPI criteria (as known "Solely Payment of Principal and Interests). For this reason, the IAS Board has decided to introduce the benchmark test that is designated to assess the significance of the monetary value of time value of financial instruments. The benchmark test must be conducted for each financial instrument by considering the appropriate information at the initial recognition and by considering the differences found between the financial instrument and the benchmark instrument at the reporting period and the entire duration of the analyzed financial instrument.

3.D – Impacts of International Financial Reporting Standards 9: Impairment methodology

The accounting standards IFRS 9 state, in the second part, the impairment methodology that is implemented in the financial statements of banks, financial institutions and entities. At each reporting date, banks or financial institutions or entities must close the reporting exercise of the considered year and must make estimates of the losses. These estimates are done thanks for the introduction of the new impairment model explained in the IFRS 9 sections: the *expected credit losses model* that can be applied for all financial assets that are evaluated and measured at *amortized cost* or at *fair value through other comprehensive income*. In addition to these financial instruments, the accounting standards also includes:

- commitments and guarantees that are not measured at fair value through profit and loss;
- receivables for leasing activities (regulated in the accounting standards IAS 17);
- trade receivables (regulated in the accounting standards IFRS 15);
- hedged financial assets.

But the accounting standards IFRS 9 don't include, in the application of impairment methodology, equity instruments that are evaluated at *fair value through other comprehensive income* (FVOCI) and financial liabilities.

At each balance sheet reporting date, the bank or the financial institution or the entity has to measure the possible impairment of financial instruments based on:

- 1) the *12-months "Expected Credit Losses"* (Stage 1); or
- 2) the *Lifetime "Expected Credit Losses"* if since the initial recognition, the credit risk of the considered financial instrument has increased significantly (Stage 2-3).

The passage from a stage to another stage is related to the aggravation of credit situation.

The accounting standards IFRS 9 focus on the recognition of expected credit losses related to financial instruments for the impairment process. The financial instruments must report significant increases in credit risk from their initial recognition but it could happen that the credit risk is not increased significantly and consequently banks or financial institutions should adopt the impairment process at Stage 1, known as *12-months Expected Credit Losses*. Therefore, the expected credit losses are recognized when there is an increase of credit risk after the initial recognition, regardless of whether a financial instrument has had changes or is credit-impaired at the balance sheet reporting date. A change in credit risk since the date of initial recognition depends on the *default risk* at the initial recognition date. A variation of default risk will have a higher impact for financial instruments that have a lower level of

credit risk, respect of financial instruments with a higher level of credit risk. Furthermore, a default risk of financial instruments will have a higher impact if the lifetime of the financial instrument is high: for example, the default risk of a financial instrument, as a bond with rating AAA that have 10 lifetime years, has a higher impact than a financial instrument, as a bond with rating AAA that have 5 lifetime years.⁹³ The bank takes into account the characteristics of the financial instruments and the trends of default risk during the lifetime of the financial instrument.

As mentioned in the previous paragraphs, at each balance sheet reporting date, banks or financial institutions should assess if since the initial recognition, the credit risk of a financial instrument has increased its level significantly. The impairment model is a symmetric model that is divided in three stages/steps, mentioned in Chapter 2. The financial assets can passage from a stage to another: from 12-months Expected Credit Loss to the Lifetime Expected Credit Loss or the contrary.

In the International Financial Reporting Standards 9, the IAS Board states that banks and financial institutions must take into account the variations of default risk in order to determine the possible increases of credit risk. For determining and defining the concept of default risk, it is necessary that the bank should associate the default risk with the definition used by the internal risk management. Under the implementation of the accounting standards IFRS 9, the IAS Board advises banks to allocate the definition of default risk in order to reach estimating models; precisely, the purpose is to adopt a definition that is consistent with the financial situation and aligned with the definition adopted in credit risk model in the Basilea frameworks.

For having a correct vision about an increase in default risk, the bank must consider the starting values of default risk in absolute terms at initial recognition in order to consider it significant: for example, a 2% variation of the probability of default will be more significant for a financial instrument characterized by an initial 5% of probability of default, compared to a financial instrument characterized by an initial 20% of probability of default.

The expected credit losses are considered as a set of probability-weighted estimates of credit losses (*cash shortfalls*⁹⁴) relative to financial instruments. These expected losses are related to

⁹³ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9: Replacement of IAS 39*”, Section 5, Paragraph 5.10

⁹⁴ As mentioned in the “*International Financial Reporting Standards 9: Replacement of IAS 39*”: “[...] *Cash shortfalls are credit losses that derive from the difference between*

the amount and the frequency of payments and consequently a loss can occur even if the lender expects to receive all the contractual cash flows with a different time value. For measuring the expected credit losses, banks or financial institutions should consider three main elements: the *probability-weighted amount*, the *time value of money* and *information and characteristics of financial instruments*. The IAS Board states that there isn't a unique method to measure the expected credit losses but it is necessary to have different methods in relation to the nature and the characteristics of financial instruments. After having measured the expected credit loss, banks and financial institutions should recognize the impairment loss in their income statement that corresponds to the required amount necessary to adjust the bad debt provisions.

For funding commitments, these cash shortfalls correspond to the difference between:

- the contractual cash flows that are due to the bank if the owner uses the commitment; and
- the contractual cash flows that the bank would expect to get if the loan is disbursed.

For financial guarantees or credit commitments, instead, these cash shortfalls are the difference between:

- payments necessary to reimburse the holder that goes on default; and
- possible amounts that the bank expects to receive from the owner, the debtor or other counterparties.

In conclusion, as mentioned in the explanation of impairment methodology, an important element of the impairment model, reported in the International Financial Reporting Standards no. 9, is represented by the substitution of *incurred credit losses model* and the transition to a new estimation methodology, the *expected credit losses model*. This transition has involved the introduction of important interpretations in the IFRS 9 documentation related to the credit risk. The International Accounting Standards Board has adopted a formula necessary for banks and financial institutions to calculate “Lifetime Expected Credit Losses” and “12-months Expected Credit Losses”. This formula can assume the following simplified form:

$$ECL_t = \sum_{t=1}^T MPD_t * LGD_t * EaD_t * D_t,$$

-
- *the contractual cash flows due to the bank in accordance with the contractual terms; and*
 - *the contractual cash flows that the bank expects to receive.*

These shortfalls happen even if the bank expects to be repaid in all its exposure but later than the pre-fixed date. In this way, there is the creation of an expected credit loss.”, Section 5, Paragraph 5.43

where:

- MPD (Marginal Probability Default) at time t is the probability of default at time t. This corresponds to the probability that a counterparty will default within a given time horizon;
- LGD (Loss Given Default) at time t is the loss given default at time t. This represents the extent of loss at default time or the expectation of loss, expressed in percentage terms;
- EAD (Exposure at Default) is the exposure at default or a value at amortized cost at time t and represents the exposure to default during the future lifetime of the financial instrument;
- D (Discount Rate) at time t is the discount rate from period t to the reporting date that allows to actualize the expected credit loss; and
- T (Time) is the expiration date of the financial instrument that is subject of impairment model.

For “12-months Expected Credit Losses”, through this formula, banks and financial institutions estimate the probability of default risk in the time period of 12 months. For “Lifetime Expected Credit Losses”, the bank estimates, through this formula, the probability of default among contractual cash flows in different time period in order to monitor the ongoing payments.

3.E – Conclusions

In Chapter 3, there has been an analysis of regulations, directives and requirements that the European Commission with the collaboration of International Accounting Standards Board has adopted in order to better implement the new accounting standards, International Financial Reporting Standards 9. These regulations have had an impact in the main financial banking system.

In the second part of Chapter 3, there has been an analysis of the impacts on banking contest in the classification and the measurement of financial instruments and in the impairment methodology. The IAS Board is continuously working on the section relative to the hedge accounting in order to make it more understandable and consequently to abandon the section explained in the previous accounting standards, International Accounting Standards 39.

Banks, financial institutions, entities look forward to the final application of International Financial Reporting Standards no. 9 on January 1st, 2018

Conclusions

From the introduction and the implementation of International Accounting Standards 39, in 2000s, rules and requirements adopted by the International Accounting Standards Board have received, during the following years, several criticisms that became, then, weaknesses of IAS 39. Starting from these weaknesses, the IAS Board tried to modify and to change, as possible, several parts of the accounting standards IAS 39 until it decided to collaborate with the European Commission for creating a new set of accounting standards. This new document focusses its attention in the replacement of IAS 39: in fact, the purpose is to replace in full the standards no. 39 related to the recognition and the measurement of financial instruments. Through this replacement, the International Accounting Standards Board has decided to intervene, to improve and to simplify, as possible, the rules, the disciplines and the requirements that regularize the disclosure of financial instruments.

The International Accounting Standards Board has based its works and tasks in a specific work line: simplification. In fact, the IAS Board wants to make a new set of accounting standards more understandable and more manageable: consequently, the IAS Board and the European Commission have created the exposure draft of new accounting standards, known as International Financial Reporting Standards 9. This document has allowed investors, auditors and analysts to understand easily the financial situation of entities, financial institutions and banks and it has allowed to users of financial statements to use more manageable the new accounting standards.

One of the critical points of the accounting standards IAS 39 is recognized in all its complexity to interpret and to apply the rules. Due to this complexity, over time, the accounting standards no. 39 have been modified and changed several times in order to be linear with the primary goal of the IAS Board: to make them simpler, easier to understand and to read, as possible. In addition to these characteristics, it has been necessary to adapt the accounting policies to the financial crisis that has affected and continues to affect the financial markets all over the world, since 2008. The advent of financial crisis has led the IAS Board to review several rules in the various accounting documents, including IAS 39.

The complexities that have been encountered in the reading and the application of the accounting standards IAS 39 are related to the multiple categories of classification and measurement of financial assets and financial liabilities, the difficulty in the application of the prescribed rules relating to the financial instruments, the related phases of de-recognition and

elimination of financial instruments and finally the difficulty in the application of hedge accounting rules.

In addition to these complexities, the International Accounting Standards 39 have been considered by analysts, auditors and market agents as one of the main levers which has amplified the effects of the financial crisis and the consequent contagion of financial markets around the world. Some of the main reasons is, of course, the significant use and application of fair value measurement and the optimal vision and representation of the various sections of financial statements before the advent of 2008 financial crisis. In order to adjust, as possible, this situation, it was necessary the intervention of International Accounting Standards Board and other organizations to improve, as already mentioned before, the accounting standards for having a better classification and measurement of financial instruments.

As mentioned in the chapters of the present document, the International Accounting Standards Board has published the accounting document that contains the new set of accounting standards relative to the classification, the measurement and the evaluation of financial instruments. These accounting standards are known as *International Financial Reporting Standards 9* (IFRS 9). The Board has decided to structure the accounting standards IFRS 9 as the structure of accounting standards IAS 39 that are divided in three sections:

- *Section 1: classification and measurement* of financial assets and financial liabilities. The IAS Board has published, firstly, a discussion document “*Reducing complexity in reporting financial instruments*” related to the reduction of complexities that have been found in this phase from auditors and analysts. This phase is significant and important for financial instruments because it is the first phase to apply for having a correct analysis of financial instruments. The Board has tried to analyze and to solve, as possible, the problems related to the classification and the evaluation of financial instruments by creating correct classification categories and responsive evaluation methods necessary to evaluate and to measure financial instruments. Through this analysis and financial control, the Board has, subsequently, published an exposure draft known as “*Classification and Measurement of Financial Instruments*” in which the Board manages the reduction of complexities that have been found and associated in the accounting standards no. 39. The main changes are the following:
 - a. the Board has reduced the number of classification categories and specified the measurement methods of financial assets and financial liabilities in order to avoid the incorrect allocation and measurement;

- b. the accounting standards established from IAS Board in IFRS 9 pass from rule-based to principle-based.
- *Section 2: impairment methodology* applied for evaluating the financial assets and financial liabilities. The advent of 2008 banking financial crisis has conducted many banks and financial institutions to recognize later possible losses in their financial assets or credits in terms of value. In this way, the International Accounting Standards Board has decided to modify the accounting methods and consequently the impairment process necessary to evaluate the credit risk of financial instruments. The need to recognize credit losses, due to the financial crisis, has conducted the IAS Board to pass from an impairment methodology based on the recognition of *incurred credit losses* to an impairment methodology based on the recognition of *expected credit losses*. This method allows banks and financial institutions to recognize promptly the credit risk that implies the *expected credit losses* by using future information and data. Firstly, this modification of impairment method and various changes have suffered several critics and disappointments from analysts and auditors but after having overhauled the documents relative to this section, the International Accounting Standards Board has published the optimal exposure draft relative to the impairment methodology that states three main stages necessary to measure the impairment amount:
 - a. If the impairment amount hasn't registered variations from the initial recognition, the amount is recognized in the *12-months expected credit losses*.
 - b. When, in the impairment process, the bank or the financial institution recognizes a significant increase of credit risk that brings to *expected credit losses*, the impairment amount is recognized in the *lifetime expected credit losses*. As already mentioned, this method allows to recognize promptly the expected credit losses and possible variations of credit risk related the financial instruments in their lifetime.

The IAS Board has also associated the default risk to the credit risk that helps the recognition in advance.

- *Section 3: hedge accounting* that is a procedure used by banks or financial institutions that represents, as mentioned in the draft of IFRS 9, “[...] *the effect of risk management activities adopted by the entities. These activities use financial instruments in order to manage exposures that derive from specific risks that could affect profit or loss in the financial statements.*” This means that hedging operations are operations adopted to neutralize, as possible, credit losses or losses in terms of value that have been recognized in a specific financial instrument or a group of financial instruments with a particular

risk.⁹⁵ The International Accounting Standards Board has individuated and adopted three main hedging accounting methods:

- a. *fair value hedge* that is a hedge method whose purpose is to resist to possible variations of hedged financial assets and financial liabilities in terms of fair value;
- b. *cash flow hedge* that is another hedge method whose purpose is to resist to the variations between expected contractual cash flows and initial contractual cash flow;
- c. *hedges of a net investment in a foreign operation*.

As mentioned in the previous chapters, after having changed different times the official publication and introduction of International Financial Reporting Standards 9 with the replacement of International Accounting Standards 39, the International Accounting Standards Board with the collaboration of European Commission and IFRS Foundation has fixed the official date that will be on January 1st, 2018.

Banks and financial institutions have begun the implementation phase of the new accounting standards IFRS 9 in the three main sections. During the implementation, banks and financial institutions have verified and noticed several problems due to the continuous difficulties in the application of accounting standards in financial statements. But after hard works and teamwork among analysts and auditors, the accounting standards IFRS 9 are considered as a model necessary to improve the structure of business model and to align the risk management activities in order to neutralize, as possible, the risk of losses in terms of profit and loss or of value. As mentioned in the explanation of the three sections, banks and financial institutions will classify financial assets in three categories (*held to collect, held to collect and sell, trading and other instruments*) at the initial recognition and will be not subjected to modifications (unless rare cases mentioned in Chapter 2). The impairment procedure and calculation will be applied to financial instruments that have been classified on “*held to collect category*” or “*held to collect and to sell category*”. Banks and financial institutions have, also, to define better their risk management activities and structures in order to have a better and correct hedge procedure necessary to contrast, as possible, credit losses or losses in profit/loss section of financial statements or losses in terms of value.

⁹⁵ International Accounting Standards Board (IASB), “*International Financial Reporting Standards 9 – Chapter 6: Hedge Accounting*”, IFRS Foundation, 2012, paragraphs 6.1.1 – 6.1.3

The implementation process will go ahead until there will be the entry of International Financial Reporting Standards 9 in the financial statements of banks, financial institutions and entities, fixed on January 1st, 2018.

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