

Yale University

## EliScholar – A Digital Platform for Scholarly Publishing at Yale

---

YPFS Documents

[Browse by Media Type](#)

---

7-1-2014

### International Financial Reporting Standards 9 Financial Instruments

International Accounting Standards Board (IASB)

Follow this and additional works at: <https://elischolar.library.yale.edu/ypfs-documents>

---

#### Recommended Citation

International Accounting Standards Board (IASB), "International Financial Reporting Standards 9 Financial Instruments" (2014). *YPFS Documents*. 414.

<https://elischolar.library.yale.edu/ypfs-documents/414>

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact [elischolar@yale.edu](mailto:elischolar@yale.edu).

July 2014

Project Summary

# IFRS 9 *Financial Instruments*

---

# At a glance

The IASB published the final version of IFRS 9 *Financial Instruments* in July 2014. This document provides a brief overview of IFRS 9, with an emphasis on the most recent additions and changes made in finalising the Standard.

## A single and integrated Standard

The final version of IFRS 9 brings together the classification and measurement, impairment and hedge accounting phases of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement*.

IFRS 9 is built on a logical, single classification and measurement approach for financial assets that reflects the business model in which they are managed and their cash flow characteristics.

Built upon this is a forward-looking expected credit loss model that will result in more timely recognition of loan losses and is a single model that is applicable to all financial instruments subject to impairment accounting.

In addition, IFRS 9 addresses the so-called 'own credit' issue, whereby banks and others book gains through profit or loss as a result of the value of their own debt falling due to a decrease in credit worthiness when they have elected to measure that debt at fair value.

The Standard also includes an improved hedge accounting model to better link the economics of risk management with its accounting treatment.

---

## What remains to be completed?

IFRS 9 is now complete.

The IASB has an active project on accounting for dynamic risk management. This is separate from IFRS 9.

## Mandatory effective date

IFRS 9 is effective for annual periods beginning on or after 1 January 2018.

However, the Standard is available for early application. In addition, the own credit changes can be early applied in isolation without otherwise changing the accounting for financial instruments.

---

# Project background

IFRS 9 replaces IAS 39, one of the Standards inherited by the IASB when it began its work in 2001.

Many preparers of financial statements, their auditors and users of financial statements find the requirements for reporting financial instruments complex.

The reform of financial instruments accounting was one of the areas identified in the Norwalk Agreement of 2002 between the IASB and US Financial Accounting Standards Board (FASB). As a result of this agreement, a number of projects were undertaken to eliminate a variety of differences between International Financial Reporting Standards and US GAAP.

Work on IFRS 9 was accelerated in response to the financial crisis. In particular, interested parties including the G20, the Financial Crisis Advisory Group and others highlighted the timeliness of recognition of expected credit losses, the complexity of multiple impairment models and own credit as areas in need of consideration.

The IASB has worked closely with the FASB throughout the development of IFRS 9. Although every effort has been made to come to a converged solution, ultimately these efforts have been unsuccessful.

Throughout the lifecycle of the project the IASB has consulted widely with constituents and stakeholders on the development of the new standard. The IASB has received over a thousand comment letters from stakeholders and has published six Exposure Drafts, one Supplementary Document and a Discussion Paper during this process.

The IASB has also conducted an extensive programme of outreach, including hundreds of meetings with users, preparers of financial statements and others.

The IASB has previously published versions of IFRS 9 that introduced new classification and measurement requirements (in 2009 and 2010) and a new hedge accounting model (in 2013). The July 2014 publication represents the final version of the Standard, replaces earlier versions of IFRS 9 and completes the IASB's project to replace IAS 39.

---

# Classification and measurement

# A logical approach to classification and measurement

IAS 39 contained many different classification categories and associated impairment models. Many of the application issues that arose with IAS 39 were related to the classification and measurement of financial assets.

Based on feedback received, the IASB decided that the most effective way to address such issues and improve the ability of users of financial statements to better understand the information about the amounts, timing and uncertainty of future cash flows is to replace the existing classification and measurement categories for financial assets.

Classification determines how financial assets are accounted for in financial statements and, in particular, how they are measured on an ongoing basis.

Requirements for classification and measurement are the foundation of the accounting for financial instruments.

The requirements for impairment and hedge accounting are based on that classification.

## IAS 39 Classification

- Rule-based
- Complex and difficult to apply
- Multiple impairment models
- Own credit gains and losses recognised in profit or loss for fair value option (FVO) liabilities
- Complicated reclassification rules

## IFRS 9 Classification

- Principle-based
- Classification based on business model and nature of cash flows
- One impairment model
- Own credit gains and losses presented in OCI for FVO liabilities
- Business model-driven reclassification

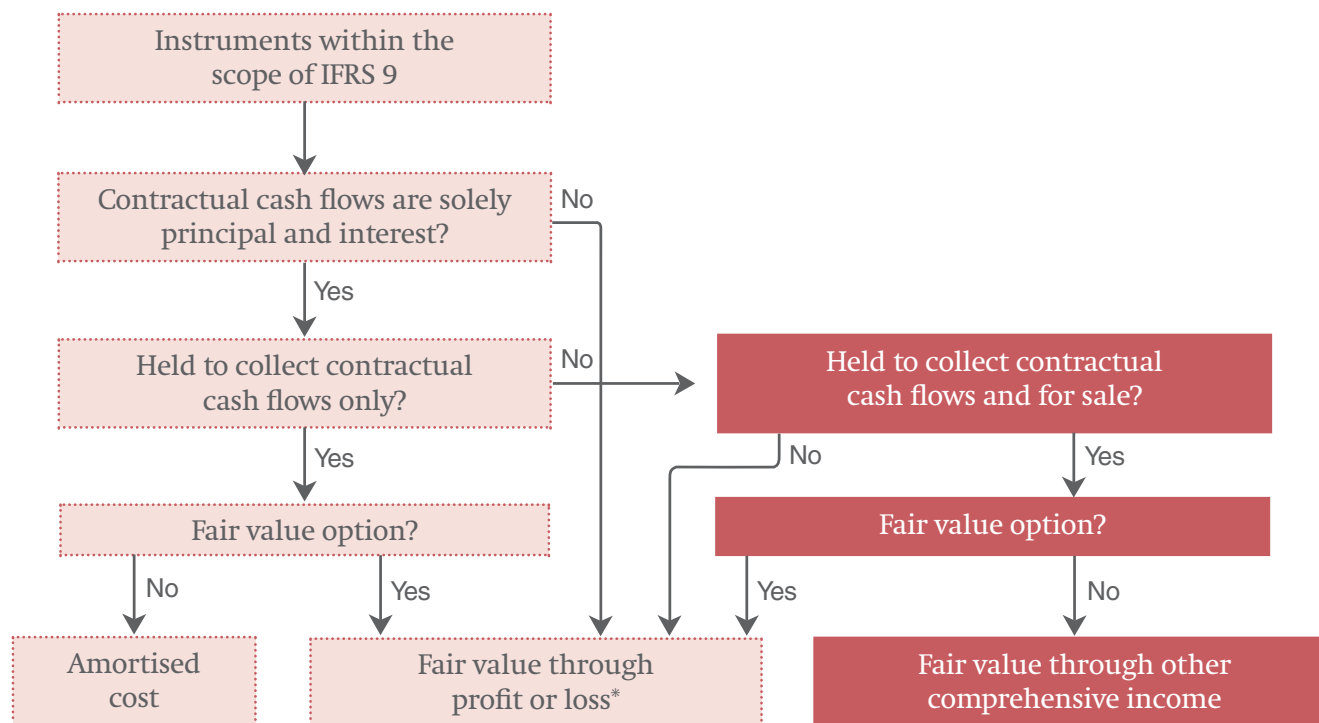
# The classification and measurement approach

IFRS 9 applies one classification approach for all types of financial assets, including those that contain embedded derivative features. Financial assets are therefore classified in their entirety rather than being subject to complex bifurcation requirements.

Two criteria are used to determine how financial assets should be classified and measured:

- (a) the entity's business model for managing the financial assets; and
- (b) the contractual cash flow characteristics of the financial asset.

## Process for determining the classification and measurement of financial assets



\* Presentation option for equity investments to present fair value changes in OCI



# Business model for managing financial assets

## What is a business model?

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.

The business model should be determined on a level that reflects how financial assets are managed to achieve a particular business objective. However, the determination is not dependent on management's intentions for an individual instrument, and should be made on a higher level of aggregation.

A business model can typically be observed through the activities that an entity undertakes to achieve its business objective. As such, a business model is a matter of fact rather than an assertion. Objective information, such as business plans, how managers of the business are compensated and the amount and frequency of sales activity should be considered. Judgement needs to be used when assessing a business model and that assessment should consider all relevant available evidence.

## What business model qualifies for amortised cost?

Financial assets at amortised cost are held in a business model whose objective is to hold assets in order to collect contractual cash flows.

The objective of this business model is unchanged in the July 2014 version of IFRS 9. To assist in application, additional guidance has however been provided.

Sales information in isolation doesn't determine the business model; however, it does provide evidence about how the business objective is achieved and how cash flows are realised. When determining whether this business model is applicable, an entity should consider past sales information and expectations about future sales activity.

Having some sales activity is not necessarily inconsistent with this business model. For example, sales that are infrequent or insignificant in value may be consistent with this business model, as are sales that occur as a result of an increase in credit risk. However, if more than an infrequent number of sales occur and those sales are more than insignificant in value, an entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

## What business model qualifies for fair value through other comprehensive income (FVOCI)?

Financial assets classified and measured at fair value through other comprehensive income are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

## Classification and measurement

---

Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and volume of sales.

Various objectives may be consistent with this business model, for example to manage liquidity, maintain a particular interest yield profile or to match the duration of financial liabilities to the duration of the assets they are funding.

This business model was added in the July 2014 version of IFRS 9. This measurement category results in amortised cost information being provided in profit or loss and fair value information in the balance sheet.

### Other business models

Any financial assets that are not held in one of the two business models mentioned above are measured at fair value through profit or loss. As such, fair value through profit or loss represents a 'residual' category. Financial assets that are held for trading and those managed on a fair value basis are also included in this category.

### Reclassification

IFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, the entity's business model for managing them changes. This is a significant event and thus is expected to be uncommon. This ensures that users of financial statements are always provided with information reflecting how the cash flows on financial assets are expected to be realised.

When reclassification is required, IFRS 7 *Financial Instruments: Disclosures* requires disclosures about such reclassifications (including the amount of financial assets moved out of and into different measurement categories and a detailed explanation of the change in business model and its effect) to ensure that users of financial statements can see clearly what has occurred.

In essence, if a financial asset is a simple debt instrument and the objective of the entity's business model within which it is held is to collect its contractual cash flows, the financial asset is measured at amortised cost.

In contrast, if that asset is held in a business model the objective of which is achieved by both collecting contractual cash flows and selling financial assets, then the financial asset is measured at fair value in the balance sheet, and amortised cost information is provided through profit or loss.

If the business model is neither of these, then fair value information is increasingly important so it is provided both in profit or loss and in the balance sheet.

## Contractual cash flow characteristics

One of the criteria for determining the classification of a financial asset is whether the contractual cash flows are solely payments of principal and interest (SPPI). Only financial assets with such cash flows are eligible for amortised cost or fair value through other comprehensive income measurement dependent on the business model in which the asset is held.

Often it will be readily apparent whether contractual cash flows meet the SPPI criteria but sometimes closer analysis is required. IFRS 9 now provides more extensive guidance on SPPI. Importantly, it has been clarified that interest can comprise a return not only for the time value of money and credit risk but also for other components such as a return for liquidity risk, amounts to cover expenses and a profit margin.

For contractual cash flows to be SPPI they must include returns consistent with a basic lending arrangement, so for example, if the contractual cash flows include a return for equity price risk then that would not be consistent with SPPI.

### Time value of money

Time value of money is the element of interest that provides consideration for only the passage of time.

Usually there is a link between the period of time for which this interest element is set and the rate that is used (for example, 3 month LIBOR is used for a 3 month period). However, in some cases this element may be modified (ie imperfect), for example if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate.

In these cases, an entity will assess the asset's contractual cash flow characteristics by assessing the modification, qualitatively or quantitatively, to determine whether the contractual cash flows represent SPPI. The objective of this assessment is to determine whether the contractual cash flows could be significantly different to those that would arise if the time value of money element was not modified.

## Classification and measurement

---

### Contractual terms that change the timing or amount of cash flows

A financial asset may contain contractual terms that could change the timing or amount of contractual cash flows. An entity must assess whether the contractual cash flows that could arise both including and excluding the effect of those contractual terms are consistent with SPPI. For example, for a prepayable financial asset to have contractual cash flows that are SPPI, the cash flows if prepayment occurs and the cash flows if prepayment does not occur must both be consistent with SPPI.

In order for the financial asset to have contractual cash flows that are SPPI, the cash flows resulting from the change in contractual terms should be consistent with a basic lending arrangement.

### Exception for regulated rates

There may be instances where a government or a regulatory authority sets interest rates. This can result in the time value of money element of interest not representing only consideration for the passage of time.

IFRS 9 requires such cash flows to be considered SPPI as long as they do not introduce risk or volatility that is inconsistent with a basic lending arrangement.

IFRS 9 provides amortised cost information in profit or loss (dependent on business model) when a financial asset has simple cash flows that are SPPI.

SPPI cash flows are used as a basis for this assessment because amortised cost is a simple measurement technique. It simply allocates interest payments over the life of a financial instrument.

# Financial liabilities and own credit

## Financial liabilities in IFRS 9

During the development of IFRS 9 the IASB received feedback that the accounting requirements for financial liabilities in IAS 39 had worked well. Most respondents did not think that a fundamental change was needed to the accounting for financial liabilities. Hence, IAS 39's treatment of financial liabilities is carried forward to IFRS 9 essentially unchanged. This means that most financial liabilities will continue to be measured at amortised cost.

IFRS 9 includes the same option as IAS 39 that permits entities to elect to measure financial liabilities at fair value through profit or loss if particular criteria are met. For example, an entity can choose to measure a structured financial liability at fair value in its entirety rather than being required to account for its component parts. This is referred to as the fair value option (FVO).

## Own credit

The only issue that the IASB was told needed urgent attention was the volatility in profit or loss caused by changes in the credit risk of financial liabilities that an entity has elected to measure at fair value. The fair value of an entity's own debt is affected by changes in the entity's own credit risk (own credit). This means, somewhat counterintuitively, that when an entity's credit quality declines the value of its liabilities fall, and if those liabilities are measured at fair value a gain is recognised in profit or loss (and vice versa). Many investors and others found this result counterintuitive and confusing.

IFRS 9 introduces new requirements for the accounting and presentation of changes in the fair value of an entity's own debt when the entity has chosen to measure that debt at fair value under the FVO. To address the so-called own credit issue, IFRS 9 requires changes in the fair value of an entity's own credit risk to be recognised in other comprehensive income rather than in profit or loss.

Such liabilities would continue to be measured in the balance sheet at fair value, which provides information that was confirmed to be useful by users of financial statements.

---

# Impairment

# A forward-looking impairment model

### Why is the IASB addressing impairment?

During the financial crisis, the delayed recognition of credit losses on loans (and other financial instruments) was identified as a weakness in existing accounting standards. Specifically, the existing model in IAS 39 (an 'incurred loss' model) delays the recognition of credit losses until there is evidence of a trigger event. This was designed to limit an entity's ability to create hidden reserves that can be used to flatter earnings during bad times.

As the financial crisis unfolded, it became clear that the incurred loss model gave room to a different kind of earnings management, namely to postpone losses. Even though IAS 39 did not require waiting for actual default before impairment is recognised, in practice this was often the case.

The complexity of IAS 39, which used multiple impairment models for financial instruments, was also identified as a concern.

### How will the new requirements improve financial reporting?

The main objective of the new impairment requirements is to provide users of financial statements with more useful information about an entity's expected credit losses on financial instruments. The model requires an entity to recognise expected credit losses at all times and to update the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments.

This model is forward-looking and it eliminates the threshold for the recognition of expected credit losses, so that it is no longer necessary for a trigger event to have occurred before credit losses are recognised. Consequently, more timely information is required to be provided about expected credit losses.

Furthermore, when credit losses are measured in accordance with IAS 39, an entity may only consider those losses that arise from past events and current conditions. The effects of possible future credit loss events cannot be considered, even when they are expected. The requirements in IFRS 9 broaden the information that an entity is required to consider when determining its expectations of credit losses.

Specifically, IFRS 9 requires an entity to base its measurement of expected credit losses on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information.

## Impairment

---

In addition, under IFRS 9 the same impairment model is applied to all financial instruments that are subject to impairment accounting, removing a major source of current complexity. This includes financial assets classified as amortised cost and fair value through other comprehensive income, lease receivables, trade receivables, and commitments to lend money and financial guarantee contracts.

### Disclosure

In addition to improving the accounting for impairment, the new model is accompanied by improved disclosure about expected credit losses and credit risk.

Entities are required to provide information that explains the basis for their expected credit loss calculations and how they measure expected credit losses and assess changes in credit risk. In addition, entities are required to provide a reconciliation from the opening to the closing allowance balances for 12-month loss allowances separately from lifetime loss allowance balances. This is provided along with a reconciliation from the opening to the closing balances of the related carrying amounts of financial instruments subject to impairment.

The reconciliations are required to be provided in a way that enables users of financial statements to understand the reason for changes in the allowance balances (such as whether it is caused by changes in credit risk or increased lending).

In addition, in response to requests from users of financial statements, information is required to be provided about the credit risk of financial assets by rating grades and about financial assets on which contractual cash flows have been modified.



# Overview of the impairment requirements

## What are the stages?

### Stage 1

As soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognised in profit or loss and a loss allowance is established.

This serves as a proxy for the initial expectations of credit losses.

For financial assets, interest revenue is calculated on the gross carrying amount (ie without adjustment for expected credit losses).

### Stage 2

If the credit risk increases significantly **and** the resulting credit quality is not considered to be low credit risk, full lifetime expected credit losses are recognised.

Lifetime expected credit losses are only recognised if the credit risk increases significantly from when the entity originates or purchases the financial instrument.

The calculation of interest revenue on financial assets remains the same as for Stage 1.

### Stage 3

If the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount adjusted for the loss allowance). Financial assets in this stage will generally be individually assessed.

Lifetime expected credit losses are still recognised on these financial assets.

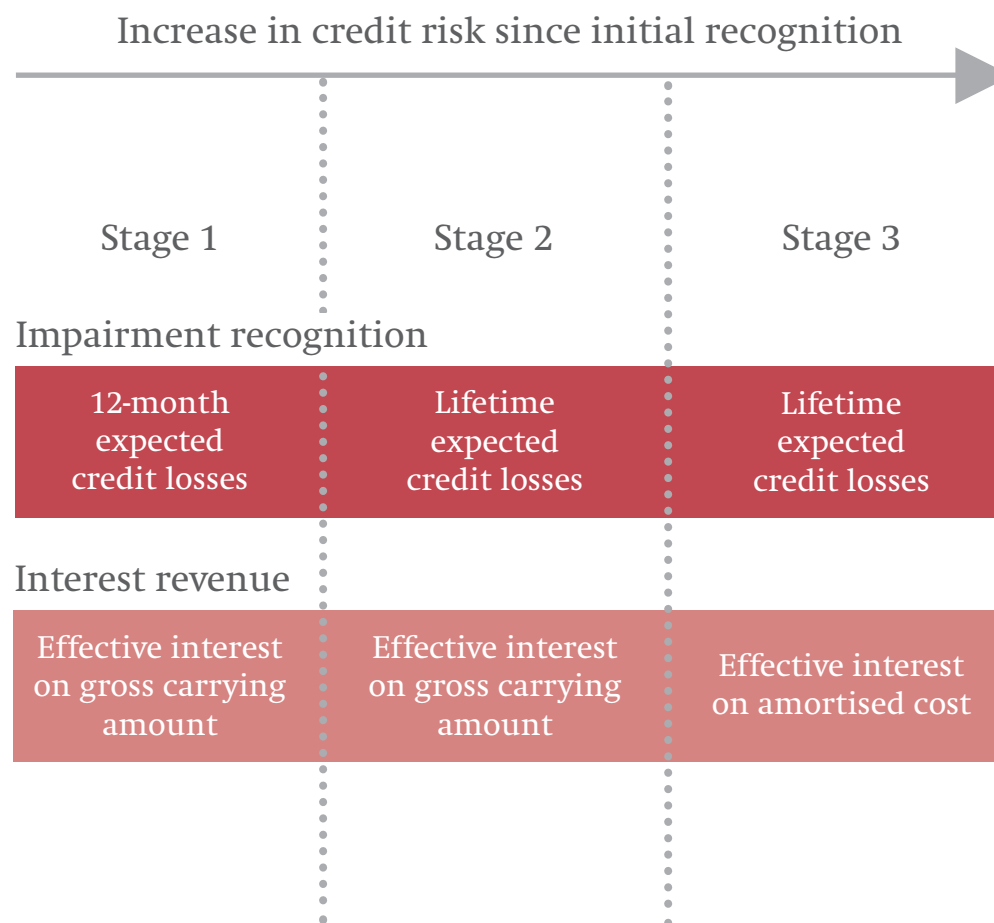
# Impairment

## What are 12-month expected credit losses?

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

It is not the expected cash shortfalls over the next twelve months—instead, it is the effect of the entire credit loss on an asset weighted by the probability that this loss will occur in the next 12 months.

It is also not the credit losses on assets that are forecast to actually default in the next 12 months. If an entity can identify such assets or a portfolio of such assets that are expected to have increased significantly in credit risk, lifetime expected credit losses are recognised.



## What are lifetime expected credit losses?

Lifetime expected credit losses are an expected present value measure of losses that arise if a borrower defaults on their obligation throughout the life of the financial instrument. They are the weighted average credit losses with the probability of default as the weight.

12-month expected credit losses are the portion of the lifetime expected credit losses associated with the possibility of a default in the next twelve months.

Because expected credit losses consider the amount and timing of payments, a credit loss (ie cash shortfall) arises even if the entity expects to be paid in full but later than when contractually due.

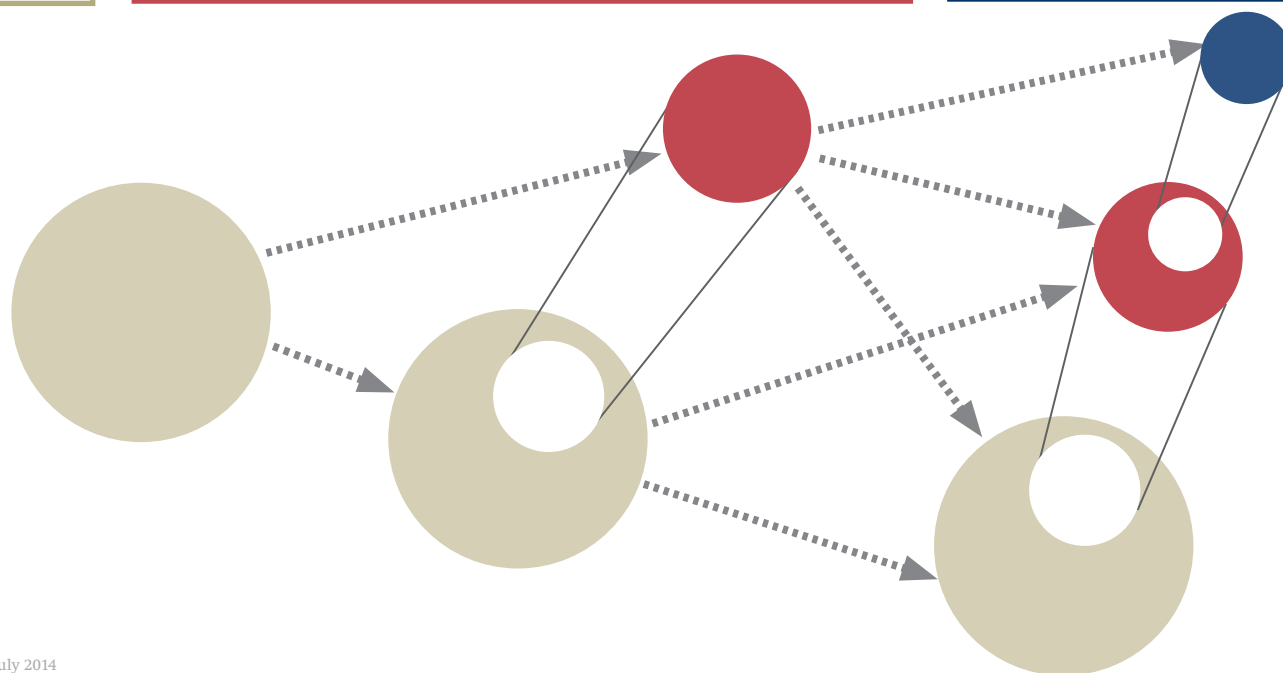
# Accounting for expected credit losses—example

Portfolio of home loans originated in a country.  
12-month expected credit losses are recognised for all the loans on initial recognition (**Stage 1**).

Information emerges that a region in the country is experiencing tough economic conditions.  
Lifetime expected credit losses are recognised for those loans within that region (**Stage 2**) and 12-month expected credit losses, including any changes in that estimate, for other loans (**Stage 1**).

More information emerges and the entity is able to identify the particular loans that have defaulted or will imminently default (**Stage 3**).  
Lifetime expected credit losses continue to be recognised and interest revenue switches to a net interest basis.

- Stage 1
- Stage 2
- Stage 3



# Measuring expected credit losses

### What should an entity consider when measuring expected credit losses?

Credit losses are the present value of all cash shortfalls. Expected credit losses are an estimate of credit losses over the life of the financial instrument. When measuring expected credit losses, an entity should consider:

- (a) the probability-weighted outcome: expected credit losses should represent neither a best or worst-case scenario. Rather, the estimate should reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs;
- (b) the time value of money: expected credit losses should be discounted to the reporting date; and
- (c) reasonable and supportable information that is available without undue cost or effort.

### What information is used?

An entity is required to use reasonable and supportable information that is available at the reporting date without undue cost or effort, and that includes information about past events, current conditions and forecasts of future conditions.

IFRS 9 does not prescribe particular measurement methods. Also, an entity may use various sources of data that may be internal (entity-specific) and external.

Entities are not required to use a 'crystal ball' to predict the future; what an entity uses depends on the availability of information. As the forecast horizon increases, it is expected that the specificity of information used to measure expected credit losses will decrease. (For example, rather than estimating specific cash flow shortfalls it may be necessary to consider information such as historical loss rates adjusted as relevant for current and forecast conditions).

Although the model is forward-looking, historical information is always considered to be an important anchor or base from which to measure expected credit losses. However, historical data should be adjusted on the basis of current observable data to reflect the effects of current conditions and forecasts of future conditions.

# Assessing significant increases in credit risk

IFRS 9 requires lifetime expected credit losses to be recognised when there are significant increases in credit risk since initial recognition.

Expected credit losses are updated at each reporting date for new information and changes in expectations even if there has not been a significant increase in credit risk.

## Why recognise lifetime expected credit losses only after a significant increase in credit risk?

When credit is first extended the initial creditworthiness of the borrower and initial expectations of credit losses are taken into account in determining acceptable pricing and other terms and conditions. As such, recognising lifetime expected credit losses from initial recognition disregards the link between pricing and the initial expectations of credit losses.

A true economic loss arises when expected credit losses exceed initial expectations (ie when the lender is not receiving compensation for the level of credit risk to which it is now exposed). Recognising lifetime expected credit losses after a significant increase in credit risk better reflects that economic loss in the financial statements.

## Timing of recognising lifetime expected credit losses

The assessment of whether lifetime expected credit losses should be recognised is based on a significant increase in the likelihood or risk of a default occurring since initial recognition. Generally, there will be a significant increase in credit risk before a financial asset becomes credit-impaired or an actual default occurs.

IFRS 9 does not mandate the use of an explicit probability of default to make this assessment. An entity may apply various approaches when assessing whether the credit risk on a financial instrument has increased significantly.

### What information should be used?

An entity should consider reasonable and supportable information that is available without undue cost or effort when determining whether the recognition of lifetime expected credit losses is required.

Credit risk analysis is a multifactor and holistic analysis—whether a specific factor is relevant, and its weight compared to other factors will depend on factors such as the type of product, characteristics of the financial instruments and the borrower.

### Collective and individual assessment basis

Assessment of significant increases in credit risk may be done on a collective basis, for example on a group or sub-group of financial instruments. This is to ensure that lifetime expected credit losses are recognised when there is a significant increase in credit risk even if evidence of that increase is not yet available on an individual level.

Lifetime expected credit losses are expected to be recognised before a financial instrument becomes delinquent. Typically, credit risk increases significantly before a financial instrument becomes past-due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed.

However, depending on the nature of the financial instrument and the credit risk information available, an entity may not be able to identify significant changes in credit risk for individual financial instruments before delinquency. It may be necessary to group financial instruments to capture significant increases in credit risk on a timely basis (such as by identifying particular geographical regions that have been most adversely affected by changing economic conditions).

# Assessing significant increases in credit risk continued...

### More than 30 days past due rebuttable presumption

Regardless of the way in which an entity assesses significant increases in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

The rebuttable presumption is not an absolute indicator, but is presumed to be the latest point at which lifetime expected credit losses should be recognised even when using forward-looking information.

### Financial instruments that have low credit risk at the reporting date

If a financial instrument is determined to have low credit risk at the reporting date an entity may assume that the credit risk of the financial instrument has not increased significantly since initial recognition.

Credit risk is considered low if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in conditions in the longer term may, but will not necessarily reduce the ability of the borrower to fulfil its obligations.

An example of a low credit risk instrument is one that has an investment grade rating (although an external rating grade is not a prerequisite for a financial instrument to be considered low credit risk).

---

# Hedge accounting



# A better link between accounting and risk management

IFRS 9 incorporates new hedge accounting requirements that represent a major overhaul of hedge accounting and introduce significant improvements, principally by aligning the accounting more closely with risk management.

The new requirements were first published in November 2013 and are unchanged in the July 2014 publication of IFRS 9 except to reflect the addition of the FVOCI measurement category to IFRS 9.

## What is the objective of hedge accounting?

The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities when they use financial instruments to manage exposures arising from particular risks and those risks could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income).

## Why use hedge accounting?

An entity uses hedging to manage its exposure to risks, for example, foreign exchange risk, interest rate risk or the price of a commodity. Many choose to apply hedge accounting to show the effect of managing those risks in the financial statements.

# Why change the hedge accounting requirements?

## Reflecting risk management appropriately

The hedge accounting requirements in IAS 39 were developed when hedging activities were relatively new and not as widely understood as they are today. As a result of the increased use and sophistication of hedging activities the IASB decided to undertake a fundamental overhaul of all aspects of hedge accounting.

Hedging risks and components of items has become common business practice. Investors have said that they want to be able to understand the risks that an entity faces, what management is doing to manage those risks and how effective those risk management strategies are.

Many investors believe that the IAS 39 hedge accounting requirements fall short in providing this information. As a result, investors often use non-audited (pro-forma) information to understand risk management. Investors, and others, also believe that the requirements in IAS 39 are arbitrary and too rule-based, and they argue for a closer alignment with risk management.

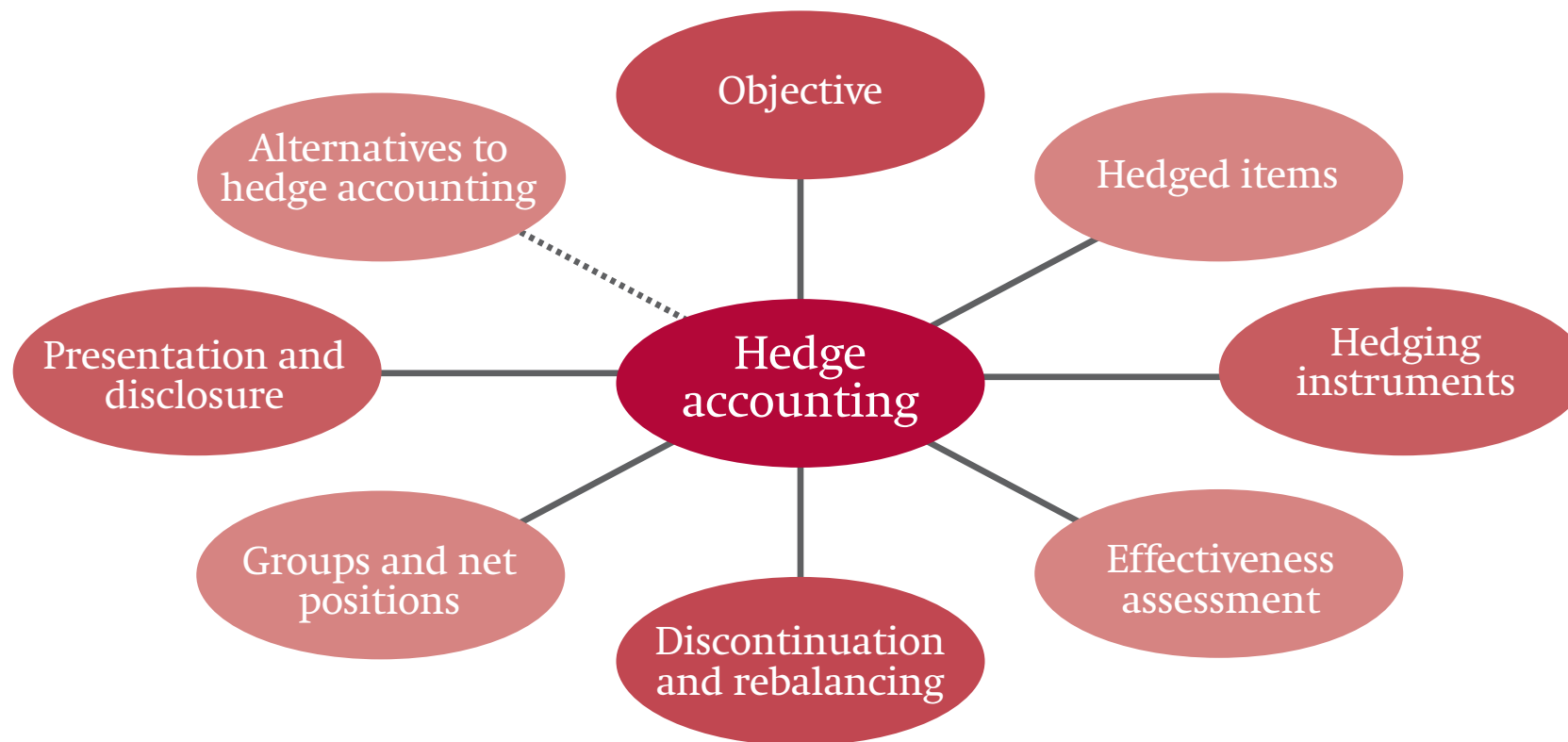
In addition, many preparers felt that IAS 39 does not allow entities to adequately reflect their risk management practices. For example, there are instances in which hedge accounting cannot be applied to groups of items, whereas for risk management purposes items are often hedged on a group basis. In addition, IAS 39 does not allow hedge accounting to be applied to components of non-financial items, but when entities hedge such items they usually only hedge components (parts) of them.

This meant that the greatest challenges were faced by those hedging non-financial risks; therefore, entities hedging such risks (such as non-financial institutions) are expected to benefit most from the new hedge accounting model.

## Insufficient disclosures

Others believed that the disclosure requirements in IAS 39 did not provide sufficient information in the financial statements about an entity's risk management activities.

## Fundamental review of hedge accounting Aspects reconsidered



# What does the new hedge accounting model achieve?

The new hedge accounting model enables companies to better reflect their risk management activities in the financial statements. This will help investors to understand the effect of hedging activities on the financial statements and on future cash flows.

### **Closer alignment with risk management**

The new model more closely aligns hedge accounting with risk management activities undertaken by companies when hedging their financial and non-financial risk exposures. It will enable more entities, particularly non-financial institutions, to apply hedge accounting to reflect their actual risk management activities. This will assist users of financial statements to understand entities' risk management activities.

An example of this is the treatment of risk components. Largely as a reflection of less advanced risk management practices when the IAS 39 hedge accounting model was developed, IAS 39 allowed components of financial items to be hedged, but not components of non-financial items.

An example of a risk component in a financial item is the LIBOR risk component of a bond. Risk managers often hedge risk components for non-financial items as well; for instance, they may hedge the oil price component of jet fuel. This is an important issue for many companies.

IFRS 9 eliminates this distinction. As a principle-based approach, IFRS 9 looks at whether a risk component can be identified and measured and does not distinguish between types of items. This will enable more entities to apply hedge accounting that reflects their risk management activities.

The new model also enables an entity to use information produced internally for risk management purposes as a basis for hedge accounting. Today it is necessary to exhibit eligibility and compliance with the requirements in IAS 39 using metrics that are designed solely for accounting purposes. The new model also includes eligibility criteria but these are based on an economic assessment of the strength of the hedging relationship. This can be determined using risk management data. This should reduce the costs of implementation compared with those for IAS 39 hedge accounting because it reduces the amount of analysis that is required to be undertaken only for accounting purposes.

# Improved information about risk management activities

When an entity enters into derivatives for hedging purposes but hedge accounting cannot be applied, the derivatives are accounted for as if they were trading instruments. This gives rise to volatility in profit or loss that is inconsistent with the economic situation. This means that the hedging relationship is not apparent to users of financial statements and an entity that has reduced its risk by entering into derivatives for hedging purposes may paradoxically appear more risky. Enabling hedge accounting to better reflect risk management improves the information provided to users of financial statements.

Improved disclosures are provided with the new hedge accounting model. These disclosures explain both the effect that hedge accounting has had on the financial statements and an entity's risk management strategy, as well as providing details about derivatives that have been entered into and their effect on the entity's future cash flows.

Today, information about hedge accounting is provided by the type of hedge, and those types are established by accounting standards (such as cash flow and fair value hedges). Users of financial statements have told us this is confusing as these distinctions use terms only used for accounting purposes. To make this information more accessible, information about all hedges is now required to be provided in a single location in the notes to the financial statements.

# Separate project on accounting for macro hedging

The IASB currently has a separate, active project on accounting for macro hedging activities. In this project, the IASB is exploring a new way to account for dynamic risk management of open portfolios. This project is still at an early stage of development with a Discussion Paper *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging* having been published in April 2014.

Currently, entities undertaking such risk management and using hedge accounting use a combination of IAS 39's general hedge accounting requirements and the specific model in IAS 39 for accounting for macro hedging. That model only applies to fair value hedges of interest rate risk. IFRS 9 has been designed so that entities are not adversely affected while the new macro project is ongoing. Therefore, an entity undertaking macro hedging activities can apply the new accounting model in IFRS 9 while continuing to apply the specific IAS 39 accounting for macro hedges if they wish to do so.

In response to the draft final hedge accounting requirements posted on the IASB's website in September 2012, some requested that they be allowed to continue to apply IAS 39 for all of their hedge accounting.

Although the IASB noted that entities would not be disadvantaged by the change to IFRS 9 and that the change was not expected to be unduly burdensome, it acknowledged that some may prefer to move directly from using IAS 39 to the potential new model for accounting for macro hedging.

Hence, the IASB decided to allow an accounting policy choice to apply either the hedge accounting model in IFRS 9 or IAS 39 in its entirety, with the additional choice to use the IAS 39 accounting for macro hedges if applying IFRS 9 hedge accounting.

Until the completion of the project on 'macro hedging' entities can account for their macro hedging activities using the specific model in IAS 39 for portfolio hedges of interest rate risk. In the case of cash flow hedge accounting, so-called 'proxy hedging' is still an eligible way to designate a hedged item in accordance with IFRS 9 as long as the designation reflects risk management. This in effect maintains the position that existed prior to IFRS 9.

# Implementation

## Mandatory effective date

IFRS 9 is effective for annual periods beginning on or after 1 January 2018.

Entities can however choose to apply IFRS 9 before then. From February 2015 entities newly applying IFRS 9 will need to apply the version published in July 2014. This means that entities would need to apply the classification and measurement, impairment and hedge accounting requirements<sup>1</sup>. As an exception to this, prior to January 2018 the own credit changes can be applied at any time in isolation without the need to otherwise change the accounting for financial instruments.

## Transition Resource Group

The IASB announced in June 2014 its intention to create a transition resource group for the new requirements for impairment of financial instruments.

The IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) will provide a discussion forum to support stakeholders on implementation issues that may arise as a result of the new impairment requirements under IFRS 9. The ITG will be comprised of subject matter experts involved in implementation (from preparers and audit firms) and will include regulatory representatives. ITG members will also provide representation from different geographical locations.

Specifically, the ITG will:

- hold public meetings;
- solicit, analyse, and discuss stakeholder issues arising from implementation of the new Standard;
- inform the IASB about those implementation issues, which will help the IASB determine what, if any, action will be needed to address those issues; and
- provide a forum for stakeholders to learn about the new Standard from others involved with implementation.

The ITG will not publish authoritative guidance.

---

<sup>1</sup> Subject to the election to continue to apply IAS 39 hedge accounting.

---

# Important information

This Project Summary has been compiled by the staff of the IFRS Foundation for the convenience of interested parties. The views within this document are those of the staff who prepared this document and are not the views or the opinions of the IASB and should not be considered authoritative in any way. The content of this Project Summary does not constitute any advice.

Official pronouncements of the IASB are available in electronic format to eIFRS subscribers. Publications are available for ordering from our website at [www.ifrs.org](http://www.ifrs.org).

## Further information

The Basis for Conclusions on IFRS 9 analyses the considerations of the IASB when developing IFRS 9 including an analysis of the feedback received on the proposals that preceded the Standard and how the IASB responded to that feedback. It also includes an analysis of the likely effects of IFRS 9.



International Accounting Standards Board® (IASB®)

The IASB is the independent standard-setting body of the IFRS Foundation®

30 Cannon Street | London EC4M 6XH | United Kingdom

Telephone: +44 (0)20 7246 6410 | Fax: +44 (0)20 7246 6411

Email: [info@ifrs.org](mailto:info@ifrs.org) | Web: [www.ifrs.org](http://www.ifrs.org)

Publications Department

Telephone: +44 (0)20 7332 2730 | Fax: +44 (0)20 7332 2749

Email: [publications@ifrs.org](mailto:publications@ifrs.org)

**Copyright © 2014 IFRS Foundation®**

**All rights reserved.** No part of this publication may be translated, reprinted, reproduced or used in any form either in whole or in part or by any electronic, mechanical or other means, now known or hereafter invented, including photocopying and recording, or in any information storage and retrieval system, without prior permission in writing from the IFRS Foundation.

The IFRS Foundation logo/the IASB logo/the IFRS for SMEs logo/‘Hexagon Device’, ‘IFRS Foundation’, ‘eIFRS’, ‘IASB’, ‘IFRS for SMEs’, ‘IAS’, ‘IASs’, ‘IFRIC’, ‘IFRS’, ‘IFRSs’, ‘SIC’, ‘International Accounting Standards’ and ‘International Financial Reporting Standards’ are Trade Marks of the IFRS Foundation.

The IFRS Foundation is a not-for-profit corporation under the General Corporation Law of the State of Delaware, USA and operates in England and Wales as an overseas company (Company number: FC023235) with its principal office as above.



Printed on 100 per cent recycled paper