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Approval by the Board of IFRS 9 issued in November 2009

International Financial Reporting Standard 9 *Financial Instruments* was approved for issue by thirteen of the fifteen members of the International Accounting Standards Board. Mr Leisenring and Ms McConnell dissented from the issue of the Standard. Their dissenting opinions are set out after the Basis for Conclusions.

Sir David Tweedie	Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Robert P Garnett	
Gilbert Gélard	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
James J Leisenring	
Patricia McConnell	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

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Approval by the Board of the requirements added to IFRS 9 in October 2010

The requirements added to International Financial Reporting Standard 9 *Financial Instruments* in October 2010 were approved for issue by fourteen of the fifteen members of the International Accounting Standards Board (IASB). Mr Scott abstained in view of his recent appointment to the IASB.

Sir David Tweedie	Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
Elke König	
Patricia McConnell	
Warren J McGregor	
Paul Pacter	
Darrel Scott	
John T Smith	
Tatsumi Yamada	
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Approval by the Board of *Mandatory Effective Date* of IFRS 9 and *Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) issued in December 2011

Mandatory Effective Date of IFRS 9 and Transition Disclosures (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7) was approved for publication by fourteen of the fifteen members of the International Accounting Standards Board. Ms McConnell dissented from the issue of the amendments. Her dissenting opinion is set out after the Basis for Conclusions.

Hans Hoogervorst	Chairman
Ian Mackintosh	Vice-Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
Elke König	
Patricia McConnell	
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John T Smith	
Wei-Guo Zhang	

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Approval by the Board of IFRS 9 *Financial Instruments* (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39) issued in November 2013

IFRS 9 *Financial Instruments* (Hedge Accounting and amendments to IFRS 9, IFRS 7 and IAS 39) was approved for issue by fifteen of the sixteen members of the International Accounting Standards Board. Mr Finnegan dissented. His dissenting opinion is set out after the Basis for Conclusions.

Hans Hoogervorst	Chairman
Ian Mackintosh	Vice-Chairman
Stephen Cooper	
Philippe Danjou	
Martin Edelmann	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Gary Kabureck	
Prabhakar Kalavacherla	
Patricia McConnell	
Takatsugu Ochi	
Darrel Scott	
Chungwoo Suh	
Mary Tokar	
Wei-Guo Zhang	

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Approval by the Board of IFRS 9 *Financial Instruments* issued in July 2014

IFRS 9 *Financial Instruments* (as issued in July 2014) was approved for issue by fourteen of the sixteen members of the International Accounting Standards Board. Messrs Cooper and Engström dissented. Their dissenting opinion is set out after the Basis for Conclusions.

Hans Hoogervorst	Chairman
Ian Mackintosh	Vice-Chairman
Stephen Cooper	
Philippe Danjou	
Martin Edelmann	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Gary Kabureck	
Suzanne Lloyd	
Patricia McConnell	
Takatsugu Ochi	
Darrel Scott	
Chungwoo Suh	
Mary Tokar	
Wei-Guo Zhang	

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Approval by the Board of *Prepayment Features with Negative Compensation* (Amendments to IFRS 9) issued in October 2017

Prepayment Features with Negative Compensation (Amendments to IFRS 9) was approved for issue by 11 of 14 members of the International Accounting Standards Board (Board). Messrs Anderson and Lu and Ms Tarca abstained in view of their recent appointments to the Board.

Hans Hoogervorst	Chairman
Suzanne Lloyd	Vice-Chair
Nick Anderson	
Martin Edelmann	
Françoise Flores	
Amaro Luiz de Oliveira Gomes	
Gary Kabureck	
Jianqiao Lu	
Takatsugu Ochi	
Darrel Scott	
Thomas Scott	
Chungwoo Suh	
Ann Tarca	
Mary Tokar	

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Approval by the Board of *Interest Rate Benchmark Reform* issued in September 2019

Interest Rate Benchmark Reform, which amended IFRS 9, IAS 39 and IFRS 7, was approved for issue by all 14 members of the International Accounting Standards Board (Board).

Hans Hoogervorst	Chairman
Suzanne Lloyd	Vice-Chair
Nick Anderson	
Tadeu Cendon	
Martin Edelmann	
Françoise Flores	
Gary Kabureck	
Jianqiao Lu	
Darrel Scott	
Thomas Scott	
Chungwoo Suh	
Rika Suzuki	
Ann Tarca	
Mary Tokar	

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Approval by the Board of *Interest Rate Benchmark Reform—Phase 2* issued in August 2020

Interest Rate Benchmark Reform—Phase 2, which amended IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16, was approved for issue by 12 of 13 members of the International Accounting Standards Board (Board). Mr Gast abstained in view of his recent appointment to the Board.

Hans Hoogervorst	Chairman
Suzanne Lloyd	Vice-Chair
Nick Anderson	
Tadeu Cendon	
Martin Edelmann	
Françoise Flores	
Zach Gast	
Jianqiao Lu	
Darrel Scott	
Thomas Scott	
Rika Suzuki	
Ann Tarca	
Mary Tokar	

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Basis for Conclusions on IFRS 9 *Financial Instruments*

This Basis for Conclusions accompanies, but is not part of, IFRS 9.

IFRS 9 replaced IAS 39 Financial Instruments: Recognition and Measurement. *When revised in 2003 IAS 39 was accompanied by a Basis for Conclusions summarising the considerations of the IASB as constituted at the time, in reaching some of its conclusions in that Standard. That Basis for Conclusions was subsequently updated to reflect amendments to the Standard. For convenience the IASB has incorporated into its Basis for Conclusions on IFRS 9 material from the Basis for Conclusions on IAS 39 that discusses matters that the IASB has not reconsidered. That material is contained in paragraphs denoted by numbers with the prefix BCZ. In those paragraphs cross-references to the Standard have been updated accordingly and minor necessary editorial changes have been made. In 2003 and later some IASB members dissented from the issue of IAS 39 and subsequent amendments, and portions of their dissenting opinions relate to requirements that have been carried forward to IFRS 9. Those dissenting opinions are set out in an appendix after this Basis for Conclusions.*

Paragraphs describing the IASB's considerations in reaching its own conclusions on IFRS 9 are numbered with the prefix BC.

Introduction

BCIN.1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) when developing IFRS 9 *Financial Instruments*. Individual IASB members gave greater weight to some factors than to others.

BCIN.2 The IASB has long acknowledged the need to improve the requirements for financial reporting of financial instruments to enhance the relevance and understandability of information about financial instruments for users of financial statements. That need became more urgent in the light of the global financial crisis that started in 2007 ('the global financial crisis'), so the IASB decided to replace IAS 39 *Financial Instruments: Recognition and Measurement* in its entirety as expeditiously as possible. To do this the IASB divided the project into several phases. In adopting this approach, the IASB acknowledged the difficulties that might be created by differences in timing between this project and others, in particular the project on insurance contracts.

Classification and measurement

BCIN.3 IFRS 9 is a new Standard that deals with the accounting for financial instruments. When developing IFRS 9, the IASB considered the responses to its 2009 Exposure Draft *Financial Instruments: Classification and Measurement* (the '2009 Classification and Measurement Exposure Draft').

BCIN.4 That 2009 Classification and Measurement Exposure Draft contained proposals for all items within the scope of IAS 39. However, some respondents said that the IASB should finalise its proposals on the classification and measurement of financial assets while retaining the existing requirements for financial liabilities (including the requirements for embedded derivatives and the fair value option) until the IASB had more fully considered the issues relating to financial liabilities. Those respondents pointed out that the IASB had accelerated its project on financial instruments because of the global financial crisis, which had placed more emphasis on issues in the accounting for financial assets than for financial liabilities. They suggested that the IASB should consider issues related to financial liabilities more closely before finalising the requirements for classification and measurement of financial liabilities.

BCIN.5 The IASB noted those concerns and, as a result, in November 2009 it finalised the first chapters of IFRS 9, dealing with the classification and measurement of financial assets. In the IASB's view, requirements for classification and measurement are the foundation for a financial reporting standard on accounting for financial instruments, and the requirements on associated matters (for example, on impairment and hedge accounting) have to reflect those requirements. In addition, the IASB noted that many of the application issues that arose in the global financial crisis were related to the classification and measurement of financial assets in accordance with IAS 39.

BCIN.6 Thus, financial liabilities, including derivative liabilities, initially remained within the scope of IAS 39. Taking that course enabled the IASB to obtain further feedback on the accounting for financial liabilities, including how best to address accounting for changes in own credit risk.

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BCIN.7 Immediately after issuing IFRS 9, the IASB began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities. The IASB obtained information and views from its Financial Instruments Working Group (FIWG) and from users of financial statements, regulators, preparers, auditors and others from a range of industries across different geographical regions. The primary messages that the IASB received were that the requirements in IAS 39 for classifying and measuring financial liabilities were generally working well but that the effects of the changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. As a result of the feedback received, the IASB decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities and carry them forward to IFRS 9 (see paragraphs BC4.46–BC4.53).

BCIN.8 By taking that course, the issue of accounting for the effects of changes in credit risk does not arise for most liabilities and would remain only in the context of financial liabilities designated as measured at fair value under the fair value option. Thus, in May 2010, the IASB published the Exposure Draft *Fair Value Option for Financial Liabilities* (the '2010 Own Credit Risk Exposure Draft'), which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The IASB considered the responses to the 2010 Own Credit Risk Exposure Draft and finalised the requirements, which were then added to IFRS 9 in October 2010.

BCIN.9 In November 2012 the IASB published the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) (the '2012 Limited Amendments Exposure Draft'). In that Exposure Draft, the IASB proposed limited amendments to the classification and measurement requirements in IFRS 9 for financial assets with the aims of:

(a) considering the interaction between the classification and measurement of financial assets and the accounting for insurance contract liabilities;

(b) addressing specific application questions that had been raised by some interested parties since IFRS 9 was issued; and

(c) seeking to reduce key differences with the US national standard-setter, the Financial Accounting Standards Board's (FASB) tentative classification and measurement model for financial instruments.

BCIN.10 Accordingly, the 2012 Limited Amendments Exposure Draft proposed limited amendments to clarify the application of the existing classification and measurement requirements for financial assets and to introduce a fair value through other comprehensive income measurement category for particular debt investments. Most respondents to the 2012 Limited Amendments Exposure Draft—as well as participants in the IASB's outreach programme—generally supported the proposed limited amendments. However, many asked the IASB for clarifications or additional guidance on particular aspects of the proposals. The IASB considered the responses in the comment letters and the information received during its outreach activities when it finalised the limited amendments in July 2014.

Amortised cost and impairment methodology

BCIN.11 In October 2008, as part of a joint approach to dealing with the financial reporting issues arising from the global financial crisis, the IASB and the FASB set up the Financial Crisis Advisory Group (FCAG). The FCAG considered how improvements in financial reporting could help to enhance investor confidence in financial markets. In its report, published in July 2009, the FCAG identified weaknesses in the current accounting standards for financial instruments and their application. Those weaknesses included the delayed recognition of credit losses on loans (and other financial instruments) and the complexity of multiple impairment approaches. One of the FCAG's recommendations was to explore alternatives to the incurred credit loss model that would use more forward looking information.

BCIN.12 Following a Request for Information that the IASB posted on its website in June 2009, the IASB published, in November 2009, the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the '2009 Impairment Exposure Draft'). Comments received on the 2009 Impairment Exposure Draft and during outreach indicated support for the concept of such an impairment model, but highlighted the operational difficulties of applying it.

BCIN.13 In response, the IASB decided to modify the impairment model proposed in the 2009 Impairment Exposure Draft to address those operational difficulties while replicating the outcomes of that model that it proposed in that Exposure Draft as closely as possible. These simplifications were published in the Supplementary Document *Financial Instruments: Impairment* in January 2011, however the IASB did not receive strong support on these proposals.

BCIN.14 The IASB started developing an impairment model that would reflect the general pattern of deterioration in the credit quality of financial instruments and in which the amount of the expected credit losses recognised

as a loss allowance or provision would depend on the level of deterioration in the credit quality of financial instruments since initial recognition.

BCIN.15 In 2013 the IASB published the Exposure Draft *Financial Instruments: Expected Credit Losses* (the '2013 Impairment Exposure Draft'), which proposed to recognise a loss allowance or provision at an amount equal to lifetime expected credit losses if there was a significant increase in credit risk after initial recognition of a financial instrument and at 12-month expected credit losses for all other instruments.

BCIN.16 Most respondents to the 2013 Impairment Exposure Draft—as well as participants in the IASB's outreach and field work programme—generally supported the proposed impairment model. However, many asked the IASB for clarifications or additional guidance on particular aspects of the proposals. The IASB considered the responses in the comment letters and the information received during its outreach activities when it finalised the impairment requirements in July 2014.

Hedge accounting

BCIN.17 In December 2010 the IASB published the Exposure Draft *Hedge Accounting* (the '2010 Hedge Accounting Exposure Draft'). That Exposure Draft contained an objective for hedge accounting that aimed to align accounting more closely with risk management and to provide useful information about the purpose and effect of hedging instruments. It also proposed requirements for:

(a) what financial instruments qualify for designation as hedging instruments;

(b) what items (existing or expected) qualify for designation as hedged items;

(c) an objective-based hedge effectiveness assessment;

(d) how an entity should account for a hedging relationship (fair value hedge, cash flow hedge or a hedge of a net investment in a foreign operation as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*); and

(e) hedge accounting presentation and disclosures.

BCIN.18 After the publication of the 2010 Hedge Accounting Exposure Draft, the IASB began an extensive outreach programme to gather feedback on the hedge accounting proposals. The IASB obtained information and views from users of financial statements, preparers, treasurers, risk management experts, auditors, standard-setters and regulators from a range of industries across different geographical regions.

BCIN.19 The views from participants in the IASB's outreach activities were largely consistent with the views in the comment letters to the 2010 Hedge Accounting Exposure Draft. The IASB received strong support for the objective of aligning accounting more closely with risk management. However, many asked the IASB for added clarification on some of the fundamental changes proposed in the 2010 Hedge Accounting Exposure Draft.

BCIN.20 The IASB considered the responses in the comment letters to the 2010 Hedge Accounting Exposure Draft and the information received during its outreach activities when it finalised the requirements for hedge accounting that were then added to IFRS 9 in November 2013.

Scope (Chapter 2)

BC2.1 The scope of IAS 39 was not raised as a matter of concern during the global financial crisis and, hence, the IASB decided that the scope of IFRS 9 should be based on that of IAS 39. Consequently, the scope of IAS 39 was carried forward to IFRS 9. It has been changed only as a consequence of other new requirements, such as to reflect the changes to the accounting for expected credit losses on loan commitments that an entity issues (see paragraph BC2.8). As a result, most of paragraphs in this section of the Basis for Conclusions were carried forward from the Basis for Conclusion on IAS 39 and describe the IASB's rationale when it set the scope of that Standard.

Loan commitments

BCZ2.2 Loan commitments are firm commitments to provide credit under pre-specified terms and conditions. In the IAS 39 implementation guidance process, the question was raised whether a bank's loan commitments are derivatives accounted for at fair value under IAS 39. This question arises because a commitment to make a loan at a specified rate of interest during a fixed period of time meets the definition of a derivative. In effect, it is a written option for the potential borrower to obtain a loan at a specified rate.

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BCZ2.3 To simplify the accounting for holders and issuers of loan commitments, the IASB decided to exclude particular loan commitments from the scope of IAS 39. The effect of the exclusion is that an entity will not recognise and measure changes in fair value of these loan commitments that result from changes in market interest rates or credit spreads. This is consistent with the measurement of the loan that results if the holder of the loan commitment exercises its right to obtain financing, because changes in market interest rates do not affect the measurement of an asset measured at amortised cost (assuming it is not designated in a category other than loans and receivables).[1]

BCZ2.4 However, the IASB decided that an entity should be permitted to measure a loan commitment at fair value with changes in fair value recognised in profit or loss on the basis of designation at inception of the loan commitment as a financial liability through profit or loss. This may be appropriate, for example, if the entity manages risk exposures related to loan commitments on a fair value basis.

BCZ2.5 The IASB further decided that a loan commitment should be excluded from the scope of IAS 39 only if it cannot be settled net. If the value of a loan commitment can be settled net in cash or another financial instrument, including when the entity has a past practice of selling the resulting loan assets shortly after origination, it is difficult to justify its exclusion from the requirement in IAS 39 to measure at fair value similar instruments that meet the definition of a derivative.

BCZ2.6 Some comments received on the Exposure Draft that preceded the issuance of these requirements in IAS 39 disagreed with the IASB's proposal that an entity that has a past practice of selling the assets resulting from its loan commitments shortly after origination should apply IAS 39 to all of its loan commitments. The IASB considered this concern and agreed that the words in that Exposure Draft did not reflect the IASB's intention. Thus, the IASB clarified that if an entity has a past practice of selling the assets resulting from its loan commitments shortly after origination, it applies IAS 39 only to its loan commitments in the same class.

BCZ2.7 Finally, in developing the requirements in IAS 39, the IASB decided that commitments to provide a loan at a below-market interest rate should be initially measured at fair value, and subsequently measured at the higher of (a) the amount that would be recognised under IAS 37 and (b) the amount initially recognised less, where appropriate, cumulative amortisation recognised in accordance with IAS 18 *Revenue*.[2] It noted that without such a requirement, liabilities that result from such commitments might not be recognised in the balance sheet, because in many cases no cash consideration is received.

BC2.8 In developing IFRS 9, the IASB decided to retain the accounting in IAS 39 for loan commitments, except to reflect the new impairment requirements. Consequently, in accordance with Section 5.5 of IFRS 9, an entity must apply the impairment requirements of IFRS 9 to loan commitments that are not otherwise within the scope of that Standard. Additionally, IFRS 9 requires that an issuer of a loan commitment to provide a loan at a below-market interest rate must measure it at the higher of (a) the amount of the loss allowance determined in accordance with Section 5.5 of that Standard and (b) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15. The IASB did not change the accounting for loan commitments held by potential borrowers.

Financial guarantee contracts

BCZ2.9 In finalising IFRS 4 *Insurance Contracts* in early 2004, the IASB reached the following conclusions:

(a) Financial guarantee contracts can have various legal forms, such as that of a guarantee, some types of letter of credit, a credit default contract or an insurance contract. However, although this difference in legal form may in some cases reflect differences in substance, the accounting for these instruments should not depend on their legal form.

(b) If a financial guarantee contract is not an insurance contract, as defined in IFRS 4, it should be within the scope of IAS 39. This was the case before the IASB finalised IFRS 4.

(c) As required before the IASB finalised IFRS 4, if a financial guarantee contract was entered into or retained on transferring to another party financial assets or financial liabilities within the scope of IAS 39, the issuer should apply IAS 39 to that contract even if it is an insurance contract, as defined in IFRS 4.

(d) Unless (c) applies, the following treatment is appropriate for a financial guarantee contract that meets the definition of an insurance contract:

(i) At inception, the issuer of a financial guarantee contract has a recognisable liability and should measure it at fair value. If a financial guarantee contract was issued in a stand-alone arm's

[1] IFRS 9 eliminated the category of loans and receivables.

[2] IFRS 15 *Revenue from Contracts with Customers*, issued in May 2014, replaced IAS 18.

length transaction to an unrelated party, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary.

(ii) Subsequently, the issuer should measure the contract at the higher of the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.[3]

BCZ2.10 Mindful of the need to develop a 'stable platform' of Standards for 2005, the IASB finalised IFRS 4 in early 2004 without specifying the accounting for these contracts and then published an Exposure Draft *Financial Guarantee Contracts and Credit Insurance* in July 2004 to expose for public comment the conclusion set out in paragraph BCZ2.9(d). The IASB set a comment deadline of 8 October 2004 and received more than 60 comment letters. Before reviewing the comment letters, the IASB held a public education session at which it received briefings from representatives of the International Credit Insurance & Surety Association and of the Association of Financial Guaranty Insurers.

BCZ2.11 Some respondents to the Exposure Draft of July 2004 argued that there were important economic differences between credit insurance contracts and other forms of contract that met the proposed definition of a financial guarantee contract. However, both in developing the Exposure Draft of July 2004 and in subsequently discussing the comments received, the IASB was unable to identify differences that would justify differences in accounting treatment.

BCZ2.12 Some respondents to the Exposure Draft of July 2004 noted that some credit insurance contracts contain features, such as cancellation and renewal rights and profit-sharing features, that the IASB will not address until Phase II of its project on insurance contracts. They argued that the Exposure Draft did not give enough guidance to enable them to account for these features. The IASB concluded it could not address such features in the short term. The IASB noted that when credit insurers issue credit insurance contracts, they typically recognise a liability measured as either the premium received or an estimate of the expected losses. However, the IASB was concerned that some other issuers of financial guarantee contracts might argue that no recognisable liability existed at inception. To provide a temporary solution that balances these competing concerns, the IASB decided the following:

(a) If the issuer of financial guarantee contracts has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either IAS 39 or IFRS 4 to such financial guarantee contracts.

(b) In all other cases, the issuer of a financial guarantee contract should apply IAS 39.

BCZ2.13 The IASB does not regard criteria such as those described in paragraph BCZ2.12(a) as suitable for the long term, because they can lead to different accounting for contracts that have similar economic effects. However, the IASB could not find a more compelling approach to resolve its concerns for the short term. Moreover, although the criteria described in paragraph BCZ2.12(a) may appear imprecise, the IASB believes that the criteria would provide a clear answer in the vast majority of cases. Paragraph B2.6 in IFRS 9 gives guidance on the application of those criteria.

BCZ2.14 The IASB considered convergence with US generally accepted accounting principles (GAAP). In US GAAP, the requirements for financial guarantee contracts (other than those covered by US Standards specific to the insurance sector) are in FASB Interpretation 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45). The recognition and measurement requirements of FIN 45 do not apply to guarantees issued between parents and their subsidiaries, between entities under common control, or by a parent or subsidiary on behalf of a subsidiary or the parent. Some respondents to the Exposure Draft of July 2004 asked the IASB to provide a similar exemption. They argued that the requirement to recognise these financial guarantee contracts in separate or individual financial statements would cause costs disproportionate to the likely benefits, given that intragroup transactions are eliminated on consolidation. However, to avoid the omission of material liabilities from separate or individual financial statements, the IASB did not create such an exemption.

BCZ2.15 The IASB issued the amendments for financial guarantee contracts in August 2005. After those amendments, the recognition and measurement requirements for financial guarantee contracts within the scope of IAS 39 were consistent with FIN 45 in some areas, but differed in others:

(a) Like FIN 45, IAS 39 requires initial recognition at fair value.

(b) IAS 39 requires systematic amortisation, in accordance with IAS 18[4], of the liability recognised initially. This is compatible with FIN 45, though FIN 45 contains less prescriptive requirements on subsequent measurement. Both IAS 39 and FIN 45 include a liability adequacy (or loss recognition)

[3] IFRS 15, issued in May 2014, replaced IAS 18.

[4] IFRS 15, issued in May 2014, replaced IAS 18.

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test, although the tests differ because of underlying differences in the Standards to which those tests refer (IAS 37 and Statement of Financial Accounting Standards No. 5 *Accounting for Contingencies*).

(c) Like FIN 45, IAS 39 permits a different treatment for financial guarantee contracts issued by insurers.

(d) Unlike FIN 45, IAS 39 does not contain exemptions for parents, subsidiaries or other entities under common control. However, any differences are reflected only in the separate or individual financial statements of the parent, subsidiaries or common control entities.

BCZ2.16 Some respondents to the Exposure Draft of July 2004 asked for guidance on the treatment of financial guarantee contracts by the holder. However, this was beyond the limited scope of the project.

BC2.17 In developing IFRS 9, the IASB decided to retain the accounting in IAS 39 for financial guarantee contracts, except to reflect the new impairment requirements. Consequently, financial guarantee contracts that are within the scope of IFRS 9 and that are not measured at fair value through profit or loss, are measured at the higher of (a) the amount of the loss allowance determined in accordance with Section 5.5 of that Standard and (b) the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

Contracts to buy or sell a non-financial item

BCZ2.18 Before the amendments in 2003, IAS 39 and IAS 32 were not consistent with respect to the circumstances in which a commodity-based contract meets the definition of a financial instrument and is accounted for as a derivative. The IASB concluded that the amendments should make them consistent on the basis of the notion that a contract to buy or sell a non-financial item should be accounted for as a derivative when it (i) can be settled net or by exchanging financial instruments and (ii) is not held for the purpose of receipt or delivery of the non-financial item in accordance with the entity's expected purchase, sale or usage requirements (a 'normal' purchase or sale). In addition, the IASB concluded that the notion of when a contract can be settled net should include contracts:

(a) where the entity has a practice of settling similar contracts net in cash or another financial instrument or by exchanging financial instruments;

(b) for which the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin; and

(c) in which the non-financial item that is the subject of the contract is readily convertible to cash.

Because practices of settling net or taking delivery of the underlying and selling it within a short period after delivery also indicate that the contracts are not 'normal' purchases or sales, such contracts are within the scope of IAS 39 and are accounted for as derivatives. The IASB also decided to clarify that a written option that can be settled net in cash or another financial instrument, or by exchanging financial instruments, is within the scope of the Standard and cannot qualify as a 'normal' purchase or sale.

Accounting for a contract to buy or sell a non-financial item as a derivative

BCZ2.19 In the third phase of its project to replace IAS 39 with IFRS 9, the IASB considered replacing the hedge accounting requirements in IAS 39. As part of those deliberations, the IASB considered the accounting for executory contracts that gives rise to accounting mismatches in some situations. The IASB's decision is discussed in more detail below.

BCZ2.20 Contracts accounted for in accordance with IAS 39 include those contracts to buy or sell a non-financial item that can be settled net in cash (including net settlement in another financial instrument or by exchanging financial instruments), as if the contracts were financial instruments. In addition, IAS 39 specifies that there are various ways in which a contract to buy or sell a non-financial item can be settled net in cash. For example, a contract is considered to be settleable net in cash even if it is not explicit in the terms of the contract, but the entity has a practice of settling similar contracts net in cash.

BCZ2.21 However, such contracts are excluded from the scope of IAS 39 if they were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This is commonly referred to as the 'own use' scope exception of IAS 39. The own use scope exception in IAS 39 mostly applies to contracts for commodity purchases or sales.

BCZ2.22 It is not uncommon for a commodity contract to be within the scope of IAS 39 and meet the definition of a derivative. Many commodity contracts meet the criteria for net settlement in cash because in many instances

commodities are readily convertible to cash. When such a contract is accounted for as a derivative, it is measured at fair value with changes in the fair value recognised in profit or loss. If an entity enters into a derivative to hedge the change in the fair value of the commodity contract, that derivative is also measured at fair value with changes in fair value recognised in profit or loss. Because the changes in the fair value of the commodity contract and the derivative are recognised in profit or loss, an entity does not need hedge accounting.

BCZ2.23 However, in situations in which a commodity contract is not within the scope of IAS 39, it is accounted for as a normal sale or purchase contract ('executory contract'). Consequently, if an entity enters into a derivative contract to hedge changes in the fair value arising from a commodity supply contract that is not within the scope of IAS 39, an accounting mismatch is created. This is because the change in the fair value of the derivative is recognised in profit or loss while the change in the fair value of the commodity supply contract is not recognised (unless the contract is onerous).

BCZ2.24 To eliminate this accounting mismatch, an entity could apply hedge accounting. It could designate the commodity supply contracts (which meet the definition of a firm commitment) as a hedged item in a fair value hedge relationship. Consequently, the commodity supply contracts would be measured at fair value and the fair value changes would offset the changes in the fair value of the derivative instruments (to the extent that those are effective hedges). However, hedge accounting in these circumstances is administratively burdensome and often produces a less meaningful result than fair value accounting. Furthermore, entities enter into large volumes of commodity contracts and some positions may offset each other. An entity would therefore typically hedge on a net basis. Moreover, in many business models, this net position also includes physical long positions such as commodity inventory. That net position as a whole is then managed using derivatives to achieve a net position (after hedging) of nil (or close to nil). The net position is typically monitored, managed and adjusted daily. Because of the frequent movement of the net position and therefore the frequent adjustment of the net position to nil or close to nil by using derivatives, an entity would have to adjust the fair value hedge relationships frequently if the entity were to apply hedge accounting.

BCZ2.25 The IASB noted that in such situations hedge accounting would not be an efficient solution because entities manage a net position of derivatives, executory contracts and physical long positions in a dynamic way. Consequently, the IASB considered amending the scope of IAS 39 so that it would allow a commodity contract to be accounted for as a derivative in such situations. The IASB considered two alternatives for amending the scope of IAS 39:

(a) allowing an entity to elect to account for commodity contracts as derivatives (ie a free choice); or

(b) accounting for a commodity contract as a derivative if that is in accordance with the entity's fair value-based risk management strategy.

BCZ2.26 The IASB noted that giving an entity the choice to account for commodity contracts as derivatives would be tantamount to an elective 'own use' scope exception, which would have outcomes that would be similar to the accounting treatment in US GAAP. This approach would, in effect, allow an entity to elect the own use scope exception instead of derivative accounting at inception or a later date. Once the entity had elected to apply the scope exception it would not be able to change its election and switch to derivative accounting.

BCZ2.27 However, the IASB noted that such an approach would not be consistent with the approach in IAS 39 because:

(a) the accounting treatment in accordance with IAS 39 is dependent on, and reflects, the purpose (ie whether it is for 'own use') for which the contracts to buy or sell non-financial items are entered into and continue to be held for. This is different from a free choice, which would allow, but not require, the accounting treatment to reflect the purpose of the contract.

(b) in accordance with IAS 39, if similar contracts have been settled net, a contract to buy or sell non-financial items that can be settled net in cash must be accounted for as a derivative. Hence, a free choice would allow an entity to account for a commodity contract as a derivative regardless of whether similar contracts have been settled net in cash.

Consequently, in the Exposure Draft *Hedge Accounting* (the '2010 Hedge Accounting Exposure Draft'), the IASB decided not to propose that entities can elect to account for commodity contracts as derivatives.

BCZ2.28 Alternatively, the IASB considered applying derivative accounting to commodity contracts if that is in accordance with the entity's underlying business model and how the contracts are managed. Consequently, the actual type of settlement (ie whether settled net in cash) would not be conclusive for the evaluation of the appropriate accounting treatment. Instead, an entity would consider not only the purpose (based solely on the actual type of settlement) but also how the contracts are managed. As a result, if an entity's underlying business model changes and the entity no longer manages its commodity contracts on a fair value basis, the contracts would revert to the own use scope exception. This would be consistent with the criteria for using the fair value option for financial instruments (ie eliminating an accounting mismatch or if the financial instruments are managed on a fair value basis).

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BCZ2.29 Consequently, the IASB proposed that derivative accounting would apply to contracts that would otherwise meet the own use scope exception if that is in accordance with the entity's fair value-based risk management strategy. The IASB believed that this approach would faithfully represent the financial position and the performance of entities that manage their entire business on a fair value basis, provide more useful information to users of financial statements, and be less onerous for entities than applying hedge accounting.

BCZ2.30 Most respondents to the 2010 Hedge Accounting Exposure Draft supported the IASB's approach of using fair value accounting for resolving the accounting mismatch that arises when a commodity contract that is outside the scope of IAS 39 is hedged with a derivative. Those who supported the proposal thought that it would facilitate a better presentation of the overall economic effects of entering into such hedging transactions.

BCZ2.31 However, some respondents were concerned that the proposal would have unintended consequences by creating an accounting mismatch for some entities. They argued that in scenarios in which there are other items that are managed within a fair value-based risk management strategy and those other items are not measured at fair value under IFRS, applying derivative accounting to 'own use contracts' would introduce (instead of eliminate) an accounting mismatch. For example, in the electricity industry the risk management for some power plants and the related electricity sales is on a fair value basis. If these entities had to apply derivative accounting for customer sales contracts it would create an accounting mismatch. This accounting mismatch would result in artificial profit or loss volatility if the power plant is measured at cost under IAS 16 *Property, Plant and Equipment*. Another example raised by respondents was that of entities risk-managing the own use contracts, inventory and derivatives on a fair value basis. An accounting mismatch would arise if the inventory is measured in accordance with IAS 2 *Inventories* at the lower of cost and net realisable value while the own use contracts are measured at fair value.

BCZ2.32 Some respondents also requested that the IASB remove the precondition that an entity achieves a nil or close to nil net risk position in order to qualify for accounting for executory contracts as derivatives. They argued that if the condition was not removed it would limit the benefits of the proposal. This is because some entities, while generally seeking to maintain a net risk position close to nil, may sometimes take an open position depending on market conditions. These respondents noted that, from an entity's perspective, whether it takes a position or manages its exposure close to nil, it is still employing a fair value-based risk management strategy and that the financial statements should reflect the nature of its risk management activities.

BCZ2.33 Some also requested that the IASB clarify whether the proposal required that a fair value-based risk management strategy is adopted at an entity level or whether the business model can be assessed at a level lower than the entity level. These respondents commented that within an entity, a part of the business may be risk-managed on a fair value basis while other businesses within the entity may be managed differently.

BCZ2.34 In the light of the arguments raised by respondents to the 2010 Hedge Accounting Exposure Draft, the IASB discussed whether an alternative would be extending the fair value option in IFRS 9 (for situations in which it eliminates or significantly reduces an accounting mismatch) to contracts that meet the own use scope exception. The IASB noted that because the fair value option would be an election by the entity, it would address the concerns raised about creating unintended accounting mismatches (see paragraph BCZ2.31) while still providing an efficient solution to the problem that the IASB wanted to address through its 2010 Hedge Accounting Exposure Draft.

BCZ2.35 The IASB considered that the disadvantage of providing an election (ie different accounting outcomes as the result of the entity's choice) by extending the fair value option in IFRS 9 was outweighed by the benefits of this alternative because:

(a) it is consistent with the IASB's objective to represent more faithfully the financial position and performance of entities that risk-manage an entire business on a fair value basis;

(b) it provides operational relief for entities that risk-manage an entire business on a dynamic fair value basis (ie it is less onerous than applying hedge accounting); and

(c) it does not have the unintended consequences of creating an accounting mismatch in some situations.

BCZ2.36 The IASB also considered whether specific transition requirements were needed for this amendment to IAS 39. Without those, the amendment would, by default, apply retrospectively. However, the IASB noted that because the decision is to be made at inception of a contract, the transition to the amended scope of IAS 39 would in effect be prospective in that the election would not be available for contracts that already exist on the date on which an entity applies the amendment for the first time.

BCZ2.37 The IASB considered that this transition would detrimentally affect financial statements because of the co-existence of two different accounting treatments (derivative and executory contract accounting) for similar contracts until all own use contracts that existed on transition would have matured. The IASB also noted that this effect may create a practical disincentive that would dissuade entities from making the election for new contracts. This could result in a failure to achieve the benefit of reducing accounting mismatches that the changes were designed to address.

BCZ2.38 Consequently, the IASB decided to provide entities with an option to elect accounting as at fair value through profit or loss for own use contracts that already exist on the date on which an entity applies the amendment for the first time. The IASB decided that that option would apply on an 'all-or-none basis' for all similar contracts in order to prevent selective use of this option for similar contracts. The IASB also noted that because these contracts would previously have been outside the scope of IFRS 7 *Financial Instruments: Disclosures*, entities would not have measured the fair value of these contracts for measurement or disclosure purposes. Consequently, restating comparatives would be impracticable because it would involve hindsight.

Business combination forward contracts

BCZ2.39 The IASB was advised that there was diversity in practice regarding the application of the exemption in paragraph 2(g) of IAS 39 (now paragraph 2.1(f) of IFRS 9).[5] That paragraph applies to particular contracts associated with a business combination and results in those contracts not being accounted for as derivatives while, for example, necessary regulatory and legal processes are being completed.

BCZ2.40 As part of the *Improvements to IFRSs* issued in April 2009, the IASB concluded that that paragraph should be restricted to forward contracts between an acquirer and a selling shareholder to buy or sell an acquiree in a business combination at a future acquisition date and should not apply to option contracts, whether or not currently exercisable, that on exercise will result in control of an entity.

BCZ2.41 The IASB concluded that the purpose of paragraph 2(g) is to exempt from the provisions of IAS 39 contracts for business combinations that are firmly committed to be completed. Once the business combination is consummated, the entity follows the requirements of IFRS 3. Paragraph 2(g) applies only when completion of the business combination is not dependent on further actions of either party (and only the passage of a normal period of time is required). Option contracts allow one party to control the occurrence or non-occurrence of future events depending on whether the option is exercised.

BCZ2.42 Several respondents to the Exposure Draft that proposed the amendment expressed the view that it should also apply to contracts to acquire investments in associates, referring to paragraph 20 of IAS 28. However, the acquisition of an interest in an associate represents the acquisition of a financial instrument. The acquisition of an interest in an associate does not represent an acquisition of a business with subsequent consolidation of the constituent net assets. The IASB noted that paragraph 20 of IAS 28 explains only the methodology used to account for investments in associates. This should not be taken to imply that the principles for business combinations and consolidations can be applied by analogy to accounting for investments in associates and joint ventures. The IASB concluded that paragraph 2(g) should not be applied by analogy to contracts to acquire investments in associates and similar transactions. This conclusion is consistent with the conclusion the IASB reached regarding impairment losses on investments in associates as noted in the *Improvements to IFRSs* issued in May 2008 and stated in paragraph BC27 of the Basis for Conclusions on IAS 28.

BCZ2.43 Some respondents to the Exposure Draft that proposed the amendment raised concerns about the proposed transition requirement. The IASB noted that determining the fair value of a currently outstanding contract when its inception was before the effective date of this amendment would require the use of hindsight and might not achieve comparability. Accordingly, the IASB decided not to require retrospective application. The IASB also rejected applying the amendment prospectively only to new contracts entered into after the effective date because that would create a lack of comparability between contracts outstanding as of the effective date and contracts entered into after the effective date. Consequently, the IASB concluded that the amendment to paragraph 2(g) should be applied prospectively to all unexpired contracts for annual periods beginning on or after 1 January 2010.

[5] In October 2012 the IASB issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which amended paragraph 2(g) of IAS 39 (now paragraph 2.1(f) of IFRS 9) to clarify that the exception should only apply to forward contracts that result in a business combination within the scope of IFRS 3 *Business Combinations*.

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Recognition and derecognition (Chapter 3)

Derecognition of a financial asset

The original IAS 39[6]

BCZ3.1 Under the original IAS 39, several concepts governed when a financial asset should be derecognised. It was not always clear when and in what order to apply those concepts. As a result, the derecognition requirements in the original IAS 39 were not applied consistently in practice.

BCZ3.2 As an example, the original IAS 39 was unclear about the extent to which risks and rewards of a transferred asset should be considered for the purpose of determining whether derecognition is appropriate and how risks and rewards should be assessed. In some cases (eg transfers with total returns swaps or unconditional written put options), the Standard specifically indicated whether derecognition was appropriate, whereas in others (eg credit guarantees) it was unclear. Also, some questioned whether the assessment should focus on risks and rewards or only risks and how different risks and rewards should be aggregated and weighed.

BCZ3.3 To illustrate, assume an entity sells a portfolio of short-term receivables of CU100[7] and provides a guarantee to the buyer for credit losses up to a specified amount (say CU20) that is less than the total amount of the receivables, but higher than the amount of expected losses (say CU5). In this case, should (a) the entire portfolio continue to be recognised, (b) the portion that is guaranteed continue to be recognised or (c) the portfolio be derecognised in full and a guarantee be recognised as a financial liability? The original IAS 39 did not give a clear answer and the IAS 39 Implementation Guidance Committee—a group set up by the IASB's predecessor body to resolve interpretative issues raised in practice—was unable to reach an agreement on how IAS 39 should be applied in this case. In developing proposals for improvements to IAS 39, the IASB concluded that it was important that IAS 39 should provide clear and consistent guidance on how to account for such a transaction.

Exposure draft of proposed amendments to IAS 39 published in 2002

BCZ3.4 To resolve the problems, the exposure draft published in 2002 proposed an approach to derecognition under which a transferor of a financial asset continues to recognise that asset to the extent the transferor has a continuing involvement in it. Continuing involvement could be established in two ways: (a) a reacquisition provision (such as a call option, put option or repurchase agreement) and (b) a provision to pay or receive compensation based on changes in value of the transferred asset (such as a credit guarantee or net cash-settled option).

BCZ3.5 The purpose of the approach proposed in the exposure draft was to facilitate consistent implementation and application of IAS 39 by eliminating conflicting concepts and establishing an unambiguous, more internally consistent and workable approach to derecognition. The main benefits of the proposed approach were that it would greatly clarify IAS 39 and provide transparency on the balance sheet about any continuing involvement in a transferred asset.

Comments received

BCZ3.6 Many respondents to the exposure draft agreed that there were inconsistencies in the existing derecognition requirements in IAS 39. However, there was limited support for the proposed continuing involvement approach. Respondents expressed conceptual and practical concerns, including:

(a) any benefits of the proposed changes did not outweigh the burden of adopting a different approach that had its own set of (as yet unidentified and unsolved) problems;

(b) the proposed approach was a fundamental change from that in the original IAS 39;

(c) the proposal did not achieve convergence with US GAAP;

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[6] In this Basis for Conclusions, the phrase 'the original IAS 39' refers to the Standard issued by the IASB's predecessor body, the International Accounting Standards Committee (IASC) in 1999 and revised in 2000.

[7] In this Basis for Conclusions, monetary amounts are denominated in 'currency units (CU)'.

(d) the proposal was untested; and

(e) the proposal was not consistent with the *Framework for the Preparation and Presentation of Financial Statements*.

BCZ3.7 Many respondents expressed the view that the basic approach in the original IAS 39 should be retained and the inconsistencies removed. The reasons included: (a) the existing IAS 39 had proven to be reasonable in concept and operational in practice and (b) the approach should not be changed until the IASB developed an alternative comprehensive approach.

Revisions to IAS 39

BCZ3.8 In response to the comments received, the IASB decided to revert to the derecognition concepts in the original IAS 39 and to clarify how and in what order the concepts should be applied. In particular, the IASB decided that an evaluation of the transfer of risks and rewards should precede an evaluation of the transfer of control for all types of transactions.

BCZ3.9 Although the structure and wording of the derecognition requirements were substantially amended, the IASB concluded that the requirements in the revised IAS 39 should not be substantially different from those in the original IAS 39. In support of this conclusion, it noted that the application of the requirements in the revised IAS 39 generally resulted in answers that could have been obtained under the original IAS 39. In addition, although there would be a need to apply judgement to evaluate whether substantially all risks and rewards had been retained, this type of judgement was not new compared with the original IAS 39. However, the revised requirements clarified the application of the concepts in circumstances in which it was previously unclear how IAS 39 should be applied (this guidance is now in IFRS 9). The IASB concluded that it would be inappropriate to revert to the original IAS 39 without such clarifications.

BCZ3.10 The IASB also decided to include guidance in the Standard that clarified how to evaluate the concepts of risks and rewards and of control. The IASB regarded such guidance as important to provide a framework for applying the concepts in IAS 39 (this guidance is now in IFRS 9). Although judgement was still necessary to apply the concepts in practice, the guidance was expected to increase consistency in how the concepts were applied.

BCZ3.11 More specifically, the IASB decided that the transfer of risks and rewards should be evaluated by comparing the entity's exposure before and after the transfer to the variability in the amounts and timing of the net cash flows of the transferred asset. If the entity's exposure, on a present value basis, had not changed significantly, the entity would conclude that it had retained substantially all risks and rewards. In this case, the IASB concluded that the asset should continue to be recognised. This accounting treatment was consistent with the treatment of repurchase transactions and some assets subject to deep in-the-money options under the original IAS 39. It was also consistent with how some interpreted the original IAS 39 when an entity sells a portfolio of short-term receivables but retains all substantive risks through the issue of a guarantee to compensate for all expected credit losses (see the example in paragraph BCZ3.3).

BCZ3.12 The IASB decided that control should be evaluated by looking to whether the transferee has the practical ability to sell the asset. If the transferee could sell the asset (eg because the asset was readily obtainable in the market and the transferee could obtain a replacement asset if it needed to return the asset to the transferor), the transferor had not retained control because the transferor did not control the transferee's use of the asset. If the transferee could not sell the asset (eg because the transferor had a call option and the asset was not readily obtainable in the market, so that the transferee could not obtain a replacement asset), the transferor had retained control because the transferee was not free to use the asset as its own.

BCZ3.13 The original IAS 39 also did not contain guidance on when a part of a financial asset could be considered for derecognition. The IASB decided to include such guidance in the Standard to clarify the issue (this guidance is now in IFRS 9). It decided that an entity should apply the derecognition principles to a part of a financial asset only if that part contained no risks and rewards relating to the part not being considered for derecognition. Accordingly, a part of a financial asset would be considered for derecognition only if it comprised:

(a) only specifically identified cash flows from a financial asset (or a group of similar financial assets);

(b) only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets); or

(c) only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets).

In all other cases the derecognition principles would be applied to the financial asset in its entirety.

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Arrangements under which an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay the cash flows to one or more recipients

BCZ3.14 The original IAS 39 did not provide explicit guidance about the extent to which derecognition is appropriate for contractual arrangements in which an entity retains its contractual right to receive the cash flows from an asset, but assumes a contractual obligation to pay those cash flows to another entity (a 'pass-through arrangement'). Questions were raised in practice about the appropriate accounting treatment and divergent interpretations evolved for more complex structures.

BCZ3.15 To illustrate the issue using a simple example, assume the following. Entity A makes a five-year interest-bearing loan (the 'original asset') of CU100 to Entity B. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU90, Entity A agrees to pass to Entity C 90 per cent of all principal and interest payments collected from Entity B (as, when and if collected). Entity A accepts no obligation to make any payments to Entity C other than 90 per cent of exactly what has been received from Entity B. Entity A provides no guarantee to Entity C about the performance of the loan and has no rights to retain 90 per cent of the cash collected from Entity B nor any obligation to pay cash to Entity C if cash has not been received from Entity B. In the example above, does Entity A have a loan asset of CU100 and a liability of CU90 or does it have an asset of CU10? To make the example more complex, what if Entity A first transfers the loan to a consolidated special purpose entity (SPE), which in turn passes through to investors the cash flows from the asset? Does the accounting treatment change because Entity A first sold the asset to an SPE?[8]

BCZ3.16 To address these issues, the exposure draft of proposed amendments to IAS 39 in 2002 included guidance to clarify under which conditions pass-through arrangements could be treated as a transfer of the underlying financial asset. The IASB concluded that an entity does not have an asset and a liability, as defined in the *Framework*,[9] when it enters into an arrangement to pass through cash flows from an asset and that arrangement meets specified conditions. In these cases, the entity acts more as an agent of the eventual recipients of the cash flows than as an owner of the asset. Accordingly, to the extent that those conditions are met the arrangement is treated as a transfer and considered for derecognition even though the entity may continue to collect cash flows from the asset. Conversely, to the extent the conditions are not met, the entity acts more as an owner of the asset with the result that the asset should continue to be recognised.

BCZ3.17 Respondents to the exposure draft (2002) were generally supportive of the proposed changes. Some respondents asked for further clarification of the requirements and the interaction with the requirements for consolidation of special purpose entities (in SIC-12 *Consolidation—Special Purpose Entities*). Respondents in the securitisation industry noted that under the proposed guidance many securitisation structures would not qualify for derecognition.

BCZ3.18 Considering these and other comments, the IASB decided to proceed with its proposals to issue guidance on pass-through arrangements and to clarify that guidance in finalising the revised IAS 39 (this guidance is now in IFRS 9).

BCZ3.19 The IASB concluded that the following three conditions must be met for treating a contractual arrangement to pass through cash flows from a financial asset as a transfer of that asset:

(a) The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. However, the entity is allowed to make short-term advances to the eventual recipient so long as it has the right of full recovery of the amount lent plus accrued interest.

(b) The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.

(c) The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay. In addition, during the short settlement period, the entity is not entitled to reinvest such cash flows except for investments in cash or cash equivalents and where any interest earned from such investments is remitted to the eventual recipients.

BCZ3.20 These conditions followed from the definitions of assets and liabilities in the *Framework*. Condition (a) indicates that the transferor has no liability (because there is no present obligation to pay cash), and

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[8] SIC-12 *Consolidation—Special Purpose Entities* was withdrawn and superseded by IFRS 10 *Consolidated Financial Statements* issued in May 2011. There is no longer specific accounting guidance for special purpose entities because IFRS 10 applies to all types of entities.

[9] References to the *Framework* in this Basis for Conclusions are to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when parts of the Standard were developed and revised.

conditions (b) and (c) indicate that the transferor has no asset (because the transferor does not control the future economic benefits associated with the transferred asset).

BCZ3.21 The IASB decided that the derecognition tests that apply to other transfers of financial assets (ie the tests of transferring substantially all the risks and rewards and control) should also apply to arrangements to pass through cash flows that meet the three conditions but do not involve a fully proportional share of all or specifically identified cash flows. Thus, if the three conditions are met and the entity passes on a fully proportional share, either of all cash flows (as in the example in paragraph BCZ3.15) or of specifically identified cash flows (eg 10 per cent of all interest cash flows), the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership. Thus, in the example in paragraph BCZ3.15, Entity A would report a loan asset of CU10 and derecognise CU90. Similarly, if an entity enters into an arrangement that meets the three conditions above, but the arrangement is not on a fully proportionate basis, the contractual arrangement would have to meet the general derecognition conditions to qualify for derecognition. This ensures consistency in the application of the derecognition model, whether a transaction is structured as a transfer of the contractual right to receive the cash flows of a financial asset or as an arrangement to pass through cash flows.

BCZ3.22 To illustrate a disproportionate arrangement using a simple example, assume the following. Entity A originates a portfolio of five-year interest-bearing loans of CU10,000. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU9,000, Entity A agrees to pay to Entity C the first CU9,000 (plus interest) of cash collected from the loan portfolio. Entity A retains rights to the last CU1,000 (plus interest), ie it retains a subordinated residual interest. If Entity A collects, say, only CU8,000 of its loans of CU10,000 because some debtors default, Entity A would pass on to Entity C all of the CU8,000 collected and Entity A keeps nothing of the CU8,000 collected. If Entity A collects CU9,500, it passes CU9,000 to Entity C and retains CU500. In this case, if Entity A retains substantially all the risks and rewards of ownership because the subordinated retained interest absorbs all of the likely variability in net cash flows, the loans continue to be recognised in their entirety even if the three pass-through conditions are met.

BCZ3.23 The IASB recognised that many securitisations might fail to qualify for derecognition either because one or more of the three conditions (now in paragraph 3.2.5 of IFRS 9) were not met or because the entity has retained substantially all the risks and rewards of ownership.

BCZ3.24 Whether a transfer of a financial asset qualifies for derecognition does not differ depending on whether the transfer is direct to investors or through a consolidated SPE or trust that obtains the financial assets and, in turn, transfers a portion of those financial assets to third-party investors.

Transfers that do not qualify for derecognition

BCZ3.25 The original IAS 39 did not provide guidance about how to account for a transfer of a financial asset that does not qualify for derecognition. The amendments included such guidance (that guidance is now in IFRS 9). To ensure that the accounting reflects the rights and obligations that the transferor has in relation to the transferred asset, there is a need to consider the accounting for the asset as well as the accounting for the associated liability.

BCZ3.26 When an entity retains substantially all the risks and rewards of the asset (eg in a repurchase transaction), there are generally no special accounting considerations because the entity retains upside and downside exposure to gains and losses resulting from the transferred asset. Consequently, the asset continues to be recognised in its entirety and the proceeds received are recognised as a liability. Similarly, the entity continues to recognise any income from the asset along with any expense incurred on the associated liability.

Continuing involvement in a transferred asset

BCZ3.27 The IASB decided that if the entity determines that it has neither retained nor transferred substantially all of the risks and rewards of an asset and that it has retained control, the entity should continue to recognise the asset to the extent of its continuing involvement. This is to reflect the transferor's continuing exposure to the risks and rewards of the asset and that this exposure is not related to the entire asset, but is limited in amount. The IASB noted that precluding derecognition to the extent of the continuing involvement is useful to users of financial statements in such cases, because it reflects the entity's retained exposure to the risks and rewards of the financial asset better than full derecognition.

BCZ3.28 When the entity transfers some significant risks and rewards and retains others and derecognition is precluded because the entity retains control of the transferred asset, the entity no longer retains all the upside and downside exposure to gains and losses resulting from the transferred asset. Consequently, the revised IAS 39 required (and IFRS 9 now requires) the asset and the associated liability to be measured in a way that ensures

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that any changes in value of the transferred asset that are not attributed to the entity are not recognised by the entity.

BCZ3.29 For example, special measurement and income recognition issues arise if derecognition is precluded because the transferor has retained a call option or written a put option and the asset is measured at fair value. In those situations, in the absence of additional guidance, application of the general measurement and income recognition requirements for financial assets and financial liabilities may result in accounting that does not represent the transferor's rights and obligations related to the transfer.

Improved disclosure requirements issued in October 2010

BC3.30 In March 2009 the IASB published an Exposure Draft *Derecognition* (Proposed amendments to IAS 39 and IFRS 7) (the '2009 Derecognition Exposure Draft'). In June 2009 the IASB held public round tables in North America, Asia and Europe to discuss the proposals in the 2009 Derecognition Exposure Draft. In addition to the round tables, the IASB undertook an extensive outreach programme with users, preparers, regulators, auditors, trade associations and others.

BC3.31 However, in June 2010 the IASB revised its strategy and work plan. The IASB and the US Financial Accounting Standards Board (FASB) decided that their near-term priority should be to increase the transparency and comparability of their standards by improving and aligning US GAAP and IFRS disclosure requirements for financial assets transferred to another entity. The boards also decided to conduct additional research and analysis, including a post-implementation review of the FASB's recently amended requirements, as a basis for assessing the nature and direction of any further efforts to improve or align IFRS and US GAAP. As a result, the IASB finalised the disclosure requirements that were included in the 2009 Derecognition Exposure Draft with a view to aligning the disclosure requirements in IFRS with US GAAP requirements for transfers of financial assets. Those disclosure requirements were issued in October 2010 as an amendment to IFRS 7. In October 2010 the requirements in IAS 39 for derecognition of financial assets and financial liabilities were carried forward unchanged to IFRS 9.

BC3.32 [See IFRS 17 *Insurance Contracts*]

Fees in the '10 per cent' Test for Derecognition of Financial Liabilities (*Annual Improvements to IFRS Standards 2018–2020*)

BC3.33 Paragraph 3.3.2 requires an entity to derecognise the original financial liability and recognise a new financial liability when there is:

(a) an exchange between an existing borrower and lender of debt instruments with substantially different terms; or

(b) a substantial modification of the terms of an existing financial liability or a part of it.

Paragraph B3.3.6 specifies that the terms are substantially different if the discounted present value of the cash flows under the new terms using the original effective interest rate is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability (10 per cent test). Paragraph B3.3.6 requires an entity to include 'any fees paid net of any fees received' in the 10 per cent test.

BC3.34 The Board decided to amend paragraph B3.3.6 in response to a request to clarify which fees an entity includes in the 10 per cent test. The clarification aligns with the objective of the test, which is to quantitatively assess the significance of any difference between the old and new contractual terms on the basis of the changes in the contractual cash flows between the borrower and lender.

BC3.35 The transition requirements in paragraph 7.2.35 reflect the Board's view that the expected benefit from retrospective application of the amendment would not outweigh the cost of requiring entities to reassess all previous modifications and exchanges. In particular, retrospective application would be unlikely to provide users of financial statements with trend information because financial liabilities are generally modified or exchanged on an ad hoc basis.

BC3.36 Paragraph AG62 of IAS 39 includes the same requirements as those in paragraph B3.3.6 of IFRS 9. An entity that has not previously applied any version of IFRS 9 and whose activities are predominantly connected with insurance is permitted to apply IAS 39 for a limited period of time. In providing the temporary exemption from applying IFRS 9, the Board had not contemplated maintaining IAS 39 (other than for hedge accounting) given the temporary and limited nature of the exemption. Therefore, the Board did not amend paragraph AG62 of IAS 39.

Classification (Chapter 4)

Classification of financial assets

BC4.1 In IFRS 9 as issued in 2009 the IASB aimed to help users to understand the financial reporting of financial assets by:

(a) reducing the number of classification categories and providing a clearer rationale for measuring financial assets in a particular way that replaces the numerous categories in IAS 39, each of which has specific rules dictating how an asset can or must be classified;

(b) applying a single impairment method to all financial assets not measured at fair value, which replaces the many different impairment methods that are associated with the numerous classification categories in IAS 39; and

(c) aligning the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics, thus providing relevant and useful information to users for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

BC4.2 The IASB believes that IFRS 9 both helps users to understand and use the financial reporting of financial assets and eliminates much of the complexity in IAS 39. The IASB disagrees with the assertion made by a dissenting IASB member that IFRS 9 does not meet the objective of reducing the number of classification categories for financial assets and eliminating the specific rules associated with those categories. Unlike IAS 39, IFRS 9 provides a clear rationale for measuring a financial asset at either amortised cost or fair value, and hence helps users to understand the financial reporting of financial assets. IFRS 9 aligns the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics. In so doing, IFRS 9 significantly reduces complexity by eliminating the numerous rules associated with each classification category in IAS 39. Consistently with all other financial assets, hybrid contracts with financial asset hosts are classified and measured in their entirety, thereby eliminating the complex and rule-based requirements in IAS 39 for embedded derivatives. Furthermore, IFRS 9 requires a single impairment method, which replaces the different impairment methods associated with the many classification categories in IAS 39. The IASB believes that these changes will help users to understand the financial reporting of financial assets and to better assess the amounts, timing and uncertainty of future cash flows.

Measurement categories for financial assets

BC4.3 Some users of financial statements support a single measurement method—fair value—for all financial assets. They view fair value as more relevant than other measurements in helping them to assess the effect of current economic events on an entity. They assert that having one measurement attribute for all financial assets promotes consistency in valuation, presentation and disclosure and improves the usefulness of financial statements.

BC4.4 However, many users and others, including many preparers and auditors of financial statements and regulators, do not support the recognition in the statement of comprehensive income of changes in fair value for financial assets that are not held for trading or are not managed on a fair value basis. Some users say that they often value an entity on the basis of its business model and that in some circumstances cost-based information provides relevant information that can be used to predict likely actual cash flows.

BC4.5 Some, including some of those who generally support the broad application of fair value for financial assets, raise concerns about the use of fair value when fair value cannot be determined within a narrow range. Those views were consistent with the general concerns raised during the financial crisis. Many also believe that other issues, including financial statement presentation, need to be addressed before a comprehensive fair value measurement requirement would be feasible.

BC4.6 In response to those views, the IASB decided that measuring all financial assets at fair value is not the most appropriate approach to improving the financial reporting for financial instruments. Accordingly, the 2009 Exposure Draft *Financial Instruments: Classification and Measurement* (the '2009 Classification and Measurement Exposure Draft') proposed that entities should classify financial assets into two primary measurement categories: amortised cost and fair value (the 'mixed attribute approach'). The IASB noted that both of those measurement methods can provide useful information to users of financial statements for particular types of financial assets in particular circumstances.

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BC4.7 Almost all respondents to the 2009 Classification and Measurement Exposure Draft supported the mixed attribute approach, stating that amortised cost provides relevant and useful information about particular financial assets in particular circumstances because it provides information about the entity's likely actual cash flows. Some respondents said that fair value does not provide such information because it assumes that the financial asset is sold or transferred on the measurement date.

BC4.8 Accordingly, IFRS 9 requires some financial assets to be measured at amortised cost if particular conditions are met.

Fair value information in the statements of financial position and financial performance

BC4.9 Some respondents to the 2009 Classification and Measurement Exposure Draft proposed that fair value information should be presented in the statement of financial position for financial assets measured at amortised cost. Some of those supporting such presentation said that the information provided would be more reliable and timely if it were required to be presented in the statement of financial position instead of in the notes.

BC4.10 The IASB also considered whether the total gains and losses for the period related to fair value measurements in Level 3 of the fair value measurement hierarchy (paragraph 27A of IFRS 7 describes the levels in the fair value hierarchy[10]) should be presented separately in the statement of comprehensive income. Those supporting such presentation said that its prominence would draw attention to how much of the total fair value gain or loss for the period was attributable to fair value measurements that are subject to more measurement uncertainty.

BC4.11 The IASB decided that it would reconsider both issues at a future date. The IASB noted that the Level 3 gains or losses for the period are required to be disclosed in the notes to the financial statements in accordance with IFRS 7.[11] The IASB also noted that neither proposal had been exposed for public comment and further consultation was required. The IASB decided that these two issues should form part of convergence discussions with the FASB.

Approach to classifying financial assets

BC4.12 The 2009 Classification and Measurement Exposure Draft proposed that an entity should classify its financial assets into two primary measurement categories on the basis of the financial assets' characteristics and the entity's business model for managing them. Thus, a financial asset would be measured at amortised cost if two conditions were met:

(a) the financial asset has only basic loan features; and

(b) the financial asset is managed on a contractual yield basis.

A financial asset that did not meet both conditions would be measured at fair value.

BC4.13 Most respondents supported classification on the basis of the contractual terms of the financial asset and how an entity manages groups of financial assets. Although they agreed with the principles proposed in the 2009 Classification and Measurement Exposure Draft, some did not agree with the way the approach was described and said that more application guidance was needed, in particular to address the following issues:

(a) the order in which the two conditions are considered;

(b) how the 'managed on a contractual yield basis' condition should be applied; and

(c) how the 'basic loan features' condition should be applied.

BC4.14 Most respondents agreed that the two conditions for determining how financial assets are measured were necessary. However, many questioned the order in which the two conditions should be considered. The IASB agreed with those who commented that it would be more efficient for an entity to consider the business model condition first. Consequently, the IASB clarified that entities would consider the business model first. However, the IASB noted that the contractual cash flow characteristics of any financial asset within a business

[10] IFRS 13 *Fair Value Measurement*, issued in May 2011, defines fair value and contains requirements for measuring fair value and for disclosing information about fair value measurements. IFRS 13 contains a three-level fair value hierarchy for the inputs used in valuation techniques to measure fair value and for the related disclosures. As a consequence paragraph 27A of IFRS 7 has been deleted.

[11] IFRS 13, issued in May 2011, requires disclosures about fair value measurements. As a consequence paragraph 27B(c) and (d) of IFRS 7 has been deleted.

model that has the objective of collecting contractual cash flows must also be assessed to ensure that amortised cost provides relevant information to users.

The entity's business model

BC4.15 The IASB concluded that an entity's business model affects the predictive quality of contractual cash flows—ie whether the likely actual cash flows will result primarily from the collection of contractual cash flows. Accordingly, the 2009 Classification and Measurement Exposure Draft proposed that a financial asset should be measured at amortised cost only if it is 'managed on a contractual yield basis'. This condition was intended to ensure that the measurement of a financial asset provides information that is useful to users of financial statements in predicting likely actual cash flows.

BC4.16 Almost all respondents to the exposure draft agreed that classification and measurement should reflect how an entity manages its financial assets. However, most expressed concern that the term 'managed on a contractual yield basis' would not adequately describe that principle and that more guidance was needed.

BC4.17 In August 2009 the FASB posted on its website a description of its tentative approach to classification and measurement of financial instruments. That approach also considers the entity's business model. Under that approach, financial instruments would be measured at fair value through profit or loss unless:

> ... an entity's business strategy is to hold debt instruments with principal amounts for collection or payment(s) of contractual cash flows rather than to sell or settle the financial instruments with a third party ...

The FASB also provided explanatory text:

> ... an entity's business strategy for a financial instrument would be evaluated based on how the entity manages its financial instruments rather than based on the entity's intent for an individual financial instrument. The entity also would demonstrate that it holds a high proportion of similar instruments for long periods of time relative to their contractual terms.

BC4.18 The IASB had intended 'managed on a contractual yield basis' to describe a similar condition. However, it decided not to use the FASB's proposed guidance because the additional guidance included would still necessitate significant judgement. In addition, the IASB noted that the FASB's proposed approach might be viewed as very similar to the notion of 'held to maturity' in IAS 39, which could result in 'bright line' guidance on how to apply it. Most respondents believed the IASB should avoid such bright lines and that an entity should be required to exercise judgement.

BC4.19 Therefore, in response to the concerns noted in paragraph BC4.16, the IASB clarified the condition by requiring an entity to measure a financial asset at amortised cost only if the objective of the entity's business model is to hold the financial asset to collect the contractual cash flows. The IASB also clarified in the application guidance that:

(a) it is expected that an entity may sell some financial assets that it holds with an objective of collecting the contractual cash flows. Very few business models entail holding all instruments until maturity. However, frequent buying and selling of financial assets is not consistent with a business model of holding financial assets to collect contractual cash flows.

(b) an entity needs to use judgement to determine at what level this condition should be applied. That determination is made on the basis of how an entity manages its business. It is not made at the level of an individual financial asset.

BC4.20 The IASB noted that an entity's business model does not relate to a choice (ie it is not a voluntary designation) but instead it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management.

BC4.21 For example, if an investment bank uses a trading business model, it could not easily become a savings bank that uses an 'originate and hold' business model. Consequently, a business model is very different from 'management intentions', which can relate to a single instrument. The IASB concluded that sales or transfers of financial instruments before maturity would not be inconsistent with a business model with an objective of collecting contractual cash flows, as long as such transactions were consistent with that business model; instead of with a business model that has the objective of realising changes in fair values.

Contractual cash flow characteristics

BC4.22 The 2009 Classification and Measurement Exposure Draft proposed that only financial instruments with basic loan features could be measured at amortised cost. It specified that a financial instrument has basic loan features if its contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. For the purposes of this condition, interest is consideration

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for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time, which may include a premium for liquidity risk.

BC4.23 The objective of the effective interest method for financial instruments measured at amortised cost is to allocate interest revenue or expense to the relevant period. Cash flows that are interest always have a close relation to the amount advanced to the debtor (the 'funded' amount) because interest is consideration for the time value of money and the credit risk associated with the issuer of the instrument and with the instrument itself. The IASB noted that the effective interest method is not an appropriate method to allocate cash flows that are not principal or interest on the principal amount outstanding. The IASB concluded that if a financial asset contains contractual cash flows that are not principal or interest on the principal amount outstanding then a valuation overlay to contractual cash flows (fair value) is required to ensure that the reported financial information provides useful information.

BC4.24 Most respondents to the 2009 Classification and Measurement Exposure Draft agreed with the principle that classification should reflect the contractual terms of the financial asset. However, many objected to the label 'basic loan features' and requested more guidance to apply the principle to particular financial assets. Respondents were also concerned that the 2009 Classification and Measurement Exposure Draft did not discuss 'immaterial' or 'insignificant' features that they believed ought not to affect classification.

BC4.25 The IASB decided to clarify how contractual cash flow characteristics should affect classification and improve the examples that illustrate how the condition should be applied. It decided not to add application guidance clarifying that the notion of materiality applies to this condition, because that notion applies to every item in the financial statements. However, it did add application guidance that a contractual cash flow characteristic does not affect the classification of a financial asset if it is 'not genuine'.

Application of the two classification conditions to particular financial assets

Investments in contractually linked instruments (tranches)

BC4.26 A structured investment vehicle may issue different tranches to create a 'waterfall' structure that prioritises the payments by the issuer to the holders of the different tranches. In typical waterfall structures, multiple contractually linked instruments effect concentrations of credit risk in which payments to holders are prioritised. Such structures specify the order in which any losses that the issuer incurs are allocated to the tranches. The 2009 Classification and Measurement Exposure Draft concluded that tranches providing credit protection (albeit on a contingent basis) to other tranches are leveraged because they expose themselves to higher credit risk by writing credit protection to other tranches. Hence their cash flows do not represent solely payments of principal and interest on the principal amount outstanding. Thus, only the most senior tranche could have basic loan features and might qualify for measurement at amortised cost, because only the most senior tranche would receive credit protection in all situations.

BC4.27 The 2009 Classification and Measurement Exposure Draft proposed that the classification principle should be based on whether a tranche could provide credit protection to any other tranches in any possible scenario. In the IASB's view, a contract that contains credit concentration features that create ongoing subordination (not only in a liquidation scenario) would include contractual cash flows that represent a premium for providing credit protection to other tranches. Only the most senior tranche does not receive such a premium.

BC4.28 In proposing this approach, the IASB concluded that subordination in itself should not preclude amortised cost measurement. The ranking of an entity's instruments is a common form of subordination that affects almost all lending transactions. Commercial law (including bankruptcy law) typically sets out a basic ranking for creditors. This is required because not all creditors' claims are contractual (eg claims regarding damages for unlawful behaviour and for tax liabilities or social insurance contributions). Although it is often difficult to determine exactly the degree of leverage resulting from this subordination, the IASB believes that it is reasonable to assume that commercial law does not intend to create leveraged credit exposure for general creditors such as trade creditors. Thus, the IASB believes that the credit risk associated with general creditors does not preclude the contractual cash flows representing the payments of principal and interest on the principal amount outstanding. Consequently, the credit risk associated with any secured or senior liabilities ranking above general creditors should also not preclude the contractual cash flows from representing payments of principal and interest on the principal amount outstanding.

BC4.29 Almost all respondents disagreed with the approach in the 2009 Classification and Measurement Exposure Draft for investments in contractually linked instruments for the following reasons:

(a) It focused on form and legal structure instead of the economic characteristics of the financial instruments.

(b) It would create structuring opportunities because of the focus on the existence of a waterfall structure, without consideration of the characteristics of the underlying instruments.

(c) It would be an exception to the overall classification model, driven by anti-abuse considerations.

BC4.30 In particular, respondents argued that the proposals in the 2009 Classification and Measurement Exposure Draft would conclude that some tranches provide credit protection and therefore were ineligible for measurement at amortised cost, even though that tranche might have a lower credit risk than the underlying pool of instruments that would themselves be eligible for measurement at amortised cost.

BC4.31 The IASB did not agree that the proposals in the 2009 Classification and Measurement Exposure Draft were an exception to the overall classification model. In the IASB's view, those proposals were consistent with many respondents' view that any financial instrument that creates contractual subordination should be subject to the proposed classification criteria and no specific guidance should be required to apply the classification approach to these instruments. However, it noted that, for contractually linked instruments that effect concentrations of credit risk, many respondents did not agree that the contractual cash flow characteristics determined by the terms and conditions of the financial asset in isolation best reflected the economic characteristics of that financial asset.

BC4.32 Respondents proposed other approaches in which an investor 'looks through' to the underlying pool of instruments of a waterfall structure and measures the instruments at fair value if looking through is not possible. They made the following points:

(a) *Practicability*: The securitisation transactions intended to be addressed were generally over-the-counter transactions in which the parties involved had sufficient information about the assets to perform an analysis of the underlying pool of instruments.

(b) *Complexity*: Complex accounting judgement was appropriate to reflect the complex economic characteristics of the instrument. In particular, in order to obtain an understanding of the effects of the contractual terms and conditions, an investor would have to understand the underlying pool of instruments. Also, requiring fair value measurement if it were not practicable to look through to the underlying pool of instruments would allow an entity to avoid such complexity.

(c) *Mechanics*: Amortised cost measurement should be available only if all of the instruments in the underlying pool of instruments had contractual cash flows that represented payments of principal and interest on the principal amount outstanding. Some also suggested that instruments that change the cash flow variability of the underlying pool of instruments in a way that is consistent with representing solely payments of principal and interest on the principal amount outstanding, or aligned currency/interest rates with the issued notes, should not preclude amortised cost measurement.

(d) *Relative exposure to credit risk*: Many favoured use of a probability-weighted approach to assess whether an instrument has a lower or higher exposure to credit risk than the average credit risk of the underlying pool of instruments.

BC4.33 The IASB was persuaded that classification solely on the basis of the contractual features of the financial asset being assessed for classification would not capture the economic characteristics of the instruments when a concentrated credit risk arises through contractual linkage. Consequently, the IASB decided that, unless it is impracticable, an entity should 'look through' to assess the underlying cash flow characteristics of the financial assets and to assess the exposure to credit risk of those financial assets relative to the underlying pool of instruments.

BC4.34 The IASB concluded that the nature of contractually linked instruments that effect concentrations of credit risk justifies this approach because the variability of cash flows from the underlying pool of instruments is a reference point, and tranching only reallocates credit risk. Thus, if the contractual cash flows of the assets in the underlying pool represent payments of principal and interest on the principal amount outstanding, any tranche that is exposed to the same or lower credit risk (as evidenced by the cash flow variability of the tranche relative to the overall cash flow variability of the underlying instrument pool) would also be deemed to represent payments of principal and interest on the principal amount outstanding. The IASB also took the view that such an approach would address many of the concerns raised in the comment letters with regard to structuring opportunities and the focus on the contractual form of the financial asset, instead of its underlying economic characteristics. The IASB also noted that in order to understand and make the judgement about whether particular types of financial assets have the required cash flow characteristics, an entity would have to understand the characteristics of the underlying issuer to ensure that the instrument's cash flows are solely payments of principal and interest on the principal amount outstanding.

BC4.35 To apply this approach, the IASB decided that an entity should:

(a) determine whether the contractual terms of the issued instrument (the financial asset being classified) give rise to cash flows that are solely payments of principal and interest on the principal amount

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outstanding. The IASB concluded that the issued instrument must have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

(b) look through to the underlying pool of instruments until it can identify the instruments that are creating (instead of simply passing through) the cash flows.

(c) determine whether one or more of the instruments in the underlying pool has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. The IASB concluded that the underlying pool must contain one or more instruments that have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding.

(d) assess whether any other instruments in the underlying pool only:

(i) reduce the cash flow variability of the underlying pool of instruments in a way that is consistent with representing solely payments of principal and interest on the principal amount outstanding, or

(ii) align the cash flows of the issued financial assets with the underlying pool of financial instruments.

The IASB concluded that the existence of such instruments does not preclude the cash flows from representing solely payments of principal and interest on the principal amount outstanding. The IASB determined that the existence of other instruments in the pool would, however, preclude the cash flows representing solely payments of principal and interest on the principal amount outstanding. For example, an underlying pool that contains government bonds and an instrument that swaps government credit risk for (riskier) corporate credit risk would not have cash flows that represent solely principal and interest on the principal amount outstanding.

(e) measure at fair value any issued instrument in which any of the financial instruments in the underlying pool:

(i) have cash flows that do not represent solely payments of principal and interest on the principal amount outstanding; or

(ii) could change so that cash flows may not represent solely payments of principal and interest on the principal amount outstanding at any point in the future.

(f) measure at fair value any issued instrument whose exposure to credit risk in the underlying pool of financial instruments is greater than the exposure to credit risk of the underlying pool of financial instruments. The IASB decided that if the range of expected losses on the issued instrument is greater than the weighted average range of expected losses on the underlying pool of financial instruments, then the issued instrument should be measured at fair value.

BC4.36 The IASB also decided that if it were not practicable to look through to the underlying pool of financial instruments, entities should measure the issued instrument at fair value.

Financial assets acquired at a discount that reflects incurred credit losses

BC4.37 The 2009 Classification and Measurement Exposure Draft proposed that if a financial asset is acquired at a discount that reflects incurred credit losses, it cannot be measured at amortised cost because:

(a) the entity does not hold such financial assets to collect the cash flows arising from those assets' contractual terms; and

(b) an investor acquiring a financial asset at such a discount believes that the actual losses will be less than the losses that are reflected in the purchase price. Thus, that asset creates exposure to significant variability in actual cash flows and such variability is not interest.

BC4.38 Almost all respondents disagreed with the IASB's conclusion that these assets cannot be held to collect the contractual cash flows. They regarded that conclusion as an exception to a classification approach based on the entity's business model for managing the financial assets. In particular, they noted that entities could acquire and subsequently manage such assets as part of an otherwise performing asset portfolio for which the objective of the entity's business model is to hold the assets to collect contractual cash flows.

BC4.39 Respondents also noted that an entity's expectations about actual future cash flows are not the same as the contractual cash flows of the financial asset. Those expectations are irrelevant to an assessment of the financial asset's contractual cash flow characteristics.

BC4.40 The IASB agreed that the general classification approach in IFRS 9 should apply to financial assets acquired at a discount that reflects incurred credit losses. Thus, when such assets meet the conditions in paragraph 4.1.2, they are measured at amortised cost.

Alternative approaches to classifying assets

BC4.41 In its deliberations leading to the 2009 Classification and Measurement Exposure Draft, the IASB discussed alternative approaches to classification and measurement. In particular, it considered an approach in which financial assets that have basic loan features, are managed on a contractual yield basis and meet the definition of loans and receivables in IAS 39 would be measured at amortised cost. All other financial assets would be measured at fair value. The fair value changes for each period for those financial assets with basic loan features that are managed on a contractual yield basis would be disaggregated and presented as follows:

(a) changes in recognised value determined on an amortised cost basis (including impairments determined using the incurred loss impairment requirements in IAS 39) would be presented in profit or loss; and

(b) any difference between the amortised cost measure in (a) and the fair value change for the period would be presented in other comprehensive income.

BC4.42 The IASB also considered variants in which all financial assets and financial liabilities would be measured at fair value. One variant would be to present both the amounts in paragraph BC4.41(a) and (b) in profit or loss, but separately. Another variant would be to measure all financial instruments (including financial assets that meet the two conditions specified in the 2009 Classification and Measurement Exposure Draft and meet the definition of loans and receivables in IAS 39) at fair value in the statement of financial position. All financial instruments (including financial liabilities) with basic loan features that are managed on a contractual yield basis would be disaggregated and presented as described in paragraph BC4.41(a) and (b).

BC4.43 Respondents noted that the alternative approach described in paragraph BC4.41 and both variants described in paragraph BC4.42 would result in more financial assets and financial liabilities being measured at fair value. Respondents also noted that the alternative approach would apply only to financial assets. Lastly, almost all respondents noted that splitting gains and losses between profit or loss and other comprehensive income would increase complexity and reduce understandability. The IASB concluded that those approaches would not result in more useful information than the approach in IFRS 9 and did not consider them further.

BC4.44 The IASB also considered and rejected the following approaches to classification:

(a) *Classification based on the definition of held for trading:* A few respondents suggested that all financial assets and financial liabilities that are not 'held for trading' should be eligible for measurement at amortised cost. However, in the IASB's view, the notion of 'held for trading' is too narrow and cannot appropriately reflect all situations in which amortised cost does not provide useful information.

(b) *Three-category approach:* Some respondents suggested retaining a three-category approach, ie including a third category similar to the available-for-sale category in IAS 39. However, in the IASB's view, such an approach would neither significantly improve nor reduce the complexity of the reporting for financial instruments.

(c) *Classification based only on the business model:* A small number of respondents thought the contractual terms of the instrument condition was unnecessary and that classification should depend solely on the entity's business model for managing financial instruments. However, in the IASB's view, determining classification solely on the basis of how an entity manages its financial instruments would result in misleading information that is not useful to a user in understanding the risks associated with complex or risky instruments. The IASB concluded, as had almost all respondents, that the contractual cash flow characteristics condition is required to ensure that amortised cost is used only when it provides information that is useful in predicting the entity's future cash flows.

(d) *Amortised cost as the default option:* The IASB considered developing conditions that specified when a financial asset must be measured at fair value, with the requirement that all other financial instruments would be measured at amortised cost. The IASB rejected that approach because it believes that new conditions would have to be developed in the future to address innovative financial products. In addition, the IASB noted that such an approach would not be practical because an entity can apply amortised cost only to some types of financial instruments.

(e) *Originated loan approach:* In developing an approach to distinguish between financial assets measured at fair value and amortised cost the IASB considered a model in which only loans originated by the entity would qualify for amortised cost measurement. The IASB acknowledged that for originated instruments the entity potentially has better information about the future contractual cash flows and credit risk than for purchased loans. However, the IASB decided not to pursue that approach,

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mainly because some entities manage originated and purchased loans in the same portfolio. Distinguishing between originated and purchased loans, which would be done mainly for accounting purposes, would involve systems changes. In addition, the IASB noted that 'originated loans' might easily be created by placing purchased loans into an investment vehicle. The IASB also noted that the definition of loans and receivables in IAS 39 had created application problems in practice.

Tainting

BC4.45 The IASB considered whether it should prohibit an entity from classifying a financial asset as measured at amortised cost if the entity had previously sold or reclassified financial assets instead of holding them to collect the contractual cash flows. A restriction of this kind is often called 'tainting'. However, the IASB believes that classification based on the entity's business model for managing financial assets and the contractual cash flow characteristics of those financial assets provides a clear rationale for measurement. A tainting provision would increase the complexity of application, be unduly prohibitive in the context of that approach and could give rise to classification that is inconsistent with the classification approach in IFRS 9. However, in 2009 the IASB amended IAS 1 *Presentation of Financial Statements* to require an entity to present separately in the statement of comprehensive income all gains and losses arising from the derecognition of financial assets measured at amortised cost. The IASB also amended IFRS 7 in 2009 to require an entity to disclose an analysis of those gains and losses, including the reasons for derecognising those financial assets. Those requirements enable users of financial statements to understand the effects of derecognising before maturity instruments measured at amortised cost and also provides transparency in situations where an entity has measured financial assets at amortised cost on the basis of having an objective of managing those assets in order to collect the contractual cash flows but regularly sells them.

Classification of financial liabilities

BC4.46 Immediately after issuing the first chapters of IFRS 9 in November 2009, the IASB began an extensive outreach programme to gather feedback on the classification and measurement of financial liabilities, in particular how best to address the effects of changes in the fair value of a financial liability caused by changes in the risk that the issuer will fail to perform on that liability. The IASB obtained information and views from its FIWG and from users, regulators, preparers, auditors and others from a range of industries across different geographical regions. The IASB also developed a questionnaire to ask users of financial statements how they use information about the effects of changes in liabilities' credit risk (if at all) and what their preferred method of accounting is for selected financial liabilities. The IASB received over 90 responses to that questionnaire.

BC4.47 During the outreach programme, the IASB explored several approaches for classification and subsequent measurement of financial liabilities that would exclude the effects of changes in a liability's credit risk from profit or loss, including:

(a) measuring liabilities at fair value and presenting in other comprehensive income the portion of the change in fair value that is attributable to changes in the liability's credit risk. A variant of this alternative would be to present in other comprehensive income the entire change in fair value.

(b) measuring liabilities at an 'adjusted' fair value whereby the liability would be remeasured for all changes in fair value except for the effects of changes in its credit risk (ie 'the frozen credit spread method'). In other words, the effects of changes in its credit risk would be ignored in the primary financial statements.

(c) measuring liabilities at amortised cost. This would require estimating the cash flows over the life of the instrument, including those cash flows associated with any embedded derivative features.

(d) bifurcating liabilities into hosts and embedded features. The host contract would be measured at amortised cost and the embedded features (eg embedded derivatives) would be measured at fair value through profit or loss. The IASB discussed either carrying forward the bifurcation requirements in IAS 39 for financial liabilities or developing new requirements.

BC4.48 The primary message that the IASB received from users of financial statements and others during its outreach programme was that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.

BC4.49 In addition to that view, there were several other themes in the feedback that the IASB received:

(a) Symmetry between how an entity classifies and measures its financial assets and its financial liabilities is not necessary and often does not result in useful information. Most constituents said that in its

deliberations on financial liabilities the IASB should not be constrained or biased by the requirements in IFRS 9 for financial assets.

(b) Amortised cost is the most appropriate measurement attribute for many financial liabilities because it reflects the issuer's legal obligation to pay the contractual amounts in the normal course of business (ie on a going concern basis) and in many cases, the issuer will hold liabilities to maturity and pay the contractual amounts. However, if a liability has structured features (eg embedded derivatives), amortised cost is difficult to apply and understand because the cash flows can be highly variable.

(c) The bifurcation methodology in IAS 39 is generally working well and practice has developed since those requirements were issued. For many entities, bifurcation avoids the issue of own credit risk because the host is measured at amortised cost and only the derivative is measured at fair value through profit or loss. Many constituents, including users of financial statements, favoured retaining bifurcation for financial liabilities even though they supported eliminating it for financial assets. That was because bifurcation addresses the issue of own credit risk, which is only relevant for financial liabilities. Users preferred structured assets to be measured at fair value in their entirety. Many constituents were sceptical that a new bifurcation methodology could be developed that was less complex and provided more useful information than using the bifurcation methodology in IAS 39. Moreover, a new bifurcation methodology would be likely to have the same classification and measurement outcomes as the existing methodology in most cases.

(d) The IASB should not develop a new measurement attribute. The almost unanimous view was that a 'full' fair value amount is more understandable and useful than an 'adjusted' fair value amount that ignores the effects of changes in the liability's credit risk.

(e) Even for preparers with sophisticated valuation expertise, it is difficult to determine the amount of change in the fair value of a liability that is attributable to changes in its credit risk. Under existing Standards only entities that elect to designate liabilities under the fair value option are required to determine that amount. If the IASB were to extend that requirement to more entities and to more financial liabilities, many entities would have significant difficulty determining that amount and could incur significant costs in doing so.

BC4.50 Although there were common themes in the feedback received, there was no consensus on which of the alternative approaches being explored by the IASB was the best way to address the effects of changes in liabilities' credit risk. Many constituents said that none of the alternatives being discussed was less complex or would result in more useful information than the existing bifurcation requirements.

BC4.51 As a result of the feedback received, the IASB decided to retain almost all of the existing requirements for the classification and measurement of financial liabilities. The IASB decided that the benefits of changing practice at this point do not outweigh the costs of the disruption that such a change would cause. Accordingly, in October 2010 the IASB carried forward almost all of the requirements unchanged from IAS 39 to IFRS 9.[12]

BC4.52 By retaining almost all of the existing requirements, the issue of credit risk is addressed for most liabilities because they would continue to be subsequently measured at amortised cost or would be bifurcated into a host, which would be measured at amortised cost, and an embedded derivative, which would be measured at fair value. Liabilities that are held for trading (including all derivative liabilities) would continue to be subsequently measured at fair value through profit or loss, which is consistent with the widespread view that all fair value changes for those liabilities should affect profit or loss.

BC4.53 The issue of credit risk would remain only in the context of financial liabilities designated under the fair value option. Thus, in May 2010 the IASB published an Exposure Draft *Fair Value Option for Financial Liabilities* (the '2010 Own Credit Risk Exposure Draft'), which proposed that the effects of changes in the credit risk of liabilities designated under the fair value option would be presented in other comprehensive income. The IASB considered the responses to 2010 Own Credit Risk Exposure Draft and finalised amendments to IFRS 9 in October 2010 (see paragraphs BC5.35–BC5.64). Those amendments also eliminated the cost exception for particular derivative liabilities that will be settled by delivering unquoted equity instruments[13] whose fair values cannot be reliably determined (see paragraph BC5.20).

[12] In 2017 the IASB discussed the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in derecognition of the financial liability. See paragraphs BC4.252–BC4.253.

[13] IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IFRS 9 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

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Option to designate a financial asset or financial liability at fair value through profit or loss

Background to the fair value option in IAS 39

BCZ4.54 In 2003 the IASB concluded that it could simplify the application of IAS 39 (as revised in 2000) for some entities by permitting the use of fair value measurement for any financial instrument. With one exception, this greater use of fair value is optional. The fair value measurement option does not require entities to measure more financial instruments at fair value.

BCZ4.55 IAS 39 (as revised in 2000)[14] did not permit an entity to measure particular categories of financial instruments at fair value with changes in fair value recognised in profit or loss. Examples included:

(a) originated loans and receivables, including a debt instrument acquired directly from the issuer, unless they met the conditions for classification as held for trading (now in Appendix A of IFRS 9).

(b) financial assets classified as available for sale, unless as an accounting policy choice gains and losses on all available-for-sale financial assets were recognised in profit or loss or they met the conditions for classification as held for trading (now in Appendix A of IFRS 9).

(c) non-derivative financial liabilities, even if the entity had a policy and practice of actively repurchasing such liabilities or they formed part of an arbitrage/customer facilitation strategy or fund trading activities.

BCZ4.56 The IASB decided in IAS 39 (as revised in 2003) to permit entities to designate irrevocably on initial recognition any financial instruments as ones to be measured at fair value with gains and losses recognised in profit or loss ('fair value through profit or loss'). To impose discipline on this approach, the IASB decided that financial instruments should not be reclassified into or out of the category of fair value through profit or loss. In particular, some comments received on the exposure draft of proposed amendments to IAS 39 published in June 2002 suggested that entities could use the fair value option to recognise selectively changes in fair value in profit or loss. The IASB noted that the requirement (now in IFRS 9) to designate irrevocably on initial recognition the financial instruments for which the fair value option is to be applied results in an entity being unable to 'cherry pick' in this way. This is because it will not be known at initial recognition whether the fair value of the instrument will increase or decrease.

BCZ4.57 Following the issue of IAS 39 (as revised in 2003), as a result of continuing discussions with constituents on the fair value option, the IASB became aware that some, including prudential supervisors of banks, securities companies and insurers, were concerned that the fair value option might be used inappropriately. These constituents were concerned that:

(a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable. If so, because the valuation of these financial assets and financial liabilities is subjective, entities might determine their fair value in a way that inappropriately affects profit or loss.

(b) the use of the option might increase, instead of decreasing, volatility in profit or loss, for example if an entity applied the option to only one part of a matched position.

(c) if an entity applied the fair value option to financial liabilities, it might result in an entity recognising gains or losses in profit or loss associated with changes in its own creditworthiness.

BCZ4.58 In response to those concerns, the IASB published in April 2004 an exposure draft of proposed restrictions to the fair value option contained in IAS 39 (as revised in 2003). After discussing comments received from constituents and a series of public round-table meetings, the IASB issued an amendment to IAS 39 in June 2005 permitting entities to designate irrevocably on initial recognition financial instruments that meet one of three conditions as ones to be measured at fair value through profit or loss.

BCZ4.59 In those amendment to the fair value option, the IASB identified three situations in which permitting designation at fair value through profit or loss either results in more relevant information ((a) and (b) below) or is justified on the grounds of reducing complexity or increasing measurement reliability ((c) below). These are:

(a) when such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise (paragraphs BCZ4.61–BCZ4.63);

[14] IFRS 9 eliminated the loans and receivables and available-for-sale categories.

(b) when a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy (paragraphs BCZ4.64–BCZ4.66); and

(c) when an instrument contains an embedded derivative that meets particular conditions (paragraphs BCZ4.67–BCZ4.70).

BCZ4.60 The ability for entities to use the fair value option simplifies the application of IAS 39 by mitigating some anomalies that result from the different measurement attributes. In particular, for financial instruments designated in this way:

(a) it eliminates the need for hedge accounting for hedges of fair value exposures when there are natural offsets, and thereby eliminates the related burden of designating, tracking and analysing hedge effectiveness.

(b) it eliminates the burden of separating embedded derivatives.

(c) it eliminates problems arising from a mixed measurement model when financial assets are measured at fair value and related financial liabilities are measured at amortised cost. In particular, it eliminates volatility in profit or loss and equity that results when matched positions of financial assets and financial liabilities are not measured consistently.

(d) the option to recognise unrealised gains and losses on available-for-sale financial assets in profit or loss is no longer necessary.

(e) it de-emphasises interpretative issues around what constitutes trading.

Designation eliminates or significantly reduces an accounting mismatch

BCZ4.61 IAS 39, like comparable standards in some national jurisdictions, imposed (and IFRS 9 now imposes) a mixed attribute measurement model. It required some financial assets and liabilities to be measured at fair value, and others to be measured at amortised cost. It required some gains and losses to be recognised in profit or loss, and others to be recognised initially as a component of equity.[15] This combination of measurement and recognition requirements could result in inconsistencies, which some refer to as 'accounting mismatches', between the accounting for an asset (or group of assets) and a liability (or group of liabilities). The notion of an accounting mismatch necessarily involves two propositions. First, an entity has particular assets and liabilities that are measured, or on which gains and losses are recognised, inconsistently; second, there is a perceived economic relationship between those assets and liabilities. For example, a liability may be considered to be related to an asset when they share a risk that gives rise to opposite changes in fair value that tend to offset, or when the entity considers that the liability funds the asset.

BCZ4.62 Some entities could overcome measurement or recognition inconsistencies by using hedge accounting or, in the case of insurers, shadow accounting. However, the IASB recognised that those techniques are complex and do not address all situations. In developing the amendment to the fair value option in 2004, the IASB considered whether it should impose conditions to limit the situations in which an entity could use the option to eliminate an accounting mismatch. For example, it considered whether entities should be required to demonstrate that particular assets and liabilities are managed together, or that a management strategy is effective in reducing risk (as is required for hedge accounting to be used), or that hedge accounting or other ways of overcoming the inconsistency are not available.

BCZ4.63 The IASB concluded that accounting mismatches arise in a wide variety of circumstances. In the IASB's view, financial reporting is best served by providing entities with the opportunity to eliminate perceived accounting mismatches whenever that results in more relevant information. Furthermore, the IASB concluded that the fair value option may validly be used in place of hedge accounting for hedges of fair value exposures, thereby eliminating the related burden of designating, tracking and analysing hedge effectiveness. Hence, the IASB decided not to develop detailed prescriptive guidance about when the fair value option could be applied (such as requiring effectiveness tests similar to those required for hedge accounting) in the amendment on the fair value option. Instead, the IASB decided to require disclosures (now in IFRS 7) about:

- the criteria an entity uses for designating financial assets and financial liabilities as at fair value through profit or loss
- how the entity satisfies the conditions for such designation
- the nature of the assets and liabilities so designated

[15] As a consequence of the revision of IAS 1 *Presentation of Financial Statements* in 2007 these other gains and losses are recognised in other comprehensive income.

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- the effect on the financial statement of using this designation, namely the carrying amounts and net gains and losses on assets and liabilities so designated, information about the effect of changes in a financial liability's credit quality on changes in its fair value, and information about the credit risk of loans or receivables and any related credit derivatives or similar instruments.

A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis

BCZ4.64 IAS 39 required financial instruments to be measured at fair value through profit or loss in only two situations, namely when an instrument is held for trading or when it contains an embedded derivative that the entity is unable to measure separately. However, the IASB recognised that some entities manage and evaluate the performance of financial instruments on a fair value basis in other situations. Furthermore, for instruments managed and evaluated in this way, users of financial statements may regard fair value measurement as providing more relevant information. Finally, it is established practice in some industries in some jurisdictions to recognise all financial assets at fair value through profit or loss. (This practice was permitted for many assets in IAS 39 (as revised in 2000) as an accounting policy choice in accordance with which gains and losses on all available-for-sale financial assets were reported in profit or loss.)

BCZ4.65 In the amendment to IAS 39 relating to the fair value option issued in June 2005, the IASB permitted financial instruments managed and evaluated on a fair value basis to be measured at fair value through profit or loss. The IASB also introduced two requirements to make this category operational. These requirements are that the financial instruments are managed and evaluated on a fair value basis in accordance with a documented risk management or investment strategy, and that information about the financial instruments is provided internally on that basis to the entity's key management personnel.

BCZ4.66 In looking to an entity's documented risk management or investment strategy, the IASB made no judgement on what an entity's strategy should be. However, the IASB noted that users, in making economic decisions, would find useful both a description of the chosen strategy and how designation at fair value through profit or loss is consistent with it. Such disclosures are required (now in IFRS 7). The IASB also noted that the required documentation of the entity's strategy need not be item by item, nor need it be in the level of detail required for hedge accounting. However, it should be sufficient to demonstrate that using the fair value option is consistent with the entity's risk management or investment strategy. In many cases, the entity's existing documentation, as approved by its key management personnel, should be sufficient for this purpose.

The instrument contains an embedded derivative that meets particular conditions

BCZ4.67 IAS 39 required virtually all derivative financial instruments to be measured at fair value. This requirement extended to derivatives that are embedded in an instrument that also includes a non-derivative host if the embedded derivative met particular conditions. Conversely, if the embedded derivative did not meet those conditions, separate accounting with measurement of the embedded derivative at fair value is prohibited. Consequently, to satisfy these requirements, the entity must:

(a) identify whether the instrument contains one or more embedded derivatives,

(b) determine whether each embedded derivative is one that must be separated from the host instrument or one for which separation is prohibited, and

(c) if the embedded derivative is one that must be separated, determine its fair value at initial recognition and subsequently.

BCZ4.68 For some embedded derivatives, like the prepayment option in an ordinary residential mortgage, this process is fairly simple. However, entities with more complex instruments have reported that the search for and analysis of embedded derivatives (steps (a) and (b) in paragraph BCZ4.67) significantly increase the cost of complying with the Standard. They report that this cost could be eliminated if they had the option to fair value the combined contract.

BCZ4.69 Other entities report that one of the most common uses of the fair value option is likely to be for structured products that contain several embedded derivatives. Those structured products will typically be hedged with derivatives that offset all (or nearly all) of the risks they contain, whether or not the embedded derivatives that give rise to those risks are separated for accounting purposes. Hence, the simplest way to account for such products is to apply the fair value option so that the combined contract (as well as the derivatives that hedge it) is measured at fair value through profit or loss. Furthermore, for these more complex instruments, the fair value of the combined contract may be significantly easier to measure and hence be more reliable than the fair value of only those embedded derivatives that are required to be separated.

BCZ4.70 The IASB sought to strike a balance between reducing the costs of complying with the embedded derivatives provisions and the need to respond to the concerns expressed regarding possible inappropriate use of the fair value option. The IASB determined that allowing the fair value option to be used for any instrument with an embedded derivative would make other restrictions on the use of the option ineffective, because many financial instruments include an embedded derivative. In contrast, limiting the use of the fair value option to situations in which the embedded derivative must otherwise be separated would not significantly reduce the costs of compliance and could result in less reliable measures being included in the financial statements. Consequently, the IASB decided to specify situations in which an entity cannot justify using the fair value option in place of assessing embedded derivatives—when the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract or is one for which it is clear with little or no analysis when a similar hybrid instrument is first considered that separation is prohibited.

The role of prudential supervisors

BCZ4.71 The IASB considered the circumstances of regulated financial institutions such as banks and insurers in determining the extent to which conditions should be placed on the use of the fair value option. The IASB recognised that regulated financial institutions are extensive holders and issuers of financial instruments and so are likely to be among the largest potential users of the fair value option. However, the IASB noted that some of the prudential supervisors that oversee these entities expressed concern that the fair value option might be used inappropriately.

BCZ4.72 The IASB noted that the primary objective of prudential supervisors is to maintain the financial soundness of individual financial institutions and the stability of the financial system as a whole. Prudential supervisors achieve this objective partly by assessing the risk profile of each regulated institution and imposing a risk-based capital requirement.

BCZ4.73 The IASB noted that these objectives of prudential supervision differ from the objectives of general purpose financial reporting. The latter is intended to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. However, the IASB acknowledged that for the purposes of determining what level of capital an institution should maintain, prudential supervisors may wish to understand the circumstances in which a regulated financial institution has chosen to apply the fair value option and evaluate the rigour of the institution's fair value measurement practices and the robustness of its underlying risk management strategies, policies and practices. Furthermore, the IASB agreed that certain disclosures would assist both prudential supervisors in their evaluation of capital requirements and investors in making economic decisions. In particular, the IASB decided to require an entity to disclose how it has satisfied the conditions for using the fair value option, including, for instruments that are now within paragraph 4.2.2(b) of IFRS 9, a narrative description of how designation at fair value through profit or loss is consistent with the entity's documented risk management or investment strategy.

Application of the fair value option to a component or a proportion (instead of the entirety) of a financial asset or a financial liability

BCZ4.74 Some comments received on the exposure draft of proposed amendments to IAS 39 published in June 2002 argued that the fair value option should be extended so that it could also be applied to a component of a financial asset or a financial liability (eg changes in fair value attributable to one risk such as changes in a benchmark interest rate). The arguments included (a) concerns regarding inclusion of own credit risk in the measurement of financial liabilities and (b) the prohibition on using non-derivatives as hedging instruments (cash instrument hedging).

BCZ4.75 The IASB concluded that IAS 39 should not extend the fair value option to components of financial assets or financial liabilities. It was concerned (a) about difficulties in measuring the change in value of the component because of ordering issues and joint effects (ie if the component is affected by more than one risk, it may be difficult to isolate accurately and measure the component); (b) that the amounts recognised in the balance sheet would be neither fair value nor cost; and (c) that a fair value adjustment for a component might move the carrying amount of an instrument away from its fair value. In finalising the 2003 amendments to IAS 39, the IASB separately considered the issue of cash instrument hedging (see paragraphs BC144 and BC145 of the Basis for Conclusions on IAS 39).

BCZ4.76 Other comments received on the April 2004 exposure draft of proposed restrictions on the fair value option contained in IAS 39 (as revised in 2003) suggested that the fair value option should be extended so that it could be applied to a proportion (ie a percentage) of a financial asset or financial liability. The IASB was concerned that such an extension would require prescriptive guidance on how to determine a proportion. For example, if an entity were to issue a bond totalling CU100 million in the form of 100 certificates each of

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CU1 million, would a proportion of 10 per cent be identified as 10 per cent of each certificate, CU10 million specified certificates, the first (or last) CU10 million certificates to be redeemed, or on some other basis? The IASB was also concerned that the remaining proportion, not being subject to the fair value option, could give rise to incentives for an entity to 'cherry pick' (ie to realise financial assets or financial liabilities selectively so as to achieve a desired accounting result). For these reasons, the IASB decided not to allow the fair value option to be applied to a proportion of a single financial asset or financial liability (that restriction is now in IFRS 9). However, if an entity simultaneously issues two or more identical financial instruments, it is not precluded from designating only some of those instruments as being subject to the fair value option (for example, if doing so achieves a significant reduction in a recognition or measurement inconsistency). Thus, in the above example, the entity could designate CU10 million specified certificates if to do so would meet one of the three criteria in paragraph BCZ4.59.

Option to designate a financial asset at fair value

BC4.77 As noted above, IAS 39 allowed entities an option to designate on initial recognition any financial asset or financial liability as measured at fair value through profit or loss if one (or more) of the following three conditions is met:

(a) Doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities on different bases or recognising the gains and losses on them on different bases.

(b) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel.

(c) The financial asset or financial liability contains one or more embedded derivatives (and particular other conditions now described in paragraph 4.3.5 of IFRS 9 are met) and the entity elects to account for the hybrid contract in its entirety.

BC4.78 However, in contrast to IAS 39, IFRS 9 requires:

(a) any financial asset that is not managed within a business model that has the objective of collecting contractual cash flows to be measured at fair value; and

(b) hybrid contracts with financial asset hosts to be classified in their entirety, hence eliminating the requirement to identify and account for embedded derivatives separately.

Accordingly, the IASB concluded that the conditions described in paragraph BC4.77(b) and (c) are unnecessary for financial assets.

BC4.79 The IASB retained the eligibility condition described in paragraph BC4.77(a) because it mitigates some anomalies that result from the different measurement attributes used for financial instruments. In particular, it eliminates the need for fair value hedge accounting of fair value exposures when there are natural offsets. It also avoids problems arising from a mixed measurement model when some financial assets are measured at amortised cost and related financial liabilities are measured at fair value. A separate phase of the project is considering hedge accounting, and the fair value option will be better considered in that context. The IASB also noted that particular industry sectors believe it is important to be able to mitigate such anomalies until other IASB projects are completed (eg insurance contracts). The IASB decided to defer consideration of changes to the eligibility condition set out in paragraph BC4.77(a) as part of the future exposure draft on hedge accounting.

BC4.80 Almost all the respondents to the 2009 Classification and Measurement Exposure Draft supported the proposal to retain the fair value option if such designation eliminates or significantly reduces an accounting mismatch. Although some respondents would prefer an unrestricted fair value option, they acknowledged that an unrestricted fair value option has been opposed by many in the past and it is not appropriate to pursue it now.

Option to designate a financial liability at fair value

Eligibility conditions

BC4.81 During its discussions about subsequent classification and measurement of financial liabilities in 2010 (see paragraphs BC4.46–BC4.53), the IASB considered whether it was necessary to propose any changes to the

eligibility conditions for designating financial liabilities under the fair value option. However, the IASB decided that such changes were not necessary because the IASB was not changing the underlying classification and measurement approach for financial liabilities. Consequently, the 2010 Own Credit Risk Exposure Draft proposed to carry forward the three eligibility conditions.

BC4.82 Most respondents agreed with that proposal in the 2010 Own Credit Risk Exposure Draft. The IASB confirmed the proposal and decided to carry forward to IFRS 9 the three eligibility conditions in October 2010. Some would have preferred an unrestricted fair value option. However, they acknowledged that an unrestricted fair value option had been opposed by many in the past and it was not appropriate to pursue it now.

Embedded derivatives

Hybrid contracts with a host that is an asset within the scope of IFRS 9

BC4.83 An embedded derivative is a derivative component of a hybrid contract that also includes a non-derivative host, with the effect that some of the cash flows of the combined contract vary like the cash flows of a stand-alone derivative contract. IAS 39 required an entity to assess all contracts to determine whether they contain one or more embedded derivatives that are required to be separated from the host and accounted for as stand-alone derivatives.

BC4.84 Many respondents to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* commented that the requirements and guidance in IAS 39 were complex, rule-based and internally inconsistent. Respondents, and others, also noted the many application problems that arose from requirements to assess all non-derivative contracts for embedded derivatives and, if required, to account for and measure those embedded derivatives separately as stand-alone derivatives.

BC4.85 In 2009 the IASB discussed three approaches for accounting for embedded derivatives:

(a) to maintain the requirements in IAS 39;

(b) to use 'closely related' (used in IAS 39 to determine whether an embedded derivative is required to be separated from the host) to determine the classification for the contract in its entirety; and

(c) to use the same classification approach for all financial assets (including hybrid contracts).

BC4.86 The IASB rejected the first two approaches. The IASB noted that both would rely on the assessment of whether an embedded derivative is 'closely related' to the host. The 'closely related' assessment is based on a list of examples that are inconsistent and unclear. That assessment is also a significant source of complexity. Both approaches would result in hybrid contracts being classified using conditions different from those that would be applied to all non-hybrid financial instruments. Consequently, some hybrid contracts whose contractual cash flows do not solely represent payments of principal and interest on the principal amount outstanding might be measured at amortised cost. Similarly, some hybrid contracts whose contractual cash flows do meet the conditions for measurement at amortised cost might be measured at fair value. The IASB also believes that neither approach would make it easier for users of financial statements to understand the information that financial statements present about financial instruments.

BC4.87 Therefore, the 2009 Classification and Measurement Exposure Draft proposed that entities should use the same classification approach for all financial instruments, including hybrid contracts with hosts within the scope of the proposed IFRS ('financial hosts'). The IASB concluded that a single classification approach for all financial instruments and hybrid contracts with financial hosts was the only approach that responded adequately to the criticisms described above. The IASB noted that using a single classification approach improves comparability by ensuring consistency in classification, and hence makes it easier for users to understand the information that financial statements present about financial instruments.

BC4.88 In the responses to the 2009 Classification and Measurement Exposure Draft, some respondents, mainly preparers, stated their preference for keeping or modifying the bifurcation model that was in IAS 39. They noted that:

(a) eliminating the requirement to account for embedded derivatives as stand-alone derivatives would lead to increased volatility in profit or loss and result in accounting that did not reflect the underlying economics and risk management or business model considerations in a transaction. For example, the components of some hybrid financial instruments may be managed separately.

(b) structuring opportunities would be created, for example if an entity entered into two transactions that have the same economic effect as entering into a single hybrid contract.

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BC4.89 However, the IASB confirmed the proposals in the 2009 Classification and Measurement Exposure Draft for the following reasons:

(a) The elimination of the embedded derivatives guidance for hybrid contracts with financial hosts reduces the complexity in financial reporting of financial assets by eliminating another classification approach and improves the reporting for financial instruments. Many constituents agreed with this conclusion.

(b) In the IASB view, the underlying rationale for separate accounting for embedded derivatives is not to reflect risk management activities, but to avoid entities circumventing the recognition and measurement requirements for derivatives. Accordingly it is an exception to the definition of the unit of account (the contract) motivated by a wish to avoid abuse. It would reduce complexity to eliminate an anti-abuse exception.

(c) The IASB noted the concerns about structuring opportunities referred to in paragraph BC4.88(b). However, two contracts represent two units of account. Reconsideration of the unit of account forms part of a far broader issue for financial reporting that is outside the scope of the IASB's considerations in IFRS 9. In addition, embedded derivative features often do not have contractual cash flows that represent payments of principal and interest on the principal amount outstanding and thus the entire hybrid contract would not be eligible to be measured at amortised cost. However, the IASB noted that this would provide more relevant information because the embedded derivative feature affects the cash flows ultimately arising from the hybrid contract. Thus, applying the classification approach to the hybrid contract in its entirety would depict more faithfully the amount, timing and uncertainty of future cash flows.

(d) In the IASB's view, accounting for the hybrid contract as one unit of account is consistent with the project's objective—to improve the usefulness for users in their assessment of the timing, amount and uncertainty of future cash flows of financial instruments and to reduce the complexity in reporting financial instruments.

This decision applies only to hybrid contracts with a host that is an asset within the scope of IFRS 9.

BC4.90 The IASB decided not to consider at this time changes to the requirements in IAS 39 for embedded derivatives in hybrid contracts with non-financial hosts. The IASB acknowledged that those requirements are also complex and have resulted in some application problems, including the question of whether particular types of non-financial contracts are within the scope of IAS 39. The IASB accepted the importance of ensuring that any proposals for hybrid contracts with non-financial hosts should also address which non-financial contracts should be within the scope of IFRS 9. The IASB also noted the importance for many non-financial entities of hedge accounting for non-financial items, and the relationship to both scope and embedded derivative requirements. Consequently, the IASB concluded that the requirements for hybrid contracts with non-financial hosts should be addressed in a later phase of the project to replace IAS 39.

Hybrid contracts with a host that is not an asset within the scope of IFRS 9

BC4.91 As discussed in paragraphs BC4.46–BC4.53, in 2010 the IASB decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities. Consequently, those requirements (including the requirements related to embedded derivatives) were carried forward unchanged to IFRS 9. Constituents told the IASB that the bifurcation methodology in IAS 39 for financial liabilities is generally working well in practice and practice has developed since those requirements were issued. Many constituents, including users of financial statements, favoured retaining bifurcation for financial liabilities even though they supported eliminating it for financial assets. That was because bifurcation addresses the issue of own credit risk, which is only relevant for financial liabilities.

Embedded foreign currency derivatives

BCZ4.92 A rationale for the embedded derivatives requirements is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract, for example, a commodity forward in a debt instrument. To achieve consistency in accounting for such embedded derivatives, all derivatives embedded in financial instruments that are not measured at fair value with gains and losses recognised in profit or loss ought to be accounted for separately as derivatives. However, as a practical expedient, an embedded derivative need not be separated if it is regarded as closely related to its host contract. When the embedded derivative bears a close economic relationship to the host contract, such as a cap or a floor on the interest rate on a loan, it is less likely that the derivative was embedded to achieve a desired accounting result.

BCZ4.93 The original IAS 39 specified that a foreign currency derivative embedded in a non-financial host contract (such as a supply contract denominated in a foreign currency) was not separated if it required payments denominated in the currency of the primary economic environment in which any substantial party to the contract operates (their functional currencies) or the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (such as the US dollar for crude oil transactions). Such foreign currency derivatives are regarded as bearing such a close economic relationship to their host contracts that they do not have to be separated.

BCZ4.94 The requirement to separate embedded foreign currency derivatives may be burdensome for entities that operate in economies in which business contracts denominated in a foreign currency are common. For example, entities domiciled in small countries may find it convenient to denominate business contracts with entities from other small countries in an internationally liquid currency (such as the US dollar, euro or yen) instead of the local currency of any of the parties to the transaction. In addition, an entity operating in a hyperinflationary economy may use a price list in a hard currency to protect against inflation, for example, an entity that has a foreign operation in a hyperinflationary economy that denominates local contracts in the functional currency of the parent.

BCZ4.95 In revising IAS 39, the IASB concluded that an embedded foreign currency derivative may be integral to the contractual arrangements in the cases mentioned in the previous paragraph. It decided that a foreign currency derivative in a contract should not be required to be separated if it is denominated in a currency that is commonly used in business transactions (that are not financial instruments) in the environment in which the transaction takes place (that guidance is now in IFRS 9). A foreign currency derivative would be viewed as closely related to the host contract if the currency is commonly used in local business transactions, for example, when monetary amounts are viewed by the general population not in terms of the local currency but in terms of a relatively stable foreign currency, and prices may be quoted in that foreign currency (see IAS 29 *Financial Reporting in Hyperinflationary Economies*).

Embedded prepayment penalties

BCZ4.96 The IASB identified an apparent inconsistency in the guidance in IAS 39 (as issued in 2003). The inconsistency related to embedded prepayment options in which the exercise price represented a penalty for early repayment (ie prepayment) of the loan. The inconsistency related to whether these are considered closely related to the loan.

BCZ4.97 The IASB decided to remove this inconsistency by amending paragraph AG30(g) in April 2009 (now paragraph B4.3.5(e) of IFRS 9). The amendment makes an exception to the examples in paragraph AG30(g) of embedded derivatives that are not closely related to the underlying. This exception is in respect of prepayment options, the exercise prices of which compensate the lender for the loss of interest income because the loan was prepaid. This exception is conditional on the exercise price compensating the lender for loss of interest by reducing the economic loss from reinvestment risk.

Reassessment of embedded derivatives

BC4.98 In October 2010 the IASB incorporated into IFRS 9 the consensus in IFRIC 9 *Reassessment of Embedded Derivatives*. This section summarises the considerations of the International Financial Reporting Interpretations Committee (IFRIC) in reaching that consensus, as approved by the IASB, and the IASB's consideration for amending IFRIC 9 in April 2009.

BCZ4.99 When an entity first becomes a party to particular hybrid contracts it is required to assess whether any embedded derivative contained in the contract needs to be separated from the host contract and accounted for as a derivative. However, the issue arises whether an entity is required to continue to carry out this assessment after it first becomes a party to a contract, and if so, with what frequency.

BCZ4.100 The question is relevant, for example, when the terms of the embedded derivative do not change but market conditions change and the market was the principal factor in determining whether the host contract and embedded derivative are closely related. Instances when this might arise are given in paragraph B4.3.8(d) of IFRS 9. Paragraph B4.3.8(d) states that an embedded foreign currency derivative is closely related to the host contract provided it is not leveraged, does not contain an option feature, and requires payments denominated in one of the following currencies:

(a) the functional currency of any substantial party to that contract;

(b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in commercial transactions around the world (such as the US dollar for crude oil transactions); or

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(c) a currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place (eg a relatively stable and liquid currency that is commonly used in local business transactions or external trade).

BCZ4.101 Any of the currencies specified in (a)–(c) above may change. Assume that when an entity first became a party to a contract, it assessed the contract as containing an embedded derivative that was closely related and hence not accounted for separately. Assume that subsequently market conditions change and that if the entity were to reassess the contract under the changed circumstances it would conclude that the embedded derivative is not closely related and therefore requires separate accounting. (The converse could also arise.) The issue was whether the entity should make such a reassessment.

BCZ4.102 When the IFRIC considered this issue in 2006, it noted that the rationale for the requirement to separate particular embedded derivatives is that an entity should not be able to circumvent the recognition and measurement requirements for derivatives merely by embedding a derivative in a non-derivative financial instrument or other contract (for example, by embedding a commodity forward in a debt instrument). Changes in external circumstances are not ways to circumvent the requirements. The IFRIC therefore concluded that reassessment was not appropriate for such changes.

BCZ4.103 The IFRIC noted that as a practical expedient IAS 39 did not require the separation of embedded derivatives that are closely related (that guidance is now in IFRS 9 for hybrid contracts with a host that is not an asset within the scope of that IFRS). Many financial instruments contain embedded derivatives. Separating all of these embedded derivatives would be burdensome for entities. The IFRIC noted that requiring entities to reassess embedded derivatives in all hybrid instruments could be onerous because frequent monitoring would be required. Market conditions and other factors affecting embedded derivatives would have to be monitored continuously to ensure timely identification of a change in circumstances and amendment of the accounting treatment accordingly. For example, if the functional currency of the counterparty changes during the reporting period so that the contract is no longer denominated in a currency of one of the parties to the contract, then a reassessment of the hybrid instrument would be required at the date of change to ensure the correct accounting treatment in future.

BCZ4.104 The IFRIC also recognised that although IAS 39 was silent on the issue of reassessment it gave relevant guidance when it stated that for the types of contracts now covered by paragraph B4.3.8(b) of IFRS 9 the assessment of whether an embedded derivative is closely related was required only at inception. Paragraph B4.3.8(b) of IFRS 9 states:

> An embedded floor or cap on the interest rate on a debt contract or insurance contract is closely related to the host contract, provided the cap is at or above the market rate of interest and the floor is at or below the market rate of interest *when the contract is issued*, and the cap or floor is not leveraged in relation to the host contract. Similarly, provisions included in a contract to purchase or sell an asset (eg a commodity) that establish a cap and a floor on the price to be paid or received for the asset are closely related to the host contract if both the cap and floor were out of the *money at inception* and are not leveraged. [Emphasis added]

BCZ4.105 The IFRIC also considered the implications of requiring subsequent reassessment. For example, assume that an entity, when it first becomes a party to a contract, separately recognises a host asset[16] and an embedded derivative liability. If the entity were required to reassess whether the embedded derivative was to be accounted for separately and if the entity concluded some time after becoming a party to the contract that the derivative was no longer required to be separated, then questions of recognition and measurement would arise. In the above circumstances, the IFRIC identified the following possibilities:

(a) The entity could remove the derivative from its balance sheet and recognise in profit or loss a corresponding gain or loss. This would lead to recognition of a gain or loss even though there had been no transaction and no change in the value of the total contract or its components.

(b) The entity could leave the derivative as a separate item in the balance sheet. The issue would then arise as to when the item was to be removed from the balance sheet. Should it be amortised (and, if so, how would the amortisation affect the effective interest rate of the asset), or should it be derecognised only when the asset is derecognised?

(c) The entity could combine the derivative (which is recognised at fair value) with the asset (which is recognised at amortised cost). This would alter both the carrying amount of the asset and its effective interest rate even though there had been no change in the economics of the whole contract. In some cases, it could also result in a negative effective interest rate.

The IFRIC noted that, under its view that subsequent reassessment is appropriate only when there has been a change in the terms of the contract that significantly modifies the cash flows that otherwise would be required by the contract, the above issues do not arise.

[16] Hybrid contracts with a host that is an asset within the scope of IFRS 9 are now classified and measured in their entirety in accordance with section 4.1 of that IFRS.

BCZ4.106 The IFRIC noted that IAS 39 required (and now IFRS 9 requires) an entity to assess whether particular embedded derivatives need to be separated from particular host contracts and accounted for as a derivative when it first becomes a party to a contract. Consequently, if an entity purchases a contract that contains an embedded derivative it assesses whether the embedded derivative needs to be separated and accounted for as a derivative on the basis of conditions at that date.

Improvements to IFRSs issued in April 2009

BCZ4.107 In 2009 the IASB observed that the changes to the definition of a business combination in the revisions to IFRS 3 *Business Combinations* (as revised in 2008) caused the accounting for the formation of a joint venture by the venturer to be within the scope of IFRIC 9. Similarly, the Board noted that common control transactions might raise the same issue depending on which level of the group reporting entity is assessing the combination.

BCZ4.108 The IASB observed that during the development of the revised IFRS 3, it did not discuss whether it intended IFRIC 9 to apply to those types of transactions. The IASB did not intend to change existing practice by including such transactions within the scope of IFRIC 9. Accordingly, in *Improvements to IFRSs* issued in April 2009, the IASB amended paragraph 5 of IFRIC 9 (now paragraph B4.3.12 of IFRS 9) to clarify that IFRIC 9 did not apply to embedded derivatives in contracts acquired in a combination between entities or businesses under common control or the formation of a joint venture.

BCZ4.109 Some respondents to the Exposure Draft *Post-implementation Revisions to IFRIC Interpretations* published in January 2009 expressed the view that investments in associates should also be excluded from the scope of IFRIC 9. Respondents noted that paragraphs 20–23 of IAS 28 *Investments in Associates*[17] state that the concepts underlying the procedures used in accounting for the acquisition of a subsidiary are also adopted in accounting for the acquisition of an investment in an associate.

BCZ4.110 In its redeliberations, the IASB confirmed its previous decision that no scope exemption in IFRIC 9 was needed for investments in associates. However, in response to the comments received, the IASB noted that reassessment of embedded derivatives in contracts held by an associate is not required by IFRIC 9 in any event. The investment in the associate is the asset the investor controls and recognises, not the underlying assets and liabilities of the associate.

Reclassification

Reclassification of financial assets

BC4.111 The 2009 Classification and Measurement Exposure Draft proposed to prohibit reclassification of financial assets between the amortised cost and fair value categories. The IASB's rationale for that proposal was as follows:

(a) Requiring (or permitting) reclassifications would not make it easier for users of financial statements to understand the information that financial statements provide about financial instruments.

(b) Requiring (or permitting) reclassifications would increase complexity because detailed guidance would be required to specify when reclassifications would be required (or permitted) and the subsequent accounting for reclassified financial instruments.

(c) Reclassification should not be necessary because classification is based on the entity's business model and that business model is not expected to change.

BC4.112 In their responses, some users questioned the usefulness of reclassified information, noting concerns about the consistency and rigour with which any requirements would be applied. Some were also concerned that opportunistic reclassifications would be possible.

BC4.113 However, almost all respondents (including most users) argued that prohibiting reclassification is inconsistent with a classification approach based on how an entity manages its financial assets. They noted that in an approach based on an entity's business model for managing financial assets, reclassifications would provide useful, relevant and comparable information to users because it would ensure that financial statements faithfully represent how those financial assets are managed at the reporting date. In particular, most users stated that, conceptually, reclassifications should not be prohibited when the classification no longer reflects

[17] In May 2011, the IASB amended IAS 28 and changed its title to *Investments in Associates and Joint Ventures*.

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how the instruments would be classified if the items were newly acquired. If reclassification were prohibited, the reported information would not reflect the amounts, timing and uncertainty of future cash flows.

BC4.114 The IASB was persuaded by these arguments and decided that reclassification should not be prohibited. The IASB noted that prohibiting reclassification decreases comparability for like instruments managed in the same way.

BC4.115 Some respondents contended that reclassifications should be permitted, instead of required, but did not explain their justification. However, the IASB noted that permitting reclassification would decrease comparability, both between different entities and for instruments held by a single entity, and would enable an entity to manage its profit or loss by selecting the timing of when future gains or losses are recognised. Consequently, the IASB decided that reclassification should be required when the entity's business model for managing those financial assets changes.

BC4.116 The IASB noted that, as highlighted by many respondents, such changes in business model would be very infrequent, significant and demonstrable and determined by the entity's senior management as a result of external or internal change.

BC4.117 The IASB considered arguments that reclassification should also be permitted or required when contractual cash flow characteristics of a financial asset vary (or may vary) over that asset's life based on its original contractual terms. However, the IASB noted that, unlike a change in business model, the contractual terms of a financial asset are known at initial recognition. An entity classifies the financial asset at initial recognition on the basis of the contractual terms over the life of the instrument. Consequently, the IASB decided that reclassification on the basis of a financial asset's contractual cash flows should not be permitted.

BC4.118 The IASB considered how reclassifications should be accounted for. Almost all respondents said that reclassifications should be accounted for prospectively and should be accompanied by robust disclosures. The IASB reasoned that if classification and reclassification are based on the business model within which they are managed, classification should always reflect the business model within which the financial asset was managed at the reporting date. To apply the reclassification retrospectively would not reflect how the financial assets were managed at the prior reporting dates.

BC4.119 The IASB also considered the date at which reclassifications could take effect. Some respondents stated that reclassifications should be reflected in the entity's financial statements as soon as the entity's business model for the relevant instruments changes. To do otherwise would be contradictory to the objective of reclassification—ie to reflect how the instruments are managed. However, the IASB decided that reclassifications should take effect from the beginning of the following reporting period. In the IASB's view, entities should be prevented from choosing a reclassification date to achieve an accounting result. The IASB also noted that a change in an entity's business model is a significant and demonstrable event; therefore, an entity will most likely disclose such an event in its financial statements in the reporting period in which the change in business model takes place.

BC4.120 The IASB also considered and rejected the following approaches:

(a) *Disclosure approach:* Quantitative and qualitative disclosure (instead of reclassification) could be used to address when the classification no longer reflects how the financial assets would be classified if they were newly acquired. However, in the IASB's view, disclosure is not an adequate substitute for recognition.

(b) *One-way reclassification:* Reclassification would be required only to fair value measurement, ie reclassification to amortised cost measurement would be prohibited. Proponents of this approach indicated that such an approach might minimise abuse of the reclassification requirements and result in more instruments being measured at fair value. However, in the IASB's view, there is no conceptual reason to require reclassification in one direction but not the other.

Reclassification of financial liabilities

BC4.121 Consistently with its decision in 2010 to retain most of the existing requirements for classifying and measuring financial liabilities (and relocate them to IFRS 9), the IASB decided to retain the requirements that prohibit reclassifying financial liabilities between amortised cost and fair value. The IASB noted that IFRS 9 requires reclassification of assets in particular circumstances. However, in line with the feedback received during the IASB's outreach programme, the classification and measurement approaches for financial assets and financial liabilities are different; therefore the IASB decided that it is unnecessary and inappropriate to have symmetrical requirements for reclassification. Moreover, although the reclassification of financial assets has been a controversial topic in recent years, the IASB is not aware of any requests or views that support reclassifying financial liabilities.

Changes in circumstances that are not reclassifications

BCZ4.122 The definition of a financial asset or financial liability at fair value through profit or loss excludes derivatives that are designated and effective hedging instruments. Paragraph 50 of IAS 39 prohibited (and unless particular conditions are met, paragraphs 4.4.1 and 4.4.2 of IFRS 9 prohibit) the reclassification of financial instruments into or out of the fair value through profit or loss category after initial recognition. The IASB noted that the prohibition on reclassification might be read as preventing a derivative financial instrument that becomes a designated and effective hedging instrument from being excluded from the fair value through profit or loss category in accordance with the definition. Similarly, it might be read as preventing a derivative that ceases to be a designated and effective hedging instrument from being accounted for at fair value through profit or loss.

BCZ4.123 The IASB decided that the prohibition on reclassification should not prevent a derivative from being accounted for at fair value through profit or loss when it does not qualify for hedge accounting and vice versa. Consequently, in *Improvements to IFRSs* issued in May 2008, the IASB addressed this point (now in paragraph 4.4.3 of IFRS 9).

Limited amendments for financial assets (July 2014)

BC4.124 When the IASB issued IFRS 9 in 2009, it acknowledged the difficulties that might be created by differences in timing between the classification and measurement phase of the project to replace IAS 39 and the Insurance Contracts project. The IASB consistently stated that the interaction between IFRS 9 and the Insurance Contracts project would be considered once the IASB's insurance contracts model had been developed sufficiently.

BC4.125 In addition, after IFRS 9 was issued in 2009, the IASB received feedback from interested parties in various jurisdictions that had chosen to apply IFRS 9 early or who had reviewed IFRS 9 in detail in preparation for application. Some asked questions or raised application issues related to the requirements for classifying and measuring financial assets.

BC4.126 Finally, when the IASB was developing the first requirements of IFRS 9, its priority was to make improvements to the accounting for financial instruments available quickly. Consequently, the IASB issued the classification and measurement requirements for financial assets in IFRS 9 in 2009 while the FASB was still developing its classification and measurement model. However, the boards remained committed to trying to achieve increased comparability internationally in the accounting for financial instruments.

BC4.127 Accordingly, in November 2011 the IASB decided to consider making limited amendments to IFRS 9 with the following objectives:

(a) consider the interaction between the classification and measurement of financial assets and the accounting for insurance contract liabilities;

(b) address specific application questions raised by interested parties since IFRS 9 was issued; and

(c) seek to reduce key differences with the FASB's tentative classification and measurement model for financial instruments.

BC4.128 In making this decision, the IASB noted that IFRS 9 was fundamentally sound and would result in useful information being provided to users of financial statements. Feedback from interested parties since IFRS 9 was issued had confirmed that it was operational. Accordingly, although some interested parties might have preferred the IASB to discuss additional issues, it decided to consider only limited amendments to IFRS 9 in line with the objectives set out in paragraph BC4.127.

BC4.129 In limiting the scope of the deliberations, the IASB was also mindful of the need to complete the entire project on financial instruments on a timely basis and minimise the cost and disruption to entities that have already applied, or have begun preparations to apply, IFRS 9. Thus, the IASB decided to focus only on the following issues:

(a) the basis for, and the scope of, a possible third measurement category for financial assets (ie fair value through other comprehensive income);

(b) the assessment of a financial asset's contractual cash flow characteristics—specifically, whether, and if so what, additional guidance is required to clarify how the assessment is to be applied and whether bifurcation of financial assets should be reintroduced; and

(c) interrelated issues arising from these topics (for example, disclosure requirements and the model for financial liabilities).

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BC4.130 At the same time, the FASB had been discussing its tentative model for classifying and measuring financial instruments. Consequently, consistently with their long-standing objective to increase international comparability in the accounting for financial instruments, in January 2012, the IASB and the FASB decided to jointly deliberate these issues. However, the boards were mindful of their different starting points. Specifically, the IASB was considering limited amendments to the existing requirements in IFRS 9 whereas the FASB was considering a comprehensive new model.

BC4.131 The boards' joint deliberations led to the publication of the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) (the '2012 Limited Amendments Exposure Draft') and the FASB's proposed Accounting Standards Update *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* in November 2012 and February 2013 respectively. While the publications had different scopes (ie to reflect the fact that the IASB was proposing limited amendments to IFRS 9 whereas the FASB was proposing a comprehensive new model) the key aspects of the boards' respective classification and measurement models were largely aligned.

BC4.132 The comment periods on the IASB's and the FASB's proposals ended on 28 March 2013 and 15 May 2013 respectively. The boards developed a plan for joint redeliberations on the basis of the feedback received. That plan reflected the fact that the feedback differed in a number of ways. Specifically, many of the FASB's respondents questioned whether a new comprehensive classification and measurement model was needed and raised concerns about the complexity of the proposals. Many of those respondents advocated that the FASB should consider making targeted improvements to current US GAAP (particularly to the current requirements for bifurcating financial instruments). Consequently, while agreeing to joint redeliberations, the FASB indicated that after those redeliberations were complete, it would consider whether it would confirm the model that the boards had been jointly discussing or pursue another approach (for example, targeted improvements to US GAAP). In contrast, overall, the IASB's respondents continued to support the classification and measurement model in IFRS 9 and supported the proposed limited amendments to that model. The boards' plan for redeliberations also reflected the fact that the boards had different scopes for their redeliberations, which reflected their different starting points. Accordingly the boards' project plan envisaged both joint and separate redeliberations.

BC4.133 At joint public meetings in September through November 2013, the boards discussed the key aspects of their respective models—specifically, the assessment of an asset's contractual cash flow characteristics and the assessment of an entity's business model for managing financial assets (including the basis for, and the scope of, the fair value through other comprehensive income measurement category). Most of the decisions were made jointly and there was general agreement on the key aspects. However, there were differences in the boards' decisions on specific details, such as the assessment of some contingent and prepayment features as well as the articulation of particular aspects of the business model assessment.

BC4.134 Subsequent to the joint discussions, the FASB continued to discuss at FASB-only public meetings the assessment of an asset's contractual cash flow characteristics and the assessment of an entity's business model for managing financial assets. The FASB tentatively decided in December 2013 and January 2014 that it would not continue to pursue the model that the boards had been jointly discussing. Instead, the FASB tentatively decided to consider targeted improvements to current US GAAP guidance for classifying and measuring financial assets.

BC4.135 At its February 2014 meeting, the IASB received and discussed an update on the FASB's tentative decisions. Although the IASB expressed disappointment that the boards had failed to achieve a more converged outcome, it decided to proceed with finalising the limited amendments to IFRS 9. The IASB noted that its stakeholders continue to support the classification and measurement model in IFRS 9 and also supported the proposed limited amendments to that model. The IASB also noted that the minor revisions to the proposed limited amendments that were made during the redeliberations of those proposals were largely to confirm and clarify the proposals in response to the feedback received on the 2012 Limited Amendments Exposure Draft.

The entity's business model

BC4.136 The requirements issued in IFRS 9 (2009) required an entity to assess its business model for managing financial assets. A financial asset was measured at amortised cost only if it was held within a business model whose objective was to hold financial assets in order to collect contractual cash flows (a 'hold to collect' business model), subject also to an assessment of the asset's contractual cash flow characteristics. All other financial assets were measured at fair value through profit or loss. Paragraph BC4.15–BC4.21 describe the IASB's rationale for that assessment.

BC4.137 Most interested parties have consistently agreed that financial assets should be classified and measured on the basis of the objective of the business model in which the assets are held, and also have consistently agreed that assets held within a hold to collect business model ought to be measured at amortised cost. However,

after IFRS 9 was issued in 2009, some interested parties asked the IASB to clarify particular aspects of the hold to collect business model, including:

(a) the level of sales activity that is consistent with a hold to collect business model;

(b) the effect on the classification of an entity's financial assets if the entity's sales activity in a particular period appears to contradict the hold to collect business model objective—specifically, the consequences both on the classification of assets that the entity currently holds (ie those assets that the entity has already recognised) and on the classification of assets that it may hold in the future; and

(c) how to classify some portfolios of assets—in particular, so-called 'liquidity portfolios' that banks hold to satisfy their actual or potential liquidity needs, often in response to regulatory requirements.

More generally, some interested parties said that significant judgement was needed to classify some financial assets and, as a result, there was some inconsistency in views in practice about whether the objective of particular business models was to hold to collect contractual cash flows.

BC4.138 In addition, some interested parties expressed the view that IFRS 9 should contain a third measurement category: fair value through other comprehensive income. These views mainly related to:

(a) whether measurement at fair value through profit or loss appropriately reflects the performance of financial assets that are managed both in order to collect contractual cash flows and for sale. Some believed that the requirements for the business model assessment issued in IFRS 9 (2009) resulted in classification outcomes that were too stark, ie an entity either holds financial assets to collect contractual cash flows or it is required to measure the assets at fair value through profit or loss.

(b) the potential accounting mismatch that may arise as a result of the interaction between the classification and measurement of financial assets in accordance with IFRS 9 and the accounting for insurance contract liabilities under the IASB's tentative decisions in its Insurance Contracts project. That was because the 2013 Exposure Draft *Insurance Contracts* (the '2013 Insurance Contracts Exposure Draft') proposed that insurance contract liabilities would be measured on the statement of financial position using a current value approach, but the effects of changes in the discount rate used to measure that current value would be required to be disaggregated and presented in other comprehensive income.

(c) the tentative classification and measurement model that the FASB was considering immediately prior to the start of the boards' joint deliberations, which contemplated three measurement categories: amortised cost, fair value through other comprehensive income and fair value through profit or loss.

BC4.139 Accordingly, in the 2012 Limited Amendments Exposure Draft, the IASB proposed to clarify the objective of the hold to collect business model by providing additional application guidance. The IASB also proposed to introduce a third measurement category; that is, a measurement category for particular financial assets with simple contractual cash flows that are managed both in order to collect contractual cash flows and for sale.

The hold to collect business model

BC4.140 As a result of the application questions raised by interested parties and the diversity in views expressed since IFRS 9 was issued in 2009, the IASB decided to propose clarifications to the hold to collect business model. The IASB noted that these clarifications are relevant irrespective of whether a third measurement category is ultimately introduced to IFRS 9. That is, in the IASB's view, the proposed clarifications would not change (narrow the scope of) the population of financial assets that are eligible to be measured at amortised cost on the basis of the business model in which they are held in order to accommodate an additional measurement category. Instead, the proposals reaffirmed the existing principle in IFRS 9 that financial assets are measured at amortised cost only if they are held within a hold to collect business model (subject also to the assessment of the asset's contractual cash flow characteristics). The proposals also clarified and supplemented that principle with additional application guidance on the types of business activities and the frequency and nature of sales that are consistent, and inconsistent, with a hold to collect business model.

BC4.141 The 2012 Limited Amendments Exposure Draft stated that in order to assess whether the objective of the business model is to hold financial assets to collect contractual cash flows, an entity needs to consider the frequency and significance of past sales activity and the reason for those sales, as well as expectations about future sales activity. The IASB noted that that assessment is consistent with determining whether the cash flows from the financial assets will arise from the collection of their contractual cash flows. The IASB also noted that it expects that sales out of the amortised cost measurement category will be less frequent than sales out of the other measurement categories, because holding assets to collect contractual cash flows is integral to achieving the objective of a hold to collect business model, while selling financial assets to realise cash flows (including fair value changes) is only incidental to that objective. However, the 2012 Limited Amendments Exposure Draft clarified that the credit quality of financial assets is relevant to the entity's

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ability to collect the assets' contractual cash flows. Consequently, selling a financial asset when its credit quality has deteriorated is consistent with an objective to collect contractual cash flows.

BC4.142 Respondents to the 2012 Limited Amendments Exposure Draft generally agreed that financial assets should be classified and measured on the basis of the objective of the business model within which the assets are held, and specifically agreed with the hold to collect business model for classifying financial assets at amortised cost. However, some respondents expressed concern about what they perceived to be an unduly narrow amortised cost measurement category and expressed the view that the application guidance seemed similar to the guidance for held-to-maturity assets in IAS 39. Specifically, the respondents said that the proposals placed too much emphasis on the frequency and volume of sales instead of focusing on the reasons for those sales and whether those sales are consistent with a hold to collect business model. In addition, while respondents agreed that selling a financial asset when its credit quality has deteriorated is consistent with an objective of collecting contractual cash flows, some asked whether such sales would be acceptable only if they occur once the entity has actually incurred a loss (or there has been significant credit deterioration and therefore lifetime expected credit losses are recognised on the financial asset in accordance with the proposals published in the Exposure Draft *Financial Instruments: Expected Credit Losses* (the '2013 Impairment Exposure Draft'). Some respondents also expressed the view that selling financial assets to manage concentrations of credit risk (for example, selling financial assets in order to limit the amount of instruments held that are issued in a particular jurisdiction) should not be inconsistent with a hold to collect business model.

BC4.143 In response to the feedback received, the IASB decided to emphasise that the business model assessment in IFRS 9 focuses on how the entity actually manages financial assets in order to generate cash flows. The IASB noted that amortised cost is a simple measurement technique that allocates interest over time using the effective interest rate, which is based on contractual cash flows. Accordingly, amortised cost provides relevant and useful information about the amounts, timing and uncertainty of cash flows only if the contractual cash flows will be collected. In order to supplement that principle and improve the clarity of the application guidance related to the hold to collect business model, the IASB also decided to expand the discussion in IFRS 9 on the activities that are commonly associated with the hold to collect business model.

BC4.144 The IASB confirmed that although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those assets until maturity. Some sales out of the hold to collect business model are expected to occur (ie some financial assets will be derecognised for accounting purposes before maturity). The IASB noted that the level of sales activity (ie the frequency and value of sales), and the reasons for those sales, play a role in assessing the objective of the business model because that assessment focuses on determining how the entity actually manages assets to generate cash flows from the financial assets.

BC4.145 The IASB decided to clarify that the value and frequency of sales do not determine the objective of the business model and therefore should not be considered in isolation. Instead, information about past sales and expectations about future sales (including the frequency, value and nature of such sales) provide evidence about the objective of the business model. Information about sales and sales patterns are useful in determining how an entity manages its financial assets and how cash flows will be realised. Information about historical sales helps an entity to support and verify its business model assessment; that is, such information provides evidence about whether cash flows have been realised in a manner that is consistent with the entity's stated objective for managing those assets. The IASB noted that while an entity should consider historical sales information, that information does not imply that newly originated or newly purchased assets should be classified differently from period to period solely on the basis of sales activity in prior periods. In other words, fluctuations in sales activity in particular periods do not necessarily mean that the entity's business model has changed. The entity will need to consider the reasons for those sales and whether they are consistent with a hold to collect business model. For example, a change in the regulatory treatment of a particular type of financial asset may cause an entity to undertake a significant rebalancing of its portfolio in a particular period. Given its nature, the selling activity in that example would likely not in itself change the entity's overall assessment of its business model if the selling activity is an isolated (ie one-time) event. The entity also needs to consider information about past sales within the context of the conditions that existed at that time as compared to existing conditions and expectations about future conditions.

BC4.146 The IASB decided to emphasise that sales due to an increase in the asset's credit risk enhance the entity's ability to collect contractual cash flows. Accordingly, the IASB noted that selling a financial asset when concerns arise about the collectability of the contractual cash flows is consistent with the objective of a hold to collect business model. The IASB noted that this guidance does not require that the entity wait to sell the financial asset until it has incurred a credit loss or until there has been a significant increase in credit risk (and lifetime expected credit losses are recognised on the asset). Instead, a sale would be consistent with the objective of a hold to collect business model if the asset's credit risk has increased based on reasonable and supportable information, including forward looking information.

BC4.147 The IASB also discussed whether sales due to managing concentrations of credit risk are consistent with a hold to collect business model. The IASB decided that such sales should be assessed in the same manner as other sales. Specifically, an entity must assess whether the assets' credit risk has increased (based on reasonable and supportable, including forward looking, information) and, if so, such sales would be consistent with a hold to collect business model. If not, the entity would need to consider the frequency, value and timing of such sales, as well as the reasons for those sales, to determine whether they are consistent with a hold to collect business model. The IASB noted that the notion of credit concentration risk is applied fairly broadly in practice and may include changes in the entity's investment policy or strategy that are not related to credit deterioration. The IASB noted that frequent sales that are significant in value and labelled as 'due to credit concentration risk' (but that are not related to an increase in the assets' credit risk) are likely to be inconsistent with the objective of collecting contractual cash flows.

Fair value through other comprehensive income

BC4.148 The requirements issued in IFRS 9 (2009) stated that financial assets were measured at either amortised cost or fair value through profit or loss.[18] However, as discussed in paragraph BC4.138, the IASB received feedback from some interested parties subsequent to IFRS 9 being issued in 2009 that the Standard should contain a third measurement category: fair value through other comprehensive income. In that feedback, some questioned whether measuring financial assets at fair value through profit or loss if those assets are not held within a hold to collect business model always results in useful information. In addition, some were concemed about the potential accounting mismatch that may arise because of the interaction between the classification and measurement of financial assets under IFRS 9 and the proposed accounting for insurance contract liabilities under the IASB's Insurance Contracts project. Others pointed out that, at the time, the FASB was considering a tentative model that included a fair value through other comprehensive income measurement category.

BC4.149 In response to that feedback, the IASB proposed in the 2012 Limited Amendments Exposure Draft to introduce into IFRS 9 a fair value through other comprehensive income measurement category for particular financial assets. Specifically, the 2012 Limited Amendments Exposure Draft proposed that an entity would be required to measure a financial asset at fair value through other comprehensive income (unless the asset qualifies for, and the entity elects to apply, the fair value option) if the asset:

(a) has contractual cash flow characteristics that give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding; and

(b) is held within a business model in which assets are managed both in order to collect contractual cash flows and for sale (a 'hold to collect and sell' business model).

BC4.150 The IASB noted that the performance of a hold to collect and sell business model will be affected by both the collection of contractual cash flows and the realisation of fair values. Accordingly, the IASB decided that both amortised cost and fair value information are relevant and useful and therefore decided to propose that both sets of information are presented in the financial statements. Specifically, the 2012 Limited Amendments Exposure Draft proposed that the assets would be measured at fair value in the statement of financial position and the following amortised cost information would be presented in profit or loss:

(a) interest revenue using the effective interest method that is applied to financial assets measured at amortised cost; and

(b) impairment gains and losses using the same methodology that is applied to financial assets measured at amortised cost.

The difference between the total change in fair value and the amounts recognised in profit or loss would be presented in other comprehensive income.

BC4.151 The IASB noted in the 2012 Limited Amendments Exposure Draft that amortised cost information in profit or loss reflects the entity's decision to hold the assets to collect contractual cash flows unless, and until, the entity sells the assets in order to achieve the objective of the business model. Fair value information reflects the cash flows that would be realised if, and when, the assets are sold. In addition, the 2012 Limited Amendments Exposure Draft proposed that when an asset measured at fair value through other comprehensive income is derecognised, the cumulative fair value gain or loss that was recognised in other comprehensive income is reclassified ('recycled') from equity to profit or loss as a reclassification adjustment (in accordance with IAS 1). The IASB noted that amortised cost information would not be provided in profit or loss unless

[18] The requirements issued in IFRS 9 (2009) permitted an entity to make an irrevocable election at initial recognition to present fair value gains and losses on particular investments in equity instruments in other comprehensive income. That election is discussed in paragraph 5.7.5 of IFRS 9 and was outside of the scope of the 2012 Limited Amendments Exposure Draft.

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the gains or losses previously accumulated in other comprehensive income are recycled to profit or loss when the financial asset is derecognised—and, therefore, recycling was a key feature of the proposed fair value through other comprehensive income measurement category.

BC4.152 However, the IASB acknowledged that requiring recycling for these financial assets is different from other requirements in IFRS 9 that prohibit recycling. Specifically, in accordance with IFRS 9, an entity is prohibited from recycling the gains and losses accumulated in other comprehensive income related to the following financial instruments:

(a) investments in equity instruments for which an entity has made an irrevocable election at initial recognition to present fair value changes in other comprehensive income (see paragraphs 5.7.5 and B5.7.1 of IFRS 9); or

(b) financial liabilities designated under the fair value option for which the effects of changes in the liability's credit risk are presented in other comprehensive income (see paragraphs 5.7.7 and B5.7.9 of IFRS 9).

BC4.153 However, the IASB noted in the 2012 Limited Amendments Exposure Draft that some of the reasons for prohibiting recycling of those gains or losses do not apply to financial assets measured at fair value through other comprehensive income. Specifically:

(a) *investments in equity instruments:* paragraph BC5.25(b) discusses the reasons why these gains and losses accumulated in other comprehensive income are not recycled. One of the primary reasons is that recycling would create the need to assess these equity investments for impairment. The impairment requirements in IAS 39 for investments in equity instruments were very subjective and indeed were among the most criticised accounting requirements during the global financial crisis. In contrast, IFRS 9 does not contain impairment requirements for investments in equity instruments. For financial assets mandatorily measured in accordance with the new fair value through other comprehensive income category, the IASB proposed that the same impairment approach would apply to those financial assets as is applied to financial assets measured at amortised cost. While recycling is prohibited, the IASB observed that an entity is not prohibited from presenting information in the financial statements about realised gains or losses on investments in equity instruments; for example, as a separate line item in other comprehensive income.

(b) *financial liabilities designated under the fair value option:* paragraphs BC5.52–BC5.57 discuss the reasons why these own credit gains and losses accumulated in other comprehensive income are not recycled. One of the primary reasons is that if the entity repays the contractual amount, which will often be the case for these financial liabilities, the cumulative effect of changes in the liability's credit risk over its life will net to zero because the liability's fair value will ultimately equal the contractual amount due. In contrast, for financial assets measured at fair value through other comprehensive income, selling financial assets is integral to achieving the objective of the business model and therefore the gains and losses accumulated in other comprehensive income will not net to zero.

BC4.154 Consistently with providing amortised cost information in profit or loss, the IASB proposed that for the purposes of recognising foreign exchange gains and losses under IAS 21 *The Effects of Changes in Foreign Exchange Rates*, a financial asset measured at fair value through other comprehensive income should be treated as if it was measured at amortised cost in the foreign currency. Consequently, exchange differences on the amortised cost (ie interest revenue calculated using the effective interest method and impairment gains and losses) would be recognised in profit or loss, with all other exchange differences recognised in other comprehensive income.

BC4.155 In addition to providing relevant and useful information for financial assets that are held within a hold to collect and sell business model, the IASB noted in the 2012 Limited Amendments Exposure Draft that the introduction of the fair value through other comprehensive income measurement category may improve consistency between the classification and measurement of financial assets under IFRS 9 and the accounting for insurance contract liabilities under the IASB's tentative decisions at that time in its Insurance Contracts project. That is because the 2013 Insurance Contracts Exposure Draft proposed that insurance contract liabilities would be measured on the statement of financial position using a current value approach but the effects of changes in the discount rate used to measure that current value would be presented in other comprehensive income. Consequently, when the entity holds both insurance contract liabilities and financial assets that qualify to be measured at fair value through other comprehensive income, particular changes in both the fair value of the financial assets (ie those changes other than interest revenue and impairment gains and losses) and the current value of the insurance contract liabilities (ie those changes arising from the effects of changes in the discount rate) would be presented in other comprehensive income.

BC4.156 The majority of respondents to the 2012 Limited Amendments Exposure Draft agreed with the introduction of the fair value through other comprehensive income measurement category. Some of those respondents agreed with the measurement category as proposed by the IASB, while others agreed in principle with the

proposals but made suggestions related to the conditions for that new measurement category. For example, some respondents expressed the view that a financial asset should be measured at fair value through other comprehensive income as long as it is held in a hold to collect and sell business model (ie irrespective of the asset's contractual cash flow characteristics) and others suggested that the fair value through other comprehensive income measurement category should be an option (either in addition to, or instead of, a mandatory measurement category). The suggestion that the fair value through other comprehensive income measurement category should be an option was most often made within the context of further reducing accounting mismatches between the classification and measurement of financial assets under IFRS 9 and accounting for insurance contract liabilities under the IASB's tentative decisions in its Insurance Contracts project. In addition, some respondents raised questions about the distinction between the fair value through other comprehensive income measurement category and the fair value through profit or loss measurement category. Some of these respondents asked the IASB to more clearly articulate the principle underpinning the fair value through other comprehensive income measurement category. A few respondents asked whether it would be more straightforward to define the conditions to measure a financial asset at fair value through profit or loss and therefore suggested that fair value through other comprehensive income should be the residual measurement category. They noted that this would be more aligned with the available-for-sale category in IAS 39.

BC4.157 Consistently with the proposal in the 2012 Limited Amendments Exposure Draft and the feedback received on that proposal, the IASB confirmed the introduction of a third measurement category—fair value through other comprehensive income—into IFRS 9. The IASB believes that this measurement category is appropriate for financial assets that have contractual cash flows that are solely payments of principal and interest and that are held in a hold to collect and sell business model. For those financial assets, the IASB believes that both amortised cost and fair value information are relevant and useful because such information reflects how cash flows are realised. That is, holding financial assets to collect contractual cash flows is integral to achieving the objective of the hold to collect and sell business model and therefore the amounts presented in profit or loss provide amortised cost information while the entity holds the assets. Other fair value changes are not presented in profit or loss until (and unless) they are realised through selling, which acknowledges that such changes may reverse while the entity holds the asset. However, because selling assets is also integral to achieving the objective of the hold to collect and sell business model, those other fair value changes are presented in other comprehensive income and the financial asset is presented at fair value in the statement of financial position.

BC4.158 Also, in order to be measured at fair value through other comprehensive income, a financial asset must have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. This is because amortised cost information is presented in profit or loss for assets measured at fair value through other comprehensive income and, as the IASB has consistently stated, the amortised cost measurement attribute provides relevant and useful information only for financial assets with 'simple' contractual cash flows (ie contractual cash flows that are solely principal and interest). Amortised cost is a relatively simple measurement technique that allocates interest over the relevant time period using the effective interest rate. As discussed in paragraph BC4.23, the IASB's long-held view is that the effective interest method, which underpins amortised cost measurement, is not an appropriate method for allocating 'complex' contractual cash flows (ie contractual cash flows that are not solely principal and interest).

BC4.159 The IASB also discussed during its redeliberations whether the fair value through other comprehensive income measurement category should be optional—either in addition to, or instead of, a mandatory measurement category. However, the IASB believes that such an option would be inconsistent with, and indeed would undermine, its decision to classify financial assets as measured at fair value through other comprehensive income on the basis of their contractual cash flows and the business model within which they are held. Indeed, the overall structure of IFRS 9 is based on classifying financial assets on the basis of those two conditions. Moreover, the IASB noted that users of financial statements have both consistently opposed permitting too much optionality in accounting requirements and have also advocated accounting requirements that provide comparability. However, the IASB acknowledged that accounting mismatches could arise as a result of the classification and measurement of financial assets under IFRS 9. In particular, such mismatches could arise because of the accounting for insurance contract liabilities under the IASB's tentative decisions in its Insurance Contracts project. In response to those potential mismatches, the IASB noted that the introduction of the fair value through other comprehensive income measurement category, which reflects a hold to collect and sell business model, and the extension of the existing fair value option in IFRS 9 to financial assets that would otherwise be measured at fair value through other comprehensive income (see paragraphs BC4.210–BC4.211), are both relevant to many entities that have insurance contract liabilities. Consequently, the IASB believes that those requirements will assist in improving the interaction between the accounting for financial assets and the proposed accounting for insurance contract liabilities as compared to the requirements issued in IFRS 9 (2009). The IASB noted that, in a sense, these amendments to the requirements in IFRS 9 for the classification and measurement of financial assets provide a number of 'tools' that the IASB can consider when it finalises the accounting for insurance contract liabilities. Moreover, the

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IASB noted that it will consider the feedback related to the accounting model for insurance contract liabilities and whether that model should be modified to reflect the interaction with the classification and measurement model for financial assets in IFRS 9 as it continues to discuss its Insurance Contracts project.

BC4.160 In order to improve the clarity of the application guidance related to the hold to collect and sell business model, the IASB decided to emphasise that holding and selling are not the *objectives* of the business model, but instead are the *outcomes* of the business model. That is, collecting contractual cash flows and selling financial assets are the outcomes of the way in which an entity manages its financial assets to achieve the objective of a particular business model. For example, an entity with a long-term investment strategy that has an objective of matching the cash flows on long-term liabilities or matching the duration of liabilities with the cash flows on financial assets may have a hold to collect and sell business model. The IASB decided to clarify that measuring financial assets at fair value through other comprehensive income provides relevant and useful information to users of financial statements only when realising cash flows by collecting contractual cash flows and selling financial assets are both integral to achieving the objective of the business model.

BC4.161 The IASB acknowledges that a third measurement category adds complexity to IFRS 9 and may seem similar to the available-for-sale category in IAS 39. However, the IASB believes that measuring particular financial assets at fair value through other comprehensive income reflects the assets' performance better than measuring those assets at either amortised cost or fair value through profit or loss. The IASB also believes that the fair value through other comprehensive income measurement category in IFRS 9 is fundamentally different to the available-for-sale category in IAS 39. That is because there is a clear and logical rationale for measuring particular financial assets at fair value through other comprehensive income, which is based on the existing structure in IFRS 9 (ie financial assets are classified on the basis of their contractual cash flow characteristics and the business model in which they are held). In contrast, the available-for-sale category in IAS 39 was essentially a residual classification and, in many cases, was a free choice. Moreover, IFRS 9 requires the same interest revenue recognition and impairment approach for assets measured at amortised cost and fair value through other comprehensive income, whereas IAS 39 applied different impairment approaches to different measurement categories. Consequently, the IASB believes that the added complexity of a third measurement category (compared to the requirements issued in IFRS 9 (2009)) is justified by the usefulness of the information provided to users of financial statements.

BC4.162 The IASB noted during its redeliberations that some interested parties have expressed concerns that the introduction of the fair value through other comprehensive income measurement category would increase the use of fair value compared to the requirements issued in IFRS 9 (2009). However, as discussed in paragraph BC4.140, the introduction of the third measurement category and the clarifications to the hold to collect business model clarify, instead of change (narrow the scope of), the population of financial assets that were intended to be eligible to be measured at amortised cost. The clarifications to the guidance for the hold to collect business model address particular application questions raised by interested parties by reaffirming the existing principle in IFRS 9. The introduction of the fair value through other comprehensive income measurement category affects only assets that are not held in a hold to collect business model and thus would otherwise be measured at fair value through profit or loss under the requirements issued in IFRS 9 (2009).

Fair value through profit or loss

BC4.163 IFRS 9 (as issued in 2009) had only two measurement categories: amortised cost and fair value through profit or loss. A financial asset was measured at amortised cost only if it met particular conditions. All other financial assets were measured at fair value through profit or loss; ie fair value through profit or loss was the residual measurement category.[19]

BC4.164 The 2012 Limited Amendments Exposure Draft proposed to introduce a third measurement category—fair value through other comprehensive income—and, during the deliberations leading to that Exposure Draft, the IASB considered whether fair value through profit or loss should remain the residual measurement category. The IASB acknowledged that there might be some benefits in making fair value through other comprehensive income the residual measurement category, because, arguably, a clearer distinction could be made between the conditions for the amortised cost measurement category and the conditions for the fair value through profit or loss measurement category. That is, it would be easier to define the two 'ends' of the classification spectrum (ie amortised cost and fair value through profit or loss) with the 'middle' (ie fair value through other comprehensive income) as the residual. As noted in paragraph BC4.156, a few respondents to the 2012 Limited Amendments Exposure Draft expressed this view.

[19] As noted previously, IFRS 9 (as issued in 2009) permitted an entity to make an irrevocable election at initial recognition to present fair value gains and losses on particular investments in equity instruments in other comprehensive income. That election is discussed in paragraph 5.7.5 of IFRS 9 and was outside of the scope of the 2012 Limited Amendments Exposure Draft.

BC4.165 However, the IASB has consistently noted that the residual measurement category must provide useful information for all of the instruments classified in that category. Amortised cost information is provided in profit or loss for both the amortised cost measurement category and the fair value through other comprehensive income measurement category, and this information is relevant only for financial assets with particular contractual cash flow characteristics that are held within particular business models. That is, amortised cost information is relevant only if the financial asset has contractual cash flows that are solely payments of principal and interest and the asset is held in a business model in which collecting contractual cash flows is integral to achieving its objective. As a result, the IASB believes that it would be inappropriate if either amortised cost or fair value through other comprehensive income was the residual measurement category. Furthermore, the IASB believes that defining the conditions for the fair value through other comprehensive income measurement category strengthens and clarifies the conditions for the amortised cost measurement category.

BC4.166 Consequently, the IASB reaffirmed the existing requirement in IFRS 9—and the proposal in the 2012 Limited Amendments Exposure Draft—that the fair value through profit or loss measurement category is the residual measurement category. In addition, to respond to feedback received, the IASB confirmed that financial assets that are held for trading purposes and financial assets that are managed and whose performance is evaluated on a fair value basis must be measured at fair value through profit or loss, because they are held neither in a hold to collect business model nor in a hold to collect and sell business model. Instead, the entity makes decisions on the basis of changes in, and with the objective of realising, the assets' fair value. Thus, the IASB believes that relevant and useful information about the amounts, timing and uncertainty of future cash flows is provided to users of financial statements only if these financial assets are measured at fair value through profit or loss.

Other considerations

BC4.167 In the deliberations leading to the publication of the 2012 Limited Amendments Exposure Draft, the IASB considered an alternative approach to assessing the business model in which financial assets are held. The approach was a 'business-activity approach' and was similar to the tentative approach that the FASB had been considering immediately prior to the start of the boards' joint deliberations. In summary, the business-activity approach would have classified financial assets on the basis of the business activity that the entity uses in acquiring and managing those financial assets, subject to an assessment of the asset's contractual cash flow characteristics. The business-activity approach focused on the strategy that resulted in an entity's initial recognition of the financial asset. Under this approach, the relevant business activities were 'customer financing' or 'lending', which would result in measurement at amortised cost; 'investing', which would result in measurement at fair value through other comprehensive income; and 'holding for sale' or 'actively managing (or monitoring) the assets at fair value', which would result in measurement at fair value through profit or loss. In order to be considered a lending (or customer financing) business activity, in addition to holding the financial assets to collect substantially all of the contractual cash flows, the entity must also have had the ability to negotiate adjustments to the contractual cash flows with the counterparty in the event of a potential credit loss.

BC4.168 The IASB noted that the business-activity approach would be different from the approach to classifying financial assets in IFRS 9 (as issued in 2009). In addition, the IASB noted that measuring financial assets at amortised cost only if the entity has the ability to negotiate the asset's terms with the counterparty might be unduly costly to implement and complex to apply and also might result in different classification of lending activities solely as a result of the different legal frameworks in different jurisdictions. The IASB also noted that, under the business-activity approach, the form of the financial asset would affect its classification; for example, widely-held bonds would typically fail to meet the criteria to be measured at amortised cost, because the holder is generally unable to renegotiate the terms with the counterparty on a bilateral basis. Accordingly, the IASB decided not to pursue the business-activity approach and instead confirmed the approach in IFRS 9, in which financial assets are measured at amortised cost if they are held with an objective to collect contractual cash flows (subject to the assessment of the asset's contractual cash flow characteristics) and reaffirmed the rationale for the business model assessment set out in paragraphs BC4.15—BC4.21.

BC4.169 In addition, during its deliberations leading to the publication of the 2012 Limited Amendments Exposure Draft, the IASB noted that the 2009 Classification and Measurement Exposure Draft had solicited views on alternative approaches in which fair value changes for particular financial assets would be disaggregated, with the result that a portion of the fair value change would be presented in profit or loss and a portion of the fair value change would be presented in other comprehensive income. Those alternative approaches, as well as the feedback received and the IASB's rationale for ultimately rejecting the approaches, are described in more detail in paragraphs BC4.41—BC4.43. The IASB believes that the fair value through other comprehensive income measurement category that was proposed in the 2012 Limited Amendments Exposure Draft, and subsequently added to IFRS 9, is different from, and significantly less complex than, those alternative

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approaches. For example, the alternative approaches continued to rely on the definition of 'loans and receivables' in IAS 39 (in addition to the assessments of the entity's business model and the asset's contractual cash flows). Moreover, the alternative approaches prohibited recycling and therefore did not present both fair value and amortised cost information in the financial statements. As discussed in paragraph BC4.157, presenting both sets of information was an important factor in the IASB's decision to add the fair value through other comprehensive income measurement category to IFRS 9.

Contractual cash flow characteristics[20]

Solely payments of principal and interest

BC4.170 IFRS 9 (as issued in 2009) required an entity to assess the contractual cash flow characteristics of financial assets. A financial asset was measured at amortised cost only if its contractual terms gave rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding, subject to the assessment of the business model within which the asset is held. For the purposes of assessing the contractual cash flow characteristics of a financial asset, interest was consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time. Paragraph BC4.22 noted that a premium for liquidity risk may be included.

BC4.171 The IASB's long-standing view has been that amortised cost provides relevant and useful information about particular financial assets in particular circumstances because, for those assets, it provides information about the amount, timing and uncertainty of future cash flows. Amortised cost is calculated using the effective interest method, which is a relatively simple measurement technique that allocates interest over the relevant time period using the effective interest rate.

BC4.172 The objective of the requirement in IFRS 9 to assess an asset's contractual cash flows is to identify instruments for which the effective interest method results in relevant and useful information. The IASB believes that the effective interest method is suitable only for instruments with 'simple' cash flows that represent solely principal and interest. In contrast, as set out in paragraph BC4.23, the effective interest method is not an appropriate method for allocating contractual cash flows that are not principal and interest on the principal amount outstanding. Instead those more complex cash flows require a valuation overlay to contractual cash flows (ie fair value) to ensure that the reported financial information provides useful information.

BC4.173 Most interested parties have consistently agreed that a financial asset should be classified and measured on the basis of its contractual cash flow characteristics and have found this requirement to be operational. However, subsequent to the issue of IFRS 9 in 2009, the IASB received some questions about how this assessment should be applied to particular financial assets. Specifically, the requirements in paragraph B4.1.13 of IFRS 9 (2009) set out an example of a financial asset with an interest rate tenor mismatch (that is, the variable interest rate on the financial asset is reset every month to a three-month interest rate or the variable interest rate is reset to always reflect the original maturity of the asset). The discussion of the example (Instrument B) concluded that such contractual cash flows are not payments of principal and interest, because the interest rate does not represent consideration for the time value of money for the tenor of the instrument (or the reset period). Subsequent to the issuance of IFRS 9 in 2009, many interested parties raised concerns related to that example. Specifically, those interested parties asked about the assessment of a financial asset's contractual cash flows when the consideration for the time value of money element of the interest rate is not perfect (ie it is 'modified') because of a contractual term such as an interest rate tenor mismatch feature. Generally, stakeholders expressed concerns that the application guidance issued in IFRS 9 (2009) could lead to an unduly narrow interpretation of the meaning of interest.

BC4.174 The IASB acknowledged these concerns. In the 2012 Limited Amendments Exposure Draft, it proposed a notion of a modified economic relationship between principal and the consideration for time value of money and credit risk—and also proposed corresponding clarifications to Instrument B in paragraph B4.1.13 of IFRS 9. Specifically, the IASB proposed that a financial asset does not necessarily need to be measured at fair value through profit or loss if the economic relationship between principal and the consideration for time value of money and credit risk is modified by an interest rate tenor mismatch feature. Instead, an entity would be required to assess the effect of the modified relationship on the financial asset's contractual cash flows relative to a 'perfect' benchmark instrument (ie a financial instrument with the same credit quality and with the same contractual terms except for the contractual term under evaluation). If the modification could result in contractual cash flows that are more than insignificantly different from the benchmark cash flows, the

[20] In this section, the discussion about amortised cost information is relevant to both financial assets in the amortised cost measurement category and financial assets in the fair value through other comprehensive income measurement category. That is because, for the latter, the assets are measured at fair value in the statement of financial position and amortised cost information is provided in profit or loss.

contractual terms of the financial asset would not give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. In other words, in the 2012 Limited Amendments Exposure Draft, the IASB clarified that the relationship between principal and the consideration for time value of money and credit risk does not need to be perfect, but only relatively minor modifications of that relationship are consistent with payments that are solely principal and interest.

BC4.175 While developing the 2012 Limited Amendments Exposure Draft, the IASB received feedback about interest rates in regulated environments that modify the economic relationship between principal and the consideration for the time value of money and the credit risk. Interested parties noted that in such environments the base interest rates are set by a central authority and may not be reset in a manner that reflects the reset period. In these circumstances, the effect of the interest rate tenor mismatch feature could be significant. Furthermore, in such environments, there may not be any financial instruments available that are priced on a different basis. Thus, some raised concerns about how to determine whether the cash flows on such instruments are solely payments of principal and interest and whether the proposed notion of a modified economic relationship was operational and appropriate in such environments. The IASB noted that it would gather further feedback during the comment period on whether the clarifications proposed in the 2012 Limited Amendments Exposure Draft appropriately addressed the concerns related to interest rates in regulated environments.

BC4.176 Nearly all respondents to the 2012 Limited Amendments Exposure Draft agreed that a financial asset with a modified economic relationship between principal and the consideration for the time value of money and the credit risk should be considered to have contractual cash flows that are solely payments of principal and interest. However, many respondents believed that the clarification did not go far enough in addressing common application questions and expressed concern that some financial assets that they view as 'plain vanilla' or 'normal lending' would still not have contractual cash flows that are solely payments of principal and interest. Specifically, these respondents expressed the view that the assessment of a modified economic relationship still implied an unduly narrow and strict interpretation of the time value of money element of an interest rate. They stated that amortised cost could provide useful information for a broader range of financial instruments. They asked the IASB to clarify the scope of the assessment of a modified economic relationship (for example, whether it should apply only to interest rate tenor mismatch features or more broadly to all circumstances in which the time value of money element is modified (ie imperfect)) and to reconsider the threshold used in that assessment (ie the threshold of 'not more than insignificantly different' from benchmark cash flows). Respondents also requested broader clarifications about the meaning of the time value of money as that notion is used in the description of interest in IFRS 9.

BC4.177 In its redeliberations, the IASB acknowledged respondents' questions and concerns and, as a result, decided to clarify the following items:

(a) The objective of the time value of money element is to provide consideration for *only* the passage of time, in the absence of a return for other risks (such as credit risk or liquidity risk) or costs associated with holding the financial asset. In assessing the time value of money element, the entity must consider the currency in which the financial asset is denominated, because interest rates vary by currency. In addition, as a general proposition, there must be a link between the interest rate and the period for which the interest rate is set, because the appropriate rate for an instrument varies depending on the term for which the rate is set.

(b) However, in some circumstances, the time value of money element could provide consideration for only the passage of time even if that element is modified by, for example, an interest rate tenor mismatch feature or a feature that sets the interest rate by reference to an average of particular short and long-term interest rates. In these cases, an entity must assess whether the time value of money element provides consideration for only the passage of time by performing either a quantitative or qualitative assessment. The objective of that assessment is to establish (on an undiscounted basis) how different the financial asset's contractual cash flows (ie taking into account all of the contractual cash flows) could be from the cash flows that would arise if the time value of money element were perfect (ie if there were a perfect link between the interest rate and the period for which that rate is set). The IASB decided not to prescribe when an entity must perform a quantitative versus a qualitative assessment.

(c) If the modified time value of money element could result in cash flows that are significantly different on an undiscounted basis from the 'perfect' cash flows (described as benchmark cash flows), either in a single reporting period or cumulatively over the life of the financial instrument, the financial asset does not have contractual cash flows that are solely payments of principal and interest. The IASB was persuaded by respondents' feedback that the 'not more than insignificantly different' threshold in the 2012 Limited Amendments Exposure Draft was unduly restrictive and, as a result, particular financial assets would be measured at fair value through profit or loss even though the objective of the modified time value of money element was in fact to provide consideration for only the passage of time. However, the IASB noted that the objective of a modified time value of money element is not to

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provide consideration for just the passage of time, and thus the contractual cash flows are not solely payments of principal and interest, if the contractual cash flows could be significantly different from the benchmark cash flows.

BC4.178 The IASB also noted that, as a general proposition, the market in which the transaction occurs is relevant to the assessment of the time value of money element. For example, in Europe it is common to reference interest rates to LIBOR and in the United States it is common to reference interest rates to the prime rate. However the IASB noted that a particular interest rate does not necessarily reflect consideration for only the time value of money merely because that rate is considered 'normal' in a particular market. For example, if an interest rate is reset every year but the reference rate is always a 15-year rate, it would be difficult for an entity to conclude that such a rate provides consideration for only the passage of time, even if such pricing is commonly used in that particular market. Accordingly the IASB believes that an entity must apply judgement to conclude whether the stated time value of money element meets the objective of providing consideration for only the passage of time.

Regulated interest rates

BC4.179 The IASB noted that in some jurisdictions the government or regulatory authority establishes interest rates and, in some cases, the objective of the time value of money element may not be to provide consideration for only the passage of time. However, the IASB decided that such a regulated interest rate is a proxy for the time value of money element if that interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

BC4.180 The IASB acknowledged that this approach for regulated interest rates is broader than the approach for interest rates that are established freely by market participants. However, the IASB noted that these regulated rates are set for public policy reasons and thus are not subject to structuring to achieve a particular accounting result. For example, the IASB noted that French retail banks collect deposits on special 'Livret A' savings accounts. The interest rate is determined by the central bank and the government according to a formula that reflects protection against inflation and an adequate remuneration that incentivises entities to use these particular savings accounts. This is because legislation requires a particular portion of the amounts collected by the retail banks to be lent to a governmental agency that uses the proceeds for social programmes. The IASB noted that the time value element of interest on these accounts may not provide consideration for only the passage of time; however the IASB believes that amortised cost would provide relevant and useful information as long as the contractual cash flows do not introduce risks or volatility that are inconsistent with a basic lending arrangement.

Other clarifications

BC4.181 Respondents to the 2012 Limited Amendments Exposure Draft also asked the IASB to clarify the overall objective of the assessment of a financial asset's contractual cash flow characteristics and also raised the following specific questions and concerns related to that assessment:

(a) the meaning of 'principal'—respondents asked the IASB to clarify the meaning of principal, in particular within the context of financial assets that are originated or purchased at a premium or discount to par;

(b) the meaning of 'interest'—respondents asked whether elements other than the time value of money and credit risk (for example, consideration for liquidity risk, funding costs and a profit margin) could be consistent with contractual cash flows that are solely payments of principal and interest; and

(c) de minimis features—respondents asked whether a contractual feature would affect the classification and measurement of a financial asset if, in all scenarios, that feature could impact the contractual cash flows only by a de minimis amount.

BC4.182 In response to the feedback received, the IASB decided to clarify the application guidance in IFRS 9 as follows:

(a) for the purposes of applying the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9, principal is the fair value of the financial asset at initial recognition. The IASB believes that this meaning reflects the economics of the financial asset from the perspective of the current holder; in other words, the entity would assess the contractual cash flow characteristics by comparing the contractual cash flows to the amount that it actually invested. However, the IASB acknowledged that the principal amount may change over the life of the financial asset (for example, if there are repayments of principal).

(b) for the purposes of applying the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9, the consideration for the time value of money and the credit risk are typically the most significant elements of interest; however, they may not be the only elements. In discussing the elements of interest (and indeed the overall objective of the assessment of an asset's contractual cash flows), the IASB considered the concept of a 'basic lending arrangement' (the form of which need not be that of a loan). In such an arrangement, the IASB noted that interest may include consideration for elements other than the time value of money and credit risk. Specifically, interest may include consideration for risks such as liquidity risk and costs associated with holding the asset (such as administrative costs) as well as a profit margin. But elements that introduce exposure to risks or variability in the contractual cash flows that are unrelated to lending (such as exposure to equity or commodity price risk) are not consistent with a basic lending arrangement. The IASB also noted that the assessment of interest focuses on *what* the entity is being compensated for (ie whether the entity is receiving consideration for basic lending risks, costs and a profit margin or is being compensated for something else), instead of *how much* the entity receives for a particular element. For example, the IASB acknowledged that different entities may price the credit risk element differently.

(c) a contractual feature does not affect the classification and measurement of a financial asset if the impact of that feature on the asset's contractual cash flows could only ever be de minimis. The IASB noted that to make this determination an entity must consider the potential effect of the feature in each reporting period and cumulatively over the life of the instrument. For example, a feature would not have a de minimis effect if it could give rise to a significant increase in contractual cash flows in one reporting period and a significant decrease in contractual cash flows in another reporting period, even if these amounts offset each other on a cumulative basis.

Contractual terms that change the timing or amount of contractual cash flows, including prepayment and extension features

BC4.183 The requirements issued in IFRS 9 (2009) provided guidance for contractual terms that permit the issuer (ie the debtor) to prepay a financial instrument or that permit the holder (ie the creditor) to put the financial instrument back to the issuer before maturity (ie 'prepayment features') and contractual terms that permit the issuer or holder to extend the contractual term of the financial instrument (ie 'extension features'). In summary, that guidance stated that prepayment and extension features result in contractual cash flows that are solely payments of principal and interest only if:

(a) the prepayment or extension feature is not contingent on future events, other than to protect the holder or issuer against particular events or circumstances; and

(b) the terms of the prepayment or extension feature result in contractual cash flows that are solely payments of principal and interest.

The guidance for prepayment features stated that the prepayment amount may include reasonable additional compensation for the early termination of the contract.

BC4.184 The requirements issued in IFRS 9 (2009) also stated that a contractual term that changes the timing or amount of payments of principal or interest does not result in contractual cash flows that are solely payments of principal and interest unless the term is a variable interest rate that is consideration for the time value of money and credit risk or the term is a prepayment or extension feature (as in paragraph BC4.183). However if a contractual term is not genuine, it does not affect the classification of a financial asset. (Consistently with IAS 32, a contractual feature is not genuine if it affects the asset's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.)

BC4.185 Although the 2012 Limited Amendments Exposure Draft did not propose any amendments to these requirements, some respondents asked the IASB to reconsider or clarify particular aspects of the guidance. In particular, some respondents asked why the requirements issued in IFRS 9 (2009) provided specific guidance for prepayment and extension features that are contingent on future events ('contingent prepayment and extension features'), but did not provide guidance for other types of features that are contingent on future events ('other contingent features'). Respondents also asked whether (and if so, why) the nature of the future event in itself affects whether the financial asset's contractual cash flows are solely payments of principal and interest. These respondents generally expressed the view that an entity should focus on the contractual cash flows that could arise over the life of the financial instrument (ie both before and after the future event), instead of on the nature of the future event itself.

BC4.186 In addition, some respondents expressed the view that a contingent feature should not affect the classification and measurement of a financial asset if the likelihood is remote that the future event will occur. Some of these respondents were specifically concerned about contingently convertible instruments or so-called 'bail-in' instruments. While the contractual terms of these instruments vary, generally, interested parties raised

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concerns about contingently convertible instruments that convert into equity instruments of the issuer on the basis of a predetermined ratio if a specified event occurs (for example, if the issuer's regulatory capital ratios decline below a specific threshold). In the case of a bail-in instrument, interested parties generally raised concerns about instruments with a contractual feature that requires (or permits) a portion or all of the unpaid amounts of principal and interest to be written off if a specified event occurs (for example, if the issuer has insufficient regulatory capital or is at a point of non-viability). These respondents expressed the view that these instruments should not be measured at fair value through profit or loss merely as a result of the contingent cash flow characteristics (ie the conversion into a predetermined number of the issuer's equity instruments or the write-off of particular unpaid amounts upon the occurrence of a particular future event) if it is unlikely that the future event will occur.

BC4.187 Other respondents asked whether a financial asset could have contractual cash flows that are solely payments of principal and interest if the asset is purchased or originated at a significant premium or discount to the contractual par amount but is prepayable at that par amount. These respondents noted that if principal is described as the fair value of the financial asset at initial recognition, then the prepayment amount (ie par) will not represent unpaid amounts of principal and interest. That is because the prepayment amount will either be *more than* unpaid amounts of principal and interest (if the asset is purchased or originated at a significant discount) or *less than* unpaid amounts of principal and interest (if the asset is purchased or originated at a significant premium). Respondents stated that discounts and premiums are generally expected to arise when the entity does not expect that the asset will be prepaid (even though prepayment is contractually possible). Many raised this issue specifically within the context of purchased credit-impaired financial assets. Many of these assets will be purchased at a significant discount to par, which reflects the credit impairment, but the contractual terms may include a prepayment feature. Respondents expressed the view that an entity should not be required to measure purchased credit-impaired financial assets at fair value through profit or loss merely as a result of the prepayment feature, particularly because it is highly unlikely that such an asset will be prepaid at its contractual par amount since it is credit impaired.

BC4.188 In its redeliberations of the 2012 Limited Amendments Exposure Draft, the IASB decided to clarify the application guidance in IFRS 9 as follows:

(a) all contingent features must be assessed in the same way. That is, there is no distinction between contingent prepayment and extension features and other types of contingent features.

(b) for all contingent features, the nature of the future event in itself does not determine whether a financial asset's contractual cash flows are solely payments of principal and interest. However, the IASB noted that there often is an important interaction between the nature of the future event and the resulting contractual cash flows. Consequently, it is often helpful (or perhaps even necessary) for the entity to consider the nature of the future event to determine whether the resulting contractual cash flows are solely payments of principal and interest. For example, if the nature of the future event is unrelated to a basic lending arrangement (for example, a particular equity or commodity index reaches or exceeds a particular level), it is unlikely that the resulting contractual cash flows are solely payments of principal and interest, because those cash flows are likely to reflect a return for equity or commodity price risk.

BC4.189 In addition, the IASB confirmed the guidance in IFRS 9 that an entity is not permitted to take into account the probability that the future event will occur, unless the contingent feature is not genuine. In other words, a financial asset must be measured at fair value through profit or loss if a remote (but genuine) contingency would result in contractual cash flows that are not solely payments of principal and interest (and those contractual cash flows are not de minimis). In reaching that conclusion, the IASB considered an alternative approach in which a contingent feature would not affect the classification and measurement of a financial asset if the likelihood is remote that the future event will occur. The IASB rejected this approach because it is inconsistent with its long-standing view that amortised cost provides relevant and useful information only for financial assets with simple contractual cash flows. As noted in paragraph BC4.23, the effective interest method is not appropriate for measuring contractual cash flows that are not solely payments of principal and interest, but instead those cash flows require a valuation overlay to contractual cash flows (ie fair value) to ensure that the reported financial information is relevant and useful.

BC4.190 In particular, the IASB noted that contingently convertible instruments and bail-in instruments could give rise to contractual cash flows that are not solely payments of principal and interest and indeed are structured for regulatory purposes such that they have contractual characteristics similar to equity instruments in particular circumstances. Consequently, the IASB believes that amortised cost does not provide relevant or useful information to users of financial statements about those financial instruments, in particular if the likelihood of that future event occurring increases. At a minimum, the IASB observed that it would be necessary to reclassify the financial asset so that it is measured at fair value through profit or loss if the future event becomes more likely than remote. Thus, the IASB observed that an approach that is based on whether the likelihood of a future event is remote would create additional complexity, because the entity would need to continuously reassess whether the likelihood of the future event has increased such that it is no longer remote,

and if so, the entity would need to reclassify the financial asset so that it is measured at fair value through profit or loss at that point.

BC4.191 However, the IASB acknowledged that, as the result of legislation, some governments or other authorities have the power in particular circumstances to impose losses on the holders of some financial instruments. The IASB noted that IFRS 9 requires the holder to analyse the *contractual terms* of a financial asset to determine whether the asset gives rise to cash flows that are solely payments of principal and interest on the principal amount outstanding. In other words, the holder would not consider the payments that arise only as a result of the government's or other authority's legislative power as cash flows in its analysis. That is because that power and the related payments are not *contractual terms* of the financial instrument.

BC4.192 Moreover, the IASB decided to provide a narrow exception for particular prepayable financial assets. The exception would apply to financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest but do not meet that condition only as a result of the prepayment feature. Such financial assets would be eligible to be measured at amortised cost or fair value through other comprehensive income (subject to the assessment of the business model in which they are held) if the following three conditions are met:

(a) the financial asset is purchased or originated at a premium or discount to the contractual par amount;

(b) the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which may include reasonable additional compensation for the early termination of the contract; and

(c) the fair value of the prepayment feature on initial recognition of the financial asset is insignificant.

BC4.193 This exception would require some financial assets that otherwise do not have contractual cash flows that are solely payments of principal and interest to be measured at amortised cost or fair value through other comprehensive income (subject to the assessment of the business model in which they are held). In particular, the IASB observed that this exception will apply to many purchased credit-impaired financial assets with contractual prepayment features. If such an asset was purchased at a deep discount, apart from the exception described in paragraph BC4.192, the contractual cash flows would not be solely payments of principal and interest if, contractually, the asset could be repaid immediately at the par amount. However that contractual prepayment feature would have an insignificant fair value if it is very unlikely that prepayment will occur. The IASB was persuaded by the feedback that stated that amortised cost would provide useful and relevant information to users of financial statements about such financial assets, because the exception applies only to those financial assets that are prepayable at the contractual par amount. Consequently, the prepayment amount does not introduce variability that is inconsistent with a basic lending arrangement because that variability would result only from the time value of money and credit risk elements; ie the entity would receive more of the contractual cash flows than it previously expected, and it would receive those contractual cash flows immediately. The IASB believes that information about that variability would be appropriately captured by amortised cost via the catch-up adjustment mechanism.

BC4.194 Similarly, the IASB observed that this exception will apply to some financial assets that are originated at below-market interest rates. For example, this scenario may arise when an entity sells an item (for example, an automobile) and, as a marketing incentive, provides financing to the customer at an interest rate that is below the prevailing market rate. At initial recognition the entity would measure the financial asset at fair value[21] and, as a result of the below-market interest rate, the fair value would be at a discount to the par amount. If the customer has a contractual right to repay the par amount at any point before maturity, then without an exception, the contractual cash flows may not be solely payments of principal and interest. The IASB observed that such a contractual prepayment feature likely would have an insignificant fair value because it is unlikely that the customer will choose to prepay; in particular, because the interest rate is below-market and thus the financing is advantageous. Consistently with the discussion in paragraph BC4.193, the IASB believes that amortised cost would provide relevant and useful information to users of financial statements about this financial asset, because the prepayment amount does not introduce variability that is inconsistent with a basic lending arrangement.

BC4.195 Paragraphs BC4.193–BC4.194 discuss circumstances in which a financial asset is originated or purchased at a *discount* to the par amount. However, the IASB noted that its rationale for the exception described in paragraph BC4.192 is equally relevant for assets that are originated or purchased at a *premium* and therefore decided that the exception should apply symmetrically to both circumstances.

[21] Unless the financial asset is a trade receivable that does not have a significant financing component (determined in accordance with IFRS 15). Such a trade receivable is measured at initial recognition in accordance with paragraph 5.1.3 in IFRS 9.

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Bifurcation

BC4.196 The requirements issued in IFRS 9 (2009) did not bifurcate hybrid contracts with financial asset hosts. Instead, all financial assets were classified in their entirety. Since 2009, many interested parties have expressed support for that approach. However, others have expressed the view that hybrid financial assets should be bifurcated into a derivative component and a non-derivative host. Much of the feedback that was received after IFRS 9 was issued in 2009 was similar to the feedback that was received during the deliberations that led to that Standard being issued. That feedback is summarised in paragraph BC4.88. In addition, some have noted that:

(a) components of some hybrid financial assets are managed separately and therefore bifurcation may provide more relevant information to users of financial statements about how the entity manages those instruments;

(b) an embedded feature that has an insignificant fair value at initial recognition (for example, because it is contingent on a future event that the entity believes is unlikely to occur) could cause a hybrid financial asset to be measured at fair value through profit or loss in its entirety; and

(c) it is important to have symmetry in the bifurcation of financial assets and financial liabilities and, consequently, hybrid financial assets should be bifurcated because the IASB retained bifurcation for hybrid financial liabilities.

BC4.197 During the deliberations that led to the publication of the 2012 Limited Amendments Exposure Draft, the IASB reconsidered whether bifurcation should be pursued for financial assets or financial liabilities (or both) and, if so, what the basis for that bifurcation should be. The IASB considered three approaches:

(a) 'closely-related' bifurcation (ie bifurcation using the 'closely-related' bifurcation criteria in IAS 39, which have been carried forward to IFRS 9 for financial liabilities);

(b) 'principal-and-interest' bifurcation; or

(c) no bifurcation (ie the financial instrument would be classified in its entirety).

BC4.198 In the 2012 Limited Amendments Exposure Draft, the IASB did not propose any changes to the requirements in IFRS 9 related to the bifurcation of financial instruments. As a result, hybrid financial assets are not bifurcated but are instead classified and measured in their entirety. Hybrid financial liabilities are bifurcated (unless the entity elects to apply the fair value option) on the basis of the closely-related criteria that were carried forward to IFRS 9 from IAS 39.

BC4.199 In reaching that conclusion, the IASB noted that, consistently with paragraphs BC4.46–BC4.53 and BC4.91, interested parties have consistently told the IASB that the bifurcation methodology in IAS 39 for financial liabilities is generally working well in practice and practice has developed since those requirements were issued. Specifically, many constituents, including users of financial statements, strongly supported retaining bifurcation for financial liabilities even though they supported eliminating it for financial assets. That was primarily because bifurcation addresses the issue of own credit risk, which is relevant only for financial liabilities.

BC4.200 In contrast, while the closely-related bifurcation methodology in IAS 39 works well for financial liabilities, it does not complement the guidance in IFRS 9 that requires an entity to assess the asset's contractual cash flow characteristics. For example, if IFRS 9 were to require both an assessment of the asset's contractual cash flow characteristics *and* a closely-related bifurcation assessment, the IASB would need to determine which of those assessments should have primacy. For example, the IASB discussed a scenario in which a financial asset had contractual cash flows that were not solely payments of principal and interest but did not contain an embedded derivative that required bifurcation. Specifically, the IASB considered how such a financial asset should be subsequently measured; ie either in its entirety at fair value through profit or loss because its contractual cash flows were not solely payments of principal and interest or, alternatively, in its entirety at amortised cost (or fair value through other comprehensive income, depending on the business model in which is it held) because it did not contain an embedded derivative that required bifurcation. Similar challenges would arise for a financial asset that had contractual cash flows that were solely payments of principal and interest but contained an embedded derivative that required bifurcation. As a result, the IASB concluded that combining the assessment in IFRS 9 of the asset's contractual cash flow characteristics with a closely-related bifurcation assessment would be complex and likely would give rise to contradictory outcomes—and indeed, in some cases, seemed unworkable. Consequently, the IASB decided not to pursue this approach for financial assets.

BC4.201 Under a principal-and-interest bifurcation approach, if a financial asset had cash flows that were not solely payments of principal and interest, that asset would be assessed to determine whether it should be bifurcated into a host (with cash flows that are solely payments of principal and interest) and an embedded residual feature. The host could qualify for a measurement category other than fair value through profit or loss, depending on the business model within which it was held. The embedded feature would be measured at fair

value through profit or loss. The IASB also considered variations of this approach whereby bifurcation would be required only if the embedded feature met the definition of a derivative or if the components were separately managed. If these conditions were not met, the financial asset would be measured in its entirety at fair value through profit or loss.

BC4.202 The IASB noted that if principal-and-interest bifurcation is based on the separate management of the components of the instrument, such an approach would be an instrument-by-instrument assessment of the management of a financial asset. That would be inconsistent with the existing assessment in IFRS 9 of the business model, which requires the management of financial assets to be assessed at a higher level of aggregation. The IASB also noted that a principal-and-interest bifurcation approach might seem generally compatible with the existing requirements in IFRS 9, but, in fact, it would introduce new concepts into the classification and measurement of financial assets and would undoubtedly raise questions about how the host and embedded feature should be defined and measured. The IASB observed that introducing a principal-and-interest bifurcation approach into IFRS 9 would significantly increase complexity, especially because it would then contain two bifurcation approaches (ie one for hybrid financial assets and another for hybrid financial liabilities). The IASB also observed that there was significant risk of unintended consequences related to introducing a new bifurcation approach. Consequently, the IASB decided not to pursue this approach for financial assets.

BC4.203 Accordingly, during the deliberations that led to the 2012 Limited Amendments Exposure Draft, the IASB confirmed its decision that hybrid contracts with financial asset hosts should be classified and measured in their entirety. In reaching that conclusion, the IASB cited its original rationale for prohibiting bifurcation, which is set out in paragraphs BC4.83–BC4.90.

BC4.204 Some respondents to the 2012 Limited Amendments Exposure Draft from particular jurisdictions continued to express a preference for bifurcating hybrid financial assets. However, most respondents did not suggest that bifurcation should be reintroduced and some respondents specifically stated that they disagreed with reintroducing it. As a result, the IASB reconfirmed the requirements in IFRS 9 that hybrid contracts with financial asset hosts should not be bifurcated but should instead be classified and measured in their entirety.

Investments in contractually linked instruments (tranches)

BC4.205 In accordance with the requirements in paragraphs B4.1.21—B4.1.26 of IFRS 9 (issued in 2009), investments in contractually linked instruments (tranches) may have contractual cash flows that are solely payments of principal and interest if (in summary):

(a) the contractual terms of the tranche being assessed for classification give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding;

(b) the underlying pool of instruments contains only instruments that have contractual cash flows that are solely principal and interest on the principal amount outstanding, that reduce cash flow variability on the instruments in the pool or that align the cash flows of the tranches with the cash flows of the instruments in the pool to address particular differences; and

(c) the exposure to credit risk inherent in the tranche being assessed is equal to, or lower than, the overall exposure to credit risk of the underlying pool of financial instruments.

BC4.206 After IFRS 9 was issued in 2009, the IASB received questions about whether a tranche could have contractual cash flows that are solely payments of principal and interest if the tranche is prepayable in the event that the underlying pool of financial instruments is prepaid or if the underlying pool includes instruments that are collateralised by assets that do not meet the conditions set out in paragraphs B4.1.23—B4.1.24 of IFRS 9 (as issued in 2009). The IASB noted that a key principle underpinning the assessment of contractually linked instruments is that an entity should not be disadvantaged simply as a result of holding an investment indirectly (ie via an investment in a tranche) if the underlying pool of instruments have contractual cash flows that are solely payments of principal and interest and the tranche is not exposed to leverage or more credit risk than the credit risk of the underlying pool of financial instruments. Accordingly, in the 2012 Limited Amendments Exposure Draft, the IASB proposed to clarify that a tranche may have contractual cash flows that are solely payments of principal and interest even if:

(a) the tranche is prepayable in the event that the underlying pool of financial instruments is prepaid. The IASB noted that because the underlying pool of assets must have contractual cash flows that are solely payments of principal and interest then, by extension, any prepayment features in those underlying financial assets must also be solely payments of principal and interest.

(b) financial assets in the underlying pool are collateralised by assets that do not meet the conditions set out in paragraphs B4.1.23 and B4.1.24 of IFRS 9. In such cases, the entity would disregard the possibility that the pool may contain the collateral in the future unless the entity acquired the

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instrument with the intention of controlling the collateral. The IASB noted that this is consistent with IFRS 9; ie financial assets can themselves still have contractual cash flows that are solely payments of principal and interest if they are collateralised by assets that do not have contractual cash flows that are solely payments of principal and interest.

BC4.207 Respondents supported these proposals but asked the IASB to consider additional clarifications to the requirements for contractually linked instruments:

(a) in assessing whether the instruments in the underlying pool meet the requirements in paragraphs B4.1.23 or B4.1.24 of IFRS 9, a detailed instrument-by-instrument analysis of the pool may not be necessary; however, the entity is required to use judgement and perform sufficient analysis to determine whether those requirements are met; and

(b) an entity may assess the requirement in paragraph B4.1.21(c) of IFRS 9 by comparing the credit rating of a tranche to the weighted average credit rating of the financial assets in the underlying pool (ie comparing the credit rating of the tranche being assessed for classification to what the credit rating would be on a *single* tranche that funded the entire underlying pool of financial instruments).

BC4.208 The IASB agreed with the points in paragraph BC4.207 and indeed noted that those clarifications are consistent with the original intention of the requirements for contractually linked instruments. The IASB therefore decided to clarify the relevant paragraphs in the application guidance to IFRS 9. However, it noted that the clarification described in paragraph BC4.206(a) would be addressed as a result of the general clarifications made to the requirements for contingent prepayment features.

Other limited amendments

BC4.209 As a result of introducing the fair value through other comprehensive income measurement category into IFRS 9, the IASB considered particular interrelated issues—specifically, whether the existing requirements issued in IFRS 9 (2009) for the fair value option and for reclassifications should be extended to financial assets measured at fair value through other comprehensive income.

Fair value option for financial assets otherwise measured at fair value through other comprehensive income

BC4.210 In accordance with the requirements issued in IFRS 9 (2009), entities are permitted to designate financial assets that would otherwise be measured at amortised cost as measured at fair value through profit or loss if, and only if, such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch'). Such designation is available at initial recognition and is irrevocable.

BC4.211 The IASB decided that the same fair value option that is available to financial assets that would otherwise be measured at amortised cost should be available for financial assets that would otherwise be measured at fair value through other comprehensive income. The IASB noted that the rationale set out in paragraph BC4.79 for permitting the fair value option for assets measured at amortised cost is equally applicable for financial assets measured at fair value through other comprehensive income.

Reclassifications into and out of the fair value through other comprehensive income measurement category

BC4.212 Paragraph 4.1.1 of IFRS 9 (as issued in 2009) required that an entity reclassify all affected financial assets when it changes its business model for managing financial assets. Paragraphs BC4.111–BC4.120 set out the IASB's rationale for the reclassification requirements.

BC4.213 The IASB noted that the number of measurement categories does not affect that rationale and therefore decided that the reclassification requirements issued in IFRS 9 (2009) should also apply to financial assets measured at fair value through other comprehensive income. Consequently, when an entity changes its business model for managing financial assets, it must reclassify all affected financial assets, including those in the fair value through other comprehensive income measurement category. Consistently with the requirements issued in IFRS 9 (2009), all reclassifications into and out of the fair value through other comprehensive income measurement category are applied prospectively from the reclassification date and previously recognised gains or losses (including impairment gains or losses) or interest revenue are not restated.

BC4.214 The IASB noted that because amortised cost information is provided in profit or loss for financial assets that are measured at fair value through other comprehensive income, reclassifications between the amortised cost measurement category and the fair value through other comprehensive income measurement category do not change the recognition of interest revenue or the measurement of expected credit losses. Specifically, the entity would have established the effective interest rate when the financial asset was originally recognised and would continue to use that rate if the financial asset is reclassified between the amortised cost measurement category and the fair value through other comprehensive income measurement category. Similarly, the measurement of expected credit losses does not change because both measurement categories apply the same impairment approach.

BC4.215 The IASB also decided to extend the relevant disclosure requirements in IFRS 7 and the relevant presentation requirements in IAS 1 to reclassifications into and out of the fair value through other comprehensive income measurement category.

Amendments for prepayment features with negative compensation (October 2017)[22]

BC4.216 In 2016, the IFRS Interpretations Committee (Interpretations Committee) received a submission asking how particular prepayable financial assets would be classified applying IFRS 9. Specifically, the submission asked whether a debt instrument could have contractual cash flows that are solely payments of principal and interest on the principal amount outstanding if its contractual terms permit the borrower (ie the issuer) to prepay the instrument at an amount that could be more or less than unpaid amounts of principal and interest, such as at the instrument's current fair value or an amount that reflects the instrument's remaining contractual cash flows discounted at a current market interest rate.

BC4.217 As a result of such a contractual prepayment feature, the lender (ie the holder) could be forced to accept a prepayment amount that is substantially less than unpaid amounts of principal and interest. Such a prepayment amount would, in effect, include an amount that reflects a payment *to* the borrower from the lender, instead of compensation *from* the borrower to the lender, even though the borrower chose to prepay the debt instrument. An outcome in which the party choosing to terminate the contract receives an amount, instead of pays an amount, is inconsistent with paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Specifically, it is inconsistent with the notion of reasonable additional compensation for the early termination of the contract. In this section of the Basis for Conclusions, such an outcome is referred to as negative compensation. Thus, the financial assets described in the submission would not have contractual cash flows that are solely payments of principal and interest, and those instruments would be measured at fair value through profit or loss applying IFRS 9 (as issued in 2014).

BC4.218 Nevertheless, Interpretations Committee members suggested that the IASB consider whether amortised cost measurement could provide useful information about particular financial assets with prepayment features that may result in negative compensation, and if so, whether the requirements in IFRS 9 should be changed in this respect.

BC4.219 In the light of the Interpretations Committee's recommendation and similar concerns raised by banks and their representative bodies in response to the Interpretations Committee's discussion, the IASB proposed amendments to IFRS 9 for particular financial assets that would otherwise have contractual cash flows that are solely payments of principal and interest but do not meet that condition only as a result of a prepayment feature that may result in negative compensation. The Exposure Draft *Prepayment Features with Negative Compensation* (Proposed amendments to IFRS 9) (2017 Negative Compensation Exposure Draft) proposed that such financial assets would be eligible to be measured at amortised cost or fair value through other comprehensive income, subject to an assessment of the business model in which they are held, if two eligibility conditions are met.

BC4.220 Most respondents to the 2017 Negative Compensation Exposure Draft agreed with the IASB's decision to address the classification of such prepayable financial assets, and highlighted the urgency of the issue given the proximity to the effective date of IFRS 9.

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[22] In this section, the discussion about amortised cost measurement is relevant to both financial assets in the amortised cost measurement category and financial assets in the fair value through other comprehensive income measurement category. That is because, for the latter, the assets are measured at fair value in the statement of financial position and amortised cost information is provided in profit or loss. A financial asset is measured at amortised cost or fair value through other comprehensive income only if both conditions in paragraph 4.1.2 or paragraph 4.1.2A of IFRS 9, respectively, are met. The amendments discussed in this section address only the condition in paragraphs 4.1.2(b) and 4.1.2A(b). Accordingly, this section does not discuss the conditions in paragraphs 4.1.2(a) and 4.1.2A(a) relating to the business model but instead assumes that the asset is held in the relevant business model.

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BC4.221 In October 2017, the IASB amended IFRS 9 by issuing *Prepayment Features with Negative Compensation* (Amendments to IFRS 9), which confirmed with modifications the proposals in the 2017 Negative Compensation Exposure Draft. Specifically, in the amendments issued in October 2017, the IASB amended paragraphs B4.1.11(b) and B4.1.12(b), and added paragraph B4.1.12A of IFRS 9. As a result of those amendments, particular financial assets with prepayment features that may result in reasonable negative compensation for the early termination of the contract are eligible to be measured at amortised cost or at fair value through other comprehensive income.

The prepayment amount

BC4.222 In developing the 2017 Negative Compensation Exposure Draft, the IASB noted that any proposal to measure at amortised cost financial assets with prepayment features that may result in negative compensation must be limited to those assets for which the effective interest method provides useful information to users of financial statements about the amount, timing and uncertainty of future cash flows. Accordingly, the first eligibility condition proposed in the Exposure Draft was intended to identify those prepayment features that do not introduce any contractual cash flow amounts that are different from the cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014).

BC4.223 In the deliberations that led to that proposal, the IASB noted that paragraph B4.1.11(b) of IFRS 9 accommodates contractual terms that permit either the borrower or the lender to choose to terminate the contract early and compensate the other party for having to accept that choice. Accordingly, that paragraph already accommodates a prepayment amount that is more or less than unpaid amounts of principal and interest, depending on which party chooses to terminate the contract early. In applying the effective interest method to measure such financial assets at amortised cost, an entity considers the contractual cash flows arising from such a prepayment feature when it estimates the future cash flows and determines the effective interest rate at initial recognition. Subsequently, consistent with the treatment of all financial instruments measured at amortised cost, the entity applies paragraph B5.4.6 of IFRS 9 and adjusts the gross carrying amount of the financial asset if it revises its estimates of contractual cash flows, including any revisions related to the exercise of the prepayment feature.

BC4.224 Similarly, for a financial asset with a prepayment feature that may result in negative compensation, the prepayment amount may be more or less than unpaid amounts of principal and interest. However, the difference is that such a prepayment feature may have the result that the party that triggers the early termination of the contract may, in effect, receive an amount *from* the other party, rather than pay compensation *to* the other party. To illustrate this difference, the IASB considered a loan with a prepayment feature that may result in negative compensation. Specifically, both the borrower and the lender have the option to terminate the loan before maturity and, if the loan is terminated early, the prepayment amount includes compensation that reflects the change in the relevant benchmark interest rate. That is, if the loan is terminated early (by either party) and the relevant benchmark interest rate has fallen since the loan was initially recognised, then the lender will effectively receive an amount representing the present value of that lost interest revenue over the loan's remaining term. Conversely, if the contract is terminated early (by either party) and the relevant benchmark interest rate has risen, then the borrower will effectively receive an amount that represents the effect of that change in that interest rate over the loan's remaining term.

BC4.225 The IASB acknowledged that the contractual terms of the loan described in paragraph BC4.224 do not introduce different contractual cash flow amounts from the contractual cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). That is, the loan's prepayment amount is calculated in the same way as a prepayment amount accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Specifically, the loan's prepayment amount reflects unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate. The contractual terms of the loan described in paragraph BC4.224 change only the circumstances in which the compensation amounts may arise; ie the loan may result in either reasonable additional compensation or reasonable negative compensation for the early termination of the contract.

BC4.226 The IASB noted that from a computation standpoint, the effective interest method, and thus amortised cost measurement, could be applied to the contractual cash flows that arise from a prepayable financial asset like the loan described in paragraph BC4.224. As described in paragraph BC4.223, the entity would consider the prepayment feature when it estimates the future cash flows and determines the effective interest rate. Subsequently, the entity would apply paragraph B5.4.6 of IFRS 9 and make a catch-up adjustment if it revises its estimates of contractual cash flows, including any revisions related to the prepayment feature.

BC4.227 Furthermore, the IASB decided that amortised cost measurement could provide useful information to users of financial statements about financial assets whose prepayment amount is consistent with

paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) in all respects except that the party that chooses to terminate the contract early may receive reasonable compensation for doing so. That is because, as discussed in paragraph BC4.225, such prepayment features do not introduce different contractual cash flow amounts from the contractual cash flow amounts accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014); ie the loan's prepayment amount is calculated in the same way as a prepayment amount accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014). Therefore, the 2017 Negative Compensation Exposure Draft proposed an eligibility condition that was intended to capture those prepayment features that would have been accommodated by paragraph B4.1.11(b) except that a party may receive reasonable compensation for the early termination of the contract even if it is the party that chooses to terminate the contract early (or otherwise causes the early termination to occur).

BC4.228 Nearly all respondents agreed with that eligibility condition proposed in the 2017 Negative Compensation Exposure Draft. Specifically, they agreed that reasonable negative compensation for the early termination of the contract should not in itself preclude amortised cost measurement. The respondents agreed with the IASB's rationale described in paragraphs BC4.226–BC4.227 and they also agreed that the proposed eligibility condition would capture a population of financial assets for which amortised cost measurement could provide useful information to users of financial statements. The respondents said that measuring such assets at amortised cost, and including them in key metrics like net interest margin, would provide useful information to users of financial statements about the financial assets' performance. Those respondents consider information about expected credit losses and interest revenue (calculated using the effective interest method) to be more relevant than information about changes in fair value for the purpose of assessing the performance and future cash flows of those financial assets.

BC4.229 Consequently, in its redeliberations of the 2017 Negative Compensation Exposure Draft, the IASB confirmed that proposed eligibility condition. As a result, applying the amendments, a financial asset with a prepayment feature that may result in negative compensation is eligible to be measured at amortised cost or fair value through other comprehensive income if it would have been accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) except that the prepayment amount may include reasonable *negative* compensation for the early termination of the contract.

BC4.230 However, one respondent said that the IASB had not addressed the case in which the early termination of the contract is caused by an event that is outside the control of both parties to the contract, such as a change in law or regulation. That respondent asked the IASB to clarify the amendments in that regard. The IASB agreed with that observation. Consequently, the wording in paragraph B4.1.12A of the amendments refers to the *event or circumstance* that caused the early termination of the contract. Such an event or circumstance may be within the control of one of the parties to the contract (for example, the borrower may choose to prepay) or it may be beyond the control of both parties (for example, a change in law may cause the contract to automatically terminate early).

Other prepayment amounts

BC4.231 As described in paragraph BC4.229, the IASB decided to limit the scope of the amendments to those financial assets with prepayment features that would have been accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014) except that the prepayment amount may include reasonable negative compensation for the early termination of the contract. The IASB observed that the effective interest method, and thus amortised cost measurement, are not appropriate when the prepayment amount is inconsistent with that paragraph for any other reason.

BC4.232 As described in the submission to the Interpretations Committee, some financial assets are prepayable at their current fair value. The IASB is also aware that some financial assets are prepayable at an amount that includes the fair value cost to terminate an associated hedging instrument (which may or may not be in a hedging relationship with the prepayable financial asset for accounting purposes). Some interested parties suggested that both of those types of prepayable financial asset should be eligible for amortised cost measurement. The IASB acknowledged that there may be some circumstances in which such a contractual prepayment feature results in contractual cash flows that are solely payments of principal and interest in accordance with IFRS 9, as amended; ie there may be circumstances in which the compensation included in such a prepayment amount is reasonable for the early termination of the contract. For example, that may be the case when the calculation of the prepayment amount is intended to approximate unpaid amounts of principal and interest plus or minus an amount that reflects the effect of the change in the relevant benchmark interest rate. However, the Board observed that it will not always be the case and therefore an entity cannot presume that all such prepayable financial assets are eligible to be measured at amortised cost. Entities must assess an instrument's specific contractual cash flow characteristics.

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The probability of prepayment

BC4.233 A prepayment feature that may result in negative compensation changes the circumstances, and increases the frequency, in which the contractual compensation amounts could arise. Accordingly, in the deliberations that led to the publication of the 2017 Negative Compensation Exposure Draft, the IASB observed that if such a prepayable financial asset is measured at amortised cost, the likelihood is higher that the lender will be required to make catch-up adjustments applying paragraph B5.4.6 of IFRS 9 to reflect revisions to its estimates of contractual cash flows related to the exercise of the prepayment feature. This could include adjustments to reflect circumstances in which the lender is forced to settle the contract in a way that it would not recover its investment for reasons other than the asset's credit quality. The IASB observed that recognising frequent upward and downward adjustments in the gross carrying amount is generally inconsistent with the objective of the effective interest method, which is a relatively simple measurement technique that allocates interest using the effective interest rate over the relevant time period. Recognising more frequent adjustments in the gross carrying amount could reduce the usefulness of the interest amounts that are calculated using such a simple measurement technique and could suggest that fair value measurement would provide more useful information.

BC4.234 Consequently, the IASB proposed a second eligibility condition in the 2017 Negative Compensation Exposure Draft. That eligibility condition would have required that the fair value of the prepayment feature is insignificant when the entity initially recognises the financial asset. The objective of that proposed eligibility condition was to limit further the scope of the amendments so that financial assets would be eligible to be measured at amortised cost only if it is unlikely that prepayment, and thus negative compensation, would occur.

BC4.235 While some respondents agreed with that proposed eligibility condition, others disagreed and expressed concerns about matters such as how difficult the condition would be to apply, whether it would unduly restrict the scope of the amendments and whether it would achieve the IASB's stated objective. Most of the respondents that disagreed with the second eligibility condition said the first eligibility condition (discussed above in paragraphs BC4.222–BC4.232) was sufficient. They expressed the view that the requirements in paragraph B4.1.11(b) of IFRS 9 should accommodate reasonable negative compensation for the early termination of the contract without additional restrictions; ie an entity should be required to assess negative compensation for the early termination of the contract in the same way as it assesses additional compensation for the early termination of the contract. Some respondents suggested alternatives that they thought would better achieve the IASB's objective. Those suggestions included assessing the probability that prepayment, or negative compensation, will occur.

BC4.236 During its redeliberations, the IASB observed that the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft would, in some cases, achieve its objective. That is because the fair value of the prepayment feature would take into account the likelihood that prepayment will occur. Accordingly, if it is very unlikely that prepayment will occur, then the fair value of the prepayment feature will be insignificant. The IASB also reconfirmed its view that the scope of the amendments must be limited to financial assets for which the effective interest method, and thus amortised cost, can provide useful information, and observed that a second eligibility condition would be helpful to precisely identify the relevant population.

BC4.237 However, the IASB acknowledged the concerns expressed by respondents. The Board agreed with the concern that the fair value of a prepayment feature would reflect not only the probability that reasonable negative compensation will occur, but it would also reflect the probability that reasonable additional compensation (as accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014)) will occur. In some circumstances, the fair value of the prepayment feature may be more than insignificant due largely, or entirely, to the latter. In such circumstances, the financial asset would not meet the second eligibility condition even if the holder determined that it was very unlikely that negative compensation will occur.

BC4.238 The IASB also noted concerns that the fair value of the prepayment feature could be insignificant even if it is likely that negative compensation may occur. For example, that could be the case if the compensation structure of the prepayment feature is symmetrical so that the effect of reasonable negative compensation on that feature's fair value is offset by the effect of reasonable additional compensation (as accommodated by paragraph B4.1.11(b) of IFRS 9 (as issued in 2014)), or if the prepayment amount is close to the instrument's fair value at the prepayment date.

BC4.239 Consequently, during its redeliberations, the IASB concluded that, in some circumstances, the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft would not restrict the scope of the amendments in the way that the IASB intended and, in other circumstances, could restrict the scope in

a way that the IASB did not intend. Therefore, on balance, the IASB decided not to confirm the second eligibility condition proposed in the 2017 Negative Compensation Exposure Draft.

BC4.240 The IASB noted that the alternatives to the second eligibility condition that were suggested by respondents were not discussed in the 2017 Negative Compensation Exposure Draft and therefore interested parties did not have the opportunity to provide feedback on them. Many respondents to that Exposure Draft highlighted the importance of finalising the amendments before the effective date of IFRS 9 and the IASB noted that prioritising such timing would preclude the Board from conducting outreach to assess those alternatives. Moreover, the IASB doubted whether those alternatives would better achieve its objective without introducing significant complexity to the amendments. Therefore, the IASB decided not to replace the second proposed eligibility condition with any of those alternatives.

Corresponding amendment to paragraph B4.1.12

BC4.241 As a consequence of its decisions to confirm the first proposed eligibility condition and remove the second proposed eligibility condition, the IASB observed that paragraph B4.1.11(b) of IFRS 9 will accommodate reasonable negative compensation for the early termination of the contract without additional restrictions; ie entities will be required to assess all amounts of reasonable compensation for the early termination of the contract in the same way.

BC4.242 Accordingly, the IASB amended paragraph B4.1.12(b) of IFRS 9 to align it with paragraph B4.1.11(b). As a result, paragraph B4.1.12(b) also accommodates reasonable negative compensation for the early termination of the contract. The IASB decided that there was no compelling reason to treat the notion of reasonable compensation for the early termination of the contract in paragraph B4.1.12(b) of IFRS 9 differently from that notion in paragraph B4.1.11(b).

Effective date

BC4.243 The 2017 Negative Compensation Exposure Draft proposed that the effective date of the amendments would be the same as the effective date of IFRS 9; that is, annual periods beginning on or after 1 January 2018, with earlier application permitted.

BC4.244 Some respondents agreed with that proposal and said there would be significant benefits if entities take into account the effect of the amendments when they initially apply IFRS 9. In contrast, others preferred a later effective date for the amendments; specifically, annual periods beginning on or after 1 January 2019 (with earlier application permitted). These respondents observed that many entities are advanced in their implementation of IFRS 9 and may not have sufficient time before the effective date of IFRS 9 to determine the effect of these amendments. Additionally, some jurisdictions will need time for translation and endorsement activities and the proposed effective date may not provide them with sufficient time for those activities.

BC4.245 In the light of the feedback received, the IASB decided to require that entities apply the amendments for annual periods beginning on or after 1 January 2019, with earlier application permitted. This alleviates the concerns about the timing of these amendments while also permitting an entity to apply the amendments and IFRS 9 at the same time if it is in a position to do so.

Transition

Entities that initially apply the amendments and IFRS 9 at the same time

BC4.246 As described in paragraph BC4.245, an entity is permitted to apply the amendments earlier than the mandatory effective date and, as a result, can take into account the effect of the amendments when it initially applies IFRS 9. In such cases, an entity would apply the transition provisions in Section 7.2 of IFRS 9 (as issued in 2014) to all financial assets and financial liabilities within the scope of that Standard. No specific transition provisions are needed for the amendments.

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Entities that initially apply the amendments after previously applying IFRS 9

BC4.247 Some entities will apply the amendments after they have already applied IFRS 9. The IASB considered whether specific transition requirements are needed for those entities because, without such additional transition requirements, the transition provisions in Section 7.2 of IFRS 9 (as issued in 2014) would not be applicable. That is because, as set out in paragraph 7.2.27 of IFRS 9, an entity applies each of the transition provisions in IFRS 9 only once; ie at the relevant date of initial application of IFRS 9. This means that entities would be required to apply the amendments retrospectively applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. However, in some circumstances, an entity may not be able to apply the amendments retrospectively without the use of hindsight. When the IASB developed the transition requirements in IFRS 9, it provided requirements to address scenarios when it would be impracticable to apply particular requirements retrospectively. Accordingly, the IASB decided to provide transition requirements for entities that apply the amendments after they have already applied IFRS 9.

BC4.248 Consistent with the existing transition requirements in IFRS 9 for assessing whether the contractual terms of a financial asset give rise to cash flows that are solely payments of principal and interest, the amendments must be applied retrospectively. To do so, an entity applies the relevant transition provisions in IFRS 9 necessary for applying the amendments. For example, an entity applies the transition requirements in paragraph 7.2.11 related to the effective interest method and paragraphs 7.2.17–7.2.20 related to the impairment requirements to a financial asset that is newly measured at amortised cost or fair value through other comprehensive income as a result of applying the amendments.

BC4.249 The IASB provided specific transition provisions related to the fair value option because an entity may change the classification and measurement of some financial assets as a result of applying the amendments. Therefore, an entity is permitted to newly designate, and is required to revoke its previous designation of, a financial asset or a financial liability at the date of initial application of the amendments only to the extent that a new accounting mismatch is created, or a previous accounting mismatch no longer exists, as a result of applying the amendments.

BC4.250 Finally, the IASB decided that an entity is not required to restate prior periods to reflect the effect of the amendments, and could choose to do so only if such restatement is possible without the use of hindsight and if the restated financial statements reflect all the requirements in IFRS 9. This decision is consistent with the transition requirements in IFRS 9.

BC4.251 In addition to any disclosures required by other IFRS Standards, the IASB required disclosures that would provide information to users of financial statements about changes in the classification and measurement of financial instruments as a result of applying the amendments. These disclosures are similar to the disclosures in paragraphs 42I–42J of IFRS 7, which are required when an entity initially applies IFRS 9.

Another issue

Modification or exchange of a financial liability that does not result in derecognition

BC4.252 Concurrent with the development of the amendments to IFRS 9 for prepayment features with negative compensation, the IASB also discussed the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in the derecognition of the financial liability. More specifically, at the request of the Interpretations Committee, the Board discussed whether, applying IFRS 9, an entity recognises any adjustment to the amortised cost of the financial liability arising from such a modification or exchange in profit or loss at the date of the modification or exchange.

BC4.253 The IASB decided that standard-setting is not required because the requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition. In doing so, the Board highlighted that the requirements in IFRS 9 for adjusting the amortised cost of a financial liability when a modification (or exchange) does not result in the derecognition of the financial liability are consistent with the requirements for adjusting the gross carrying amount of a financial asset when a modification does not result in the derecognition of the financial asset.

Measurement (Chapter 5)

Fair value measurement considerations[23]

BCZ5.1 The IASB decided to include in the revised IAS 39 (published in 2002) expanded guidance about how to determine fair values (the guidance is now in IFRS 9), in particular for financial instruments for which no quoted market price is available (now paragraphs B5.4.6–B5.4.13 of IFRS 9). The IASB decided that it is desirable to provide clear and reasonably detailed guidance about the objective and use of valuation techniques to achieve reliable and comparable fair value estimates when financial instruments are measured at fair value.

Use of quoted prices in active markets

BCZ5.2 The IASB considered comments received that disagreed with the proposal in the exposure draft published in 2002 that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market. Some respondents argued that (a) valuation techniques are more appropriate for measuring fair value than a quoted price in an active market (eg for derivatives) and (b) valuation models are consistent with industry best practice, and are justified because of their acceptance for regulatory capital purposes.

BCZ5.3 However, the IASB confirmed that a quoted price is the appropriate measure of fair value for an instrument quoted in an active market, notably because (a) in an active market, the quoted price is the best evidence of fair value, given that fair value is defined in terms of a price agreed by a knowledgeable, willing buyer and a knowledgeable, willing seller; (b) it results in consistent measurement across entities; and (c) fair value (now defined in IFRS 9) does not depend on entity-specific factors. The IASB further clarified that a quoted price includes market-quoted rates as well as prices.

Entities that have access to more than one active market

BCZ5.4 The IASB considered situations in which entities operate in different markets. An example is a trader that originates a derivative with a corporate in an active corporate retail market and offsets the derivative by taking out a derivative with a dealer in an active dealers' wholesale market. The IASB decided to clarify that the objective of fair value measurement is to arrive at the price at which a transaction would occur at the balance sheet date in the same instrument (ie without modification or repackaging) in the most advantageous active market[24] to which an entity has immediate access. Thus, if a dealer enters into a derivative instrument with the corporate, but has immediate access to a more advantageously priced dealers' market, the entity recognises a profit on initial recognition of the derivative instrument. However, the entity adjusts the price observed in the dealer market for any differences in counterparty credit risk between the derivative instrument with the corporate and that with the dealers' market.

Bid-ask spreads in active markets

BCZ5.5 The IASB confirmed the proposal in the exposure draft published in 2002 that the appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the asking price.[25] It concluded that applying mid-market prices to an individual instrument is not appropriate because it would result in entities recognising upfront gains or losses for the difference between the bid-ask price and the mid-market price.

BCZ5.6 The IASB discussed whether the bid-ask spread should be applied to the net open position of a portfolio containing offsetting market risk positions, or to each instrument in the portfolio. It noted the concerns raised by constituents that applying the bid-ask spread to the net open position better reflects the fair value of the risk retained in the portfolio. The IASB concluded that for offsetting risk positions, entities could use mid-market prices to determine fair value, and hence may apply the bid or asking price to the net open position as

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[23] IFRS 13, issued in May 2011, contains the requirements for measuring fair value. As a consequence paragraphs 5.4.1 –5.4.3 and B5.4.1–B5.4.13 of IFRS 9 have been deleted. *Annual Improvements to IFRSs 2010–2012 Cycle*, issued in December 2013, added paragraph BC138A to the Basis for Conclusions on IFRS 13 to clarify the IASB's reason for deleting paragraph B5.4.12.

[24] IFRS 13, issued in May 2011, states that a fair value measurement assumes that the transaction to sell an asset or to transfer a liability takes place in the principal market, or in the absence of a principal market, the most advantageous market for the asset or liability.

[25] IFRS 13, issued in May 2011, states that fair value is measured using the price within the bid-ask spread that is most representative of fair value in the circumstances.

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appropriate. The IASB believes that when an entity has offsetting risk positions, using the mid-market price is appropriate because the entity (a) has locked in its cash flows from the asset and liability and (b) potentially could sell the matched position without incurring the bid-ask spread.[26]

BCZ5.7 Comments received on the exposure draft published in 2002 revealed that some interpret the term 'bid-ask spread' differently from others and from the IASB. Thus, the IASB clarified that the spread represents only transaction costs.

No active market

BCZ5.8 The exposure draft published in 2002 proposed a three-tier fair value measurement hierarchy as follows:

(a) For instruments traded in active markets, use a quoted price.

(b) For instruments for which there is not an active market, use a recent market transaction.

(c) For instruments for which there is neither an active market nor a recent market transaction, use a valuation technique.

BCZ5.9 The IASB decided to simplify the proposed fair value measurement hierarchy[27] by requiring the fair value of financial instruments for which there is not an active market to be determined by using valuation techniques, including recent market transactions between knowledgeable, willing parties in an arm's length transaction.

BCZ5.10 The IASB also considered constituents' comments regarding whether an instrument should always be recognised on initial recognition at the transaction price or whether gains or losses may be recognised on initial recognition when an entity uses a valuation technique to estimate fair value. The IASB concluded that an entity may recognise a gain or loss at inception only if fair value is evidenced by comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or is based on a valuation technique incorporating only observable market data. The IASB concluded that those conditions were necessary and sufficient to provide reasonable assurance that fair value was other than the transaction price for the purpose of recognising upfront gains or losses. The IASB decided that in other cases, the transaction price gave the best evidence of fair value.[28] The IASB also noted that its decision achieved convergence with US GAAP.[29]

Measurement of financial liabilities with a demand feature[30]

BCZ5.11–BCZ5.12 [Deleted]

Exception in IAS 39 from fair value measurement for some unquoted equity instruments[31] (and some derivative assets linked to those instruments)

BC5.13 The IASB believes that measurement at amortised cost is not applicable to equity investments because such financial assets have no contractual cash flows and hence there are no contractual cash flows to amortise. IAS 39 contained an exception from fair value measurement for investments in equity instruments (and some derivatives linked to those investments) that do not have a quoted price in an active market and whose fair value cannot be reliably measured. Those equity investments were required to be measured at cost less impairment, if any. Impairment losses are measured as the difference between the carrying amount of the

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[26] IFRS 13, issued in May 2011, permits an exception to the fair value measurement requirements when an entity manages its financial assets and financial liabilities on the basis of the entity's net exposure to market risks or the credit risk of a particular counterparty, allowing the entity to measure the fair value of its financial instruments on the basis of the entity's net exposure to either of those risks.

[27] IFRS 13, issued in May 2011, contains a three-level fair value hierarchy for the inputs used in the valuation techniques used to measure fair value.

[28] IFRS 13, issued in May 2011, describes when a transaction price might not represent the fair value of an asset or a liability at initial recognition.

[29] FASB Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) superseded EITF Issue No. 02-3 *Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Involved in Energy Trading and Risk Management Activities* (Topic 820 *Fair Value Measurement* in the *FASB Accounting Standards Codification*® codified SFAS 157). As a result, IFRS and US GAAP have different requirements for when an entity may recognise a gain or loss when there is a difference between fair value and the transaction price at initial recognition.

[30] IFRS 13, issued in May 2011, resulted in the relocation of paragraphs BCZ5.11 and BCZ5.12 of IFRS 9 to paragraphs BCZ102 and BCZ103 of IFRS 13. As a consequence minor necessary edits have been made to that material.

[31] IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IFRS 9 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset.

BC5.14 The 2009 Classification and Measurement Exposure Draft proposed that all investments in equity instruments (and derivatives linked to those investments) should be measured at fair value for the following reasons:

(a) For investments in equity instruments and derivatives, fair value provides the most relevant information. Cost provides little, if any, information with predictive value about the timing, amount and uncertainty of the future cash flows arising from the instrument. In many cases, fair value will differ significantly from historical cost (this is particularly true for derivatives measured at cost under the exception).

(b) To ensure that a financial asset accounted for under the cost exception is not carried above its recoverable amount, IAS 39 required an entity to monitor instruments measured at cost for any impairment. Calculating any impairment loss is similar to determining fair value (ie the estimated future cash flows are discounted using the current market rate of return for a similar financial asset and compared with the carrying amount).

(c) Removing the exception would reduce complexity because the classification model for financial assets would not have a third measurement attribute and would not require an additional impairment methodology. Although there might be an increase in the complexity of determining fair values on a recurring basis that complexity would be offset (at least partially) by the fact that all equity instruments and derivatives have one common measurement attribute; thus the impairment requirements would be eliminated.

BC5.15 Many respondents agreed that cost does not provide useful information about future cash flows arising from equity instruments and that conceptually such equity instruments should be measured using a current measurement attribute such as fair value. Some of those respondents generally agreed with the removal of the exception, but suggested that disclosures would have to include information about the uncertainties surrounding measurement.

BC5.16 However, many respondents (mainly preparers from non-financial entities and some auditors) disagreed with the proposal to eliminate the current cost exception on the grounds of the reliability and usefulness of fair value measurement and the cost and difficulty involved in determining fair value on a recurring basis. They generally preferred to keep a cost exception, similar to that in IAS 39. Some noted that the proposals would not reduce complexity, because they would increase complexity in measurement. Furthermore, a few believed that cost could provide useful information if the financial asset is held for the long term.

BC5.17 The IASB considered those arguments as follows:

(a) *Reliability and usefulness of fair value measurement*
Respondents noted that IAS 39 included a cost exception because of the lack of reliability of fair value measurement for particular equity instruments and contended that this rationale is still valid. They believed that, given the lack of available reliable information, any fair value measurement would require significant management judgement or might be impossible. They also believed that comparability would be impaired by the requirement to measure such equity instruments at fair value. However, those respondents had considered the question of reliability of fair value for the instruments concerned in isolation. In the IASB's view, the usefulness of information must be assessed against all four of the qualitative characteristics in the *Framework*: reliability, understandability, relevance and comparability. Thus, cost is a reliable (and objective) amount, but has little, if any, relevance. In the IASB's view measuring all equity instruments at fair value, including those that are currently measured using the cost exception in IAS 39, meets the criteria in the *Framework* for information to be reliable if appropriate measurement techniques and inputs are employed. The IASB noted that its project on fair value measurement will provide guidance on how to meet that objective.[32]

(b) *Cost and difficulty involved in determining fair value on a recurring basis*
Many respondents, particularly in emerging economies, said that they faced difficulty in obtaining information that might be relied on to use in valuation. Others said that they would inevitably rely heavily on external experts at significant cost. Many questioned whether the requirement to determine fair value on a recurring basis would involve significant costs and efforts that are not offset by the incremental benefit to usefulness from fair value. The IASB considered the costs of requiring such equity investments to be measured at fair value from the perspectives of valuation methodology and expertise, as well as the ability to obtain the information required for a fair value measurement. The IASB noted that valuation methods for equity investments are well-developed and are often far less complex than those required for other financial instruments that are required to be measured at fair value, including many complex derivative products. Although some expressed concern that smaller

[32] IFRS 13, issued in May 2011, contains the requirements for measuring fair value.

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entities applying IFRS might not have internal systems or expertise to determine easily the fair value of equity investments held, the IASB noted that basic shareholder rights generally enable an entity to obtain the necessary information to perform a valuation. The IASB acknowledged that there are circumstances in which the cost of determining fair value could outweigh the benefits from fair value measurement. In particular, the IASB noted that, in some jurisdictions, entities hold high numbers of unquoted equity instruments that are currently accounted for under the cost exception and the value of a single investment is considered low. However, the IASB concluded that if the volume of the investments individually or aggregated is material the incremental benefit of fair value generally outweighs the additional cost because of the impact of the investments on the financial performance and position of the entity.[33]

BC5.18 The IASB noted that there are some circumstances in which cost might be representative of fair value and decided to provide additional application guidance on those circumstances to alleviate some of the concerns expressed. However, the IASB also noted that those circumstances would never apply to equity investments held by particular entities such as financial institutions and investment funds.

BC5.19 The IASB considered whether a simplified approach to measurement should be provided for equity instruments when fair value measurement was impracticable. The IASB also discussed possible simplified measurement approaches, including management's best estimate of the price it would accept to sell or buy the instrument, or changes in the share of net assets. However, the IASB concluded that a simplified measurement approach would add complexity to the classification approach and reduce the usefulness of information to users of financial statements. Those disadvantages would not be offset by the benefit of reduced cost to preparers of financial statements.

Elimination of the cost exception for particular derivative liabilities

BC5.20 Consistently with the requirements in IFRS 9 for some investments in equity instruments and some derivative assets linked to those instruments (see paragraphs BC5.13—BC5.19), the IASB decided in 2010 that the cost exception should be eliminated for derivative liabilities that will be physically settled by delivering unquoted equity instruments whose fair values cannot be reliably determined. That proposal was included in the 2009 Classification and Measurement Exposure Draft.

Gains and losses

Investments in equity instruments

BC5.21 IFRS 9 permits an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading. The term 'equity instrument' is defined in IAS 32 *Financial Instruments: Presentation*. The IASB noted that in particular circumstances a puttable instrument (or an instrument that imposes on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation) is classified as equity. However, the IASB noted that such instruments do not meet the definition of an equity instrument.

BC5.22 In the IASB's view, fair value provides the most useful information about investments in equity instruments to users of financial statements. However, the IASB noted arguments that presenting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment. An example could be a requirement to hold such an investment if an entity sells its products in a particular country.

BC5.23 The IASB also noted that, in their valuation of an entity, users of financial statements often differentiate between fair value changes arising from equity investments held for purposes other than generating investment returns and equity investments held for trading. Thus, the IASB believes that separate presentation in other comprehensive income of gains and losses for some investments could provide useful information to users of financial statements because it would allow them to identify easily, and value accordingly, the associated fair value changes.

BC5.24 Almost all respondents to the 2009 Classification and Measurement Exposure Draft supported recognition of fair value gains and losses in other comprehensive income for particular equity investments. They agreed that

[33] IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result IFRS 9 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

an entity should make an irrevocable election to identify those equity instruments. However, some users did not support these proposals in the 2009 Classification and Measurement Exposure Draft.

BC5.25 The concerns expressed in the comment letters were as follows:

(a) *Dividends:* The 2009 Classification and Measurement Exposure Draft proposed that dividends on equity instruments measured at fair value with changes recognised in other comprehensive income would also be recognised in other comprehensive income. Nearly all respondents objected to that proposal. They argued that dividends are a form of income that should be presented in profit or loss in accordance with IAS 18 *Revenue* and noted that those equity investments are sometimes funded with debt instruments whose interest expense is recognised in profit or loss. As a result, presenting dividends in other comprehensive income would create a 'mismatch'. Some listed investment funds stated that without recognising dividend income in profit or loss their financial statements would become meaningless to their investors. The IASB agreed with those arguments. The IASB noted that structuring opportunities might remain because dividends could represent a return of investment, instead of a return on investment. Consequently, the IASB decided that dividends that clearly represent a recovery of part of the cost of the investment are not recognised in profit or loss. However, in the IASB's view, those structuring opportunities would be limited because an entity with the ability to control or significantly influence the dividend policy of the investment would not account for those investments in accordance with IFRS 9.[34] Furthermore, the IASB decided to require disclosures that would allow a user to compare easily the dividends recognised in profit or loss and the other fair value changes.

(b) *Recycling:* Many respondents, including many users, did not support the proposal to prohibit subsequent transfer ('recycling') of fair value changes to profit or loss (on derecognition of the investments in an equity instrument). Those respondents supported an approach that maintains a distinction between realised and unrealised gains and losses and said that an entity's performance should include all realised gains and losses. However, the IASB concluded that a gain or loss on those investments should be recognised once only; therefore, recognising a gain or loss in other comprehensive income and subsequently transferring it to profit or loss is inappropriate. In addition, the IASB noted that recycling of gains and losses to profit or loss would create something similar to the available-for-sale category in IAS 39 and would create the requirement to assess the equity instrument for impairment, which had created application problems. That would not significantly improve or reduce the complexity of the financial reporting for financial assets. Accordingly, the IASB decided to prohibit recycling of gains and losses into profit or loss when an equity instrument is derecognised.

(c) *Scope of exception:* Some respondents asked the IASB to identify a principle that defined the equity instruments to which the exception should apply. However, they did not specify what that principle should be. The IASB previously considered developing a principle to identify other equity investments whose fair value changes should be presented in profit or loss (or other comprehensive income), including a distinction based on whether the equity instruments represented a 'strategic investment'. However, the IASB decided that it would be difficult, and perhaps impossible, to develop a clear and robust principle that would identify investments that are different enough to justify a different presentation requirement. The IASB considered whether a list of indicators could be used to support the principle, but decided that such a list would inevitably be rule-based and could not be comprehensive enough to address all possible situations and factors. Moreover, the IASB noted that such an approach would create complexity in application without necessarily increasing the usefulness of information to users of financial statements.

(d) *Irrevocability of the exception:* A small number of respondents believed that an entity should be able to reclassify equity instruments into and out of the fair value through other comprehensive income category if an entity starts or ceases to hold the investments for trading purposes. However, the IASB decided that the option must be irrevocable to provide discipline to its application. The IASB also noted that the option to designate a financial asset as measured at fair value is also irrevocable.

BC5.26 An entity may transfer the cumulative gain or loss within equity. In the light of jurisdiction-specific restrictions on components of equity, the IASB decided not to provide specific requirements related to that transfer.

BC5.27 IFRS 9 amended IFRS 7 in 2009 to require additional disclosures about investments in equity instruments that are measured at fair value through other comprehensive income. The IASB believes those disclosures

[34] In October 2012 the IASB issued *Investment Entities* (Amendments to IFRS 10, IFRS 12 and IAS 27), which required investment entities, as defined in IFRS 10 *Consolidated Financial Statements*, to measure their investments in subsidiaries, other than those providing investment-related services or activities, at fair value through profit or loss.

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will provide useful information to users of financial statements about instruments presented in that manner and the effect of that presentation.

BC5.28 The IASB noted that permitting an option for entities to present some gains and losses in other comprehensive income is an exception to the overall classification and measurement approach and adds complexity. However, the IASB believes that the requirement that the election is irrevocable, together with the additional disclosures required, addresses many of those concerns.

Liabilities designated as at fair value through profit or loss

Previous discussions related to the effects of changes in a liability's credit risk

BCZ5.29 In 2003 the IASB discussed the issue of including changes in the credit risk of a financial liability in its fair value measurement. It considered responses to the exposure draft of proposed amendments to IAS 39 published in June 2002 that expressed concern about the effect of including this component in the fair value measurement and that suggested the fair value option should be restricted to exclude all or some financial liabilities. However, the IASB concluded that the fair value option could be applied to any financial liability, and decided not to restrict the option in IAS 39 (as revised in 2003) because to do so would negate some of the benefits of the fair value option set out in paragraph BCZ4.60.

BCZ5.30 The IASB considered comments on the exposure draft published in 2002 that disagreed with the view that, in applying the fair value option to financial liabilities, an entity should recognise income as a result of deteriorating credit quality (and expense as a result of improving credit quality). Commentators noted that it is not useful to report lower liabilities when an entity is in financial difficulty precisely because its debt levels are too high, and that it would be difficult to explain to users of financial statements the reasons why income would be recognised when a liability's creditworthiness deteriorates. These comments suggested that fair value should exclude the effects of changes in the instrument's credit risk.

BCZ5.31 However, the IASB noted that because financial statements are prepared on a going concern basis, credit risk affects the value at which liabilities could be repurchased or settled. Accordingly, the fair value of a financial liability reflects the credit risk relating to that liability. Consequently, it decided to include credit risk relating to a financial liability in the fair value measurement of that liability for the following reasons:

(a) Entities realise changes in fair value, including fair value attributable to the liability's credit risk, for example, by renegotiating or repurchasing liabilities or by using derivatives.

(b) Changes in credit risk affect the observed market price of a financial liability and hence its fair value.

(c) It is difficult from a practical standpoint to exclude changes in credit risk from an observed market price.

(d) The fair value of a financial liability (ie the price of that liability in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller) on initial recognition reflects its credit risk. The IASB believes that it is inappropriate to include credit risk in the initial fair value measurement of financial liabilities, but not subsequently.

BCZ5.32 In 2003 the IASB also considered whether the component of the fair value of a financial liability attributable to changes in credit quality should be specifically disclosed, separately presented in the income statement, or separately presented in equity. The IASB decided that whilst separately presenting or disclosing such changes might be difficult in practice, disclosure of such information would be useful to users of financial statements and would help alleviate the concerns expressed. Consequently, it decided to require a disclosure to help identify the changes in the fair value of a financial liability that arise from changes in the liability's credit risk. The IASB believes this is a reasonable proxy for the change in fair value that is attributable to changes in the liability's credit risk, in particular when such changes are large, and will provide users with information with which to understand the profit or loss effect of such a change in credit risk.

BCZ5.33 The IASB decided to clarify that this issue relates to the credit risk of the financial liability, instead of the creditworthiness of the entity. The IASB noted that this more appropriately describes the objective of what is included in the fair value measurement of financial liabilities.

BCZ5.34 The IASB also noted that the fair value of liabilities secured by valuable collateral, guaranteed by third parties or ranking ahead of virtually all other liabilities is generally unaffected by changes in the entity's creditworthiness.

BC5.34A IFRS 13, issued in May 2011, includes requirements for measuring the fair value of a liability issued with an inseparable third-party credit enhancement from the issuer's perspective.

Requirements added to IFRS 9 in October 2010 to address the effects of changes in credit risk for liabilities designated as at fair value through profit or loss

BC5.35 As noted above, if an entity designates a financial liability under the fair value option, IAS 39 required the entire fair value change to be presented in profit or loss. However, many users and others told the IASB over a long period of time that changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading. That is because an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading.

BC5.36 To respond to that long-standing and widespread concern, in May 2010 the IASB proposed that the effects of changes in a liability's credit risk should be presented in other comprehensive income. The proposals in the 2010 Own Credit Risk Exposure Draft would have applied to all liabilities designated under the fair value option.

BC5.37 However, in its deliberations leading to the 2010 Own Credit Risk Exposure Draft, the IASB discussed whether such treatment would create or enlarge an accounting mismatch in profit or loss in some limited cases. The IASB acknowledged that this might be the case if an entity holds large portfolios of financial assets that are measured at fair value through profit or loss and there is an economic relationship between changes in the fair value of those assets and the effects of changes in the credit risk of the financial liabilities designated under the fair value option. A mismatch would arise because the entire change in the fair value of the assets would be presented in profit or loss but only a portion of the change in the fair value of the liabilities would be presented in profit or loss. The portion of the liabilities' fair value change attributable to changes in their credit risk would be presented in other comprehensive income. To address potential mismatches, the IASB set out an alternative approach in the 2010 Own Credit Risk Exposure Draft whereby the effects of changes in the liabilities' credit risk would be presented in other comprehensive income unless such treatment would create or enlarge an accounting mismatch in profit or loss (in which case, the entire fair value change would be presented in profit or loss). The 2010 Own Credit Risk Exposure Draft stated that the determination about potential mismatches would be made when the liability is initially recognised and would not be reassessed. The IASB asked respondents for feedback on the alternative approach.

BC5.38 Many respondents preferred the alternative approach. They agreed that in almost all cases the effects of changes in credit risk ought not to be presented in profit or loss. However, those respondents said that if such treatment would create or enlarge an accounting mismatch in profit or loss, the entire fair value change should be presented in profit or loss. Respondents thought such cases would be rare and asked the IASB to provide guidance on how to determine whether presenting the effects of changes in credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss.

BC5.39 The IASB agreed with the responses and finalised the alternative approach. Consequently, entities are required to present the effects of changes in the liabilities' credit risk in other comprehensive income unless such treatment would create or enlarge an accounting mismatch in profit or loss (in which case, the entire fair value change is required to be presented in profit or loss). The IASB acknowledged that that approach will introduce some additional complexity to financial reporting because not all liabilities designated under the fair value option will be treated the same. However, the IASB decided that it was necessary to address circumstances in which the proposals would create or enlarge a mismatch in profit or loss. Although the IASB expects those circumstances to be rare, they could be significant in some industries in some jurisdictions.

BC5.40 The IASB discussed how an entity should determine whether a mismatch would be created or enlarged. It decided that an entity has to assess whether it expects that changes in the credit risk of a liability will be offset by changes in the fair value of another financial instrument. The IASB decided that such an assessment must be based on an economic relationship between the characteristics of the liability and the characteristics of the other financial instrument. Such a relationship does not arise by coincidence.

BC5.41 The IASB believes that in many cases the relationship will be contractual (as described in paragraph B5.7.10 of IFRS 9) but decided that a contractual relationship is not required. Requiring a contractual relationship would have created a very high threshold for presenting the effects of changes in a liability's credit risk in profit or loss and the IASB decided that such a high threshold was too strict to accommodate all of the possible scenarios in which a mismatch would be created or enlarged by presenting those amounts in other comprehensive income.

BC5.42 However, to increase transparency about an entity's determination about potential mismatches, the IASB decided to require disclosures about an entity's methodology for making that determination. Also, an entity is required to apply its methodology consistently. The determination must be made at initial recognition of the liability and is not reassessed, which is consistent with the entity's overall election to use the fair value option.

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BC5.43 Some respondents to the 2010 Own Credit Risk Exposure Draft asked whether the IASB intended that the proposals should apply to loan commitments and financial guarantee contracts that are designated under the fair value option. Those respondents suggested that the proposals should not apply to those items because the IASB's intention seemingly had always been to address the issue of own credit risk for non-derivative liabilities. The respondents noted that loan commitments and financial guarantee contracts either meet the definition of a derivative or are very similar to a derivative from an economic perspective and therefore changes in their fair value should always be presented in profit or loss. The IASB agreed with those respondents and decided that all changes in the fair value of loan commitments and financial guarantee contracts designated under the fair value option should be presented in profit or loss. In addition to the comments put forward by respondents, the IASB also noted that phase II of the insurance project was discussing whether all financial guarantee contracts should be within the scope of that proposed Standard.

Alternative approaches to address the issue of own credit risk

BC5.44 In 2010 the IASB discussed and rejected the following approaches for addressing the issue of credit risk:

(a) *Present the effects of changes in credit risk directly in equity:* Some believe that the effects of changes in credit risk should not affect the entity's performance; therefore they believe that those amounts should be presented directly in equity. The IASB rejected this approach in the 2010 Own Credit Risk Exposure Draft because it believes that changes in the liability's credit risk ought to affect the entity's performance if the liability is measured at fair value. If those amounts were presented directly in equity, they would never be presented in the entity's statement of comprehensive income. The IASB acknowledged that IFRS does not provide a clear objective for when an item should be presented in other comprehensive income instead of in profit or loss or whether the amounts in other comprehensive income should be reclassified to profit or loss. However, the IASB believes that presenting the effects of changes in credit risk in other comprehensive income is preferable to presenting them directly in equity because the latter would create a new problem by causing confusion or creating inconsistencies in what items are presented directly in equity. The IASB noted that remeasurements of assets and liabilities should not be presented directly in equity because remeasurements are not transactions with equity holders. The IASB asked respondents for feedback on presenting directly in equity the effects of changes in a liability's credit risk and almost all respondents, including users, did not support it. Accordingly the IASB did not pursue this alternative.

(b) *Present the entire change in the fair value of liabilities in other comprehensive income:* Some believe that the entire change in fair value (not just the portion attributable to changes in credit risk) should be presented in other comprehensive income. They argue that this approach would avoid the difficult question of how to measure the effects of changes in credit risk. The IASB rejected this approach because it believes that at least some of the change in fair value should be presented in profit or loss. The IASB's objective was to address issues related to the effects of changes in liabilities' credit risk; therefore, presenting the entire change in fair value in other comprehensive income is not appropriate. Also, this approach would result in mismatches in profit or loss because changes in the fair value of an entity's assets would be presented in profit or loss and changes in the fair value of its liabilities would be presented in other comprehensive income (see similar discussion in paragraph BC5.37). Moreover, this alternative would raise difficult questions about what (if any) amounts should be presented in profit or loss during the life of the liability (eg interest or other financing costs). The IASB has discussed the topic of disaggregating finance costs from other fair value changes on numerous occasions without reaching any conclusions.

Presenting the effects of changes in credit risk in other comprehensive income via a one-step or two-step approach

BC5.45 The 2010 Own Credit Risk Exposure Draft proposed a 'two-step approach' for presenting a liability's credit risk in the statement of comprehensive income, with the result that those changes would not affect profit or loss. In the first step, the entity would present the entire fair value change in profit or loss. In the second step, the entity would 'back out' from profit or loss the portion of the fair value change that is attributable to changes in the liability's credit risk and present that amount in other comprehensive income.

BC5.46 The 2010 Own Credit Risk Exposure Draft also set out a 'one-step approach', which would present the portion of the fair value change that is attributable to changes in the liability's credit risk directly in other comprehensive income. All other portions of the fair value change would be presented in profit or loss.

BC5.47 The IASB acknowledged that the only difference between those two approaches is how the effects of changes in the liability's credit risk are presented. The two-step approach would present those amounts first in profit

or loss and then transfer them to other comprehensive income, whereas the one-step approach would present them directly in other comprehensive income.

BC5.48 The IASB proposed the two-step approach in the 2010 Own Credit Risk Exposure Draft because it thought that it would present more clearly all of the relevant information in the primary financial statements, but it decided to ask respondents which approach they supported.

BC5.49 Almost all respondents, including users, supported the one-step approach. They said that the one-step approach is more efficient and less complicated than the two-step approach. They pointed out that both approaches have the same net result in profit or loss and other comprehensive income. Respondents said that there is little (if any) added benefit of the 'gross' presentation in the two-step approach and the extra line items on the face of the performance statement result in unnecessary clutter. Furthermore, respondents noted the IASB's exposure draft published in May 2010 on the presentation of items in other comprehensive income. That exposure draft proposes that the profit or loss section and other comprehensive income should be displayed as separate components within an overall statement of profit or loss and other comprehensive income. Respondents questioned whether the two-step approach would have any added benefit if the Board finalised the proposals in that exposure draft.

BC5.50 Users told the IASB that the two-step approach would not be more helpful to their analysis than the one-step approach. Some users noted that the effects of changes in a liability's credit risk should not be presented in profit or loss, even if those effects were subsequently backed out.

BC5.51 The IASB was persuaded by respondents' arguments and decided to require the one-step approach. The IASB noted that no information is lost by using the one-step approach because IFRS 7 and IAS 1 *Presentation of Financial Statements* require entities to disclose (either on the financial statements or in the notes) all of the information required by the two-step approach.

Reclassifying amounts to profit or loss

BC5.52 The 2010 Own Credit Risk Exposure Draft proposed to prohibit reclassification of gains or losses to profit or loss (on derecognition of the liability or otherwise)—sometimes called 'recycling'. In the Basis for Conclusions on that Exposure Draft, the IASB noted that the proposal was consistent with the requirements in IFRS 9 that prohibit recycling for investments in equity instruments that are measured at fair value with changes presented in other comprehensive income.

BC5.53 Moreover, the IASB noted that if the entity repays the contractual amount, the cumulative effect over the life of the instrument of any changes in the liability's credit risk will net to zero because its fair value will equal the contractual amount. Consequently, for many liabilities, the issue of reclassification is irrelevant.

BC5.54 Most respondents to the 2010 Own Credit Risk Exposure Draft disagreed with that proposal and urged the IASB to require reclassification if the liability was derecognised and the effects of changes in its credit risk were realised. They acknowledged that there would not be any amount to reclassify if the entity repays the contractual amount. But they believe that if the entity repays an amount other than the contractual amount, the realised amounts in other comprehensive income should be reclassified. Those respondents view other comprehensive income as a 'temporary holding place' for unrealised gains and losses. They believe that unrealised and realised amounts are fundamentally different and thus should not be treated the same. The former are still uncertain and may never be crystallised. In contrast, the latter have crystallised and are backed by cash flows.

BC5.55 However, the IASB was not persuaded and confirmed the proposal to prohibit reclassification. The IASB acknowledged that it needs to address the overall objective of other comprehensive income, including when an item should be presented in other comprehensive income instead of in profit or loss and whether amounts in other comprehensive income should be reclassified to profit or loss (and if so, when). However, in the absence of such an objective, the IASB noted that its decision is consistent with the requirements in IFRS 9 that prohibit recycling for investments in equity instruments that are measured at fair value with changes presented in other comprehensive income.

BC5.56 However, to provide users with information about how much of the accumulated other comprehensive income balance has been realised during the current reporting period (ie how much would have been reclassified if the IASB had required reclassification upon derecognition), the IASB decided to require entities to disclose that amount.

BC5.57 Also, consistently with the requirements for equity investments measured at fair value with changes presented in other comprehensive income, the IASB decided that an entity may transfer the cumulative gain or loss within equity.

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Determining the effects of changes in the liability's credit risk

BC5.58 IFRS 7 required an entity, when designating a financial liability under the fair value option, to disclose the amount of the change in fair value that is attributable to changes in the liability's credit risk. The application guidance in IFRS 7 provided a default method for determining that amount. If the only relevant changes in market conditions for the liability are changes in an observed (benchmark) interest rate, that method attributes all changes in fair value, other than changes in the benchmark interest rate, to changes in the credit risk of the liability. In the Basis for Conclusions on IFRS 7, the IASB acknowledged that quantifying the change in a liability's credit risk might be difficult in practice. It noted that it believes that the default method provides a reasonable proxy for changes in the liability's credit risk, in particular when such changes are large, and would provide users with information with which to understand the effect on profit or loss of such a change in credit risk. However, IFRS 7 permitted entities to use a different method if it provides a more faithful representation of the changes in the liability's credit risk.

BC5.59 During the IASB's outreach programme preceding the publication of the 2010 Own Credit Risk Exposure Draft, preparers told the IASB that the default method in IFRS 7 is appropriate in many circumstances but a more sophisticated method is sometimes needed to reflect faithfully the effects of changes in the liabilities' credit risk (eg when the volume of liabilities outstanding significantly changed during the reporting period).

BC5.60 In the user questionnaire conducted during that outreach programme, the IASB asked users whether the default method in IFRS 7 was appropriate for determining the change in a liability's credit risk. Most users said that it was an appropriate method. Many users noted the difficulty in determining that amount more precisely.

BC5.61 Therefore, for the purposes of measuring the effects of changes in the credit risk of a liability, the 2010 Own Credit Risk Exposure Draft proposed to use the guidance in IFRS 7. Under the proposals, the default method would be carried forward but entities would continue to be permitted to use a different method if it provides a more faithful representation of the amount of the change in fair value that is attributable to changes in the liability's credit risk.

BC5.62 Most respondents agreed with the proposals in the 2010 Own Credit Risk Exposure Draft. Those respondents agreed that the guidance in IFRS 7 for measuring the effects of changes in a liability's credit risk is appropriate and operational. They noted that determining the effects of changes in a liability's credit risk can be complex, and therefore it was necessary to allow some flexibility in how it is measured. They acknowledged that the default method described in IFRS 7 is imprecise but said that it is a reasonable proxy in many cases. Moreover, although some respondents acknowledged that the default method does not isolate changes in a liability's credit risk from some other changes in fair value (eg general changes in the price of credit or changes in liquidity risk), those respondents said that it is often very difficult or impossible to separate those items. However, some respondents (including those who supported the IASB's proposals in the 2010 Own Credit Risk Exposure Draft) asked for some clarification on particular aspects of the guidance in IFRS 7.

BC5.63 Consistently with the majority of responses, the IASB decided to confirm the proposals in the 2010 Own Credit Risk Exposure Draft to use the guidance in IFRS 7 related to determining the effects of changes in a liability's credit risk. Thus, that guidance was carried forward from IFRS 7 to IFRS 9. However, to respond to some of the questions raised in the comment letters, the IASB decided to clarify the difference between the creditworthiness of the entity and the credit risk of a liability. Moreover, the IASB addressed the difference between a liability's credit risk and asset-specific performance risk—and confirmed that a change in a liability's credit risk does not include changes in asset-specific performance risk. Furthermore, the IASB noted that in some cases a liability might not have credit risk. Consequently, the IASB included additional examples in the application guidance to clarify those points.

BC5.64 Also, the IASB clarified that the default method illustrated in IFRS 7 (and relocated to IFRS 9) is appropriate only if the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate. If that is not the case, an entity is required to use a more precise method. Moreover, an entity is always permitted to use a different method if that method more faithfully represents the effects of changes in a liability's credit risk.

Amortised cost measurement

Effective interest rate

BCZ5.65 In developing the revised IAS 39, the IASB considered whether the effective interest rate for all financial instruments should be calculated on the basis of estimated cash flows (consistently with the original IAS 39) or whether the use of estimated cash flows should be restricted to groups of financial instruments with

contractual cash flows being used for individual financial instruments. The IASB agreed to reconfirm the position in the original IAS 39 because it achieves consistent application of the effective interest method throughout the Standard.

BCZ5.66 The IASB noted that future cash flows and the expected life can be reliably estimated for most financial assets and financial liabilities, in particular for a group of similar financial assets or similar financial liabilities. However, the IASB acknowledged that in some rare cases it might not be possible to estimate the timing or amount of future cash flows reliably. It therefore decided to require that if it is not possible to estimate reliably the future cash flows or the expected life of a financial instrument, the entity should use contractual cash flows over the full contractual term of the financial instrument.

BCZ5.67 The IASB also decided to clarify that expected future defaults should not be included in estimates of cash flows because this would be a departure from the incurred loss model for impairment recognition.[35] At the same time, the IASB noted that in some cases, for example, when a financial asset is acquired at a deep discount, credit losses have occurred and are reflected in the price. If an entity does not take into account such credit losses in the calculation of the effective interest rate, the entity would recognise a higher interest income than that inherent in the price paid. The IASB therefore decided to clarify that such credit losses are included in the estimated cash flows when computing the effective interest rate.

BCZ5.68 The revised IAS 39 refers to all fees 'that are an integral part of the effective interest rate'. The IASB included this reference to clarify that IAS 39 relates only to those fees that are determined to be an integral part of the effective interest rate in accordance with IAS 18.[36]

BCZ5.69 Some commentators noted that it was not always clear how to interpret the requirement in the original IAS 39 that the effective interest rate must be based on discounting cash flows through maturity or the next market-based repricing date. In particular, it was not always clear whether fees, transaction costs and other premiums or discounts included in the calculation of the effective interest rate should be amortised over the period until maturity or the period to the next market-based repricing date.

BCZ5.70 For consistency with the estimated cash flows approach, the IASB decided to clarify that the effective interest rate is calculated over the expected life of the instrument or, when applicable, a shorter period. A shorter period is used when the variable (eg interest rates) to which the fee, transaction costs, discount or premium relates is repriced to market rates before the expected maturity of the instrument. In such a case, the appropriate amortisation period is the period to the next such repricing date.

BCZ5.71 The IASB identified an apparent inconsistency in the guidance in the revised IAS 39. It related to whether the revised or the original effective interest rate of a debt instrument should be applied when remeasuring the instrument's carrying amount on the cessation of fair value hedge accounting. A revised effective interest rate is calculated when fair value hedge accounting ceases. The IASB removed this inconsistency as part of *Improvements to IFRSs* issued in May 2008 by clarifying that the remeasurement of an instrument in accordance with paragraph AG8 (now paragraph B5.4.6 of IFRS 9) is based on the revised effective interest rate calculated in accordance with paragraph 92 (now paragraph 6.5.10 of IFRS 9), when applicable, instead of the original effective interest rate.

Presentation of interest revenue

BC5.72 As part of its work on the Impairment project (Section 5.5 of IFRS 9), the IASB published the 2009 Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the '2009 Impairment Exposure Draft'). The 2009 Impairment Exposure Draft proposed a model in which an entity would have considered initial expectations of credit losses when determining the effective interest rate on financial assets. Consequently, interest revenue would have represented the economic yield, or the effective return, on those financial assets. In contrast, the decoupled approach in IFRS 9 considers the recognition of interest revenue and the recognition of expected credit losses separately. Under this approach, an entity recognises interest on the gross carrying amount of a financial asset without taking expected credit losses into consideration (except when financial assets become credit-impaired or are credit-impaired on initial recognition). Paragraphs BC5.88–BC5.91 discusses further the reasons why the IASB did not proceed with the proposals in the 2009 Impairment Exposure Draft in finalising IFRS 9.

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[35] The IASB did not change this approach to determining the effective interest rate for financial instruments (other than those that are purchased or originated credit impaired) when changing from an incurred loss in IAS 39 to an expected credit loss impairment model. This was because the decoupled approach in IFRS 9 considers the recognition of interest revenue and the recognition of expected credit losses separately.

[36] IFRS 15, issued in May 2014, replaced IAS 18. See paragraphs B5.4.1–B5.4.3 of IFRS 9 for the requirements for fees that are an integral part of the effective interest rate.

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BC5.73 Respondents told the IASB that calculating an effective interest rate that considers initial expected credit losses is operationally burdensome, particularly for open portfolios of financial assets. In addition, users of financial statements stressed the need for an interest revenue recognition model that allows them to continue to analyse net interest margin and credit losses separately.

BC5.74 Consequently, the IASB proposed in the 2013 Impairment Exposure Draft, consistently with the proposals in the Supplementary Document *Financial Instruments: Impairment* (the 'Supplementary Document'), that, an entity would calculate interest revenue on the gross carrying amount of a financial asset using an effective interest rate that is not adjusted for expected credit losses. However, the IASB noted that there are some financial assets for which credit risk has increased to such an extent that presenting interest revenue on the basis of the gross carrying amount of the financial asset, that reflects the contractual return, would no longer faithfully represent the economic return. The 2013 Impairment Exposure Draft therefore proposed that if a financial asset is credit-impaired at the reporting date, an entity should change the interest revenue calculation from being based on the gross carrying amount to the amortised cost of a financial asset (ie the amount net of the loss allowance) at the beginning of the following reporting period.

BC5.75 The IASB received feedback on the 2013 Impairment Exposure Draft that showed the majority of respondents agreed that the interest revenue calculation should change to a calculation on a net basis for some financial assets, because it best supported faithful representation. These requirements only affect the calculation and presentation of interest revenue and not the measurement of the loss allowance.

BC5.76 The IASB acknowledged the concerns of using 'incurred loss' criteria in a model based on expected credit losses. However, in the IASB's view, it was necessary to retain the faithful representation of interest revenue, while minimising the operational challenges of requiring entities to calculate interest revenue on the amortised cost amount for all financial assets.

BC5.77 Financial assets that are credit-impaired at the reporting date and on which interest revenue is calculated on the amortised cost of a financial asset are a subset of financial assets with a loss allowance measured at lifetime expected credit losses. IFRS preparers are already required to determine interest on the amortised cost amount of these financial assets in accordance with IAS 39 and therefore the IASB noted that this requirement would result in a minimal change in practice. Accordingly, the IASB decided to retain the scope of assets on which interest is calculated on the amortised cost amount of a financial asset that is credit-impaired as identified in by IAS 39 (but excluding the concept of 'incurred but not reported').

BC5.78 The IASB is of the view that, conceptually, an entity should assess whether financial assets have become credit-impaired on an ongoing basis, thus altering the presentation of interest revenue as the underlying economics change. However, the IASB noted that such an approach would be unduly onerous for preparers to apply. Thus, the IASB decided that an entity should be required to make the assessment of whether a financial asset is credit-impaired at the reporting date and then change the interest calculation from the beginning of the following reporting period.

BC5.79 However, a few respondents to the 2013 Impairment Exposure Draft supported presenting nil interest revenue on credit-impaired financial assets for operational reasons. In accordance with such an approach an entity would be required to offset interest revenue on a subset of financial assets with an equal amount of expected credit losses. The IASB noted that an advantage of presenting nil interest revenue is the operational simplicity. The only information that an entity would need to know to apply this approach would be the interest revenue on the subset of financial assets. That is, an entity would not be required to identify the loss allowance related to that subset of financial assets. However, the IASB noted that such an approach would blend together the effect of the unwinding of the present value of expected cash flows with other expected credit losses. In the IASB's view, a nil interest approach would not improve the calculation of interest revenue, because it would not faithfully represent the economic return in a manner that is consistent with the measurement of the gross carrying amount and expected credit losses at a present value.

BC5.80 Consequently, the IASB decided to confirm the requirement to present interest revenue on a net basis and to do so from the beginning of the reporting period following the reporting period when the financial instrument became credit-impaired.

Write-off

BC5.81 In the IASB's view, a definition of 'write-off' is necessary to faithfully represent the gross carrying amount of the financial assets within the scope of IFRS 9. The definition is also necessary for the newly introduced disclosure requirements about expected credit losses. The 2009 Impairment Exposure Draft proposed definitions and requirements related to the term 'write off'. Following positive comments about those definitions, the IASB decided to retain the definitions and requirements related to the term 'write-off' in IFRS 9 with minimal changes to the definition proposed in the 2009 Impairment Exposure Draft.

Impairment

Background

Objectives for depicting expected credit losses

BC5.82 For financial assets measured at amortised cost and debt instruments measured at fair value through other comprehensive income the effect of changes in credit risk are more relevant to an investor's understanding of the likelihood of the collection of future contractual cash flows than the effects of other changes, such as changes in market interest rates. This is because an integral aspect of both business models is to collect contractual cash flows.

BC5.83 The IASB noted that a model that faithfully represents the economic phenomenon of expected credit losses should provide users of financial statements with relevant information about the amount, timing and uncertainty of an entity's future cash flows. It should also ensure that the amounts that an entity reports are comparable, timely and understandable. Furthermore, the IASB also sought to ensure that the model address the criticisms of the incurred loss model in IAS 39. These criticisms included the concerns that the model in IAS 39 overstated interest revenue in periods before a credit loss event occurs, delayed the recognition of credit losses and was complex due to its multiple impairment approaches.

BC5.84 In developing a model that depicts expected credit losses, the IASB observed that:

(a) when an entity prices a financial instrument, part of the yield, the credit risk premium, compensates the entity for the credit losses initially expected (for example, an entity will typically demand a higher yield for those instruments with higher expected credit losses at the date the instrument is issued). Consequently, no economic loss is suffered at initial recognition simply because the credit risk on a financial instrument is high at that time, because those expected credit losses are implicit in the initial pricing of the instrument.

(b) for most financial instruments, the pricing is not adjusted for changes in expected credit losses in subsequent periods. Consequently, subsequent changes in expected credit losses are economic losses (or gains) of the entity in the period in which they occur.

BC5.85 Expected credit losses, in isolation, are not directly observable. However, because the credit risk premium is a component of the market yield for financial instruments, the indirect measurement of expected credit losses is a daily occurrence in the pricing of such instruments in the market. A number of models exist to assist market participants and regulators in the measurement of expected credit losses. But, because expected credit losses are not directly observable, their measurement is inherently based on judgement and any model that attempts to depict expected credit losses will be subject to measurement uncertainty.

BC5.86 Some interested parties would prefer an impairment model that results in a more conservative, or prudential, depiction of expected credit losses. Those interested parties argue that such a depiction would better meet the needs of both the regulators who are responsible for maintaining financial stability and investors and other users of financial statements. However, to be consistent with the *Conceptual Framework*,[37] faithful representation of expected credit losses implies that the depiction of those credit losses is neutral and free from bias. The depiction of expected credit losses in an unbiased way informs the decisions of a broad range of users of financial statements, including regulators and investors and creditors. In the IASB's view, incorporating a degree of conservatism would be arbitrary and would result in a lack of comparability. The risk of an outcome other than the probability-weighted expected outcome is only relevant for particular purposes, such as determining the extent of economic or regulatory capital requirements.

Alternative models considered to depict expected credit losses

The model proposed in the 2009 Impairment Exposure Draft

BC5.87 In November 2009 the IASB published the 2009 Impairment Exposure Draft, which proposed that an entity should measure amortised cost at the expected (credit-adjusted) cash flows discounted at the original credit-adjusted effective interest rate, ie the effective interest rate adjusted for the initial expected credit losses. The

[37] References to the *Conceptual Framework* in this Basis for Conclusions are to the *Conceptual Framework for Financial Reporting*, issued in 2010 and in effect when parts of the Standard were developed and amended.

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IASB was aware that these proposals were a fundamentally new approach to impairment accounting for financial reporting purposes that was much more closely linked to credit risk management concepts. In order to fully understand the consequences of this, the IASB established a panel of credit risk experts (the Expert Advisory Panel (EAP)) to provide input during the comment period.

BC5.88 In the IASB's view, the model in the 2009 Impairment Exposure Draft most faithfully represents expected credit losses and would determine the carrying amount, interest revenue and impairment gains or losses to be recognised through a single, integrated calculation. Thus, an entity would recognise:

(a) the initial expected credit losses over the life of the asset through the credit-adjusted effective interest rate; and

(b) any changes in expected credit losses when those changes occurred.

BC5.89 Users of financial statements have told the IASB that they support a model that distinguishes between the effect of initial estimates of expected credit losses and subsequent changes in those estimates. They noted that such a distinction would provide useful information about changes in credit risk and the resulting economic losses. Many other respondents also supported the concepts in the 2009 Impairment Exposure Draft, but said that the proposals would present significant operational challenges. In particular, they highlighted the following:

(a) estimating the full expected cash flows for all financial instruments;

(b) applying a credit-adjusted effective interest rate to those cash flow estimates; and

(c) maintaining information about the initial estimate of expected credit losses.

BC5.90 These operational challenges arose because entities typically operate separate accounting and credit risk management systems. To have applied the 2009 Impairment Exposure Draft, entities would have had to have integrated those separate systems. The IASB was told that this would have required substantial costs and lead time. Respondents noted that these operational challenges would be especially acute for open portfolios (ie portfolios to which new financial instruments are added over time).

BC5.91 The IASB initially considered different approaches to address the specific operational challenges that respondents raised while at the same time replicating the outcomes of the 2009 Impairment Exposure Draft to the maximum extent possible.

Simplifications to address operational challenges of the 2009 Impairment Exposure Draft

BC5.92 To address the operational challenges outlined in paragraph BC5.89 and as suggested by the EAP, the IASB decided to decouple the measurement and allocation of initial expected credit losses from the determination of the effective interest rate (except for purchased or originated credit-impaired financial assets). Thus, an entity would measure the financial asset and the loss allowance separately using the original effective interest rate (ie not adjusted for initial expected credit losses). The IASB considered that such an approach would address some of the operational challenges of the 2009 Impairment Exposure Draft by allowing an entity to leverage its existing accounting and credit risk management systems and reduce the extent of integration between these systems.

BC5.93 As a result of the decoupling simplification, an entity would measure the present value of expected credit losses using the original effective interest rate. This presents a dilemma, because measuring expected credit losses using such a rate double-counts the expected credit losses that were priced into the financial asset at initial recognition. The IASB therefore concluded that recognising the lifetime expected credit losses from initial recognition would be inappropriate under a model that discounts expected credit losses using the original effective interest rate. The IASB further concluded that a recognition mechanism was required that preserves, to as great an extent as possible, the objective of the 2009 Impairment Exposure Draft and reduces the effect of this double-counting. Thus, the IASB proposed to pursue a model that recognises two different amounts based on the extent of increases in credit risk since initial recognition. Such a dual-measurement model would require an entity to recognise:

(a) a portion of the lifetime expected credit losses from initial recognition as a proxy for recognising the initial expected credit losses over the life of the financial asset; and

(b) the lifetime expected credit losses when credit risk has increased since initial recognition (ie when the recognition of only a portion of the lifetime expected credit losses is no longer appropriate because the entity has suffered a significant economic loss).

BC5.94 The IASB considered the interaction between the timing of the recognition of the full lifetime expected credit losses, and the size of the portion of the lifetime expected credit losses that are recognised before that, to be a determinant of what would provide a more faithful representation of the economic loss. Thus, if an entity

recognises a smaller portion of the lifetime expected credit losses initially, it should recognise the full lifetime expected credit losses earlier than if it had been required to recognise a larger portion of the lifetime expected credit losses initially.

BC5.95 As a result of the decoupling simplification as discussed in paragraphs BC5.92–BC5.93, the IASB acknowledges that any model that recognises different amounts of expected credit losses based on the extent of increases in credit risk since initial recognition cannot perfectly replicate the outcome of the model in the 2009 Impairment Exposure Draft. Furthermore, while there is always recognition of some expected credit losses, such a model retains a criterion for when lifetime expected credit losses are recognised. Once that criterion is met, the recognition of lifetime expected credit losses results in a loss representing the difference between the portion that was recognised previously and the lifetime expected credit losses (a 'cliff effect'). In the IASB's view, any approach that seeks to approximate the outcomes of the model in the 2009 Impairment Exposure Draft without the associated operational challenges will include a recognition threshold for lifetime expected credit losses and a resulting cliff effect.

The model proposed in the Supplementary Document

BC5.96 Based on the feedback from the 2009 Impairment Exposure Draft and the simplifications considered to address the challenges of that model, the IASB published the Supplementary Document in January 2011. The Supplementary Document proposed a two-tier loss allowance, which would be recognised as follows:

(a) the higher of, a time-proportionate allowance (TPA) or expected credit losses for the foreseeable future, for the good book. If applying a TPA, an entity would recognise the lifetime expected credit losses over the weighted average life of the portfolio of assets.

(b) the lifetime expected credit losses for the bad book. Financial assets would be moved to the bad book if the collectability of contractual cash flows on a financial asset became so uncertain that the entity's credit risk management objective changes from receiving the regular payments to recovery of all, or a portion of, the asset.

BC5.97 The Supplementary Document proposed to reflect the relationship between expected credit losses and interest revenue using the TPA. The TPA would achieve this through the allocation of expected credit losses over time, indirectly 'adjusting' the contractual interest. However, the TPA does this through a short cut and therefore it would not represent the economics as faithfully as the 2009 Impairment Exposure Draft did. Because the TPA allocates both the initial expected credit losses and the subsequent changes in lifetime expected credit losses over time, the measurement results in an understatement of changes in expected credit losses until the entity recognises lifetime expected credit losses. This effect is particularly problematic for financial assets that increase in credit risk and thus whose expected credit losses increase early in the asset's life.

BC5.98 Allocating the change in estimated expected credit losses in this way results in the deferred recognition of the full amount of the change in expected credit losses and, consequently, the TPA closely replicated the outcome of the model in the 2009 Impairment Exposure Draft only in situations in which expectations of credit losses do not change or the credit losses emerge at, or close to, maturity (extremely back-ended losses). This shortcoming was addressed by including a foreseeable future floor in the SD. However, because the calculation of the TPA relied on the weighted average age over the weighted average life of the portfolio, the outcome may not have reflected the economics of a growing or declining portfolio.

BC5.99 The TPA calculation proposed by the Supplementary Document (whereby the loss allowance was, at a minimum, equal to the expected credit losses in the foreseeable future) was unique and would not be a calculation required to be used by entities for other purposes. Some of the identified operational challenges of the proposals in the 2009 Impairment Exposure Draft would still exist, including the need to change systems to calculate the weighted average age and the weighted average life of open portfolios, as would the need to estimate the full expected cash flows for all financial assets.

BC5.100 The IASB did not receive strong support for the proposals in the Supplementary Document. Many respondents were concerned that the Supplementary Document required an entity to make two calculations to measure the loss allowance balance for the good book. They viewed the dual calculation as operationally difficult, lacking conceptual merit and providing confusing information to users of financial statements, because the basis for these loss calculations could change over time for the same financial assets and be different for different financial assets. Respondents also expressed concerns about the calculation of expected credit losses for the foreseeable future, with many expressing confusion about the conceptual basis for the time period. Many also noted that the term 'foreseeable future' had not been sufficiently defined to ensure consistent application. Furthermore, feedback on the Supplementary Document proposals were geographically split, with respondents in the US generally preferring the foreseeable future floor while respondents outside the US generally preferred the TPA approach.

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BC5.101 Although the IASB did not receive strong support for the proposals in the Supplementary Document, some respondents, particularly users of financial statements and prudential regulators, supported the distinction between 'good book' and 'bad book' assets even if they were concerned that the criteria for transferring from the 'good book' to the 'bad book' were not sufficiently clear. On balance, the IASB decided not to further pursue this two-tier approach.

The model proposed in the 2013 Impairment Exposure Draft

BC5.102 The model proposed in the 2013 Impairment Exposure Draft continued to build on a tiered approach by requiring an entity to measure:

(a) the expected credit losses for a financial instrument at an amount equal to the lifetime expected credit losses, if the credit quality on that financial instrument has decreased significantly (or the credit risk increases significantly) since initial recognition; and

(b) the expected credit losses for a financial instrument at an amount equal to the 12-month expected credit losses for all other financial instruments.

BC5.103 The model proposed in the 2013 Impairment Exposure Draft eliminated the operational challenge of estimating the full expected cash flows for all financial instruments by limiting the recognition of lifetime expected credit losses to financial instruments for which credit risk has increased significantly since initial recognition.

BC5.104 To assist entities that have less sophisticated credit risk management systems, the 2013 Impairment Exposure Draft included simplifications to account for trade receivables and lease receivables. The proposed simplifications would reduce the need to track increases in credit risk by requiring (or allowing) an entity to recognise lifetime expected credit losses from the date of initial recognition.

BC5.105 The 2013 Impairment Exposure Draft proposed that interest revenue would be calculated using the effective interest method using the effective interest rate unadjusted for expected credit losses, except for purchased or originated credit-impaired financial assets, in which case the entity would use a credit-adjusted effective interest rate.

BC5.106 Overall, the majority of participants in the outreach conducted by the IASB while developing this model, including users of financial statements, supported a model that distinguishes between instruments for which credit risk has increased significantly since initial recognition and those that have not. In the IASB's view, this requirement for recognising lifetime expected credit losses strikes the best balance between the benefits of making distinctions on the basis of an increase in credit risk and the costs and complexity of making that assessment. Furthermore, the proposals aimed to limit the new information that an entity would be required to capture and maintain about the initial credit risk of financial assets by using information that preparers have said is consistent with current credit risk management systems.

BC5.107 To further reduce the cost of assessing the increases in credit risk, the proposed model included practical expedients and rebuttable presumptions (see paragraphs BC5.180–BC5.194) to assess if there have been significant increases in credit risk.

BC5.108 On the basis of the comments received about the proposals in the 2013 Impairment Exposure Draft, the IASB proceeded to refine the proposals while developing IFRS 9 and its requirements to account for impairment based on expected credit losses.

Joint deliberations with the FASB

BC5.109 In May 2010, the FASB published a proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the '2010 proposed Update') that included proposals for impairment as part of its comprehensive approach to replacing the accounting requirements for financial instruments in US Generally Accepted Accounting Principles (US GAAP). The FASB's objective for credit impairment was to develop a single model for all financial instruments that provides more timely credit loss information for users of financial statements.

BC5.110 Many respondents to both the IASB's 2009 Impairment Exposure Draft and the FASB's 2010 proposed Update commented that achieving a common outcome for impairment accounting would be highly desirable. The boards agreed and, in January 2011, jointly published the Supplementary Document, which built on their individual original Exposure Drafts and sought to incorporate the objectives of both boards' original impairment proposals (see paragraphs BC5.96–BC5.101 for further discussions on the Supplementary Document's proposals and feedback).

BC5.111 The feedback received on the Supplementary Document, combined with the importance of achieving convergence, encouraged the IASB and the FASB to jointly develop an alternative expected credit loss model. In May 2011, the boards decided to jointly develop a model that would reflect the general pattern of increases in the credit risk of financial instruments, the so-called 'three-bucket model'. In the three-bucket model, the amount of the expected credit losses recognised as a loss allowance would depend on the extent of increases in the credit risk on financial instruments since initial recognition.

BC5.112 However, in response to feedback received from respondents in the US about that model, in July 2012 the FASB decided to develop an alternative expected credit loss model.

BC5.113 In December 2012, the FASB published the proposed Accounting Standards Update *Financial Instruments—Credit Losses* (the '2012 proposed Update'). The proposed Update would require an entity to measure the net amortised cost at the present value of cash flows that it expects to collect, discounted at the original effective interest rate. To achieve this, an entity would recognise a loss allowance for expected credit losses from initial recognition at an amount equal to the lifetime expected credit losses. The comment period on this document overlapped with the IASB's comment period on the 2013 Impairment Exposure Draft.

BC5.114 Feedback received by the IASB on the 2013 Impairment Exposure Draft and by the FASB on the 2012 proposed Update was shared at joint board meetings to enable the boards to consider the comments received and differences in the opinions of their respective stakeholders. For many respondents to the 2013 Impairment Exposure Draft convergence was still preferable; however, many noted that their preference was subject to the impairment model being similar to that proposed in the IASB's 2013 Impairment Exposure Draft. Only a limited number of the IASB's respondents preferred convergence to the 2012 proposed Update model exposed by the FASB. Furthermore, very few respondents demanded convergence at the cost of finalising the requirements in a timely manner. Many respondents urged the IASB to finalise the proposed model as soon as possible, with or without convergence, stressing the importance of improving the accounting for the impairment of financial assets in IFRS as soon as possible.

BC5.115 The FASB and the IASB reported differences in views from the users of the financial statements. The FASB reported that users of financial statements overwhelmingly supported its 2012 proposed Update model. The IASB however reported on its outreach activities that a majority of non-US users preferred an impairment model similar to what was proposed in the 2013 Impairment Exposure Draft, while the majority of US users preferred a model similar to that proposed by the FASB.

BC5.116 Because of the importance of the user perspective and the apparent inconsistency in feedback subsequent to the comment letter analysis discussed in July 2013, the IASB conducted further outreach activities to understand the reasons for the difference in the feedback received by the IASB and the FASB on their respective proposals. The IASB identified the following:

(a) the starting point of how preparers apply US GAAP for loss allowances is different from the starting point of IFRS preparers. The IASB believe that this difference in starting point has influenced users' perceptions of the two proposed models.

(b) the interaction between the role of prudential regulators and loss allowances is historically stronger in the US.

(c) many users of financial statements in the US place greater weight on the adequacy of loss allowances in the balance sheet.

BC5.117 Before and during the redeliberations the IASB was made aware of the feedback received from all respondents, including the users of financial statements. The issue of convergence was discussed at length throughout the course of the project. Having considered all the feedback and the points discussed in paragraphs BC5.114–BC5.116, the IASB decided to proceed with the model proposed in the 2013 Impairment Exposure Draft.

Scope

BC5.118 In addition to financial assets that are measured at amortised cost (including trade receivables) and at fair value through other comprehensive income, the IASB decided to include the following within the scope of the impairment requirements of IFRS 9:

(a) loan commitments and financial guarantee contracts for the issuer, that are not measured at fair value through profit or loss;

(b) lease receivables that are accounted for in accordance with IAS 17 *Leases*; and

(c) contract assets that are recognised and measured in accordance with IFRS 15.

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Financial assets measured at fair value through other comprehensive income

BC5.119 The objective of the fair value through other comprehensive income measurement category is to provide users of financial statements with information on both a fair value and an amortised cost basis. To achieve that objective, paragraph 5.7.10 of IFRS 9 requires an entity to calculate interest revenue and impairment gains or losses in a manner that is consistent with the requirements that are applicable to financial assets measured at amortised cost. Thus, the IASB decided that the requirements for the recognition and measurement of expected credit losses shall apply to the fair value through other comprehensive income measurement category, in the same way as for assets measured at amortised cost. However, the loss allowance is recognised in other comprehensive income instead of reducing the carrying amount of the financial asset in the statement of financial position.

BC5.120 The IASB has noted feedback that recommended including a practical expedient that will provide relief from recognising 12-month expected credit losses on financial assets measured at fair value through other comprehensive income, when the fair value of the financial asset exceeds its amortised cost or when the loss allowance is insignificant. Interested parties noted that such a practical expedient would reduce the operational burden of assessing whether increases in credit risk since initial recognition are significant on financial assets that are already measured at fair value. They also noted that it would not be appropriate to recognise impairment gains or losses in profit or loss on financial assets that were purchased in an active market that prices the initial expectations of credit losses into the financial asset.

BC5.121 The IASB rejected these views. The IASB noted that not all debt instruments acquired in an active market are measured at fair value through other comprehensive income. In accordance with paragraph 4.1.2 of IFRS 9, such instruments can also be measured at amortised cost if the business model criteria are met (subject to the cash flow characteristics criteria). Having separate impairment models for similar financial assets that are measured differently would be inconsistent with the IASB's objective of having a single impairment model.

BC5.122 Furthermore, the IASB observed that a fair value-based practical expedient is inconsistent with the general impairment approach, which is based on an entity's assessment of the changes in the risk of a default occurring since initial recognition. Introducing a fair value-based practical expedient would represent a different impairment approach and would not result in the amounts recognised in profit or loss being the same as if the financial assets were measured at amortised cost.

BC5.123 The IASB noted that the assessment of credit risk is based on management's view of collecting contractual cash flows instead of on the perspective of a market participant as is the case with fair value measurement. It was noted that market prices are not in themselves intended to be a determinant of whether credit risk has increased significantly because, for example, market prices can be affected by factors that are not relevant to credit risk (such as changes in the level of general interest rates and the price of liquidity). However, the IASB noted that market prices are an important source of information that should be considered in assessing whether credit risk has changed. It was also noted that market information is relevant for financial instruments within the scope of the impairment model irrespective of the classification in accordance with IFRS 9. This is because the form of a financial asset (as a bond or a loan) does not determine its classification in accordance with IFRS 9 and because the accounting for expected credit losses is the same for financial assets measured at amortised cost and those measured at fair value through other comprehensive income.

BC5.124 In the IASB's view, applying a single impairment model to both financial assets at amortised cost and financial assets at fair value through other comprehensive income will facilitate comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics. In addition, the IASB noted that having a single impairment model reduces a significant source of complexity for both users of financial statements and preparers compared with applying IAS 39. The IASB's view was strongly supported by respondents to the 2013 Impairment Exposure Draft. During its redeliberations on the 2013 Impairment Exposure Draft, the IASB, having noted the support from respondents, confirmed the inclusion of these financial assets within the scope of the impairment requirements.

Loan commitments and financial guarantee contracts

BC5.125 Loan commitments and financial guarantee contracts outside the scope of IAS 39 were previously accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The Supplementary Document asked respondents whether an entity should apply the same impairment model to loan commitments and financial guarantee contracts as for financial assets measured at amortised cost. On the basis of the support from respondents to the Supplementary Document, the 2013 Impairment Exposure Draft retained the proposal that an entity should recognise expected credit losses that result from loan commitments and financial guarantee contracts when there is a present contractual obligation to extend credit.

BC5.126 The vast majority of respondents to the 2013 Impairment Exposure Draft agreed that loan commitments and financial guarantee contracts should be within the scope of the impairment model because:

(a) expected credit losses on loan commitments and financial guarantee contracts (off balance sheet exposures) are similar to those on loans and other on balance sheet exposures. The only difference is that in the latter case, the borrower has already drawn down the loan whereas in the former case it has not.

(b) in practice, loan commitments and financial guarantee contracts are often managed using the same credit risk management approach and information systems as loans and other on balance sheet items.

(c) a single impairment model for all credit exposures, irrespective of their type, removes the complexity previously caused by different impairment models in IFRS.

BC5.127 However, many of the respondents that supported including loan commitments and financial guarantee contracts within the scope of the impairment requirements proposed that the expected credit losses should be measured over the behavioural life of the product, instead of over the contractual life as was proposed (see paragraphs BC5.254–BC5.261).

BC5.128 The IASB therefore confirmed the inclusion within the scope of the impairment requirements of loan commitments that are not measured at fair value through profit or loss in accordance with IFRS 9 and financial guarantee contracts to which IFRS 9 is applied and that are not measured at fair value through profit or loss.

Trade receivables, contract assets and lease receivables

BC5.129 The 2009 Impairment Exposure Draft proposed that entities should apply an expected credit loss model to trade receivables. It also proposed a practical expedient by which they could use a provision matrix as the basis for measurement. Many respondents told the IASB that applying an expected credit loss model to non-interest-bearing trade receivables would not provide useful information because of their short maturity. They also noted that there would be operational challenges for non-financial institutions and less sophisticated financial institutions in applying an expected credit loss model. Consequently, the IASB conducted further outreach to gather information about current practice and the operational challenges of applying an expected credit loss model to trade receivables. That outreach indicated that the practical application of the impairment requirements in IAS 39 often results in credit losses not being recognised until trade receivables become past due.

BC5.130 In finalising IFRS 9, the IASB concluded that requiring entities to recognise a loss allowance on a more forward-looking basis before trade receivables become past due would improve financial reporting.

BC5.131 The IASB also noted in both the 2009 and 2013 Impairment Exposure Drafts, that, although the requirements in IAS 17 result in the measurement of a lease receivable in a manner that is similar to financial assets that are measured at amortised cost in accordance with IFRS 9, there are differences in the application of the effective interest method. In addition, the cash flows included in lease contracts could include features such as contingent payments that would not be present in other financial instruments. The existence of contingent and variable lease payments results in:

(a) specific requirements for identifying the cash flows that are included in the measurement of the lease receivable (such as the criteria for including contingent lease payments, the treatment of renewal options and the bifurcation of any embedded derivatives); and

(b) a consequential effect on determining the discount rate (ie given (a), the discount rate cannot always be determined in the same way as the effective interest rate for a financial asset measured at amortised cost).

BC5.132 The IASB decided that these differences do not justify applying a different impairment model and therefore included lease receivables within the scope of the impairment requirements in IFRS 9. In reaching this decision, the IASB concluded that the impairment model could be applied to lease receivables as long as:

(a) the cash flows assessed for expected credit losses are consistent with those included in the measurement of the lease receivable; and

(b) the rate used to discount the expected credit losses is consistent with the rate that is determined in accordance with IAS 17.

BC5.133 Some respondents to the 2013 Impairment Exposure Draft noted that the IASB has an active project affecting the accounting treatment of lease receivables that is yet to be finalised. They requested further clarification of the interaction between the expected credit loss requirements and the proposed accounting for lease receivables in accordance with that project. The IASB acknowledged these concerns and noted that it will further consider this interaction if needed when deliberating the accounting treatment for lease receivables as part of the leases project.

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BC5.134 When finalising IFRS 15, the IASB noted that although contract assets are specifically excluded from the scope of IFRS 9 and accounted for in accordance with IFRS 15, the exposure to credit risk on contract assets is similar to that of trade receivables. The IASB therefore decided to include contract assets in the scope of the impairment requirements. The IASB also decided that if an entity applies IFRS 9 before it applies IFRS 15, an entity should apply the impairment requirements in IFRS 9 to those receivables that arise from transactions that are accounted for in accordance with IAS 18 *Revenue* and IAS 11 *Construction Contracts*.

Recognition of expected credit losses

General approach

BC5.135 On the basis of the feedback received from respondents on the proposals in the 2013 Impairment Exposure Draft about the usefulness of the information and the responsiveness of the impairment model to changes in credit risk, the IASB decided to finalise the proposed approach. In doing so, the IASB considered that this expected credit loss approach will improve financial reporting because:

(a) financial statements will clearly distinguish between financial instruments for which credit risk has increased significantly since initial recognition and those for which it has not;

(b) a loss allowance at an amount equal to at least 12-month expected credit losses will be recognised throughout the life of financial assets, thereby reducing the systematic overstatement of interest revenue in accordance with the requirements in IAS 39, and acting as a proxy for the recognition of initial expected credit losses over time as proposed in the 2009 Impairment Exposure Draft;

(c) a loss allowance at an amount equal to lifetime expected credit losses will be recognised when credit risk has significantly increased since initial recognition, resulting in the timely recognition of expected credit losses; and

(d) amounts reported about expected credit losses will better reflect the effective return and the changes in the credit risk on financial instruments compared to the requirements in IAS 39.

Collective and individual assessment of changes in credit risk

BC5.136 It was apparent in responses and comments received on the 2013 Impairment Exposure Draft that some respondents were of the view that the proposals would not require (or even allow) lifetime expected credit losses to be recognised on financial instruments unless there was evidence of significant increases in credit risk at an individual instrument level. The IASB also became aware that some understood the 2013 Impairment Exposure Draft as only requiring lifetime expected credit losses to be recognised when a financial asset became past due.

BC5.137 In considering the feedback received, the IASB confirmed that the objective of the impairment requirements is to capture lifetime expected credit losses on all financial instruments that have significant increases in credit risk, regardless of whether it is on an individual or a collective basis.

BC5.138 Consequently, the IASB considered whether the impairment requirements in Section 5.5 of IFRS 9 should specify whether an entity should evaluate financial instruments individually or collectively when deciding whether it should recognise lifetime expected credit losses. In accordance with IFRS 9, the unit of account is the individual financial instrument. The timeliness of capturing significant increases in credit risk primarily depends on whether the entity has reasonable and supportable information that is available without undue cost or effort to identify significant increases in credit risk in a timely manner before financial assets become past due. However, when credit risk management systems are heavily dependent on past due information, there may be a delay between identifying significant increases in credit risk and when the increase in credit risk has actually occurred.

BC5.139 The IASB observed that any delay is minimised when credit risk management systems capture a comprehensive range of credit risk information that is forward-looking and is updated on a timely basis at the individual instrument level. The delay is more apparent for portfolios of financial instruments that are managed on the basis of past due information.

BC5.140 The IASB noted that in some circumstances the segmentation of portfolios based on shared credit risk characteristics may assist in determining significant increases in credit risk for groups of financial instruments. The IASB considered that individual financial assets could be grouped into segments on the basis of common borrower-specific information and the effect of forward-looking information (ie changes in macroeconomic indicators) that affect the risk of a default occurring could be considered for each segment. As a result, an entity could use the change in that macroeconomic indicator to determine that the credit risk

of one or more segments of financial instruments in the portfolio has increased significantly, although it is not yet possible to identify the individual financial instruments for which credit risk has increased significantly. The IASB also noted that in other cases an entity may use reasonable and supportable information to determine that the credit risk of a homogeneous portion of a portfolio should be considered to have increased significantly in order to meet the objective of recognising all significant increases in credit risk.

BC5.141 The IASB noted that measuring expected credit losses on a collective basis approximates the result of using comprehensive credit risk information that incorporates forward-looking information at an individual instrument level. However, financial instruments should not be grouped in order to measure expected credit losses on a collective basis in a way that obscures significant increases in credit risk on individual financial instruments within the group.

BC5.142 The IASB observed that, although an entity may group financial instruments in a portfolio with similar characteristics to identify significant increases in credit risk, ultimately, information will emerge that may enable an entity to distinguish between instruments that are more likely to default from instruments that are not. As the passage of time reduces the uncertainty about the eventual outcome, the risk of a default occurring on the financial instruments in the portfolio should diverge until the financial instruments either default or are collected in full. Consequently, the appropriate level of grouping is expected to change over time in order to capture all significant increases in credit risk. The IASB concluded that an entity should not group financial instruments at a higher level of aggregation if a subgroup exists for which the recognition of lifetime expected credit losses is more appropriate.

Timing of the recognition of lifetime expected credit losses

BC5.143 Some respondents to the 2009 Impairment Exposure Draft and the Supplementary Document believed that the value of a financial asset measured at amortised cost is most faithfully represented by discounting the expected cash flows (ie contractual cash flows reduced for expected credit losses) at the original effective interest rate (ie the effective interest rate that is not reduced for initial expected credit losses). In other words, an entity would be required to recognise a loss allowance for lifetime expected credit losses, discounted using the original effective interest rate, from initial recognition. Those respondents believe that because credit losses do not occur rateably throughout the life of a loan, or throughout the life of a portfolio of loans, there is a fundamental disconnect between the 'lumpy' pattern of actual credit losses and a time-based accounting approach that attempts to link the recognition of credit losses that are anticipated at initial recognition of the financial asset with the recognition of interest revenue.

BC5.144 The IASB considered and rejected this view. At initial recognition, the timing of initial expected credit losses affects the amount of the adjustment to the effective interest rate. Thus, an earlier expected credit loss would give rise to a larger credit adjustment to the effective interest rate than a later expected credit loss of an equal nominal value. Because the pattern of initially expected credit losses is priced into the asset as represented by its present value, compensation is received for the amount and timing of those initially expected credit losses. Thus, in the IASB's view, if initial credit loss expectations do not subsequently change:

(a) interest revenue should reflect the credit-adjusted effective return over time; and

(b) there is no credit loss (or gain), because no economic loss (or gain) has occurred.

BC5.145 Respondents also believe that the evaluation of the creditworthiness that influences pricing is based on historical experience for groups of similar assets. This means that, while the credit spread that is charged on the lender's overall portfolio of individual loans may be expected to compensate the entity for credit losses for a large portfolio of assets over time, the credit spread on any individual asset is not necessarily established in a way that compensates the lender for expected credit losses on that particular asset.

BC5.146 The IASB considered and rejected these views. First, expected credit losses are a probability-weighted estimate of expected cash shortfalls. Thus, the pricing of individual instruments would reflect the probability of credit losses and would be no different to the pricing of an instrument that is part of a portfolio. Market participants price individual instruments consistently, irrespective of whether they will hold that instrument in isolation or as part of a portfolio. Second, it is not necessary to measure separately the initial expected credit losses and the compensation for those credit losses, and then precisely match the amount and timing of those credit losses and the related compensation. An estimate of expected credit losses at initial recognition (which an entity could estimate in a number of different ways) would be sufficient for the purposes of determining the credit adjustment to the effective interest rate. Indeed, any models requiring the recognition of the lifetime expected credit losses at initial recognition would require an entity to make the same estimate.

BC5.147 A few respondents also argued that the amortised cost amount of a financial asset should reflect the present value of the cash flows that are expected to be collected, discounted at the original effective interest rate (ie a

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rate that is not adjusted for initial expected credit losses). They believe that it is misleading to investors to allow the balance sheet to reflect a greater amount.

BC5.148 The IASB considered and rejected that view. The original effective interest rate is the rate that exactly discounts the expected cash flows (before deducting expected credit losses) of the asset to the transaction price (ie the fair value or principal) at initial recognition. Thus, the original effective interest rate already takes into consideration an entity's initial estimate of expected credit losses (ie it reflects the riskiness of the contractual cash flows). One of the general principles of any present value technique is that the discount rate should reflect assumptions that are consistent with those inherent in the cash flows that are being discounted. Requiring the entity to further deduct an amount from the transaction price that represents the same amount that it has already discounted from the contractual cash flows results in the entity double-counting its initial estimate of expected credit losses. The effect of this would be most apparent at initial recognition, because the carrying amount of the asset would be below the transaction price.

BC5.149 As noted in paragraph BC5.103, the impairment model proposed in the 2013 Impairment Exposure Draft eliminated the operational challenge of having to estimate the full expected (credit-loss adjusted) cash flows for all financial instruments. It did this by limiting the measurement of lifetime expected credit losses to financial instruments for which credit risk has significantly increased since initial recognition. The majority of participants in the outreach conducted by the IASB while developing the proposals in the 2013 Impairment Exposure Draft noted that if financial instruments were to move too quickly to a lifetime expected credit loss measurement (for example, on the basis of minor increases in credit risk) the costs of implementing the model (ie one that would require lifetime expected credit losses to be measured on many financial assets in addition to requiring a distinction to be made on the basis of the extent of the change in the credit risk) might not be justified.

BC5.150 Respondents to the 2013 Impairment Exposure Draft strongly supported the proposal to recognise lifetime expected credit losses only when the credit risk of a financial instrument has increased significantly since initial recognition, because it captures the underlying economics of a transaction while easing operational complexities. They also noted that:

(a) it reflects and provides a clear indication that an economic loss occurred as a result of changes in credit risk from initial expectations.

(b) it avoids excessive front-loading of expected credit losses.

(c) measuring lifetime expected credit losses for financial instruments that have signs of significant increases in credit risk would be operationally simpler because more data is available for these financial instruments.

(d) the proposal would result in recognising lifetime expected credit losses in a timelier and more forward-looking manner compared to IAS 39. Respondents therefore believed that the proposal addresses the concerns of the G20 and others about the delayed recognition of credit losses under an incurred loss approach.

BC5.151 Consequently, in the light of the support and arguments presented, the IASB decided to require an entity to recognise lifetime expected credit losses when the credit risk of a financial instrument has increased significantly since initial recognition.

BC5.152 The IASB received requests to clarify whether a financial instrument for which the interest rate on the instrument has been repriced to reflect an increase in credit risk should continue to have a loss allowance measured at an amount equal to 12-month expected credit losses, even if the increase in credit risk since initial recognition is assessed to be significant. The IASB considered that, conceptually, the loss allowance on such an instrument should continue to be measured at 12-month expected credit losses. This is because the contractual interest rate has been repriced to reflect the entity's expectations about credit losses and is similar to the economic position on initial recognition of a similar financial instrument with a similar credit risk at origination. However, the IASB noted that requiring an entity to assess whether the increase in the interest rate appropriately compensates it for the increase in credit risk would give rise to operational complexity similar to that arising from the 2009 Impairment Exposure Draft. The IASB further noted that the objective of the impairment requirements is to recognise lifetime expected credit losses for financial instruments if there have been significant increases in credit risk since initial recognition.

BC5.153 The IASB also considered that when a financial instrument is repriced to take into account an increase in credit risk, the risk of a default occurring on the financial instrument has increased, implying that the customer is more likely to default than was expected at initial recognition. The fact that the entity is entitled to a higher yield because of the increase in credit risk does not mean that the risk of a default occurring on the financial instrument has not increased. The IASB therefore decided that, on balance, the assessment of whether lifetime expected credit losses should be recognised should be based solely on the increase in the risk of a default occurring since initial recognition.

Determining significant increases in credit risk

Use of changes in the risk of a default occurring

BC5.154 In the 2013 Impairment Exposure Draft, the IASB proposed using the risk of a default occurring on a financial instrument to determine whether there has been an increase in credit risk since initial recognition. The IASB noted that the risk of a default occurring is a measurement of the financial instrument's credit risk that does not require the full estimation of expected credit losses. The 2009 Impairment Exposure Draft required the tracking of the initial expected credit losses and the measurement of all subsequent changes in those expected credit losses. In contrast, the model proposed in the 2013 Impairment Exposure Draft required:

(a) the tracking of the initial risk of a default occurring (a component of the expected credit losses); and

(b) an assessment of the significance of subsequent changes in the risk of a default occurring to decide whether the recognition of lifetime expected credit losses is required.

BC5.155 Many respondents to the proposals in the 2013 Impairment Exposure Draft agreed that an assessment of when to recognise lifetime expected credit losses should take into consideration only the changes in credit risk (ie the risk of a default occurring) instead of changes in the amount of expected credit losses. These respondents noted that the risk of a default occurring was considered the most relevant factor in assessing credit risk, and that tracking only the risk of a default occurring makes the model more operational, because that generally aligns with their credit risk management practices.

BC5.156 Respondents to the 2013 Impairment Exposure Draft supported the proposed principle-based approach of assessing significant increases in credit risk instead of prescriptive rules and 'bright lines'. However, some requested clarification about the information that needs to be considered in that assessment. In particular, some thought that the 2013 Impairment Exposure Draft could be interpreted to explicitly require the use of a mechanistic approach to determine the 'probability of default' when assessing significant increases in credit risk. Respondents were concerned that this would require the explicit calculation and storage of the lifetime probability of default curve for a financial instrument to compare the expected remaining lifetime probability of default at inception with the remaining lifetime probability of default at the reporting date.

BC5.157 The IASB noted that it did not intend to prescribe a specific or mechanistic approach to assess changes in credit risk and that the appropriate approach will vary for different levels of sophistication of entities, the financial instrument and the availability of data. The IASB confirmed that the use of the term 'probability of a default' occurring was intended to capture the concept of the risk of a default occurring. A specific probability of default measure is one way in which that could be assessed, but the IASB decided that it would not be appropriate to require particular sources of information to be used to make the assessment. This is because credit analysis is a multifactor and holistic analysis, and when making that analysis entities have differences in the availability of data. Such differences include whether a specific factor is relevant, and its weight compared to other factors which will depend on the type of product, characteristics of the financial instrument and the customer as well as the geographical region. However, to reduce the risk of misinterpretation, the IASB decided to change the terminology from 'probability of a default occurring' to 'risk of a default occurring'.

BC5.158 In the IASB's view, the recognition requirements for lifetime expected credit losses in IFRS 9 strike the best balance between the benefits of making distinctions on the basis of increases in credit risk and the costs and complexity of making that assessment.

Approaches for determining significant increases in credit risk considered and rejected

BC5.159 The IASB considered a number of alternative approaches for determining when to recognise lifetime expected credit losses to make the impairment model in IFRS 9 more operational.

Absolute level of credit risk

BC5.160 The IASB considered whether lifetime expected credit losses should be recognised on the basis of an assessment of the absolute credit risk of a financial instrument at each reporting date. Under this approach, an entity would recognise lifetime expected credit losses on all financial instruments at, or above, a particular credit risk at the reporting date. An approach based on the absolute credit risk at each reporting date would be much simpler to apply, because it does not require tracking of credit risk at initial recognition. However, such an approach would provide very different information. It would not approximate the economic effect of

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initial credit loss expectations and subsequent changes in expectations. In addition, if the absolute credit risk threshold for recognising lifetime expected credit losses was too high, too many financial instruments would be below the threshold and expected credit losses would be understated. If the absolute threshold was too low, too many financial instruments would be above the threshold, overstating the expected credit losses (for example, financial instruments with a high credit risk that an entity prices appropriately to compensate for the higher credit risk would always have lifetime expected credit losses recognised). Furthermore, depending on which absolute credit risk threshold is selected, such an approach might be similar to the incurred loss model in IAS 39 (in which the absolute threshold is objective evidence of impairment). Consequently, the IASB rejected this approach.

BC5.161 Although the IASB rejected using an absolute level of credit risk for the recognition of lifetime expected credit losses, it noted that the assessment of significant increases in credit risk could be implemented more simply by determining the maximum initial credit risk accepted by the reporting entity for a particular portfolio of financial instruments and then comparing the credit risk of financial instruments in that portfolio at the reporting date to that maximum initial credit risk. However, the IASB noted that this would only be possible for portfolios of financial instruments with similar credit risk at initial recognition. Such an approach would enable a change in credit risk to be the basis for the recognition of lifetime expected credit losses, but does not require specific tracking of the credit risk on an individual financial instrument since initial recognition.

Change in the credit risk management objective

BC5.162 Some interested parties suggested that lifetime expected credit losses should be recognised when an entity's credit risk management objective changes; for example, when contractual cash flows are no longer received consistently with the terms of the contract, the entity changes its credit risk management objective from collecting past due amounts to recovery of the total (or part of the) contractual amount outstanding and the financial assets are being monitored on an individual basis. While recognising lifetime expected credit losses when the credit risk management objective changes would be operationally simpler (ie financial instruments that are being managed differently would be identified immediately, with no need to assess a change in credit risk since initial recognition), the approach would be likely to have a similar effect to the incurred loss model in IAS 39. Because the management of a financial instrument may change only relatively late compared with when significant increases in credit risk occur, the IASB considered this to be a less timely approach to recognising lifetime expected credit losses.

Credit underwriting policies

BC5.163 Some interested parties suggested that lifetime expected credit losses should be recognised when a financial instrument's credit risk at the reporting date is higher than the credit risk at which the entity would originate new loans for that particular class of financial instruments (ie if the level of credit risk exceeded the credit underwriting limit for that class of financial instruments at the reporting date).

BC5.164 The IASB noted a number of disadvantages to this approach. In a similar way to an approach based on the absolute level of credit risk or a change in the credit risk management objective, this approach would not require the change in credit risk since initial recognition to be assessed. It would thus be inconsistent with the IASB's objective of reflecting increases in credit risk and linking that to pricing. The objective of setting credit underwriting limits also follows a different objective compared to that of financial reporting, which could result in a misstatement of expected credit losses. For example, changes in underwriting policies may occur for business reasons, such as wishing to increase lending, resulting in changes to the recognition of expected credit losses on existing financial instruments irrespective of changes in credit risk.

BC5.165 The IASB further noted that the underwriting standards at the time that a financial instrument is initially recognised do not in themselves provide evidence of a significant increase in credit risk. This is because the new financial instruments cannot, by definition, have experienced significant increases in credit risk at initial recognition. Furthermore, the underwriting standards of new financial instruments are not relevant to the credit risk of existing financial instruments. However, the IASB notes that particular vintages may be more prone to increases in credit risk, and thus financial instruments of particular vintages may need to be monitored and assessed with increased vigilance.

Counterparty assessment

BC5.166 Some interested parties suggested that an entity should recognise lifetime expected credit losses on all financial instruments it holds with the same borrower (ie counterparty), if the credit risk of the borrower has reached a specified level at the reporting date (including on newly originated or purchased financial

instruments for which the yield appropriately reflects the credit risk at the reporting date). Respondents supporting this approach noted that they manage credit risk on a counterparty level instead of an individual instrument level and that assessing significant increases in credit risk on an instrument level was in their view counterintuitive. This was because different loss allowance measurements could be recognised for similar instruments held with the same counterparty, depending on when the instruments were initially recognised.

BC5.167 The IASB noted that the objective of the impairment requirements is to reflect the economics of lending to provide users of financial statements with relevant information about the performance of financial instruments instead of the performance of a counterparty. A counterparty assessment could misstate expected credit losses if its credit risk had changed; for example, because it would not reflect that a recently recognised financial instrument of a counterparty was priced taking into consideration the current credit risk. Furthermore, like the absolute approach, this approach might be similar to the incurred loss model in IAS 39 in effect, depending on which level of credit risk is selected as the threshold for recognising lifetime expected credit losses. The IASB also noted that not all entities manage credit risk on a counterparty level and that a counterparty assessment of credit risk could produce very different information compared to the information resulting from the impairment model in IFRS 9.

BC5.168 However, the IASB acknowledged that assessing credit risk on a basis that considers a customer's credit risk (ie the risk that a customer will default on its obligations) more holistically may nevertheless be consistent with the impairment requirements. An overall assessment of a counterparty's credit risk could be undertaken, for example, to make an initial assessment of whether credit risk has increased significantly, as long as such an assessment satisfies the requirements for recognising lifetime expected credit losses and the outcome would not be different to the outcome if the financial instruments had been individually assessed.

Extent of increase in credit risk required

BC5.169 The model proposed in the 2013 Impairment Exposure Draft requires an entity to initially account for a portion of expected credit losses. However, the IASB decided that, if an entity suffers a significant economic loss, recognition of only a portion of the lifetime expected credit losses is no longer appropriate and it should recognise the full lifetime expected credit losses. The IASB considered how significant the extent of the increase in credit risk should be, from both an economic and a practical perspective, to justify the recognition of lifetime expected credit losses.

BC5.170 In the IASB's joint deliberations with the FASB, the boards had tentatively agreed that the deterioration criteria for the recognition of lifetime expected credit losses should be that the credit quality had deteriorated more than insignificantly subsequent to the initial recognition of the financial instrument. However, in the IASB's outreach undertaken while developing the model proposed in the 2013 Impairment Exposure Draft, participants expressed concern that this criterion would have the result that even a minor change in the credit quality would satisfy the test. In response to that concern, the 2013 Impairment Exposure Draft proposed that the criterion for the recognition of lifetime expected credit losses is significant increases in credit risk, expressed as an increase in the risk of a default occurring since initial recognition.

BC5.171 During outreach and as part of their responses to the 2013 Impairment Exposure Draft, some interested parties and respondents asked the IASB to specify the amount of change in the risk of a default occurring that would require the recognition of lifetime expected credit losses. Those making this request argued that this would provide clarity and improve comparability. The IASB did not pursue this approach for the following reasons:

(a) not all entities use an explicit probability of default to measure or assess credit risk—in particular, entities other than regulated financial institutions. The IASB observed that entities manage financial instruments and credit risk in different ways, with different levels of sophistication and by using different information. If the IASB were to propose a precise definition of significant increases in credit risk, for example, a change of 5 per cent in the probability of default, then an entity would need to calculate a probability of default measure to make the assessment. Thus, the costs of assessing changes in credit risk would increase.

(b) the measure for the risk of a default occurring (ie probability of default) selected would be arbitrary and it would be difficult to properly reflect the structure and pricing of credit that an entity should consider for different types of financial instruments, maturities and initial credit risk. Selecting a single measure could not properly reflect the assessment of credit across entities, products and geographical regions. Because of the arbitrariness of defining the extent of increases in credit risk, the IASB questioned the perceived comparability that would result.

BC5.172 Consequently, the IASB confirmed its view that the requirements for when to recognise lifetime expected credit losses should be clear but also be broadly defined and objective based.

BC5.173 The IASB noted that the assessment of the significance of the change in the risk of a default occurring for different financial instruments would depend on the credit risk at initial recognition and the time to maturity.

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This is because it would be consistent with the structure of credit risk and therefore with the pricing of financial instruments. In the IASB's view, an entity should consider the term structure and the initial credit risk in assessing whether it should recognise lifetime expected credit losses. Doing so will improve the comparability of the requirements for financial instruments with different maturities and different initial credit risks. For example, all other things being equal, a given increase (in absolute terms) in the risk of a default occurring reflects a greater increase in credit risk the shorter the term of the financial instrument and the lower its initial credit risk. This would also be consistent with the IASB's understanding of existing models for measuring credit risk, such as those underlying external credit ratings, option pricing models and their variants, including the models for measuring the risk of a default occurring for the purposes of prudential regulatory requirements.

BC5.174 If an entity were not required to consider both the initial credit risk and the time until maturity, the assessment would benefit shorter-term financial instruments with low credit risk and would disadvantage longer-term instruments with high credit risk. In addition, not reflecting the term structure might also result in the assessment that the risk of a default occurring has changed merely because of the passage of time. This could happen even if an entity had expected such a change at initial recognition. In the IASB's view, the assessment of the criteria should not change solely because the maturity date is closer.

BC5.175 To assist in the application of the impairment requirements, the IASB decided to provide application guidance, including guidance about the types of information that an entity should consider. The IASB reaffirmed its view that an entity should use the best information that is available without undue cost and effort when measuring expected credit losses.

Use of changes in the risk of a default occurring within the next 12 months

BC5.176 The 2013 Impairment Exposure Draft required the determination of an increase in credit risk to be based on changes in the risk of a default occurring over the life of a financial instrument but noted that a 12-month measure could be used "if the information considered did not suggest that the outcome would differ".

BC5.177 Many respondents to the 2013 Impairment Exposure Draft noted that the assessment of significant increases in credit risk could be made more operational by aligning it with credit risk management practices, including enabling the use of a 12-month instead of lifetime risk of a default occurring when assessing changes in credit risk. Many of these respondents were however concerned that the 2013 Impairment Exposure Draft would require entities to compare the outcome from a 12-month assessment and prove that it would not differ from the outcome of a lifetime assessment.

BC5.178 In response to the feedback, the IASB noted that, ideally, an entity should use changes in the lifetime risk of a default occurring to assess changes in credit risk since initial recognition. However, the IASB observed that changes in the risk of a default occurring within the next 12 months generally should be a reasonable approximation of changes in the risk of a default occurring over the remaining life of a financial instrument and thus would not be inconsistent with the requirements. The IASB also noted that some entities use a 12-month probability of default measure for prudential regulatory requirements. These entities could therefore use their existing systems and methodologies as a starting point for determining significant increases in credit risk, thus reducing the costs of implementation.

BC5.179 However, the IASB noted that there may be circumstances in which the use of the risk of a default occurring within the next 12 months will not be appropriate. For example, this may be the case for financial instruments with a payment profile in which significant payment obligations occur beyond the next 12 months or when there are changes in macroeconomic or other credit-related factors that are not adequately reflected in the risk of a default occurring in the next 12 months. Consequently, an entity may use changes in the risk of a default occurring within the next 12 months unless circumstances indicate that a lifetime assessment is necessary to meet the objective of identifying significant increases in credit risk since initial recognition.

Financial instruments that have low credit risk at the reporting date

BC5.180 The IASB proposed in the 2013 Impairment Exposure Draft that irrespective of the change in credit risk from initial recognition, an entity should not recognise lifetime expected credit losses on financial instruments with low credit risk at the reporting date. The IASB proposed this to reduce the operational costs and to make the model more cost-effective. The IASB observed that for financial instruments with low credit risk, the effect of this simplification on the timing of recognition, and the amount of expected credit losses would be minimal. This would be the case even if the recognition of lifetime expected credit losses occurred later than it otherwise would have if there had been no simplification. In the IASB's view, this would help to achieve an appropriate balance between the benefits of distinguishing between financial instruments on the basis of

changes in credit risk and the costs of making that distinction. The IASB also noted that financial instruments of such a quality were not the primary focus for the recognition of lifetime expected credit losses.

BC5.181 The 2013 Impairment Exposure Draft proposed that the credit risk on a financial instrument should be considered low if the financial instrument has a low risk of default, and the borrower has a strong capacity to meet its contractual cash flow obligations in the near term. The 2013 Impairment Exposure Draft noted that this is the case even if adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability to fully recover cash flows in the long term. It was noted that such credit risk is typically equivalent to the investment grade market convention, ie an entity need not assess the extent of the increase in credit risk since initial recognition for financial instruments with credit risk that is equivalent to investment grade.

BC5.182 Respondents to the 2013 Impairment Exposure Draft had mixed views on the inclusion of the low credit risk simplification. Most respondents supported a simplification based on low credit risk and noted that it reduces the costs of implementation and avoids recognising lifetime expected credit losses inappropriately. However, a number of clarifications were suggested regarding the meaning of low credit risk and its application. Some noted that the low credit risk simplification could paradoxically increase operational complexity because, in addition to assessing the change in credit risk, the absolute credit risk at the reporting date would need to be assessed.

BC5.183 In response, the IASB noted that the intention was to reduce operational complexity and therefore decided to retain the low credit risk simplification but to *allow* instead of *require* this to be used. This would allow entities to better align the assessment of increases in credit risk for the purpose of IFRS 9 with their internal credit risk systems.

BC5.184 The IASB considered whether to allow reporting entities to have an accounting policy choice on whether to apply the requirement to assess whether a financial instrument is considered to have low credit risk at the reporting date. It noted that the intention of the low credit risk concept was to provide relief from tracking changes in the credit risk of high quality financial instruments and that requiring an entity to apply it as an accounting policy choice for a class of financial instrument would be inconsistent with this intention. The assessment of low credit risk can therefore be made on an instrument-by-instrument basis.

BC5.185 Some respondents were confused about the role of the low credit risk simplification. For example, some were concerned that as soon as a financial instrument was no longer low credit risk, lifetime expected credit losses would be required to be recognised irrespective of the initial credit risk on the financial instrument.

BC5.186 The IASB therefore clarified that:

(a) the objective of the low credit risk simplification is to provide operational relief for high quality financial instruments, in other words, those with a low risk of default.

(b) an increase in credit risk that results in a financial instrument no longer being considered to have low credit risk at the reporting date is not an automatic trigger for the recognition of lifetime expected credit losses. Instead, if a financial instrument is not low credit risk at the reporting date, an entity should assess the extent of the increase in credit risk and recognise lifetime expected credit losses only when the increase since initial recognition is significant in accordance with the usual requirements.

BC5.187 Respondents also raised questions about the ambiguity of using 'investment grade' as an example of low credit risk. Respondents were concerned that only financial instruments that are externally rated by a credit rating agency as investment grade would be considered to have low credit risk. They also questioned whether the reference to investment grade referred to global or national rating scales.

BC5.188 The IASB noted that:

(a) financial instruments are not required to be externally rated to meet the low credit risk requirements. Instead, the reference to investment grade serves only as an example of a financial instrument that may be considered to have low credit risk. The credit risk can be determined using alternative measures, such as internal rating grades based on commonly understood notions of credit risk.

(b) its intention was to use a globally comparable notion of low credit risk instead of a level of risk determined, for example, by an entity or jurisdiction's view of risk based on entity-specific or jurisdictional factors.

(c) ratings should consider or be adjusted to take into consideration the specific risks of the financial instruments being assessed.

BC5.189 Consequently, the IASB confirmed that low credit risk refers to a level of credit risk that is akin to a globally accepted definition of low credit risk. Credit risk ratings and methodologies that are consistent with these requirements and that consider the risks and the type of financial instruments that are being assessed may be used to apply the requirements in paragraph 5.5.10 of IFRS 9.

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More than 30 days past due rebuttable presumption

BC5.190 In the 2013 Impairment Exposure Draft, the IASB proposed that an entity may consider information about delinquency or past due status, together with other, more forward-looking information, in its assessment of the increases in credit risk since initial recognition, if appropriate. To supplement the requirement to determine the extent of increases in credit risk since initial recognition, and to ensure that its application does not revert to an incurred loss notion, the IASB proposed a rebuttable presumption that the credit risk on a financial instrument has increased significantly, and that lifetime expected credit losses shall be recognised, when a financial asset is more than 30 days past due.

BC5.191 The majority of respondents to the 2013 Impairment Exposure Draft considered that the rebuttable presumption results in an appropriate balance between identifying significant increases in credit risk and the cost of tracking and assessing those increases in credit risk. Respondents noted that the outcome is broadly in line with existing credit risk management practices (ie looking at past due information). Field test participants observed that there was generally a correlation between financial instruments that are more than 30 days past due and significant increases in the 12-month probability of default. However, some respondents did not support having a past due measure as an indication of when there has been a significant increase in credit risk. They believe that a past due measure creates a bright line for the recognition of lifetime expected credit losses and, because past due status is a lagging indicator of increases in credit risk, it will fail to identify significant increases in credit risk on a timely basis.

BC5.192 In response, the IASB confirmed that, consistent with the forward-looking nature of expected credit losses, an entity should use forward-looking information, such as the price for credit risk, probabilities of default and internal or external credit ratings, to update the measurement of expected credit losses and when assessing whether to recognise lifetime expected credit losses. However, the IASB acknowledged the feedback that supported the view that many entities manage credit risk on the basis of information about past due status and have a limited ability to assess credit risk on an instrument-by-instrument basis in more detail on a timely basis.

BC5.193 The IASB therefore decided to retain the rebuttable presumption, but also wanted to ensure that this did not contribute to the delayed recognition of lifetime expected credit losses. The IASB clarified that the objective of the rebuttable presumption in paragraph 5.5.11 of IFRS 9 is not to be an absolute indicator of when lifetime expected credit losses should be recognised, but serves as a backstop for when there has been a significant increase in credit risk. The IASB noted that the application of the rebuttable presumption should identify significant increases in credit risk before financial assets become credit-impaired or an actual default occurs. The IASB also noted that, ideally, significant increases in credit risk should be identified before financial assets become past due.

BC5.194 The IASB decided to confirm the ability of an entity to rebut the presumption if the entity has reasonable and supportable information to support a more lagging past due measure. The IASB acknowledged that 30 days past due might not be an appropriate indicator for all types of products or jurisdictions. However, it noted that to be able to rebut the presumption, an entity would need reasonable and supportable information that indicates that the credit risk has not increased significantly. Furthermore, an entity is not required to rebut the presumption on an instrument-by-instrument basis but can rebut it if the entity has information that indicates that, for a particular product, region or customer type, more than 30 days past due is not representative of the point at which credit risk increases significantly. The IASB noted that if significant increases in credit risk were identified before a financial asset(s) was 30 days past due, the presumption does not need to be rebutted.

Recognition of 12-month expected credit losses

BC5.195 During the development of the 2013 Impairment Exposure Draft, the IASB considered what measure of expected credit losses would be both appropriate and cost-effective for financial instruments before significant increases in credit risk have occurred. The IASB accepted the concerns of interested parties about the operational complexity of the methods proposed in the 2009 Impairment Exposure Draft and the Supplementary Document. The IASB also accepted that significant judgement would be required for any estimation technique that an entity might use. Consequently, the IASB decided that an entity should measure the loss allowance at an amount equal to 12-month expected credit losses. In the IASB's view, the overall result of such a measurement, combined with the earlier recognition of the full lifetime expected credit losses compared to IAS 39, achieves an appropriate balance between the benefits of a faithful representation of expected credit losses and the operational costs and complexity. The IASB acknowledged that this is an operational simplification, and that cost-benefit is the only conceptual justification for the 12-month time horizon.

BC5.196 The majority of respondents to the 2013 Impairment Exposure Draft supported the IASB's reasoning, noting that the recognition of 12-month expected credit losses is a pragmatic solution to achieve an appropriate

balance between faithfully representing the underlying economics of a transaction and the cost of implementation. Furthermore, it would allow preparers to make use of existing reporting systems that some regulated financial institutions already apply and would therefore be less costly to implement for those entities. In addition, users of financial statements considered 12 months a reliable period to estimate expected credit losses for financial instruments that have not significantly increased in credit risk.

BC5.197 However, some respondents proposed alternative measures for the loss allowance on financial instruments for which there were no significant increases in credit risk since initial recognition. These alternatives and the IASB's reasons for rejecting them are discussed in paragraphs BC5.200–BC5.209.

BC5.198 In finalising the Standard, the IASB acknowledged that the recognition of 12-month expected credit losses would result in an overstatement of expected credit losses for financial instruments, and a resulting understatement of the value of any related financial asset, immediately after initial recognition of those financial instruments. In particular, the initial carrying amount of financial assets would be below their fair value. However, isolating initial credit loss expectations for recognition over the life of financial instruments is operationally complex. Furthermore, this measurement of expected credit losses serves as a practical approximation of the adjustment of the effective interest rate for credit risk as required by the 2009 Impairment Exposure Draft. The recognition of a portion of expected credit losses for financial instruments for which there have not been significant increases in credit risk also limits the requirement to perform the more costly and complex calculation of the lifetime expected credit losses. In addition, in the IASB's view, measuring 12-month expected credit losses for some financial instruments would be less costly than always calculating the lifetime expected credit losses as proposed in the Supplementary Document.

BC5.199 The IASB decided to retain the recognition of 12-month expected credit losses for the measurement and allocation of initial expected credit losses, which was necessary as a result of the decision to decouple the measurement and allocation of initial expected credit losses from the determination of the effective interest rate as proposed in the 2009 Impairment Exposure Draft. The IASB considered such a measure of expected credit losses to be superior to the alternatives discussed below.

Approaches to recognition of 12-month expected credit losses considered and rejected

No allowance for instruments without a significant increase in credit risk

BC5.200 Some respondents did not agree with recognising any expected credit loss allowance for financial instruments that have not experienced significant increases in credit risk since initial recognition. These respondents considered initial expectations of credit losses to be included in the pricing of a financial instrument and they were conceptually opposed to the recognition of a loss allowance on initial recognition.

BC5.201 The IASB acknowledged that not recognising an allowance balance for financial instruments for which credit risk has not increased significantly would be consistent with the requirement in paragraph 5.1.1 of IFRS 9 that a financial asset should be recognised at fair value on initial recognition. However, only recognising lifetime expected credit losses when there have been significant increases in credit risk, without recognising any expected credit losses before that to reflect the changes in initial expectations of credit risk since initial recognition, would fail to appropriately reflect the economic losses experienced as a result of those (non-significant) changes. Expected credit losses are implicit in the initial pricing for the instrument, but subsequent changes in those expectations represent economic losses (or gains) in the period in which they occur. Not reflecting changes in credit risk before the change is considered significant would therefore fail to recognise those economic losses (or gains).

BC5.202 The IASB noted that not recognising any expected credit losses before there have been significant increases in credit risk would not be consistent with preserving, to as great an extent as possible, the objective of the 2009 Impairment Exposure Draft (see paragraphs BC5.87–B5.88). In the view of the IASB, this approach would fail to appropriately reflect the economic effects of over-recognition of interest revenue prior to losses being recognised and would also fail to recognise economic losses experienced as a result of non-significant changes in credit risk or significant increases not yet identified.

Recognise a portion of lifetime expected credit losses larger than 12-month expected credit losses

BC5.203 The IASB considered whether an entity should recognise a portion of lifetime expected credit losses that is greater than 12-month expected credit losses before there are significant increases in credit risk. However, it rejected requiring a larger portion of expected credit losses to be recognised because:

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(a) as noted in paragraph BC5.198, the IASB acknowledges that the 12-month measure is a practical concession that initially overstates expected credit losses before there are significant increases in credit risk. Recognising a greater portion would further increase the overstatement of expected credit losses and, thus, when considered with the much earlier timing of the recognition of lifetime expected credit losses, would be a less faithful representation of the underlying economics.

(b) 12-month expected credit losses would allow preparers to make use of existing reporting systems that some regulated financial institutions already apply and would therefore be less costly to implement for those entities.

Recognise expected credit losses for the loss emergence period

BC5.204 This alternative would require entities to consider all reasonable and supportable information available, including historical information, in order to determine the average period of time over which meaningful increases in credit risk are expected to occur.

BC5.205 The IASB acknowledged that different asset classes have different loss patterns and different loss emergence periods. Consequently, estimating expected credit losses over the relevant period of time it takes for an event to happen and for the effects to be known, may have conceptual merit. However, the IASB noted that 'emergence' notions fit more naturally in an incurred loss model in which it is difficult to identify when a loss has been incurred on individual instruments.

BC5.206 The IASB also noted that emergence periods may change over the life of financial instruments and depend on the economic cycle. As a result, the IASB considered that this approach would be more operationally difficult than one that has a defined period, because an entity would have to continually assess that it was using the appropriate emergence period.

Recognise expected credit losses for the foreseeable future

BC5.207 The Supplementary Document proposed that the loss allowance for financial assets in the good book should be calculated as the greater of the time-proportionate amount and expected credit losses for the foreseeable future (see paragraphs BC5.96–BC5.101).

BC5.208 The feedback received about the foreseeable future floor for the good book was geographically split, with respondents outside the US generally opposing it. Furthermore, respondents expressed concerns about the calculation of expected credit losses for the foreseeable future, with many expressing confusion about the underlying conceptual basis for such a limitation to the time period. Many also noted that, despite the conceptual concerns, the term 'foreseeable future' was not sufficiently defined to ensure consistent application.

BC5.209 In response to the concerns raised about the foreseeable future, the IASB rejected the approach. To address these concerns about the ambiguity of the foreseeable future definition in the Supplementary Document, the IASB decided to define the measurement objective for financial instruments for which credit risk has not increased significantly as 12-month expected credit losses. The IASB did not receive any new information that caused it to change its view.

Symmetry

BC5.210 The IASB's view is that an entity should recognise favourable changes in credit risk consistently with unfavourable changes in credit risk (ie the model should be 'symmetrical'), but only to the extent that those favourable changes represent a reversal of risk that was previously recognised as unfavourable changes. In accordance with the general model, if the credit risk on financial instruments, for which lifetime expected credit losses have been recognised, subsequently improves so that the requirement for recognising lifetime expected credit losses is no longer met, the loss allowance should be measured at an amount equal to 12-month expected credit losses with a resulting gain recognised in profit or loss. Doing so would reflect the fact that the expectations of credit losses have moved back towards the initial expectations. For purchased or originated credit-impaired financial assets (to which the general model does not apply (see paragraph BC5.214–BC5.220), an entity would recognise a gain if credit risk improves after initial recognition, reflecting an increase in the expected cash flows.

BC5.211 To address concerns about potential earnings management, the IASB considered requiring a change back to a loss allowance measured at an amount equal to 12-month expected credit losses to be based on stricter criteria than is required for the recognition of lifetime expected credit losses. The IASB rejected such a requirement because it reduces the usefulness, neutrality and faithful representation of expected credit losses,

and anti-abuse considerations should not override that. The IASB also noted that such arbitrary distinctions can have unintended consequences, such as creating a disincentive to recognise lifetime expected credit losses, because of the higher hurdle to change back to the recognition of 12-month expected credit losses.

BC5.212 As a result of this, the 2013 Impairment Exposure Draft proposed that the model should be symmetrical with lifetime expected credit losses being recognised, and ceasing to be recognised, depending on whether the credit risk at the reporting date has increased significantly since initial recognition. Nearly all respondents to the 2013 Impairment Exposure Draft agreed that the approach should be symmetrical. In doing so, they noted that this would be consistent with the objective of a model based on changes in credit risk and would faithfully represent the underlying economics.

BC5.213 Consequently, the IASB confirmed its reasoning in the 2013 Impairment Exposure Draft and confirmed that a loss allowance measured at an amount equal to 12-month expected credit losses shall be re-established for financial instruments for which the criteria for the recognition of lifetime expected credit losses are no longer met.

Purchased or originated credit-impaired financial assets

BC5.214 The 2013 Impairment Exposure Draft proposed to carry forward the scope and requirements in paragraph AG5 of IAS 39. That paragraph required an entity to include the initial expected credit losses in the estimated cash flows when calculating the effective interest rate for financial assets that are credit-impaired on initial recognition. In addition, it was proposed that an entity calculate interest revenue from financial assets subject to this measurement requirement by applying the credit-adjusted effective interest rate to the amortised cost of the financial asset (adjusted for any loss allowance).

BC5.215 Some users of financial statements expressed a preference for a single impairment model for all financial assets to ensure comparability. However, in the IASB's view, applying the general approach to purchased or originated credit-impaired financial assets would not achieve the desired comparability. This is because, in the IASB's view, the model proposed in the 2009 Impairment Exposure Draft more faithfully represents the underlying economics for these financial assets than the general approach proposed in the 2013 Impairment Exposure Draft, and the benefits of this better representation outweigh the costs for these financial assets.

BC5.216 The IASB noted that, while the scope of the requirements for financial assets that are credit-impaired at initial recognition usually relates to purchased financial assets, in unusual circumstances financial assets could be originated that would be within this scope. However, this does not mean that all financial assets originated at a high credit risk are within the scope—the financial assets have to be credit-impaired on initial recognition. In confirming that a financial asset could be credit-impaired on origination the IASB focussed on the potential for the modification of contractual cash flows to result in derecognition. The IASB considered an example in which a substantial modification of a distressed asset resulted in derecognition of the original financial asset. Such a case is an example of the rare situation in which a newly originated financial asset may be credit-impaired—it would be possible for the modification to constitute objective evidence that the new asset is credit-impaired at initial recognition.

BC5.217 Consistent with the 2009 Impairment Exposure Draft, for these financial assets, the 2013 Impairment Exposure Draft considered the initial credit loss expectations to be part of the effective interest rate and thus interest revenue will represent the effective yield on the asset. An entity will recognise changes in the initial expected credit losses as gains or losses. Paragraph BC5.89 sets out the operational challenges that would have arisen if the 2009 Impairment Exposure Draft had applied to all financial assets. However, in developing the proposals in the 2013 Impairment Exposure Draft, the IASB observed that this requirement in IAS 39 has not presented issues in practice and proposed to retain it, and to use a scope that is based on IAS 39 to minimise the operational challenges for preparers.

BC5.218 Respondents to the 2013 Impairment Exposure Draft almost unanimously supported the proposals for purchased or originated credit-impaired financial assets. These respondents noted that the proposals were the conceptually correct outcome, similar to the 2009 Impairment Exposure Draft, and appropriately reflect the economics of the transaction and management's objective when acquiring or originating such assets. Respondents additionally noted that the proposals were operable because they are consistent with the existing accounting treatment in accordance with IAS 39.

BC5.219 However, some respondents preferred a gross-up approach, whereby an allowance is recognised for initial expected credit losses and is used to gross-up the carrying amount of the purchased or originated credit-impaired financial asset. These respondents considered that it would be operationally simpler to have a gross presentation of expected credit losses for all financial assets, and comparability would be improved if there was an allowance balance for purchased or originated credit-impaired financial assets like there is for other financial assets.

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BC5.220 The IASB noted in response that even if the loss allowance balance was calculated for purchased or originated credit-impaired financial assets at initial recognition, the carrying amounts would not be comparable. Purchased or originated credit-impaired assets are initially recognised at fair value and would be grossed-up for the loss allowance balance, resulting in a carrying amount above fair value. In contrast, other assets within the scope of IFRS 9 are carried net of the loss allowance, and so would be grossed-up to fair value. The IASB therefore rejected these arguments. Consequently, the IASB decided to confirm the proposals in the 2013 Impairment Exposure Draft.

Simplified approach for trade receivables, contract assets and lease receivables

BC5.221 The 2013 Impairment Exposure Draft proposed that trade receivables that do not have a significant financing component in accordance with IFRS 15 should be accounted for as follows:

(a) an entity would be required to measure the trade receivable at initial recognition at the transaction price as defined in IFRS 15 (ie the invoiced amount in many cases); and

(b) an entity would be required to recognise a loss allowance for lifetime expected credit losses on those trade receivables throughout their life.

BC5.222 Most respondents to the 2013 Impairment Exposure Draft supported the approach proposed for trade receivables without a significant financing component. Respondents noted that most trade receivables without a significant financing component would have a maturity that is less than one year, so the lifetime expected credit losses and the 12-month expected credit losses would be the same, or very similar. In addition, respondents supported the recognition of these trade receivables at transaction price, because it aligns the requirements in IFRS 9 with revenue recognition requirements and results in the amortised cost of these receivables at initial recognition being closer to fair value.

BC5.223 Respondents indicated that they would not have significant operational difficulty in applying an impairment model based on expected credit losses to their trade receivables without a significant financing component. While these participants acknowledge that such an impairment model would require a change in practice, they believe that they can incorporate forward-looking information within their current methodologies. In addition, the outreach participants noted that the IASB had made the application of the impairment model to current trade receivables (ie those that are not past due) more operational without the loss of useful information.

BC5.224 The IASB therefore decided to retain the proposed approach for trade receivables without a significant financing component.

BC5.225 In the 2013 Impairment Exposure Draft, the IASB noted that, in its view, a provision matrix can be an acceptable method to measure expected credit losses for trade receivables in accordance with the objectives for the measurement of expected credit losses in IFRS 9. An entity would adjust historical provision rates, which are an average of historical outcomes, to reflect relevant information about current conditions as well as reasonable and supportable forecasts and their implications for expected credit losses, including the time value of money. Such a technique would be consistent with the measurement objective of expected credit losses as set out in IFRS 9. The 2013 Impairment Exposure Draft therefore proposed that entities would have a choice of an accounting policy both for trade receivables that have a significant financing component in accordance with IFRS 15 and separately for lease receivables in accordance with IAS 17. Those accounting policy choices would allow entities to decide between fully applying the proposed model or recognising a loss allowance for lifetime expected credit losses from initial recognition until derecognition (the simplified approach). The IASB noted that allowing this option for trade receivables and lease receivables would reduce comparability. However, the IASB believed it would alleviate some of the practical concerns of tracking changes in credit risk for entities that do not have sophisticated credit risk management systems.

BC5.226 The IASB noted that feedback on the 2013 Impairment Exposure Draft indicated that many respondents agreed that the operational relief was of greater weight than concerns about comparability, and supported the simplified approach as an accounting policy choice. In addition, the IASB noted that removing the accounting policy choice would require either removing the simplified approach or making it mandatory, neither of which the IASB considered appropriate. In the IASB's view, the benefits of achieving comparability do not outweigh the costs to implement the full model in this case. The IASB therefore decided to confirm these proposals in IFRS 9. As noted in paragraph BC5.134, the IASB decided that the impairment requirements in IFRS 9 should also apply to contract assets that are recognised and measured in accordance with IFRS 15. Because the nature of contract assets and the exposure to credit risk is similar to trade receivables, the IASB decided that an entity should have the same accounting policy choice as for trade receivables with a significant financing component and for lease receivables.

Modifications of contractual cash flows

BC5.227 Some modifications of contractual cash flows result in the derecognition of a financial instrument and the recognition of a new financial instrument in accordance with IFRS 9. However, modifications frequently do not result in the derecognition of a financial instrument. The IASB considered how the proposed model will apply to these financial instruments with modified contractual cash flows.

BC5.228 In the 2013 Impairment Exposure Draft the IASB proposed that, when an entity is assessing whether it should recognise a loss allowance at an amount equal to 12-month expected credit losses or lifetime expected credit losses, it should compare the credit risk of the modified financial instrument at the reporting date to the credit risk of the (unmodified) financial instrument at initial recognition when the modification has not resulted in derecognition. The simplification for financial instruments with low credit risk would also apply to modified financial instruments.

BC5.229 This decision reflected the fact that financial instruments that are modified but not derecognised are not new financial instruments from an accounting perspective and, as a result, the amortised cost measurement would keep the same original effective interest rate. Consequently, the impairment model should apply as it does for other financial instruments, reflecting the changes in credit risk since initial recognition.

BC5.230 The IASB further noted that when the modification of a financial asset results in the derecognition of the asset and the subsequent recognition of the modified financial asset, the modified asset is considered a 'new' asset from an accounting perspective. The IASB observed that entities should consider whether a modified financial asset is originated credit-impaired at initial recognition (see paragraphs BC5.214–BC5.220). If not, subsequent recognition of a loss allowance would be determined in accordance with the requirements in Section 5.5 of IFRS 9.

BC5.231 The IASB also proposed in the 2013 Impairment Exposure Draft that the modification requirements should apply to all modifications or renegotiations of the contractual cash flows of financial instruments. Although most respondents supported the proposals, some noted that they would have preferred that the requirements be limited to modifications of credit-impaired assets or modifications undertaken for credit risk management purposes. These respondents believed that the proposed requirements do not represent the economics of modifications performed for commercial or other reasons that are unrelated to credit risk management.

BC5.232 However, the IASB has previously considered the difficulty of identifying the reason for modifications and renegotiations. Before May 2010, IFRS 7 required the disclosure of the carrying amount of financial assets that would otherwise be past due or credit-impaired but whose terms have been renegotiated. The IASB received feedback from constituents that it is operationally difficult to determine the purpose of modifications (ie whether they are performed for commercial or credit risk management reasons). The IASB noted in paragraph BC54A of IFRS 7 the difficulty in identifying financial assets whose terms have been renegotiated for reasons other than credit reasons, especially when commercial terms of loans are often renegotiated regularly for reasons that are not related to impairment. This led the IASB to remove this requirement from IFRS 7.

BC5.233 The IASB further noted that these requirements were consistent with the previous requirements in paragraph AG8 of IAS 39, which did not differentiate between modifications based on the reason for the modification. Paragraph AG8 applied to all revisions of estimates of payments or receipts. This is because amortised cost is a measurement method whereby the carrying amount equates to the present value of the estimated future cash payments or receipts discounted at the effective interest rate. Consequently, the amortised cost amount should be updated in all cases in which those cash flows are modified (or expectations change other than in respect of impairment changes).[38]

BC5.234 The IASB also noted that even if the intention of a modification could be clearly identified to be for commercial purposes, any change in the contractual terms of a financial instrument will have a consequential effect on the credit risk of the financial instrument since initial recognition and will affect the measurement of the loss allowance. Furthermore, the difficulty involved in discerning the purpose of modifications, and to what extent a modification is related to credit risk reasons, could create opportunities for manipulation. This could happen if entities were able to select a 'preferred' treatment for modifications simply because of the purpose of the modification. Limiting the scope of the modification requirements in Section 5.5 of IFRS 9 to those undertaken for credit reasons could therefore result in different accounting treatments for the same economic event.

BC5.235 Consequently, the IASB decided to confirm the proposals in the 2013 Impairment Exposure Draft that the modification requirements should apply to all modifications or renegotiations of the contractual terms of financial instruments.

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[38] In 2017 the IASB discussed the accounting for a modification or exchange of a financial liability measured at amortised cost that does not result in derecognition of the financial liability. See paragraphs BC4.252–BC4.253.

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Assessment of significant increases in credit risk

BC5.236 The IASB considered whether an entity should assess the increase in credit risk by comparing it to the credit risk at the point of modification. However, the IASB noted that if the original financial instrument has not been derecognised, the modified financial instrument is not a new financial instrument. The IASB also noted that by using such an approach the financial instrument would, by definition, not have experienced an increase in credit risk that is more than insignificant since modification. As a result, if the IASB took this approach, an entity would recognise 12-month expected credit losses for every modified financial instrument at the point of modification.

BC5.237 Thus, the IASB decided that an entity should compare the credit risk at the reporting date with the credit risk as at initial recognition of the unmodified financial instrument in a manner that is consistent with that applied to all other financial instruments. An entity should base the risk of default occurring after a modification on the ability to meet the modified contractual cash flows. This should include an assessment of historical and forward-looking information and an assessment of the credit risk over the remaining life of the instrument, which should include the circumstances that led to the modification. Consequently, the credit risk on a financial asset will not necessarily decrease merely because of a modification.

Symmetry

BC5.238 The IASB observed that it is not unusual for distressed financial instruments to be modified more than once and, therefore, the assessment of whether lifetime expected credit losses should continue to be recognised after modification may be perceived to be based on projections that are optimistic. The IASB considered prohibiting modified financial instruments that continue to be recognised reverting to a loss allowance at an amount equal to 12-month expected credit losses or alternatively proposing more restrictive criteria than usual before allowing 12-month expected credit losses to be re-established.

BC5.239 The IASB concluded that the expected credit loss requirements should allow the loss allowance on such modified financial instruments to revert to being measured at an amount equal to 12-month expected credit losses when they no longer meet the requirements for the recognition of lifetime expected credit losses, consistent with the treatment of unmodified financial instruments. In the IASB's view, this faithfully represents the economics of the transaction and it should not override that faithful representation for anti-abuse purposes. In addition, the IASB observed that entities also modify financial instruments for reasons other than increases in credit risk and, therefore, it would be difficult from an operational standpoint to prescribe asymmetrical guidance only for financial assets that have been modified because of credit risk factors (see paragraphs BC5.227–BC5.235).

Adjustment of gross carrying amount

BC5.240 As explained in more detail in paragraphs BC5.102–BC5.108, IFRS 9 requires a decoupled approach to interest revenue and recognition of expected credit losses for financial assets. In accordance with a decoupled approach, an entity would calculate the interest revenue by multiplying the effective interest rate by the gross carrying amount (ie the amount that does not include an adjustment for the loss allowance). As a result, not adjusting the carrying amount upon a modification would result in inflating interest revenue and the loss allowance.

BC5.241 Consequently, the IASB decided that an entity should adjust the gross carrying amount of a financial asset if it modifies the contractual cash flows and recognise modification gains or losses in profit or loss. For example, if credit losses are crystallised by a modification, an entity should recognise a reduction in the gross carrying amount. There may be situations in which adjusting the gross carrying amount result in the recognition of a gain. Except for purchased or originated credit-impaired financial assets, the new gross carrying amount will represent the future contractual cash flows discounted at the original effective interest rate.

Measurement of expected credit losses

BC5.242 The 2013 Impairment Exposure Draft and 2009 Impairment Exposure Draft proposed to define expected credit losses as the expected present value of all cash shortfalls over the remaining life of the financial instrument. The IASB decided to retain the emphasis on the objective of the measurement of expected credit losses, and to keep the requirements principle-based instead of specifying techniques to measure expected credit losses. Respondents have commented that adopting such a principle-based approach would help reduce complexity and mitigate operational challenges by allowing an entity to use techniques that work best in its specific circumstances.

Loan commitments and financial guarantee contracts

BC5.243 The 2013 Impairment Exposure Draft proposed that an entity should recognise expected credit losses that result from loan commitments and financial guarantee contracts when there is a present contractual obligation to extend credit. The IASB believe that expected credit losses of obligations to extend credit (off balance sheet exposures) are similar to those of loans and other on balance sheet exposures. The only difference is that, in the latter case, the borrower has already drawn down the loan whereas in the former case it has not. The recognition of a liability for expected credit losses was limited to loan commitments and financial guarantee contracts with a present contractual obligation to extend credit. Without a present contractual obligation to extend credit, an entity may withdraw its loan commitment before it extends credit. Consequently, the IASB concluded that a liability does not exist for loan commitments or financial guarantee contracts when there is no present contractual obligation to extend credit.

BC5.244 The 2013 Impairment Exposure Draft proposed that the impairment requirements should apply to these financial instruments in the same way as for other financial instruments, including the assessment of the increase in credit risk to decide whether it should recognise 12-month or lifetime expected credit losses. When measuring expected credit losses of loan commitments and financial guarantee contracts, additional uncertainty arises in respect of one of the input factors: the exposure at default. To measure the exposure at default of the loan commitments, the issuer needs to estimate the amount that a borrower will have drawn down at the time of default. That is, the issuer needs to estimate the part of the undrawn facility that the borrower will convert into a funded amount, typically referred to as a credit conversion factor or a utilisation rate. Some financial institutions are required to make similar assessments for regulatory capital purposes.

BC5.245 Respondents to the Supplementary Document, and participants in the IASB's outreach that preceded the publication of the 2013 Impairment Exposure Draft, noted that estimating future drawdowns over the lifetime of the financial instrument will introduce additional complexities. These additional complexities arise because of the uncertainty involved in estimating the behaviour of customers over a longer period. Interested parties were concerned that the requirements would hold entities to a standard of accuracy that they would not be able to meet.

BC5.246 The IASB considered and rejected the following alternatives that were suggested for measuring future drawdowns:

(a) limiting the estimate of future drawdowns to the next 12 months. While it would be less complex to use an estimate over a 12-month time period, such a limit would be arbitrary and inconsistent with estimating lifetime expected credit losses.

(b) estimating future drawdowns based only on historical information. While it would be less complex to limit the estimate to historical information, it would be inconsistent with the objective of an impairment model based on expected credit losses. Historical utilisation rates might be a good indicator for future drawdowns, but an entity would also need to consider the need to make adjustments for current and future expectations when estimating expected credit losses.

(c) using the credit conversion factor provided by prudential regulators. Regulators typically provide credit conversion factors over a 12-month period. Generally, they are not forward-looking, and are specific to product types or particular to the entity. Similarly as for the issues mentioned in (a)–(b), applying such a standardised parameter when estimating expected credit losses is inconsistent with the general approach. It also would also not address the issue for entities that are not subject to such regulations.

BC5.247 The IASB acknowledged the complexity involved in estimating future drawdowns over the life of financial instruments. Nevertheless, this estimate is necessary to have a consistent application of the impairment model. The IASB considered that not having it would defeat the purpose of removing the inconsistency between on balance sheet and off balance sheet exposures. Consequently, the IASB decided that for financial instruments that include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period, an entity shall estimate the usage behaviour over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period (see paragraphs BC5.254—BC5.261).

Definition of default

BC5.248 The 2013 Impairment Exposure Draft did not define default. Instead, it proposed allowing entities to use different definitions of default including, when applicable, regulatory definitions of default. In making this decision, the IASB observed that expected credit losses are not expected to change as a result of differences

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in the definition of default that was applied, because of the counterbalancing interaction between the way an entity defines default and the credit losses that arise as a result of that definition of default.

BC5.249 Although the 2013 Impairment Exposure Draft did not ask a specific question on the definition of default, some respondents commented on the topic and most of those respondents recommended that default should be clearly described or defined. Those respondents noted that the notion of default is fundamental to the application of the model, particularly because it affects the population that is subject to the 12-month expected credit loss measure. Some of those respondents considered the term 'default event' to be ambiguous, and were unclear whether the notion of default should align more closely with indicators about significant increases in credit risk or with the indicators for credit-impaired financial assets. Those respondents also expressed concern that the absence of prescriptive guidance could result in inconsistent application. Regulators, in particular, were concerned about the delayed recognition of expected credit losses if default were interpreted solely as non-payment.

BC5.250 Other respondents supported the proposal not to define default, and noted that the point of default would be different for different instruments and across jurisdictions and legal systems. These respondents noted that any attempt to be more prescriptive or provide guidance would add confusion and could result in differing default definitions for credit risk management, regulatory and accounting purposes.

BC5.251 The IASB noted during its redeliberations on the 2013 Impairment Exposure Draft that default can be interpreted in various ways, ranging from broad judgemental definitions based on qualitative factors to narrower, non-judgemental definitions focusing only on non-payment. The appropriate definition also depends on the nature of the financial instrument in question. One of the objectives of the 2013 Impairment Exposure Draft was to allow entities to leverage existing credit risk management systems. Because of the various interpretations of default, the IASB was concerned that defining it could result in a definition for financial reporting that is inconsistent with that applied internally for credit risk management. That could result in the impairment model being applied in a way that does not provide useful information about actual credit risk management.

BC5.252 Consequently, the IASB decided not to specifically define default in IFRS 9. However, to address the feedback received and noting in particular the effect on the financial instruments captured within the scope of the 12-month expected credit losses, the IASB decided to include a rebuttable presumption that default does not occur later than 90 days past due unless an entity has reasonable and supportable information to support a more lagging default criterion. The IASB also decided to emphasise that an entity should consider qualitative indicators of default when appropriate (for example, for financial instruments that include covenants that can lead to events of default) and clarify that an entity should apply a default definition that is consistent with its credit risk management practices for the relevant financial instruments, consistently from one period to another. The IASB noted that an entity may have multiple definitions of default, for example, for different types of products.

BC5.253 The IASB noted that this rebuttable presumption serves as a 'backstop' to ensure a more consistent population of financial instruments for which significant increases in credit risk is determined when applying the model. It was also noted that the purpose of the rebuttable presumption is not to delay the default event until a financial asset becomes 90 days past due, but to ensure that entities will not define default later than that point without reasonable and supportable information to substantiate the assertion (for example, financial instruments that include covenants that can lead to events of default). The IASB acknowledges that defining the backstop as 90 days past due is arbitrary, but it considered that any number of days would be arbitrary and that 90 days past due best aligned with current practice and regulatory requirements in many jurisdictions.

Period over which to estimate expected credit losses

BC5.254 Respondents to the 2013 Impairment Exposure Draft widely supported the proposed requirements for loan commitments and financial guarantee contracts in general, and no new arguments were raised that the IASB considered would call into question its prior analysis. However, the majority of respondents that supported including loan commitments within the scope of the proposed model noted that expected credit losses on some loan commitments should be estimated over the behavioural life of the financial instrument, instead of over the contractual commitment period. Although they noted that the use of the contractual period would be conceptually appropriate, there was concern that using the contractual period:

(a) would be contrary to how the exposures are handled for credit risk management and regulatory purposes;

(b) could result in insufficient allowances for the exposures arising from these contracts; and

(c) would result in outcomes for which no actual loss experience exists on which to base the estimates.

BC5.255 Respondents noted that the use of the contractual period was of particular concern for some types of loan commitments that are managed on a collective basis, and for which an entity usually has no practical ability to withdraw the commitment before a loss event occurs and to limit the exposure to credit losses to the contractual period over which it is committed to extend the credit. Respondents noted that this applies particularly to revolving credit facilities such as credit cards and overdraft facilities. For these types of facilities, estimating the expected credit losses over the behavioural life of the instruments was viewed as more faithfully representing their exposure to credit risk.

BC5.256 Respondents also noted that those revolving credit facilities lack a fixed term or repayment structure and allow borrowers flexibility in how frequently they make drawdowns on the facility. Such facilities can be viewed as a combination of an undrawn loan commitment and a drawn-down loan asset. Typically, these facilities can be contractually cancelled by a lender with little or no notice, requiring repayment of any drawn balance and cancellation of any undrawn commitment under the facility. There would be no need on a conceptual basis to recognise expected credit losses on the undrawn portion of these facilities, because the exposure period could be as little as one day under the proposals in the 2013 Impairment Exposure Draft.

BC5.257 Outreach performed during the comment period on the 2013 Impairment Exposure Draft indicated that, in practice, lenders generally continue to extend credit under these types of financial instruments for a duration longer than the contractual minimum and only withdraw the facility if observable credit risk on the facility has increased significantly. The IASB noted that, for such facilities, the contractual maturities are often set for protective reasons and are not actively enforced as part of the normal credit risk management processes. Participants also noted that it may be difficult to withdraw undrawn commitments on these facilities for commercial reasons unless there has been an increase in credit risk. Consequently, economically, the contractual ability to demand repayment and cancel the undrawn commitment does not necessarily prevent an entity from being exposed to credit losses beyond the contractual notice period.

BC5.258 The IASB noted that the expected credit losses on these type of facilities can be significant and that restricting the recognition of a loss allowance to expected credit losses in the contractual notice period would arguably be inconsistent with the notion of expected credit losses (ie it would not reflect actual expectations of loss) and would not reflect the underlying economics or the way in which those facilities are managed for credit risk purposes. The IASB also noted that the amount of expected credit losses for these facilities could be significantly lower if the exposure is restricted to the contractual period, which may be inconsistent with an economic assessment of that exposure.

BC5.259 The IASB further noted that from a credit risk management perspective, the concept of expected credit losses is as relevant to off balance sheet exposures as it is to on balance sheet exposures. These types of financial instruments include both a loan (ie financial asset) and an undrawn commitment (ie loan commitment) component and are managed, and expected credit losses are estimated, on a facility level. In other words there is only one set of cash flows from the borrower that relates to both components. Expected credit losses on the on balance sheet exposure (the financial asset) are not estimated separately from the expected credit losses on the off balance sheet exposure (the loan commitment). Consequently, the period over which the expected credit losses are estimated should reflect the period over which the entity is expected to be exposed to the credit risk on the instrument as a whole.

BC5.260 The IASB remains of the view that the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) is the correct conceptual outcome. The IASB noted that most loan commitments will expire at a specified date, and if an entity decides to renew or extend its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions. Consequently, the IASB decided to confirm that the maximum period over which expected credit losses for loan commitments and financial guarantee contracts are estimated is the contractual period over which the entity is committed to provide credit.

BC5.261 However, to address the concerns raised about the financial instruments noted in paragraphs BC5.254–BC5.257, the IASB decided that for financial instruments that include both a loan and an undrawn commitment component and the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period, an entity shall estimate expected credit losses over the period that the entity is expected to be exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period. When determining the period over which the entity is exposed to credit risk on the financial instrument, the entity should consider factors such as relevant historical information and experience on similar financial instruments. The measurement of expected credit losses should take into account credit risk management actions that are taken once an exposure has increased in credit risk, such as the reduction or withdrawal of undrawn limits.

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Probability-weighted outcome

BC5.262 The requirement in paragraph 5.5.17 of IFRS 9 states that the estimates of cash flows are expected values. Hence, estimates of the amounts and timing of cash flows are based on probability-weighted possible outcomes.

BC5.263 The term 'expected' as used in the terms 'expected credit losses', 'expected value' and 'expected cash flow' is a technical term that refers to the probability-weighted mean of a distribution and should not be confused with a most likely outcome or an entity's best estimate of the ultimate outcome.

BC5.264 In the IASB's view, an expected value measurement is the most relevant measurement basis because it provides information about the timing, amounts and uncertainty of an entity's future cash flows. This is because an expected value measurement would:

(a) include consideration of expected credit losses using all the available evidence, including forward-looking information. Thus, an entity will be required to consider multiple scenarios and possible outcomes and their probability of occurrence.

(b) reflect that the pricing of financial instruments includes the consideration of expected credit losses. Although entities might not attribute specific credit loss estimates to individual financial instruments, and although competitive pressures might influence pricing, entities still consider credit loss expectations for the credit risk of similar obligors when pricing loans on origination and purchase.

(c) not revert (at any time) to an incurred credit loss model—all financial instruments have risk of a default occurring and the measurement will therefore reflect that risk of default and not the most likely outcome.

(d) have the same objective regardless of whether an entity performs the measurement at an individual or a portfolio level. Consequently, there is no need to specify specific conditions or criteria for grouping financial instruments for the purposes of measurement.

(e) provide useful information to users of financial statements (ie information about the risk that the investment might not perform).

BC5.265 The IASB observed that an entity can use a variety of techniques to meet the objective of an expected value without requiring detailed statistical models. The calculation of an expected value need not be a rigorous mathematical exercise whereby an entity identifies every single possible outcome and its probability. Instead, when there are many possible outcomes, an entity can use a representative sample of the complete distribution for determining the expected value. The main objective is that at least two outcomes are considered: the risk of a default and the risk of no default. Based on the feedback received and fieldwork performed, the IASB believes that many preparers are already performing calculations for internal purposes that would provide an appropriate measure of expected values.

BC5.266 The IASB also acknowledged that an entity may use various techniques to measure expected credit losses, including, for the 12-month expected credit losses measurement, techniques that do not include an explicit 12-month probability of default as an input, such as a loss rate methodology. The requirements in Section 5.5 of IFRS 9 do not list acceptable techniques or methods for measuring the loss allowance. The IASB was concerned that listing acceptable methods might rule out other appropriate methods for measuring expected credit losses, or be interpreted as providing unconditional acceptance of a particular method even when such a measurement would result in an amount that is not consistent with the required attributes of an expected credit loss measurement. Instead, Section 5.5 of IFRS 9 sets out the objectives for the measurement of expected credit losses, allowing entities to decide the most appropriate techniques to satisfy those objectives.

Time value of money

BC5.267 Consistent with the proposals in the Supplementary Document, the 2013 Impairment Exposure Draft proposed to allow an entity to discount expected credit losses using the risk-free rate, the effective interest rate on the related financial asset or any rate in between these two rates.

BC5.268 In developing the proposals in the Supplementary Document, the IASB noted that, conceptually, the discount rate for cash flows of an asset cannot be below the risk-free rate. The IASB further noted that the discount rate used in the 2009 Impairment Exposure Draft is conceptually appropriate for calculations of amortised cost. However, if the IASB were to propose that the upper limit should be the credit-adjusted effective interest rate from the 2009 Impairment Exposure Draft, entities would need to calculate that rate to decide whether they could use a rate that is more readily determinable. Therefore, such a proposal would not avoid the operational complexity of determining that credit-adjusted effective interest rate, which would be counter-

productive. Thus, the IASB proposed that an entity should use any rate between the risk-free rate and the effective interest rate, not adjusted for credit risk, as the discount rate.

BC5.269 The IASB observed that some credit risk management systems discount expected cash flows to the date of default. The proposals would require an entity to discount expected credit losses to the reporting date.

BC5.270 Most respondents to the Supplementary Document supported flexibility in an entity choosing which discount rate it should apply. These respondents agreed that this flexibility was helpful for easing the operational challenges of determining and maintaining the discount rate. They also felt that it was appropriate to allow preparers to choose a rate that is suitable for the level of sophistication of their systems and their operational capability. Those who did not support permitting flexibility in determining the appropriate rate wanted to maintain comparability between entities.

BC5.271 The IASB confirmed these proposals in the 2013 Impairment Exposure Draft, but additionally proposed that an entity should disclose the discount rate it used and any significant assumptions that it made in determining that rate. This choice of discount rates did not apply to purchased or originated credit-impaired financial assets, on which the amortised cost measurement always uses the credit-adjusted effective interest rate.

BC5.272 Given the support previously expressed for the proposals in the Supplementary Document, the 2013 Impairment Exposure Draft did not specifically ask respondents to comment on the proposals relating to the discount rate when calculating expected credit losses. However, a number of respondents commented on the proposals, the majority of which disagreed with them. The reasons for their disagreement included that:

(a) using the effective interest rate would be consistent with the proposals for originated or purchased credit-impaired financial assets and financial assets that are credit-impaired at the reporting date (ie the rate used to recognise interest revenue should be the same as the rate used to discount expected credit losses);

(b) discounting cash flows using a risk-free rate disregards any compensation that the entity receives to compensate it for credit risk; and

(c) the permitted range of discount rates is too flexible and differences in the amount of the loss allowance due to different discount rates could be material.

BC5.273 Considering these views, the IASB noted that the advantages of using the effective interest rate to discount expected credit losses included:

(a) that the effective interest rate is the conceptually correct rate and is consistent with amortised cost measurement;

(b) it limits the range of rates that an entity can use when discounting cash shortfalls, thereby limiting the potential for manipulation;

(c) it enhances comparability between entities; and

(d) it avoids the adjustment that arises when financial assets become credit-impaired (interest revenue is required to be calculated on the carrying amount net of expected credit losses) if a rate other than the effective interest rate has been used up to that point.

BC5.274 The IASB acknowledged that, unlike the requirements of IAS 39, in which shortfalls on cash flows were only measured on a subset of financial instruments, the impairment requirements will result in expected credit losses being measured on all financial instruments in the scope of the requirements. Respondents have previously noted that they would have to integrate their credit risk management and accounting systems to improve the interaction between them if they have to discount cash shortfalls using the effective interest rate. However, the IASB noted that even in accordance with the requirements of IAS 39 to use the effective interest rate to discount expected cash flows, there are operational challenges with using the effective interest rate for open portfolios and that entities use approximations of the effective interest rate.

BC5.275 Consequently, on the basis of the feedback received and the advantages noted in paragraph BC5.273, the IASB decided to require the use of the effective interest rate (or an approximation of it) when discounting expected credit losses.

Loan commitments and financial guarantee contracts

BC5.276 The 2013 Impairment Exposure Draft proposed that because loan commitments and financial guarantee contracts are unfunded, the effective interest method and, hence, an effective interest rate, would not be applicable. This is because the IASB considered that those financial instruments by themselves, before they are drawn down, do not give rise to the notion of interest and that, instead, their cash flow profiles are akin to that of derivatives. The fact that interest revenue does not apply is reflected in the accounting for loan commitments and financial guarantee contracts within the scope of IFRS 9. For those loan commitments and

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financial guarantee contracts, revenue recognition of the related fee income does not use the effective interest method. Consequently, the IASB did not consider it appropriate to simply extend the requirements for the discount rate for measuring expected credit losses that arise from financial assets to the requirements for the discount rate for measuring expected credit losses that arise from loan commitments and financial guarantee contracts.

BC5.277 As a result, the IASB proposed in the 2013 Impairment Exposure Draft that the discount rate to be applied when discounting the expected credit losses that arise from a loan commitment or a financial guarantee contract would be the rate that reflects:

(a) current market assessments of the time value of money (ie a rate that does not provide consideration for credit risk such as a risk-free rate); and

(b) the risks that are specific to the cash flows, to the extent that the risks are taken into account by adjusting the discount rate instead of adjusting the cash flows that are being discounted.

BC5.278 Consistent with their feedback in paragraph BC5.272, respondents commented on the disconnect between the discount rate used for the financial asset component (the drawn balance) and the loan commitment component (the undrawn commitment). They noted that this was an unnecessary complication, because, in accordance with the proposals, the measurement of expected credit losses associated with the loan commitment would change when the facility is drawn, merely as a result of the difference in discount rate. Furthermore, respondents noted that for credit risk management purposes, a single discount rate is usually applied to these facilities as a whole. The loan commitment relates directly to the recognised financial asset for which the effective interest rate has already been determined. The effective interest rate applied to the financial asset therefore already reflects an assessment of the time value of money and the risks that are specific to the cash flows on the loan commitment. This rate could be considered to represent a reasonable approximation of the discount rate for loan commitments.

BC5.279 Consequently, the IASB agreed that the expected credit losses on loan commitments should be discounted using the same effective interest rate (or an approximation of it) that is used to discount the expected credit losses on the financial asset. However, for financial guarantee contracts and loan commitments for which the effective interest rate cannot be determined, the discount rate should be determined as proposed in the 2013 Impairment Exposure Draft.

Reasonable and supportable information

BC5.280 Consistent with the proposals in the 2013 Impairment Exposure Draft, the Supplementary Document and the 2009 Impairment Exposure Draft, the IASB specified that the information set required for measuring expected credit losses in accordance with Section 5.5 of IFRS 9 is the best information that is available without undue cost or effort, and that this includes reasonable and supportable forward-looking information.

BC5.281 In the IASB's view, historical information is an important foundation on which to measure expected credit losses. However, an entity should adjust the historical information using reasonable and supportable information that is available without undue cost or effort to reflect current observable data and forecasts of future conditions if such forecasts are different from past information. The IASB noted that an entity is not required to incorporate forecasts of future conditions over the entire remaining life of a financial instrument. Instead, paragraph B5.5.50 of IFRS 9 acknowledges the difficulty arising from estimating expected credit losses as the forecast horizon increases. In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of that information and when it was calculated compared to the reporting date, but it should not be assumed to be appropriate in all circumstances. The IASB notes that even if an unadjusted historical measure was not appropriate, it could still be used as a starting point from which adjustments are made to estimate expected credit losses on the basis of reasonable and supportable information that incorporates both current and forward-looking information.

Prudential information

BC5.282 Some respondents to the 2013 Impairment Exposure Draft asked the IASB to ensure that the requirements for measuring expected credit losses in accordance with Section 5.5 of IFRS 9 are aligned to the prudential capital frameworks. Certain prudential regulation and capital adequacy systems, such as the framework developed by the Basel Committee on Banking Supervision, already require financial institutions to calculate 12-month expected credit losses as part of their regulatory capital requirements. However, some of those systems only use credit loss experience based on historical events to set out 'provisioning' levels over the entire economic cycle ('through-the-cycle'). Furthermore, through-the-cycle approaches consider a range of possible economic outcomes instead of those that are actually expected at the reporting date. This would result in a

loss allowance that does not reflect the economic characteristics of the financial instruments at the reporting date.

BC5.283 The IASB notes that financial reporting, including estimates of expected credit losses, are based on information, circumstances and events at the reporting date. The IASB expects entities to be able to use some regulatory measures as a basis for the calculation of expected credit losses in accordance with the requirements in IFRS 9. However, these calculations may have to be adjusted to meet the measurement requirements in Section 5.5 of IFRS 9. Only information that is available without undue cost or effort and supportable at the reporting date should be considered. This may include information about current economic conditions as well as reasonable and supportable forecasts of future economic conditions, as long as the information is supportable and available without undue cost or effort when the estimates are made.

BC5.284 Some interested parties are also of the view that loss allowance balances should be used to provide a counter-cyclical effect by building up loss allowances in good times to be used in bad times. This would, however, mask the effect of changes in credit loss expectations.

BC5.285 Some users of financial statements would prefer a representation of credit losses with a conservative or prudential bias, arguing that such a representation would better meet the needs of regulators, who are responsible for maintaining financial stability, and investors. The IASB notes that the objective of the impairment requirements is to faithfully represent the economic reality of expected credit losses in relation to the carrying amount of a financial asset. The IASB does not include in this objective the recognition of a loss allowance that will sufficiently cover unexpected credit losses, because that is not the primary objective of general purpose financial reporting.

BC5.286 The impairment requirements in IFRS 9 are based on the information available at the reporting date and are designed to reflect economic reality, instead of adjusting the assumptions and inputs applied to achieve a counter-cyclical effect. For example, when credit risk improves, the measurement of the loss allowance will faithfully represent that change. This is consistent with the objective of general purpose financial statements.

Amendments for *Interest Rate Benchmark Reform—Phase 2* (August 2020)

Background

BC5.287 In 2014, the Financial Stability Board recommended the reform of specified major interest rate benchmarks such as interbank offered rates (IBORs). Since then, public authorities in many jurisdictions have taken steps to implement interest rate benchmark reform and have increasingly encouraged market participants to ensure timely progress towards the reform of interest rate benchmarks, including the replacement of interest rate benchmarks with alternative, nearly risk-free interest rates that are based, to a greater extent, on transaction data (alternative benchmark rates). The progress towards interest rate benchmark reform follows the general expectation that some major interest rate benchmarks will cease to be published by the end of 2021. The term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark as described in paragraph 6.8.2 of IFRS 9 (the reform).

BC5.288 In September 2019 the IASB amended IFRS 9, IAS 39 and IFRS 7, to address as a priority issues affecting financial reporting in the period before the reform of an interest rate benchmark, including the replacement of an interest rate benchmark with an alternative benchmark rate (Phase 1 amendments). The Phase 1 amendments provide temporary exceptions to specific hedge accounting requirements due to the uncertainty arising from the reform. Paragraphs BC6.546–BC6.603 discuss the background to the Phase 1 amendments.

BC5.289 After the issuance of the Phase 1 amendments, the IASB commenced its Phase 2 deliberations. In Phase 2 of its project on the reform, the IASB addressed issues that might affect financial reporting during the reform of an interest rate benchmark, including changes to contractual cash flows or hedging relationships arising from the replacement of an interest rate benchmark with an alternative benchmark rate (replacement issues).

BC5.290 The objective of Phase 2 is to assist entities in providing useful information to users of financial statements and to support preparers in applying IFRS Standards when changes are made to contractual cash flows or hedging relationships because of the transition to alternative benchmark rates. The IASB observed that for information about the effects of the transition to alternative benchmark rates to be useful, the information has to be relevant to users of financial statements and faithfully represent the economic effects of that transition on the entity. This objective assisted the IASB in assessing whether it should amend IFRS Standards or whether the requirements in IFRS Standards already provided an adequate basis to account for such effects.

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BC5.291 In April 2020 the IASB published the Exposure Draft *Interest Rate Benchmark Reform—Phase 2* (2020 Exposure Draft), which proposed amendments to specific requirements in IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 *Leases* to address replacement issues.

BC5.292 Almost all respondents to the 2020 Exposure Draft welcomed the IASB's decision to address replacement issues and agreed that the proposed amendments would achieve the objective of Phase 2. Many respondents highlighted the urgency of these amendments, especially in some jurisdictions that have progressed towards the reform or the replacement of interest rate benchmarks with alternative benchmark rates.

BC5.293 In August 2020 the IASB amended IFRS 9, IAS 39, IFRS 7, IFRS 4 and IFRS 16 by issuing *Interest Rate Benchmark Reform—Phase 2* (Phase 2 amendments). The Phase 2 amendments, which confirmed with modifications the proposals in the 2020 Exposure Draft, added paragraphs 5.4.5–5.4.9, 6.8.13, Section 6.9 and paragraphs 7.1.10 and 7.2.43–7.2.46 to IFRS 9.

Changes in the basis for determining the contractual cash flows of financial assets and financial liabilities arising from the reform

BC5.294 The IASB was informed that changes to financial assets or financial liabilities arising from the reform could be made in different ways. Specifically, entities may change the basis for determining the contractual cash flows of a financial instrument by:

(a) amending the contractual terms of a financial asset or a financial liability to replace the referenced interest rate benchmark with an alternative benchmark rate;

(b) altering the method for calculating the interest rate benchmark without amending the contractual terms of the financial instrument; and/or

(c) triggering the activation of an existing contractual term such as a fallback clause.

BC5.295 To meet the objective described in paragraph BC5.290, the IASB concluded that the scope of the Phase 2 amendments in paragraphs 5.4.5–5.4.9 of IFRS 9 should include all changes to a financial asset or financial liability as a result of the reform, regardless of the legal form triggering those changes. In each situation outlined in paragraph BC5.294 the basis for determining the contractual cash flows of a financial instrument changes as a result of the reform. Therefore, for the purpose of the Phase 2 amendments, the IASB collectively refers to these changes as 'changes in the basis for determining the contractual cash flows of a financial asset or a financial liability'.

What constitutes 'a change in the basis for determining the contractual cash flows of a financial asset or a financial liability'

BC5.296 In the IASB's view, determining whether a change in the basis for determining the contractual cash flows of a financial instrument has occurred will be straightforward in most cases, for example, when the contractual terms of a financial instrument are amended to replace the interest rate benchmark with an alternative benchmark rate. However, it may be less straightforward if the basis for determining the contractual cash flows changes after the initial recognition of the financial instrument, without an amendment to the contractual terms of that financial instrument—for example, when, to effect the reform, the method for calculating the interest rate benchmark is altered. Although the contractual terms of the financial instrument may not be amended, such a change in the method for calculating the interest rate benchmark may change the basis for determining the contractual cash flows of that financial instrument compared to the prior basis (ie the basis immediately preceding the change).

BC5.297 The IASB noted that paragraph 5.4.3 of IFRS 9 refers to the 'modification or renegotiation of the contractual cash flows' of a financial asset, while paragraph 3.3.2 of IFRS 9 refers to the 'modification of the terms' of an existing financial liability. The IASB noted that although these paragraphs use different words, both refer to a change in the contractual cash flows or contractual terms after the initial recognition of the financial instrument. In both cases, such a change was not specified or considered in the contract at initial recognition.

BC5.298 The IASB considered that if the amendments in paragraphs 5.4.6–5.4.9 of IFRS 9 applied only to cases in which the contractual terms are amended as a result of the reform, the form rather than the substance of the change would determine the appropriate accounting treatment. This could cause the economic effects of a change in the basis for determining the contractual cash flows arising as a result of the reform to be obscured by the form of the change and not reflected in the financial statements, and result in changes with equivalent economic effects being accounted for differently.

BC5.299 Consequently, the IASB highlighted that the basis for determining the contractual cash flows of a financial asset or a financial liability can change even if the contractual terms of the financial instrument are not

amended. In the IASB's view, accounting consistently for a change in the basis for determining the contractual cash flows arising as a result of the reform, even if the contractual terms of the financial instrument are not amended, would reflect the economic substance of such a change and would therefore provide useful information to users of financial statements.

BC5.300 In addition, as noted in paragraph BC5.294(c), the IASB also learned that some entities may implement the reform through the activation of existing contractual terms, such as fallback provisions. For example, a fallback provision could specify the hierarchy of rates to which an interest rate benchmark would revert in case the existing benchmark rate ceases to exist. The IASB decided these situations—ie revisions to an entity's estimates of future cash payments or receipts arising from the activation of existing contractual terms that are required by the reform—should also be within the scope of the Phase 2 amendments. Doing so, avoids differences in accounting outcomes simply because the changes in the basis for determining the contractual cash flows were triggered by an existing contractual term instead of by a change in the contractual cash flows or contractual terms after the initial recognition of the financial instrument. Such diversity in accounting outcomes would reduce the usefulness of information provided to users of financial statements and would be burdensome to preparers.

Changes required by the reform

BC5.301 As set out in paragraph 5.4.7 of IFRS 9, the Phase 2 amendments provide a practical expedient that requires entities to apply paragraph B5.4.5 of IFRS 9 to account for changes in the basis for determining the contractual cash flows of a financial asset or a financial liability that are required by the reform. In reaching that decision, the IASB considered the usefulness of the information that would result from applying the requirements in IFRS 9 that would otherwise apply to these changes.

BC5.302 In the absence of the practical expedient in paragraph 5.4.7 of IFRS 9, when a financial asset or financial liability is modified, an entity applying IFRS 9 is required to determine whether the modification results in the derecognition of the financial instrument. Different accounting for the modification is specified depending on whether derecognition is required. IFRS 9 sets out separate requirements for derecognition of financial assets and derecognition of financial liabilities.

BC5.303 The IASB noted that, because alternative benchmark rates are intended to be nearly risk-free while many existing interest rate benchmarks are not, it is likely that a fixed spread will be added to compensate for a basis difference between an existing interest rate benchmark and an alternative benchmark rate to avoid a transfer of economic value between the parties to a financial instrument. If these are the only changes made, the IASB considers that it would be unlikely that the transition to an alternative benchmark rate alone would result in the derecognition of that financial instrument.

BC5.304 Paragraph 5.4.3 of IFRS 9 applies to modifications of financial assets that do not result in derecognition of those assets. Applying that paragraph, a modification gain or loss is determined by recalculating the gross carrying amount of the financial asset as the present value of the renegotiated or modified contractual cash flows that are discounted at the financial asset's original effective interest rate. Any resulting modification gain or loss is recognised in profit or loss at the date of the modification. The accounting for other revisions in estimated future contractual cash flows, including modifications of financial liabilities that do not result in the derecognition of those liabilities (see paragraph B5.4.6 of IFRS 9), is consistent with the accounting for modified financial assets that do not result in derecognition.[39]

BC5.305 Thus, in the absence of the practical expedient in paragraph 5.4.7 of IFRS 9, an entity would generally apply the requirements in paragraphs 5.4.3 or B5.4.6 of IFRS 9 to a change required by the reform, by recalculating the carrying amount of a financial instrument with any difference recognised in profit or loss. In addition, an entity would be required to use the original effective interest rate (ie the interest rate benchmark preceding the transition to the alternative benchmark rate) to recognise interest revenue or interest expense over the remaining life of the financial instrument.

BC5.306 In the IASB's view, in the context of the reform, such an outcome would not necessarily provide useful information to users of financial statements. In reaching this view, the IASB considered a situation in which a financial instrument was amended only to replace an interest rate benchmark with an alternative benchmark rate. Using the interest rate benchmark-based effective interest rate to calculate interest revenue or interest expense over the remaining life in this situation would not reflect the economic effects of the modified financial instrument. Maintaining the original effective interest rate could also be difficult, and perhaps impossible, if that rate is no longer available.

BC5.307 The IASB therefore decided that applying the practical expedient, which requires an entity to apply paragraph B5.4.5 of IFRS 9 to account for changes in the basis for determining the contractual cash flows of financial

[39] Paragraph B5.4.6 does not apply to changes in estimates of expected credit losses.

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assets and financial liabilities as a result of the reform, would provide more useful information to users of financial statements in circumstances when the changes are limited to changes required by the reform and would be less burdensome for preparers for the reasons noted in paragraph BC5.306.

BC5.308 Applying the practical expedient in paragraph 5.4.7 of IFRS 9, an entity would account for a change in the basis for determining the contractual cash flows of a financial asset or a financial liability required by the reform as being akin to a 'movement in the market rates of interest' applying paragraph B5.4.5 of IFRS 9. As a result, an entity applying the practical expedient to account for a change in the basis for determining the contractual cash flows of a financial asset or a financial liability that is required by the reform would not apply the derecognition requirements to that financial instrument, and would not apply paragraphs 5.4.3 or B 5.4.6 of IFRS 9 to account for the change in contractual cash flows. In other words, changes in the basis for determining the contractual cash flows of a financial asset or a financial liability that are required by the reform would not result in an adjustment to the carrying amount of the financial instrument or immediate recognition of a gain or loss. The IASB concluded that the application of the practical expedient would provide useful information about the effect of the reform on an entity's financial instruments in the circumstances in which it applies.

BC5.309 The IASB considered the risk that the practical expedient could be applied too broadly, which could result in unintended consequences. The IASB decided to limit the scope of the practical expedient so that it applies only to changes in the basis for determining the contractual cash flows of a financial asset or a financial liability that are required by the reform. For this purpose, applying paragraph 5.4.7 of IFRS 9, a change is required by the reform if, and only if, the change is necessary as a direct consequence of the reform and the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the change). This is consistent with the conditions proposed in the 2020 Exposure Draft.

BC5.310 In the 2020 Exposure Draft, the IASB considered only changes in the basis for determining the contractual cash flows of a financial asset or a financial liability that are required as a direct consequence of the reform. This condition was designed to capture changes in the basis for determining the contractual cash flows that are necessary—or in other words, changes that are required—to implement the reform.

BC5.311 Furthermore, because the objective of the reform is limited to the transition to alternative benchmark rates—ie it does not encompass other changes that would lead to value transfer between the parties to a financial instrument—in the 2020 Exposure Draft, the IASB proposed economic equivalence as the second condition for applying the practical expedient. That is, to be within the scope of the practical expedient, at the date the basis is changed, the new basis for determining the contractual cash flows would be required to be economically equivalent to the previous basis.

BC5.312 In discussing the concept of economic equivalence, the IASB considered circumstances in which an entity makes changes necessary as a direct consequence of the reform in a way so that the overall contractual cash flows (including amounts relating to interest) of the financial instrument are substantially similar before and after the changes. For example, a change would be economically equivalent if it involved only replacing an interest rate benchmark with an alternative benchmark rate plus a fixed spread that compensated for the basis difference between the interest rate benchmark and the alternative benchmark rate. The IASB observed that, in this situation, applying paragraph B5.4.5 of IFRS 9 (that is, revising the effective interest rate when cash flows are re-estimated) would have an accounting outcome similar to applying paragraph 5.4.3 or B5.4.6 of IFRS 9 (that is, recognising a modification gain or loss) because it is unlikely that the resulting modification gain or loss would be significant.

BC5.313 With respect to the proposed condition described in paragraph BC5.310, some respondents to the 2020 Exposure Draft asked whether the practical expedient would apply even if the transition to alternative benchmark rates is not required by law or regulation, or if the existing interest rate benchmark is not being discontinued. For example, these respondents said that some existing interest rate benchmarks prevalent in their jurisdictions are not—at least in the near future—being discontinued. Nonetheless, entities are expected to transition to alternative benchmark rates because, for example, they anticipate reduced liquidity for the existing benchmark or want to align with global market developments. In response, the IASB noted that the practical expedient is not limited to only particular ways of effecting the reform, provided the reform is consistent with the description in paragraph 6.8.2 of IFRS 9. The IASB also noted that the Phase 2 amendments encompass changes that are required to implement the reform—or, in other words, changes that are necessary as a direct consequence of the reform—even if the reform itself is not mandatory.

BC5.314 With respect to the proposed condition described in paragraph BC5.311, some respondents to the 2020 Exposure Draft asked the IASB to specify whether an entity would need to perform detailed quantitative analysis of the cash flows of a financial instrument to demonstrate that a particular change meets the economic equivalence condition. For example, some respondents asked whether an entity would need to determine that the discounted present value of the cash flows of the affected financial instrument or its fair value are substantially similar before and after the transition to alternative benchmark rates.

BC5.315 The IASB intended 'economic equivalence' to be principle-based and therefore decided not to include detailed application guidance related to the assessment of that condition. Acknowledging that different entities in different jurisdictions would implement the reform differently, the IASB did not require a particular approach for assessing this condition. The IASB noted that because it set no 'bright lines', an entity is required to apply judgement to assess whether circumstances meet the economic equivalence condition. For example, assuming that the entity determines that replacing an interest rate benchmark with an alternative benchmark rate is necessary for the affected financial instrument as a direct consequence of the reform (ie the condition in paragraph 5.4.7(a) of IFRS 9 is met), the entity determines:

(a) what alternative benchmark rate will replace the interest rate benchmark and whether a fixed spread adjustment is necessary to compensate for a basis difference between the alternative benchmark rate and the interest rate benchmark preceding replacement. The entity would assess the overall resulting cash flows, including amounts relating to interest (ie alternative benchmark rate plus any fixed spread adjustment), to determine whether the economic equivalence condition is met. In other words, in this example, the entity would assess whether the interest rate remained substantially similar before and after the replacement—specifically, whether the interest rate after replacement (eg the alternative benchmark rate plus the fixed spread) was substantially similar to the interest rate benchmark immediately preceding the replacement; and

(b) whether the alternative benchmark rate (plus the necessary fixed spread described in paragraph BC5.315(a)) was applied to the relevant affected financial instrument(s).

BC5.316 The IASB noted that for a scenario such as the one described in the example in paragraph BC5.315, that assessment would be sufficient to determine that the economic equivalence condition had been met for those changes. As described in paragraph 5.4.8(a) of IFRS 9, an entity in such circumstances would not be required to do further analysis in order to determine that the economic equivalence condition has been satisfied (eg the entity would not be required to analyse whether the discounted present value of the cash flows of that financial instrument are substantially similar before and after the replacement).

BC5.317 The IASB acknowledged that changes in the basis for determining the contractual cash flows of a financial asset or a financial liability are likely to vary significantly across jurisdictions, product types and contracts. Developing a comprehensive list of changes required by the reform—and, hence, that qualify for the practical expedient—would not be feasible. Nonetheless, the IASB decided to include in paragraph 5.4.8 of IFRS 9 some examples of changes that give rise to a new basis for determining the contractual cash flows that is economically equivalent to the previous basis. If an entity makes only the changes specified in paragraph 5.4.8 of IFRS 9, the entity would not be required to analyse these changes further to conclude that the changes meet the condition in paragraph 5.4.7(b) of IFRS 9—ie the changes in paragraph 5.4.8 of IFRS 9 are examples of changes that satisfy that condition. The IASB concluded that adding such examples would assist entities in understanding and applying the amendments. These examples are not exhaustive.

Changes that are not required by the reform

BC5.318 The IASB noted that during negotiations with counterparties to agree on changes to the contractual cash flows required by the reform, entities could simultaneously agree to make changes to the contractual terms that are not necessary as a direct consequence of the reform or are not economically equivalent to the previous terms (eg to reflect a change in the counterparty's credit worthiness). If there are changes in addition to those required by the reform, an entity would first apply the practical expedient in paragraph 5.4.7 of IFRS 9 to account for the changes to the basis for determining the contractual cash flows of a financial asset or financial liability determined to be required by the reform (ie changes that meet the conditions in paragraph 5.4.7 of IFRS 9) by updating the effective interest rate based on the alternative benchmark rate. Then the entity would apply the relevant requirements in IFRS 9 to determine if the additional changes to that financial instrument (ie any changes to which the practical expedient does not apply) result in the derecognition of the financial instrument. If the entity determines that the additional changes do not result in derecognition of that financial asset or financial liability, the entity would account for the additional changes (ie changes not required by the reform) by applying paragraph 5.4.3 or paragraph B5.4.6 of IFRS 9. In the IASB's view, this approach would provide useful information to users of financial statements about the economic effects of any changes to financial instruments not required by the reform while consistently accounting for changes required by the reform.

Other classification and measurement issues

BC5.319 In anticipation of the potential financial reporting implications of changes to financial instruments as a result of the reform, including the potential derecognition of existing financial instruments and the recognition of new financial instruments, some stakeholders asked the IASB to consider additional matters related to

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applying the classification and measurement requirements in IFRS 9 to financial assets and financial liabilities. These matters included:

(a) whether IFRS 9 provides an adequate basis to account for the derecognition of a financial instrument in the statement of financial position and the recognition of any resulting gain or loss in the statement of profit or loss when an entity determines that it is required to derecognise a financial asset or financial liability because of the reform.

(b) determining whether derecognition of a financial asset following changes in the basis for determining the contractual cash flows resulting from the reform affects an entity's business model for managing its financial assets.

(c) assessing the contractual cash flow characteristics of a financial asset that refers to an alternative benchmark rate. Specifically, assessing whether some alternative benchmark rates are consistent with the description of 'interest' in paragraph 4.1.3(b) of IFRS 9 including if the time value of money element of that rate is modified (ie imperfect).

(d) assessing the effect on expected credit losses of derecognising an existing financial asset and recognising a new financial asset as a result of the reform.

(e) determining potential effects on the accounting for embedded derivatives in the context of the reform. Specifically, following the transition to alternative benchmark rates, whether entities reassess whether an embedded derivative is required to be separated from the host contract.

(f) determining whether the practical expedient in paragraph 5.4.7 of IFRS 9 applies to a hybrid financial liability that has been separated into a host contract (measured at amortised cost) and an embedded derivative (measured at fair value through profit or loss). Specifically, determining whether the practical expedient applies when the interest rate benchmark is not a contractual term of the host contract but instead is imputed at initial recognition.

BC5.320 The IASB discussed these matters and concluded that IFRS 9 provides an adequate basis to determine the required accounting for each of these matters. Therefore, considering the objective of Phase 2, the IASB made no amendments for these matters. Specific to paragraph BC5.319(f), the IASB observed that the practical expedient in paragraph 5.4.7 of IFRS 9 would apply to such a host contract if the conditions set out in paragraph 5.4.7 of IFRS 9 are met.

Hedge accounting (Chapter 6)

BC6.1–BC6.75 [Relocated to paragraphs BCE.174–BCE.238]

The objective of hedge accounting

BC6.76 Hedge accounting is an exception to the normal recognition and measurement requirements in IFRS. For example, the hedge accounting guidance in IAS 39 permitted:

(a) the recognition of items that would otherwise have not been recognised (for example, a firm commitment);

(b) the measurement of an item on a basis that is different from the measurement basis that is normally required (for example, adjusting the measurement of a hedged item in a fair value hedge); and

(c) the deferral of the changes in the fair value of a hedging instrument for a cash flow hedge in other comprehensive income. Such changes in fair value would otherwise have been recognised in profit or loss (for example, the hedging of a highly probable forecast transaction).

BC6.77 The IASB noted that, although hedge accounting was an exception from normal accounting requirements, in many situations the information that resulted from applying those normal requirements without using hedge accounting either did not provide useful information or omitted important information. Hence, the IASB concluded that hedge accounting should be retained.

BC6.78 In the IASB's view, a consistent hedge accounting model requires an objective that describes when and how an entity should:

(a) override the general recognition and measurement requirements in IFRS (ie when and how an entity should apply hedge accounting); and

(b) recognise effectiveness and/or ineffectiveness of a hedging relationship (ie when and how gains and losses should be recognised).

BC6.79 The IASB considered two possible objectives of hedge accounting—that hedge accounting should:

(a) provide a link between an entity's risk management and its financial reporting. Hedge accounting would convey the context of hedging instruments, which would allow insights into their purpose and effect.

(b) mitigate the recognition and measurement anomalies between the accounting for derivatives (or other hedging instruments) and the accounting for hedged items and manage the timing of the recognition of gains or losses on derivative hedging instruments used to mitigate cash flow risk.

BC6.80 However, the IASB rejected both objectives for hedge accounting. The IASB thought that an objective that linked an entity's risk management and financial reporting was too broad: it was not clear enough what risk management activity was being referred to. Conversely, the IASB thought that an objective that focused on the accounting anomalies was too narrow: it focused on the mechanics of hedge accounting instead of on why hedge accounting was being done.

BC6.81 Consequently, the IASB decided to propose in the 2010 Hedge Accounting Exposure Draft an objective that combined elements of both objectives. The IASB considered that the proposed objective of hedge accounting reflected a broad articulation of a principle-based approach with a focus on the purpose of the entity's risk management activities. In addition, the objective also provided for a focus on the statement of financial position and the statement of comprehensive income, thereby reflecting the effects of the individual assets and liabilities associated with the risk management activities on those statements. This reflected the IASB's intention: that entities should provide useful information about the purpose and effect of hedging instruments for which hedge accounting is applied.

BC6.82 The IASB also noted that, despite that an entity's risk management activities were central to the objective of hedge accounting, an entity would only achieve hedge accounting if it met all the qualifying criteria.

BC6.83 Almost all respondents to the 2010 Hedge Accounting Exposure Draft as well as participants in the IASB's outreach activities supported the objective of hedge accounting proposed in the 2010 Hedge Accounting Exposure Draft.

Open portfolios

BC6.84 Closed hedged portfolios are hedged portfolios in which items cannot be added, removed or replaced without treating each change as the transition to a new portfolio (or a new layer). The hedging relationship specifies at inception the hedged items that form that particular hedging relationship.

BC6.85 In practice, risk management often assesses risk exposures on a continuous basis and at a portfolio level. Risk management strategies tend to have a time horizon (for example, two years) over which an exposure is hedged. Consequently, as time passes new exposures are continuously added to such hedged portfolios and other exposures are removed from them. These are referred to as open portfolios.

BC6.86 Hedges of open portfolios introduce complexity to the accounting for such hedges. Changes could be addressed by treating them like a series of closed portfolios with a short life (ie by periodic discontinuations of the hedging relationships for the previous closed portfolios of items and designations of new hedging relationships for the revised closed portfolios of items). However, this gives rise to complexities related to tracking, amortisation of hedge adjustments and the reclassification of gains or losses deferred in accumulated other comprehensive income. Furthermore, it may be impractical to align such an accounting treatment with the way in which the exposures are viewed from a risk management perspective, which may update hedge portfolios more frequently (for example, daily).

BC6.87 The IASB decided not to specifically address open portfolios or 'macro' hedging (ie hedging at the level that aggregates portfolios) as part of the 2010 Hedge Accounting Exposure Draft. The IASB considered hedge accounting only in the context of groups of items that constitute a gross or net position for which the items that make up that position are included in a specified overall group of items (see paragraphs BC6.427–BC6.467).

BC6.88 Consequently, for fair value hedge accounting for a portfolio hedge of interest rate risk the 2010 Hedge Accounting Exposure Draft did not propose replacing the requirements in IAS 39.

BC6.89 The IASB received feedback from financial institutions as well as from entities outside the financial sector that addressing situations in which entities use a dynamic risk management strategy was important. Financial institutions also noted that this was important because some of their risk exposures might only qualify for hedge accounting in an open portfolio context (for example, non-interest bearing demand deposits).

BC6.90 The IASB noted that this is a complex topic that warrants thorough research and feedback from interested parties. Accordingly, the IASB decided to separately deliberate on the accounting for macro hedging as part of its active agenda with the objective of issuing a Discussion Paper. The IASB noted that this would enable

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IFRS 9 to be completed more quickly and would enable the new 'general' hedge accounting requirements to be available as part of IFRS 9. The IASB also noted that during the project on accounting for macro hedging the status quo of 'macro hedge accounting' under previous Standards would broadly be maintained so that entities would not be worse off in the meantime.

BC6.91 The IASB noted that broadly maintaining the status quo of 'macro hedge accounting' meant that:

(a) an entity could continue to apply IAS 39 for fair value hedge accounting for a portfolio hedge of interest rate risk (see paragraph BC6.88), which includes the application of the specific 'macro hedge accounting' requirements in IAS 39; but

(b) all cash flow hedges would be within the scope of the hedge accounting model of IFRS 9—including those that are colloquially referred to as 'macro cash flow hedges' under IAS 39 today.

BC6.92 The IASB noted that this approach appropriately reflected the interaction between the IAS 39 hedge accounting requirements and the new hedge accounting model it had developed for IFRS 9 for the following reasons:

(a) the new hedge accounting model does apply to situations in which entities manage risk in a 'macro' context, for example, for risk exposures that result from large groups of items that are managed on an aggregated level, including open portfolios. It also applies to all types of hedges and risks. But entities must use the designations that are available under the new hedge accounting model (and can only apply hedge accounting if they meet the qualifying criteria).

(b) the new hedge accounting model does not however provide specific 'customised' solutions that would be an exception to (instead of an application of) the model designed to make the implementation of hedge accounting in those situations easier. For example, it does not provide an exception to allow a net position cash flow hedge for interest rate risk or to allow non-interest bearing demand deposits to be designated as hedged items.

(c) the specific fair value hedge accounting for a portfolio hedge of interest rate risk is an exception to the hedge accounting model in IAS 39 and is strictly limited to that particular type of hedge. This exception does not fit into the new hedge accounting model. The IASB decided that in order to retain this exception pending the completion of the project on accounting for macro hedging, a scope exception that allows the continued application of IAS 39 for this particular type of hedge is appropriate.

(d) in contrast, cash flow hedge accounting in a 'macro' context was an application of the (general) hedge accounting model under IAS 39. Consequently, it is consistent with that approach to include 'macro cash flow hedge accounting' as an application of the new hedge accounting model.

BC6.93 However, the IASB received feedback that some entities were unsure whether and how 'macro cash flow hedge accounting' could also be applied under the hedge accounting requirements of IFRS 9. In response, the IASB considered whether it could address those concerns by carrying forward the Implementation Guidance that accompanied IAS 39 and that illustrated 'macro cash flow hedge accounting'. The IASB noted that to do so would be inconsistent with its decision not to carry forward any of the hedge accounting Implementation Guidance that accompanied IAS 39. The IASB also noted that making an exception by carrying forward some parts of the Implementation Guidance but not others could have unintended consequences because it would inevitably create the perception that the IASB had endorsed some parts while it had rejected others.

BC6.94 The IASB also noted that carrying forward Implementation Guidance could not be justified as a means to address any concerns about whether a particular accounting practice complies with the hedge accounting requirements. Implementation Guidance only accompanies, but is not part of, a Standard, which means that it does not override the requirements of a Standard.

BC6.95 Consequently, the IASB decided to retain its original approach of not carrying forward any of the hedge accounting related Implementation Guidance that accompanied IAS 39. However, the IASB emphasised that not carrying forward the Implementation Guidance did not mean that it had rejected that guidance.

BC6.96 The IASB also received feedback that some entities were concerned that 'proxy hedging' would not be possible under the hedge accounting model in IFRS 9—a concern that was highlighted by the 'macro cash flow hedge accounting' related Implementation Guidance that accompanied IAS 39 not being carried forward. 'Proxy hedging' is a colloquial reference to the use of designations of hedging relationships that do not exactly represent an entity's actual risk management. Examples include using a designation of a gross amount of an exposure (gross designation) when risks are actually managed on a net position basis, and using designations of variable-rate debt instruments in cash flow hedges when risk management is based on managing the interest rate risk of prepayable fixed-rate debt instruments or deposits (such as core deposits). Similarly, 'proxy hedging' can involve designating fixed-rate debt instruments in fair value hedges when risk management is based on managing the interest rate risk of variable-rate debt instruments.

BC6.97 The IASB noted that its rationale for not including a scope exception from the IFRS 9 hedge accounting requirements for 'macro cash flow hedge accounting' reflected that designations of hedging relationships that represent 'proxy hedging' are possible. The IASB was aware that many financial institutions use 'proxy hedging' as described in paragraph BC6.96.

BC6.98 The IASB considered that in those situations the designation for hedge accounting purposes was inevitably not the same as the entity's risk management view of its hedging, but that the designation reflects risk management in that it relates to the same type of risk that was being managed and the instruments used for that purpose. For example, like IAS 39, IFRS 9 also does not allow cash flow hedges of interest rate risk to be designated on a net position basis but entities must instead designate gross positions. This requires so called 'proxy hedging' because the designation for hedge accounting purposes is on a gross position basis even though risk management typically manages on a net position basis. This 'proxy hedging' also includes approaches that for risk management purposes determine the net interest rate risk position on the basis of fixed-rate items. A cash flow hedge designation can still reflect those approaches in that the net interest rate risk position can be viewed as having a dual character: the hedges bridge, for example, the economic mismatch between fixed-rate assets and variable-rate funding (existing variable-rate funding as well as funding to be obtained in the future to continue to fund the assets as existing funding matures). Such an economic mismatch can be regarded as fair value interest rate risk when looking at the assets and as cash flow interest rate risk when looking at the funding. The net position hedging combines the two aspects because both affect the net interest margin. Hence, both fair value and cash flow interest rate risk are inherent aspects of the hedged exposure. However, hedge accounting requires the designation of the hedging relationship as either a fair value hedge or as a cash flow hedge. The IASB noted that in that sense, even if a fair value hedge designation better represented a risk management perspective that considers the fixed-rate assets as the primary or leading aspect, a cash flow hedge designation would still reflect the risk management because of the dual character of the risk position. Consequently, the IASB regarded 'proxy hedging' as an eligible way of designating the hedged item under IFRS 9 as long as that still reflected risk management, which was the case in this situation.

BC6.99 The IASB noted that in such situations entities have to select some items that give rise to interest rate risk and that qualify for designation as a hedged item and designate them as a gross exposure in order to achieve hedge accounting. The IASB acknowledged that in those circumstances there is typically no obvious link between any particular designated hedged item and the designated hedging instrument, and that entities select items for designation that are most suitable for hedge accounting purposes. This means that different entities can have different ways of selecting those items depending on their situation (for example, whether designating an interest rate risk exposure related to a financial asset or a financial liability).

BC6.100 The IASB also noted that designations of hedging relationships that reflect 'proxy hedging' were not unique to hedging of interest rate risk by banks in, for example, a 'macro' context. Despite the objective of the project to represent, in the financial statements, the effect of an entity's risk management activities, the IASB considered that this would in many situations not be possible as a simple, exact '1:1 copy' of the actual risk management perspective. In the IASB's view this was already apparent from other aspects of the hedge accounting model of IFRS 9, for example:

(a) the mere fact that the IASB had limited net position cash flow hedges to foreign currency risk meant that for all other types of hedged risks an entity would have to designate gross amounts (gross designation). But this did not mean that cash flow hedge accounting was prohibited for all other risks that are managed on a net position basis.

(b) an entity that actually hedges on a risk component basis in accordance with its risk management view might not meet the criteria for designating the hedged item as a risk component. But this did not mean that the entity was prohibited from applying hedge accounting altogether. Instead, it was only prohibited from using that particular designation of a risk component. Consequently, the entity could designate the item in its entirety as the hedged item and apply hedge accounting (if it met the qualifying criteria on the basis of that designation).

(c) for many entities the actual risk management is based on a 'flow perspective' for cash flow hedges, which only considers mismatches in the variable cash flows of the hedging instrument and the hedged item as a source of hedge ineffectiveness. However, the measurement of hedge effectiveness for hedge accounting purposes does not allow an entity to assume perfect hedge effectiveness in those circumstances (or limiting the analysis to only the variable cash flows of the hedging instrument). However, this did not mean that hedge accounting was prohibited. Instead, it meant that the entity had to measure hedge ineffectiveness as required for accounting purposes.

(d) the presentation of hedges of net positions requires the use of a separate line item in the income statement instead of directly adjusting the line items affected by the hedged items (for example, grossing up revenue and cost of sales). In contrast, entities' actual risk management often considers the respective line items as hedged at the respective rates that were locked in by the hedges. This difference between the risk management and accounting views did not mean that an entity was

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prohibited from using hedge accounting. Instead, it meant that the entity had to follow the presentation requirements for accounting purposes if it wanted to apply hedge accounting.

BC6.101 Consequently, the IASB did not agree that designations of hedging relationships under IFRS 9 could not represent 'proxy hedging'. The IASB also decided to provide further guidance on how 'proxy hedging' is related to the discontinuation of hedge accounting (see paragraph BC6.331).

BC6.102 However, the IASB also received feedback from some entities that they did not want to have to apply the hedge accounting requirements of IFRS 9 before the IASB's project on accounting for macro hedging was completed. Those entities cited concerns about remaining uncertainty as to whether IAS 39-compliant practices of designating hedging relationships for portfolio hedging or macro hedging activities would still be available, the costs of assessing whether those practices are IFRS 9-compliant and the risk of having to change those practices twice. Some entities questioned whether it was appropriate to require entities to re-examine and potentially make changes to their hedge accounting while the project on accounting for macro hedging was ongoing.

BC6.103 The IASB considered whether it should provide a scope exception to the hedge accounting requirements of IFRS 9 to address those concerns over the interaction with macro hedging activities. This scope exception would be separate from that for fair value hedge accounting for a portfolio hedge of interest rate risk, which complements the hedge accounting requirements of IFRS 9 and which the IASB had already proposed in the 2010 Hedge Accounting Exposure Draft (see paragraph BC6.88). In this case the IASB considered whether there was a need to allow entities to continue to apply IAS 39 to cash flow hedges in the context of macro hedging activities. In the IASB's view it was not necessary from a technical perspective to make any changes in addition to the clarifications that it had already provided (see paragraphs BC6.93–BC6.101). However, the IASB acknowledged that it had not yet completed its project on accounting for macro hedging and that providing a choice to continue to apply the hedge accounting requirements in IAS 39 would allow entities to wait for the complete picture related to the accounting for hedging activities before applying a new hedge accounting model.

BC6.104 Consequently, the IASB considered whether it could provide a specific scope exception that would confine the continued application of IAS 39 to situations in which entities seek to apply 'macro cash flow hedge accounting'. However, the IASB determined that such a specific scope would be difficult to describe, resulting in added complexity and the risk that interpretation questions would arise. The IASB therefore decided to provide entities with an accounting policy choice between applying the hedge accounting requirements of IFRS 9 (including the scope exception for fair value hedge accounting for a portfolio hedge of interest rate risk) and continuing to apply the existing hedge accounting requirements in IAS 39 for all hedge accounting until its project on the accounting for macro hedging is completed. The IASB noted that an entity could subsequently decide to change its accounting policy and commence applying the hedge accounting requirements of IFRS 9 at the beginning of any reporting period (subject to the other transition requirements of IFRS 9). The IASB also emphasised that, once IFRS 9 as amended in November 2013 is applied, the new disclosure requirements related to hedge accounting are part of IFRS 7 and would consequently apply to all entities using hedge accounting under IFRS (even if electing to continue to apply IAS 39 for hedge accounting).

Hedge accounting for equity investments designated as at fair value through other comprehensive income

BC6.105 In accordance with IFRS 9 an entity may, at initial recognition, make an irrevocable election to present subsequent changes in the fair value of some investments in equity instruments in other comprehensive income. Amounts recognised in other comprehensive income for such equity instruments are not reclassified to profit or loss. However, IAS 39 defined a hedging relationship as a relationship in which the exposure to be hedged could affect profit or loss. Consequently, an entity could not apply hedge accounting if the hedged exposure affected other comprehensive income without reclassification out of other comprehensive income to profit or loss because only such a reclassification would mean that the hedged exposure could ultimately affect profit or loss.

BC6.106 For its 2010 Hedge Accounting Exposure Draft, the IASB considered whether it should amend the definition of a fair value hedge to state that the hedged exposure could affect either profit or loss or other comprehensive income, instead of only profit or loss. However, the IASB had concerns about the mechanics of matching the changes in the fair value of the hedging instrument with the changes in the value of the hedged item attributable to the hedged risk. Furthermore, the IASB was concerned about how to account for any related hedge ineffectiveness. To address these concerns, the IASB considered alternative approaches.

BC6.107 The IASB considered whether the hedge ineffectiveness should remain in other comprehensive income when the changes in the value of the hedged item attributable to the hedged risk are bigger than the changes in the fair value of the hedging instrument. This approach would:

(a) be consistent with the IASB's decision on classification and measurement (the first phase of the IFRS 9 project), whereby changes in the fair value of the equity investment designated as at fair value through other comprehensive income should not be reclassified to profit or loss; but

(b) contradict the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss.

BC6.108 Conversely, if the hedge ineffectiveness were recognised in profit or loss it would:

(a) be consistent with the hedge accounting principle that hedge ineffectiveness should be recognised in profit or loss; but

(b) contradict the prohibition of reclassifying from other comprehensive income to profit or loss gains or losses on investments in equity instruments accounted for as at fair value through other comprehensive income.

BC6.109 Consequently, in its 2010 Hedge Accounting Exposure Draft the IASB proposed prohibiting hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income, because it could not be achieved within the existing framework of hedge accounting. Introducing another framework would add complexity. Furthermore, the IASB did not want to add another exception (ie contradicting the principle in IFRS 9 of not reclassifying between other comprehensive income and profit or loss, or contradicting the principle of recognising hedge ineffectiveness in profit or loss) to the existing exception of accounting for investments in equity instruments (ie the option to account for those investments at fair value through other comprehensive income).

BC6.110 However, the IASB noted that dividends from such investments in equity instruments are recognised in profit or loss. Consequently, a forecast dividend from such investments could be an eligible hedged item (if all qualifying criteria for hedge accounting are met).

BC6.111 Almost all respondents to the 2010 Hedge Accounting Exposure Draft disagreed with the IASB's proposal to prohibit hedge accounting for investments in equity instruments designated as at fair value through other comprehensive income. Those respondents argued that hedge accounting should be available for equity investments at fair value through other comprehensive income so that hedge accounting can be more closely aligned with risk management activities. In particular, respondents commented that it was a common risk management strategy for an entity to hedge the foreign exchange risk exposure of equity investments (irrespective of the accounting designation at fair value through profit or loss or other comprehensive income). In addition, an entity might also hedge the equity price risk even though it does not intend to sell the equity investment because it might still want to protect itself against equity volatility.

BC6.112 In the light of those concerns, the IASB reconsidered whether it should allow investments in equity instruments designated as at fair value through other comprehensive income to be designated as a hedged item in a fair value hedge. Some respondents argued that the inconsistencies that the IASB had discussed in its original deliberations (see paragraphs BC6.107–BC6.108) could be overcome by using a differentiating approach, whereby if fair value changes of the hedging instrument exceeded those of the hedged item hedge ineffectiveness would be presented in profit or loss and otherwise in other comprehensive income. However, the IASB noted that the cumulative ineffectiveness presented in profit or loss or other comprehensive income over the total period of the hedging relationship might still contradict the principle of not recycling to profit or loss changes in the fair value of equity investments at fair value through other comprehensive income. Hence, the IASB rejected that approach.

BC6.113 The IASB noted that recognising hedge ineffectiveness always in profit or loss would be inconsistent with the irrevocable election of presenting in other comprehensive income fair value changes of investments in equity instruments (see paragraph BC6.108). The IASB considered that that outcome would defeat its aim to reduce complexity in accounting for financial instruments.

BC6.114 The IASB considered that an approach that would recognise hedge ineffectiveness always in other comprehensive income (without recycling) could facilitate hedge accounting in situations in which an entity's risk management involves hedging risks of equity investments designated as at fair value through other comprehensive income without contradicting the classification and measurement requirements of IFRS 9. The IASB noted that, as a consequence, hedge ineffectiveness would not always be presented in profit or loss but would always follow the presentation of the value changes of the hedged item.

BC6.115 The IASB considered that, on balance, the advantages of the approach that always recognises hedge ineffectiveness in other comprehensive income (without recycling) for those investments in equity instruments would outweigh any disadvantages and, overall, that this alternative was superior to the other alternatives that the IASB had contemplated. Hence, the IASB decided to include this approach in the final requirements.

BC6.116 The IASB also considered whether hedge accounting should be more generally available for exposures that only affect other comprehensive income (but not profit or loss). However, the IASB was concerned that such

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a broad scope might result in items qualifying for hedge accounting that might not be suitable hedged items and hence have unintended consequences. Consequently, the IASB decided against making hedge accounting more generally available to such exposures.

Hedging instruments

Qualifying instruments

Derivatives embedded in financial assets

BC6.117 IAS 39 required the separation of derivatives embedded in hybrid financial assets and liabilities that are not closely related to the host contract (bifurcation). In accordance with IAS 39, the separated derivative was eligible for designation as a hedging instrument. In accordance with IFRS 9, hybrid financial assets are measured in their entirety (ie including any embedded derivative) at either amortised cost or fair value through profit or loss. No separation of any embedded derivative is permitted.

BC6.118 In the light of the decision that it made on IFRS 9, the IASB considered whether derivatives embedded in financial assets should be eligible for designation as hedging instruments. The IASB considered two alternatives:

(a) an entity could choose to separate embedded derivatives solely for the purpose of designating the derivative component as a hedging instrument; or

(b) an entity could designate a risk component of the hybrid financial asset, equivalent to the embedded derivative, as the hedging instrument.

BC6.119 The IASB rejected both alternatives. Consequently, the IASB proposed not to allow derivative features embedded in financial assets to be eligible hedging instruments (even though they can be an integral part of a hybrid financial asset that is measured at fair value through profit or loss and designated as the hedging instrument in its entirety—see paragraph BC6.129). The reasons for the IASB's decision are summarised in paragraphs BC6.120–BC6.121.

BC6.120 Permitting an entity to separate embedded derivatives for the purpose of hedge accounting would retain the IAS 39 requirements in terms of their eligibility as hedging instruments. However, the IASB noted that the underlying rationale for separating embedded derivatives in IAS 39 was not to reflect risk management activities, but instead to prevent an entity from circumventing the requirements for the recognition and measurement of derivatives. The IASB also noted that the designation of a separated embedded derivative as a hedging instrument in accordance with IAS 39 was not very common in practice. Hence, the IASB considered that reintroducing the separation of embedded derivatives for hybrid financial assets does not target hedge accounting considerations, would consequently not be an appropriate means to address any hedge accounting concerns and in addition would reintroduce complexity for situations that are not common in practice.

BC6.121 Alternatively, permitting an entity to designate, as the hedging instrument, a risk component of a hybrid financial asset would allow that entity to show more accurately the results of its risk management activities. However, such an approach would be a significant expansion of the scope of the Hedge Accounting project because the IASB would need to address the question of how to disaggregate a hedging instrument into components. In order to be consistent, a similar question would need to be addressed for non-financial items (for example, non-financial liabilities in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with currency or commodity risk elements). The IASB did not want to expand the scope of the hedge accounting project beyond financial instruments because the outcome of exploring this alternative would be highly uncertain, could possibly necessitate a review of other Standards and could significantly delay the project.

BC6.122 The IASB therefore retained its original decision when deliberating its 2010 Hedge Accounting Exposure Draft.

Non-derivative financial instruments

BC6.123 Hedge accounting shows how the changes in the fair value or cash flows of a hedging instrument offset the changes in the fair value or cash flows of a designated hedged item attributable to the hedged risk if it reflects an entity's risk management strategy.

BC6.124 IAS 39 permitted non-derivative financial assets and non-derivative financial liabilities (for example, monetary items denominated in a foreign currency) to be designated as hedging instruments only for a hedge of foreign currency risk. Designating a non-derivative financial asset or liability denominated in a foreign currency as a hedge of foreign currency risk in accordance with IAS 39 was equivalent to designating a risk component of a hedging instrument in a hedging relationship. This foreign currency risk component is determined in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Because the foreign currency risk component is determined in accordance with foreign currency translation requirements in IAS 21, it is already available for incorporation by reference in the financial instruments Standard. Consequently, permitting the use of a foreign currency risk component for hedge accounting purposes did not require separate, additional requirements for risk components within the hedge accounting model.

BC6.125 Not allowing the disaggregation of a non-derivative financial instrument used as a hedge into risk components, other than foreign currency risk, has implications for the likelihood of achieving hedge accounting for those instruments. This is because the effects of components of the cash instrument that are not related to the risk being hedged cannot be excluded from the hedging relationship and consequently from the effectiveness assessment. Consequently, depending on the size of the components that are not related to the risk being hedged, in most scenarios it will be difficult to demonstrate that there is an economic relationship between the hedged item and the hedging instrument that gives rise to an expectation that their values will systematically change in response to movements in either the same underlying or underlyings that are economically related in such a way that they respond in a similar way to the risk that is being hedged.

BC6.126 In the light of this consequence, the IASB considered whether it should permit non-derivative financial instruments to be eligible for designation as hedging instruments for risk components other than foreign currency risk. The IASB noted that permitting this would require developing an approach for disaggregating non-derivative hedging instruments into components. For reasons similar to those set out in paragraph BC6.121 the IASB decided not to explore such an approach.

BC6.127 The IASB also considered two alternatives to the requirements of IAS 39 (those requirements that limit the eligibility of non-derivative financial instruments as hedging instruments to hedges of foreign currency risk). The IASB considered whether for hedges of all types of risk (ie not limited to hedges of foreign currency risk) it should extend the eligibility as hedging instruments to non-derivative financial instruments:

(a) that are classified as at fair value through profit or loss; or (alternatively to those); and

(b) that are part of other categories of IFRS 9.

BC6.128 The IASB noted that extending the eligibility to non-derivative financial instruments in categories other than fair value through profit or loss would give rise to operational problems because to apply hedge accounting would require changing the measurement of non-derivative financial instruments measured at amortised cost when they are designated as hedging instruments. The IASB considered that the only way to mitigate this issue was to allow for the designation of components of the non-derivative financial instrument. This would limit the change in measurement to a component of the instrument attributable to the hedged risk. However, the IASB had already rejected that idea in its deliberations (see paragraph BC6.126).

BC6.129 However, the IASB noted that extending the eligibility to non-derivative financial instruments that are measured at fair value through profit or loss, if designated in their entirety (instead of only some risk components of them), would not give rise to the need to change the measurement or the recognition of gains and losses of the financial instrument. The IASB also noted that extending the eligibility to these financial instruments would align the new hedge accounting model more closely with the classification model of IFRS 9 and make it better able to address hedging strategies that could evolve in the future. Consequently, the IASB proposed in its 2010 Hedge Accounting Exposure Draft that non-derivative financial instruments that are measured at fair value through profit or loss should also be eligible hedging instruments if they are designated in their entirety (in addition to hedges of foreign currency risk for which the hedging instrument can be designated on a risk component basis—see paragraph BC6.124).

BC6.130 Generally, respondents to the 2010 Hedge Accounting Exposure Draft agreed that distinguishing between derivative and non-derivative financial instruments was not appropriate for the purpose of determining their eligibility as hedging instruments. Many respondents believed that extending the eligibility criteria to non-derivative financial instruments at fair value through profit or loss would allow better representation of an entity's risk management activities in the financial statements. The feedback highlighted that this was particularly relevant in countries that have legal and regulatory restrictions on the use and availability of derivative financial instruments.

BC6.131 Some respondents argued that there was no conceptual basis to restrict the eligibility of non-derivative financial instruments to those that are measured at fair value through profit or loss. In their view all non-derivative financial instruments should be eligible as hedging instruments.

BC6.132 Other respondents thought that that the proposals were not restrictive enough, particularly in relation to non-derivative financial instruments that are measured at fair value through profit or loss as a result of applying

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the fair value option. Those respondents thought that the IASB should specifically restrict the use of non-derivative financial instruments designated under the fair value option because these have usually been elected to be measured at fair value to eliminate an accounting mismatch and hence should not qualify for hedge accounting. Some respondents also questioned whether a financial liability that is measured at fair value, with changes in the fair value attributable to changes in the liability's credit risk presented in other comprehensive income, would be an eligible hedging instrument under the proposals in the 2010 Hedge Accounting Exposure Draft.

BC6.133 The IASB noted that in its deliberations leading to the 2010 Hedge Accounting Exposure Draft it had already considered whether non-derivative financial instruments measured at amortised cost should also be eligible for designation as hedging instruments. The IASB remained concerned that designating as hedging instruments those non-derivative financial instruments that were not already accounted for at fair value through profit or loss would result in hedge accounting that would change the measurement or recognition of gains and losses of items that would otherwise result from applying IFRS 9. For example, the IASB noted that it would have to determine how to account for the difference between the fair value and the amortised cost of the non-derivative financial instrument upon designation as a hedging instrument. Furthermore, upon discontinuation of the hedging relationship, the measurement of the non-derivative financial instrument would revert to amortised cost resulting in a difference between its carrying amount as of the date of discontinuation (the fair value as at the discontinuation date which becomes the new deemed cost) and its maturity amount. The IASB considered that addressing those aspects would inappropriately increase complexity.

BC6.134 The IASB was also concerned that allowing non-derivative financial instruments that are not already accounted for at fair value through profit or loss to be designated as hedging instruments would mean that the hedge accounting model would not only change the measurement basis of the hedged item, as the existing hedge accounting model already does, but also the measurement basis of hedging instruments. Hence, it could, for example, result in situations in which a natural hedge (ie an accounting match) is already achieved on an amortised cost basis between two non-derivative financial instruments, but hedge accounting could still be used to change the measurement basis of both those instruments to fair value (one as a hedged item and the other as the hedging instrument).

BC6.135 Consequently, the IASB decided that non-derivative financial instruments should be eligible hedging instruments only if they are already accounted for at fair value through profit or loss.

BC6.136 The IASB also discussed whether or not those non-derivative financial instruments that are accounted for at fair value through profit or loss as a result of applying the fair value option should be eligible for designation as a hedging instrument. The IASB considered that any designation as a hedging instrument should not contradict the entity's election of the fair value option (ie recreate the accounting mismatch that the election of the fair value option addressed). For example, if a non-derivative financial instrument that has previously been designated under the fair value option is included in a cash flow hedge relationship, the accounting for the non-derivative financial instrument under the fair value option would have to be overridden. This is because all (or part) of the changes in the fair value of that hedging instrument are recognised in other comprehensive income. However, recognising the changes in fair value in other comprehensive income re-introduces the accounting mismatch that the application of the fair value option eliminated in the first instance. The IASB noted that similar considerations apply to fair value hedges and hedges of net investments in foreign operations.

BC6.137 Consequently, the IASB considered whether it should introduce a general prohibition against designating, as hedging instruments, non-derivative financial instruments that are accounted for at fair value through profit or loss as a result of electing the fair value option. However, such a prohibition would not necessarily be appropriate. The IASB noted that one of the items underlying the fair value option might be sold or terminated at a later stage (ie the circumstances that made the fair value option available might be subject to change or later disappear). However, because the fair value option is irrevocable it would mean a non-derivative financial instrument for which the fair value option was initially elected could never qualify as a hedging instrument even if there was no longer a conflict between the purpose of the fair value option and the purpose of hedge accounting. A general prohibition would not allow the use of hedge accounting at a later stage even when hedge accounting might then mitigate an accounting mismatch (without recreating another one).

BC6.138 The IASB noted that when a non-derivative financial instrument is accounted for at fair value through profit or loss as a result of electing the fair value option, the appropriateness of its use as a hedging instrument depends on the relevant facts and circumstances underlying the fair value option designation. The IASB considered that if an entity designates as a hedging instrument a financial instrument for which it originally elected the fair value option, and this results in the mitigation of an accounting mismatch (without recreating another one), using hedge accounting was appropriate. However, the IASB emphasised that if applying hedge accounting recreates, in the financial statements, the accounting mismatches that electing the fair value option sought to eliminate, then designating the financial instrument for which the fair value option was elected as a hedging instrument would contradict the basis (qualifying criterion) on which the fair value option was elected. Hence, in those situations there would be a conflict between the purpose of the fair value option and

the purpose of hedge accounting as they could not be achieved at the same time but instead would, overall, result in another accounting mismatch. Consequently, the IASB emphasised that designating the non-derivative financial instrument as a hedging instrument in those situations would call into question the legitimacy of electing the fair value option and would be inappropriate. The IASB considered that, to this effect, the requirements of the fair value option were sufficient and hence no additional guidance was necessary.

BC6.139 As a result, the IASB decided not to introduce a general prohibition against the eligibility of designating as hedging instruments non-derivative financial instruments accounted for at fair value through profit or loss as a result of electing the fair value option.

BC6.140 The IASB also considered whether it needed to provide more guidance on when a non-derivative financial liability designated as at fair value through profit or loss under the fair value option would qualify as a hedging instrument. The IASB noted that IFRS 9 refers to liabilities for which the fair value option is elected as "liabilities designated at fair value through profit or loss", irrespective of whether the effects of changes in the liability's credit risk are presented in other comprehensive income or (if that presentation would enlarge an accounting mismatch) in profit or loss. However, for the eligibility as a hedging instrument, the IASB considered that it would make a difference whether the effects of changes in the liability's credit risk are presented in other comprehensive income or profit or loss. The IASB noted that if a financial liability whose credit risk related fair value changes are presented in other comprehensive income was an eligible hedging instrument there would be two alternatives for what could be designated as part of the hedging relationship:

(a) only the part of the liability that is measured at fair value through profit or loss, in which case the hedging relationship would exclude credit risk and hence any related hedge ineffectiveness would not be recognised; or

(b) the entire fair value change of the liability, in which case the presentation in other comprehensive income of the changes in fair value related to changes in the credit risk of the liability would have to be overridden (ie using reclassification to profit or loss) to comply with the hedge accounting requirements.

BC6.141 Consequently, the IASB decided to clarify its proposal by adding an explicit statement that a financial liability is not eligible for designation as a hedging instrument if under the fair value option the amount of change in the fair value attributable to changes in the liability's own credit risk is presented in other comprehensive income.

Internal derivatives as hedging instruments

BC6.142 An entity may follow different risk management models depending on the structure of its operations and the nature of the hedges. Some use a centralised treasury or similar function that is responsible for identifying the exposures and managing the risks borne by various entities within the group. Others use a decentralised risk management approach and manage risks individually for entities in the group. Some also use a combination of those two approaches.

BC6.143 Internal derivatives are typically used to aggregate risk exposures of a group (often on a net basis) to allow the entity to manage the resulting consolidated exposure. However, IAS 39 was primarily designed to address one-to-one hedging relationships. Consequently, in order to explore how to align accounting with risk management, the IASB considered whether internal derivatives should be eligible for designation as hedging instruments. However, the IASB noted that the ineligibility of internal derivatives as hedging instruments was not the root cause of misalignment between risk management and hedge accounting. Instead, the challenge was how to make hedge accounting operational for groups of items and net positions.

BC6.144 The IASB noted that, for financial reporting purposes, the mitigation or transformation of risk is generally only relevant if it results in a transfer of risk to a party outside the reporting entity. Any transfer of risk within the reporting entity does not change the risk exposure from the perspective of that reporting entity as a whole. This is consistent with the principles of consolidated financial statements.

BC6.145 For example, a subsidiary might transfer cash flow interest rate risk from variable-rate funding to the group's central treasury using an interest rate swap. The central treasury might decide to retain that exposure (instead of hedging it out to a party external to the group). In that case, the cash flow interest rate risk of the stand-alone subsidiary has been transferred (the swap is an external derivative from the subsidiary's perspective). However, from the group's consolidated perspective, the cash flow interest rate risk has not changed but merely been reallocated between different parts of the group (the swap is an internal derivative from the group's perspective).

BC6.146 Consequently, in the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB decided that internal derivatives should not be eligible hedging instruments in the financial statements of the reporting

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entity (for example, intragroup derivatives in the consolidated financial statements) because they do not represent an instrument that the reporting entity uses to transfer the risk to an external party (ie outside the reporting entity). This meant that the related requirements in IAS 39 would be retained.

BC6.147 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Intragroup monetary items as hedging instruments

BC6.148 In accordance with IAS 39, the difference arising from the translation of intragroup monetary items in the consolidated financial statements in accordance with IAS 21 was eligible as a hedged item but not as a hedging instrument. This may appear inconsistent.

BC6.149 The IASB noted that, when translating an intragroup monetary item, IAS 21 requires the recognition of a gain or loss in the consolidated statement of profit or loss and other comprehensive income. Consequently, in the IASB's view, considering intragroup monetary items for eligibility as hedging instruments would require a review of the requirements in IAS 21 at the same time as considering any hedge accounting requirements. The IASB noted that at that time there was no active project on foreign currency translation. Hence, it decided that it should not address this issue as part of its project on hedge accounting. Consequently, in the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB decided not to allow intragroup monetary items to be eligible hedging instruments (ie to retain the restriction in IAS 39).

BC6.150 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Written options

BC6.151 In its 2010 Hedge Accounting Exposure Draft, the IASB retained the restriction in IAS 39 that a written option does not qualify as a hedging instrument except when it is used to hedge a purchased option or unless it is combined with a purchased option as one derivative instrument (for example, a collar) and that derivative instrument is not a net written option.

BC6.152 However, respondents to the 2010 Hedge Accounting Exposure Draft commented that a stand-alone written option should not be excluded from being eligible for designation as a hedging instrument if it is jointly designated with other instruments such that in combination they do not result in a net written option. Those respondents highlighted that entities sometimes enter into two separate option contracts because of, for example, legal or regulatory considerations, and that the two separate option contracts achieve, in effect, the same economic outcome as one contract (for example, a collar contract).

BC6.153 The IASB considered that the eligibility of an option contract to be designated as a hedging instrument should depend on its economic substance instead of its legal form. Consequently, the IASB decided to amend the requirements such that a written option and a purchased option (regardless of whether the hedging instrument arises from one or several different contracts) can be jointly designated as the hedging instrument, provided that the combination is not a net written option. The IASB also noted that by aligning the accounting for combinations of written and purchased options with that for derivative instruments that combine written and purchased options (for example, a collar contract), the assessment of what is, in effect, a net written option would be the same, ie it would follow the established practice under IAS 39. That practice considers the following cumulative factors to ascertain that an interest rate collar or other derivative instrument that includes a written option is not a net written option:

(a) no net premium is received either at inception or over the life of the combination of options. The distinguishing feature of a written option is the receipt of a premium to compensate the writer for the risk incurred.

(b) except for the strike prices, the critical terms and conditions of the written option component and the purchased option component are the same (including underlying variable or variables, currency denomination and maturity date). Also, the notional amount of the written option component is not greater than the notional amount of the purchased option component.

Hedged items

Qualifying items

Financial instruments held within a business model whose objective is to collect or pay contractual cash flows

BC6.154 Against the background of potential interaction with the classification of financial instruments in accordance with IFRS 9, the IASB, in its deliberations leading to the 2010 Hedge Accounting Exposure Draft, considered the eligibility for hedge accounting of financial instruments held within a business model whose objective is to collect or pay contractual cash flows. The IASB focused on fair value hedges of interest rate risk because other risks (for example, foreign currency risk) affect cash flows that are collected or paid and the application of hedge accounting seemed clearly appropriate. More specifically, the IASB was concerned about whether a desire to enter into a fair value hedge can be seen as calling into question whether the entity's business model is to hold the financial instrument to collect (or pay) contractual cash flows, instead of selling (or settle/transfer) the instrument before contractual maturity in order to realise the fair value changes. Consequently, some argue that, on the basis of the assertion underlying the business model assessment, the entity should be interested only in the contractual cash flows arising from those investments and not in the changes in fair value.

BC6.155 The IASB discussed several situations in which a fair value hedge of interest rate risk does not contradict the fact that a financial instrument is held with the objective to collect or pay contractual cash flows. One example is an entity that seeks to invest in a variable-rate asset of a particular credit quality, but could only obtain a fixed-rate asset of the desired credit quality. That entity could create the cash flow profile of a variable-rate asset indirectly by buying both the available fixed-rate investment and entering into an interest rate swap that transforms the fixed-interest cash flows from that asset into variable-interest cash flows. The IASB noted that this and other examples demonstrated that what is a fair value hedge for accounting purposes is, from a risk management perspective, often a choice between receiving (or paying) fixed versus variable interest cash flows, instead of a strategy to protect against fair value changes. Hence, the IASB considered that a fair value hedge of interest rate risk would not in itself contradict the assertion that a financial instrument is held with the objective to collect or pay contractual cash flows.

BC6.156 The IASB also noted that, under the classification model for financial instruments in IFRS 9, an entity may sell or transfer some financial instruments that qualify for amortised cost, even if they are held with the objective to collect or pay contractual cash flows. Consequently, the IASB decided that fair value hedge accounting should be available for financial instruments that are held with the objective to collect or pay contractual cash flows.

BC6.157 The IASB retained its original decisions when redeliberating its 2010 Hedge Accounting Exposure Draft.

Designation of derivatives

BC6.158 The guidance on implementing IAS 39 stated that derivatives could be designated as hedging instruments only, not as hedged items (either individually or as part of a group of hedged items). As the sole exception, paragraph AG94 in the application guidance in IAS 39 allowed a purchased option to be designated as a hedged item. In practice, this has generally prevented derivatives from qualifying as hedged items. Similarly, positions that are a combination of an exposure and a derivative ('aggregated exposures') failed to qualify as hedged items. The implementation guidance accompanying IAS 39 provided the rationale for not permitting derivatives (or aggregated exposures that include a derivative) to be designated as hedged items. It stated that derivative instruments were always deemed to be held for trading and measured at fair value with gains or losses recognised in profit or loss unless they are designated as hedging instruments.

BC6.159 However, this rationale is difficult to justify in the light of the exception to permit some purchased options to qualify as hedged items irrespective of whether the option is a stand-alone derivative or an embedded derivative. If a stand-alone purchased option can be a hedged item then prohibiting derivatives that are part of an aggregated exposure to be part of a hedged item is arbitrary. Many raised similar concerns in response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* about the prohibition of designating derivatives as hedged items.

BC6.160 The IASB noted that an entity was sometimes economically required to enter into transactions that result in, for example, both interest rate risk and foreign currency risk. While those two exposures can be managed together at the same time and for the entire term, the IASB noted that entities often use different risk

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management strategies for the interest rate risk and foreign currency risk. For example, for 10-year fixed-rate debt denominated in a foreign currency an entity may hedge the foreign currency risk for the entire term of the debt instrument but require fixed-rate exposure in its functional currency only for the short to medium term (say, two years) and floating-rate exposure in its functional currency for the remaining term to maturity. At the end of each of the two-year intervals (ie on a two-year rolling basis) the entity fixes the next two years (if the interest level is such that the entity wants to fix interest rates). In such a situation an entity may enter into a 10-year fixed-to-floating cross-currency interest rate swap that swaps the fixed-rate foreign currency debt into a variable-rate functional currency exposure. This is then overlaid with a two-year interest rate swap that—on the basis of the functional currency—swaps variable-rate debt into fixed-rate debt. In effect, the fixed-rate foreign currency debt and the 10-year fixed-to-floating cross-currency interest rate swap in combination are viewed as a 10-year variable-rate debt functional currency exposure for risk management purposes.

BC6.161 Consequently, for the purpose of its 2010 Hedge Accounting Exposure Draft, the IASB concluded that the fact that an aggregated exposure is created by including an instrument that has the characteristics of a derivative should not, in itself, preclude the designation of that aggregated exposure as a hedged item.

BC6.162 Most respondents to the 2010 Hedge Accounting Exposure Draft supported the proposal to allow aggregated exposures to be designated as hedged items. Those respondents noted that the proposal better aligns hedge accounting with an entity's risk management by allowing hedge accounting to be used for common ways in which entities manage risks. In addition, those respondents noted that the proposal removes the arbitrary restrictions that were in IAS 39 and moves closer towards a principle-based requirement. The IASB therefore decided to retain the notion of an aggregated exposure as proposed in the 2010 Hedge Accounting Exposure Draft.

BC6.163 The main requests that respondents made to the IASB were:

(a) to provide examples that would illustrate the accounting mechanics for aggregated exposures;

(b) to clarify that accounting for aggregated exposures is not tantamount to 'synthetic accounting'; and

(c) to clarify whether an entity would, in a first step (and as a precondition), have to achieve hedge accounting for the combination of the exposure and the derivative that together constitute the aggregated exposure so that, in a second step, the aggregated exposure itself can then be eligible as the hedged item in the other hedging relationship.

BC6.164 In response to the request for examples of the accounting mechanics for aggregated exposures, the IASB decided to provide illustrative examples to accompany IFRS 9. The IASB considered that numerical examples illustrating the mechanics of the accounting for aggregated exposures would, at the same time, address other questions raised in the feedback on the proposals, such as how hedge ineffectiveness is recognised and the type of the hedging relationships involved. Moreover, the IASB noted that those examples would also demonstrate that the proposed accounting for aggregated exposures is very different from 'synthetic accounting', which would reinforce the second clarification that respondents had requested.

BC6.165 The IASB thought that the confusion about 'synthetic accounting' arose from accounting debates in the past about whether two items should be treated for accounting purposes as if they were one single item. This would have had the consequence that a derivative could have assumed the accounting treatment for a non-derivative item (for example, accounting at amortised cost). The IASB noted that, in contrast, under the 2010 Hedge Accounting Exposure Draft's proposal for aggregated exposures the accounting for derivatives would always be at fair value and hedge accounting would be applied to them. Hence, the IASB emphasised that accounting for aggregated exposures does not allow 'synthetic accounting'.

BC6.166 The IASB noted that most respondents had correctly understood the 2010 Hedge Accounting Exposure Draft (ie that it does not allow 'synthetic accounting') but the IASB was still concerned because any misconception that aggregated exposures are tantamount to 'synthetic accounting' would result in a fundamental accounting error. Hence, the IASB decided to provide, in addition to illustrative examples, an explicit statement confirming that derivatives that form part of an aggregated exposure are always recognised as separate assets or liabilities and measured at fair value.

BC6.167 The IASB also discussed the request to clarify whether an entity would have to first (as a precondition) achieve hedge accounting for the combination of the underlying exposure and the derivative that constitute the aggregated exposure (the first level relationship) so that the aggregated exposure itself can be eligible as the hedged item in the other hedging relationship (the second level relationship). The IASB noted that the effect of not achieving hedge accounting for the first level relationship depended on the circumstances (in particular, the types of hedge used). In many circumstances, it would make the accounting for the aggregated exposure more complicated and the outcome inferior compared to achieving hedge accounting for the first level relationship. However, the IASB considered that achieving hedge accounting for the first level relationship was not required to comply with the general hedge accounting requirements for the second level relationship (ie the hedging relationship in which the aggregated exposure is the hedged item). Consequently,

the IASB decided not to make achieving hedge accounting for the first level relationship a prerequisite for qualifying for hedge accounting for the second level relationship.

BC6.168 The IASB also clarified two other aspects that had been raised by some respondents:

(a) that the notion of an aggregated exposure includes a highly probable forecast transaction of an aggregated exposure if that aggregated exposure, once it has occurred, is eligible as a hedged item; and

(b) how to apply the general requirements of designating a derivative as the hedging instrument in the context of aggregated exposures. The IASB noted that the way in which a derivative is included in the hedged item that is an aggregated exposure must be consistent with the designation of that derivative as the hedging instrument at the level of the aggregated exposure (ie at the level of the first level relationship—if applicable, ie if hedge accounting is applied at that level). If the derivative is not designated as the hedging instrument at the level of the aggregated exposure, it must be designated in its entirety or as a proportion of it. The IASB noted that, consistent with the general requirements of the hedge accounting model, this also ensures that including a derivative in an aggregated exposure does not allow splitting a derivative by risk, by parts of its term or by cash flows.

Designation of hedged items

Designation of a risk component

BC6.169 IAS 39 distinguished the eligibility of risk components for designation as the hedged item by the type of item that includes the component:

(a) for financial items, an entity could designate a risk component if that risk component was separately identifiable and reliably measurable; however,

(b) for non-financial items, an entity could only designate foreign currency risk as a risk component.

BC6.170 Risk components of non-financial items, even when they are contractually specified, were not eligible risk components in accordance with IAS 39. Consequently, other than for foreign currency risk, a non-financial item was required to be designated as the hedged item for all risks. The rationale for including this restriction in IAS 39 was that permitting risk components (portions) of non-financial assets and non-financial liabilities to be designated as the hedged item for a risk other than foreign currency risk would compromise the principles of identification of the hedged item and effectiveness testing because the portion could be designated so that no ineffectiveness would ever arise.

BC6.171 The hedge accounting model in IAS 39 used the entire item as the default unit of account and then provided rules to govern what risk components of that entire item were available for separate designation in hedging relationships. This has resulted in the hedge accounting requirements being misaligned with many risk management strategies. The outcome was that the normal approach for risk management purposes was treated as the exception by the hedge accounting requirements.

BC6.172 Many of the comment letters received on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* criticised the prohibition on designating risk components for non-financial items. This was also the most common issue raised during the IASB's outreach activities.

BC6.173 The IASB noted that the conclusion in IAS 39, that permitting, as hedged items, risk components of non-financial assets and non-financial liabilities would compromise the principles of identification of the hedged item and effectiveness testing, was not appropriate in all circumstances. As part of its deliberations, the IASB considered whether risk components should be eligible for designation as hedged items when they are:

(a) contractually specified; and

(b) not contractually specified.

BC6.174 Contractually specified risk components determine a currency amount for a pricing element of a contract independently of the other pricing elements and, therefore, independently of the non-financial item as a whole. Consequently, these components are separately identifiable. The IASB also noted that many pricing formulas that use a reference to, for example, benchmark commodity prices are designed in that way to ensure that there is no gap or misalignment for that risk component compared with the benchmark price. Consequently, by reference to that risk component, the exposure can be economically fully hedged using a derivative with the benchmark as the underlying. This means that the hedge effectiveness assessment on a risk components basis accurately reflects the underlying economics of the transaction (ie that there is no or very little ineffectiveness).

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BC6.175 However, in many situations risk components are not an explicit part of a fair value or a cash flow. Nonetheless, many hedging strategies involve the hedging of components even if they are not contractually specified. There are different reasons for using a component approach to hedging, including:

(a) the entire item cannot be hedged because there is a lack of appropriate hedging instruments;

(b) it is cheaper to hedge the single components individually than the entire item (for example, because an active market exists for the risk components, but not for the entire item); and

(c) the entity makes a conscious decision to hedge only particular parts of the fair value or cash flow risk (for example, because one of the risk components is particularly volatile and it therefore justifies the costs of hedging it).

BC6.176 The IASB learned from its outreach activities that there are circumstances in which entities are able to identify and measure many risk components (not only foreign currency risk) of non-financial items with sufficient reliability. Appropriate risk components (if they are not contractually specified) can be determined only in the context of the particular market structure related to that risk. Consequently, the determination of appropriate risk components requires an evaluation of the relevant facts and circumstances (ie careful analysis and knowledge of the relevant markets). The IASB noted that as a result there is no 'bright line' to determine eligible risk components of non-financial items.

BC6.177 Consequently, in its 2010 Hedge Accounting Exposure Draft, the IASB proposed that risk components (both those that are and those that are not contractually specified) should be eligible for designation as hedged items as long as they are separately identifiable and reliably measurable. This proposal would align the eligibility of risk components of non-financial items with that of financial items in IAS 39.

BC6.178 Most respondents to the 2010 Hedge Accounting Exposure Draft supported the IASB's proposal and its rationale for allowing risk components (both those that are and those that are not contractually specified) to be eligible for designation as hedged items. Those respondents noted that the proposal on risk components was a key aspect of the new hedge accounting model because it would allow hedge accounting to reflect that, in commercial reality, hedging risk components was the norm and hedging items in their entirety was the exception.

BC6.179 Many respondents noted that IAS 39 was biased against hedges of non-financial items such as commodity hedges. They considered the distinction between financial and non-financial items for determining which risk components would be eligible hedged items as arbitrary and without conceptual justification. The main request by respondents was for additional guidance or clarifications.

BC6.180 Only a few respondents disagreed with the IASB's proposal on risk components. Those respondents believed that, in situations in which non-contractually specified risk components of non-financial items would be designated as hedged items, no hedge ineffectiveness would be recognised.

BC6.181 The IASB noted that the debate about risk components suffered from some common misunderstandings. In the IASB's opinion, the root cause of those misunderstandings is the large number of markets and circumstances in which hedging takes place. This results in an inevitable lack of familiarity with many markets. In the light of the arguments raised and to address some of the misunderstandings, the IASB focused its discussions on non-contractually specified risk components of non-financial items and, in particular, on:

(a) the effect of risk components; and

(b) hedge ineffectiveness when designating a risk component.

BC6.182 The IASB noted that some believe that designating a risk component as a hedged item should not be allowed if it could result in the value of that risk component moving in an opposite direction to the value of the entire item (ie its overall price). For example, if the hedged risk component increases in value this would offset the loss on the hedging instrument, while decreases in the value of other unhedged risk components remain unrecognised.

BC6.183 The IASB noted that this was not specific to non-contractually specified risk components of non-financial items, but that it applied to risk components in general. For example, consider an entity that holds a fixed-rate bond and the benchmark interest rate decreases but the bond's spread over the benchmark increases. If the entity hedges only the benchmark interest rate using a benchmark interest rate swap, the loss on the swap is offset by a fair value hedge adjustment for the benchmark interest rate component of the bond (even though the bond's fair value is lower than its carrying amount after the fair value hedge adjustment because of the increase in the spread).

BC6.184 The IASB also noted that designating a risk component was not tantamount to 'hiding losses' or avoiding their recognition by applying hedge accounting. Instead, it would help to mitigate accounting mismatches that would otherwise result from how an entity manages its risks. If hedge accounting is not applied, only the gain or loss from the change in the fair value of the financial instrument that hedges the risk is recognised in profit or loss, whereas the gain or loss on the entire item that gives rise to the risk remains fully unrecognised (until

it is realised in a later period) so that any offset is obscured. If designation on a risk component basis is not available, that initially creates an issue of whether the hedge qualifies at all for hedge accounting and is inconsistent with the economic decision of hedging done on a components basis. Consequently, the accounting assessment would be completely disconnected from the decision making of an entity, which is driven by risk management purposes. The IASB also noted that this consequence would be amplified by the fact that the hedged component is not necessarily the main or largest component (for example, in the case of a power purchase agreement with a contractual pricing formula that includes indexations to fuel oil and inflation, only the inflation risk but not the fuel oil price risk is hedged).

BC6.185 The IASB noted that even if hedge accounting can be achieved between the hedging instrument and the item (which includes the hedged risk component) in its entirety, the accounting outcome would be more akin to a fair value option for the entire item than reflecting the effect of the economic hedge. However, because hedge accounting would be disconnected from what is economically hedged, there would also be ramifications for the hedge ratio that would have to be used for designating the hedging relationship. The hedge ratio that an entity actually uses (ie for decision making purposes driven by risk management) would be based on the economic relationship between the underlyings of the hedged risk component and the hedging instrument. This is the sensible basis for hedging decisions. However, for accounting purposes, an entity would be forced to compare changes in the value of the hedging instrument to those of the entire item. This means that, in order to improve the offset for the hedging relationship that is designated for accounting purposes, an entity would have to create a deliberate mismatch compared to the economic hedging relationship, which is tantamount to distorting the economic hedge ratio for accounting purposes. The IASB noted that distorting the hedge ratio also meant that prohibiting the designation of hedged items on a risk components basis would, ultimately, not necessarily result in the financial statements reflecting the change in the value of the unhedged risk component as a gain or loss for which there is no offset. Hence, prohibiting that kind of designation would not achieve transparency about the changes in the value of unhedged components by showing a gain or loss for which there is no offset.

BC6.186 The IASB also noted that designating risk components as hedged items would reflect the fact that risk management typically operates on a 'by risk' basis instead of on a 'by item' basis (which is the unit of account for financial reporting purposes). Hence, the use of risk components as hedged items would reflect what in commercial reality is the norm instead of requiring that all hedged items are 'deemed' to be hedged in their entirety (ie for all risks).

BC6.187 The IASB also considered the effect that risk components have on the recognition of hedge ineffectiveness. A few respondents believed that if a risk component was designated as the hedged item, it would result in no hedge ineffectiveness being recognised.

BC6.188 The IASB noted that the effect of designating a risk component as the hedged item was that it became the point of reference for determining offset (ie the fair value change on the hedging instrument would be compared to the change in value of the designated risk component instead of the entire item). This would make the comparison more focused because it would exclude the effect of changes in the value of risks that are not hedged, which would also make hedge ineffectiveness a better indicator of the success of the hedge. The IASB noted that the hedge accounting requirements would apply to the risk component in the same way as they apply to other hedged items that are not risk components. Consequently, even when a risk component was designated as the hedged item, hedge ineffectiveness could still arise and would have to be measured and recognised. For example:

(a) a floating-rate debt instrument is hedged against the variability of cash flows using an interest rate swap. The two instruments are indexed to the same benchmark interest rate but have different reset dates for the variable payments. Even though the hedged item is designated as the benchmark interest rate related variability in cash flows (ie as a risk component), the difference in reset dates causes hedge ineffectiveness. There is no market structure that would support identifying a 'reset date' risk component in the variable payments on the floating rate debt that would mirror the reset dates of the interest rate swap. In particular, the terms and conditions of the interest rate swap cannot be simply imputed by projecting terms and conditions of the interest rate swap onto floating-rate debt.

(b) a fixed-rate debt instrument is hedged against fair value interest rate risk using an interest rate swap. The two instruments have different day count methods for the fixed-rate payments. Even though the hedged item is designated as the benchmark interest rate related change in fair value (ie as a risk component), the difference in the day count methods causes hedge ineffectiveness. There is no market structure that would support identifying a 'day count' risk component in the payments on the debt that would mirror the day count method of the interest rate swap. In particular, the terms and conditions of the interest rate swap cannot be simply imputed by projecting terms and conditions of the interest rate swap onto the fixed-rate debt.

(c) an entity purchases crude oil under a variable-price oil supply contract that is indexed to a light sweet crude oil benchmark. Because of the natural decline of the benchmark oil field the derivatives market

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for that benchmark has suffered a significant decline in liquidity. In response, the entity decides to use derivatives for a different benchmark for light sweet crude oil in a different geographical area because the derivatives market is much more liquid. The changes in the crude oil price for the more liquid benchmark and the less liquid benchmark are closely correlated but vary slightly. The variation between the two oil benchmark prices causes hedge ineffectiveness. There is no market structure that would support identifying the more liquid benchmark as a component in the variable payments under the oil supply contract. In particular, the terms and conditions of the derivatives indexed to the more liquid benchmark cannot simply be imputed by projecting terms and conditions of those derivatives onto the oil supply contract.

(d) an entity is exposed to price risk from forecast purchases of jet fuel. The entity's jet fuel purchases are in North America and Europe. The entity determines that the relevant crude oil benchmark for jet fuel purchases at its North American locations is West Texas Intermediate (WTI) whereas it is Brent for jet fuel purchases at its European locations. Hence, the entity designates as the hedged item a WTI crude oil component for its jet fuel purchases in North America and a Brent crude oil component for its jet fuel purchases in Europe. Historically, WTI and Brent have been closely correlated and the entity's purchase volume in North America significantly exceeds its European purchase volume. Hence, the entity uses one type of hedge contract—indexed to WTI—for all its crude oil components. Changes in the price differential between WTI and Brent cause hedge ineffectiveness related to the forecast purchases of jet fuel in Europe. There is no market structure that would support identifying WTI as a component of Brent. In particular, the terms and conditions of the WTI futures cannot simply be imputed by projecting terms and conditions of those derivatives onto the forecast jet fuel purchases in Europe.

BC6.189 Consequently, the IASB noted that the designation of a risk component as a hedged item did not mean that no hedge ineffectiveness arises or that it would not be recognised.

BC6.190 The IASB noted that the concerns about hedge ineffectiveness not being recognised related particularly to non-contractually specified risk components of non-financial items. However, the IASB considered that this was not a financial versus non-financial item problem. Determining the hedge ineffectiveness, for example, for a fixed-rate debt instrument when designating the benchmark interest rate component as the hedged item is no more or less troublesome than doing so for commodity price risk. In both cases the appropriate designation of a risk component depends on an appropriate analysis of the market structure. The IASB noted that the derivative markets for commodity risk had evolved and had resulted in customs that helped improve the effectiveness of hedging. For example, very liquid commodity benchmarks have evolved, allowing for a market volume for derivatives that is far larger than the physical volume of the underlying commodity, thus facilitating benchmarks that can be widely used.

BC6.191 In the light of those considerations and the responses received on the 2010 Hedge Accounting Exposure Draft, the IASB decided to retain the notion of risk components as eligible hedged items. Because of the large variety of markets and circumstances in which hedging takes place, the IASB considered that, in order to avoid arbitrary discrimination against some markets, risks or geographies, there was no alternative to using a criteria-based approach to identifying eligible risk components. Consequently, the IASB decided that for risk components (of both financial and non-financial items) to qualify as eligible hedged items, they must be separately identifiable and reliably measureable. In response to requests from respondents, the IASB also decided to expand the examples of how to determine eligible risk components, including illustrations of the role of the market structure.

BC6.192 The IASB also discussed the proposal in the 2010 Hedge Accounting Exposure Draft to prohibit the designation of non-contractually specified inflation risk components of financial instruments. That prohibition was carried over from IAS 39. The IASB noted that an outright ban meant that the general criteria for the eligibility of risk components could not be applied and, as a result, would leave no room for the possibility that in some situations there might be circumstances that could support identifying a risk component for inflation risk. On the other hand, the IASB was concerned that the removal of the restriction would encourage the use of inflation risk components for hedge accounting when it was not necessarily appropriate to do so. This would be the case when a risk component, instead of being supported by the market structure and independently determined for the hedged item, would, for example, be determined by simply projecting the terms and conditions of the inflation derivative that was actually used as the hedge onto the hedged item. In the light of this trade-off, the IASB also considered that financial markets continuously evolve and that the requirements should be capable of addressing changes in the market over time.

BC6.193 On balance, the IASB decided to remove the prohibition. However, it was concerned that its decision could be misunderstood as simply 'rubber stamping' the use of inflation risk components for hedge accounting without proper application of the criteria for designating risk components. The IASB therefore agreed to include a caution in the final requirements that, in order to determine whether inflation risk is an eligible risk component, a careful analysis of the facts and circumstances is required so that the criteria for designating

risk components are properly applied. Consequently, the IASB decided to add a rebuttable presumption related to non-contractually specified inflation risk components of financial instruments.

Designation of 'one-sided' risk components

BC6.194 IAS 39 permitted an entity to designate changes in the cash flows or fair value of a hedged item above or below a specified price or other variable (a 'one-sided' risk). So, an entity might hedge an exposure to a specific type of risk of a financial instrument (for example, interest rates) above a pre-determined level (for example, above 5 per cent) using a purchased option (for example, an interest rate cap). In this situation an entity hedged some parts of a specific type of risk (ie interest exposure above 5 per cent).

BC6.195 Furthermore, the IASB noted that hedging one-sided risk exposures is a common risk management activity. The IASB also noted that the main issue that relates to the hedging of one-sided risk is the use of options as hedging instruments. Consequently, the IASB decided to permit the designation of one-sided risk components as hedged items, as was the case in IAS 39 for some risk components. However, the IASB decided to change the accounting for the time value of options (see paragraphs BC6.386–BC6.413).

BC6.196 The IASB retained its original decisions about the eligibility of one-sided risk components as hedged items when redeliberating its 2010 Hedge Accounting Exposure Draft.

Components of a nominal amount—designation of a component that is a proportion

BC6.197 The IASB noted that components that form some quantifiable nominal part of the total cash flows of the instrument are typically separately identifiable. For example, a proportion, such as 50 per cent, of the contractual cash flows of a loan includes all the characteristics of that loan. In other words, changes in the value and cash flows for the 50 per cent component are half of those for the entire instrument.

BC6.198 The IASB noted that a proportion of an item forms the basis of many different risk management strategies and are commonly hedged in practice (often in combination with risk components). The IASB concluded that if the effectiveness of the hedging relationship can be measured, an entity should be permitted to designate a proportion of an item as a hedged item (as previously permitted by IAS 39).

BC6.199 The IASB retained its original decisions when redeliberating its 2010 Hedge Accounting Exposure Draft.

Components of a nominal amount—designation of a layer component

BC6.200 IAS 39 required an entity to identify and document anticipated (ie forecast) transactions that are designated as hedged items with sufficient specificity so that when the transaction occurs, it is clear whether the transaction is or is not the hedged transaction. As a result, IAS 39 permitted forecast transactions to be identified as a 'layer' component of a nominal amount, for example, the first 100 barrels of the total oil purchases for a specific month (ie a layer of the total oil purchase volume). Such a designation accommodates the fact that there is some uncertainty surrounding the hedged item related to the amount or timing. This uncertainty does not affect the hedging relationship to the extent that the hedged volume occurs (irrespective of which particular individual items make up that volume).

BC6.201 The IASB considered whether similar considerations should also apply to a hedge of an existing transaction or item in some situations. For example, a firm commitment or a loan might also involve some uncertainty because:

(a) a contract might be cancelled for breach of contract (ie non-performance); or

(b) a contract with an early termination option (for repayment at fair value) might be terminated before maturity.

BC6.202 Because there is uncertainty for both anticipated transactions and existing transactions and items, the IASB decided not to distinguish between such transactions and items for the purposes of designating a layer component.

BC6.203 The IASB noted that designating as the hedged item a component that is a proportion of an item can give rise to a different accounting outcome when compared with designating a layer component. If the designation of those components is not aligned with the risk management strategy of the entity, it might result in profit or loss providing confusing or less useful information to users of financial statements.

BC6.204 In the IASB's view there might be circumstances when it is appropriate to designate a layer component as a hedged item. Consequently, in its 2010 Hedge Accounting Exposure Draft the IASB proposed to permit the designation of a layer component as the hedged item (for anticipated and existing transactions). The IASB

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also proposed that a layer component of a contract that includes a prepayment option should not be eligible as a hedged item in a fair value hedge if the option's fair value is affected by changes in the hedged risk. The IASB noted that if the prepayment option's fair value changed in response to the hedged risk a layer approach would be tantamount to identifying a risk component that was not separately identifiable (because the change in the value of the prepayment option owing to the hedged risk would not be part of how the hedge effectiveness would be measured).

BC6.205 Most respondents to the 2010 Hedge Accounting Exposure Draft agreed with the proposed change for fair value hedges, which would allow an entity to designate a layer component from a defined nominal amount. They agreed that such layers would allow entities to better reflect what risk they actually hedge.

BC6.206 However, many respondents disagreed with the IASB's proposal to prohibit, in any circumstances, the designation of a layer component in a fair value hedge for all contracts that include any prepayment option whose fair value is affected by changes in the hedged risk. Those respondents' main objection was that the proposal was inconsistent with common risk management strategies and that the fair value changes of a prepayment option were irrelevant in the context of a bottom layer.

BC6.207 In the light of the comments received, the IASB discussed:

(a) whether the prohibition to designate a layer component as the hedged item in a fair value hedge should relate to an entire item or contract containing a prepayment option or whether it should relate only to those situations in which the designated layer contains a prepayment option;

(b) whether a layer component can be designated as the hedged item in a fair value hedge if it includes the effect of a related prepayment option; and

(c) whether the requirement should differentiate between written and purchased prepayment options, thereby allowing a layer component to be designated for items with a purchased option, ie if the entity is the option holder (for example, a debtor's call option included in prepayable debt).

BC6.208 The IASB discussed situations in which a contract is prepayable for only a part of its entire amount, which means that the remainder is not prepayable and hence does not include a prepayment option. For example, a loan with a principal amount of CU100 and a maturity of five years that allows the debtor to repay (at par) up to CU10 at the end of each year would mean that only CU40 is prepayable (at different points in time), whereas CU60 is non-prepayable but has a five-year fixed term. Because the CU60 is fixed-term debt that is not affected by prepayments, its fair value does not include the effect of a prepayment option. Consequently, the changes in the fair value related to the CU60 are unrelated to the fair value changes of the prepayment option for other amounts. This means that if the CU60 were designated as a layer component, the hedge ineffectiveness would appropriately exclude the change in the fair value of the prepayment option. The IASB considered that this would be consistent with its rationale for proposing to prohibit a layer component of an (entire) item or contract that contains a prepayment option (see paragraph BC6.204) to be designated. However, the IASB noted that the changes in fair value of the amounts that are prepayable (ie the CU40 at inception, CU30 after one year, CU20 after two years and CU10 after three years) include a prepayment option and the designation of a layer for these amounts would therefore contradict the IASB's rationale (see paragraph BC6.204). The IASB noted that the layer of CU60 in this example should not be confused with a bottom layer of CU60 that is expected to remain at maturity from a total amount of CU100 that is prepayable in its entirety. The difference is that the expected remaining amount of a larger prepayable amount is the expected eventual outcome of a variable contractual maturity, whereas the CU60 in this example is the definite outcome of a fixed contractual maturity.

BC6.209 Consequently, the IASB decided to:

(a) confirm the proposals in the 2010 Hedge Accounting Exposure Draft to allow a layer-based designation of a hedged item (when the item does not include a prepayment option whose fair value is affected by changes in the hedged risk); and

(b) to allow a layer-based designation for those amounts that are not prepayable at the time of designation of a partially prepayable item.

BC6.210 The IASB also discussed whether a layer component should be available for designation as the hedged item in a fair value hedge if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.

BC6.211 Including the change in fair value of the prepayment option that affects a layer when determining hedge ineffectiveness has the following consequences:

(a) the designated hedged item would include the entire effect of changes in the hedged risk on the fair value of the layer, ie including those resulting from the prepayment option; and

(b) if the layer was hedged with a hedging instrument (or a combination of instruments that are designated jointly) that does not have option features that mirror the layer's prepayment option, hedge ineffectiveness would arise.

BC6.212 The IASB noted that a designation of a layer as the hedged item, if it included the effects of a related prepayment option when determining the change in fair value of the hedged item, would not conflict with its rationale for proposing the requirements related to the implication of prepayment options for layer designations (see paragraph BC6.204).

BC6.213 Consequently, the IASB decided that designating a layer as the hedged item should be allowed if it includes the effect of a related prepayment option when determining the change in fair value of the hedged item.

BC6.214 The IASB also considered whether it should differentiate between written and purchased prepayment options for the purpose of determining the eligibility of a layer-based designation of a hedged item in a fair value hedge. Some respondents had argued that if the entity was the option holder, it would control the exercise of the option and could therefore demonstrate that the option was not affected by the hedged risk.

BC6.215 However, the IASB noted that the hedged risk affects the fair value of a prepayment option irrespective of whether the particular option holder actually exercises it at that time or intends to actually exercise it in the future. The fair value of the option captures the possible outcomes and hence the risk that an amount that would be in the money might be repaid at a different amount than at fair value before taking the prepayment option into account (for example, at par). Consequently, the IASB noted that whether a prepayment option is a purchased or a written option does not affect the change in the option's absolute fair value but instead determines whether it is either a gain or a loss from the entity's perspective. In other words, the IASB considered that the aspect of who controls the exercise of the option relates to whether any intrinsic value would be realised (but not whether it exists).

BC6.216 Consequently, the IASB decided not to differentiate between written and purchased prepayment options for the purpose of the eligibility of a layer-based designation of hedged items.

Relationship between components and the total cash flows of an item

BC6.217 IAS 39 allowed an entity to designate the LIBOR component of an interest-bearing asset or liability provided that the instrument has a zero or positive spread over LIBOR. When an entity has an interest-bearing debt instrument with an interest rate that is below LIBOR (or linked to a reference rate that is demonstrably below LIBOR), it would not be able to designate a hedging relationship based on a LIBOR risk component that assumes LIBOR cash flows that would exceed the actual cash flows on that debt instrument. However, for an asset or liability with a negative spread to LIBOR, an entity could still achieve hedge accounting by designating all of the cash flows of the hedged item for LIBOR interest rate risk (which is different from designating a LIBOR component that assumes cash flows exceeding those of the hedged item).

BC6.218 When an entity (particularly a bank) has access to sub-LIBOR funding (bearing a variable-interest coupon at LIBOR minus a spread or an equivalent fixed-rate coupon), the negative spread represents a positive margin for the borrower. This is because banks on average pay LIBOR for their funding in the interbank market. Another example of when this occurs is when the reference rate is highly correlated with LIBOR and the negative spreads arise because of the better credit risk of the contributors to the reference index compared with LIBOR. When entering into hedging relationships, an entity cannot obtain (at a reasonable cost) a standardised hedging instrument for all transactions that are priced sub-LIBOR. Consequently, such an entity uses hedging instruments that have LIBOR as their underlying.

BC6.219 In the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB noted that it had received feedback on the sub-LIBOR issue from its outreach activities that accompanied those deliberations. That feedback showed that some participants believed that designating a risk component that assumes cash flows that would exceed the actual cash flows of the financial instrument reflected risk management in situations in which the hedged item has a negative spread to the benchmark rate. They believed that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component. They argued that they were hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps.

BC6.220 In the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB noted that, for risk management purposes, an entity normally does not try to hedge the effective interest rate of the financial instrument but instead the change in the variability of the cash flows attributable to LIBOR. By doing this, such an entity ensures that exposure to benchmark interest rate risk is managed and that the profit margin of the hedged items (ie the spread relative to the benchmark) is protected against LIBOR changes, provided that LIBOR is not below the absolute value of the negative spread. This risk management strategy provides offsetting changes related to the LIBOR-related interest rate risk in a similar way to situations in which the spread above LIBOR is zero or positive. However, if LIBOR falls below the absolute value of that negative

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spread it would result in 'negative' interest, or interest that is inconsistent with the movement of market interest rates (similar to a 'reverse floater'). The IASB noted that these outcomes are inconsistent with the economic phenomenon to which they relate.

BC6.221 To avoid those outcomes, the IASB proposed retaining the restriction in IAS 39 for the designation of risk components when the designated component would exceed the total cash flows of the hedged item. However, the IASB emphasised that hedge accounting would still be available on the basis of designating all the cash flows of an item for a particular risk, ie a risk component for the actual cash flows of the item (see paragraph BC6.217).

BC6.222 The IASB received mixed views on its proposal to retain this restriction. Some agreed with the restriction and the IASB's rationale for retaining it. Others were concerned that the restriction was inconsistent with common risk management practices. Those who disagreed believed that it should be possible to designate as the hedged item a benchmark risk component that is equivalent to the entire LIBOR and to treat the spread between the entire LIBOR and the contractual rate as a negative residual component. Their view reflects the fact that they are hedging their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps (see paragraph BC6.226 for an example). In their view, the IASB's proposal would not allow them to properly reflect the hedging relationship, and would force them to recognise hedge ineffectiveness that, in their view, would not reflect their risk management strategy.

BC6.223 In response to the concerns raised, the IASB considered whether it should allow the designation of risk components on a benchmark risk basis that assumes cash flows exceeding the total actual cash flows of the hedged item.

BC6.224 As part of its redeliberations, the IASB discussed how contractual terms and conditions that determine whether an instrument has a zero interest rate floor or 'negative' interest (ie no floor) might affect the designation of a full LIBOR component of a sub-LIBOR instrument.

BC6.225 The IASB discussed an example of an entity that has a liability that pays a fixed rate and grants a loan at a floating rate with both instruments being priced at sub-LIBOR interest rates. The entity enters into a LIBOR-based interest rate swap with the aim of locking in the margin that it will earn on the combined position. If the entity wants to designate the hedged item on the basis of the interest rate risk that results from its financial asset, this would be an example of a cash flow hedge of variable-rate interest cash flows from a sub-LIBOR asset.

BC6.226 The IASB noted that if the floating-rate asset had a zero interest rate floor and LIBOR decreased below the absolute value of the negative spread on the asset, the return on the asset (after taking into account the effect of the swap) would increase as a result of the interest rate swap not having a floor. This means that if designated on a full LIBOR risk component basis, the hedging relationship would have outcomes that would be inconsistent with the notion of a locked margin. In this example, the margin could become variable instead of being locked. The IASB was of the view that, in the context of hedge accounting, this would give rise to hedge ineffectiveness that must be recognised in profit or loss. The IASB noted that this hedge ineffectiveness resulted from the absence of offsetting cash flows and hence represented a genuine economic mismatch between changes in cash flows on the floating-rate asset and the swap. Hence, if a full LIBOR component was imputed for interest bearing instruments that are priced sub-LIBOR, it would inappropriately defer hedge ineffectiveness in other comprehensive income. In the IASB's view this would be tantamount to accrual accounting for the interest rate swap.

BC6.227 In contrast, the IASB noted that if the floating-rate asset had no floor, the sub-LIBOR instrument included in the hedging relationship would still have changes in their cash flows that would move with LIBOR even if LIBOR was below the absolute value of the spread. Consequently, the variability in cash flows of the hedging instrument that locks the margin would be offset by the variability of the cash flows of the sub-LIBOR instrument irrespective of the LIBOR level. In other words, the LIBOR-related cash flow variability when the asset had no floor would be equivalent to that of a full LIBOR component and therefore the proposed requirement would not prohibit designating the hedged item accordingly (ie as changes in cash flows of a full LIBOR risk component).

BC6.228 As a result, the IASB decided to confirm the proposal in the 2010 Hedge Accounting Exposure Draft that if a component of the cash flows of a financial or non-financial item is designated as the hedged item, that component must be less than or equal to the total cash flows of the entire item.

BC6.229 Furthermore, the IASB noted that the examples carried over from IAS 39 to the 2010 Hedge Accounting Exposure Draft only included financial items because under IAS 39 the issue could only apply to that type of item. But, given that under the new hedge accounting model this issue also applies to non-financial items that are traded below their respective benchmark price, the IASB decided to add an example of a hedge of commodity price risk in a situation in which the commodity is priced at a discount to the benchmark commodity price.

Qualifying criteria for hedge accounting

Effectiveness assessment

BC6.230 To qualify for hedge accounting in accordance with IAS 39, a hedge had to be highly effective, both prospectively and retrospectively. Consequently, an entity had to perform two effectiveness assessments for each hedging relationship. The prospective assessment supported the expectation that the hedging relationship would be effective in the future. The retrospective assessment determined that the hedging relationship had been effective in the reporting period. All retrospective assessments were required to be performed using quantitative methods. However, IAS 39 did not specify a particular method for testing hedge effectiveness.

BC6.231 The term 'highly effective' referred to the degree to which the hedging relationship achieved offsetting between changes in the fair value or cash flows of the hedging instrument and changes in the fair value or cash flows of the hedged item attributable to the hedged risk during the hedge period. In accordance with IAS 39, a hedge was regarded as highly effective if the offset was within the range of 80–125 per cent (often colloquially referred to as a 'bright line test').

BC6.232 In the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB noted that it had received feedback on the hedge effectiveness assessment under IAS 39 from its outreach activities that accompanied those deliberations. The feedback showed that:

(a) many participants found that the hedge effectiveness assessment in IAS 39 was arbitrary, onerous and difficult to apply;

(b) as a result, there was often little or no link between hedge accounting and the risk management strategy; and

(c) because hedge accounting was not achieved if the hedge effectiveness was outside the 80–125 per cent range, it made hedge accounting difficult to understand in the context of the risk management strategy of the entity.

BC6.233 Consequently, in its 2010 Hedge Accounting Exposure Draft the IASB proposed a more principle-based hedge effectiveness assessment. The IASB proposed that a hedging relationship meets the hedge effectiveness requirements if it:

(a) meets the objective of the hedge effectiveness assessment (ie that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness); and

(b) is expected to achieve other than accidental offsetting.

BC6.234 Most respondents to the 2010 Hedge Accounting Exposure Draft supported the removal of the 80–125 per cent quantitative test. Those respondents also supported the IASB in avoiding the use of bright lines in hedge accounting generally and the move towards a more principle-based effectiveness assessment.

BC6.235 Only a few respondents disagreed with the proposal, largely because they believed that the quantitative threshold in IAS 39 was appropriate. They also believed that an approach that was completely principle-based would generate operational difficulties and would have the potential to inappropriately extend the application of hedge accounting.

BC6.236 The sections below elaborate on the IASB's considerations.

The objective of the hedge effectiveness assessment

BC6.237 Traditionally, accounting standard-setters have set high thresholds for hedging relationships to qualify for hedge accounting. The IASB noted that this resulted in hedge accounting that was considered by some as arbitrary and onerous. Furthermore, the arbitrary 'bright line' of 80–125 per cent resulted in a disconnect between hedge accounting and risk management. Consequently, it made it difficult to explain the results of hedge accounting to users of financial statements. To address those concerns, the IASB decided that it would propose an objective-based model for testing hedge effectiveness instead of the 80–125 per cent 'bright line test' in IAS 39.

BC6.238 During its deliberations, the IASB initially considered an objective-based assessment to determine which hedging relationships would qualify for hedge accounting. The IASB's intention was that the assessment should not be based on a particular level of hedge effectiveness. The IASB decided that, in order to avoid the arbitrary outcomes of the assessment under IAS 39, it had to remove, instead of just move, the bright line. The IASB held the view that the objective of the hedge effectiveness assessment should reflect the fact that hedge accounting was based on the notion of offset.

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BC6.239 In accordance with the approach that the IASB initially considered, the effectiveness assessment would have aimed only to identify accidental offsetting and prevent hedge accounting in those situations. This assessment would have been based on an analysis of the possible behaviour of the hedging relationship during its term to ascertain whether it could be expected to meet the risk management objective. The IASB believed that the proposed approach would therefore have strengthened the relationship between hedge accounting and risk management practice.

BC6.240 However, the IASB was concerned that this approach might not be rigorous enough. This was because, without clear guidance, an entity might designate hedging relationships that would not be appropriate because they would give rise to systematic hedge ineffectiveness that could be avoided by a more appropriate designation of the hedging relationship and hence be biased. The IASB noted that the bright line of 80-125 per cent in IAS 39 created a trade-off when an entity chose a hedge ratio that would have a biased result, because that result came at the expense of higher ineffectiveness and hence increased the risk of falling outside that range. However, the IASB noted that the 80–125 per cent range would be eliminated by its proposals and therefore decided to extend its initial objective of the effectiveness assessment so that it also included the hedge ratio. Consequently, in its 2010 Hedge Accounting Exposure Draft, the IASB proposed that the objective of assessing the effectiveness of a hedging relationship was that the entity designated the hedging relationship so that it gave an unbiased result and minimised expected ineffectiveness.

BC6.241 The IASB noted that many types of hedging relationships inevitably involve some ineffectiveness that cannot be eliminated. For example, ineffectiveness could arise because of differences in the underlyings or other differences between the hedging instrument and the hedged item that the entity accepts in order to achieve a cost-effective hedging relationship. The IASB considered that when an entity establishes a hedging relationship there should be no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the change in value of the hedged item. As a result, the IASB proposed in its 2010 Hedge Accounting Exposure Draft that hedging relationships should not be established (for accounting purposes) in such a way that they include a deliberate mismatch in the weightings of the hedged item and of the hedging instrument.

BC6.242 However, many respondents to the 2010 Hedge Accounting Exposure Draft asked the IASB to provide further guidance on the objective-based effectiveness assessment, particularly on the notions of 'unbiased result' and 'minimise expected hedge ineffectiveness'. Those respondents were concerned that the requirements, as drafted in the 2010 Hedge Accounting Exposure Draft, could be interpreted to be more restrictive and onerous than the bright line effectiveness test in IAS 39 and would be inconsistent with risk management practice. More specifically, those respondents were concerned that the objective of the hedge effectiveness assessment as drafted in the 2010 Hedge Accounting Exposure Draft could be interpreted as requiring entities to set up a hedging relationship that was 'perfectly effective'. They were concerned that this would result in an effectiveness assessment that would be based on a bright line of 100 per cent effectiveness, and that such an approach:

(a) would not take into account that, in many situations, entities do not use a hedging instrument that would make the hedging relationship 'perfectly effective'. They noted that entities use hedging instruments that do not achieve perfect hedge effectiveness because the 'perfect' hedging instrument is:

  (i) not available; or

  (ii) not cost-effective as a hedge (compared to a standardised instrument that is cheaper and/or more liquid, but does not provide the perfect fit).

(b) could be interpreted as a mathematical optimisation exercise. In other words, they were concerned that it would require entities to search for the perfect hedging relationship at inception (and on a continuous basis), because if they did not, the results could be considered to be biased and hedge ineffectiveness would probably not be 'minimised'.

BC6.243 In the light of the concerns about the use of hedging instruments that are not 'perfectly effective', the IASB noted that the appropriate hedge ratio was primarily a risk management decision instead of an accounting decision. When determining the appropriate hedge ratio, risk management would take into consideration, among other things, the following factors:

(a) the availability of hedging instruments and the underlyings of those hedging instruments (and, as a consequence, the level of the risk of differences in value changes involved between the hedged item and the hedging instrument);

(b) the tolerance levels in relation to expected sources of hedge ineffectiveness (which determine when the hedging relationship is adjusted for risk management purposes); and

(c) the costs of hedging (including the costs of adjusting an existing hedging relationship).

BC6.244 The IASB's intention behind its proposal in the 2010 Hedge Accounting Exposure Draft was that an entity would choose the actual hedge basing its decision on commercial considerations, designate it as the hedging instrument and use it as a starting point to determine the hedge ratio that would comply with the proposed requirements. In other words, the IASB did not intend that an entity would have to consider the hedge effectiveness and related hedge ratio that could have been achieved with a different hedging instrument that might have been a better fit for the hedged risk if it did not enter into that hedging instrument.

BC6.245 The IASB also reconsidered the proposed objective of the hedge effectiveness assessment in the light of the concerns that it might result in a mathematical optimisation exercise. In particular, the IASB considered the effect of its proposal in situations in which a derivative is designated as a hedging instrument only after its inception so that it is already in or out of the money at the time of its designation (often colloquially referred to as a 'late hedge'). The IASB considered whether the hedge ratio would have to be adjusted to take into account the (non-zero) fair value of the derivative at the time of its designation. This is because the fair value of the hedging instrument at the time of its designation is a present value. Over the remaining life of the hedging instrument this present value will accrete to the undiscounted amount (the 'unwinding of the discount'). The IASB noted that there is no offsetting fair value change in the hedged item for this effect (unless the hedged item was also in or out of the money in an equal but opposite way). Consequently, in situations in which the derivative is designated as the hedging instrument after its inception, an entity would expect that the changes in the value of the hedging instrument will systematically either exceed or be less than the changes in the value of the hedged item (ie the hedge ratio would not be 'unbiased'). To meet the proposed objective of the hedge effectiveness assessment an entity would need to explore whether it could adjust the hedge ratio to avoid the systematic difference between the value changes of the hedging instrument and the hedged item over the hedging period. However, to determine the ratio that would avoid that systematic difference, an entity would need to know what the actual price or rate of the underlying will be at the end of the hedging relationship. Hence, the IASB noted that the proposed objective of the hedge effectiveness assessment could be interpreted to the effect that, in the (quite common) situations in which an entity has a 'late hedge', the proposed hedge effectiveness requirements would not be met. This is because the entity would not be able to identify a hedge ratio for the designation of the hedging relationship that would not involve an expectation that the changes in value of the hedging instrument will systematically either exceed or be less than the changes in the value of the hedged item. The IASB did not intend this outcome when it developed its proposals in its 2010 Hedge Accounting Exposure Draft.

BC6.246 The IASB noted that the feedback about the requirement that the hedging relationship should minimise hedge ineffectiveness suggested that identifying a 'minimum' would involve considerable effort in all situations in which the terms of the hedging instrument and the hedged item are not fully matched. Hence, the requirement to minimise hedge ineffectiveness would bring back many of the operational problems of the hedge effectiveness assessment in IAS 39. Furthermore, regardless of the effort involved, it would be difficult to demonstrate that the 'minimum' had been identified.

BC6.247 The IASB noted that when it developed its 2010 Hedge Accounting Exposure Draft, it included the notions of 'unbiased' and 'minimise expected hedge ineffectiveness' to ensure that:

(a) entities would not deliberately create a difference between the quantity actually hedged and the quantity designated as the hedged item in order to achieve a particular accounting outcome; and

(b) an entity would not inappropriately designate a hedging relationship such that it would give rise to systematic hedge ineffectiveness, which could be avoided by a more appropriate designation.

The IASB noted that both aspects could result in undermining the 'lower of' test for cash flow hedges or achieving fair value hedge adjustments on a greater quantity of the hedged item than an entity actually hedged (ie fair value accounting would be disproportionately expanded compared to the quantity actually hedged).

BC6.248 Taking into account the responses to the 2010 Hedge Accounting Exposure Draft, the IASB decided to remove the terms 'unbiased' (ie no expectation that changes in the value of the hedging instrument will systematically either exceed or be less than the changes in the value of the hedged item such that they would produce a biased result) and 'minimising expected hedge ineffectiveness'. Instead, the IASB decided to state, more directly, that the entity's designation of the hedging relationship shall use a hedge ratio based on:

(a) the quantity of the hedged item that it actually hedges; and

(b) the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item.

BC6.249 The IASB noted that this approach has the following advantages:

(a) the use of the hedge ratio resulting from the requirement in this Standard provides information about the hedge ineffectiveness in situations in which an entity uses a hedging instrument that does not provide the best fit (for example, because of cost-efficiency considerations). The IASB noted that the hedge ratio determined for risk management purposes has the effect of showing the characteristics of

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the hedging relationship and the entity's expectations about hedge ineffectiveness. This includes hedge ineffectiveness that results from using a hedging instrument that does not provide the best fit.

(b) it also aligns hedge accounting with risk management and hence is consistent with the overall objective of the new hedge accounting model.

(c) it addresses the requests from respondents to the 2010 Hedge Accounting Exposure Draft for clarification that the relevant hedging instrument to be considered in the hedge effectiveness assessment is the actual hedging instrument the entity decided to use.

(d) it retains the notion proposed in the 2010 Hedge Accounting Exposure Draft that the hedge ratio is not a free choice for accounting purposes as it was in IAS 39 (subject to passing the 80–125 per cent bright line test).

BC6.250 The IASB noted that the only situation open to abuse is if the entity purposefully (for risk management purposes) used a hedge ratio that would be considered 'inappropriately loose' from an accounting perspective, for example:

(a) if an entity uses an excess quantity of the hedging instrument it would have more costs and risks because of having more hedging instruments than needed to mitigate the risks resulting from the hedged items. However, from an accounting perspective, this would not lead to any advantage because it would create fair value changes for the hedging instrument that affect profit or loss for both fair value hedges and cash flow hedges. The result of an entity using an excess quantity of the hedging instrument would therefore solely be the presentation of fair value changes within profit or loss as hedge ineffectiveness instead of other or trading gains or losses. This would increase the hedge ineffectiveness in an entity's financial statements while having no impact on overall profit or loss.

(b) if an entity uses a quantity of the hedging instrument that is too small it would leave, economically, a gap in its hedging. From an accounting perspective, this might create an advantage for fair value hedges if an entity wanted to achieve fair value hedge adjustments on a greater quantity of 'hedged items' than it would achieve when using an appropriate hedge ratio. In addition, for cash flow hedges, an entity could abuse the lower of test because the hedge ineffectiveness arising from the larger change in fair value on the hedged item compared to that on the hedging instrument would not be recognised. Consequently, even though using a 'deficit' quantity of the hedging instrument would not be economically advantageous, from an accounting perspective it might have the desired outcome for an entity.

BC6.251 The IASB noted that the potential for abuse, as illustrated above, was implicitly addressed in IAS 39 by the 80–125 per cent bright line of the retrospective hedge effectiveness assessment. Given its decision to remove that bright line (see paragraph BC6.237), the IASB decided to explicitly address this potential for abuse. As a consequence, this Standard requires that, for the purpose of hedge accounting, an entity shall not designate a hedging relationship in a manner that reflects an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness (irrespective of whether recognised or not) that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting.

Other than accidental offsetting

BC6.252 IAS 39 was based on a purely accounting-driven percentage-based bright line test (the 80–125 per cent range). This disconnected accounting from risk management (see paragraph BC6.237). Consequently, the IASB proposed replacing the bright line test with a notion that aims to reflect the way entities look at the design and monitoring of hedging relationships from a risk management perspective. Inherent in this was the notion of 'other than accidental offsetting'. This linked the risk management perspective with the hedge accounting model's general notion of offset between gains and losses on hedging instruments and hedged items. The IASB also considered that this link reflected the intention that the effectiveness assessment should not be based on a particular level of effectiveness (hence avoiding a new bright line).

BC6.253 Many respondents to the 2010 Hedge Accounting Exposure Draft asked the IASB to provide further guidance on the notion of 'other than accidental offsetting'. Many also suggested that the IASB revise the proposed guidance by introducing a direct reference to the aspect of an economic relationship between the hedged item and the hedging instrument that was included in the application guidance proposed in the 2010 Hedge Accounting Exposure Draft.

BC6.254 The IASB noted that qualifying criteria that use terminology such as 'other than accidental offsetting' can be abstract. The feedback suggested that this makes the relevant aspects or elements of the hedge effectiveness assessment more difficult to understand. The IASB considered that it could address the respondents' request and reduce the abstractness of this proposal by avoiding the use of an 'umbrella term' and instead making

explicit all aspects that the requirement comprises. This would provide greater clarity and facilitate a better understanding of what aspects are relevant when assessing hedge effectiveness.

BC6.255 Consequently, the IASB decided to replace the term 'other than accidental offsetting' with requirements that better conveyed its original notion:

(a) an economic relationship between the hedged item and the hedging instrument, which gives rise to offset, must exist at inception and during the life of the hedging relationship; and

(b) the effect of credit risk does not dominate the value changes that result from that economic relationship.

A 'reasonably effective' threshold

BC6.256 A few respondents suggested that the IASB could consider using a 'qualitative threshold' instead of a principle-based hedge effectiveness assessment. Those respondents believed that, in order to meet the hedge effectiveness criteria, a hedging relationship should be required to be 'reasonably effective' in achieving offsetting changes in the fair value of the hedged item and in the fair value of the hedging instrument.

BC6.257 The IASB noted that a 'reasonably effective' criterion would retain the threshold design of the effectiveness assessment that was used in IAS 39. The IASB considered that moving, instead of removing, the threshold would not address the root cause of the problem (see paragraph BC6.237). The suggested approach would instead only change the level of the threshold. The IASB considered that, even though the threshold would be of a qualitative nature, it would still create a danger of reverting back to a quantitative measure (such as the percentage range of IAS 39) in order for it to be operational. The IASB noted that similar concerns had been raised as part of the feedback to the 2010 Hedge Accounting Exposure Draft.

BC6.258 The IASB also noted that one of the major concerns that respondents had raised about the reference in the 2010 Hedge Accounting Exposure Draft to 'unbiased result' was that it could be perceived as requiring entities to identify the 'perfect' hedging instrument or that the entity's commercial decision of which hedging instrument to actually use could be restricted or second guessed (see paragraph BC6.242).

BC6.259 The IASB considered that using a reference to 'reasonably effective' would give rise to similar concerns because it would raise the question of how much ineffectiveness that results from the choice of the actual hedging instrument is 'reasonable' (similar to the notion of 'unbiased' proposed in the 2010 Hedge Accounting Exposure Draft). The IASB was also concerned that this might have a particular impact on emerging economies because entities in those economies often have to transact hedging instruments in more liquid markets abroad, which means that it is more difficult for them to find a hedging instrument that fits their actual exposure than it is for entities in economies with those liquid markets.

BC6.260 Furthermore, the IASB was concerned that using the single term 'reasonably effective' would mingle different aspects, which would be tantamount to aggregating the different aspects of the effectiveness assessment that the IASB had considered (ie the economic relationship, the effect of credit risk and the hedge ratio). The IASB noted that it was clear from feedback received on its proposed objective of the hedge effectiveness assessment that a single term was too abstract if the notion described by that term included a number of different aspects (see also paragraph BC6.254).

BC6.261 Consequently, the IASB decided not to use a qualitative 'reasonably effective' threshold for assessing hedge effectiveness.

Frequency of assessing whether the hedge effectiveness requirements are met

BC6.262 In the deliberations leading to the 2010 Hedge Accounting Exposure Draft, as a consequence of its proposed hedge effectiveness requirements, the IASB considered how frequently an entity should assess whether the hedge effectiveness requirements were met. The IASB decided that an entity should perform this assessment at the inception of the hedging relationship.

BC6.263 Furthermore, the IASB considered that an entity should assess, on an ongoing basis, whether the hedge effectiveness requirements are still met, including any adjustment (rebalancing) that might be required in order to continue to meet those requirements (see paragraphs BC6.300–BC6.313). This was because the proposed hedge effectiveness requirements should be met throughout the term of the hedging relationship. The IASB also decided that the assessment of those requirements should be only forward-looking (ie prospective) because it related to expectations about hedge effectiveness.

BC6.264 Hence, in the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB concluded that the reassessment of the hedge ratio should be performed at the beginning of each reporting period or upon a significant change in the circumstances underlying the effectiveness assessment, whichever comes first.

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BC6.265 Given that the changes made to the proposed hedge effectiveness requirements when redeliberating the 2010 Hedge Accounting Exposure Draft did not affect the IASB's rationale for its proposals for the frequency of the assessment, the IASB retained its original decision.

Method of assessing hedge effectiveness

BC6.266 The method used to assess the effectiveness of the hedging relationship needs to be suitable to demonstrate that the objective of the hedge effectiveness assessment has been achieved. The IASB considered whether the effectiveness of a hedging relationship should be assessed on either a qualitative or a quantitative basis.

BC6.267 Hedging relationships have one of two characteristics that affect the complexity of the hedge effectiveness assessment:

(a) the critical terms of the hedged item and hedging instrument match or are closely aligned. If there are no substantial changes in the critical terms or in the credit risk of the hedging instrument or hedged item, the hedge effectiveness can typically be determined using a qualitative assessment.

(b) the critical terms of the hedged item and hedging instrument do not match and are not closely aligned. These hedging relationships involve an increased level of uncertainty about the degree of offset and so the effectiveness of the hedge during its term is more difficult to evaluate.

BC6.268 Qualitative hedge effectiveness assessments use a comparison of the terms of the hedged item and the hedging instrument (for example, the commonly termed 'critical-terms-match' approach). The IASB considered that, in the context of an effectiveness assessment that does not use a threshold, it can be appropriate to assess the effectiveness qualitatively for a hedging relationship for which the terms of the hedging instrument and the hedged item match or are closely aligned.

BC6.269 However, assessing the hedging relationship qualitatively is less effective than a quantitative assessment in other situations. For example, when analysing the possible behaviour of hedging relationships that involve a significant degree of potential ineffectiveness resulting from terms of the hedged item that are less closely aligned with the hedging instrument, the extent of future offset has a high level of uncertainty and is difficult to determine using a qualitative approach. The IASB considered that a quantitative assessment would be more suitable in such situations.

BC6.270 Quantitative assessments or tests encompass a wide spectrum of tools and techniques. The IASB noted that selecting the appropriate tool or technique depends on the complexity of the hedge, the availability of data and the level of uncertainty of offset in the hedging relationship. The type of assessment and the method used to assess hedge effectiveness therefore depends on the relevant characteristics of the hedging relationship. Consequently, in the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB decided that an entity should assess the effectiveness of a hedging relationship either qualitatively or quantitatively depending on the relevant characteristics of the hedging relationship and the potential sources of ineffectiveness. However, the IASB decided not to prescribe any specific method of assessing hedge effectiveness.

BC6.271 The IASB retained its original decisions when redeliberating its 2010 Hedge Accounting Exposure Draft.

Accounting for qualifying hedging relationships

Hedge of a foreign currency risk of a firm commitment

BC6.272 IAS 39 allowed an entity to choose fair value hedge accounting or cash flow hedge accounting for hedges of the foreign currency risk of a firm commitment. When developing the 2010 Hedge Accounting Exposure Draft, the IASB considered whether it should continue to allow this choice.

BC6.273 The IASB noted that requiring an entity to apply cash flow hedge accounting for all hedges of foreign currency risk of a firm commitment could result in what some regard as 'artificial' other comprehensive income and equity volatility (see paragraphs BC6.353–BC6.354). The IASB also noted that, by requiring an entity to apply cash flow hedge accounting, the lower of test would apply to transactions that already exist (ie firm commitments).

BC6.274 However, the IASB also noted that requiring an entity to apply fair value hedge accounting for all hedges of foreign currency risk of a firm commitment would require a change in the type of hedging relationship to a fair value hedge when the foreign currency cash flow hedge of a forecast transaction becomes a hedge of a firm commitment. This results in operational complexity. For example, this would require changing the measurement of ineffectiveness from a 'lower of' test to a symmetrical test.

BC6.275 The IASB also noted that for existing hedged items (such as firm commitments) foreign currency risk affects both the cash flows and the fair value of the hedged item and hence has a dual character.

BC6.276 Consequently, the IASB proposed in its 2010 Hedge Accounting Exposure Draft to continue to permit an entity the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge.

BC6.277 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Measuring the ineffectiveness of a hedging relationship

BC6.278 Because the measurement of hedge ineffectiveness is based on the actual performance of the hedging instrument and the hedged item, the IASB in its deliberations leading to the 2010 Hedge Accounting Exposure Draft decided that hedge ineffectiveness should be measured by comparing the changes in their values (on the basis of currency unit amounts).

BC6.279 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Time value of money

BC6.280 The objective of measuring hedge ineffectiveness is to recognise, in profit or loss, the extent to which the hedging relationship did not achieve offset (subject to the restrictions that apply to the recognition of hedge ineffectiveness for cash flow hedges—often referred to as the lower of test).

BC6.281 The IASB noted that hedging instruments are subject to measurement either at fair value or amortised cost, both of which are present value measurements. Consequently, in order to be consistent, the amounts that are compared with the changes in the value of the hedging instrument must also be determined on a present value basis. The IASB noted that hedge accounting does not change the measurement of the hedging instrument, but that it might change only the location of where the change in its carrying amount is presented. As a result, the same basis (ie present value) for the hedged item must be used in order to avoid a mismatch when determining the amount to be recognised as hedge ineffectiveness.

BC6.282 Consequently, in the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB decided that the time value of money must be considered when measuring the ineffectiveness of a hedging relationship.

BC6.283 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Hypothetical derivatives

BC6.284 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB considered the use of a 'hypothetical derivative', which is a derivative that would have critical terms that exactly match those of a hedged item. The IASB considered the use of a hypothetical derivative in the context of the hedge effectiveness assessment as well as for the purpose of measuring hedge ineffectiveness.

BC6.285 The IASB noted that the purpose of a hypothetical derivative is to measure the change in the value of the hedged item. Consequently, a hypothetical derivative is not a method in its own right for assessing hedge effectiveness or measuring hedge ineffectiveness. Instead, a hypothetical derivative is one possible way of determining an input for other methods (for example, statistical methods or dollar-offset) to assess the effectiveness of the hedging relationship or to measure ineffectiveness.

BC6.286 Consequently, in the deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB decided that an entity can use the fair value of a hypothetical derivative to calculate the fair value of the hedged item. This allows determining changes in the value of the hedged item against which the changes in the fair value of the hedging instrument are compared to assess hedge effectiveness and measure ineffectiveness. The IASB noted that this notion of a hypothetical derivative means that using a hypothetical derivative is only one possible way to determine the change in the value of the hedged item and would result in the same outcome as if that change in the value was determined by a different approach (ie it is a mathematical expedient).

BC6.287 When redeliberating its 2010 Hedge Accounting Exposure Draft the IASB considered feedback that disagreed with this proposal. The main reasons cited for disagreement were:

(a) cash flow hedges and fair value hedges are different concepts. Unlike fair value hedges, cash flow hedges are not based on a valuation concept and therefore do not give rise to hedge ineffectiveness from differences in value changes between the hedging instrument and the hedged item as long as

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their variable cash flows match. However, some conceded that credit risk was a source of hedge ineffectiveness even if all variable cash flows were perfectly matched.

(b) the new hedge accounting model has the objective of aligning hedge accounting more closely with risk management. Risk management has a 'flow perspective' that considers cash flow hedges as (fully) effective if the variable cash flows of the actual derivative match those of the hedged item (ie if the entity uses a 'perfect derivative' to hedge the risk exposure).

(c) the accounting treatment for the effect of a foreign currency basis spread is inconsistent with that for the time value of options and the forward element of forward contracts, ie the notion of 'costs of hedging' that the new hedge accounting model introduces. The foreign currency basis spread is also a cost of hedging and should be treated consistently with the other types of costs of hedging.

BC6.288 The IASB considered whether a cash flow hedge is a different concept from a fair value hedge. The IASB noted that IFRS uses a hedge accounting model that is based on a valuation at the reporting date of both the hedging instrument and the hedged item (valuation model); hedge (in)effectiveness is then measured by comparing the changes in the value of the hedging instrument and the hedged item. Consequently, for determining the effective part of a cash flow hedge, an entity also needs to look at the change in cash flows on a present value basis, ie based on a valuation. Consequently, simply comparing the cash flow variability of the hedging instrument and the hedged item (ie a pure 'flow perspective' without involving a valuation) was not appropriate.

BC6.289 The IASB also noted that IFRS uses a hedge accounting model that does not allow perfect hedge effectiveness to be assumed, and that this applies even if for a cash flow hedge the critical terms of the hedging instrument and the hedged item perfectly match. Doing so could conceal differences in credit risk or liquidity of the hedging instrument and the hedged item, which are potential sources of hedge ineffectiveness for fair value hedges and cash flow hedges alike.

BC6.290 The IASB therefore rejected the view that cash flow hedges and fair value hedges were different concepts in that the former represented a mere comparison of cash flows whereas only the latter represented a comparison of valuations. Consequently, the IASB also rejected the view that a hypothetical derivative is meant to represent the 'perfect hedge' instead of the hedged item. Instead, the IASB confirmed its view that for fair value hedges and cash flow hedges the hedge accounting model:

(a) is a valuation model; and

(b) requires that the value of the hedged item is measured independently of the value of the hedging instrument.

BC6.291 The IASB noted that the objective of aligning hedge accounting with risk management meant that the IASB developed a new hedge accounting model that would facilitate hedge accounting in more circumstances than the previous one and would provide more useful information about the risk management associated with hedging. But this objective did not mean that an entity could override accounting requirements with its particular risk management view.

BC6.292 Consequently, the IASB rejected the view that if risk management considered cash flow hedges as fully effective when the variable cash flows of the actual derivative match those of the hedged item (ie if the entity uses a 'perfect derivative') that hedge should also be considered as fully effective for accounting purposes.

BC6.293 The IASB then considered the concern that the accounting treatment for the effect of a foreign currency basis spread was inconsistent with that for the time value of options and the forward element of forward contracts, ie the notion of 'costs of hedging' that the new hedge accounting model introduces.

BC6.294 The IASB noted that its proposals would result in hedge ineffectiveness arising from the fair value changes of the hedging instrument that are attributable to the effect of a foreign currency basis spread. Taking the example of a cross-currency interest rate swap that is a hedge of the foreign currency risk (and the interest rate risk) of a debt instrument that is denominated in a foreign currency, the IASB noted that the cross-currency interest rate swap included a pricing element that reflected that the derivative instrument resulted in the exchange of two currencies. This led to the IASB questioning whether there was a similar feature or characteristic in the hedged item that would offset the effect of the foreign currency basis spread on the fair value of the cross-currency interest rate swap. The IASB noted that the hedged debt instrument was a single-currency instrument, ie unlike the cross-currency interest rate swap, the hedged item itself did not involve the exchange of two currencies. Instead, any exchange of the debt instrument's currency of denomination for another currency was a circumstance of the holder or issuer of that debt instrument instead of a characteristic or feature of the debt instrument itself.

BC6.295 The IASB noted that whether reflecting the effect of the foreign currency basis spread within hedge ineffectiveness, as proposed in the 2010 Hedge Accounting Exposure Draft, was inconsistent with the new hedge accounting model depended on whether that spread could be regarded as a cost of hedging. Foreign currency basis spreads are an economic phenomenon that would not exist in a perfect market because the

existence of such a spread creates economic arbitrage opportunities that would result in its reduction to zero. However, in the actual markets for cross-currency swaps the foreign currency basis spread is not zero because of factors that prevent perfect arbitrage. Those factors include, for example, the credit risk embedded in the underlying reference rates of the currencies as well as the demand and supply for the particular financial product (for example, cross-currency interest rate swaps), which relates to specific situations in foreign currency (product) markets. Also, the interaction between the spot and the forward foreign currency markets can sometimes have an effect.

BC6.296 The IASB considered that, overall, a foreign currency basis spread could be considered as a charge to convert one currency into another. Consequently, the IASB agreed that the foreign currency basis spread could be subsumed under the notion of 'costs of hedging' that it had developed for the accounting for the time value of options and the forward element of forward contracts. The IASB therefore decided to expand the notion of 'costs of hedging' so as to include foreign currency basis spreads. In the IASB's view, this would provide the most transparent accounting, reflect best the economics of the transaction and fit into the new hedge accounting model.

BC6.297 The IASB also considered whether it should expand the notion of 'costs of hedging' by broadening the exception it had proposed for the time value of options and the forward element of forward contracts or by replacing that exception with a broader principle. The IASB acknowledged that, conceptually, a principle would be preferable but it was concerned that using a broader principle for the costs of hedging could result in some types of hedge ineffectiveness being inappropriately deferred in accumulated other comprehensive income as costs of hedging.

BC6.298 Consequently, the IASB decided to expand the notion of 'costs of hedging' but only for foreign currency basis spreads by broadening the exception for the forward elements of forward contracts so that it also covers those spreads.

BC6.299 The IASB also decided to more closely align the structure of this exception with that used for the accounting for the time value of options. The IASB noted that for hedges of transaction related hedged items, using the forward rate method to measure the hedged item would allow entities to achieve an equivalent accounting outcome for the forward element of forward contracts (see paragraphs BC6.418–BC6.420). However, the IASB acknowledged that in order to allow a similar accounting outcome not only for the forward element of forward contracts but also for foreign currency basis spreads, entities would need to be able to apply the notion of 'costs of hedging', including for hedges of transaction related hedged items. Consequently, the IASB introduced the notion of 'costs of hedging' also for those types of cost of hedging for both hedges of time–period related hedged items and for hedges of transaction related hedged items.

Rebalancing the hedging relationship

BC6.300 IAS 39 did not allow adjustments that were not envisaged and documented at the inception of the hedge to be treated as adjustments to a continuing hedging relationship. IAS 39 treated adjustments to an existing hedging relationship that were not envisaged at the inception of the hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. The IASB noted that this resulted from a hedge accounting model that did not include the notion of accounting for changes to an existing hedging relationship as a continuation of that relationship.

BC6.301 The IASB noted that this is inconsistent with risk management practices. There are instances where, although the risk management objective remains the same, adjustments to an existing hedging relationship are made because of changes in circumstances related to the hedging relationship's underlyings or risk variables. For example, such adjustments are often required to re-align the hedging relationship with risk management policies in view of changed circumstances. Hence, those adjustments to the hedged item or hedging instrument do not change the original risk management objective but instead reflect a change in how it is executed owing to the changes in circumstances. The IASB considered that in those situations the revised hedging relationship should be accounted for as a continuation of the existing hedging relationship. The IASB referred to such adjustments of hedging relationships as 'rebalancing'.

BC6.302 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB also considered the ramifications of the proposed hedge effectiveness requirements, which, for some changes in circumstances, would create the need for an adjustment to the hedging relationship to ensure that those requirements would continue to be met. An example is a change in the relationship between two variables in such a way that the hedge ratio would need to be adjusted in order to avoid a level of ineffectiveness that would fail the effectiveness requirements (which would not be met when using the original hedge ratio in the new circumstances).

BC6.303 The IASB concluded that, in such situations, if the original risk management objective remained unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. Consequently, the IASB proposed that an adjustment to a hedging relationship is treated as a rebalancing

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when that adjustment changes the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument but risk management otherwise continues the originally designated hedging relationship.

BC6.304 However, if the adjustment represents an overhaul of the existing hedging relationship, the IASB considered that treating the adjustment as a rebalancing would not be appropriate. Instead, the IASB considered that such an adjustment should result in the discontinuation of that hedging relationship. An example is a hedging relationship with a hedging instrument that experiences a severe deterioration of its credit quality and hence is no longer used for risk management purposes.

BC6.305 Most respondents to the 2010 Hedge Accounting Exposure Draft agreed that the hedge accounting model should include a notion whereby a hedging relationship can be adjusted and accounted for as the continuation of an existing hedging relationship. Respondents thought that the inclusion of the concept of rebalancing would enhance the application of hedge accounting and would be a better representation of what entities do as part of their risk management activities. However, some respondents requested that the IASB clarify the circumstances in which rebalancing is required or permitted. They were unsure as to whether rebalancing has been designed in the narrower sense to only deal with adjustments to the hedge ratio in the context of the hedge effectiveness requirements, or whether in a wider sense it also relates to the adjustment of hedged volumes when the hedge ratio is still appropriate (ie when the entity simply wants to hedge more or less than originally).

BC6.306 Even though respondents generally supported the concept of rebalancing, some were concerned that, on the basis of how the hedge effectiveness requirement was proposed in the 2010 Hedge Accounting Exposure Draft, it would be unclear when to rebalance and that the IASB should provide more guidance to ensure consistent application. Some respondents also thought that rebalancing should be permitted but not mandatory. They argued that risk management often chose not to adjust its (economic) hedging relationships based on a mathematical optimisation exercise that was implied in the 2010 Hedge Accounting Exposure Draft (see paragraph BC6.242). This was because of cost-effectiveness considerations or simply because the hedge was still within the tolerance limits that an entity might use for adjusting the hedging relationship. There was concern that the wording, as proposed in the 2010 Hedge Accounting Exposure Draft, implied a continuous optimisation exercise (ie to always have the perfect hedge ratio) and would therefore require constant rebalancing. Consequently, almost all respondents (directly or indirectly) requested that the IASB clarify that rebalancing should only be required when done for risk management purposes. They believed that hedge accounting should follow and represent rebalancing based on what an entity actually did for risk management purposes but that rebalancing should not be triggered merely by accounting requirements.

BC6.307 In the light of the feedback, the IASB decided to retain the notion of rebalancing but to add some clarification on:

(a) whether rebalancing should be mandatory or voluntary; and

(b) the notion of rebalancing.

Mandatory or voluntary rebalancing

BC6.308 The IASB noted that its decision on the hedge effectiveness assessment when deliberating the 2010 Hedge Accounting Exposure Draft had ramifications for rebalancing. This decision resulted in designating hedging relationships using a hedge ratio based on the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that it actually uses to hedge that quantity of hedged item. However, this is provided that the hedge ratio would not reflect an imbalance that would create hedge ineffectiveness that could result in an accounting outcome that would be inconsistent with the purpose of hedge accounting (see paragraphs BC6.248–BC6.251). The IASB considered that this decision addressed the main concerns respondents had about rebalancing (ie how rebalancing for hedge accounting purposes related to rebalancing for risk management purposes).

BC6.309 The IASB's proposal in the 2010 Hedge Accounting Exposure Draft included the notion of proactive rebalancing as a complement to the proposed hedge effectiveness assessment in order to allow an entity to adjust hedging relationships on a timely basis and at the same time strengthen the link between hedge accounting and risk management. However, the IASB considered that its decision on the hedge effectiveness assessment when deliberating the 2010 Hedge Accounting Exposure Draft (see paragraph BC6.248) had an effect on rebalancing that would facilitate the adjustments to a hedging relationship that the 2010 Hedge Accounting Exposure Draft had addressed by the proposed notion of proactive rebalancing. In other words, if an entity adjusted the hedge ratio in response to changes in the economic relationship between the hedged item and the hedging instrument for risk management purposes (including adjustments that the 2010 Hedge Accounting Exposure Draft would have considered 'proactive'), the hedging relationship for hedge

accounting purposes would usually be adjusted in the same way. Consequently, the IASB considered that the notion of proactive rebalancing had become obsolete.

BC6.310 The IASB also noted that the decisions that it made on the hedge effectiveness assessment when deliberating the 2010 Hedge Accounting Exposure Draft addressed respondents' concerns about the frequency of rebalancing because those decisions also clarified that rebalancing was not a mathematical optimisation exercise (see paragraphs BC6.248–BC6.249).

Clarification of the term 'rebalancing'

BC6.311 The IASB noted that it had already clarified the notion of 'rebalancing' as a result of its decision on the hedge effectiveness assessment when deliberating the 2010 Hedge Accounting Exposure Draft (see paragraphs BC6.308–BC6.310). However, the IASB considered whether it also needed to provide clarification on the scope of rebalancing—in other words, what adjustments to a hedging relationship constitute rebalancing.

BC6.312 The IASB noted that the notion of rebalancing, as proposed in its 2010 Hedge Accounting Exposure Draft, was used in the context of adjusting the designated quantities of the hedging instrument or hedged item in order to maintain a hedge ratio that complies with the hedge effectiveness requirements. Changes to designated quantities of a hedging instrument or of a hedged item for different purposes did not constitute the notion of 'rebalancing' that was proposed in the 2010 Hedge Accounting Exposure Draft.

BC6.313 Consequently, the IASB decided to clarify that rebalancing only covers adjustments to the designated quantities of the hedged item or of the hedging instrument for the purpose of maintaining a hedge ratio that complies with the requirements of the hedge effectiveness assessment (ie not when the entity simply wants to hedge more or less than it did originally).

Discontinuation of hedge accounting

Mandatory or voluntary discontinuation of hedge accounting

BC6.314 In accordance with IAS 39, an entity had to discontinue hedge accounting when the hedging relationship ceased to meet the qualifying criteria (including when the hedging instrument no longer existed or was sold). However, in accordance with IAS 39, an entity also had a free choice to voluntarily discontinue hedge accounting by simply revoking the designation of the hedging relationship (ie irrespective of any reason).

BC6.315 The IASB noted that entities voluntarily discontinued hedge accounting often because of how the effectiveness assessment in IAS 39 worked. For example, entities revoked the designation of a hedging relationship and re-designated it as a new hedging relationship in order to apply a different method of assessing hedge ineffectiveness from the method originally documented (expecting that the new method would be a better fit). Another example was entities that revoked the designation of a hedging relationship because they wanted to adjust the hedge ratio following a change in the relationship between the hedged item and the hedging instrument (typically in response to a change in the relationship between different underlyings). The hedging relationship was then re-designated, including the adjustment to the volume of the hedging instrument or the hedged item, in order to achieve the new hedge ratio. The IASB noted that in those situations the hedging relationship was discontinued and then restarted even though the risk management objective of the entity had not changed. In the IASB's view, those outcomes created a disconnect between the hedge accounting model in IAS 39 and hedging from a risk management perspective and also undermined the usefulness of the information provided.

BC6.316 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB concluded that the proposed hedge accounting model would improve the link between hedge accounting and risk management because:

(a) the new hedge effectiveness assessment requirements would not involve a percentage band or any other bright line criterion and would result in changing the method for assessing hedge effectiveness in response to changes in circumstances as part of a continuing hedging relationship; and

(b) the notion of rebalancing would allow the hedge ratio to be adjusted as part of a continuing hedging relationship.

BC6.317 The IASB also noted that sometimes a hedging relationship was discontinued because of a decrease in the hedged quantities of forecast transactions (ie the volume that remains highly probable of occurring falls or is expected to fall below the volume designated as the hedged item). Under IAS 39 this had resulted in discontinuing hedge accounting for the hedging relationship as designated, ie the volume designated as the

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hedged item in its entirety. The IASB considered that the quantity of forecast transactions that were still highly probable of occurring was in fact a continuation of the original hedging relationship (albeit with a lower volume). Hence, the IASB decided to propose in its 2010 Hedge Accounting Exposure Draft that hedge accounting should be discontinued only for the volume that was no longer highly probable of occurring and that the remaining volume that was still highly probable of occurring should be accounted for as a continuation of the original hedging relationship. In the IASB's view, this would more closely align hedge accounting with risk management and provide more useful information.

BC6.318 However, the IASB was concerned that this accounting might possibly undermine the requirement that forecast transactions must be highly probable in order to qualify as a hedged item. Hence, the IASB decided to also propose to clarify that a history of having designated hedges of forecast transactions and having subsequently determined that the forecast transactions are no longer expected to occur would call into question the entity's ability to predict similar forecast transactions accurately. This would affect the assessment of whether similar forecast transactions are highly probable and hence their eligibility as hedged items.

BC6.319 In view of its aim to better link hedge accounting to risk management and provide more useful hedge accounting information, the IASB also discussed whether it should retain an entity's choice to revoke the designation of a hedging relationship, taking into consideration that the designation of a hedging relationship (and hence the discontinuation of hedge accounting) at will does not result in useful information. The IASB noted that this would allow hedge accounting to be discontinued even if the entity for risk management purposes continued to hedge the exposure in accordance with its risk management objective that was part of the qualifying criteria that initially allowed the entity to achieve hedge accounting. The IASB considered that, in such situations, voluntary discontinuation of hedge accounting would be arbitrary and unjustifiable. Hence, the IASB decided to propose not to allow entities a free choice to revoke the designation of a hedging relationship in this situation. The IASB also noted that if the hedging relationship no longer reflected the risk management objective for that particular hedging relationship, discontinuation of hedge accounting was not a choice but was required because the qualifying criteria would no longer be met. The IASB considered that applying hedge accounting without a risk management objective would not provide useful information.

BC6.320 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB did not consider new designations of any hedging relationships of the acquiree in the consolidated financial statements of the acquirer following a business combination. The IASB noted that this was a requirement of IFRS 3 *Business Combinations* and hence not within the scope of its project on hedge accounting.

BC6.321 The responses to the proposals on the discontinuation of hedge accounting in the 2010 Hedge Accounting Exposure Draft provided mixed views. Those who agreed thought that the proposals would strengthen the reliability of financial reporting because the ability to change accounting for no valid reason would be reduced.

BC6.322 More specifically, those who agreed also thought that the model in IAS 39 provided an opportunity for structuring. They noted that allowing a hedging relationship to be arbitrarily discontinued at any point in time is not conceptually sound and does not result in useful information.

BC6.323 Even though many respondents agreed with the proposals, there were also requests that the IASB provide additional guidance on the meaning of 'risk management' and at what level it should be considered for the purpose of hedge accounting.

BC6.324 Generally, those who disagreed with the proposals argued that if starting hedge accounting was voluntary, ceasing it should also be voluntary. Some respondents who disagreed did so because they believed that voluntary discontinuation was necessary in scenarios in which an entity decided to terminate a hedging relationship on the basis that the hedge was no longer cost efficient (for example, a high administrative burden makes it is too onerous and costly to apply hedge accounting). Some of these respondents raised the concern that voluntary discontinuation was an important tool in the current hedge accounting model for financial institutions that normally run hedging programmes based on portfolios of items on a macro basis. Those portfolios were subject to constant changes and entities removed the hedge designation with the aim of adjusting the hedging relationship for new hedged items and hedging instruments.

BC6.325 Others who disagreed argued that not allowing voluntary discontinuation was inconsistent with the mechanics of cash flow hedge accounting. For example, when an entity entered into a cash flow hedge for forecast sales in a foreign currency, the risk management strategy aimed to protect the cash flows until settlement of the invoice. However, hedge accounting was only applied until the moment when the sales invoice became an on-balance-sheet item, after which the entity obtained a natural offset in the statement of profit or loss and other comprehensive income because of the translation of the hedged item in accordance with IAS 21 and the accounting for the hedging instrument at fair value through profit or loss. Those respondents thought that voluntary discontinuation of the hedging relationship was necessary at the time that the forecast transaction became an on-balance-sheet item (for example, a trade receivable).

BC6.326 Based on this feedback, the IASB, in its redeliberations, considered:

(a) whether voluntary discontinuation should be allowed, given that hedge accounting remained optional; and

(b) how the link of the proposed discontinuation requirements to the risk management objective and strategy would work.

BC6.327 The IASB noted that even though the application of hedge accounting remained optional, it facilitated the provision of useful information for financial reporting purposes (ie how hedging instruments are used to manage risk). The IASB considered that this purpose could not be ignored when considering the voluntary discontinuation of hedge accounting. If an entity chose to apply hedge accounting, it did so with the aim of using that particular accounting to represent in the financial statements the effect of pursuing a particular risk management objective. If the risk management objective had not changed and the other qualifying criteria for hedge accounting were still met, the ability to discontinue hedge accounting would undermine the aspect of consistency over time in accounting for, and providing information about, that hedging relationship. The IASB noted that a free choice to discontinue hedge accounting reflected a view that hedge accounting is a mere accounting exercise that does not have a particular meaning. Consequently, the IASB considered that it was not valid to argue that because hedge accounting was voluntary, the discontinuation of hedge accounting should also be voluntary.

BC6.328 In addition, the IASB noted that other optional accounting treatments of IFRS does not allow the entity to overturn its initial election:

(a) the fair value option in IAS 39 and IFRS 9; and

(b) the lessee's option to account for a property interest held under an operating lease as an investment property, which is available (irrevocably) on a property-by-property basis.

BC6.329 The IASB also did not think that the ability to voluntarily discontinue hedge accounting was necessary for hedge accounting to work as intended in particular situations mentioned in the feedback (see paragraphs BC6.324–BC6.325). The IASB considered that the impression of some respondents that voluntary discontinuation was necessary in those situations resulted from a lack of clarity about the distinction between the notions of risk management strategy and risk management objective. The IASB noted that that distinction was important for determining when the discontinuation of a hedging relationship was required (or not allowed). The IASB also noted that the term 'risk management strategy' was used in the 2010 Hedge Accounting Exposure Draft as a reference to the highest level at which an entity determines how it manages risk. In other words, the risk management strategy typically identified the risks to which the entity was exposed and set out how the entity responded to them. Conversely, the 2010 Hedge Accounting Exposure Draft used the term 'risk management objective' (for a hedging relationship) to refer to the objective that applies at the level of that particular hedging relationship (instead of what the entity aims to achieve with the overall strategy). In other words, it related to how the particular designated hedging instrument is used to hedge the particular exposure designated as the hedged item.

BC6.330 The IASB noted that a risk management strategy could (and often would) involve many different hedging relationships whose risk management objectives relate to executing that risk management strategy. Hence, the risk management objective for a particular hedging relationship could change even though an entity's risk management strategy remained unchanged. The IASB's intention was to prohibit voluntary discontinuation of hedge accounting when the risk management objective at the level of a particular hedging relationship (ie not only the risk management strategy) remained the same and all other qualifying criteria were still met.

BC6.331 Consequently, the IASB decided to prohibit the voluntary discontinuation of hedge accounting when the risk management objective for a particular hedging relationship remains the same and all the other qualifying criteria are still met. However, the IASB also decided to add additional guidance on how the risk management objective and the risk management strategy relate to each other using examples that contrast these two notions, including for situations in which 'proxy hedging' designations are used.

Novation of derivatives

BC6.332 When deliberating its 2010 Hedge Accounting Exposure Draft, the IASB received an urgent request to clarify whether an entity is required to discontinue hedge accounting for hedging relationships in which a derivative has been designated as a hedging instrument when that derivative is novated to a central counterparty (CCP) due to the introduction of a new law or regulation.[40] This question applied equally to the designation of

[40] In this context, the term 'novation' indicates that the parties to a derivative agree that one or more clearly counterparties replace their original counterparty to each of the parties. For this purpose, a clearing counterparty is a central counterparty or an entity or entities, for

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hedging instruments in accordance with IAS 39 and under the new hedge accounting model for IFRS 9 that the IASB was redeliberating. Consequently, the IASB considered this question and possible solutions, both in the context of hedge accounting under IAS 39 and IFRS 9.[41]

BC6.333 The IASB considered the derecognition requirements of IFRS 9 to determine whether the novation in such a circumstance would lead to the derecognition of an existing derivative that had been designated as a hedging instrument. The IASB noted that a derivative should be derecognised only when it meets both the derecognition criteria for a financial asset and the derecognition criteria for a financial liability in circumstances in which the derivative involves two-way payments between parties (ie the payments are or could be from and to each of the parties).

BC6.334 The IASB observed that paragraph 3.2.3(a) of IFRS 9 requires that a financial asset is derecognised when the contractual rights to the cash flows from the financial asset expire. The IASB noted that through novation to a CCP, a party (Party A) to the original derivative has new contractual rights to cash flows from a (new) derivative with the CCP, and this new contract replaces the original contract with a counterparty (Party B). Thus, the original derivative with Party B has expired and, as a consequence, the original derivative through which Party A has engaged with Party B meets the derecognition criteria for a financial asset.

BC6.335 The IASB also observed that paragraph B3.3.1(b) of IFRS 9 states that a financial liability is extinguished when the debtor is legally released from primary responsibility for the liability. The IASB noted that the novation to the CCP would release Party A from the responsibility to make payments to Party B and would also oblige Party A to make payments to the CCP. Consequently, the original derivative through which Party A has transacted with Party B also meets the derecognition criteria for a financial liability.

BC6.336 Consequently, the IASB concluded that the novation of a derivative to a CCP would be accounted for as the derecognition of the original derivative and the recognition of the (new) novated derivative.

BC6.337 Taking into account the conclusion of the assessment on the derecognition requirements, the IASB considered the guidance it had proposed on the discontinuation of hedge accounting, which would require an entity to discontinue hedge accounting prospectively if the hedging instrument expires or is sold, terminated or exercised. The IASB noted that novation to a CCP would require the entity to discontinue hedge accounting because the derivative that was designated as a hedging instrument has been derecognised and consequently the hedging instrument in the existing hedging relationship no longer exists.

BC6.338 The IASB was, however, concerned about the financial reporting effects that would arise from novations that result from new laws or regulations. The IASB noted that the requirement to discontinue hedge accounting meant that although an entity could designate the new derivative as the hedging instrument in a new hedging relationship, this could result in more hedge ineffectiveness, especially for cash flow hedges, compared to a continuing hedging relationship. This is because the derivative that would be newly designated as the hedging instrument would be on terms that would be different from a new derivative, ie it was unlikely to be 'at-market' (for example, a non-option derivative such as a swap or forward might have a significant fair value) at the time of the novation.

BC6.339 The IASB, taking note of this financial reporting effect, was convinced that accounting for the hedging relationship that existed before the novation as a continuing hedging relationship, in this specific situation, would provide more useful information to users of financial statements. The IASB also considered the feedback from outreach that involved the members of the International Forum of Accounting Standard Setters (IFASS) and securities regulators and noted that this issue is not limited to a specific jurisdiction because many jurisdictions have introduced, or are expected to mandate, laws or regulations that encourage or require the novation of derivatives to a CCP.

BC6.340 The IASB noted that the widespread legislative changes across jurisdictions were prompted by a G20 commitment to improve transparency and regulatory oversight of over-the-counter (OTC) derivatives in an internationally consistent and non-discriminatory way. Specifically, the G20 agreed to improve OTC derivatives markets so that all standardised OTC derivatives contracts are cleared through a CCP.

BC6.341 Consequently, the IASB decided to publish, in January 2013, the Exposure Draft *Novation of Derivatives and Continuation of Hedge Accounting* (the '2013 Novation of Derivatives and Continuation of Hedge Accounting Exposure Draft'), which proposed amendments to IAS 39 and revisions to the IASB's hedge accounting proposals to IFRS 9. In the 2013 Novation of Derivatives and Continuation of Hedge Accounting Exposure Draft, the IASB proposed revised requirements for the discontinuation of hedge accounting to provide relief from discontinuing hedge accounting when the novation to a CCP is required by new laws or regulations and meets particular criteria.

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example, a clearing member of a clearing organisation or a client of a clearing member of a clearing organisation, that are acting as counterparty in order to effect clearing by a central counterparty.

[41] The references in the Basis for Conclusions of this Standard are to the relevant requirements of IFRS 9. The Basis for Conclusions of the equivalent amendments to IAS 39 referred to the relevant requirements in that Standard (which were equivalent).

BC6.342 When developing the 2013 Novation of Derivatives and Continuation of Hedge Accounting Exposure Draft, the IASB tentatively decided that the terms of the novated derivative should be unchanged other than the change in counterparty. However, the IASB noted that, in practice, other changes may arise as a direct consequence of the novation. For example, in order to enter into a derivative with a CCP it may be necessary to make adjustments to the collateral arrangements. Such narrow changes that are a direct consequence of, or are incidental to, the novation were acknowledged in the proposals. However, this would not include changes to, for example, the maturity of the derivatives, the payment dates or the contractual cash flows or the basis of their calculation, except for changes that may arise as a consequence of transacting with a CCP.

BC6.343 When developing the 2013 Novation of Derivatives and Continuation of Hedge Accounting Exposure Draft, the IASB also discussed whether to require an entity to disclose that it has been able to continue hedge accounting by applying the relief provided by these proposals. The IASB considered that it was not appropriate to mandate a specific disclosure in this situation because, from the perspective of a user of financial statements, hedge accounting would continue.

BC6.344 The vast majority of respondents agreed that the proposed revisions are necessary. However, a few respondents expressed disagreement with the proposal on the basis that they disagreed with the IASB's conclusion that hedge accounting would be required to be discontinued as a result of such novations. In expressing such disagreement some noted that the guidance on the discontinuation of hedge accounting expressly acknowledges that certain replacements or rollovers of hedging instruments are not expirations or terminations for the purposes of discontinuing hedge accounting. The IASB noted that this exception applies if "[a] replacement or rollover is part of, and consistent with, the entity's documented risk management objective". The IASB questioned whether replacement of a contract as a result of unforeseen legislative changes (even if documented) fits the definition of a replacement that is part of a 'documented risk management objective'.

BC6.345 Even though the vast majority of respondents agreed with the proposal, a considerable majority of respondents disagreed with the scope of the proposals. They believed that the proposed scope of 'novation required by laws or regulations' is too restrictive and that the scope should therefore be expanded by removing this criterion. In particular, they argued that voluntary novation to a CCP should be provided with the same relief as novation required by laws or regulations. A few respondents further requested that the scope should not be limited to novation to a central counterparty and that novation in other circumstances should also be considered.

BC6.346 When considering respondents' comments, the IASB noted that voluntary novation to a CCP could be prevalent in some circumstances such as novation in anticipation of regulatory changes, novation owing to operational ease, and novation induced but not actually mandated by laws or regulations as a result of the imposition of charges or penalties. The IASB also noted that many jurisdictions would not require the existing stock of outstanding historical derivatives to be moved to CCPs, although this was encouraged by the G20 commitment.

BC6.347 The IASB observed, however, that for hedge accounting to continue, voluntary novation to a CCP should be associated with laws or regulations that are relevant to central clearing of derivatives. The IASB noted that while a novation need not be required by laws or regulations for hedge accounting to be allowed to continue, allowing all novations to CCPs to be accommodated was broader than the IASB had intended. In addition, the IASB agreed that hedge accounting should continue when novations are performed as a consequence of laws or regulations or the introduction of laws or regulations but noted that the mere possibility of laws or regulations being introduced was not a sufficient basis for the continuation of hedge accounting.

BC6.348 Some respondents were concerned that restricting the relief to novation directly to a CCP was too narrow. In considering respondents' comments, the IASB noted that in some cases a CCP has a contractual relationship only with its 'clearing members', and therefore an entity must have a contractual relationship with a clearing member in order to transact with a CCP; a clearing member of a CCP provides a clearing service to its client who cannot access a CCP directly. The IASB also noted that some jurisdictions are introducing a so-called 'indirect clearing' arrangement in their laws or regulations to effect clearing with a CCP, by which a client of a clearing member of a CCP provides a (indirect) clearing service to its client in the same way as a clearing member of a CCP provides a clearing service to its client. In addition, the IASB observed that an intragroup novation can also occur in order to access a CCP; for example, if only particular group entities can transact directly with a CCP.

BC6.349 On the basis of respondents' comments, the IASB decided to expand the scope of the amendments by providing relief for novations to entities other than a CCP if such novation is undertaken with the objective of effecting the clearing with a CCP instead of limiting relief to situations in which novation is direct to a CCP. The IASB decided that in those circumstances the novation had occurred in order to effect clearing through a CCP, albeit indirectly. The IASB thus decided to also include such novations in the scope of the amendments because they are consistent with the objective of the proposed amendments—they enable hedge accounting to continue when novations occur as a consequence of laws or regulations or the introduction of

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laws or regulations that increase the use of CCPs. However, the IASB noted that when parties to a hedging instrument enter into novations with different counterparties (for example, with different clearing members), these amendments only apply if each of those parties ultimately effects clearing with the same central counterparty.

BC6.350 Respondents raised a concern about the phrase 'if and only if' that was used in the 2013 Novation of Derivatives and Continuation of Hedge Accounting Exposure Draft when describing that the relief is provided 'if and only if' the criteria are met. In considering respondents' comments, the IASB noted that the 2013 Novation of Derivatives and Continuation of Hedge Accounting Exposure Draft was intended to address a narrow issue—novation to CCPs—and therefore changing the phrase 'if and only if' to 'if' would target the amendment on the fact patterns that the IASB sought to address. The IASB noted that this would have the effect of requiring an analysis of whether the general conditions for the continuation of hedge accounting are satisfied in other cases (for example, as was raised by some respondents, in determining the effect of intragroup novations in consolidated financial statements).

BC6.351 The 2013 Novation of Derivatives and Continuation of Hedge Accounting Exposure Draft did not propose any additional disclosures. The vast majority of respondents agreed with this. The IASB confirmed that additional disclosures are not required. However, the IASB noted that an entity may consider disclosures in accordance with IFRS 7, which requires qualitative and quantitative disclosures about credit risk.

BC6.352 The IASB also decided to retain the transition requirements proposed in the 2013 Novation of Derivatives and Continuation of Hedge Accounting Exposure Draft so that the revised guidance should apply retrospectively and early application should be permitted. The IASB noted that even with retrospective application, if an entity had previously discontinued hedge accounting as a result of a novation, that (pre-novation) hedge accounting relationship could not be reinstated because doing so would be inconsistent with the requirements for hedge accounting (ie hedge accounting cannot be applied retrospectively).

Fair value hedges

Accounting for fair value hedges

BC6.353 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB considered reducing the complexity of hedge accounting by replacing the fair value hedge accounting mechanics with the cash flow hedge accounting mechanics. Such an approach would recognise gains or losses on the hedging instruments outside profit or loss in other comprehensive income instead of requiring the hedged item to be remeasured. The IASB considered such an approach because it would:

(a) improve the usefulness of the reported information for users of financial statements. In accordance with such an approach, all hedging activities to which hedge accounting is applied (including hedges of fair value risk) would be reflected in other comprehensive income, resulting in greater transparency and comparability. In addition, the measurement of the hedged item would not be affected.

(b) simplify existing requirements. Although fair value and cash flow hedge accounting are designed to address different exposures, the same mechanisms can be used to reflect how an entity manages these exposures in the financial statements. Eliminating one of two different methods (fair value hedge accounting or cash flow hedge accounting) would reduce complexity. Such an approach would align fair value hedge accounting and cash flow hedge accounting, resulting in a single method for hedge accounting.

(c) be an expeditious approach to finalise this phase of the project to replace IAS 39. Such an approach would draw on the existing mechanics of cash flow hedge accounting in IAS 39 and, consequently, such an approach would not require much further development.

BC6.354 However, during its outreach activities conducted before publishing the 2010 Hedge Accounting Exposure Draft, the IASB received mixed views on this approach. Some supported the approach for the reasons that the IASB had considered, which was consistent with the feedback received on the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*. However, others raised concerns that such an approach:

(a) would not reflect the underlying economics. They argued that if an entity applies a fair value hedge, the hedged item exists and hence there is an actual gain or loss on the hedged item (not just an anticipated gain or loss on a forecast transaction that does not yet exist). Consequently, hedge accounting should not cause 'artificial' volatility in other comprehensive income and equity.

(b) would make the movements in other comprehensive income less understandable.

(c) would make it difficult to identify the type of risk management strategy that the entity employs.

(d) could result in scenarios in which equity would be significantly reduced or even negative because of losses on the hedging instrument deferred in other comprehensive income. This could have serious implications in terms of solvency and regulatory requirements.

BC6.355 In the light of the views received, the IASB decided to propose a different approach in the 2010 Hedge Accounting Exposure Draft. The IASB proposed to continue to account for fair value hedges differently from cash flow hedges. However, the IASB proposed some changes to the presentation and mechanics of fair value hedge accounting:

(a) in relation to the gain or loss on remeasuring the hedging instrument—IAS 39 required the gain or loss to be recognised in profit or loss. The IASB proposed to require the recognition of the gain or loss in other comprehensive income.

(b) in relation to the gain or loss on the hedged item—IAS 39 required such a gain or loss to result in an adjustment to the carrying amount of the hedged item and to be recognised in profit or loss. The IASB proposed to require the gain or loss to be recognised as an asset or a liability that is presented in a separate line item in the statement of financial position and in other comprehensive income. That separate line item would have been presented within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or a liability).

BC6.356 The IASB noted that the separate line item represented measurement adjustments to the hedged items instead of separate assets or liabilities in their own right. The IASB thought that the additional line item might be perceived to add complexity and would increase the number of line items in the statement of financial position. In addition, the IASB noted that this approach is more complex than the approach initially considered, which would have eliminated fair value hedge accounting mechanics.

BC6.357 However, the IASB decided to propose these changes because they would:

(a) eliminate the mixed measurement for the hedged item (for example, an amount that is amortised cost with a partial fair value adjustment).

(b) avoid volatility in other comprehensive income and equity that some consider artificial.

(c) present in one place (ie other comprehensive income) the effects of risk management activities (for both cash flow and fair value hedges).

(d) provide information in the statement of comprehensive income about the extent of the offsetting achieved for fair value hedges.

BC6.358 Most respondents supported providing the information proposed in the 2010 Hedge Accounting Exposure Draft, but many disagreed with providing this information on the face of the financial statements.

BC6.359 With respect to recognising gains or losses on the hedging instrument and the hedged item in other comprehensive income, many respondents thought that the use of other comprehensive income should be limited until the IASB completed a project on what 'other comprehensive income' represents. Many respondents expressed a preference for the approach in IAS 39 (ie presenting the gain or loss on the hedging instrument and the hedged item in profit or loss). As an alternative, those respondents suggested that the gain or loss on the hedging instrument and the hedged item should be disclosed in the notes to the financial statements.

BC6.360 With respect to presenting separate line items in the statement of financial position, many respondents expressed concern about the excessive number of additional line items in the statement of financial position that could result from the proposals in the 2010 Hedge Accounting Exposure Draft. Those respondents thought that the statement of financial position would appear too cluttered. As an alternative, those respondents suggested that entities disclose the accumulated adjustment made to the carrying amount of the hedged item in the notes to the financial statements.

BC6.361 In the light of this feedback, the IASB, in its redeliberations, decided to retain the fair value hedge accounting mechanics that were in IAS 39. However, the IASB also decided that it would require information to be disclosed so that users of financial statements could understand the effects of hedge accounting on the financial statements and that all hedge accounting disclosures are presented in a single note or separate section in the financial statements (those disclosure requirements were included in IFRS 7).

Linked presentation for fair value hedges

BC6.362 During its outreach activities conducted before the publication of the 2010 Hedge Accounting Exposure Draft, the IASB was alerted to the effect on financial reporting that fair value hedge accounting has on hedges of the foreign currency risk of firm commitments in a specific industry. This issue is a particular concern to that industry because of the magnitude of firm commitments that are denominated in a foreign currency because of the industry's business model. In response to that concern, the IASB considered whether applying linked

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presentation for fair value hedges of firm commitments might be appropriate. Linked presentation is a way of presenting information so that it shows how particular assets and liabilities are related. Linked presentation is not the same as offsetting, which presents a net asset or liability. Linked presentation displays the 'gross' amount of related items in the statement of financial position (while the net amount is included in the total for assets or liabilities).

BC6.363 The industry was concerned that the presentation resulting from fair value hedge accounting would not reflect the economic effects of hedges of foreign currency risk. For example, an entity that has a large firm commitment for a sale denominated in a foreign currency enters into currency forward contracts to hedge the foreign currency risk of that firm commitment (the forward contract and the firm commitment could be considered 'linked transactions'). The fair value of the derivative liability (asset) and the firm commitment asset (liability) could be significant depending on the volatility of the currency being hedged. That industry was concerned that, as a result, on the basis of the statement of financial position, the entity would appear to be exposed to a higher risk than it actually was. In that industry's view, confusion might arise because the statement of financial position would show large amounts for total assets and total liabilities and hence a high leverage (which typically suggests higher risk) even though the entity hedged the foreign currency risk of the firm commitment and thus sought to reduce risk.

BC6.364 That industry argued that linked presentation of the firm commitment (recognised as a result of fair value hedge accounting) and the hedging instrument could present the effect of an entity's hedging activity and the relationship of the hedged item and the hedging instrument. Linked presentation would not require changing the requirements of offsetting in IAS 32 or other requirements in IAS 39 and IFRS 9.

BC6.365 Moreover, that industry argued that a firm commitment is recognised in the statement of financial position only when fair value hedge accounting is applied. Consequently, that industry advocated that a firm commitment and the related hedging instrument should be accounted for as two parts of a single transaction. That industry also argued that totals for assets and liabilities that include only the 'net' amount (of the linked transactions) would be most appropriate for financial analysis purposes. That industry believed that the ratios, such as leverage, should be calculated on the basis of the difference between the hedged item and the hedging instrument, ie the net amount instead of the gross amount of those items.

BC6.366 The IASB noted that while linked presentation could provide some useful information about a particular relationship between an asset and a liability, it does not differentiate between the types of risk that are covered by that relationship and those that are not. Consequently, linked presentation could result in one net amount for an asset and liability that are 'linked' even though that link (ie the relationship) affects only one of several risks underlying the asset or liability (for example, only the currency risk but not the credit risk or interest rate risk). Furthermore, the IASB did not consider that linked presentation would result in more appropriate totals of assets and liabilities for the purpose of ratio analysis because the hedging affected only one risk but not all risks. Instead, the IASB believed that disclosures about hedging would be a better alternative for providing information that allows users of financial statements to assess the relevance of the information for their own analysis.

BC6.367 Consequently, the IASB decided not to propose the use of linked presentation for the purposes of hedge accounting.

BC6.368 Most respondents to the 2010 Hedge Accounting Exposure Draft agreed with the IASB's conclusion not to allow linked presentation. Some respondents also thought that linked presentation is not an appropriate topic for a project on hedge accounting, but instead that it should be considered as a separate project or as part of a project on either financial statement presentation or the *Conceptual Framework*.

BC6.369 However, those respondents that supported linked presentation argued that, without it, entities that use hedge accounting would be perceived to be riskier than those that do not, and that the true economic effects of hedges of foreign currency risk of firm commitments would not be reflected.

BC6.370 The IASB noted that in the absence of a clear principle for linked presentation, it should be considered in a broader context than just hedge accounting. Consequently, the IASB decided not to require or allow the use of linked presentation for the purpose of hedge accounting.

Cash flow hedges

The 'lower of' test

BC6.371 When a hedge accounting relationship is fully effective, the fair value changes of the hedging instrument perfectly offset the value changes of the hedged item. Hedge ineffectiveness arises when the value changes of the hedging instrument exceed those of the hedged item, or when the value changes of the hedging instrument are less than those of the hedged item.

BC6.372 For cash flow hedges, recognising in profit or loss gains and losses arising on the hedged item in excess of the gains and losses on the hedging instrument is problematic because many hedged items of cash flow hedges are highly probable forecast transactions. Those hedged items do not yet exist although they are expected to occur in the future. Hence, recognising gains and losses on those items in excess of the gains and losses on the hedging instrument is tantamount to recognising gains and losses on items that do not yet exist (instead of a deferral of the gain or loss on the hedging instrument). The IASB noted that this would be conceptually questionable as well as a counter-intuitive outcome.

BC6.373 IAS 39 required a 'lower of' test for determining the amounts that were recognised for cash flow hedges in other comprehensive income (the effective part) and profit or loss (the ineffective part). The 'lower of' test ensured that cumulative changes in the value of the hedged items that exceed cumulative fair value changes of the hedging instrument are not recognised. In contrast, the lower of test did not apply to fair value hedges because, for that type of hedge, the hedged item exists. For example, while a firm commitment might not be recognised in accordance with IFRS, the transaction already exists. Conversely, a forecast transaction does not yet exist but will occur only in the future.

BC6.374 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB discussed whether the requirements for measuring the hedge ineffectiveness that is recognised in profit or loss should be aligned for fair value hedges and cash flow hedges. The IASB noted that the requirements could be aligned by also applying the lower of test to fair value hedges or by eliminating it for cash flow hedges. In the IASB's view, aligning the requirements would reduce complexity. However, the IASB considered that, for conceptual reasons, recognising gains and losses on items that do not yet exist instead of only deferring the gain or loss on the hedging instrument was not appropriate. On the other hand, the IASB considered that the nature of fair value hedges is different from that of cash flow hedges. Also applying the lower of test to fair value hedges, even though that test was designed to address only the specific characteristics of cash flow hedges, was not justified. Consequently, the IASB decided to retain the lower of test for cash flow hedges and not to introduce it for fair value hedges.

Basis adjustments for hedges of forecast transactions that will result in the recognition of a non-financial asset or a non-financial liability

BC6.375 A forecast transaction could subsequently result in the recognition of a non-financial asset or a non-financial liability. Similarly, a forecast transaction for a non-financial asset or non-financial liability could subsequently result in the recognition of a firm commitment for which fair value hedge accounting is applied. In these cases IAS 39 permitted an entity an accounting policy choice:

(a) to reclassify the associated gains or losses that were recognised in other comprehensive income to profit or loss in the same period or periods during which the asset acquired or liability assumed affects profit or loss; or

(b) to remove the associated gains or losses that were recognised in other comprehensive income and include them in the initial cost or other carrying amount of the asset or liability. This approach was commonly referred to as a 'basis adjustment'.

BC6.376 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB considered whether to continue allowing this accounting policy choice. The IASB noted that if an entity was precluded from applying a basis adjustment, this would require the entity to track the hedging gains and losses separately (after the hedging relationship had ended) and to match them to the period or periods in which the non-financial item that had resulted from the hedged transaction affected profit or loss. The entity would also need to consider whether or not the remaining amount in other comprehensive income was recoverable in one or more future periods. In contrast, if an entity applied a basis adjustment, the hedging gain or loss was included in the carrying amount of the non-financial item and automatically recognised in profit or loss in the period in which the related non-financial item affected profit or loss (for example, through depreciation expense for items of property, plant and equipment or cost of sales for inventories). It would also be automatically considered when an entity tested a non-financial asset for impairment. The IASB noted that for a non-financial asset that is tested for impairment as part of a cash-generating unit, tracking amounts in other comprehensive income and including them in the impairment test is difficult (even more so if the composition of cash-generating units changes over time).

BC6.377 The IASB acknowledged that there were different views on whether a basis adjustment would achieve or reduce comparability. One view was that two identical assets purchased at the same time and in the same way (except for the fact that one was hedged) should have the same initial carrying amount. From this viewpoint, basis adjustments would impair comparability.

BC6.378 The other view was that basis adjustments allowed identical assets for which the acquisitions are subject to the same risk to be measured so that they had the same initial carrying amount. For example, Entity A and

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Entity B want to purchase the same asset from a supplier that has a different functional currency. Entity A is able to secure the purchase contract denominated in its functional currency. Conversely, while Entity B also wants to fix the purchase price in its functional currency, it has to accept a purchase contract denominated in the functional currency of the supplier (ie a foreign currency) and is therefore exposed to the variability in cash flows arising from movements in the exchange rate. Hence, Entity B hedges its exposure to foreign currency risk using a currency forward contract which, in effect, fixes the price of the purchase in its functional currency. When taking into account the currency forward contract, Entity B has, in effect, the same foreign currency risk exposure as Entity A. From this viewpoint, basis adjustments would enhance comparability.

BC6.379 The IASB also considered the interaction between basis adjustments and the choice of accounting for a hedge of foreign currency risk of a firm commitment as either a cash flow hedge or a fair value hedge (see paragraphs BC6.272–BC6.277). The IASB noted that for hedges of the foreign currency risk of a firm commitment the basis adjustment at the end of the cash flow hedge has the same effect on the presentation of the hedged item as accounting for the hedge as a fair value hedge. Thus, using fair value hedge accounting for those firm commitments was tantamount to a basis adjustment. The IASB thought that, in this context, basis adjustments would also enhance comparability.

BC6.380 Consequently, the IASB decided to eliminate the accounting policy choice in IAS 39 and require basis adjustments. The IASB decided that when the entity removes the associated gain or loss that was recognised in other comprehensive income in order to include it in the initial cost or other carrying amount of the asset or liability, that gain or loss should be directly applied against the carrying amount of the asset or liability. This means that it would not be a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*) and hence would not affect other comprehensive income when removing it from equity and adding it to, or deducting it from, the asset or liability. The IASB noted that accounting for the basis adjustment as a reclassification adjustment would distort comprehensive income because the amount would affect comprehensive income twice but in different periods:

(a) first (in other comprehensive income) in the period in which the non-financial item is recognised; and

(b) again in the later periods when the non-financial item affects profit or loss (for example, through depreciation expense or cost of sales).

The IASB also noted that presenting a basis adjustment as a reclassification adjustment would create the misleading impression that the basis adjustment was a performance event.

BC6.381 The IASB acknowledged that the total comprehensive income across periods will be distorted because the gain or loss on the hedging instrument during the period of the cash flow hedge is recognised in other comprehensive income, whereas the cumulative hedging gain or loss that is removed from the cash flow hedge reserve (ie from equity) and directly applied to the subsequently recognised non-financial item does not affect other comprehensive income. The IASB considered that one type of distortion of other comprehensive income was inevitable (ie either in the period of the basis adjustment or over the total period) and hence there was a trade-off. The IASB concluded that, on balance, the effect of a reclassification adjustment in the period of the basis adjustment would be more misleading than the effect over the total period of not using a reclassification adjustment.

BC6.382 The IASB retained its original decision when deliberating its 2010 Hedge Accounting Exposure Draft.

Hedges of a net investment in a foreign operation

BC6.383 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB decided not to address a hedge of a net investment in a foreign operation as part of its hedge accounting project. The IASB noted that a net investment in a foreign operation was determined and accounted for in accordance with IAS 21. The IASB also noted that the hedge of a net investment in a foreign operation also related to IAS 21. Hence, similar to the issue of considering intragroup monetary items for eligibility as hedging instruments for hedges of foreign exchange risk (see paragraph BC6.149), the IASB considered that comprehensively addressing this type of hedge would require a review of the requirements in IAS 21 at the same time as considering the hedge accounting requirements.

BC6.384 Consequently, the IASB proposed retaining the requirements of IAS 39 for a hedge of a net investment in a foreign operation.

BC6.385 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Accounting for the time value of options

BC6.386 IAS 39 allowed an entity a choice:

(a) to designate an option-type derivative as a hedging instrument in its entirety; or

(b) to separate the time value of the option and designate as the hedging instrument only the intrinsic value element.

BC6.387 The IASB noted that under the IAS 39 hedge accounting model entities typically designated option-type derivatives as hedging instruments on the basis of their intrinsic value. Consequently, the undesignated time value of the option was treated as held for trading and was accounted for as at fair value through profit or loss, which gave rise to significant volatility in profit or loss. This particular accounting treatment is disconnected from the risk management view, whereby entities typically consider the time value of an option (at inception, ie included in the premium paid) as a cost of hedging. It is a cost of obtaining protection against unfavourable changes of prices, while retaining participation in any favourable changes.

BC6.388 Against this background, the IASB, in its deliberations leading to the 2010 Hedge Accounting Exposure Draft, considered how best to portray the time value of options (in the context of hedging exposures only against changes to one side of a specified level—a 'one-sided risk'). The IASB noted that the standard-setting debate about accounting for the time value of options had historically been focused on hedge ineffectiveness. Many typical hedged transactions (such as firm commitments, forecast transactions or existing items) do not involve a time value notion because they are not options. Hence, such hedged items do not have a change in their value that offsets the fair value change related to the time value of the option that is used as a hedging instrument. The IASB concluded that, unless the time value of the option was excluded from being designated as the hedging instrument, hedge ineffectiveness would arise.

BC6.389 However, the IASB noted that the time value of an option could also be considered from a different perspective—that of a premium for protection against risk (an 'insurance premium' view).

BC6.390 The IASB noted that entities that use purchased options to hedge one-sided risks typically consider the time value that they pay as a premium to the option writer or seller as similar to an insurance premium. In order to protect themselves against the downside of an exposure (an adverse outcome) while retaining the upside, they have to compensate someone else for assuming the inverse asymmetrical position, which has only the downside but not the upside. The time value of an option is subject to 'time decay'. This means that it loses its value over time as the option approaches expiry, which occurs at an increasingly rapid rate. At expiry the option's time value reaches zero. Hence, entities that use purchased options to hedge one-sided risks know that over the life of the option they will lose the time value that they paid. This explains why entities typically view the premium paid as being similar to an insurance premium and hence as a cost of using this hedging strategy.

BC6.391 The IASB considered that by taking an insurance premium view, the accounting for the time value of options could be aligned with the risk management perspective as well as with other areas of accounting. The IASB noted that under IFRS some costs of insuring risks were treated as transaction costs that were capitalised into the costs of the insured asset (for example, freight insurance paid by the buyer in accordance with IAS 2 Inventories or IAS 16 *Property, Plant and Equipment*), whereas costs of insuring some other risks were recognised as expenses over the period for which the entity was insured (for example, fire insurance for a building). Hence, the IASB considered that aligning the accounting for the time value of options with such other areas would provide more comparable results that would also be more aligned with how preparers and users of financial statements think about the issue.

BC6.392 The IASB took the view that, like the distinction between the different types of costs of insuring risk, the time value of options should be distinguished by the type of hedged item that the option hedges, into time value that is:

(a) transaction related (for example, the forecast purchase of a commodity); or

(b) time-period related (for example, hedging an existing commodity inventory for commodity price changes).

BC6.393 The IASB considered that for transaction related hedged items the cumulative change in fair value of the option's time value should be accumulated in other comprehensive income and be reclassified in a way similar to that for cash flow hedges. In the IASB's view, this would best reflect the character of transaction costs (like those capitalised for inventory or property, plant and equipment).

BC6.394 In contrast, the IASB considered that for time-period related hedged items the nature of the time value of the option used as the hedging instrument is that of a cost for obtaining protection against a risk over a particular period of time. Hence, the IASB considered that the cost of obtaining the protection should be allocated as an expense over the relevant period on a systematic and rational basis. The IASB noted that this would require accumulating the cumulative change in fair value of the option's time value in other comprehensive income and amortising the original time value by transferring in each period an amount to profit or loss. The IASB considered that the amortisation pattern should be determined on a systematic and rational basis, which would best reflect principle-based standard-setting.

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BC6.395 The IASB also considered situations in which the option used has critical terms (such as the nominal amount, the life and the underlying) that do not match the hedged item. This raises the following questions:

(a) which part of the time value included in the premium relates to the hedged item (and therefore should be treated as costs of hedging) and which part does not?

(b) how should any part of the time value that does not relate to the hedged item be accounted for?

BC6.396 The IASB proposed in the 2010 Hedge Accounting Exposure Draft that the part of the time value of the option that relates to the hedged item should be determined as the time value that would have been paid for an option that perfectly matches the hedged item (for example, with the same underlying, maturity and notional amount). The IASB noted that this would require an option pricing exercise using the terms of the hedged item as well as other relevant information about the hedged item (in particular, the volatility of its price or cash flow, which is a driver of an option's time value).

BC6.397 The IASB noted that the accounting for the time value of the option would need to distinguish whether the initial time value of the purchased option (actual time value) is higher or lower than the time value that would have been paid for an option that perfectly matches the hedged item (aligned time value). The IASB noted that if, at inception of the hedging relationship, the actual time value is higher than the aligned time value, the entity pays a higher premium than that which reflects the costs of hedging. Hence, the IASB considered that the amount that is recognised in accumulated other comprehensive income should be determined only on the basis of the aligned time value, whereas the remainder of the actual time value should be accounted for as a derivative.

BC6.398 Conversely, the IASB noted that if, at inception of the hedging relationship, the actual time value is lower than the aligned time value, the entity actually pays a lower premium than it would have to pay to cover the risk fully. The IASB considered that in this situation, in order to avoid accounting for a higher time value of an option than was actually paid, the amount that is recognised in accumulated other comprehensive income would have to be determined by reference to the lower of the cumulative fair value change of:

(a) the actual time value; and

(b) the aligned time value.

BC6.399 The IASB also considered whether the balances accumulated in other comprehensive income would require an impairment test. The IASB decided that because the accounting for the time value of the option was closely linked to hedge accounting, an impairment test that uses features of the hedge accounting model would be appropriate. Hence, for transaction related hedged items the impairment test would be similar to that for the cash flow hedge reserve. For time-period related hedged items the IASB considered that the part of the option's time value that remains in accumulated other comprehensive income should be immediately recognised in profit or loss when the hedging relationship is discontinued. That would reflect that the reason for amortising the amount would no longer apply after the insured risk (ie the hedged item) no longer qualifies for hedge accounting. The IASB noted that impairment of the hedged item affects the criteria for qualifying hedges and if those are no longer met it would result in an impairment loss for the remaining unamortised balance of the time value of the option.

BC6.400 Most of the respondents to the 2010 Hedge Accounting Exposure Draft agreed with the 'insurance premium' view. They thought that the proposal provided a better representation of the performance and effect of the entity's risk management strategy than under IAS 39. In their view, the proposals alleviated undue profit or loss volatility and reflected the economic substance of the transaction. They also thought that the costs of hedging should be associated with the hedged item instead of being mischaracterised as hedge ineffectiveness.

BC6.401 However, there were mixed views about the complexity of the proposals, in particular in relation to:

(a) the requirement to differentiate between transaction related and time-period related hedged items; and

(b) the requirement to measure the fair value of the aligned time value. Those concerns included the concern that the costs of implementing the proposals could outweigh the benefits, for instance, for less sophisticated (for example, smaller) entities.

BC6.402 Some respondents did not agree with the proposed accounting for transaction related hedged items. Some argued that time value should always be expensed over the option period.

BC6.403 In the light of this feedback the IASB considered in its redeliberations:

(a) whether the time value of an option should always be expensed over the life of the option instead of applying the accounting as proposed in the 2010 Hedge Accounting Exposure Draft;

(b) whether it should remove the differentiation between transaction related and time-period related hedged items and replace it with a single accounting treatment; and

(c) whether it should simplify the requirement to account for the fair value of the aligned time value.

BC6.404 The IASB discussed whether the time value of an option should always be expensed over the life of the option instead of applying the accounting as proposed in the 2010 Hedge Accounting Exposure Draft. The IASB noted that such an accounting treatment would have outcomes that would be inconsistent with the notion of the time value being regarded as costs of hedging. This is because it could result in recognising an expense in periods that are unrelated to how the hedged exposure affects profit or loss.

BC6.405 The IASB also reconsidered whether it was appropriate to defer in accumulated other comprehensive income the time value of options for transaction related hedged items. The IASB noted that the deferred time value does not represent an asset in itself, but that it is an ancillary cost that is capitalised as part of the measurement of the asset acquired or liability assumed. This is consistent with how other Standards treat ancillary costs. The IASB also noted that the 2010 Hedge Accounting Exposure Draft included an impairment test to ensure that amounts that are not expected to be recoverable are not deferred.

BC6.406 The IASB also discussed whether the proposals in the 2010 Hedge Accounting Exposure Draft could be simplified by removing the differentiation between transaction related and time-period related hedged items. However, the IASB noted that a single accounting treatment would be inconsistent with other Standards because it would not distinguish situations in a similar way (see paragraphs BC6.391–BC6.392). Hence, the IASB considered that the suggested single accounting treatment would essentially treat unlike situations as alike. The IASB noted that this would actually diminish comparability and hence not be an improvement to financial reporting.

BC6.407 The IASB also considered whether it should paraphrase the requirements as a single general principle to clarify the accounting for transaction related and time-period related hedged items, instead of having requirements that distinguish between those two types of hedged items. However, on balance the IASB decided that this approach risked creating confusion, particularly because it would still involve the two different types of accounting treatments.

BC6.408 The IASB also discussed possible ways to simplify the requirements to account for the fair value of the aligned time value. As part of those discussions the IASB considered:

(a) applying the proposed accounting treatment for the time value of options to the entire amount of the time value paid even if it differs from the aligned time value. This means that entities would not need to perform a separate valuation for the fair value of the aligned time value. However, the IASB considered that only the time value that relates to the hedged item should be treated as a cost of hedging. Hence, any additional time value paid should be accounted for as a derivative at fair value through profit or loss.

(b) providing entities with a choice (for each hedging relationship or alternatively as an accounting policy choice) to account for the time value of options either as proposed in the 2010 Hedge Accounting Exposure Draft or in accordance with the treatment in IAS 39. In the latter case, the amount recognised in profit or loss as a 'trading instrument' is the difference between the change in the fair value of the option in its entirety and the change in fair value of the intrinsic value. In contrast, the proposals in the 2010 Hedge Accounting Exposure Draft would require two option valuations (ie the change in fair value of the actual time value of the option and the aligned time value of the option). However, the IASB noted that the accounting treatment in accordance with IAS 39 would, in effect, present the change in fair value of the time value as a trading profit or loss. This accounting treatment would not be consistent with the character of the changes in the time value that the IASB is seeking to portray, ie that of costs of hedging. In addition, the IASB noted that providing a choice would reduce comparability between entities and it would make financial statements more difficult to understand.

BC6.409 Consequently, the IASB decided to retain the accounting requirements related to the time value of options proposed in the 2010 Hedge Accounting Exposure Draft (ie that the accounting would depend on the nature of the hedged item and that the new accounting treatment only applied to the aligned time value).

Zero-cost collars

BC6.410 The proposed accounting treatment for the time value of options in the 2010 Hedge Accounting Exposure Draft only addressed situations in which the option had a time value (other than nil) at inception. That proposed accounting would not have applied to situations in which there was a combination of a purchased and a written option (one being a put option and one being a call option) that at inception of the hedging relationship had a net time value of nil (often referred to as 'zero-cost collars' or 'zero premium collars').

BC6.411 Many respondents to the 2010 Hedge Accounting Exposure Draft commented that the proposed accounting for purchased options should also apply to all zero-cost collars. They thought that without generally aligning the accounting treatment for the time value of zero-cost collars and options, it would encourage entities to undertake particular types of transactions and replace zero-cost collars with collars with a nominal cost only to achieve a desired accounting outcome.

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BC6.412 Furthermore, those respondents noted that even though the zero-cost collar had no net time value at inception, the time value of the collar would fluctuate during the life of the hedge. They noted that time value was subject to 'time decay' and that both the purchased and the written option would lose their time value over time as the collar approaches expiry. They argued that the time value of zero-cost collars should also be recognised in other comprehensive income during the life of the hedging relationship. They considered it unjustified to limit the proposed accounting to options that have an initial time value of greater than nil, given that one of the main concerns being addressed by the proposal was the volatility resulting from changes in the time value over the life of the hedge.

BC6.413 In the light of those arguments, the IASB decided to align the accounting treatment for changes in the time value of options and zero-cost collars.

Accounting for the forward element of forward contracts

BC6.414 IAS 39 allowed an entity a choice between:

(a) designating a forward contract as a hedging instrument in its entirety; or

(b) separating the forward element and designating as the hedging instrument only the spot element.

BC6.415 If not designated, the forward element was treated as held for trading and was accounted for as at fair value through profit or loss, which gave rise to significant volatility in profit or loss.

BC6.416 The IASB noted that the characteristics of forward elements depended on the underlying item, for example:

(a) for foreign exchange rate risk, the forward element represents the interest differential between the two currencies;

(b) for interest rate risk, the forward element reflects the term structure of interest rates; and

(c) for commodity risk, the forward element represents what is called the 'cost of carry' (for example, it includes costs such as storage costs).

BC6.417 Respondents to the 2010 Hedge Accounting Exposure Draft as well as participants in the IASB's outreach activities requested that the IASB consider extending the proposal on the accounting for the time value of options (see paragraphs BC6.386–BC6.413) to forward elements.

BC6.418 The IASB noted that even though under IAS 39 the hedge accounting requirements were identical for forward elements and options, the actual accounting implications were different. In contrast to many typical situations in which options were used to hedge transactions that did not involve a time value notion because they were not options (see paragraph BC6.388), in situations in which forward contracts were used the value of hedged items typically did have a forward element that corresponded to that of the hedge. The IASB noted that this meant that an entity could choose to designate the forward contract in its entirety and use the 'forward rate method' to measure the hedged item.

BC6.419 Using the forward rate method, the forward element is essentially included in the hedging relationship by measuring the change in the value of the hedged item on the basis of forward prices or rates. An entity can then recognise the forward element as costs of hedging by using the forward rate method, resulting in, for example:

(a) capitalising the forward element into the cost of the acquired asset or liability assumed; or

(b) reclassifying the forward element into profit or loss when the hedged item (for example, hedged sales denominated in a foreign currency) affects profit or loss.

BC6.420 Consequently, changes in forward elements are not recognised in profit or loss until the hedged item affects profit or loss. The IASB noted that this outcome was equivalent to what it had proposed in its 2010 Hedge Accounting Exposure Draft for accounting for the time value of options that hedge transaction related hedged items. Hence, the IASB considered that, for situations similar to hedges of transaction related hedged items using options, applying the forward rate method would, in effect, achieve an accounting outcome that treated the forward element like costs of hedging. This would be consistent with the IASB's overall approach to accounting for the costs of hedging and would therefore not require any amendments to the proposals in the 2010 Hedge Accounting Exposure Draft.

BC6.421 However, the IASB acknowledged that in situations that were equivalent to those addressed by its decision on the accounting for time-period related hedged items that were hedged using options, its proposals in the 2010 Hedge Accounting Exposure Draft (like IAS 39) would prevent an entity from achieving an equivalent accounting outcome for the forward element of a forward contract. The reason was that, like IAS 39, the proposals in the 2010 Hedge Accounting Exposure Draft did not allow the forward element to be amortised. For example, if an entity hedged the fair value changes resulting from the price changes of its existing

commodity inventory (ie a time-period related hedged item) it could, under the proposals in the 2010 Hedge Accounting Exposure Draft (like IAS 39), either:

(a) use the forward rate method (ie forward elements are capitalised into the cost of inventory, instead of being accounted for as at fair value through profit or loss over the time of the hedge); or

(b) designate as the hedging instrument only changes in the spot element (ie fair value changes in the forward element of the forward contract are recognised in profit or loss).

Neither of the above accounting outcomes are aligned with the treatment for the time value of options for time-period related hedged items that requires that the time value is amortised on a systematic and rational basis.

BC6.422 The IASB also noted that the accounting for monetary financial assets and liabilities denominated in a foreign currency had an important consequence. Like IAS 39, IFRS 9 (see paragraph B5.7.2) requires an entity to apply IAS 21 to those assets and liabilities, which means that they are translated into the entity's functional currency by using the spot exchange rate. Hence, the forward rate method does not provide a solution when entities hedge monetary financial assets and liabilities denominated in a foreign currency.

BC6.423 Consequently, the IASB acknowledged that aligning the accounting for forward elements with the accounting for the time value of options was a particular concern to entities that, for example, had more funding in their functional currency than they could invest in financial assets in their functional currency. To generate an economic return on their surplus funds, such entities exchange those funds into a foreign currency and invest in assets denominated in that foreign currency. To manage their exposure to foreign exchange risk (and to stabilise their net interest margin), such entities commonly enter into foreign exchange derivatives. Such transactions usually involve the following simultaneously:

(a) swapping the functional currency surplus funds into a foreign currency;

(b) investing the funds in a foreign currency financial asset for a period of time; and

(c) entering into a foreign exchange derivative to convert the foreign currency funds back into the functional currency at the end of the investment period. This amount typically covers the principal plus the interest at maturity.

BC6.424 The difference between the forward rate and the spot rate (ie the forward element) represents the interest differential between the two currencies at inception. The net economic return (ie the interest margin) over the investment period is determined by adjusting the yield of the investment in the foreign currency by the forward points (ie the forward element of the foreign exchange derivative) and then deducting the interest expense. The combination of the three transactions described in paragraph BC6.423 allows the entity to, in effect, 'lock in' a net interest margin and generate a fixed economic return over the investment period.

BC6.425 Respondents argued that risk management viewed the forward elements as an adjustment of the investment yield on foreign currency denominated assets. They believed that, as in the case of the accounting for the time value of options, it gave rise to a similar need for adjusting profit or loss against other comprehensive income to represent the cost of achieving a fixed economic return in a way that is consistent with the accounting for that return.

BC6.426 In the light of the arguments raised by respondents, the IASB decided to permit forward points that exist at inception of the hedging relationship to be recognised in profit or loss over time on a systematic and rational basis and to accumulate subsequent fair value changes through other comprehensive income. The IASB considered that this accounting treatment would provide a better representation of the economic substance of the transaction and the performance of the net interest margin.

Hedges of a group of items

BC6.427 IAS 39 restricted the application of hedge accounting for groups of items. For example, hedged items that together constitute an overall net position of assets and liabilities could not be designated into a hedging relationship with that net position as the hedged item. Other groups were eligible if the individual items within that group had similar risk characteristics and shared the risk exposure that was designated as being hedged. Furthermore, the change in the fair value attributable to the hedged risk for each individual item in the group had to be approximately proportional to the overall change in the fair value of the group for the hedged risk. The effect of those restrictions was that a group would generally qualify as a hedged item only if all the items in that group would qualify for hedge accounting for the same hedged risk on an individual basis (ie each as an individual hedged item).

BC6.428 In response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments*, many commented that restricting the ability to achieve hedge accounting for groups of items, including net positions, had resulted in a hedge accounting model that was inconsistent with the way in which an entity

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actually hedges (ie for risk management purposes). Similar concerns about the restrictions of IAS 39 for applying hedge accounting to groups of items were raised as part of the IASB's outreach activities for its Hedge Accounting project.

BC6.429 In practice, most entities hedge their risk exposures using different approaches, resulting in hedges of:

(a) individual items;

(b) groups of items that form a gross position; or

(c) groups of (partially) offsetting items or risks that result in a net position.

BC6.430 The group hedging approach involves identifying the risk from particular groups of items (including a net position), and then hedging some or all of that risk with one or more hedging instruments. The group hedging approach views the risk at a higher aggregated level. The reasons for taking this approach include:

(a) items in the group have some offsetting risk positions that provide a natural hedge for some of those risks and therefore those offsetting risks do not need to be separately hedged;

(b) hedging derivatives that hedge different risks together can be more readily available than individual derivatives that each hedge a different risk;

(c) it is more expedient (cost, practicality, etc) to enter into fewer derivatives to hedge a group instead of hedging individual exposures;

(d) the minimisation of counterparty credit risk exposure, because offsetting risk positions are hedged on a net basis (this aspect is particularly important for an entity that has regulatory capital requirements); and

(e) the reduction of gross assets/liabilities in the statement of financial position, because offset accounting may not be achieved if multiple derivatives (with offsetting risk exposures) are entered into.

BC6.431 The restrictions in IAS 39 prevented an entity that hedges on a group or net basis from presenting its activities in a manner that is consistent with its risk management practice. For example, an entity may hedge the net (ie residual) foreign currency risk from a sequence of sales and expenses that arise over several reporting periods (say, two years) using a single foreign currency derivative. Such an entity could not designate the net position of sales and expenses as the hedged item. Instead, if it wanted to apply hedge accounting it had to designate a gross position that best matched its hedging instrument. However, the IASB noted there were a number of reasons why this could render information less useful, for example:

(a) a matching hedged item might not exist, in which case hedge accounting cannot be applied.

(b) if the entity did identify and designate a matching gross exposure from the sequence of sales and expenses, that item would be portrayed as the only hedged item and would be presented at the hedged rate. All other transactions (for instance, in earlier reporting periods) would appear unhedged and would be recognised at the prevailing spot rates, which would give rise to volatility in some reporting periods.

(c) if the designated hedged transaction did not arise, but the net position remained the same, hedge ineffectiveness would be recognised for accounting purposes even though it does not exist from an economic perspective.

BC6.432 Consequently, in its 2010 Hedge Accounting Exposure Draft, the IASB proposed that groups of items (including net positions) should be eligible for hedge accounting. However, the IASB also proposed limiting the application of cash flow hedge accounting for some types of groups of items that constitute a net position (see paragraphs BC6.442–BC6.447).

BC6.433 Respondents to the 2010 Hedge Accounting Exposure Draft supported the proposal to allow hedge accounting for groups and net positions and most supported the IASB's rationale for doing so. However, some disagreed with specific aspects of the IASB's proposals in the 2010 Hedge Accounting Exposure Draft. Their concerns focused on the proposals related to cash flow hedges of net positions.

BC6.434 The following subsections set out the IASB's considerations about the application of hedge accounting in the context of groups of items.

Criteria for the eligibility of a group of items as a hedged item

BC6.435 An individual hedge approach involves an entity entering into one or more hedging instruments to manage a risk exposure from an individual hedged item to achieve a desired outcome. This is similar for a group hedge approach. However, for a group hedge approach an entity seeks to manage the risk exposure from a group of items. Some of the risks in the group may offset (for their full term or for a partial term) and provide a hedge against each other, leaving the group residual risk to be hedged by the hedging instrument.

BC6.436 An individual hedge approach and a group hedge approach are similar in concept. Hence, the IASB decided that the requirements for qualifying for hedge accounting should also be similar. Consequently, the IASB proposed that the eligibility criteria that apply to individual hedged items should also apply to hedges of groups of items. However, some restrictions were retained for cash flow hedges of net positions.

BC6.437 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Designation of a layer component of a nominal amount for hedges of a group of items

BC6.438 The IASB proposed in its 2010 Hedge Accounting Exposure Draft that an entity could designate a layer component of a nominal amount (a 'layer') of a single item in a hedging relationship. The IASB also considered whether it would be appropriate to extend that decision on single items to groups of items and hence allow the designation of a layer of a group in a hedging relationship.

BC6.439 The IASB noted that the benefits of identifying a layer component of a nominal amount of a group of items are similar to the benefits it had considered for layer components of single items (see paragraphs BC6.200–BC6.204). In addition, the IASB also noted other reasons that support the use of components for groups of items:

(a) uncertainties such as a breach (or cancellation) of contracts, or prepayment, can be better modelled when considering a group of items;

(b) in practice, hedging layers of groups of items (for example, a bottom layer) is a common risk management strategy; and

(c) arbitrarily identifying and designating (as hedged items) specific items from a group of items that are exposed to the same hedged risk can:

  (i) give rise to arbitrary accounting results if the designated items do not behave as originally expected (while other items, sufficient to cover the hedged amount, do behave as originally expected); and

  (ii) can provide opportunities for earnings management (for example, by choosing to transfer and derecognise particular items from a group of homogeneous items when only some were specifically designated into a fair value hedge and therefore have fair value hedge adjustments attached to them).

BC6.440 The IASB noted that, in practice, groups of items hedged together are not likely to be groups of identical items. Given the different types of groups that could exist in practice, in some cases it could be easy to satisfy the proposed conditions and in some cases it could be more challenging or even impossible. The IASB considered that it is not appropriate to define the cases in which the proposed conditions were satisfied because it would depend on the specific facts and circumstances. The IASB therefore considered a criteria-based approach would be more operational and appropriate. Such an approach would allow hedge accounting to be applied in situations in which the criteria are easy to meet as well as in cases in which, although the criteria are more challenging to meet, an entity is prepared to undertake the necessary efforts (for example, to invest in systems in order to achieve compliance with the hedge accounting requirements).

BC6.441 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Cash flow hedges of a group of items that constitutes a net position that qualifies for hedge accounting

BC6.442 In a cash flow hedge, changes in the fair value of the hedging instrument are deferred in other comprehensive income to be reclassified later from accumulated other comprehensive income to profit or loss when the hedged item affects profit or loss. For hedges of net positions, items in the group have some offsetting risk positions that provide a natural hedge for some of the risks in the group (ie the gains on some items offset the losses on others). Hence, for a cash flow hedge of a net position that is a group of forecast transactions, the cumulative change in value (from the inception of the hedge) that arises on some forecast transactions (to the extent that it is effective in achieving offset) must be deferred in other comprehensive income. This is necessary because the gain or loss that arises on the forecast transactions that occur in the early phase of the hedging relationship must be reclassified to profit or loss in the later phase until the last hedged item in the net position affects profit or loss.

BC6.443 The forecast transactions that constitute a hedged net position might differ in their timing such that they affect profit or loss in different reporting periods. For example, sales and unrelated expenditure hedged for foreign currency risk might affect profit or loss in different reporting periods. When this happens, the cumulative

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change in value of the designated sales (to be reclassified later when the expenditure is recognised as an expense) needs to be excluded from profit or loss and instead be deferred in other comprehensive income. This is required in order to ensure that the effect of the sales on profit or loss is based on the hedged exchange rate.

BC6.444 Hence, in its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB noted that cash flow hedge accounting for net positions of forecast transactions would involve a deferral in accumulated other comprehensive income of cumulative gains and losses on some forecast transactions, from the time they occurred until some other forecast transactions would affect profit or loss in later reporting periods. The IASB considered that this would be tantamount to measuring the transactions that occurred first at a different amount from the transaction amount (or other amount that would be required under general IFRS requirements) in contemplation of other forecast transactions that were expected to occur in the future and that would have an offsetting gain or loss. When those other transactions occurred, their measurement would be adjusted for the amounts deferred in accumulated other comprehensive income on forecast transactions that had occurred earlier.

BC6.445 The IASB acknowledged that this approach would not result in the recognition of gains and losses on items that do not yet exist but would instead defer gains and losses on some forecast transactions as those transactions occurred. However, the IASB considered that this approach would be a significant departure from general IFRS regarding the items that resulted from the forecast transactions. The IASB noted that this departure would affect the forecast transactions:

(a) that occurred in the early phases of the hedging relationship, ie those for which gains and losses were deferred when the transaction occurred; and

(b) those that occurred in the later phases of the hedging relationship and were adjusted for the gains or losses that had been deferred on the forecast transactions as those transactions had occurred in the early phases of the hedging relationship.

BC6.446 The IASB noted that the accounting for the forecast transactions that occurred in the later phases of the hedging relationship was comparable to that of forecast transactions that were hedged items in a cash flow hedge. However, the treatment of the forecast transactions that occurred in the early phases of the hedging relationship would be more similar to that of a hedging instrument than to that of a hedged item. The IASB concluded that this would be a significant departure from general IFRS requirements and the requirements of the hedge accounting model for hedging instruments.

BC6.447 Consequently, in its 2010 Hedge Accounting Exposure Draft, the IASB proposed that a cash flow hedge of a net position should not qualify for hedge accounting when the offsetting risk positions would affect profit or loss in different periods. The IASB noted that when the offsetting risk positions affected profit or loss in the same period those concerns would not apply in the same way as no deferral in accumulated other comprehensive income of cumulative gains and losses on forecast transactions would be required. Hence, the IASB proposed that such net positions should be eligible as hedged items.

BC6.448 Some respondents to the 2010 Hedge Accounting Exposure Draft agreed with the IASB's rationale for not allowing the application of cash flow hedge accounting to net positions that consist of forecast transactions that would affect profit or loss in different reporting periods. They believed that without this restriction the potential for earnings management would arise. Despite agreeing with the proposals, some respondents asked the IASB to provide additional guidance on the treatment of the amounts deferred in accumulated other comprehensive income if, in a cash flow hedge of a net position, the offsetting risk positions that were initially expected to affect profit or loss in the same reporting period subsequently changed and, as a result, were expected to affect profit or loss in different periods.

BC6.449 Others requested the IASB to reconsider the restriction on the application of hedge accounting to cash flow hedges of a net position with offsetting risk positions that affect profit or loss in different reporting periods. Those respondents believed that this restriction would not allow entities to properly reflect their risk management activities. In addition, some respondents requested that the IASB consider the annual reporting period as the basis for this restriction (if retained) instead of any reporting period (ie including an interim reporting period), noting that the frequency of reporting would otherwise affect the eligibility for this form of hedge accounting.

BC6.450 The IASB noted that the feedback on its proposals in the 2010 Hedge Accounting Exposure Draft reflected two different perspectives:

(a) a treasury perspective—this is a cash flow perspective. The respondents who provided comments from this perspective typically look at cash inflows and cash outflows arising from both sides of the net position. The treasury view stops at the level of the cash flows and does not take into account the time lag that might exist between the cash flow and the recognition of related income or expense in profit or loss. From this perspective, once the first forecast transaction is recognised, the natural hedge lapses and the remainder of the net position will be hedged by entering into an additional derivative (or

alternatively by using, for example, the foreign currency denominated cash instrument that arises as a result of the occurrence of the first forecast transaction). Subsequently (ie at the time of settlement of the second forecast transaction), the cash flows from the financial instrument being used as a hedging instrument will be used to settle the payments resulting from the forecast transaction.

(b) an accounting perspective—this perspective focuses on how to present the effect of the two forecast transactions in profit or loss and in which accounting period. This goes beyond the cash flow view of the treasury perspective. This is because the way in which the item affects profit or loss can be different, while the cash flow is a point-in-time event. For example, while the purchase of services and the sales of goods can be designated as part of a net position in a way that they will affect profit or loss in one reporting period, purchases of property, plant and equipment affect profit or loss over several different reporting periods through the depreciation pattern. Similarly, if inventory is sold in the period after it was purchased, the cash flow and the related effect on profit or loss occur in different periods.

BC6.451 In the light of the comments received, the IASB reconsidered the restriction on cash flow hedges of net positions with offsetting risk positions that affect profit or loss in different reporting periods, as proposed in the 2010 Hedge Accounting Exposure Draft. The IASB did not think that it was appropriate to completely remove the restriction. However, the IASB considered whether there was an alternative approach that could better reflect an entity's risk management activities but that would also address the earnings management concerns that had been raised.

BC6.452 The IASB noted that entities would only be able to reflect their risk management activities if it removed the restriction on the application of hedge accounting to cash flow hedges of a net position with offsetting risk positions that affect profit or loss in different reporting periods. However, the IASB noted that it could address the concerns about earnings management by introducing some requirements for documenting the hedging relationship instead of prohibiting the designation altogether.

BC6.453 The IASB noted that the potential for earnings management could be addressed if the recognition pattern for profit or loss arising from the hedged net position for all reporting periods affected was set at the inception of the hedge, in such a way that it was clear what amounts would affect profit or loss, when they would affect profit or loss and to which hedged volumes and types of items they related.

BC6.454 However, the IASB had concerns about applying cash flow hedges for net positions to many different types of risks because it might have unintended consequences for some risks. The IASB noted that foreign currency risk was the risk most commented on by respondents and the risk that the IASB intended to address by this type of hedge.

BC6.455 Consequently, the IASB decided that cash flow hedges of net positions would only be available for hedges of foreign currency risk (but no other risks). In addition, the IASB decided to remove the restriction that the offsetting risk positions in a net position must affect profit or loss in the same reporting period. However, the IASB was concerned that without sufficiently specific documentation of the items within the designated net position, an entity could use hindsight to allocate the hedging gains or losses to those items so as to achieve a particular result in profit or loss (selection effect). Consequently, the IASB decided that for all items within the designated net position for which there could be a selection effect, an entity must specify each period in which the transactions are expected to affect profit or loss as well as the nature and volume of each type of forecast transaction in such a way that it eliminates the selection effect. For example, depending on the circumstances, eliminating a selection effect could require that specifying the nature of a forecast purchase of items of property, plant and equipment includes aspects such as the depreciation pattern for items of the same kind, if the nature of those items is such that the depreciation pattern could vary depending on how the entity uses those items (such as different useful lives because of being used in different production processes). The IASB noted that this would also address the issue that some respondents had raised about changes in the original expectations of when the risk positions would affect profit or loss resulting in items affecting profit or loss in different reporting periods (see paragraph BC6.449).

Presentation for groups of items that are a net position

BC6.456 For cash flow hedges of groups of items with offsetting risk positions (ie net positions), the hedged items might affect different line items in the statement of profit or loss and other comprehensive income. Consequently, this raises the question of how hedging gains or losses should be presented for a cash flow hedge of such a group. In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB noted that hedging gains or losses would need to be grossed up to offset each of the hedged items individually.

BC6.457 The IASB noted that if it proposed to adjust (gross up) all the affected line items in the statement of profit or loss and other comprehensive income it would result in the recognition of gross (partially offsetting) gains or losses that did not exist, and that this would not be consistent with general accounting principles.

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Consequently, in its 2010 Hedge Accounting Exposure Draft, the IASB decided not to propose adjusting (grossing up) all affected line items in the statement of profit or loss and other comprehensive income.

BC6.458 Instead, the IASB proposed that in the statement of profit or loss or other comprehensive income hedging gains or losses for cash flow hedges of a net position should be presented in a separate line item. This would avoid the problem of distorting gains or losses with amounts that did not exist. However, the IASB acknowledged that this results in additional disaggregation of information in the statement of profit or loss and other comprehensive income. This would also result in hedges of net positions being presented differently from hedges of gross positions.

BC6.459 In a fair value hedge, changes in the fair value of both the hedged item and the hedging instrument, for changes in the hedged risk, are recognised in the statement of profit or loss and other comprehensive income. Because the treatment of gains or losses for both the hedged item and the hedging instrument is the same, the IASB did not believe any changes to the fair value hedge accounting mechanics were necessary to accommodate net positions. However, in situations in which some hedging gains or losses are considered a modification of revenue or an expense (for example, when the net interest accrual on an interest rate swap is considered a modification of the interest revenue or expense on the hedged item), those gains or losses should be presented in a separate line when the hedged item is a net position. In the IASB's view, in those situations the same reasons applied that it had considered for cash flow hedges in relation to their presentation in the statement of profit or loss and other comprehensive income.

BC6.460 Most of the respondents to the 2010 Hedge Accounting Exposure Draft supported the IASB's proposal to require the hedging gains or losses to be presented in a separate line item for a hedging relationship that includes a group of items with offsetting risks that affect different line items in the statement of profit or loss and other comprehensive income.

BC6.461 The IASB decided to retain the proposal in the 2010 Hedge Accounting Exposure Draft, as it would make transparent that an entity is hedging on a net basis and would clearly present the effect of those hedges of net positions on the face of the statement of profit or loss and other comprehensive income.

Identifying the hedged item for hedges of a group of items that constitutes a net position

BC6.462 The IASB considered in its deliberations leading to the 2010 Hedge Accounting Exposure Draft how an entity that applies hedge accounting to net positions should identify the hedged item. The IASB concluded that an entity would need to designate a combination of gross positions if it were to apply the hedge accounting mechanics to the hedged position. Consequently, the IASB proposed that an entity could not designate a merely abstract net position (ie without specifying the items that form the gross positions from which the net position arises) as the hedged item.

BC6.463 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Hedges of a group of items that results in a net position of nil

BC6.464 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB noted that when an entity managed and hedged risks on a net basis, the proposals would allow the entity to designate the net risk from hedged items into a hedging relationship with a hedging instrument. For an entity that hedges on such a basis, the IASB acknowledged that there might be circumstances in which, by coincidence, the net position of hedged items for a particular period was nil.

BC6.465 The IASB considered whether, when an entity hedges risk on a net basis, a nil net position should be eligible for hedge accounting. Such a hedging relationship could be, in its entirety, outside the scope of hedge accounting if it did not include any financial instruments. Furthermore, eligibility for hedge accounting would be inconsistent with the general requirement that a hedging relationship must contain both an eligible hedged item and an eligible hedging instrument.

BC6.466 However, the IASB noted that the accounting result of prohibiting the application of hedge accounting to nil net positions could distort the financial reporting of an entity that otherwise hedged (with eligible hedging instruments) and applied hedge accounting on a net basis, for example:

(a) in periods in which hedge accounting is permitted (because a net position exists and is hedged with a hedging instrument), the transactions would affect profit or loss at an overall hedged rate or price; whereas

(b) in periods in which hedge accounting would not be permitted (because the net position is nil), transactions would affect profit or loss at prevailing spot rates or prices.

BC6.467 Consequently, the IASB proposed that nil net positions should qualify for hedge accounting. However, the IASB noted that such situations would be coincidental and hence it expected that nil net positions would be rare in practice.

BC6.468 The IASB retained its original decision when redeliberating its 2010 Hedge Accounting Exposure Draft.

Hedging credit risk using credit derivatives

The IASB's deliberations leading to the 2010 Hedge Accounting Exposure Draft

The issue

BC6.469 Many financial institutions use credit derivatives to manage their credit risk exposures arising from their lending activities. For example, hedges of credit risk exposure allow financial institutions to transfer the risk of credit loss on a loan or a loan commitment to a third party. This might also reduce the regulatory capital requirement for the loan or loan commitment while at the same time allowing the financial institution to retain nominal ownership of the loan and to preserve the relationship with the client. Credit portfolio managers frequently use credit derivatives to hedge the credit risk of a proportion of a particular exposure (for example, a facility for a particular client) or the bank's overall lending portfolio.

BC6.470 However, the credit risk of a financial item is not a risk component that meets the eligibility criteria for hedged items. The spread between the risk-free rate and the market interest rate incorporates credit risk, liquidity risk, funding risk and any other unidentified risk component and margin elements. Although it is possible to determine that the spread includes credit risk, the credit risk cannot be isolated in a way that would allow the change in fair value that is attributable solely to credit risk to be separately identifiable (see also paragraph BC6.503).

BC6.471 As an alternative to hedge accounting, IFRS 9 permits an entity to designate, as at fair value through profit or loss, at initial recognition, financial instruments that are within the scope of that Standard if doing so eliminates or significantly reduces an accounting mismatch. However, the fair value option is only available at initial recognition, is irrevocable and an entity must designate the financial item in its entirety (ie for its full nominal amount). Because of the various optional features and the drawdown behavioural pattern of the loans and loan commitments, credit portfolio managers often engage in a flexible and active risk management strategy. Credit portfolio managers most often hedge less than 100 per cent of a loan or loan commitment. They might also hedge longer periods than the contractual maturity of the loan or the loan commitment. Furthermore, the fair value option is available only for instruments that are within the scope of IFRS 9. Most of the loan commitments for which credit risk is managed fall within the scope of IAS 37, not IFRS 9. Consequently, most financial institutions do not (and often cannot) elect to apply the fair value option because of the associated restrictions and scope.

BC6.472 As a result, financial institutions that use credit default swaps to hedge the credit risk of their loan portfolios measure their loan portfolios at amortised cost and do not recognise most loan commitments (ie those that meet the scope exception of IFRS 9). The changes in fair value of the credit default swaps are recognised in profit or loss in every reporting period (as for a trading book). The accounting outcome is an accounting mismatch of gains and losses of the loans and loan commitments versus those of the credit default swaps, which creates volatility in profit or loss. During the IASB's outreach programme, many users of financial statements pointed out that that outcome does not reflect the economic substance of the credit risk management strategy of financial institutions.

BC6.473 In its 2010 Hedge Accounting Exposure Draft, the IASB proposed that a risk component should be separately identifiable and reliably measurable in order to qualify as a hedged item. As mentioned before, measuring the credit risk component of a loan or a loan commitment is complex. Consequently, to accommodate an equivalent to hedge accounting when entities hedge credit risk, a different accounting requirement would have to be developed specifically for this type of risk, or the proposed hedge accounting requirements would have to be significantly modified (for example, in relation to eligible hedged items and effectiveness testing).

Alternatives considered by the IASB

BC6.474 In its deliberations leading to the 2010 Hedge Accounting Exposure Draft, the IASB considered three alternative approaches to hedge accounting in order to address situations in which credit risk is hedged by

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credit derivatives. Those alternatives would, subject to qualification criteria, permit an entity with regard to the hedged credit exposure (for example, a bond, loan or loan commitment):

(a) Alternative 1:

(i) to elect fair value through profit or loss only at initial recognition;

(ii) to designate a component of nominal amounts; and

(iii) to discontinue fair value through profit or loss accounting.

(b) Alternative 2:

(i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and the then fair value is recognised immediately in profit or loss);

(ii) to designate a component of nominal amounts; and

(iii) to discontinue fair value through profit or loss accounting.

(c) Alternative 3:

(i) to elect fair value through profit or loss at initial recognition or subsequently (if subsequently, the difference between the then carrying amount and the then fair value is amortised or deferred);

(ii) to designate a component of nominal amounts; and

(iii) to discontinue fair value through profit or loss accounting.

BC6.475 The election of fair value through profit or loss would be available for a financial instrument (or a proportion of it) that is managed in such a way that an economic relationship on the basis of the same credit risk exists with credit derivatives (measured at fair value through profit or loss) that causes offset between changes in fair value of the financial instrument and the credit derivatives. This would also apply to financial instruments that fall outside the scope of IFRS 9, for example, loan commitments. Instead of the qualifying criteria for hedge accounting (see paragraphs BC6.230–BC6.271), the IASB considered the following qualifying criteria for electing fair value through profit or loss:

(a) the name of the credit exposure matches the reference entity of the credit derivative (name matching); and

(b) the seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

BC6.476 The qualification criteria in BC6.475 are set with a view to accommodating economic hedges of credit risk that would otherwise qualify for hedge accounting, but for the fact that the credit risk component within the hedged exposure cannot be separately identified and hence is not a risk component that meets the eligibility criteria for hedged items. Those qualification criteria are also consistent with regulatory requirements and the risk management strategy underlying the current business practice of financial institutions. However, using name matching as a qualifying criterion means that index-based credit default swaps would not meet that criterion.

BC6.477 For discontinuation, the IASB considered the following criteria:

(a) the qualifying criteria are no longer met; and

(b) retaining the measurement at fair value through profit or loss is not needed because of any other requirements.

BC6.478 Given the rationale for electing fair value through profit or loss, an entity would typically discontinue accounting at fair value through profit or loss if the discontinuation criteria in BC6.477 are met, because that would ensure that the accounting is aligned with how the exposure is managed (ie the credit risk is no longer managed using credit derivatives). The IASB noted that in circumstances when the discontinuation criteria apply, the financial instrument, if fair value through profit or loss accounting had not already been elected, would not qualify (any more) for that election. Hence, the IASB considered that it would be logical to make the discontinuation of fair value through profit or loss accounting mandatory (instead of optional) if the discontinuation criteria are fulfilled.

BC6.479 Alternative 1 permits electing fair value through profit or loss for a component of the nominal amount of the financial instrument if qualifying criteria are met. This is available only at initial recognition. Fair value through profit or loss can be discontinued if the qualification criteria are met. Loan commitments that fall outside the scope of IFRS 9 could also be eligible in accordance with this alternative if the qualification criteria are met. In accordance with Alternative 1, at the date of discontinuation of accounting for the financial instrument at fair value through profit or loss, the fair value of the financial instrument will be its deemed

cost. For loan commitments outside the scope of IFRS 9 the recognition and measurement criteria of IAS 37 would apply.

BC6.480 The IASB noted that a significant disadvantage of Alternative 1 is that in many situations in practice (when a financial institution obtains credit protection for an exposure after the initial recognition of that exposure) this alternative is not aligned with the credit risk management strategy and would therefore not reflect its effect. An advantage of Alternative 1 is that it is less complex than the other alternatives that the IASB considered. By not permitting the election of fair value through profit or loss after initial recognition (or inception of a loan commitment), the difference at later points in time between the carrying amount and the fair value of the financial instrument will not arise.

BC6.481 In addition to the election of fair value through profit or loss at initial recognition in accordance with Alternative 1, Alternative 2 also permits that election after initial recognition. This means that the election is available again for an exposure for which fair value through profit or loss was elected previously (which logically cannot apply if the election is restricted to initial recognition). An example is a volatile longer-term exposure that was previously deteriorating and was then protected by credit default derivatives, then significantly improved so that the credit derivatives were sold, but then again deteriorated and was protected again. This ensures that an entity that uses a credit risk management strategy that protects exposures that drop below a certain quality or risk level could align the accounting with their risk management.

BC6.482 The IASB noted that when the financial instrument is elected for measurement as at fair value through profit or loss after initial recognition, a difference could arise between its carrying amount and its fair value. This difference is a result of the change in the measurement basis (for example, from amortised cost to fair value for a loan). The IASB considers this type of difference a measurement change adjustment. Alternative 2 proposes to recognise the measurement change adjustment in profit or loss immediately. At the date of discontinuation of fair value through profit or loss accounting, the fair value will be the deemed cost (as in Alternative 1). If the financial instrument is elected again after a previous discontinuation, the measurement change adjustment at that date is also recognised immediately in profit or loss.

BC6.483 A significant advantage of Alternative 2 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It is reflective of how credit exposures are managed. Credit exposures are actively managed by credit risk portfolio managers. Alternative 2 allows the effects of such an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives.

BC6.484 A disadvantage of Alternative 2 is that it is more complex than Alternative 1. Furthermore, it might appear susceptible to earnings management. An entity can decide at what time to elect fair value through profit or loss accounting for the financial instrument and thus when the difference between the carrying amount and the fair value at that date would be recognised in profit or loss. The accounting impact of immediately recognising the measurement change adjustment in profit or loss may also deter an entity from electing fair value through profit or loss accounting. For example, when an entity decides to take out credit protection at a time when the fair value has already moved below the carrying amount of the loan because of credit concerns in the market, it will immediately recognise a loss if it elects fair value through profit or loss accounting.

BC6.485 On the other hand, the advantage of recognising the measurement change adjustment immediately in profit or loss is that it is operationally simpler than Alternative 3. Alternative 3 provides the same eligibility of fair value through profit or loss accounting and its discontinuation as Alternative 2. Consequently, it also allows financial institutions to achieve an accounting outcome that reflects their credit risk management strategy.

BC6.486 An important difference between Alternatives 2 and 3 is the treatment of the measurement change adjustment (ie the difference that could arise between the carrying amount and the fair value of the financial instrument when fair value through profit or loss accounting is elected after initial recognition of the credit exposure). Alternative 3 proposes that the measurement change adjustment should be amortised for loans and deferred for loan commitments that fall within the scope of IAS 37.

BC6.487 As in Alternative 2, a significant advantage of Alternative 3 is that it would eliminate the accounting mismatch and produce more consistent and relevant information. It allows the effects of an active and flexible risk management approach to be reflected appropriately and significantly reduces the measurement inconsistency between the credit exposures and the credit derivatives. An advantage of Alternative 3 over Alternative 2 is that it would be less susceptible to earnings management and would not deter the election of fair value through profit or loss in scenarios after initial recognition of the exposure when the fair value of the exposure has already declined.

BC6.488 However, a disadvantage of Alternative 3 is that it is the most complex of the alternatives. The IASB noted that the measurement change adjustment in accordance with Alternative 3 would have presentation implications. The measurement change adjustment could be presented in the statement of financial position in the following ways:

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(a) as an integral part of the carrying amount of the exposure (ie it could be added to the fair value of the loan): this results in a mixed amount that is neither fair value nor amortised cost;

(b) presentation as a separate line item next to the line item that includes the credit exposure: this results in additional line items in the statement of financial position and may easily be confused as a hedging adjustment; or

(c) in other comprehensive income.

BC6.489 The IASB noted that disclosures could make the measurement change adjustment transparent.

BC6.490 However, in the light of the complexities that these three alternatives would introduce, the IASB decided not to propose allowing elective fair value accounting for hedged credit exposures (such as loans and loan commitments).

The feedback received on the 2010 Hedge Accounting Exposure Draft

BC6.491 Many respondents to the 2010 Hedge Accounting Exposure Draft were of the view that the IASB should consider how to accommodate hedges of credit risk using credit derivatives under IFRS. Respondents commented that hedges of credit risk using credit derivatives are becoming an increasingly significant practice issue in the application of IFRS. They noted that this issue is just as significant as other issues that had been addressed in the 2010 Hedge Accounting Exposure Draft (for example, the time value of options, hedges of aggregated exposures and risk components of non-financial items). They also noted that financial reporting under IFRS should allow entities to reflect the effects of such activities in the financial statements consistently with the overall hedge accounting objective to better reflect risk management activities.

BC6.492 Respondents also commented that IFRS today fails to represent the effect of credit risk management activities and distort the financial performance of financial institutions. They noted that, because of the accounting mismatch between loans and loan commitments on the one hand and the related credit derivatives on the other hand, the profit or loss under IFRS is significantly more volatile for financial institutions that hedge their credit risk exposures than for financial institutions that do not hedge.

BC6.493 Many respondents noted that the objective of hedge accounting would not be met if IFRS would not provide a way to account for hedges of credit risk so that financial statements can reflect the credit risk management activities of financial institutions.

BC6.494 Most users of financial statements commented that the IASB should address this issue. Many also noted that the financial statements currently reflect accounting-driven volatility when credit risk is hedged and that those financial statements do not align with those risk management activities.

BC6.495 Participants in the outreach provided the same feedback. Most of them were also of the view that this is an important practice issue that the IASB should address.

BC6.496 However, the feedback was mixed on how the IASB should address or resolve this issue. Many respondents were of the view that it was difficult to reliably measure credit risk as a risk component for the purposes of hedge accounting. However, some respondents suggested that for some types of instruments the credit risk component of financial instruments could be reliably measured on the basis of credit default swap (CDS) prices, subject to some adjustments.

BC6.497 Many agreed that the alternatives set out in the Basis for Conclusions of the 2010 Hedge Accounting Exposure Draft (see paragraph BC6.474) were too complex, although some respondents supported elective fair value through profit or loss accounting as an alternative to hedge accounting. Of the three fair value through profit or loss alternatives, most respondents supported Alternative 3.

BC6.498 Respondents who supported elective fair value through profit or loss accounting thought that it would be operational and believed that it would be no more complex than the other possible approaches, for example, identifying risk components. Most preferred Alternative 3 as it would align most closely with the dynamic credit risk management approach of many financial institutions. Some users of financial statements supported elective fair value through profit or loss accounting because they thought that the benefits of providing a better depiction of the economics of the risk management activities would outweigh the complexity.

The IASB's redeliberations of the 2010 Hedge Accounting Exposure Draft

BC6.499 In the light of the feedback received on its 2010 Hedge Accounting Exposure Draft, the IASB decided to specifically address the accounting for hedges of credit risk using credit derivatives. In its redeliberations the IASB explored various accounting alternatives.

Treating credit risk as a risk component

BC6.500 The IASB noted that for credit risk there are unique differences between how the relevant risk might affect the hedging instrument and the hedged risk exposure when compared to other risk components.

BC6.501 The IASB also noted that there is sometimes uncertainty about whether voluntary debt restructurings constitute a credit event under a standard credit default swap contract. Whether an event constitutes a credit event is determined by a committee consisting of representatives of banks and fund entities. This can (and in practice did) result in situations in which the fair value of a debt instrument has decreased, reflecting the market view of credit losses on those debt instruments while any payout on credit default swaps for those debt instruments depends on how the difficulties of the debtor will be resolved and what related measures might be considered a credit event. This is a factor that affects credit default swaps in a different way than the actual underlying debt. It is an additional factor inherent in credit default swaps that is not inherent in the debt as such. Hence, there could be scenarios in which, for example, an impairment loss on a loan might not be compensated by a payout from a credit default swap that is linked to the obligor of that debt. Also, market liquidity and the behaviour of speculators trying to close positions and taking gains affect the credit default swap and the debt market in different ways.

BC6.502 The IASB also noted that when a financial institution enters into a credit default swap to hedge the credit exposure from a loan commitment it might result in a situation in which the reference entity defaults while the loan commitment remains undrawn or partly undrawn. In such situations the financial institution receives compensation from the payout on the credit default swaps without actually incurring a credit loss.

BC6.503 Furthermore, the IASB considered the implications of the fact that, upon a credit event, the protection buyer receives the notional principal less the fair value of the reference entity's obligation. Hence, the compensation received for credit risk depends on the fair value of the reference instrument. The IASB noted that, for a fixed-rate loan, the fair value of the reference instrument is also affected by changes in market interest rates. In other words, on settlement of the credit default swap, the entity also settles the fair value changes attributable to interest rate risk—and not solely fair value changes attributable to the credit risk of the reference entity. Hence, the way credit default swaps are settled reflects that credit risk inextricably depends on interest rate risk. This in turn reflects that credit risk is an 'overlay' risk that is affected by all other value changes of the hedged exposure because those value changes determine the value of what is lost in case of a default.

BC6.504 Hence, the IASB considered that credit risk is not a separately identifiable risk component and thus does not qualify for designation as a hedged item on a risk component basis.

Exception to the general risk component criteria

BC6.505 The IASB then considered whether it should provide an exception to the general risk component criteria specifically for credit risk.

BC6.506 Some respondents suggested that, as an exception to the general risk component criteria, the IASB should consider an approach that would provide a reasonable approximation of the credit risk. This approach could be based on the guidance in IFRS 7 and IFRS 9 for the measurement of an entity's own credit risk on financial liabilities designated as at fair value through profit or loss. Those respondents noted that if this method of determining own credit risk for such liabilities is acceptable in IFRS 7 and IFRS 9, the IASB should provide the same 'relief' for measuring the credit risk component for the purposes of hedge accounting.

BC6.507 The IASB noted that, in finalising the requirement for the fair value option for financial liabilities in IFRS 9, it retained the default method in the application guidance in IFRS 7 to determine the effects of changes in the liability's credit risk. The IASB received comments on its 2010 Own Credit Risk Exposure Draft that determining the effects of changes in a liability's credit risk can be complex, and that it was therefore necessary to allow some flexibility in how a liability's credit risk could be measured. Respondents to that Exposure Draft, like the IASB, acknowledged that the default method was imprecise but considered the result a reasonable proxy in many cases. Moreover, the IASB noted that respondents to the 2010 Own Credit Risk Exposure Draft did acknowledge that the 'IFRS 7 method' did not isolate changes in a liability's credit risk from other changes in fair value (for example, general changes in the price of credit or changes in liquidity risk). Those respondents said that it was often very difficult or impossible to separate those items.

BC6.508 The IASB noted that the IFRS 7 method (which was incorporated into IFRS 9) involves the use of an observed market price at the beginning and end of the period to determine the change in the effects of credit. That method requires entities to deduct any changes in market conditions from changes in the fair value of the instrument. Any residual amount is deemed to be attributable to changes in credit. The IASB noted that the loans and loan commitments for which the credit risk is hedged very often have no observable market price and that, in order to achieve a close approximation of the credit risk, complex modelling would be involved to arrive at a 'market price'. Applying the IFRS 7 method would then require the deduction of valuations for

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parts of the instrument and analysing them for changes in market conditions to arrive at a credit risk component. This would also be complex when trying to achieve a close approximation of the credit risk.

BC6.509 Furthermore, the IASB noted that the loans and loan commitments for which the credit exposure is hedged often have embedded options whose fair value depends on both market and non-market conditions. For example, the exercise of prepayment options could be because of changes in general interest rates (a market condition) while loans are typically refinanced (exercise of the prepayment option) well in advance of the scheduled maturity, irrespective of movements in general interest rates. Hence, in order to achieve a close approximation of the credit risk, isolating the changes for market conditions on those embedded options could involve significant judgement and could become extremely complex.

BC6.510 The IASB also considered that applying the IFRS 7 method in a way that was operational (ie so that the approximation would provide relief) would mean using many of the same simplifications that some had suggested for applying the general risk component criteria to credit risk (for example, using a standardised haircut for prepayment and term-out options, and ignoring immaterial options).

BC6.511 The IASB considered that for exchange-traded bonds for which market prices are readily observable and that do not have embedded options, the IFRS 7 method might result in an approximation or proxy for the credit risk component in some circumstances. However, the IASB was concerned that for loans and loan commitments that are not actively traded, the IFRS 7 method could become a complicated 'circular' pricing exercise and in any case it would very likely result in only a rough approximation or imprecise measurement of the credit risk component.

BC6.512 The IASB further noted that it had acknowledged the shortcomings of the approach used for IFRS 7 and IFRS 9 and that the approach was only a proxy for measuring credit risk. Hence, the IASB had actively sought to limit the application of this approach by retaining the bifurcation requirement for hybrid financial liabilities, even though bifurcation of financial assets was eliminated. Hence, the approach was only applied to financial liabilities designated as at fair value through profit or loss.

BC6.513 The IASB acknowledged that in order to ensure that hedge ineffectiveness is recognised the qualifying criteria for risk components use a higher degree of precision than a mere proxy. Also, for the classification and measurement of financial liabilities the IASB sought to minimise the application of this proxy by retaining the separation of embedded derivatives. Consequently, the IASB decided that also using the guidance in IFRS 7 and IFRS 9 for the measurement of an entity's own credit risk on financial liabilities designated as at fair value through profit or loss for the purpose of measuring credit risk as a hedged item would be inappropriate.

BC6.514 The IASB also considered whether it should permit 'residual risks' as an eligible hedged item. Such an approach would allow an entity to designate as the hedged item those changes in cash flows or fair value of an item that are not attributable to a specific risk or risks that meet the separately identifiable and reliably measurable criteria for risk components. For example, an entity could designate as the hedged item the fair value changes of a loan that are attributable to all risks other than interest rate risk.

BC6.515 The IASB noted that that approach would have the advantage of not requiring an entity to directly measure credit risk. However, the IASB noted that this approach would entail similar complexity as the IFRS 7 method for financial instruments with multiple embedded options. Hence, determining the part of the fair value changes that is attributable to a specific risk (for example, interest rate risk) could be complex.

BC6.516 The IASB also noted that that approach would have other disadvantages:

(a) the problem that credit risk inextricably depends on interest rate risk because of the nature of credit risk as an overlay risk (see paragraphs BC6.503–BC6.504) would remain; and

(b) entities would struggle with the hedge effectiveness assessment of the new hedge accounting model as it would be difficult to establish and demonstrate a direct economic relationship between the 'residual risk' and the hedging instrument (ie the credit default swap), which gives rise to offset—a requirement to qualify for hedge accounting.

BC6.517 Consequently, the IASB decided against permitting 'residual risks' as an eligible hedged item.

Applying financial guarantee contract accounting

BC6.518 The IASB considered whether the accounting for financial guarantee contracts in IFRS 9 could be applied to credit derivatives.

BC6.519 The IASB noted that credit derivatives, such as credit default swaps, do not typically meet the definition of a financial guarantee contract in IFRS 9 because:

(a) the credit events that trigger payment on a standardised credit default swap (for example, bankruptcy, repudiation, moratorium or restructuring) might not directly relate to the failure to pay on the particular debt instrument held by an entity; and

(b) in order to meet the definition of a financial guarantee contract, it must be a precondition for payment that the holder is exposed to, and has incurred a loss on, the failure of the debtor to make payments on the guaranteed asset when due. However, it is not a precondition for entering into a credit default swap that the holder is exposed to the underlying reference financial instrument (ie an entity can hold a 'naked' position).

BC6.520 The IASB noted that it would have to broaden the definition of 'financial guarantee contract' in order to include such credit derivatives. The IASB also noted that accounting for credit default swaps as financial guarantee contracts would mean that credit default swaps would not be measured at fair value but at 'cost', ie it would result in applying accrual accounting to a derivative financial instrument.

BC6.521 The IASB therefore rejected this alternative.

Applying the accounting for the time value of options

BC6.522 Some respondents to the 2010 Hedge Accounting Exposure Draft suggested that the premium paid on credit default swaps is similar to buying protection under an insurance contract and, accordingly, the premium should be amortised to profit or loss. Those respondents supported applying to credit default swaps the accounting treatment for the time value of options that was proposed in the 2010 Hedge Accounting Exposure Draft. They argued that, from a risk management perspective, changes in the fair value of the derivative during the reporting period were irrelevant, as long as the issuer of the debt was solvent because if there was no credit event the fair value of the credit default swap on maturity would be zero. Hence, those respondents believed that 'interim' fair value changes could be recognised in other comprehensive income similarly to the accounting treatment proposed in the 2010 Hedge Accounting Exposure Draft for the time value of options.

BC6.523 The IASB noted that in contrast to 'normal' options for which the time value paid is known from the beginning (hence the amount to be amortised or deferred is known), for a credit default swap the premium is contingent on the occurrence of a credit event and hence the total premium that is ultimately paid is not known at the outset. This is because the premium for a credit default swap, or at least a large part of the premium, is paid over time—but only until a credit event occurs. The IASB noted that in order to apply the same accounting as for the time value of options, the contingent nature of the credit default swap premium would have to be ignored so that the amortisation of the premium to profit or loss could be based on the assumption that no credit event occurs—even though that risk is reflected in the fair value of the credit default swap. The IASB also noted that in substance this would be 'as-you-go' accounting for the credit default swap premium (ie recognising it in profit or loss on an accrual basis).

BC6.524 The IASB also noted that applying to credit default swaps the same accounting treatment as for the time value of options would require splitting the fair value of the credit default swap into an intrinsic value and a time value. This raises the question of whether the credit default swap would only have time value (and hence no intrinsic value) until a credit event occurs, ie whether before a credit event occurs the entire fair value of the credit default swap should be deemed to be its time value.

BC6.525 The IASB considered that it would be inappropriate to simply attribute the entire fair value of the credit default swap before a credit event to time value. The IASB noted that hedged items such as bonds or loans have 'intrinsic' value but not an equivalent to time value. In an effective economic hedge, the changes in the intrinsic value in the hedged item would offset the changes in the intrinsic value of the hedging instrument. During times of financial difficulty, but before a credit event (for example, before an actual default), the fair value of the loan would have decreased because of credit deterioration. Also, the fair value of the related credit default swap would increase because of the higher risk of default. Hence, the IASB considered that the increase in fair value of the credit default swap includes some intrinsic value element even though it would be difficult to isolate and separately quantify it.

BC6.526 The IASB also noted that if the entire fair value on a credit default swap was treated as time value before default, there could be an accounting mismatch when an entity recognised an impairment loss on the loan or loan commitment before default. This is because all fair value changes from the credit default swap would still be recognised in other comprehensive income. One solution might be to recycle the amount recognised as an impairment loss on the loan or loan commitment from other comprehensive income to profit or loss and hence to simply deem the amount of the impairment loss to be the intrinsic value of the credit default swap. The IASB considered that this would give rise to the same problems as other approximations it had discussed when it rejected an exception to the general risk component criteria, namely that any mismatch of economic gains or losses from the hedge would not be recognised as hedge ineffectiveness. Instead, under this approach

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profit or loss recognition for the credit default swap would be the same as accrual accounting while assuming perfect hedge effectiveness.

BC6.527 The IASB therefore rejected this alternative.

Applying an 'insurance approach'

BC6.528 Some respondents to the 2010 Hedge Accounting Exposure Draft supported an 'insurance approach' or accrual accounting for credit derivatives. They argued that such an approach would best address the accounting mismatch between loans or loan commitments and credit derivatives and would reflect the risk management of financial institutions.

BC6.529 The IASB considered that under an insurance approach the following accounting could be applied to a credit default swap that is used to manage credit exposures:

(a) any premium paid at the inception of the credit default swap (or its fair value if an existing contract is used) would be amortised over the life of that contract;

(b) the periodic premium would be expensed as paid each period (including adjustments for premium accruals);

(c) the fair value of the credit default swap would be disclosed in the notes; and

(d) in the assessment of impairment, the cash flow that might result from the credit default swap in case of a credit event is treated in the same way as cash flows that might result from the collateral or guarantee of a collateralised or guaranteed financial asset. In other words, the loan or loan commitment for which credit risk is managed using the credit default swap is treated like a collateralised or guaranteed financial asset with the credit default swap accounted for like collateral or a guarantee.

BC6.530 The IASB noted that the insurance approach is a simple and straightforward solution if a credit default swap is used as credit protection for one particular credit exposure with a matching (remaining) maturity. Also, situations in which the maturity of the credit default swap exceeds that of the credit exposure could be addressed by using an 'aligned' credit default swap (similar to the notion of 'aligned' time value that is used for the new accounting treatment for the time value of options; see paragraphs BC6.386–BC6.409). However, the aligned credit default swap would only address maturity mismatches. It would not capture other differences between the actual credit default swap and the hedged credit exposure (for example, that a loan might be prepayable) because the insurance approach only intends to change the accounting for the credit default swap instead of adjusting the credit exposure for value changes that reflect all of its characteristics.

BC6.531 The IASB considered that the insurance approach would have a simple interaction with an impairment model as a result of treating the credit default swap like collateral or a guarantee, which means it would affect the estimate of the recoverable cash flows. Hence, this interaction would be at the most basic level of the information that any impairment model uses so that the effect would not differ by type of impairment model (assuming only credit derivatives with a remaining life equal to, or longer than, the remaining exposure period would qualify for the insurance approach).

BC6.532 However, the IASB noted that difficulties would arise when the insurance approach was discontinued before the credit exposure matures. In such a situation the consequences of using accrual (or 'as-you-go') accounting for the credit default swap would become obvious, ie it would be necessary to revert from off-balance-sheet accounting to measurement at fair value.

BC6.533 The IASB also noted that under the insurance approach neither the credit derivative nor the loan or loan commitment would be recognised in the statement of financial position at fair value. Hence, any mismatch of economic gains or losses (ie economic hedge ineffectiveness) between loans or loan commitments and the credit derivatives would not be recognised in profit or loss. In addition, it would result in omitting the fair value of the credit default swap from the statement of financial position even though fair value provides important and relevant information about derivative financial instruments.

BC6.534 The IASB therefore rejected this alternative.

Applying a 'deemed credit adjustment approach'

BC6.535 The IASB also considered an approach that would adjust the carrying amount of the hedged credit exposure against profit or loss. The adjustment would be the change in the fair value of a credit default swap that matches the maturity of the hedged credit exposure ('aligned' credit default swap value). The mechanics of this would be similar to how, in a fair value hedge, the gain or loss on the hedged item that is attributable to a risk component adjusts the carrying amount of the hedged item and is recognised in profit or loss. Essentially, the cumulative change in the fair value of the aligned credit default swap would be deemed to be

the credit risk component of the exposure in a fair value hedge of credit risk (ie act as a proxy for credit risk—'deemed credit adjustment'). When the deemed credit adjustment approach is discontinued before the credit exposure matures an accounting treatment that is similar to that used for discontinued fair value hedges could be used.

BC6.536 The IASB noted that the deemed credit adjustment approach would retain the measurement of credit default swaps at fair value through profit or loss. Hence, in contrast to the insurance approach (see paragraphs BC6.528–BC6.534), an advantage of this approach would be that the accounting for the credit default swap would not be affected by any switches between periods for which the credit derivative is used and those for which it is not used to manage a particular credit exposure.

BC6.537 However, the IASB was concerned that the interaction between the deemed credit adjustment approach and impairment accounting would be significantly more complex than under the insurance approach because the deemed credit adjustment and the impairment allowance would be 'competing mechanisms' in the accounting for impairment losses. This would also involve the danger of double counting for credit losses. The interaction would depend on the type of impairment model and would be more difficult in conjunction with an expected loss model.

BC6.538 The IASB therefore rejected this alternative.

Allowing entities to elect fair value accounting for the hedged credit exposure

BC6.539 Because the discussions of those various alternatives did not identify an appropriate solution, the IASB reconsidered the alternatives it had contemplated in its original deliberations leading to the 2010 Hedge Accounting Exposure Draft (see paragraph BC6.474).

BC6.540 The IASB considered that only Alternatives 2 and 3 of allowing an entity to elect fair value through profit or loss accounting for the hedged credit exposure would be viable. Given that Alternative 1 would be limited to an election only on initial recognition of the credit exposure (or when entering into a loan commitment), the IASB was concerned that, in many situations in practice (when an entity obtains credit protection for an exposure after the initial recognition of that exposure or entering into the loan commitment), this alternative would not be aligned with the credit risk management strategy and would therefore fail to resolve the problem (ie that no useful information is provided).

BC6.541 The IASB noted that Alternative 3 would involve amortising the measurement change adjustment (ie the difference between the carrying amount, or nil for an unrecognised loan commitment, and the fair value of the financial instrument when it is elected for measurement at fair value through profit or loss after initial recognition or after entering into a loan commitment) over the life of the financial instrument hedged for credit risk. As a consequence, to ensure that the measurement change adjustment is not inappropriately deferred but recognised immediately in profit or loss when impaired, the measurement change adjustment would require an impairment test. This would result in interaction with the impairment model.

BC6.542 The IASB was concerned that the interaction of Alternative 3 with the impairment model could create a compatibility problem and might be a potential restriction of the impairment phase of its project to replace IAS 39.

BC6.543 Hence, the IASB reconsidered Alternative 2, noting that:

(a) the status quo under IAS 39, in which credit default swaps are accounted for at fair value through profit or loss while credit exposures are accounted for at amortised cost or are unrecognised (for example, many loan commitments), does not convey the full picture. It results in the recognition of gains on credit default swaps while the impairment is recognised on a different measurement basis and with a time lag because of the impairment models. Hence, in a situation in which the situation of a lender deteriorates but it has protected itself, gains are shown even though the protection keeps the situation neutral at best.

(b) Alternative 2 would use fair value accounting for both the credit default swap and the credit exposure. This would best capture all economic mismatches but would come at the expense of inevitably including in the remeasurement interest rate risk in addition to credit risk. Alternative 2 would have the clearest objective of all the approaches considered (fair value measurement) and, as a result, it would require the least guidance. The IASB noted that under Alternative 2 there could be concerns about earnings management because on electing fair value accounting the difference to the previous carrying amount of the credit exposure would be immediately recognised in profit or loss. However, the IASB also noted that some would consider that outcome as relevant because it would signal a different approach to managing credit risk and this difference would often be a loss that is a reflection of any lag in the impairment model behind the 'market view'. To be consistent, this should be removed by changing the measurement basis when switching to a fair value-based credit risk management.

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(c) the accounting under Alternative 2 is completely de-linked from the impairment model and consequently has the least interaction with impairment of all approaches considered.

(d) Alternative 2 is operationally the least complex of the approaches considered.

BC6.544 The IASB considered that, on balance, the advantages of Alternative 2 outweighed its disadvantages and, overall, that it was superior to all other approaches. Hence, the IASB decided to include Alternative 2 in the final requirements.

BC6.545 In response to feedback received on the 2010 Hedge Accounting Exposure Draft, the IASB also decided to align the accounting for the discontinuation of fair value through profit or loss accounting for loan commitments with that for loans (ie use amortisation unless a higher liability is required by IAS 37, instead of simply reverting to that Standard as contemplated during the IASB's initial deliberations—see paragraphs BC6.479 and BC6.482). The IASB's reasons for also using an amortisation approach for loan commitments were that:

(a) it would prevent an immediate gain from the derecognition of the loan commitment under IAS 37 if the probable threshold is not met when discontinuing fair value through profit or loss accounting. This would reduce concerns about earnings management.

(b) the amortisation of the carrying amount when discontinuing fair value through profit or loss accounting would use the effective interest method. This would require the entity to assume that a loan had been drawn under the loan commitment in order to determine an amortisation profile. The rationale for this alternative is that a credit loss only results from a loan commitment if that loan commitment gets drawn and the resulting loan is not repaid. Hence, an amortisation on an 'as if drawn' basis would be appropriate for the amortisation of the carrying amount.

(c) this accounting also provides operational relief for loan commitments that allow repayments and redraws (for example, a revolving facility). It would avoid the need to capitalise any remaining carrying amount into individual drawings to ensure its amortisation, which would be operationally complex.

Amendments for Interest Rate Benchmark Reform (September 2019)

BC6.546 Interest rate benchmarks such as interbank offered rates (IBORs) play an important role in global financial markets. These interest rate benchmarks index trillions of dollars and other currencies in a wide variety of financial products, from derivatives to residential mortgages. However, cases of attempted market manipulation of some interest rate benchmarks, together with the post-crisis decline in liquidity in interbank unsecured funding markets, have undermined confidence in the reliability and robustness of some interest rate benchmarks. Against this background, the G20 asked the Financial Stability Board (FSB) to undertake a fundamental review of major interest rate benchmarks. Following the review, the FSB published a report setting out its recommended reforms of some major interest rate benchmarks such as IBORs. Public authorities in many jurisdictions have since taken steps to implement those recommendations. In some jurisdictions, there is already clear progress towards the reform of interest rate benchmarks, or the replacement of interest rate benchmarks with alternative, nearly risk-free interest rates that are based, to a greater extent, on transaction data (alternative benchmark rates). This has in turn led to uncertainty about the long-term viability of some interest rate benchmarks. In these amendments, the term 'interest rate benchmark reform' refers to the market-wide reform of an interest rate benchmark including its replacement with an alternative benchmark rate, such as that resulting from the FSB's recommendations set out in its July 2014 report 'Reforming Major Interest Rate Benchmarks' (the reform).[42]

BC6.547 In 2018 the IASB noted the increasing levels of uncertainty about the long-term viability of some interest rate benchmarks and decided to address as a priority the issues affecting financial reporting in the period before the reform (referred to as pre-replacement issues).

BC6.548 As part of the pre-replacement issues, the IASB considered the implications for specific hedge accounting requirements in IFRS 9 and IAS 39, which require forward-looking analysis. As a result of the reform, contractual cash flows of hedged items and hedging instruments based on an existing interest rate benchmark will likely change when that interest rate benchmark is subject to the reform—in these amendments, contractual cash flows encompass both contractually specified and non-contractually specified cash flows. The same uncertainty arising from the reform regarding the timing and the amount of future cash flows will likely affect the changes in fair value of hedged items and hedging instruments in a fair value hedge of the interest rate benchmark exposure. Until decisions are made about what the alternative benchmark rate is, and

[42] The report, 'Reforming Major Interest Rate Benchmarks', is available at http://www.fsb.org/wp-content/uploads/r_140722.pdf.

when and how the reform will occur, including specifying its effects on particular contracts, uncertainties will exist regarding the timing and the amount of future cash flows of the hedged item and the hedging instrument.

BC6.549 The IASB noted that the hedge accounting requirements in IFRS 9 and IAS 39 provide a clear basis for accounting for such uncertainties. In applying these requirements, the uncertainties about the timing and the amount of future cash flows could affect an entity's ability to meet those specific forwardlooking hedge accounting requirements in the period when uncertainty is created by the reform. In some cases, solely due to such uncertainties, entities could be required to discontinue hedge accounting for hedging relationships that would otherwise qualify for hedge accounting. Also, because of the uncertainties arising from the reform, entities may not be able to designate new hedging relationships that would otherwise qualify for hedge accounting applying IFRS 9 and IAS 39. In some cases, discontinuation of hedge accounting would require an entity to recognise gains or losses in profit or loss.

BC6.550 In the IASB's view, discontinuation of hedge accounting solely due to such uncertainties before the reform's economic effects on hedged items and hedging instruments are known would not provide useful information to users of financial statements. Therefore, the IASB decided to publish in May 2019 the Exposure Draft *Interest Rate Benchmark Reform* (2019 Exposure Draft), which proposed exceptions to IFRS 9 and IAS 39 to provide relief during this period of uncertainty.

BC6.551 The 2019 Exposure Draft proposed exceptions to specific hedge accounting requirements such that entities would apply those requirements assuming the interest rate benchmark on which the hedged risk and/or cash flows of the hedged item or of the hedging instrument are based is not altered as a result of the reform. The proposed exceptions applied only to the hedge accounting requirements specified in that Exposure Draft and were not intended to provide relief from all consequences arising from the reform.

BC6.552 Almost all respondents to the 2019 Exposure Draft agreed with the IASB's decision to address pre-replacement issues. Many highlighted the urgency of these issues, especially in some jurisdictions where there is already clear progress towards the reform or replacement of interest rate benchmarks with alternative benchmark rates.

BC6.553 In September 2019 the IASB amended IFRS 9, IAS 39 and IFRS 7 by issuing *Interest Rate Benchmark Reform*, which confirmed with modifications the proposals in the 2019 Exposure Draft. In the amendments issued in September 2019, the IASB added paragraphs 6.8.1–6.8.12 and 7.1.8 to IFRS 9 and amended paragraph 7.2.26 of IFRS 9.

BC6.554 The IASB decided to propose amendments to IAS 39 as well as IFRS 9 because when entities first apply IFRS 9, they are permitted to choose as an accounting policy to continue to apply the hedge accounting requirements of IAS 39. The IASB understands that a significant number of IFRS preparers—financial institutions in particular—have made such an accounting policy choice.

Scope of the exceptions

BC6.555 In the 2019 Exposure Draft, the IASB noted that the hedge accounting issues being addressed arise in the context of interest rate benchmark reform, and, therefore, the proposed exceptions would apply only to hedging relationships of interest rate risk that are affected by the reform. However, some respondents expressed the view that the scope of the exceptions, as set out in the 2019 Exposure Draft, would not include other types of hedging relationships that may be affected by uncertainties arising from the reform such as hedging relationships in which an entity designates cross-currency interest rate swaps to hedge its exposure to both foreign currency and interest rate risk. These respondents asked the IASB to clarify whether the scope of the exceptions was meant to include such hedging relationships.

BC6.556 In its redeliberations on the 2019 Exposure Draft, the IASB clarified that it did not intend to exclude from the scope of the amendments hedging relationships in which interest rate risk is not the only designated hedged risk. The IASB agreed with respondents that other hedging relationships could be directly affected by the reform when the reform gives rise to uncertainties about the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. Therefore, the IASB confirmed that the exceptions would apply to the interest rate benchmark-based cash flows in these situations. The IASB noted that many derivatives, designated in hedging relationships in which there is no uncertainty about the timing or the amount of interest rate benchmark-based cash flows, could be indirectly affected by the reform. For example, this would be the case when the valuation of the derivatives is affected by general uncertainty in the market caused by the reform. The IASB confirmed that the exceptions do not apply to these hedging relationships, despite the indirect effect the uncertainties arising from the reform could have on the valuation of derivatives.

BC6.557 Consequently, the IASB clarified the wording in paragraph 6.8.1 of IFRS 9 to refer to all hedging relationships that are directly affected by interest rate benchmark reform. Paragraph 6.8.1 of IFRS 9 explains that a hedging relationship is directly affected by interest rate benchmark reform only if the reform gives rise to uncertainties

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about the interest rate benchmark (contractually or non-contractually specified) designated as a hedged risk and/or the timing or the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. The scope of the exceptions does not exclude hedging relationships in which interest rate risk is not the only hedged risk.

Highly probable requirement

BC6.558 The IASB noted that, if an entity designates a forecast transaction as the hedged item in a cash flow hedge, applying paragraph 6.3.3 of IFRS 9, that transaction must be highly probable (highly probable requirement). This requirement is intended to ensure that changes in the fair value of designated hedging instruments are recognised in the cash flow hedge reserve only for those hedged forecast transactions that are highly probable to occur. This requirement is an important discipline in applying hedge accounting to forecast transactions. The IASB noted that the requirements in IFRS 9 provide a clear basis to account for the effects of the reform—that is, if the effects of the reform are such that the hedged cash flows are no longer highly probable, hedge accounting should be discontinued. As set out in paragraph BC6.550, in the IASB's view, discontinuing all affected hedging relationships solely due to such uncertainty would not provide useful information to users of financial statements.

BC6.559 Therefore, the IASB amended IFRS 9 to provide an exception to the highly probable requirement that would provide targeted relief during this period of uncertainty. More specifically, applying the exception, if the hedged future cash flows are based on an interest rate benchmark that is subject to the reform, an entity assumes that the interest rate benchmark on which the hedged cash flows are based is not altered when assessing whether the future cash flows are highly probable. If the hedged future cash flows are based on a highly probable forecast transaction, by applying the exception in paragraph 6.8.4 of IFRS 9 when performing the assessment of the highly probable requirement for that forecast transaction, the entity would assume that the interest rate benchmark on which the hedged cash flows are based will not be altered in the future contract as a result of the reform. For example, for a future issuance of a London Interbank Offered Rate (LIBOR)-referenced debt instrument, the entity would assume that the LIBOR benchmark rate on which the hedged cash flows are based will not be altered as a result of the reform.

BC6.560 The IASB noted that this exception does not necessarily result in an entity determining that the hedged cash flows are highly probable. In the example described in paragraph BC6.559, the entity assumed that the interest rate benchmark in the future contract would not be altered as a result of the reform when determining whether that forecast transaction is highly probable. However, if the entity decides not to issue the debt instrument because of uncertainty arising from the reform or for any other reason, the hedged future cash flows are no longer highly probable (and are no longer expected to occur). The exception would not permit or require the entity to assume otherwise. In this case, the entity would conclude that the LIBOR-based cash flows are no longer highly probable (and are no longer expected to occur).

BC6.561 The IASB also included an exception for discontinued hedging relationships. Applying this exception, any amount remaining in the cash flow hedge reserve when a hedging relationship is discontinued would be reclassified to profit or loss in the same period(s) during which the hedged cash flows affect profit or loss, based on the assumption that the interest rate benchmark on which the hedged cash flows are based is not altered as a result of the reform. If, however, the hedged future cash flows are no longer expected to occur for other reasons, the entity is required to immediately reclassify to profit or loss any amount remaining in the cash flow hedge reserve. In addition, the exception would not exempt entities from reclassifying the amount that is not expected to be recovered into profit or loss as required by paragraph 6.5.11(d)(iii) of IFRS 9.

Assessment of the economic relationship between the hedged item and the hedging instrument

BC6.562 Applying IFRS 9, a hedging relationship qualifies for hedge accounting only if there is an economic relationship between the hedged item and the hedging instrument.

BC6.563 Demonstrating the existence of an economic relationship requires the estimation of future cash flows because the assessment is prospective in nature. Interest rate benchmark reform could affect this assessment for hedging relationships that may extend beyond the timing of the reform. That is because entities would have to consider possible changes to the fair value or future cash flows of hedged items and hedging instruments to assess whether an economic relationship continues to exist between the hedged item and hedging instrument. Consequently, at some point in time, it is possible that entities would not be able to demonstrate the existence of an economic relationship solely because of uncertainties arising from the reform.

BC6.564 The IASB considered the usefulness of the information that would result from the potential discontinuation of hedge accounting for affected hedging relationships and decided to amend the requirements in IFRS 9 to

provide an exception for assessing the economic relationship between the hedged item and the hedging instrument for the same reasons discussed in paragraph BC6.550.

BC6.565 Applying this exception, an entity shall assess whether the economic relationship as required by paragraph 6.4.1(c)(i) of IFRS 9 exists based on the assumption that the hedged risk or the interest rate benchmark on which the hedged item or the hedging instrument is based is not altered as a result of the reform. Similarly, if an entity designates a highly probable forecast transaction as the hedged item, the entity shall perform the assessment based on the assumption that the interest rate benchmark on which the hedged cash flows are based will not change as a result of the reform.

BC6.566 The IASB noted that an offset between the hedged item and the hedging instrument is a fundamental principle of the hedge accounting model in IFRS 9 and, therefore, the IASB considered it critical to maintain this principle. The exception addresses only the uncertainties arising from the reform. Therefore, if an entity is unable to demonstrate the existence of an economic relationship between the hedged item and the hedging instrument for other reasons, the entity shall discontinue hedge accounting as required by IFRS 9.

Measurement of ineffectiveness

BC6.567 The IASB noted that the exceptions were not intended to change the requirement that entities measure and recognise hedge ineffectiveness. The IASB considered that the actual results of the hedging relationships would provide useful information to users of financial statements during the period of uncertainty arising from the reform. Therefore, the IASB decided that entities should continue to measure and recognise hedge ineffectiveness as required by IFRS Standards.

BC6.568 The IASB also considered whether any exceptions should be made to the measurement of hedged items or hedging instruments because of the uncertainty arising from the reform. However, the IASB noted that such an exception would be inconsistent with the decision not to change the requirements to measure and recognise hedge ineffectiveness in the financial statements. Therefore, the IASB decided not to provide an exception from the measurement of hedging instruments and hedged items. This means that the fair value of a derivative designated as the hedging instrument should continue to be measured using the assumptions that market participants would use when pricing that derivative as required by IFRS 13 *Fair Value Measurement*.

BC6.569 For a hedged item designated in a fair value hedge, IFRS 9 requires an entity to remeasure the hedged item for changes in fair value attributable to the hedged risk and recognise the gain or loss related to that fair value hedge adjustment in profit or loss. In doing so, the entity uses the assumptions that market participants would use when pricing the hedged item for changes in fair value attributable to the hedged risk. This would include a risk premium for uncertainty inherent in the hedged risk that market participants would consider. For example, to measure changes in fair value attributable to the hedged risk such as the IBOR component of a fixed-rate loan, an entity needs to reflect the uncertainty caused by the reform. When applying a present value technique to calculate the changes in fair value attributable to the designated risk component, such measurement should reflect market participants' assumptions about the uncertainty arising from the reform.

BC6.570 When an entity designates interest rate benchmark-based cash flows as the hedged item in a cash flow hedge, to calculate the change in the value of the hedged item for the purpose of measuring hedge ineffectiveness, the entity may use a derivative that would have terms that match the critical terms of the designated cash flows and the hedged risk (this is commonly referred to as a 'hypothetical derivative'). As the IASB decided that entities should continue to measure and recognise hedge ineffectiveness as required by IFRS Standards, entities should continue to apply assumptions that are consistent with those applied to the hedged risk of the hedged item. For example, if an entity designated interest rate benchmark-based cash flows as the hedged item in a cash flow hedge, the entity would not assume for the purpose of measuring hedge ineffectiveness that the expected replacement of the interest rate benchmark with an alternative benchmark rate will result in zero cash flows after the replacement. The hedging gain or loss on the hedged item should be measured using the interest rate benchmark-based cash flows (that is, the cash flows on which the hypothetical derivative is based) when applying a present value technique, discounted at a market-based discount rate that reflects market participants' assumptions about the uncertainty arising from the reform. The IASB concluded that reflecting market participants' assumptions when measuring hedge ineffectiveness provides useful information to users of financial statements about the effects of the uncertainty arising from the reform on an entity's hedging relationships. Therefore, the IASB decided that no exceptions are needed for the measurement of actual ineffectiveness.

Hedges of risk components

BC6.571 The IASB noted that in accordance with IFRS 9 an entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. For example, an entity that issues a 5-year floating-rate debt instrument that bears interest at 3-month LIBOR + 1%, could designate as the hedged item either

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the entire debt instrument (that is, all of the cash flows) or only the 3-month LIBOR risk component of the floating-rate debt instrument. Specifically, paragraph 6.3.7(a) of IFRS 9 allows entities to designate only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component) provided that the risk component is separately identifiable and reliably measurable.

BC6.572 The IASB observed that an entity's ability to conclude that an interest rate benchmark is a separately identifiable component in accordance with paragraph 6.3.7(a) of IFRS 9 requires a continuous assessment over the duration of the hedging relationship and could be affected by the reform. For example, if the outcome of the reform affects the market structure of an interest rate benchmark, it could affect an entity's assessment of whether a non-contractually specified LIBOR component is separately identifiable and, therefore, an eligible hedged item in a hedging relationship. The IASB considered only risk components that are implicit in the fair value or the cash flows of an item of which they are a part (referred to as non-contractually specified) because the same issue does not arise for risk components that are explicitly specified in the contract.

BC6.573 For the reasons outlined in paragraph BC6.550, the IASB noted that discontinuing hedging relationships due to uncertainty arising from the reform would not provide useful information. Consequently, the IASB decided to propose amending IFRS 9 so that entities would not discontinue hedge accounting solely because the risk component is no longer separately identifiable as a result of the reform. In the 2019 Exposure Draft, the IASB proposed that the separately identifiable requirement for hedges of the benchmark component of interest rate risk be applied only at the inception of those hedging relationships affected by the reform.

BC6.574 The IASB proposed not to extend the relief to allow entities to designate the benchmark component of interest rate risk as the hedged item in a new hedging relationship if the risk component is not separately identifiable at the inception of the hedging relationship. In the IASB's view, allowing hedge accounting for risk components that are not separately identifiable at the inception would be inconsistent with the objective of the exception. The IASB noted that such circumstances are different from allowing continued designation as the hedged item for risk components that had met the requirement at the inception of the hedging relationship.

BC6.575 Furthermore, the IASB did not propose any exception from the requirement that changes in the fair value or cash flows of the risk component must be reliably measurable. As noted in paragraph BC6.566, in the IASB's view, an offset between the hedged item and the hedging instrument is a fundamental principle of the hedge accounting model in IFRS 9 and, therefore, the IASB considered reliable measurement of the hedged item and the hedging instrument to be critical to maintain this principle.

BC6.576 Almost all respondents agreed with the exception proposed in the 2019 Exposure Draft to apply the separately identifiable requirement only at the inception of a hedging relationship. However, some respondents noted that the proposed exception did not provide equivalent relief to hedging relationships that frequently reset (ie discontinue and restart). In those hedging relationships both the hedging instrument and the hedged item frequently change (ie the entity uses a dynamic process in which both the hedged items and the hedging instruments used to manage that exposure do not remain the same for long). As hedging instruments and hedged items are being added or removed from a portfolio, entities are de-designating and redesignating hedging relationships regularly to adjust the exposure. If each redesignation of the hedging relationship is considered to be the inception of a new hedging relationship (even though it is still the same hedging strategy), then the separately identifiable requirement would need to be assessed for all hedged items at each redesignation even if they have been assessed previously. For the same reasons as those noted in paragraph BC6.572, this could affect an entity's ability to conclude that a non-contractually specified risk component remains separately identifiable and, therefore, an eligible hedged item for hedge accounting purposes.

BC6.577 The IASB noted that the exception proposed in the 2019 Exposure Draft has the effect that if a non-contractually specified risk component meets the separately identifiable requirement at the inception of a hedging relationship, then that requirement would not be reassessed subsequently. Hence, providing a similar exception for hedging relationships that frequently reset (ie discontinue and restart) would be consistent with the objective of the exception originally provided in the 2019 Exposure Draft.

BC6.578 Thus, the IASB confirmed the proposal that a risk component is only required to be separately identifiable at the inception of the hedging relationship. In addition, to respond to the feedback described in paragraph BC6.576, the IASB added the exception in paragraph 6.8.8 of IFRS 9 for hedging relationships that, consistent with an entity's hedge documentation, frequently reset (ie discontinue and restart) because both the hedging instrument and the hedged item frequently change. Applying that paragraph, an entity shall determine whether the risk component is separately identifiable only when it initially designates an item as a hedged item in the hedging relationship. The hedged item is not reassessed at any subsequent redesignation in the same hedging relationship.

BC6.579 In reaching its decision for the exception in paragraph 6.8.8 of IFRS 9 the IASB considered an example where an entity uses a dynamic process to manage interest rate risk as discussed in paragraph B6.5.24(b) of IFRS 9 and designates the LIBOR risk component of floating-rate loans as the hedged risk. At the inception of the

relationship, the entity assesses whether LIBOR is a separately identifiable risk component for all loans designated within the hedging relationship. As the entity updates the risk position with the origination of new loans and the maturity or repayment of existing loans, the hedging relationship is adjusted by de-designating the 'old' hedging relationship and redesignating a 'new' hedging relationship for the updated amount of the hedged items. Applying the exception in paragraph 6.8.8 of IFRS 9 requires the entity to assess whether LIBOR is a separately identifiable risk component only for the new loans added to the hedging relationship. The entity would not reassess the separately identifiable requirement for the loans that have been redesignated.

Mandatory application

BC6.580 The IASB decided to require entities to apply the exceptions in Section 6.8 of IFRS 9 to all hedging relationships to which the exceptions are applicable. In other words, the IASB decided that an entity is required to apply the exceptions to all hedging relationships that are directly affected by the uncertainties arising from the reform and continue to apply the exceptions until required to cease their application as specified in paragraphs 6.8.9–6.8.12 of IFRS 9.

BC6.581 The IASB considered but rejected alternatives that would have allowed entities to apply the exceptions voluntarily. In the IASB's view, voluntary application of these exceptions could give rise to selective discontinuation of hedge accounting and selective reclassification of the amounts recorded in other comprehensive income related to previously discontinued hedging relationships. The IASB does not expect that requiring entities to apply the exceptions would entail significant cost for preparers and other affected parties because the exceptions require entities to assume that the interest rate benchmark, on which the hedged risk and the hedged cash flows, and cash flows of the hedging instrument are based, is not altered as a result of the reform.

BC6.582 In addition, the IASB observed that in some circumstances, the exceptions in Section 6.8 of IFRS 9 may not be applicable. For example, for a particular interest rate benchmark not subject to the reform or replacement with an alternative benchmark rate, there is no uncertainty affecting the timing or the amount of the interest rate benchmark-based cash flows arising from a hedged item or a hedging instrument. The exceptions set out in Section 6.8 of IFRS 9 would not be applicable to such a hedging relationship.

BC6.583 Furthermore, for a particular hedging relationship the exceptions may be applicable to some but not all aspects of the hedging relationship. For example, if an entity designates a hedged item that is based on LIBOR against a hedging instrument that is already referenced to an alternative benchmark rate (assuming the entity can demonstrate that hedging relationship meets the qualifying criteria for hedge accounting in IFRS 9), the exceptions in paragraphs 6.8.4 and 6.8.6 of IFRS 9 would apply for the hedged item because there is uncertainty related to its future cash flows. However, there is no uncertainty regarding how the reform would impact the cash flows of the hedging instrument and, therefore, the exception in paragraph 6.8.6 of IFRS 9 is not applicable for the hedging instrument. Similarly, the exception applicable to non-contractually specified components would not be relevant for hedging relationships that do not involve the designation of noncontractually specified risk components.

End of application

BC6.584 As described in paragraph BC6.550, the IASB decided to amend IFRS 9 to address specific aspects of hedge accounting affected by uncertainties in relation to the hedged items and hedging instruments about when the interest rate benchmarks will change to alternative benchmark rates, when any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined (collectively, timing) and what the cash flows based on the alternative benchmark rate will be, including their frequency of reset, and any spread adjustment between the interest rate benchmark and the alternative benchmark rate (collectively, amount). Therefore, the IASB intended the exceptions set out in Section 6.8 of IFRS 9 to be available only while these uncertainties are present.

BC6.585 The IASB considered whether to provide an explicit end date for the exceptions but decided not to do so. The reform is following different timelines in different markets and jurisdictions and contracts are being modified at different times and, therefore, at this stage, it is not possible to define a period of applicability for the exceptions.

BC6.586 The IASB decided that an entity ceases applying the exceptions at the earlier of (a) when the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows is no longer present as it relates to a hedged item and/or hedging instrument (depending on the particular exception) and (b) the

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discontinuation of the hedging relationship.[43] The exceptions require entities to apply specific hedge accounting requirements assuming the interest rate benchmark on which the hedged risk, hedged cash flows or the cash flows of the hedging instrument are based is not altered as a result of the reform. The end of applicability of the exceptions means that entities would from that date apply all hedge accounting requirements in IFRS 9 without applying these exceptions.

BC6.587 In the IASB's view, for uncertainty regarding the timing and the amount of cash flows arising from a change in an interest rate benchmark to be eliminated, the underlying contracts are generally required to be amended to specify the timing and the amount of cash flows based on the alternative benchmark rate (and any spread adjustment between the interest rate benchmark and the alternative benchmark rate). The IASB noted that, in some cases, a contract may be amended to include reference to the alternative benchmark rate without actually altering the interest rate benchmark-based cash flows in the contract. Such an amendment may not eliminate the uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows in the contract. The IASB considered the following scenarios to assess the robustness of the end of application requirements. However, these scenarios are not exhaustive and other scenarios may exist in which the uncertainties arising from the reform regarding the timing and the amount of cash flows would no longer be present.

BC6.588 Scenario A—a contract is amended to include a clause that specifies (a) the date the interest rate benchmark will be replaced by an alternative benchmark rate and (b) the alternative benchmark rate on which the cash flows will be based and the relevant spread adjustment between the interest rate benchmark and the alternative benchmark rate. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract is eliminated when the contract is amended to include this clause.

BC6.589 Scenario B—a contract is amended to include a clause that states modifications of contractual cash flows will occur due to the reform but that specifies neither the date that the interest rate benchmark will be replaced nor the alternative benchmark rate on which the amended cash flows will be based. In this case, the uncertainty regarding the timing and the amount of cash flows for this contract has not been eliminated by amending the contract to include this clause.

BC6.590 Scenario C—a contract is amended to include a clause which states that conditions specifying the amount and timing of interest rate benchmark-based cash flows will be determined by a central authority at some point in the future. But the clause does not specify those conditions. In this case, the uncertainty regarding the timing and the amount of the interest rate benchmark-based cash flows for this contract has not been eliminated by including this clause in the contract. Uncertainty regarding both the timing and the amount of cash flows for this contract will be present until the central authority specifies when the replacement of the benchmark will become effective, and what the alternative benchmark rate and any related spread adjustment will be.

BC6.591 Scenario D—a contract is amended to include a clause in anticipation of the reform that specifies the date the interest rate benchmark will be replaced and any spread adjustment between the interest rate benchmark and the alternative benchmark rate will be determined. However, the amendment does not specify the alternative benchmark rate, or the spread adjustment between the interest rate benchmark and the alternative benchmark rate, on which the cash flows will be based. In this scenario, by amending the contract to include this clause, uncertainty regarding the timing has been eliminated but uncertainty about the amount remains.

BC6.592 Scenario E—a contract is amended to include a clause in anticipation of the reform that specifies the alternative benchmark rate on which the cash flows will be based and the spread adjustment between the interest rate benchmark and the alternative benchmark rate, but does not specify the date from which the amendment to the contract will become effective. In this scenario, by amending the contract to include this clause, uncertainty about the amount has been eliminated but uncertainty with respect to timing remains.

BC6.593 Scenario F—in preparation for the reform, a central authority in its capacity as the administrator of an interest rate benchmark undertakes a multi-step process to replace an interest rate benchmark with an alternative benchmark rate. The objective of the reform is to cease the publication of the current interest rate benchmark and replace it with an alternative benchmark rate. As part of the reform, the administrator introduces an interim benchmark rate and determines a fixed spread adjustment based on the difference between the interim benchmark rate and the current interest rate benchmark. Uncertainty about the timing or the amount of the alternative benchmark rate-based cash flows will not be eliminated during the interim period because the interim benchmark rate (including the fixed spread adjustment determined by the administrator) represent an interim measure in progressing towards the reform but it does not represent the alternative benchmark rate (or any related spread adjustment agreed between parties to the contract).

BC6.594 For reasons similar to those described in paragraph BC6.583, the IASB noted that there could be situations in which the uncertainty for particular elements of a single hedging relationship could end at different times. For

[43] For the purpose of applying the exception in paragraph 6.8.5 of IFRS 9 to a discontinued hedging relationship, the amendments require an entity to cease applying the exception at the earlier of (a) as described above and (b) when the entire amount accumulated in the cash flow hedge reserve with respect to the hedging relationship has been reclassified to profit or loss. See paragraph 6.8.10 of IFRS 9.

example, assume an entity is required to apply the relevant exceptions to both the hedged item and the hedging instrument. If the hedging instrument in that hedging relationship is subsequently amended through market protocols covering all derivatives in that market, and will be based on an alternative benchmark rate such that the uncertainty about the timing and the amount of interest rate benchmark-based cash flows of the hedging instrument is eliminated, the relevant exceptions would continue to apply to the hedged item but would no longer apply to the hedging instrument.[44]

BC6.595 The IASB observed that continuing to apply the exception after the uncertainty was resolved would not faithfully represent the actual characteristics of the elements of the hedging relationship in which the uncertainty arising from the reform is eliminated. The IASB considered whether it should extend the relief provided such that the exceptions would apply at the hedging relationship level for as long as any element of that hedging relationship was affected by the uncertainties arising from the reform. The IASB agreed that doing so would be beyond the objective of addressing only those issues directly affected by the uncertainty arising from the reform. This is also because the exceptions in paragraphs 6.8.4–6.8.12 of IFRS 9 and the respective requirements in IFRS 9 apply to the same elements of the hedging relationship. Therefore, applying each exception at the hedging relationship level would be inconsistent with how the underlying requirements are applied.

BC6.596 The IASB decided that the end of application requirement would also apply to hedges of a forecast transaction. The IASB noted that IFRS 9 requires an entity to identify and document a forecast transaction with sufficient specificity so that, when the transaction occurs, the entity is able to determine whether the transaction is the hedged transaction. For example, if an entity designates a future issuance of a LIBOR-based debt instrument as the hedged item, although there may be no contract at the time of designation, the hedge documentation would refer specifically to LIBOR. Consequently, the IASB concluded that entities should be able to identify when the uncertainty regarding the timing and the amount of the resulting cash flows of a forecast transaction is no longer present.

BC6.597 In addition, the IASB decided not to require end of application with respect to the exception for the separately identifiable requirements set out in paragraphs 6.8.7 and 6.8.8 of IFRS 9. Applying these exceptions, entities would continue applying hedge accounting when an interest rate benchmark meets the separately identifiable requirement at the inception of the hedging relationship (assuming all other hedge accounting requirements continue to be met). If the IASB included an end date for these exceptions, an entity may be required to immediately discontinue hedge accounting because, at some point, as the reform progresses, the component based on the interest rate benchmark may no longer be separately identifiable (for example, as the market for the alternative benchmark rate is established). Such immediate discontinuation of hedge accounting would be inconsistent with the objective of the exception. The IASB noted that linking the end of application for these exceptions to contract amendments would not achieve the IASB's intention either because, by definition, non-contractually specified risk components are not explicitly stated in a contract and, therefore, these contracts may not be amended for the reform. This is particularly relevant for fair value hedges of a fixed-rate debt instrument. Therefore, the IASB decided that an entity should cease applying the exceptions to a hedging relationship only when the hedging relationship is discontinued applying IFRS 9.

BC6.598 Some respondents to the 2019 Exposure Draft noted that the IASB had not addressed when an entity ceases applying the proposed exceptions to a group of items designated as the hedged item or a combination of financial instruments designated as the hedging instrument. Specifically, when assessing whether the uncertainty arising from the reform is no longer present, these respondents asked whether that assessment should be performed on an individual basis (that is, for each individual item within the group or financial instrument within the combination) or on a group basis (that is, for all items in the group or all financial instruments in the combination until there is no uncertainty surrounding any of the items or financial instruments).

BC6.599 Consequently, the IASB decided to add paragraph 6.8.12 of IFRS 9 to clarify that, when designating a group of items as the hedged item or a combination of financial instruments as the hedging instrument, entities assess when the uncertainty arising from the reform with respect to the hedged risk and/or the timing and amount of the interest rate benchmark-based cash flows of that item or financial instrument is no longer present on an individual basis—that is, for each individual item in the group or financial instrument in the combination.

[44] In this scenario, the entity would first consider the accounting consequences of amending the contractual terms of the hedging instrument. The IASB will consider the accounting consequences of the actual amendment of financial instruments as a result of interest rate benchmark reform in the next phase of this project (ie the replacement phase).

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Effective date and transition

BC6.600 The IASB decided that entities shall apply the amendments for annual periods beginning on or after 1 January 2020, with earlier application permitted.

BC6.601 The IASB decided that the amendments apply retrospectively. The IASB highlighted that retrospective application of the amendments would not allow reinstating hedge accounting that has already been discontinued. Nor would it allow designation in hindsight. If an entity had not designated a hedging relationship, the exceptions, even though applied retrospectively, would not allow the entity to apply hedge accounting in prior periods to items that were not designated for hedge accounting. Doing so would be inconsistent with the requirement that hedge accounting applies prospectively. Retrospective application of the exceptions would enable entities to continue hedge accounting for a hedging relationship that the entity had previously designated and that qualifies for hedge accounting applying IFRS 9.

BC6.602 Many respondents to the 2019 Exposure Draft commented on the clarity of the proposed retrospective application and suggested that further explanation be provided in the Standard. Consequently, the IASB amended the transition paragraph to specify that retrospective application applies only to those hedging relationships that existed at the beginning of the reporting period in which an entity first applies those requirements or were designated thereafter, and to the amount accumulated in the cash flow hedge reserve that existed at the beginning of the reporting period in which an entity first applies those requirements. The IASB used this wording to permit an entity to apply the amendments from the beginning of the reporting period in which an entity first applies these amendments even if the reporting period is not an annual period.

BC6.603 The IASB noted that these amendments would also apply to entities adopting IFRS Standards for the first time as required by IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Accordingly, the IASB did not provide specific transition provisions for those entities.

Amendments for *Interest Rate Benchmark Reform—Phase 2* (August 2020)

Amendments to hedging relationships

BC6.604 The Phase 2 amendments relating to the hedge accounting requirements in IFRS 9 apply to hedging relationships directly affected by the reform as and when the requirements in paragraphs 6.8.4–6.8.8 of IFRS 9 cease to apply to a hedging relationship (see paragraphs 6.8.9–6.8.13 of IFRS 9). Therefore, an entity is required to amend the hedging relationship to reflect the changes required by the reform as and when the uncertainty arising from the reform is no longer present with respect to the hedged risk or the timing and the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument. The scope of the hedging relationships to which the Phase 2 amendments apply is therefore the same as the scope to which the Phase 1 amendments apply, except for the amendment to the separately identifiable requirement, which also applies to the designation of new hedging relationships (see paragraph 6.9.13 of IFRS 9).

BC6.605 As part of the Phase 1 amendments, the IASB acknowledged that, in most cases, for uncertainty regarding the timing and the amount of interest rate benchmark-based cash flows arising from the reform to be resolved, the underlying financial instruments designated in the hedging relationship would have to be changed to specify the timing and the amount of alternative benchmark rate-based cash flows.

BC6.606 The IASB noted that, applying the hedge accounting requirements in IFRS 9, changes to the basis for determining the contractual cash flows of a financial asset or a financial liability (see paragraphs 5.4.6–5.4.9 of IFRS 9) that are designated in a hedging relationship would affect the designation of such a hedging relationship in which an interest rate benchmark was designated as a hedged risk.

BC6.607 The IASB observed that amending the formal designation of a hedging relationship to reflect the changes required by the reform would result in the discontinuation of the hedging relationship. This is because, as part of the qualifying criteria for hedge accounting to be applied, IFRS 9 requires the formal designation of a hedging relationship to be documented at inception. The hedge documentation includes identification of the hedging instrument, the hedged item, the nature of the risk being hedged and how the entity will assess hedge effectiveness. IFRS 9 permits the hedge designation and documentation to be amended without causing the discontinuation of hedge accounting only in limited circumstances. In all other circumstances, amendments to the hedge designation as documented at inception of the hedging relationship, result in the discontinuation of hedge accounting.

BC6.608 The IASB therefore concluded that, in general, the hedge accounting requirements in IFRS 9 are sufficiently clear about how to account for hedging relationships directly affected by the reform after the Phase 1

exceptions set out in paragraphs 6.8.4–6.8.8 of IFRS 9 cease to apply. However, consistent with the IASB's objective for Phase 2 (see paragraph BC5.290) and its objective for Phase 1 (see paragraph BC6.550), the IASB considered that discontinuing hedge accounting solely due to the effects of the reform would not always reflect the economic effects of the changes required by the reform on a hedging relationship and therefore would not always provide useful information to users of financial statements.

BC6.609 Accordingly, the IASB decided that if the reform requires a change to a financial asset or a financial liability designated in a hedging relationship (see paragraphs 5.4.6–5.4.8 of IFRS 9), it would be consistent with the IASB's objective for Phase 2 to require the hedging relationship to be amended to reflect such a change without requiring discontinuation of that hedging relationship. For these reasons, in the 2020 Exposure Draft, the IASB proposed that an entity would be required to amend the formal designation of the hedging relationship as previously documented to make one or more of these changes:

(a) designating the alternative benchmark rate (contractually or non-contractually specified) as a hedged risk;

(b) amending the description of the hedged item so it refers to the alternative benchmark rate; or

(c) amending the description of the hedging instrument so it refers to the alternative benchmark rate.

BC6.610 Respondents to the 2020 Exposure Draft agreed with the proposed amendments because those proposals would generally result in an entity continuing to apply hedge accounting to hedging relationships directly affected by the reform. Respondents also said that changes to the hedge designation necessary to reflect changes required by the reform are not expected to represent a change in an entity's risk management strategy or risk management objective for hedging their exposure to interest rate risk. Therefore, the IASB concluded that continuing to apply hedge accounting to the affected hedging relationships when making changes required by the reform would correspond with the IASB's objective for issuing the Phase 1 amendments in September 2019.

BC6.611 However, notwithstanding their general agreement with the proposed amendments, some respondents asked the IASB to clarify the scope and timing of the required changes to the affected hedging relationships.

BC6.612 Regarding the scope of the required changes to the affected hedging relationships, the IASB acknowledged it may be necessary to amend the designated hedged portion of the cash flows or fair value being hedged when the hedging relationship is amended to reflect the changes required by the reform. The IASB also noted that the changes required by the reform described in paragraphs 5.4.6–5.4.8 of IFRS 9 were implicit in the required amendments to the hedging relationships as proposed in the 2020 Exposure Draft. In considering the timing of when entities are required to amend an affected hedging relationship, the IASB sought to balance the operational effort needed to amend the hedging relationships with maintaining the required discipline in the amendments to hedging relationships. Specifically, it sought to address the challenges associated with specifying the timing of when entities have to amend hedging relationships as required in paragraph 6.9.1 of IFRS 9—particularly in the context of the large volume of changes that entities may need to make in a relatively short time—while also ensuring that the amendments to hedging relationships are accounted for in the applicable reporting period.

BC6.613 In response to respondents' requests, the IASB revised the proposed wording in paragraph 6.9.1 of IFRS 9 so that:

(a) amending the description of the hedged item includes amending the description of the designated portion of the cash flows or fair value being hedged;

(b) the changes required by the reform described in paragraphs 5.4.6–5.4.8 of IFRS 9 are relevant when amending the formal designation of a hedging relationship; and

(c) amendments to hedging relationships are required to be made by the end of the reporting period during which the respective changes to the hedged item, hedged risk or hedging instrument are made.

BC6.614 The IASB noted that the Phase 1 amendments may cease to apply at different times to directly affected hedging relationships and to the different elements within a hedging relationship. Therefore, an entity may be required to apply the applicable Phase 2 exceptions in paragraphs 6.9.1–6.9.12 of IFRS 9 at different times, which may result in the designation of a particular hedging relationship being amended more than once. The Phase 2 amendments to the hedge accounting requirements in IFRS 9 apply only to the requirements specified in these paragraphs. All other hedge accounting requirements in IFRS 9, including the qualifying criteria in paragraph 6.4.1 of IFRS 9, apply to hedging relationships directly affected by the reform. In addition, consistent with the IASB's decision for the Phase 1 amendments (see paragraph BC6.568), the Phase 2 amendments also do not provide an exception from the measurement requirements for a hedging relationship. Therefore, entities apply the requirements in paragraphs 6.5.8 or 6.5.11 of IFRS 9 to account for any changes in the fair value of the hedged items or hedging instruments (also see paragraphs BC6.623–BC6.627).

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BC6.615 As set out in paragraph BC5.318, the IASB considered that changes might be made to a financial asset or a financial liability, or to the formal designation of a hedging relationship, in addition to those changes required by the reform. The effect of such additional changes to the formal hedge designation on the application of the hedge accounting requirements would depend on whether those changes result in the derecognition of the underlying financial instrument (see paragraph 5.4.9 of IFRS 9).

BC6.616 The IASB therefore required an entity first to apply the applicable requirements in IFRS 9 to determine if those additional changes result in discontinuation of hedge accounting, for example, if the financial asset or financial liability designated as a hedged item no longer meets the qualifying criteria to be an eligible hedged item as a result of changes in addition to those required by the reform. Similarly, if an entity amends the hedge designation to make a change other than the changes described in paragraph 6.9.1 of IFRS 9 (for example, if it extends the term of the hedging relationship), the entity would first determine if those additional changes to the hedge designation result in the discontinuation of hedge accounting. If the additional changes do not result in the discontinuation of hedge accounting, the designation of the hedging relationship would be amended as required by paragraph 6.9.1 of IFRS 9.

BC6.617 Some respondents to the 2020 Exposure Draft said that entities may change a hedging relationship as a result of the reform, but such a change is not necessary as a direct consequence of the reform. This could include, for example, designating a basis swap as a new hedging instrument to mitigate ineffectiveness arising from the difference between the compounding of the alternative benchmark rates used for cash products and derivatives. These respondents asked the IASB to permit such changes to be in the scope of the required changes to the hedging relationship set out in paragraph 6.9.1 of IFRS 9. The IASB however decided not to extend the scope of paragraph 6.9.1 of IFRS 9 to other changes an entity makes as a result of the reform. The IASB considered that its objective for the Phase 2 amendments is not only to support entities in applying the IFRS requirements during the transition to alternative benchmark rates, but also to provide users of financial statements with useful information about the effect of the reform on an entity's financial statements. To balance achieving this objective with maintaining the discipline that exists in the hedge accounting requirements in IFRS 9, the IASB limited the scope of the changes required to the designation of hedging relationships to only those changes that are necessary to reflect the changes required by the reform (as described in paragraphs 5.4.6–5.4.8 of IFRS 9).

Replacement of hedging instruments in hedging relationships

BC6.618 Respondents to the 2020 Exposure Draft said that, instead of changing the contractual terms of a derivative designated as a hedging instrument, counterparties may facilitate the transition to alternative benchmark rates using approaches that result in outcomes equivalent to changing the contractual terms of the derivative. These respondents asked whether using such an approach would be within the scope of the Phase 2 amendments—ie whether paragraph 6.9.1(c) of IFRS 9 would apply—if the approach results in an economic outcome that is similar to changing the basis for determining the contractual cash flows of the derivative.

BC6.619 The IASB confirmed that, consistent with the rationale in paragraph BC5.298, it is the substance of an arrangement, rather than its form, that determines the appropriate accounting treatment. The IASB considered that the conditions in paragraph 5.4.7 of IFRS 9—ie the change is necessary as a direct consequence of the reform and is done on economically equivalent basis—are helpful in analysing the amendments to the contractual terms of derivatives described in paragraph BC6.618. In this context, the IASB noted that if these other approaches result in derivatives with substantially different terms from those of the original derivative, the change may not have been made on an economically equivalent basis. The IASB also noted that if a hedging instrument is derecognised, hedge accounting is required to be discontinued. Therefore, the IASB decided that for hedge accounting to continue it is also necessary that the original hedging instrument would not be derecognised.

BC6.620 The IASB considered these approaches described by respondents:

(a) *close-out and replace on the same terms (ie off-market terms)*—An entity applying this approach would enter into two new derivatives with the same counterparty. These two would be, a new derivative that is equal and offsetting to the original derivative (so both contracts are based on the interest rate benchmark to be replaced), and a new alternative benchmark-based derivative with the same terms as the original derivative so its fair value at initial recognition is equivalent to the fair value—on that date—of the original derivative (ie the new derivative is off-market). Under this approach, the counterparty to the new derivatives is the same as to the original derivative, the original derivative has not been derecognised and the terms of the alternative benchmark rate derivative are not substantially different from that of the original derivative. The IASB therefore concluded that such an approach could be regarded as consistent with the changes required by the reform as required in paragraph 6.9.1 of IFRS 9.

(b) *close-out and replace on substantially different terms (eg on-market terms)*—An entity applying this approach would terminate (close-out) the existing interest rate benchmark-based derivative with a cash settlement. The entity then enters into a new on-market alternative benchmark rate derivative with substantially different terms, so that the new derivative has a fair value of zero at initial recognition. Some respondents to the 2020 Exposure Draft were of the view that since this approach does not result in any gain or loss recognised in profit or loss, it suggests the exchange was done on an economically equivalent basis. The IASB disagreed with this view because the original derivative is extinguished and replaced with an alternative benchmark rate derivative with substantially different contractual terms. Therefore, this approach is not considered consistent with the changes required by the reform as required in paragraph 6.9.1 of IFRS 9.

(c) *add a new basis swap*—An entity applying this approach would retain the original interest rate benchmark-based derivative but enter into a basis swap that swaps the existing interest rate benchmark for the alternative benchmark rate. The combination of the two derivatives is equivalent to modifying the contractual terms of the original derivative to replace the interest rate benchmark with an alternative benchmark rate. The IASB noted that, in principle, the combination of an interest rate benchmark-based derivative and an interest rate benchmark-alternative benchmark rate swap could achieve an outcome economically equivalent to amending the original interest rate benchmark-based derivative. However, the IASB observed that, in practice, basis swaps are generally entered into on an aggregated basis to economically hedge an entity's net exposure to basis risk, rather than on an individual derivative basis. The IASB, therefore, noted that for this approach to be consistent with the changes required by the reform as described in paragraph 6.9.1 of IFRS 9, the basis swap must be coupled or linked with the original derivative, ie done on an individual derivative basis. This is because a change to the basis for determining the contractual cash flows of a hedging instrument is made to an individual instrument and, to achieve the same outcome, the basis swap would need to be coupled with an individual derivative.

(d) *novating to a new counterparty*—An entity applying this approach would novate the original interest rate benchmark-based derivative to a new counterparty and subsequently change the contractual cash flows on the novated derivative to replace the interest rate benchmark with an alternative benchmark rate. The IASB noted that novation of a derivative would result in the derecognition of the original derivative and thus would require hedge accounting to be discontinued in accordance with paragraph 6.5.6 of IFRS 9 (see further paragraphs BC6.336–BC6.338). Therefore, this approach is not consistent with the changes required by the reform as set out in paragraph 6.9.1 of IFRS 9.

BC6.621 The IASB therefore added paragraph 6.9.2 of IFRS 9 so that, an entity also applies paragraph 6.9.1(c) of IFRS 9 if these three conditions are met:

(a) the entity makes a change required by the reform using an approach other than changing the basis for determining the contractual cash flows of the hedging instrument (as described in paragraph 5.4.6 of IFRS 9);

(b) the original hedging instrument is not derecognised; and

(c) the chosen approach is economically equivalent to changing the basis for determining the contractual cash flows of the original hedging instrument (as described in paragraphs 5.4.7 and 5.4.8 of IFRS 9).

BC6.622 The IASB decided not to add further amendments or provide application guidance because IFRS 9 as amended provides an adequate basis for analysing the accounting requirements in context of the approaches described in paragraph BC6.620.

Remeasurement of the hedged item and hedging instrument

BC6.623 In paragraph BC6.568, the IASB explained that no exceptions were made in Phase 1 to the measurement requirements for hedged items or hedging instruments. The IASB concluded that the most useful information would be provided to users of financial statements if requirements for recognition and measurement of hedge ineffectiveness remain unchanged (see paragraph BC6.567). This is because recognising ineffectiveness in the financial statements based on the actual results of a hedging relationship faithfully represents the economic effects of the reform, thereby providing useful information to users of financial statements.

BC6.624 Applying the hedge accounting requirements in IFRS 9, a gain or loss arising from the remeasurement of the hedged item attributable to the hedged risk or from remeasuring the hedging instrument is reflected in profit or loss when measuring and recognising hedge ineffectiveness.

BC6.625 When deliberating the Phase 2 amendments, the IASB considered that changes in the fair value of the hedged item or hedging instrument could arise when the formal designation of a hedging relationship is amended.

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The IASB considered whether to provide an exception from the requirement to include in hedge ineffectiveness such fair value changes when they arise. The IASB considered, but rejected, these approaches:

(a) *recognising the measurement adjustment in profit or loss over time*—An entity applying this approach would recognise the measurement adjustment in profit or loss over time (ie amortised) as the hedged item affects profit or loss. The IASB rejected this approach because it would require an offsetting entry to be recognised either in the statement of financial position or as an adjustment to the carrying amount of the hedged item or hedging instrument. Such an offsetting entry would fail to meet the definition of an asset or a liability in the *Conceptual Framework*. Adjusting the carrying amount of the hedged item or hedging instrument would result in the recognition of a net measurement adjustment of zero and would be inconsistent with the IASB's decision that no exceptions would be made to the measurement of hedged items or hedging instruments. The IASB also noted that such an approach would likely result in increased operational complexity because an entity would need to track adjustments that occur at different times for the purpose of amortising the adjustments in the period(s) in which the hedged item affects profit or loss.

(b) *recognising the measurement adjustment as an adjustment to retained earnings*—An entity applying this approach would recognise the measurement adjustment as an adjustment to retained earnings during the period in which the measurement difference arises. However, the IASB rejected this approach because the changes to the hedged risk might be driven by amendments to hedging relationships that may occur in different reporting periods. Therefore, recognising adjustments to retained earnings over time would be inconsistent with the IASB's previous decisions (throughout IFRS Standards) that an adjustment to retained earnings only applies on transition to new requirements in IFRS Standards. Furthermore, the IASB noted that the measurement adjustment would meet the definition of income or expense in the *Conceptual Framework* and therefore should be recognised in the statement of profit or loss. The IASB also noted that recognising measurement adjustments directly in retained earnings would be inconsistent with the decision that no exceptions should be made to the measurement of hedged items or hedging instruments.

BC6.626 Some respondents to the 2020 Exposure Draft said they would not expect any significant changes in fair value to arise from the remeasurement of a hedged item or hedging instrument based on the alternative benchmark rate. That is because these amendments would apply only when the conditions in paragraph 5.4.7 of IFRS 9 are met, which require that changes are made on an economically equivalent basis. The IASB acknowledged these comments noting that, applying paragraph 6.9.1 of IFRS 9, a significant change in fair value arising from the remeasurement of the hedged item or the hedging instrument indicates that the changes were not made on an economically equivalent basis. Furthermore, the IASB observed that the requirement in paragraph 6.9.1(b) of IFRS 9, which requires the description of the designated portion for the cash flows or fair value being hedged enables entities to amend a hedging relationship to minimise fair value changes on the remeasurement of the hedged item or the hedging instrument.

BC6.627 The IASB therefore confirmed its previous decision not to provide an exception from the requirements in IFRS 9 regarding the measurement and recognition of hedge ineffectiveness. Therefore, an entity would apply the requirements in paragraphs 6.5.8 (for a fair value hedge) and 6.5.11 (for a cash flow hedge) of IFRS 9 for the measurement and recognition of hedge ineffectiveness. The IASB considered that accounting for such fair value changes in any other way would be inconsistent with the decision to continue applying hedge accounting for such amended hedging relationships (see paragraph 6.9.1 of IFRS 9). In the IASB's view, applying the requirements in IFRS 9 for the recognition and measurement of ineffectiveness reflects the economic effects of the amendments to the formal designation of a hedging relationship and therefore, provides useful information to users of financial statements.

Accounting for qualifying hedging relationships

Assessment of the economic relationship between the hedged item and the hedging instrument

BC6.628 The Phase 1 exception in paragraph 6.8.6 of IFRS 9 requires an entity to assume that, for the purpose of assessing the economic relationship between the hedged item and the hedging instrument as required by paragraphs 6.4.1(c)(i) and B6.4.4–B6.4.6 of IFRS 9, the interest rate benchmark on which the hedged cash flows and/or the hedged risk (contractually or non-contractually specified) are based, is not altered as a result of the reform. As noted in paragraph 6.8.11 of IFRS 9, this exception ceases to apply to the hedged item and the hedging instrument, respectively, at the earlier of, when there is no longer uncertainty about the hedged risk or the timing and the amount of the interest rate benchmark-based cash flows; and when the hedging relationship that the hedged item and the hedging instrument are a part of is discontinued.

BC6.629 Consistent with the IASB's considerations on the highly probable requirement (see paragraphs BC6.630–BC6.631), the IASB considered that, when the formal designation of a hedging relationship has been amended (see paragraph 6.9.1 of IFRS 9), the assessment of the economic relationship between the hedged item and the hedging instrument should be performed based on the alternative benchmark rate on which the hedged cash flows and/or the hedged risk will be based. The IASB therefore provided no exceptions from the assessment of the economic relationship between the hedged item and the hedging instrument for the period after the Phase 1 exception in paragraph 6.8.6 of IFRS 9 ceases to apply.

Amounts accumulated in the cash flow hedge reserve

BC6.630 During the period in which a hedging relationship is affected by uncertainty arising from the reform, paragraph 6.8.4 of IFRS 9 requires an entity to assume that the interest rate benchmark on which the hedged cash flows (contractually or non-contractually specified) are based is not altered for the purpose of determining whether a forecast transaction (or a component thereof) is highly probable. An entity is required to cease applying this exception at the earlier of the date the uncertainty arising from the reform is no longer present with respect to the timing and the amount of the interest rate benchmark-based cash flows of the hedged item; and the date the hedging relationship of which the hedged item is a part of is discontinued.

BC6.631 The IASB considered that uncertainty about the timing and the amount of the hedged cash flows would no longer be present when the interest rate benchmark on which the hedged cash flows are based is altered as required by the reform. In other words, uncertainty would no longer be present when an entity amends the description of the hedged item, including the description of the designated portion of the cash flows or fair value being hedged, applying paragraph 6.9.1(b) of IFRS 9. Thereafter, applying the requirement in paragraph 6.3.3 of IFRS 9, the assessment of whether the hedged cash flows are still highly probable to occur would be based on the contractual cash flows determined by reference to the alternative benchmark rate.

BC6.632 The IASB noted that the amendment in paragraph 6.9.1(b) of IFRS 9 for amending the formal designation of a hedging relationship could lead to changes in the hedged item. Therefore, if an entity uses a hypothetical derivative—that is, a derivative that would have terms matching the critical terms of the designated cash flows and the hedged risk, commonly used in cash flow hedges to represent the forecast transaction—the entity may need to change the hypothetical derivative to calculate the change in the value of the hedged item to measure hedge ineffectiveness.

BC6.633 Consequently, as hedge accounting would not be discontinued when a hedging relationship is amended for changes required by the reform (see paragraph 6.9.1 of IFRS 9), the IASB decided that an entity would deem the amount accumulated in the cash flow hedge reserve at that point to be based on the alternative benchmark rate on which the hedged future cash flows are determined. Therefore, in applying paragraph 6.5.11(d) of IFRS 9, the amount accumulated in the cash flow hedge reserve would be reclassified to profit or loss in the same period(s) during which the hedged cash flows based on the alternative benchmark rate affect profit or loss.

BC6.634 The approach described in paragraph BC6.633 is consistent with the IASB's view that, when a hedging relationship is amended for changes required by the reform, more useful information is provided to users of financial statements if hedge accounting is not discontinued and amounts are not reclassified to profit or loss solely due to the changes required by the reform. This is because such an approach will more faithfully reflect the economic effects of changes required by the reform.

BC6.635 Consistent with the requirements in paragraphs 6.8.5 and 6.8.10 of IFRS 9, the IASB considered whether to provide similar relief for any discontinued hedging relationships in which the previously designated hedged item is subject to the reform. The IASB observed that although a hedging relationship may have been discontinued, the amount accumulated in the cash flow hedge reserve arising from that hedging relationship remains in the reserve if the hedged future cash flows are still expected to occur. The IASB noted that if the hedged future cash flows are still expected to occur, the previously designated hedged item will be subject to a change required by the reform, even if the hedging relationship has been discontinued.

BC6.636 The IASB therefore decided that, for the purpose of applying paragraph 6.5.12 of IFRS 9, an entity deems the amount accumulated in the cash flow hedge reserve for a discontinued hedging relationship to be based on the alternative benchmark rate on which the contractual cash flows will be based, which is similar to the amendment in paragraph 6.9.7 of IFRS 9. That amount is reclassified to profit or loss in the same period(s) in which the hedged future cash flows based on the alternative benchmark rate affect profit or loss.

BC6.637 Some respondents to the 2020 Exposure Draft asked the IASB to clarify whether the requirements in paragraphs 6.9.7–6.9.8 of IFRS 9 require the retrospective measurement of the hedged item based on the alternative benchmark rate-based cash flows—in other words, whether an entity would be required to recalculate what the amount accumulated in the cash flow hedge reserve would have been if the hedged item was based on the alternative benchmark rate since inception.

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BC6.638 The IASB considered that the cash flow hedge reserve is adjusted as required by paragraph 6.5.11(a) of IFRS 9 (ie the cash flow hedge reserve is not subject to separate measurement requirements, but instead is derived from the cumulative changes in the fair value of the hedged item (present value) and hedging instrument). The Phase 2 amendments do not include an exception from the measurement requirements in IFRS 9. Accordingly, the fair value of the hedging instrument or of the hedged item (ie the present value of the cumulative changes in the hedged expected future cash flows) is determined at the measurement date based on the expected future cash flows and assumptions that market participants would use. In other words, the fair values are not determined retrospectively. The IASB therefore considered that the cash flow hedge reserve is not remeasured as if it had been based on the alternative benchmark rate since inception of the hedging relationship.

BC6.639 The IASB confirmed that the amendments in paragraphs 6.9.7 and 6.9.8 of IFRS 9 extend to cash flow hedges, regardless of whether the cash flow hedge is for an open or closed hedged portfolio. The general reference to cash flow hedges in these paragraphs reflects such scope, therefore the IASB considered that explicitly addressing open or closed hedged portfolios was unnecessary.

Groups of items

BC6.640 The IASB considered that for groups of items designated as hedged items in a fair value or cash flow hedge, the hedged items could consist of items still referenced to the interest rate benchmark as well as items already referenced to the alternative benchmark rate. Therefore, an entity could not amend the description of the hedged risk or the hedged item, including the designated portion of the cash flows or fair value being hedged, with reference only to an alternative benchmark rate for the whole group. The IASB also considered that it would be inconsistent with the objectives of the Phase 2 amendments to require the discontinuation of such a hedging relationship solely because of the effects of the reform. In the IASB's view, the same requirements and relief that apply to other hedging relationships should apply to groups of items designated as hedged items, including dynamic hedging relationships.

BC6.641 Paragraphs 6.9.9–6.9.10 of IFRS 9 therefore require an entity to allocate the individual hedged items to subgroups based on the benchmark rate designated as the hedged risk for each subgroup and to apply the requirements in paragraph 6.6.1 of IFRS 9 to each subgroup separately. The IASB acknowledged this approach is an exception to the hedge accounting requirements in IFRS 9 because other hedge accounting requirements, including the requirements in paragraphs 6.5.8 and 6.5.11 of IFRS 9, are applied to the hedging relationship in its entirety. However, in the IASB's view, the robustness of the hedge accounting requirements is maintained because if any subgroup fails to meet the requirements in paragraph 6.6.1 of IFRS 9, the entity is required to discontinue hedge accounting for that entire hedging relationship. The IASB concluded this accounting outcome is appropriate because the basis for designating the hedged item on a group basis is that the entity is managing the designated hedge for the group as a whole.

BC6.642 The IASB acknowledged that preparers may incur additional costs to assess each subgroup in a hedging relationship separately, and to track items moving from one subgroup to another. However, the IASB concluded that an entity is likely to have such information available because IFRS 9 already requires it to identify and document hedged items designated within a hedging relationship with sufficient specificity. Therefore, the IASB concluded that the benefits of avoiding the discontinuation of hedge accounting and the resulting accounting impacts outweigh the associated costs of this exception.

BC6.643 Respondents to the 2020 Exposure Draft asked the IASB whether the requirement for groups of items applies to dynamic hedges of interest rate benchmark-based items when the items mature and are replaced with alternative benchmark-based items. The IASB considered that although the objective of the Phase 2 amendments is to provide relief when individual items transition to an alternative benchmark rate, the replacement of items that have expired with items that reference the alternative benchmark rate is a natural consequence of a dynamic hedging relationship. Therefore, the IASB observed that new items designated as part of the group to replace interest rate benchmark-based items that have matured would be allocated to the relevant subgroup based on the benchmark rate being hedged.

BC6.644 Respondents also asked the IASB to clarify how the requirements in paragraphs 6.9.9–6.9.10 of IFRS 9 apply to the hypothetical derivative in a cash flow hedge, specifically, whether the hypothetical derivative could be amended (and therefore measured) based on the alternative benchmark rate if the actual hedged item (such as a floating rate loan) has not yet transitioned to the alternative benchmark rate. The IASB considered that IFRS 9 does not include specific requirements for the hypothetical derivative but mentions it as one possible way of calculating the change in the value of the hedged item to measure ineffectiveness (see paragraph B6.5.5 of IFRS 9). Therefore, the terms on which the hypothetical derivative is constructed replicate the hedged risk and the hedged cash flows of the hedged item an entity is hedging. The hypothetical derivative cannot include features in the value of the hedged item that exist only in the hedging instrument (but not in the hedged item). The IASB therefore decided that the identification of an appropriate hypothetical derivative is based on the

requirements to measure hedge ineffectiveness and it would not be appropriate to include specific amendments for applying the requirements in paragraphs 6.9.9–6.9.10 to the hypothetical derivative.

Designation of risk components

End of application of the Phase 1 exception

BC6.645 An entity may designate an item in its entirety or a component of an item as the hedged item in a hedging relationship. Paragraphs 6.3.7(a) and B6.3.8 of IFRS 9 allow entities to designate only changes in the cash flows or fair value of an item attributable to a specific risk or risks (risk component).

BC6.646 When developing the Phase 1 amendments, the IASB decided not to set an end date for applying the exception for the separately identifiable requirement (see paragraphs 6.8.7–6.8.8 of IFRS 9). The IASB considered that including an end date for that exception could require an entity to immediately discontinue hedge accounting at a point in time because, as the reform progresses, a risk component based on the interest rate benchmark may no longer be separately identifiable (for example, as the market for the alternative benchmark rate is established). As noted in paragraph BC6.597, in the IASB's view, such an immediate discontinuation of hedge accounting would be inconsistent with the objective of this exception in Phase 1. Therefore, when issuing the Phase 1 amendments, the IASB decided that an entity should cease applying the Phase 1 exception from the separately identifiable requirement to a hedging relationship only when that hedging relationship is discontinued applying the requirements in IFRS 9.

BC6.647 Having considered the interaction between the Phase 1 exception from the separately identifiable requirement and the Phase 2 amendments to the hedge accounting requirements in IFRS 9, the IASB decided it is necessary to specify that an entity is required to cease applying the Phase 1 exception from the separately identifiable requirement when the uncertainty arising from the reform, which led to that exception, is no longer present.

BC6.648 The IASB considered that continuing to apply the Phase 1 amendments after the uncertainty arising from the reform is no longer present would not faithfully represent the actual characteristics of the elements of the hedging relationship in which the uncertainty has been eliminated nor the economic effects of the reform. The IASB therefore added paragraph 6.8.13 to IFRS 9 so the Phase 1 exception from the separately identifiable requirement ceases to apply at the earlier of:

(a) when changes required by the reform are made to the non-contractually specified risk component as set out in paragraph 6.9.1 of IFRS 9; or

(b) when the hedging relationship in which the non-contractually specified risk component was designated is discontinued.

Application of the 'separately identifiable' requirement to an alternative benchmark rate

BC6.649 In developing the Phase 2 amendments, the IASB was aware that considerations similar to those discussed in paragraphs BC6.645–BC6.648 apply to designating an alternative benchmark rate as a non-contractually specified risk component in either a cash flow hedge or a fair value hedge. This is because an entity's ability to conclude that the alternative benchmark rate meets the requirements in paragraphs 6.3.7(a) and B6.3.8 of IFRS 9 that a risk component must be separately identifiable and reliably measurable could be affected in the early stages of the reform.

BC6.650 Specific application guidance and examples on the separately identifiable requirement are already set out in paragraphs B6.3.9–B6.3.10 of IFRS 9. However, the IASB considered that an entity might expect an alternative benchmark rate to meet the separately identifiable requirement in IFRS 9 within a reasonable period of time even though the alternative benchmark rate does not meet the requirement when designated as a risk component.

BC6.651 The amendment in paragraph 6.9.11 of IFRS 9 applies to a different set of instruments from the Phase 1 exception. For items within the scope of paragraph 6.9.11 of IFRS 9, the separately identifiable requirement has never been satisfied. In contrast, the population of hedging relationships to which the Phase 1 relief applied had already satisfied the qualifying criteria for hedge accounting to be applied. The IASB therefore considered that any relief from the separately identifiable requirement in Phase 2 should be temporary.

BC6.652 Consequently, in the 2020 Exposure Draft, the IASB proposed that an alternative benchmark rate that does not meet the requirement to be separately identifiable at the date it is designated as a non-contractually specified risk component would be deemed to have met the requirement at that date if, and only if, an entity

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reasonably expects that the alternative benchmark rate will be separately identifiable within 24 months from the date it is designated as a risk component.

BC6.653 Respondents to the 2020 Exposure Draft agreed with this proposed amendment but asked the IASB to clarify the date from which the 24-month period applies. The IASB acknowledged respondents' concerns, and considered whether the 24-month period applies:

(a) on a hedge-by-hedge basis—that is, to each hedging relationship individually, beginning from the date an alternative benchmark rate is designated as a risk component in that relationship; or

(b) on a rate-by-rate basis—that is, to each alternative benchmark rate separately, beginning from the date when an entity first designates an alternative benchmark rate as a hedged risk for the first time.

BC6.654 The IASB acknowledged that applying the 24-month period to each hedging relationship individually (as proposed in the 2020 Exposure Draft)—that is, on a hedge-by-hedge basis—is consistent with the basis on which hedging relationships are designated. For each new hedge designation, an entity is required to assess whether the qualifying criteria to apply hedge accounting, including the separately identifiable requirement, have been met. However, the IASB also considered that applying the 24-month period to different hedging relationships (with the same alternative benchmark rate designated as a risk component) at different times could add an unnecessary operational burden as the period would end at different times and thus would need to be monitored over different periods, for different hedging relationships. For example, if an entity designates the alternative benchmark rate as the risk component in two hedging relationships—the first designated on 31 March 20X1 and the second on 30 June 20X1—the 24-month period for each hedge would begin and end at different dates, although the designated risk is the same in both hedging relationships.

BC6.655 Therefore, the IASB decided that the requirement in paragraph 6.9.11 would apply on a rate-by-rate basis so the 24-month period applies to each alternative benchmark rate separately and hence, starts from the date that an entity designates an alternative benchmark rate as a non-contractually specified risk component for the first time (but see also paragraph 7.2.45 of IFRS 9). The IASB considered that if an entity concludes for one hedging relationship that it no longer has a reasonable expectation that the alternative benchmark rate would meet the requirements within the 24-month period, it is likely that the entity would reach the same conclusion for all other hedging relationships in which that particular alternative benchmark rate has been designated. Applying this requirement to the example in paragraph BC6.654, the 24-month period will begin on 31 March 20X1 for that alternative benchmark rate.

BC6.656 Despite the requirement to apply the 24-month period to each alternative benchmark rate separately, the requirement to assess whether an alternative benchmark rate is separately identifiable continues to separately apply to each hedging relationship. In other words, an entity is required to assess, for each hedge designation, whether the qualifying criteria to apply hedge accounting, including the separately identifiable requirement, are met for the remainder of the 24-month period (ie until 31 March 20X3 following from the example in paragraph BC6.654).

BC6.657 Consistent with the requirement in IFRS 9 to continuously assess the separately identifiable requirement, an entity's ability to conclude that an alternative benchmark rate is a separately identifiable component requires assessment over the life of the hedging relationship including during the 24-month period discussed in paragraph BC6.655. However, the IASB decided that to avoid the complexity of detailed judgements during the 24-month period, an entity is required to cease applying the requirement during the 24-month period if, and only if, the entity reasonably expects that the alternative benchmark rate will not meet the separately identifiable requirement within that period. If an entity reasonably expects that an alternative benchmark rate will not be separately identifiable within 24 months from the date the entity designates it as a non-contractually specified risk component for the first time, the entity is required to cease applying the requirement in paragraph 6.9.11 of IFRS 9 to that alternative benchmark rate and discontinue applying hedge accounting prospectively from the date of that reassessment to all hedging relationships in which the alternative benchmark rate was designated as a non-contractually specified risk component.

BC6.658 The IASB acknowledged that 24 months is an arbitrary period. However, in the IASB's view, a clearly defined end point is necessary because of the temporary nature of the amendment. The exception described in paragraphs 6.9.11–6.9.13 is a significant relief from one of the requirements that is a basis for the robustness of the hedge accounting requirements, therefore the relief is intentionally short-lived. The IASB considered that a period of 24 months will assist entities in applying the hedge accounting requirements in IFRS 9 particularly during the early stages of the transition to alternative benchmark rates. Therefore, the IASB decided that a period of 24 months from the date an entity first designates an alternative benchmark rate as a non-contractually specified risk component is a reasonable period and would enable entities to implement the reform and comply with any regulatory requirements, while avoiding potential short-term disruption as the market for an alternative benchmark rate develops.

BC6.659 While developing the proposals in the 2020 Exposure Draft, the IASB considered proposing alternative periods for the requirement in paragraph 6.9.11 of IFRS 9, including a period of 12 months or a period longer

than 24 months. However, the IASB acknowledged the diversity in the approaches to the reform or replacement of interest rate benchmarks and the timing of the expected completion across various jurisdictions. The IASB was concerned that 12 months would not provide sufficient time across all jurisdictions. At the same time, the IASB considered that entities may not be able to have a reasonable expectation that an alternative benchmark rate would satisfy the separately identifiable requirement over a period longer than 24 months.

BC6.660 The IASB emphasised that the amendments apply only for the separately identifiable requirement and not the reliably measurable requirement. Therefore, if the risk component is not reliably measurable, either when it is designated or thereafter, the alternative benchmark rate would not meet the qualifying criteria to be designated as a risk component in a hedging relationship. Similarly, if the hedging relationship fails to meet any other qualifying criteria set out in IFRS 9 to apply hedge accounting, either at the date the alternative benchmark rate is designated or during the 24-month period, the entity is required to discontinue hedge accounting prospectively from that date. The IASB decided that providing relief only for the separately identifiable requirement would achieve the objective described in paragraph BC5.290.

Effective date and transition (Chapter 7)

Effective date

Requirements issued in IFRS 9 (2009)

BC7.1 The IASB recognises that many countries require time for translation and for introducing the mandatory requirements into law. In addition, entities require time to implement new standards. The IASB usually sets an effective date of between six and eighteen months after issuing a Standard. However, the IASB has adopted a phased approach to publishing IFRS 9, so this is not possible.

BC7.2 In the response to the 2009 Classification and Measurement Exposure Draft, respondents urged that:

(a) it would be helpful to preparers if the IASB were to permit all phases of the project to replace IAS 39 to be adopted at the same time.

(b) it would be helpful to entities that issue insurance contracts if the effective date of IFRS 9 were aligned with the forthcoming Standard on accounting for insurance contracts. Most of an insurer's assets are financial assets and most of its liabilities are insurance liabilities or financial liabilities. Thus, if an insurer applies IFRS 9 before it applies any new Standard on insurance contracts, it might face two rounds of major changes in a short period. This would be disruptive for both users and preparers.

(c) because a number of countries will adopt IFRS in the next few years, it would be helpful to entities in those countries if the IASB did not require them to make two changes in a short period of time.

BC7.3 With these factors in mind, the IASB decided it should require entities to apply the requirements of IFRS 9 for annual periods beginning on or after 1 January 2013. The IASB intends that this date will allow entities to adopt at the same time the guidance from all phases of the project to replace IAS 39. (Paragraphs BC7.9A–BC7.9E, BC7.9F–BC7.9H and BC7.9J–BC7.9N describe the IASB's subsequent decisions on the effective date of IFRS 9.)

BC7.4 The IASB will consider delaying the effective date of IFRS 9 if the impairment phase of the project to replace IAS 39 makes such a delay necessary, or if the new Standard on insurance contracts has a mandatory effective date later than 2013, to avoid an insurer having to face two rounds of changes in a short period.

BC7.5 The IASB decided to permit earlier application of IFRS 9 to allow an entity to apply the new requirements on classification and measurement of financial assets. This enables entities to use IFRS 9 (as issued in November 2009) in their 2009 annual financial statements and meets one of the objectives of the phased approach, ie to have improved classification and measurement requirements for financial assets in place for 2009 year-ends. (Paragraphs BC7.7–BC7.9, BC7.9H and BC7.9O–BC7.9T describe the IASB's subsequent decisions on the early application of IFRS 9.)

BC7.6 The effect of transition will be significant for some entities. As a result, there will be less comparability between entities that apply IFRS 9 and those that do not. Accordingly, IFRS 9 includes additional disclosures about the transition to IFRS 9.

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Requirements added to IFRS 9 in October 2010

BC7.7 The IASB chose to complete the project to replace IAS 39 in phases to respond to requests that the accounting for financial instruments should be improved quickly. However, the IASB is concerned that if an entity is permitted to adopt one phase early without also adopting early all of the preceding phases, there would be a period of significant incomparability among entities until all of the phases of the project are mandatorily effective. That is because there will be many possible combinations of which requirements are adopted early and which are not. Moreover, the period of incomparability would be significant because the phases will not be mandatorily effective before 1 January 2013. (Paragraphs BC7.9A–BC7.9E, BC7.9F–BC7.9H and BC7.9J–BC7.9N describe the IASB's subsequent decisions on the effective date of IFRS 9.)

BC7.8 Consequently, in the 2010 Own Credit Risk Exposure Draft the IASB proposed that if an entity elects to apply any finalised requirements early, the entity must also apply any preceding requirements in IFRS 9 that it does not already apply. Some respondents did not agree with this proposal and urged the IASB to permit an entity to adopt the proposals in the 2010 Own Credit Risk Exposure Draft early without also adopting early the requirements in IFRS 9 for financial assets. As an alternative, some respondents asked the IASB to finalise the proposals as an amendment to IAS 39, which could be applied immediately, instead of adding the proposals to IFRS 9. Those respondents thought that the proposals in the 2010 Own Credit Risk Exposure Draft are unrelated to the requirements for financial assets and would be less complex to implement. However, the IASB was not persuaded that the benefits of permitting an entity to adopt early only the proposals in the 2010 Own Credit Risk Exposure Draft exceeded the significant incomparability that would result. Moreover, the IASB noted that the transition requirements in IFRS 9 for financial assets require an entity to reassess some financial liabilities designated under the fair value option. Consequently, there is a linkage between the two phases and to permit entities to adopt early only the proposals in the 2010 Own Credit Risk Exposure Draft would be inappropriate and confusing. Moreover, the IASB decided that it would be inappropriate to amend IAS 39 while it was in the process of replacing it. For those reasons, the IASB decided to confirm the proposals in the 2010 Own Credit Risk Exposure Draft. (Paragraphs BC7.35–BC7.40 describe the IASB's subsequent decisions on the early application of the own credit risk requirements.)

BC7.9 However, if an entity chooses to adopt a phase early, the IASB does not require the entity to adopt subsequent phases early. The IASB decided that it would be unfair to require an entity to anticipate the outcomes of unfinished phases in order to make a decision about adopting a phase early. Moreover, the IASB decided that an entity is permitted to adopt early the requirements in IFRS 9 issued in 2009 without adopting early the requirements that were added to IFRS 9 in 2010. (Paragraphs BC7.9O–BC7.9T describe the IASB's subsequent decisions on the early application of IFRS 9.)

Mandatory effective date of IFRS 9—November 2011

BC7.9A IFRS 9 (2009) and IFRS 9 (2010) were issued with a mandatory effective date of 1 January 2013. At the time, the IASB noted that it would consider delaying the effective date of IFRS 9, if:

(a) the impairment phase of the project to replace IAS 39 made such a delay necessary; or

(b) the new Standard on insurance contracts had a mandatory effective date later than 2013, to avoid an insurer having to face two rounds of changes in a short period.

BC7.9B In July 2011 the IASB noted that in order to enable an appropriate period for implementation before the mandatory effective date of the new requirements, the impairment and hedge accounting phases of the project to replace IAS 39 would not be mandatory for periods beginning before 1 January 2013. In addition, any new requirements for the accounting for insurance contracts would not have a mandatory effective date as early as 1 January 2013.

BC7.9C As a result of these considerations, in August 2011 the IASB published the Exposure Draft *Mandatory Effective Date of IFRS 9* (the '2011 Mandatory Effective Date Exposure Draft'). In the 2011 Mandatory Effective Date Exposure Draft, the IASB proposed that the mandatory effective date of IFRS 9 should be deferred to annual periods beginning on or after 1 January 2015. The IASB noted that it did not want to discourage entities from applying IFRS 9 and stressed that early application would still be permitted.

BC7.9D In its redeliberations on the 2011 Mandatory Effective Date Exposure Draft, the IASB decided to confirm its proposal that IFRS 9 would be required to be applied for annual periods beginning on or after 1 January 2015. In doing so, the IASB noted that there are compelling reasons for all project phases to be implemented at the same time and that, based on current circumstances, it is still appropriate to pursue an approach of requiring the same effective date for all phases of this project. (Paragraphs BC7.9F–BC7.9H and BC7.9J–BC7.9N describe the IASB's subsequent decisions on the effective date of IFRS 9.)

BC7.9E However, the IASB noted that it is difficult to assess the amount of lead time that will be necessary to implement all phases of the project because the entire project to replace IAS 39 is not yet complete. Ultimately

this may affect the IASB's conclusion on the appropriateness of requiring the same mandatory effective date for all phases of this project.

Requirements added to, and amendments of, IFRS 9 in November 2013

Mandatory effective date of IFRS 9—November 2013

BC7.9F The 2012 Limited Amendments Exposure Draft did not propose to change the mandatory effective date of IFRS 9 and the IASB did not ask a question on that topic. However, as part of the 2013 Impairment Exposure Draft, the IASB noted that all phases of IFRS 9 would have the same effective date and asked respondents for feedback on the lead time that would be needed to implement the proposals on expected credit losses and what the resulting mandatory effective date for IFRS 9 should be.

BC7.9G Many respondents to the 2012 Limited Amendments Exposure Draft urged the IASB to confirm as soon as possible that the mandatory effective date of IFRS 9 of 1 January 2015 would be deferred. Respondents noted that the IASB has a practice of allowing a minimum of 18 months between the finalisation of a Standard and the mandatory effective date. They noted that even if the remaining phases of IFRS 9 were completed by the end of 2013, there would not be 18 months remaining until 1 January 2015. The feedback received in response to the 2013 Impairment Exposure Draft indicated that entities believed that they would need around three years to implement the proposed impairment model.

BC7.9H In the light of the feedback received, the IASB decided to defer the mandatory effective date of IFRS 9. The IASB decided that it will be able to determine the appropriate mandatory effective date only after it finalises the requirements for impairment and classification and measurement and has considered the lead time that is necessary to implement those new requirements. Consequently, the IASB decided that the mandatory effective date should not be specified in IFRS 9 but will be determined when the outstanding phases are finalised. However, the IASB confirmed that in the meantime application of IFRS 9 is still permitted. (Paragraphs BC7.9J–BC7.9N describe the IASB's subsequent decisions on the effective date of IFRS 9. Paragraphs BC7.35–BC7.40 describe the IASB's decisions in November 2013 on the early application of the own credit risk requirements.)

Hedge accounting

BC7.9I The IASB decided that the effective date of the hedge accounting requirements should be aligned with the effective date for the other requirements of IFRS 9 (see paragraph BC7.9H) and confirmed that the hedge accounting requirements cannot be applied prior to the application of the classification and measurement requirements in IFRS 9.

Requirements added to IFRS 9 in July 2014

Mandatory effective date of IFRS 9

BC7.9J The IASB concluded that the mandatory effective date for IFRS 9 would largely depend on the time and effort required to implement the impairment requirements. Accordingly, the 2013 Impairment Exposure Draft requested feedback on how much time entities would require to implement those requirements.

BC7.9K Some respondents noted that the impairment model that would be incorporated into IFRS 9 is arguably the most important part of the IASB's response to the global financial crisis. Consequently, although they believe that sufficient time should be allowed for the implementation of IFRS 9, they expressed concern about any delay that is not strictly necessary. These respondents recommended that the IASB should allow no more than two years for the implementation of IFRS 9.

BC7.9L However, most respondents noted that they would require approximately three years, noting the following reasons:

(a) entities would need to make system and model changes, in particular credit risk management systems, to monitor significant increases in credit risk and to modify credit risk models to incorporate appropriate forward-looking data;

(b) entities may have limited availability of historical and trend information. Such information is needed to build relevant models and incorporate forward-looking data in measuring expected credit losses;

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(c) entities would need to undertake parallel testing and running of new systems before final implementation; and

(d) entities would need to consider the interaction of the expected credit loss requirements with various other regulatory reforms and regulatory capital requirements. Respondents noted that resource constraints would hamper their efforts for a quicker implementation.

BC7.9M In addition, the IASB noted that most respondents to the IASB's 2013 Insurance Contracts Exposure Draft commented that it would be ideal if the requirements of the new Standard on insurance contracts could have the same mandatory effective date as IFRS 9. Those respondents were concerned that the designations and assessments that an entity would make on initial application of IFRS 9 might not be the same as those that the entity would have made if it had been applying the new Standard on insurance contracts at the same time. Although the IASB had not concluded deliberations on the Standard on insurance contracts, it had tentatively decided that it would allow approximately three years between finalising that Standard and its mandatory effective date.

BC7.9N The IASB noted that IFRS 9 is relevant to a broad range of entities. Accordingly, it concluded that it may not be appropriate to delay the application of IFRS 9 solely to mitigate the concerns of insurers since it would delay the benefits of improved financial reporting for a broad range of entities. However, in balancing the competing objectives of timely implementation of IFRS 9 and allowing entities sufficient time to implement IFRS 9 and, at the same time, considering the concerns raised in response to the 2013 Insurance Contracts Exposure Draft, the IASB concluded that a mandatory effective date of 1 January 2018 would be appropriate. In the IASB's view, that date would allow sufficient time for entities to implement IFRS 9 and give it the opportunity to progress its project on insurance contracts so that affected entities would be able to understand the direction of the insurance contracts requirements prior to implementing IFRS 9.

Early application of IFRS 9

BC7.9O Prior to IFRS 9 being issued in July 2014, three versions of IFRS 9 existed—IFRS 9 (2009), IFRS 9 (2010) and IFRS 9 (2013)—and each of these previous versions of IFRS 9 permitted early application. The relevant rationale is set out in paragraphs BC7.5, BC7.7–BC7.9 and BC7.9H–BC7.9I. In addition, an entity is permitted to early apply only the requirements in IFRS 9 related to the presentation of 'own credit' gains and losses on financial liabilities designated under the fair value option; ie without applying the other requirements in IFRS 9. The relevant rationale is set out in paragraphs BC7.35–BC7.40.

BC7.9P In the 2012 Limited Amendments Exposure Draft, the IASB proposed to limit the versions of IFRS 9 available for early application. Specifically, entities:

(a) would be permitted to early apply the completed version of IFRS 9; but

(b) entities would not be permitted to newly early apply a previous version of IFRS 9 if the entity's relevant date of initial application is six months or more after the completed version of IFRS 9 is issued. However, if the entity's relevant date of initial application is less than six months after the completed version of IFRS 9 is issued, an entity would be permitted to continue to apply that version until the completed version of IFRS 9 becomes mandatorily effective.

These proposals did not affect the provision in IFRS 9 that permits an entity to early apply only the requirements related to the presentation of 'own credit' gains and losses on financial liabilities designated under the fair value option. Moreover, the proposals did not affect those entities that chose to early apply a previous version of IFRS 9 before the completed version of IFRS 9 was issued. Those entities would be permitted to continue to apply that previous version of IFRS 9 until the completed version of IFRS 9 is mandatorily effective.

BC7.9Q In considering those proposals, the IASB noted that having multiple versions of IFRS 9 available for early application (in addition to IAS 39) is complex and significantly reduces the comparability of information that is provided to users of financial statements.

BC7.9R The IASB acknowledged in the 2012 Limited Amendments Exposure Draft that the phased approach to replacing IAS 39 (including the phased approach to the application of, and transition to, IFRS 9) was originally developed in response to requests from the G20, the Financial Stability Board and others that improvements to the accounting for financial instruments should be available quickly. For this reason, the classification and measurement requirements in IFRS 9 were issued before the phases for impairment and hedge accounting were completed. However, the IASB noted that when the completed version of IFRS 9 is issued (ie when all of the phases of the project to replace IAS 39 are completed), the lack of comparability, as well as the complexity, that results from permitting entities to early apply more than one version of IFRS 9 is no longer justified.

BC7.9S Despite the conclusion in paragraph BC7.9R, the IASB decided to propose that an entity would be permitted to early apply a previous version of IFRS 9 for six months after the completed version of IFRS 9 is issued. This was a practical accommodation to minimise the cost and disruption to entities that are preparing to apply a previous version of IFRS 9 at the time that the completed version is issued.

BC7.9T Of those respondents who commented on these proposals in the 2012 Limited Amendments Exposure Draft, nearly all agreed. Many agreed with the IASB's rationale that this would increase comparability compared to the phased early application that is currently permitted. Consequently, the IASB confirmed the proposals set out in paragraph C7.9P.

Transition related to IFRS 9 as issued in November 2009

BC7.10 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that retrospective application results in the most useful information to users because the information presented for all periods is comparable. Consequently, the 2009 Classification and Measurement Exposure Draft proposed retrospective application subject to some transition relief in particular circumstances. The IASB considered the difficulties and associated costs of full retrospective application of the proposals in the 2009 Classification and Measurement Exposure Draft.

BC7.11 Most respondents agreed, in principle, with requiring retrospective application, but many questioned the practicability of the approach. In particular, many noted that the extensive exceptions to retrospective application that would be required to make such transition practicable significantly reduced (and possibly eliminated) any benefit that users might obtain from requiring comparative information to be restated.

BC7.12 The IASB considered whether to require prospective application, but noted that such an approach does not provide comparable information for users of financial statements. In addition, the IASB noted that any transition approach (such as prospective application) that requires resetting the effective interest rate for financial assets measured at amortised cost reduces the usefulness of information about interest income.

BC7.13 The IASB decided to require retrospective application but provide transition relief to address particular difficulties that might arise from retrospective application. The IASB also noted that IAS 8 sets out transition requirements that apply if retrospective application is impracticable and prohibits the use of hindsight when applying a new accounting policy to a prior period.

Transition relief

Impracticability exceptions

BC7.14 The IASB acknowledged that it may be impracticable for an entity to apply the effective interest method or impairment requirements in IAS 39 retrospectively in some situations. The process would be cumbersome, in particular for an entity with a large number of financial assets that were previously measured at fair value but are measured at amortised cost in accordance with the approach in IFRS 9. Several loss events and reversals might have occurred between the date when the asset was initially recognised and the date of initial application of the Standard. IFRS 9 requires that if applying the impairment requirements is impracticable or requires the use of hindsight, an entity should use previously determined fair value information to determine whether a financial asset was impaired in comparative periods. IFRS 9 also requires that the fair value at the date of initial application of the new requirements should be treated as the new amortised cost carrying amount of that financial asset in that case. The IASB rejected proposals that entities should be permitted, but not required, to treat the fair value at the date of initial application as amortised cost because it would impair comparability and require significant guidance about when such an option should be permitted. (Paragraphs BC7.72–BC7.81 describe the IASB's subsequent decisions on transition to the new impairment requirements.)

BC7.15 The IASB noted that an entity would not have determined the fair value of an investment in an unquoted equity instrument[45] (or a derivative on such an investment) that was previously accounted for in accordance with paragraphs 46(c) and 66 of IAS 39. Moreover, an entity will not have the necessary information to determine fair value retrospectively without using hindsight. Accordingly, IFRS 9 requires such instruments to be measured at fair value at the date of initial application.

[45] IFRS 13, issued in May 2011, defines a Level 1 input as a quoted price in an active market for an identical asset or liability. Level 2 inputs include quoted prices for identical assets or liabilities in markets that are not active. As a result, IFRS 9 refers to such equity instruments as 'an equity instrument that does not have a quoted price in an active market for an identical instrument (ie a Level 1 input)'.

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Hybrid contracts

BC7.16 An entity may not have previously determined the fair value of a hybrid contract in its entirety. Moreover, an entity will not have the necessary information to determine fair value retrospectively without using hindsight. However, an entity would have been required to measure both the embedded derivative and host separately at fair value to apply the disclosure requirements in IFRS 7. Consequently, in comparative periods, IFRS 9 requires the sum of the fair value of the embedded derivative and the host to be used as an approximation of the fair value of the entire hybrid contract.

BC7.17 The proposals in the 2009 Classification and Measurement Exposure Draft would have resulted in fair value measurement for many hybrid contracts for which the embedded derivative was accounted for separately in accordance with IAS 39. Some respondents asked for such treatment under IAS 39 to be 'grandfathered'. The IASB noted that many such requests had been related to the proposed treatment of hybrid contracts with financial liability hosts, which were not included in IFRS 9 (2009). Consequently, the IASB decided not to permit an option to grandfather hybrid contracts with financial asset hosts that were bifurcated in accordance with IAS 39 as an accounting policy choice because it would impair comparability, and because some such contracts may still have a significant remaining maturity.

Assessment of the objective of the entity's business model for managing financial assets

BC7.18 IFRS 9 requires an entity to assess whether the objective of an entity's business model is to manage financial assets to collect the contractual cash flows on the basis of circumstances at the date of initial application. The IASB believes it would be difficult, and perhaps impossible, to assess that condition on the basis of circumstances when the instrument first satisfied the recognition criterion in IAS 39.

Assessment of qualifying criteria for the fair value option

BC7.19 The IASB decided that the assessment of whether a financial asset or financial liability meets the eligibility criterion for designation under the fair value option should be based on the circumstances at the date of initial application. IFRS 9 changes the classification of some financial assets, including eliminating two of the three eligibility criteria in IAS 39 for the fair value option for financial assets. Consequently, the IASB believes that an entity should reconsider at transition its original assessment of whether to designate a financial asset or financial liability as at fair value through profit or loss.

Comparative information

BC7.20 As noted above, many respondents were concerned that the inevitable exceptions to full retrospective application would result in restated information that is incomplete. They proposed an approach similar to that used on first-time adoption of IFRS and when entities adopted IAS 39 in 2005, in which the requirement to provide comparative information was waived. Some respondents believe that such an approach would address the concerns that, although IAS 1 requires only one year of comparative information, the legal and regulatory frameworks in many jurisdictions require further comparative periods to be presented. In those situations, the restatement of comparatives would be virtually impossible for an entity wishing to adopt IFRS 9 early.

BC7.21 In the IASB's view, waiving the requirement to restate comparatives strikes a balance between the conceptually preferable method of full retrospective application (as stated in IAS 8) and the practicability of adopting the new classification model within a short time frame. Accordingly, the IASB decided that it would permit, but not require, restatement of comparative periods by entities that implement IFRS 9 for reporting periods beginning before 1 January 2012. However, those considerations would be less applicable for entities that adopted outside a short time frame. Consequently, restated comparative information is required if an entity adopts IFRS 9 for reporting periods beginning after 1 January 2012. (Paragraphs BC7.34A–BC7.34M and BC7.82–BC7.84 describe the IASB's subsequent decisions on restating comparative information.)

Date of initial application

BC7.22 The 2009 Classification and Measurement Exposure Draft stated that the date of initial application would be the date when an entity first applies the requirements in the Standard. Many respondents questioned whether the date of initial application could be an arbitrary date between the date of issue of the Standard (or even earlier) and the mandatory effective date, resulting in a loss of comparability over a long period of time. The

IASB agreed that a free choice would impair comparability, but noted it intended that entities should be able to apply the Standard in 2009 or 2010 financial statements. Accordingly, the Standard requires the date of initial application to be the beginning of a reporting period, but provides relief from this requirement for entities applying the Standard for reporting periods beginning on or before 1 January 2011.

Hedge accounting

BC7.23 The IASB decided not to carry forward the specific transition provisions on hedge accounting proposed in the 2009 Classification and Measurement Exposure Draft because they are not necessary.

Transitional disclosures

BC7.24 The 2009 Classification and Measurement Exposure Draft proposed disclosures for entities that apply the new IFRS 9 early. However, many noted that such disclosures would be useful for all entities applying IFRS 9 for the first time, and not only early adopters. The IASB noted that the information necessary to make those disclosures would be readily available to the entity to make the necessary journal entries on transition and to account for the financial assets in the future. Accordingly, IFRS 9 requires all entities to supply additional disclosures on transition. (Paragraphs BC7.34A–BC7.34M and BC7.63–BC7.68 describe the IASB's subsequent decisions on disclosures at transition to IFRS 9.)

BC7.25 The IASB rejected a proposal in the comment letters that entities should apply disclosures similar to those based on IFRS 1 *First-time Adoption of International Financial Reporting Standards* explaining the transition to the new Standard. The IASB noted that the disclosures in IFRS 1 relate to first-time adoption and not to changes in accounting policies. Disclosures about changes in an accounting policy are required by IAS 8.

Transition related to the requirements added to IFRS 9 in October 2010

BC7.26 As noted above, IAS 8 states that retrospective application results in the most useful information to users because the information presented for all periods is comparable. The IASB noted that IFRS 7 already requires disclosure of the amount of the change in fair value that is attributable to changes in the credit risk of the liability. Consequently, entities are already calculating the information necessary to present the effects of changes in liabilities' credit risk in other comprehensive income. Thus, the 2010 Own Credit Risk Exposure Draft proposed retrospective application and almost all respondents agreed. The IASB confirmed that proposal.

BC7.27 The IASB did not change the classification and measurement approach for financial liabilities, including the eligibility conditions for the fair value option for financial liabilities. Consequently, the proposals in the 2010 Own Credit Risk Exposure Draft did not permit entities to make new designations or revoke its previous designations as a result of the proposals. Some respondents believed that the IASB should permit entities to reassess their designations in the light of the new requirements related to own credit risk.

BC7.28 However, the IASB was not persuaded that there is a compelling reason to permit entities to reassess their elections, especially because the underlying classification and measurement approach has not changed. As noted in paragraph BC7.19, when an entity initially applies IFRS 9 to assets, it is required to reassess particular liabilities designated under the fair value option. That was necessary because the requirements issued in IFRS 9 (2009) introduced a new classification and measurement approach for financial assets, which would change the classification of some (and perhaps many) financial assets. Those changes require an entity to reassess liabilities designated under the fair value option to the extent that designation was originally elected to address an accounting mismatch. However, the IASB believed that a similar case could not be made for the requirements added to IFRS 9 in 2010. And because the requirements issued in IFRS 9 (2009) already require reassessment of particular liabilities, the IASB believes that a second reassessment would make transition unnecessarily complex. Consequently, the IASB decided to confirm the proposal in the 2010 Own Credit Risk Exposure Draft.

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Transition relief

BC7.29 When the IASB issued the new requirements for financial assets in November 2009, it granted some transition relief from full retrospective transition. To be consistent with the transition requirements for assets, the IASB decided to grant similar transition relief for the requirements added to IFRS 9 in October 2010:

(a) The requirements are not applied to liabilities that have been derecognised at the date of initial application. The IASB concluded that applying the requirements in IFRS 9 to some derecognised items but not others would be confusing and unnecessarily complex.

(b) An entity is required to assess whether presenting the effects of changes in a liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss on the basis of facts and circumstances that exist at the date of initial application. This is consistent with the other transition requirements in IFRS 9 related to the fair value option. Moreover, the IASB noted that the conclusion will most likely be the same regardless of whether it is made on the basis of facts and circumstances that existed at initial recognition of the liability or at the date of initial application.

(c) Derivative liabilities that were previously accounted for at cost are measured at fair value at the date of initial application. Consistently with the requirements for financial assets, an entity will not have the necessary information to determine fair value retrospectively without using hindsight.

(d) An entity is not required to restate prior periods if the requirements are adopted for reporting periods beginning before 1 January 2012. The IASB decided that it would be inappropriate and confusing to require an entity to restate prior periods for some of the requirements in IFRS 9 but not others. However, the IASB decided that if the entity elects to restate prior periods to reflect the requirements added to IFRS 9 in October 2010, it must also restate prior periods to reflect the other requirements in IFRS 9. That conclusion is consistent with the IASB's decision that if an entity elects to adopt the requirements early, it must at the same time adopt early all of the requirements in IFRS 9 that it does not already apply. (Paragraphs BC7.34A–BC7.34M and BC7.82–BC7.84 describe the IASB's subsequent decision on restating comparative information.)

Transitional insurance issues

BC7.30 The IASB noted that insurers may face particular problems if they apply IFRS 9 before they apply the new Standard on insurance contracts (the new IFRS 4). To avoid accounting mismatches in profit or loss, many insurers classify many of their financial assets as available-for-sale. If those insurers apply IFRS 9 before the new IFRS 4, they might decide to classify many of their financial assets at amortised cost (assuming they meet the relevant conditions in IFRS 9). When those insurers later apply the new IFRS 4, they may wish to reclassify those assets from amortised cost to fair value through profit or loss, but that may not generally be possible in accordance with IFRS 9. Thus, those insurers might have either to classify those assets at fair value through profit or loss during the intervening period or to continue to classify them at amortised cost when they apply the new IFRS 4. Either choice might lead to an accounting mismatch.

BC7.31 The IASB considered whether it could reduce such mismatches by maintaining the available-for-sale category for insurers until they can apply the new IFRS 4. However, if the IASB did so, it would have to create detailed and arbitrary descriptions of the entities and instruments to which that approach would apply. The IASB concluded that permitting the continuation of that category would not provide more useful information for users.

BC7.32 The IASB will consider in developing the new IFRS 4 whether to provide an option for insurers to reclassify some or all financial assets when they first apply the new IFRS 4. This would be similar to the option in paragraph 45 of IFRS 4 and paragraph D4 of IFRS 1. The IASB included such an option in IFRS 4 for reasons that may be equally valid for phase II.

Shadow accounting for participating contracts

BC7.33 Some insurers expressed concerns that an accounting mismatch will arise if the assets backing participating insurance liabilities include equity investments and the insurer elects to present gains and losses on those investments in other comprehensive income. That accounting mismatch would arise because paragraph 30 of IFRS 4 does not give explicit authority to apply 'shadow accounting' in such cases.

BC7.34 The IASB acknowledges that this accounting mismatch is undesirable. However, for the following reasons, the IASB did not amend paragraph 30 of IFRS 4:

(a) This accounting mismatch will arise only if an insurer elects to present gains and losses on equity investments in other comprehensive income.

(b) As described in paragraph BC5.23, in creating the option to present gains and losses on equity investments in other comprehensive income, the IASB's intention was to provide a presentation alternative for some equity investments in which presenting fair value gains and losses in profit or loss may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily to generate increases in the value of the investment. The IASB did not intend to provide an alternative for investments in any other circumstances, including if an entity intends to hold an equity investment over a long time frame. In the IASB's view, if an insurer holds investments with the primary objective of realising a profit from increases in their value, for the benefit of either the insurer itself or its policyholders, the most transparent place to present those value changes is in profit or loss.

Disclosures on transition from IAS 39 to IFRS 9—November 2011

BC7.34A When IFRS 9 (2009) and IFRS 9 (2010) were issued, they provided limited relief from restating comparative financial statements. Entities that adopted the Standard for reporting periods beginning before 1 January 2012 were not required to restate prior periods. At the time, the IASB's view was that waiving the requirement to restate comparative financial statements struck a balance between the conceptually preferable method of full retrospective application (as stated in IAS 8) and the practicability of adopting the new classification model within a short time frame.

BC7.34B In August 2011 the IASB published the 2011 Mandatory Effective Date Exposure Draft. At the time, the IASB noted that these practicability considerations would be less relevant for entities that adopted outside a short time frame, and therefore proposed that restated comparative financial statements would continue to be required if an entity adopts IFRS 9 for reporting periods beginning on or after 1 January 2012.

BC7.34C Some respondents to the 2011 Mandatory Effective Date Exposure Draft believed that comparative financial statements should be required to be restated for the following reasons:

(a) The presentation of restated comparative financial statements is consistent with IAS 8.

(b) A delay in the mandatory effective date of IFRS 9 would allow a sufficient time frame for entities to prepare restated comparative financial statements.

(c) IAS 39 and IFRS 9 are sufficiently different from each other, so restatement will be necessary to provide meaningful information to users of financial statements.

BC7.34D In contrast, those who did not believe that comparative financial statements should be required to be restated argued that:

(a) Comparative relief was granted for IAS 32 and IAS 39 upon first-time adoption of IFRS for European reporting entities.

(b) Comparability is impaired by the transition requirements, which are complex and inconsistent across various phases of the project, reducing the usefulness of the comparative information (for example, the classification and measurement phase requires retrospective application with some transition reliefs, whereas the hedge accounting phase requires prospective application).

(c) Time pressures similar to those existing when IFRS 9 (2009) and IFRS 9 (2010) were initially issued will nonetheless exist when the last phase of the project to replace IAS 39 is issued.

BC7.34E Respondents to the 2011 Mandatory Effective Date Exposure Draft also raised specific implementation issues that increased the cost of applying the classification and measurement requirements of IFRS 9 in periods prior to their date of initial application. These reasons were the interaction between the date of initial application and:

(a) the fact that IFRS 9 is not applied to items that have already been derecognised as of the date of initial application;

(b) the initial business model determination; and

(c) the elections for the fair value option and the fair value through other comprehensive income presentation alternative at the date of initial application.

BC7.34F In providing views on their preferred transition approach for the project to replace IAS 39, investors consistently emphasised a need for comparable period-to-period information—that is, information that enabled them to understand the effect of the transition from IAS 39 to IFRS 9. Investors, irrespective of their preferred approach, noted that the mix of transition requirements between phases, and the modifications to retrospective application in the classification and measurement phase, would diminish the usefulness of comparative financial statements. Many also noted that the partial restatement of comparative financial statements could create either confusion or a misleading impression of period-to-period comparability.

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BC7.34G Some investor respondents, despite sharing the views in the preceding paragraph, favoured the presentation of comparative financial statements with full retrospective application of all project phases (ie including hedge accounting) as the preferred way of achieving comparability. Some of the respondents who favoured full retrospective application agreed that the modifications to retrospective application would diminish the usefulness of comparative financial statements but believed that the effect of the modifications would not be significant.

BC7.34H Due to the variation in transition requirements of the phases in the project to replace IAS 39, other investors did not favour the presentation of restated comparative financial statements. Their primary concern was having information that enabled them to understand the effect of the transition from IAS 39 to IFRS 9. They did not believe that restating comparative financial statements on the basis of the transition requirements across the phases of IFRS 9 would necessarily provide that information.

BC7.34I In addition to feedback on their preferred approach to understanding the effect of the transition to IFRS 9, investors also provided information about what they focus on when analysing financial instruments in financial statements. They noted that the statement of profit or loss and other comprehensive income (and restatement of it in comparative periods) is less important to their analysis than the statement of financial position, aside from situations where it allows for a link to the statement of financial position (for example net interest income). Similarly, where restatement means primarily the presentation of historical fair value changes, comparative information is less useful as extrapolation is not possible in the same way as it is for amortised cost information.

BC7.34J Investors also provided feedback on those disclosures that would be useful in understanding the transition from IAS 39 to IFRS 9. They cited examples that they found useful on the transition from other GAAPs to IFRS in Europe in 2005. It was also noted that disclosures similar to those required by IFRS 7 for transfers of financial assets between classification categories would be useful—ie disclosures about reclassifications are also useful when the reclassifications result from applying a new accounting standard.

BC7.34K In the light of this feedback received, the IASB considered whether modified transition disclosures could provide the information necessary for investors to understand the effect of the transition from IAS 39 to IFRS 9, while reducing the burden on preparers that would result from the restatement of comparative financial statements. The IASB also considered whether this approach would address concerns about the diminished usefulness and period-to-period comparability of comparative financial statements due to the different transition requirements of the phases of the project to replace IAS 39. The IASB believes that modified disclosures can achieve these objectives and decided to require modified transition disclosures instead of the restatement of comparative financial statements.

BC7.34L The IASB noted that much of the information requested by investors was already required by IAS 8 and IFRS 7 on transition from IAS 39 to IFRS 9. The IASB also noted that it was not modifying the requirements of IAS 8. The IASB, however, decided that the reclassification disclosures in IFRS 7 (as amended by IFRS 9 (2009)) should be required on transition from IAS 39 to IFRS 9, irrespective of whether they would normally be required due to a change in business model. The IASB also specified that the reclassification disclosures, and other disclosures required when initially applying IFRS 9, should allow reconciliations between the measurement categories in accordance with IAS 39 and IFRS 9 and individual line items in the financial statements or classes of financial instruments. This would provide useful information that would enable users to understand the transition from IAS 39 to IFRS 9.

BC7.34M The IASB also considered whether the transition disclosures should be required if the entity presents restated comparative financial statements, or only if they are not provided. The IASB noted that the disclosures provide useful information to investors on transition from IAS 39 to IFRS 9, irrespective of whether comparative financial statements are restated. The IASB also believed that the burden of these comparative transition disclosures for preparers would not be unreasonable because it was based largely on existing disclosure requirements and should require disclosure of information available as a result of preparing for transition. Consequently, the IASB decided to require these disclosures even if restated comparative financial statements are provided. However, the IASB did not want to unduly burden those who were in the process of applying IFRS 9 early by requiring disclosures that the entity was not previously required to provide. Consequently, for entities that initially apply the classification and measurement requirements from 1 January 2012 until 31 December 2012, the IASB decided to permit, but not require, the presentation of the additional disclosures. If an entity elects to provide these disclosures when initially applying IFRS 9 between 1 January 2012 and 31 December 2012, it would not be required to restate comparative periods. (Paragraphs BC7.63–BC7.68 describe the IASB's subsequent decisions on disclosures at transition to IFRS 9.)

Transition related to the requirements added to IFRS 9 in November 2013

Presentation of 'own credit' gains and losses on financial liabilities

BC7.35 After requirements were added to IFRS 9 in October 2010 to address the effects of changes in own credit risk for liabilities designated under the fair value option, many interested parties requested that the IASB permit an entity to apply those requirements without also applying the other requirements in IFRS 9. That is because markets continued to be volatile and own credit gains or losses remained significant, which accentuated the concerns about the usefulness of presenting gains in profit or loss when an entity is experiencing deterioration in its own credit quality.

BC7.36 In the 2012 Limited Amendments Exposure Draft, the IASB proposed that six months after the completed version of IFRS 9 is issued, entities would no longer be permitted to newly early apply previous versions of IFRS 9. Consequently, entities wishing to apply the classification and measurement requirements after the completed version of IFRS 9 was issued would have to develop and implement the necessary systems changes for applying the new impairment requirements before they would be able to apply the classification and measurement requirements. In effect, that would have made the availability of the own credit requirements for early application dependent on the implementation of an expected credit loss impairment model.

BC7.37 Consequently, in order to make the own credit requirements in IFRS 9 available more quickly, the 2012 Limited Amendments Exposure Draft proposed that once the completed version of IFRS 9 was issued, an entity would be permitted to early apply the requirements for presenting in other comprehensive income the 'own credit' gains or losses on financial liabilities designated under the fair value option without early applying the other requirements of IFRS 9. However, at the time, the IASB noted that its decision to incorporate the possibility to apply early only the own credit requirements into the final version of IFRS 9 instead of IFRS 9 (2010) and later versions, was based on the expectation that there would not be a significant delay in the completion of IFRS 9. In other words, the IASB believed that the own credit requirements would be available for early application at roughly the same time under both approaches. However, the IASB noted that by exposing the proposals as part of the 2012 Limited Amendments Exposure Draft, it would be possible to change this approach if necessary.

BC7.38 Nearly all respondents to the 2012 Limited Amendments Exposure Draft supported the proposal that an entity would be permitted to early apply only the own credit requirements in IFRS 9 without applying any other requirements of IFRS 9 at the same time. However, most of these respondents also asked the IASB to make these requirements available for early application before the IFRS 9 project is completed and the final Standard is issued. Many of these respondents suggested that this could be accomplished by incorporating the own credit requirements into IAS 39, whereas others suggested incorporating the requirements into IFRS 9 (2010) and later versions.

BC7.39 During the redeliberations the IASB confirmed the proposal in the 2012 Limited Amendments Exposure Draft that the own credit requirements should be made available for early application without early applying the other requirements of IFRS 9. However, in order to respond to the feedback that the own credit requirements should be made available as soon as possible, the IASB decided to incorporate those requirements into IFRS 9 (2010) and later versions. The IASB also confirmed its previous decision not to incorporate the own credit requirements into IAS 39 because that Standard is being replaced by IFRS 9.

BC7.40 Although the topic was not within the scope of the 2012 Limited Amendments Exposure Draft, some respondents asked the IASB to reconsider the requirements in IFRS 9 that prohibit an entity from reclassifying (recycling) own credit gains or losses to profit or loss when the financial liability is derecognised. The IASB noted that it is currently discussing the objective of other comprehensive income, including whether amounts should be recycled to profit or loss (and if so, when), in its project on the Conceptual Framework and therefore the IASB noted that it would be inappropriate to reconsider those requirements in IFRS 9 before it completes that work.[46]

Transition related to the hedge accounting requirements

BC7.41 IAS 8 states that retrospective application results in the most useful information to users of the financial statements. IAS 8 also states that retrospective application is the preferred approach to transition, unless such retrospective application is impracticable. In such a scenario the entity adjusts the comparative information

[46] In 2018 the IASB issued a revised *Conceptual Framework for Financial Reporting*.

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from the earliest date practicable. In conformity with these requirements, the classification and measurement chapters of IFRS 9 require retrospective application (with some relief in particular circumstances).

BC7.42 The proposals in the 2010 Hedge Accounting Exposure Draft were a significant change from the requirements in IAS 39. However, in accordance with the proposals, a hedge accounting relationship could be designated only prospectively. Consequently, retrospective application was not applicable. This reflects that retrospective application gives rise to similar concerns about using hindsight as retrospective designation of hedging relationships, which is prohibited.

BC7.43 In developing the transition requirements proposed in the 2010 Hedge Accounting Exposure Draft, the IASB considered two alternative approaches:

(a) prospective application only for new hedging relationships; or

(b) prospective application for all hedging relationships.

BC7.44 The IASB rejected the approach using prospective application of hedge accounting only for new hedging relationships. This approach would have required the current hedge accounting model in IAS 39 to be maintained until hedge accounting is discontinued for the hedging relationships established in accordance with IAS 39. Also, the proposed disclosures would be provided only for the hedging relationships accounted for in accordance with the proposed model. This approach entails the complexity of applying the two models simultaneously and also involves a set of disclosures that would be inconsistent and difficult to interpret. Because some hedging relationships are long-term, two hedge accounting models would co-exist for a potentially long period. This would make it difficult for users to compare the financial statements of different entities. Comparability would also be difficult when entities apply the old and the new model in the same financial statements, as well as for information provided over time.

BC7.45 Consequently, the IASB proposed prospective application of the proposed hedge accounting requirements for all hedging relationships, while ensuring that 'qualifying' hedging relationships could be moved from the existing model to the proposed model on the adoption date.

BC7.46 Almost all respondents agreed with prospective application of the new hedge accounting requirements to all hedging relationships because that would avoid the administrative burden of maintaining both the IAS 39 model and the new hedge accounting model and would also mitigate the risk of hindsight arising from retrospective designation of hedging relationships. Respondents also noted that prospective application is consistent with hedge accounting transition requirements that were used for previous amendments to IAS 39.

BC7.47 The IASB also received feedback that suggested a general provision, whereby hedging relationships designated under IAS 39 would be automatically 'grandfathered', ie entities could continue applying the requirements of IAS 39 to these hedging relationships. However, consistent with its proposal in the 2010 Hedge Accounting Exposure Draft (see paragraph BC7.44), the IASB decided not to allow the grandfathering of the application of IAS 39. Instead, the IASB retained its original decision that the new hedge accounting requirements are applied to hedging relationships that qualify for hedge accounting in accordance with IAS 39 and this Standard and that those are treated as continuing hedging relationships.

BC7.48 Some respondents supported varying forms of retrospective application. However, consistent with previous hedge accounting transition requirements in IAS 39 and the 2010 Hedge Accounting Exposure Draft, the IASB decided not to allow retrospective application in situations that would require retrospective designation because that would involve hindsight.

BC7.49 Some responses to the 2010 Hedge Accounting Exposure Draft suggested using retrospective application in two particular situations in which the outcomes under IAS 39 and the new hedge accounting model significantly differ but retrospective designation would not be necessary. The particular situations are when an entity under IAS 39 designated as the hedging instrument only changes in the intrinsic value (but not the time value) of an option or changes in the spot element (but not the forward element) of a forward contract. The IASB noted that in both circumstances applying the new requirements for accounting for the time value of options or the forward element of forward contracts would not involve hindsight from retrospective designation but instead use the designation that was previously made under IAS 39. The IASB also noted that in situations in which mismatches between the terms of the hedging instrument and the hedged item exist there might still be some risk of hindsight related to Level 3 fair value measurements when calculating the 'aligned' time value of an option and the 'aligned' forward element of a forward contract. However, the IASB concluded that such hindsight would be limited because hedge accounting was applied to these hedging relationships under IAS 39, meaning that the changes in the intrinsic value of an option or the changes in the value of the spot element of a forward contract had to have a high degree of offset with the changes in value of the hedged risks. Hence, the valuation inputs used for the calculation of the aligned values could not significantly differ from the valuation inputs for the overall fair value of the hedging instruments, which were known from previously applying IAS 39. The IASB also noted that retrospective application in these cases would significantly improve the usefulness of the information for the reasons that underpinned the IASB's decisions on accounting for the time value of options and the forward element of forward contracts (see

paragraphs BC6.386–BC6.426). Consequently, the IASB decided to provide for those two particular situations an exception to prospective application of the hedge accounting requirements of this Standard but only for those hedging relationships that existed at the beginning of the earliest comparative period or were designated thereafter. For the forward element of forward contracts retrospective application is permitted but not required because unlike the new treatment for time value of options the new treatment for the forward element of forward contracts is an election. However, in order to address the risk of using hindsight, the IASB decided that on transition this election is only available on an 'all-or-nothing' basis (ie not a hedge-by-hedge basis). IAS 39 did not allow excluding foreign currency basis spreads from the designation of a financial instrument as the hedging instrument. Consequently, the requirement for the time value of options and the forward element of forward contracts, that an entity excluded the part of the financial instrument that represents costs of hedging from the designation as the hedging instrument under IAS 39, does not apply to foreign currency basis spreads. The restriction that retrospective application is available only on an 'all-or-nothing' basis does not apply to foreign currency basis spreads because of the variety of hedging instruments that involve those spreads.

BC7.50 Some respondents asked the IASB to consider allowing discontinuing at the date of initial application of the new hedge accounting requirements hedging relationships designated under IAS 39 and then designating new hedging relationships in a way that is better aligned with the new hedge accounting requirements.

BC7.51 The IASB noted that an entity could revoke designations of hedging relationships without any restriction until the last day of applying IAS 39 in accordance with the requirements in that Standard. Hence, the IASB considered that any specific transition requirements to address this request were unnecessary. However, in order to address some concerns over potential practical transition issues in the context of prospective application, the IASB decided:

(a) to allow an entity to consider the moment it initially applies the new hedge accounting requirements and the moment it ceases to apply the hedge accounting requirements of IAS 39 as the same point in time. The IASB noted that this would avoid any time lag between starting the use of the new hedge accounting model and discontinuing the old hedge accounting model (because the end of the last business day of the previous reporting period often does not coincide with the beginning of the first business day of the next reporting period), which otherwise might involve significant changes in fair values between those points in time and as a result could cause difficulties in applying hedge accounting under the new hedge accounting model for hedging relationships that would otherwise qualify.

(b) to require that an entity uses the hedge ratio in accordance with IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship (if applicable) and to recognise any related gain or loss in profit or loss. The IASB considered that any change to the hedge ratio that might be required on transition so that a hedging relationship designated under IAS 39 continues to qualify for hedge accounting should not result in an entity having to discontinue that hedging relationship on transition and then newly designating it. The IASB decided to require the recognition of any gain or loss on rebalancing in profit or loss in a broadly similar manner for ongoing hedge accounting under the new model to address any concerns that hedge ineffectiveness might otherwise be recognised as a direct adjustment to retained earnings on transition. The accounting is broadly similar to that for ongoing hedge accounting under the new model in that the hedge ineffectiveness in the context of rebalancing is recognised in profit or loss. However, in contrast to ongoing hedge accounting under the new model, rebalancing on transition applies because a different hedge ratio has already been used for risk management purposes (but did not coincide with the designation of the hedging relationship under IAS 39). In other words, rebalancing does not reflect a concurrent adjustment for risk management purposes but results in aligning the hedge ratio for accounting purposes with a hedge ratio that was already in place for risk management purposes.

BC7.52 The IASB decided not to change the requirements of IFRS 1 for hedge accounting. The IASB noted that a first-time adopter would need to look at the entire population of possible hedging relationships and assess which ones would meet the qualifying criteria of the new hedge accounting model. To the extent that an entity wants to apply hedge accounting, those hedging relationships should be documented on or before the transition date. This is consistent with the transition requirements for existing users of IFRS and the existing transition requirements of IFRS 1, which state that an entity shall discontinue hedge accounting if it had designated a hedging relationship but that hedging relationship does not meet the qualifying criteria in IAS 39.

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Transition related to the requirements added to IFRS 9 in July 2014

Transition related to the limited amendments to the requirements for classifying and measuring financial assets

Assessment of an asset's contractual cash flow characteristics

BC7.53 In accordance with the existing transition provisions in IFRS 9, when IFRS 9 is initially applied, the assessment of an asset's contractual cash flow characteristics is based on the facts and circumstances that existed at the initial recognition of the financial asset, and the resulting classification is applied retrospectively.

BC7.54 The 2012 Limited Amendments Exposure Draft introduced a notion of a modified economic relationship between principal and the consideration for time value of money and credit risk. In that Exposure Draft, the IASB noted that assessing the contractual cash flow characteristics in accordance with the requirements issued in IFRS 9 (2009) requires judgement, but acknowledged that the proposed clarification introduces a greater degree of judgement and presents a greater risk that hindsight will be necessary to make the assessment. Accordingly, the IASB proposed specific transition requirements for situations in which it is impracticable (for example, because of the risk of using hindsight) to assess a modified economic relationship on the basis of the facts and circumstances that existed at initial recognition of the financial asset.

BC7.55 Specifically, the IASB proposed that in cases in which it is impracticable for an entity to apply the assessment of an asset's contractual cash flow characteristics based on the new requirements, an entity would be required to make that assessment without taking into account the specific requirements related to the modified economic relationship. In other words, the IASB proposed that, in those cases, the entity would apply the assessment of the asset's contractual cash flows characteristics as that assessment was set out in the requirements issued in IFRS 9 (2009); ie without the notion of a modified economic relationship.

BC7.56 During its redeliberations of the 2012 Limited Amendments Exposure Draft, the IASB confirmed the notion of a modified time value of money element in the assessment of an asset's contractual cash flows and therefore also confirmed the transition provision described in paragraph BC7.55. The IASB also noted that a similar transition provision is needed for the exception for particular prepayment features described in paragraph B4.1.12 of IFRS 9. That is because an entity will need to determine whether a prepayable financial asset meets the conditions set out in that paragraph on the basis of the facts and circumstances that existed at the initial recognition of the financial asset, including whether the fair value of the prepayment feature was insignificant. The IASB noted that, in some cases, it may be impracticable for an entity to determine whether the fair value of the prepayment feature was insignificant at the date of initial recognition. For example, this determination might be impracticable if the entity did not account for that embedded prepayment feature separately at fair value through profit or loss as an embedded derivative under IAS 39. Consequently, the IASB decided that in cases in which it is impracticable for an entity to assess whether the fair value of a prepayment feature was insignificant based on the facts and circumstances that existed at the initial recognition of the asset, the entity must assess the contractual cash flow characteristics of the financial asset without taking into account the specific exception for prepayment features.

Fair value option

BC7.57 In accordance with paragraph 7.2.9–7.2.10 of IFRS 9, when an entity initially applies the classification and measurement requirements for financial assets, it is:

(a) permitted to reconsider its fair value option elections for both financial assets and financial liabilities; that is, to elect to apply the fair value option even if an accounting mismatch already existed before the date of initial application and/or revoke the fair value option even if an accounting mismatch continues to exist; and

(b) required to revoke its fair value option elections for both financial assets and financial liabilities if an accounting mismatch no longer exists at the date of initial application.

BC7.58 In accordance with paragraph 7.2.27 of IFRS 9, the transition provisions described in paragraph BC7.57 are available only when the entity initially applies the classification and measurement requirements for financial assets; ie an entity applies those provisions only once. The relevant rationale is set out in paragraphs BC7.19 and BC7.27–BC7.28.

BC7.59 In the deliberations that led to the publication of the 2012 Limited Amendments Exposure Draft, the IASB noted that if an entity had already applied an earlier version of IFRS 9 (ie IFRS 9 (2009), IFRS 9 (2010) or IFRS 9 (2013)), it would have already applied the transition provisions described in paragraph BC7.57. However, the application of the proposals in the 2012 Limited Amendments Exposure Draft could cause some financial assets to be measured differently as compared to a previous version of IFRS 9 and, as a result, new accounting mismatches could arise.

BC7.60 Accordingly, the IASB proposed that an entity that has already applied a previous version of IFRS 9 should, when it applies the proposals in the 2012 Limited Amendments Exposure Draft, be:

(a) permitted to apply the fair value option to new accounting mismatches created by the initial application of the proposed amendments to the classification and measurement requirements; and

(b) required to revoke previous fair value option elections if an accounting mismatch no longer exists as a result of the initial application of the proposed amendments to the classification and measurement requirements.

BC7.61 In other words, an entity would be permitted or required to reconsider its designations under the fair value option only to the extent that previous accounting mismatches no longer exist, or new accounting mismatches are created, as a result of applying the limited amendments to the classification and measurement requirements for financial assets.

BC7.62 During its redeliberations of the 2012 Limited Amendments Exposure Draft, the IASB confirmed the transition provision described above.

Transition disclosures

BC7.63 The IASB decided to clarify the disclosure requirements in IFRS 7 that are relevant to an entity's transition to IFRS 9. That is, the IASB clarified that on transition to IFRS 9, an entity is required to comply with the quantitative disclosures set out in IFRS 7 instead of applying the general quantitative disclosure requirements in other Standards.

BC7.64 Specifically, the IASB amended paragraph 42Q of IFRS 7 to state that an entity need not disclose the line item amounts that would have been reported:

(a) in prior reporting periods in accordance with IFRS 9; or

(b) in the current reporting period in accordance with IAS 39.

BC7.65 The IASB noted that requiring disclosure of the line item amounts that would have been reported in prior reporting periods in accordance with IFRS 9 would contradict paragraph 7.2.15 of IFRS 9, which states that an entity need not restate prior periods.

BC7.66 The IASB considered three primary factors in evaluating whether an entity should be required to disclose line item amounts in the current reporting period in accordance with IAS 39:

(a) the usefulness of the disclosures;

(b) the cost of providing such disclosures; and

(c) whether the existing transition disclosure requirements are sufficient and enable users of financial statements to assess the effect of transition to IFRS 9.

BC7.67 In assessing the usefulness of this disclosure, the IASB considered the interaction at transition to IFRS 9 between the requirements for classification and measurement and hedge accounting. The IASB observed that the concept of hedge accounting does not lend itself to making assumptions about what hedge accounting (under IAS 39) might have been. That is because hedge accounting is an elective accounting treatment that allows the resolution of accounting mismatches. In order to apply hedge accounting, an entity must make that election and then, if the hedging relationship meets the qualifying criteria, the entity prospectively applies hedge accounting. In accordance with IAS 39, an entity can also discontinue hedge accounting at any time and for any reason (or for no reason). This means that any IAS 39-based hedge accounting information 'as if applied in the current period' would be based on highly speculative assumptions. Consequently, the IASB noted that it would be inappropriate to disclose hedge accounting in accordance with IAS 39 in the period during which hedge accounting is first applied in accordance with IFRS 9. Given that conclusion, providing line-item disclosures for classification and measurement in the current period in accordance with IAS 39 would be incomplete, because it would not fully or accurately reflect IFRS 9 relative to IAS 39. The IASB also noted that requiring disclosure of IAS 39 amounts in the current period would require entities to incur the costs of running parallel systems, which could be onerous.

BC7.68 In addition, the IASB noted that IFRS 7 already includes modified transition disclosure requirements that focus on changes in the statement of financial position at the date of initial application of IFRS 9 and also

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focus on the effect on the key financial statement line items for the current period. The IASB believes that these disclosures will allow users of financial statements to assess the effect of transition to IFRS 9. The IASB noted that users of financial statements expressed support for these disclosures because they provide the necessary information to explain the transition.

Transition for first-time adopters of IFRS

BC7.69 The 2012 Limited Amendments Exposure Draft did not propose amendments to IFRS 1. However it specifically requested feedback on transition to IFRS 9 by first-time adopters of IFRS, including whether there are any unique considerations. The IASB stated that the transition to IFRS 9 by first-time adopters would be considered in the redeliberations of the 2012 Limited Amendments Exposure Draft to ensure that they are given adequate lead time to apply IFRS 9 and are not at a disadvantage in comparison to existing IFRS preparers.

BC7.70 Most respondents who provided feedback on this question stated that they were not aware of any unique considerations for first-time adopters. Some specifically stated that the IASB should provide relief to first-time adopters from presenting comparative information that complies with IFRS 9. Generally, this request was made in order to give first-time adopters adequate lead time to prepare for the transition to IFRS 9 and ensure that they are not at a disadvantage compared to existing IFRS preparers.

BC7.71 Consequently, to ensure that first-time adopters are given adequate lead time to apply IFRS 9 and are not at a disadvantage in comparison to existing IFRS preparers, the IASB decided the following:

(a) first-time adopters are not required to present comparative information that complies with the completed version of IFRS 9 (issued in 2014) if the beginning of their first IFRS reporting period is earlier than the mandatory effective date of IFRS 9 plus one year (ie 1 January 2019). This ensures that a first-time adopter is not required to start applying IFRS 9 before an existing IFRS preparer.

(b) if a first-time adopter chooses to present comparative information that does not comply with the completed version of IFRS 9 (issued in 2014), it will be required to provide the same disclosures that were required by IFRS 1 for a first-time adopter that transitioned to IFRS 9 (2009) or IFRS 9 (2010) and that chose not to present comparative information that complied with those new Standards. Those disclosures are set out in paragraph E2 of IFRS 1.

Impairment

BC7.72 The 2013 Impairment Exposure Draft proposed that the expected credit loss requirements should be applied retrospectively on initial application, except when it is not possible to determine, without undue cost and effort, whether the credit risk of a financial instrument has increased significantly since initial recognition. If determining the credit risk on a financial instrument when the instrument was initially recognised would require undue cost or effort, the measurement of the loss allowance should always be determined only on the basis of whether the credit risk is low at the reporting date. However, this requirement did not apply to financial instruments whose past due status is used to assess changes in credit risk, because it is assumed that the information will be available to make the assessment.

BC7.73 In addition, the 2013 Impairment Exposure Draft did not require comparative information to be restated. Entities were, however, permitted to provide restated comparative information if it is possible to do so without the use of hindsight.

BC7.74 IAS 8 provides the principles and framework for changes in accounting policies in the absence of specific transition provisions in a Standard. IAS 8 states that, as a general rule, retrospective application results in the most useful information to users of financial statements, and that it is the preferred approach unless it is impracticable to calculate the period-specific effect or the cumulative effect of the change. The definition of impracticability is relevant to situations in which it is not possible to objectively distinguish the historical information that is relevant for estimating expected credit losses from the information that would not have been available at that earlier date (IAS 8 refers to this situation as 'hindsight').

BC7.75 During development of the proposals in the 2013 Impairment Exposure Draft the IASB identified two main issues about retrospective application for the proposed impairment model:

(a) availability of initial credit risk data—the model relies on entities assessing whether there has been a significant increase in credit risk since the initial recognition of a financial instrument to decide whether they should establish a loss allowance balance at an amount equal to lifetime expected credit losses. Entities told the IASB that they typically do not currently retain information about initial credit risk, so making this assessment on transition is likely to be difficult.

(b) risk of hindsight—entities have not previously been required to recognise or disclose expected credit losses for accounting purposes. Accordingly, there was a risk that hindsight would be needed to recognise and measure the amount of expected credit losses in prior periods.

Alternatives previously considered and rejected

BC7.76 During the deliberations that resulted in the publication of the 2013 Impairment Exposure Draft, the IASB considered and rejected the following alternatives:

(a) grandfathering existing requirements—one approach to transition that would have addressed both of the issues set out in paragraph BC7.75 would have been for the IASB to 'grandfather' the existing impairment requirements for existing financial instruments at the date of initial application. That is, entities would continue to apply the IAS 39 impairment requirements to all financial instruments that exist on transition to the proposed requirements. This would have been a form of prospective application of the proposed requirements. This grandfathering approach would have removed the need to measure expected credit losses for periods prior to the application of the proposed requirements, and would also have eliminated the problem of applying the proposed requirements to financial instruments for which information about the credit risk at initial recognition is not available or would have been very burdensome to obtain on transition to the proposed requirements. It would also have allowed the IASB to specify an earlier mandatory effective date than would otherwise be possible if full retrospective application was required (ie retrospective application that also includes a restatement of comparative periods). Although those who are concerned about the potentially significant effect on equity when making the transition to the new model (which may have regulatory consequences for some) may view this approach positively, it would delay the improvements to accounting for expected credit losses and would reduce comparability. In addition, entities would need to prepare information in accordance with both the IAS 39 impairment model and the new impairment model until they derecognised all grandfathered financial instruments, which would be burdensome, at least for some entities. For these reasons, the IASB rejected the grandfathering approach to transition.

(b) resetting the credit risk at initial recognition of the financial instrument so that it reflects the credit risk at the date that the proposed model is initially applied—this would have been the least burdensome of the three alternatives to apply, because entities would ignore credit history for all financial instruments. An entity would consider deteriorations or improvements in credit risk from the date of initial application of the proposed model, instead of relative to the credit risk at initial recognition. The IASB rejected this approach because it would have ignored changes in credit risk that had occurred since initial recognition and would not have faithfully represented expected credit losses.

(c) recognising a loss allowance at an amount equal to lifetime expected credit losses on transition until derecognition for financial instruments for which an entity does not use initial credit risk information—this alternative would have been relatively simple to apply because there would have been no requirement for an entity to analyse changes in credit risk either at transition or over the life of the relevant instruments. However, this alternative is inconsistent with the objective of the overall model, which is designed to reflect changes in credit risk. This approach would also have resulted in an entity recognising lifetime expected credit losses for financial instruments whose credit risk is actually better than that on initial recognition.

Availability of initial credit risk data

BC7.77 The 2013 Impairment Exposure Draft proposed that an entity should use available information about credit risk at initial recognition for existing financial instruments when it applies the impairment requirements for the first time, unless obtaining such information requires undue cost or effort. For financial instruments for which an entity has not used information about the initial credit risk on transition, an entity would recognise lifetime expected credit losses, except if the credit risk was low, at each reporting date until the financial instrument was derecognised.

BC7.78 The IASB considered that such an approach should be relatively simple to apply, because it would not require any assessment of changes in credit risk for these financial instruments relative to the initial credit risk. In addition, it corresponds with credit risk management systems that assess credit risk as at the reporting date. However, the IASB decided that this relief would not be appropriate when an entity uses the past due status of payments to apply the model, because in these cases an entity would have the necessary information to decide whether a financial instrument has deteriorated since initial recognition.

BC7.79 The IASB acknowledged that if an entity uses an approach that is based solely on credit risk at the reporting date, then, when the entity is deciding the amount of expected credit losses to recognise, that approach will

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not allow the entity to consider the increases in credit risk that have occurred since initial recognition. Thus, entities would be required to recognise lifetime expected credit losses for a financial instrument for which the credit risk is not considered low, even if the instrument had been priced to reflect that risk and there has not been a significant increase in credit risk since initial recognition. It would also have a more negative impact for entities whose business model focuses on originating or purchasing financial instruments with credit risk that is not low (for example, their credit risk is not equivalent to investment grade). Requiring an assessment of the credit risk alone might encourage the use of information about the initial credit risk on transition to the proposed requirements, which will enhance comparability and the quality of the information provided. However, under some circumstances, such an approach may discourage the use of information about initial credit risk, particularly if an entity is able to absorb lifetime expected credit losses on those financial instruments on transition to the proposed requirements. While acknowledging the inconsistency with the overall model, the IASB decided that such an approach was the best way to balance the provision of useful information with the associated cost of providing it.

BC7.80 The majority of respondents to the 2013 Impairment Exposure Draft supported the proposed transition requirements. Respondents noted that these proposals achieve a balance between the cost to implement the proposals and presenting relevant information. However, respondents asked the IASB to consider practical ways in which to assess whether, at the date of initial application, there have been significant increases in credit risk since initial recognition. Respondents noted that the proposed requirements could effectively result in the loss allowance for all financial instruments that are not considered to have low credit risk to be measured at lifetime expected credit losses if the entity could not obtain information about the credit risk at initial recognition. They argued that if financial instruments were inappropriately measured at lifetime expected credit losses, it might result in large releases of loss allowance balances when the instruments are derecognised.

BC7.81 The IASB considered that the intention was not to penalise entities that could not obtain information about the initial credit risk without undue cost or effort. It also noted that an entity need not have specific information about the initial credit risk of a financial instrument and clarified this in IFRS 9. For example, the IASB noted that if an entity is able to assess the change in credit risk of a financial instrument on the basis of a portfolio analysis, such an approach could similarly be applied on transition to assess the change in credit risk since initial recognition.

Restatement of comparative periods, including the use of hindsight

BC7.82 At the date of initial application of the requirements in IFRS 9, the transition requirements permit, but do not require, the restatement of comparative periods if the necessary information is available without the use of hindsight (see paragraphs BC7.34A–BC7.34M). This was also proposed in the 2013 Impairment Exposure Draft to address the risk of hindsight being used to decide whether lifetime expected credit losses would be required to be recognised in prior periods and, more generally, in measuring expected credit losses in prior periods. This would prevent entities 'looking back' to make those determinations. Instead, at the beginning of the period in which the proposed model were to be initially applied, an entity would adjust the loss allowance to be in accordance with the proposed model at that date, with an adjustment to an opening component of equity. An entity would still apply the proposed model on a (modified) retrospective basis, because the loss allowance balances would be determined on the basis of information about initial credit risk, subject to the transition relief. As a result, an entity would still assess the changes in credit risk since the initial recognition of financial instruments to decide whether, on transition to the new requirements, it should measure the loss allowance at an amount equal to lifetime or 12-month expected credit losses. A prohibition on restating comparatives would mean that an entity could only reflect the loss allowance balances that result from applying the new model in the financial statements from the beginning of the current period in which the entity applies the proposals for the first time.

BC7.83 The IASB noted that another way to address the risk of hindsight might be to allow a long lead time between issuing the new requirements and the mandatory effective date, so that an entity could calculate expected credit losses contemporaneously for comparative periods to provide restated comparative information. However, in considering a longer lead time, the IASB noted the urgency of this project. Establishing a lead time that would allow an entity to apply the proposed model on a retrospective basis, including the provision of restated comparative information, in a way that addresses the risk of hindsight would result in a significant delay between issuing the final requirements and their mandatory application.

BC7.84 The vast majority of respondents agreed with the transition proposals not to require, but to allow, the restatement of comparative information if the necessary information is available without the use of hindsight. Consequently, the IASB confirmed those proposals during redeliberations.

Transition for first-time adopters of IFRS

BC7.85 The 2013 Impairment Exposure Draft did not propose amendments to IFRS 1. However it specifically requested feedback on transition to IFRS 9 by first-time adopters of IFRS, including whether there are any unique considerations. In the redeliberations on the proposals in the 2013 Impairment Exposure Draft, the IASB confirmed that the same transition relief available on the initial application of the requirements in Section 5.5 of IFRS 9 should be available to first-time adopters of IFRS (see also paragraphs BC7.72–BC7.75).

Amendments for *Interest Rate Benchmark Reform—Phase 2* (August 2020)

Mandatory application

BC7.86 The IASB decided to require application of the Phase 2 amendments. The IASB considered that allowing voluntary application of these amendments could lead to selective application to achieve specific accounting results. The IASB also noted that the amendments are, to a large extent, interlinked and need to be applied consistently. Voluntary application, even if only possible by area or type of financial instruments, would reduce comparability of information provided in the financial statements between entities. The IASB also does not expect that mandatory application of these amendments would result in significant additional costs for preparers and other affected parties because these amendments are designed to ease the operational burden on preparers, while providing useful information to users of financial statements, and would not require significantly more effort by preparers in addition to what is already required to implement the changes required by the reform.

End of application

BC7.87 The IASB did not add specific end of application requirements for the Phase 2 amendments because the application of these amendments is associated with the point at which changes to financial instruments or hedging relationships occur as a result of the reform. Therefore, by design, the application of these amendments has a natural end.

BC7.88 The IASB noted that, in a simple scenario, the Phase 2 amendments will be applied only once to each financial instrument or element of a hedging relationship. However, the IASB acknowledged that because of differences in the approach to the reform applied in different jurisdictions, and differences in timing, implementing the reform could require more than one change to the basis for determining the contractual cash flows of a financial asset or a financial liability. This could be the case, for example, when a central authority, as the administrator of an interest rate benchmark, undertakes a multi-step process to replace an interest rate benchmark with an alternative benchmark rate. As each change to the basis for determining the contractual cash flows of the instrument is made as required by the reform, an entity would be required to apply the Phase 2 amendments to account for that change.

BC7.89 As noted in paragraph 6.9.3 of IFRS 9, the IASB considered that an entity may be required to amend the formal designation of its hedging relationships at different times, or to amend the formal designation of a hedging relationship more than once. For example, an entity may first make changes required by the reform to a derivative designated as a hedging instrument, while only making changes required by the reform to the financial instrument designated as the hedged item later. In applying the amendments, the entity would be required to amend the hedge documentation to amend the description of the hedging instrument. The hedge documentation of the hedging relationship would then have to be amended again to change the description of the hedged item and/or hedged risk as required in paragraph 6.9.1 of IFRS 9.

BC7.90 The amendment for hedges of risk components in paragraph 6.9.11 of IFRS 9 applies only at the date an entity first designates a particular alternative benchmark rate as a non-contractually specified risk component for the first time if an entity's ability to conclude that an alternative benchmark rate is separately identifiable is directly affected by the reform. Thus, an entity could not apply this amendment in other circumstances in which the entity is not able to conclude that an alternative benchmark rate is a separately identifiable risk component.

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Effective date and transition

BC7.91 Acknowledging the urgency of the amendments, the IASB decided that entities must apply the Phase 2 amendments for annual periods beginning on or after 1 January 2021, with earlier application permitted.

BC7.92 The IASB decided that the amendments apply retrospectively in accordance with IAS 8 (except as discussed in paragraphs BC7.94–BC7.98) because prospective application would have resulted in entities applying the amendments only if the transition to alternative benchmark rates occurred after the effective date of the amendments.

BC7.93 The IASB acknowledged that there could be situations in which an entity amended a hedging relationship as specified in paragraph 6.9.1 of IFRS 9 in a period before the entity first applied the Phase 2 amendments; and in the absence of the Phase 2 amendments, IFRS 9 would require the entity to discontinue hedge accounting. The IASB noted that the reasons for the amendment in paragraph 6.9.1 of IFRS 9 (see paragraphs BC6.608–BC6.609), apply equally in such situations. The IASB therefore considered that discontinuation of hedge accounting solely because of amendments an entity made in hedge documentation to reflect appropriately the changes required by the reform, regardless of when those changes occurred, would not provide useful information to users of financial statements.

BC7.94 The IASB acknowledged that the reinstatement of discontinued hedging relationships is inconsistent with the IASB's previous decisions about hedge accounting in IFRS 9. This is because hedge accounting is applied prospectively and applying it retrospectively to discontinued hedging relationships usually requires the use of hindsight. However, the IASB considered that in the specific circumstances of the reform, an entity would typically be able to reinstate a discontinued hedging relationship without the use of hindsight. The IASB noted that this reinstatement of discontinued hedging relationships would apply to a very targeted population for a short period—that is, for hedging relationships which would not have been discontinued if the Phase 2 amendments relating to hedge accounting had been applied at the point of discontinuation. The IASB therefore proposed in the 2020 Exposure Draft that an entity would be required to reinstate hedging relationships that were discontinued solely due to changes required by the reform before an entity first applies the proposed amendments.

BC7.95 Respondents to the 2020 Exposure Draft generally supported and welcomed the transition proposals but asked the IASB to reconsider a specific aspect of the proposal that would require entities to reinstate particular discontinued hedging relationships. Specifically, these respondents highlighted circumstances in which reinstating discontinued hedging relationships would be challenging or have limited benefit—for example, when:

(a) the hedging instruments or the hedged items in the discontinued hedging relationships have been subsequently designated into new hedging relationships;

(b) the hedging instruments in the discontinued hedging relationships no longer exist at the date of initial application of the amendments—eg they have been terminated or sold; or

(c) the hedging instruments in the discontinued hedging relationships are now being managed within a trading mandate with other trading positions and reported as trading instruments.

BC7.96 The IASB noted that the transition requirements as proposed in the 2020 Exposure Draft to apply the amendments retrospectively in accordance with IAS 8—including the requirement to reinstate particular discontinued hedging relationships—would be subject to impracticability applying IAS 8. However, the IASB agreed with respondents' concerns that there could be other circumstances in which it would not be impracticable to reinstate the hedging relationship, but such reinstatement would be challenging or would have limited benefit. For example, if the hedging instrument or hedged item has been designated in a new hedging relationship, it appears inappropriate to require entities to reinstate the 'old' (original) hedging relationship and discontinue or unwind the 'new' (valid) hedging relationship. Consequently, the IASB added paragraph 7.2.44(b) to IFRS 9 to address these concerns.

BC7.97 In addition, the IASB concluded that if an entity reinstates a discontinued hedging relationship applying paragraph 7.2.44 of IFRS 9, for the purpose of applying paragraphs 6.9.11–6.9.12 of IFRS 9, the 24-month period for the alternative benchmark rate designated as a non-contractually specified risk component begins from the date of initial application of the Phase 2 amendments (ie it does not begin from the date the entity designated the alternative benchmark rate as a non-contractually specified risk component for the first time in the original hedging relationship).

BC7.98 Consistent with the transition requirements for Phase 1, the IASB decided that an entity is not required to restate comparative information. However, an entity may choose to restate prior periods if, and only if, it is possible without the use of hindsight.

BC7.99 The IASB decided that it did not need to amend IFRS 1. Entities adopting IFRS Standards for the first time as required by IFRS 1 would apply IFRS Standards, including the Phase 2 amendments, and the transition requirements in IFRS 1 as applicable.

Analysis of the effects of IFRS 9

Introduction

BCE.1 Before the IASB issues new requirements, or makes amendments to existing Standards, it considers the costs and benefits of the new pronouncements. This includes assessing the effects on the costs for both preparers and users of financial statements. The IASB also considers the comparative advantage that preparers have in developing information that would otherwise cost users of financial statements to develop. One of the main objectives of developing a single set of high quality global accounting Standards is to improve the allocation of capital. The IASB therefore takes into account the benefits of economic decision-making resulting from improved financial reporting. The IASB gains insight on the likely effects of the proposals for new or revised Standards through its formal exposure of proposals and through its analysis and consultations with relevant parties through outreach activities.

BCE.2 The IASB conducted extensive outreach activities with interested parties for each phase of IFRS 9. This included extensive discussions with regulators, users of financial statements, preparers and audit firms worldwide. In addition, as part of the Impairment project, the IASB formed the Expert Advisory Panel (EAP) to address some of the operational challenges of an expected cash flow approach and conducted fieldwork to assess the proposals of the 2013 Exposure Draft *Financial Instruments: Expected Credit Losses* (the '2013 Impairment Exposure Draft'). This Effects Analysis is based on the feedback received through this process.

BCE.3 The evaluation of costs and benefits are necessarily qualitative, instead of quantitative. This is because quantifying costs and, particularly, benefits, is inherently difficult. Although other standard-setters undertake similar types of analyses, there is a lack of sufficiently well-established and reliable techniques for quantifying this analysis. Consequently, the IASB sees this Effects Analysis as being part of an evolving process. In addition, the assessment undertaken is that of the likely effects of the new requirements, because the actual effects will not be known until after the new requirements have been applied. These are subsequently analysed through the Post-implementation Review process.

BCE.4 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely associated ongoing costs and benefits of each new Standard—these costs and benefits are collectively referred to as 'effects'.

BCE.5 In evaluating the likely effects of the proposals, the IASB has considered how:

(a) activities would be reported in the financial statements of those applying IFRS;

(b) comparability of financial information would be improved both between different reporting periods for the same entity and between different entities in a particular reporting period;

(c) more useful financial reporting would result in better economic decision-making;

(d) better economic decision-making as a result of improved financial reporting could be achieved;

(e) the compliance costs for preparers would likely be affected; and

(f) the costs of analysis for users of financial statements would likely be affected.

BCE.6 Paragraphs BCE.7–BCE.238 describe the IASB's analysis of the likely effects that will result from IFRS 9. It reflects the three phases of IFRS 9, with the analysis of the classification and measurement requirements described in paragraphs BCE.7–BCE.89, the impairment requirements described in paragraphs BCE.90–BCE.173 and the hedge accounting requirements described in paragraphs BCE.174–BCE.238.

Analysis of the effects: classification and measurement

Overview

BCE.7 Many users of financial statements and other interested parties have told the IASB that the requirements in IAS 39 are difficult to understand, apply and interpret. They have urged the IASB to develop a new Standard for the financial reporting for financial instruments that is principle-based and less complex. The need to

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enhance the relevance and understandability of information about financial instruments was also raised by respondents to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* (published in 2008). That need became more urgent in the light of the global financial crisis, so the IASB decided to replace IAS 39 in its entirety as expeditiously as possible.

BCE.8 IFRS 9 is the IASB's response to the need to improve and simplify the financial reporting for financial instruments. The IASB believes that the new classification and measurement requirements address the issue that IAS 39 has many classification categories for financial assets, each with its own rules for determining which financial asset must, or can be, included and how impairment is identified and measured.

BCE.9 Overall, the IASB's assessment is that the classification and measurement requirements in IFRS 9 will bring significant and sustained improvements to the reporting of financial instruments because they:

(a) introduce a logical and clear rationale for the classification and measurement of financial assets. It is a principle-based approach, in contrast to the complex rules in IAS 39, which often result in financial assets being measured on the basis of free choice.

(b) eliminate the complex requirements for bifurcating hybrid financial assets because financial assets will be classified in their entirety.

(c) require reclassification between measurement categories when, and only when, the entity's business model for managing them changes. This eliminates the complex rules for reclassification in IAS 39 and ensures that users of financial statements are always provided with information that reflects how the cash flows on financial assets are expected to be realised.

(d) accommodate known business models with objectives to hold financial assets to collect contractual cash flows or that result in both collecting contractual cash flows and selling financial assets.

(e) respond to the long-standing concerns about the volatility that occurs in profit or loss due to changes in own credit risk when an entity elects to measure non-derivative financial liabilities at fair value. But otherwise the existing accounting for financial liabilities has been retained because it has worked well in practice.

BCE.10 The classification and measurement requirements included in IFRS 9 change many aspects of IAS 39 and these changes will affect a variety of preparers. However, it is difficult to generalise the likely impact on these entities, because it depends on their individual circumstances. In particular, the overall change in the classification of financial assets will depend on the choices previously made by preparers in applying IAS 39, their business models for managing the financial assets and the contractual cash flow characteristics of their financial assets.

BCE.11 It was not the IASB's objective to increase or decrease the application of fair value measurement, instead the IASB wanted to ensure that financial assets are measured in a way that provides useful information to investors and other users of financial statements to predict likely future cash flows. Whether an entity will have more or fewer financial assets measured at fair value through profit or loss as a result of applying IFRS 9 will depend on the way in which the financial assets are being managed (ie the entity's business model) and the characteristics of the instrument's contractual cash flows. For example, a financial asset with contractual cash flows that are solely payments of principal and interest on the principal amount outstanding will be measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss, depending on the entity's business model (ie amortised cost if the financial assets are held to collect the contractual cash flows or fair value through other comprehensive income if the financial assets are held within a business model whose objective is achieved by collecting contractual cash flows and selling the financial assets and otherwise at fair value through profit or loss).

BCE.12 The requirements for the classification of financial liabilities are largely unchanged from IAS 39. This reflects feedback received that the accounting for financial liabilities has worked well in practice, except for the issue of own credit. However, IFRS 9 addresses the own credit issue by requiring the changes in fair value attributable to changes in the liability's credit risk to be recognised in other comprehensive income for financial liabilities that an entity elects to measure at fair value.

BCE.13 The IASB expects that most costs for preparers will be incurred on transition. The ongoing costs will be mitigated primarily by the fact that:

(a) the business model assessment for the classification of a financial asset is determined on an aggregate basis and is a matter of fact (ie consistent with the entity's actual business model rather being simply an accounting concept);

(b) the contractual cash flow assessment for financial assets need not be analysed in all business models; and

(c) the requirements for the classification of financial liabilities are largely unchanged or should not create incremental costs (such as for the new own credit requirements given that entities are already required to disclose the gains or losses recognised for changes in own credit risk).

The IASB's assessment is that the significant improvements in terms of comparability and transparency will outweigh those costs.

How activities would be reported in the financial statements of those applying IFRS

BCE.14 The following analysis focuses on the key differences between the existing classification model in IAS 39 and the new classification and measurement model in IFRS 9 and how the new model will affect financial reporting.

Objective of the classification and measurement requirements of IFRS 9

BCE.15 The classification and measurement requirements are part of the IASB's response to a long recognised need to improve the accounting for financial instruments.

BCE.16 In view of the criticisms of IAS 39, the IASB introduced a single classification approach for all financial assets in IFRS 9 that is principle-based. Its objective is to faithfully represent, in the financial statements, how the cash flows on financial assets are expected to be realised.

BCE.17 The classification approach is based on the entity's business model and thereby focuses on the matter of fact instead of on management's intention or free choice as is often the case in IAS 39. Most interested parties have agreed that information is improved by a single classification approach as introduced by IFRS 9.

BCE.18 The requirements for the classification and measurement of financial liabilities are largely unchanged from IAS 39, except for the own credit requirements, which was a response to long-standing concerns about the volatility that occurs in profit or loss because of changes in an issuer's own credit risk.

Approach to classifying financial assets

BCE.19 IAS 39 requires financial assets to be classified into one of four categories, each having its own eligibility criteria and different measurement requirements. The eligibility criteria are a combination of the nature of the instrument, its manner of use and management choice.

BCE.20 The IASB believed that the best way to address the complexity arising from the different classification categories in IAS 39 was to replace them with a single classification approach based on a logical structure and clear rationale. IFRS 9 requires entities to classify financial assets on the basis of the entity's business model for managing the financial assets and the characteristics of the financial asset's contractual cash flows.

BCE.21 The business model is relevant to the classification because it determines whether an entity's future cash flows will arise from contractual amounts or by realising the fair value. The nature of the contractual cash flows is relevant to ensure that the cash flows on a financial asset can be properly and adequately reflected by amortised cost measurement, which is a simple technique for allocating interest over the life of a financial instrument. In IFRS 9 such simple cash flows are described as being 'solely payments of principal and interest'.

BCE.22 The requirements issued in IFRS 9 (2009) included only two categories for financial assets—amortised cost and fair value through profit or loss. Financial instruments were classified and measured at amortised cost only if:

(a) they are held in a business model whose objective is to hold financial assets in order to collect contractual cash flows ('held to collect' business model); and

(b) their contractual cash flow terms represented solely payments of principal and interest.

In accordance with the requirements issued in IFRS 9 (2009), all other financial assets were measured at fair value through profit or loss.

BCE.23 The completed version of IFRS 9, issued in 2014, introduces a fair value through other comprehensive income measurement category for debt instruments but retains the classification structure that always existed in IFRS 9. Accordingly, a financial asset shall be measured at fair value through other comprehensive income if:

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(a) it is held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial instruments; and

(b) its contractual cash flows represent solely payments of principal and interest.[47]

In this measurement category the statement of financial position will reflect the fair value carrying amount while amortised cost information will be presented in profit or loss. The difference between the fair value information and amortised cost information will be recognised in other comprehensive income.

BCE.24 The fair value through other comprehensive income measurement category was added to IFRS 9 in response to feedback requesting accommodation of known business models whose objective results in both collecting contractual cash flows and selling financial assets. This means that both amortised cost (ie information about contractual cash flows) and fair value information are relevant. In addition to providing relevant and useful information for financial assets that are held within a 'hold to collect and sell' business model, the introduction of the fair value through other comprehensive income measurement category also addresses potential accounting mismatches that could arise because of the interaction between the accounting for financial assets and the accounting for insurance contract liabilities.

BCE.25 Although the fair value through other comprehensive income measurement category has been introduced, the existing structure of IFRS 9 has been retained. Thus, IFRS 9 still eliminates the specific rules (which dictate how an asset can or must be classified) and accounting choice in IAS 39. For example, the fair value through other comprehensive income measurement category in IFRS 9 is fundamentally different to the available-for-sale measurement category in IAS 39. That is because financial assets are classified on the basis of their contractual cash flow characteristics and of the business model in which they are held. In contrast, the available-for-sale measurement category in IAS 39 is essentially a residual classification and, in many cases, is a free choice.

Bifurcation of embedded features in financial assets

BCE.26 Another key change is that IFRS 9 eliminates the application of the complex, internally inconsistent and rule-based requirements in IAS 39 for the bifurcation of hybrid financial assets.

BCE.27 In accordance with IFRS 9, a financial asset is accounted for in its entirety on the basis of its contractual cash flow features and the business model within which it is held. Thus, under IFRS 9, a hybrid financial asset is classified as a whole using the same classification approach as all other financial assets. That is in contrast to IAS 39, in which components of a financial asset could have been classified and measured separately—resulting in a component of a financial asset being measured at amortised cost or classified as available-for-sale, while some or all of the embedded features were measured at fair value through profit or loss, even though the financial asset was a single instrument that was settled as a whole on the basis of all of its features.

BCE.28 Consequently, IFRS 9 simplifies the classification of hybrid financial instruments. Consistently with all other financial assets, hybrid contracts with financial asset hosts are classified and measured in their entirety, thereby eliminating the complexity of bifurcation for financial assets.

Effect of classification on impairment

BCE.29 IAS 39 requires different impairment assessments and methods for financial assets depending on their classification. Some of those impairments could not be reversed.

BCE.30 During the global financial crisis some users of financial statements were confused, because the same financial assets were impaired differently simply because they were classified differently for accounting purposes.

BCE.31 As a result of the classification requirements issued in IFRS 9 (2009), only financial assets measured at amortised cost were subject to impairment accounting. IFRS 9 (2014) extends the impairment model to financial assets measured at fair value through other comprehensive income. Consequently, the same impairment model is applied for all financial assets that are not measured at fair value through profit or loss (ie financial assets measured at amortised cost and financial assets measured at fair value through other comprehensive income). This replaces the many different impairment methods that are associated with the numerous classification categories in IAS 39 and thereby addresses the criticism that the impairment models in IAS 39 were not aligned and were therefore confusing. In addition, by using the same impairment model,

[47] The fair value through other comprehensive income measurement category is available only for debt instruments. It is different from the presentation election set out in paragraph 5.7.5 of IFRS 9 that permits an entity to present in other comprehensive income subsequent changes in the fair value of particular investments in equity instruments.

amortised cost information is provided in profit or loss for financial assets measured at fair value through other comprehensive income.

Reclassification

BCE.32 IAS 39 includes complex rules for the reclassification of financial assets, and different entities could choose to reclassify financial assets in different circumstances. In contrast, IFRS 9 requires the reclassification of financial assets when, and only when, the business model for managing those financial assets changes. IFRS 9 states that changes in a business model are demonstrable events and are expected to be very infrequent. For example, a change in a business model can arise from a business combination or if a reporting entity changes the way it manages its financial assets following the acquisition of a new business. By requiring financial assets to be reclassified when the business model changes, IFRS 9 ensures that relevant information is always provided about the cash flows that an entity expects to realise from managing its financial assets.

The cost exception for unquoted equity investments

BCE.33 IAS 39 has an exception to the measurement requirements for investments in unquoted equity instruments that do not have a quoted market price in an active market (and derivatives on such an instrument) and for which fair value cannot therefore be measured reliably. Such financial instruments are measured at cost. IFRS 9 removes this exception, requiring all equity investments (and derivatives on them) to be measured at fair value. However, IFRS 9 provides guidance on when cost may be an appropriate estimate of fair value.

Gains and losses—equity investments

BCE.34 IFRS 9 provides a presentation option for investments in equity instruments that are not held for trading. Otherwise, equity investments are measured at fair value through profit or loss.

BCE.35 IFRS 9 permits an entity to make an irrevocable election on an instrument-by-instrument basis to present in other comprehensive income changes in the fair value of an investment in an equity instrument that is not held for trading. Dividends received from those investments are presented in profit or loss. Gains and losses presented in other comprehensive income cannot be subsequently transferred to profit or loss (ie there is no recycling). However, the entity may transfer the cumulative gain or loss within equity.

BCE.36 Although the IASB believes that fair value provides the most useful information about investments in equity instruments to users of financial statements, the IASB provided this presentation option because it notes that changes in the value of particular investments in equity instruments may not be indicative of the performance of the entity. This would be the case, for example, if the entity holds those equity instruments primarily for non-contractual benefits. Another reason was because users of financial statements often differentiate between fair value changes arising from equity investments held for purposes other than generating investment returns and equity investments held for trading.

BCE.37 The IASB decided to prohibit recycling of gains and losses into profit or loss when an equity investment is derecognised, even though many respondents said that subsequent transfers of fair value changes to profit or loss should be required. These respondents view the sale of an investment as the realisation of the changes in its fair value. However, such recycling of gains and losses would have made it necessary to introduce an impairment test to ensure that impairments were presented on a consistent basis. Impairment accounting for equity investments has been a significant source of complexity in IAS 39. The IASB thus decided that introducing recycling and associated impairment accounting would create application problems in practice and would not significantly improve or reduce the complexity of the financial reporting for financial assets. Accordingly, the IASB decided to prohibit recycling.

BCE.38 Although IFRS 9 prohibits recycling of gains and losses into profit or loss when an equity investment is derecognised, entities are able to transfer the cumulative gain or loss within equity at any time; for example, to provide information on realisation. The IASB considered specific requirements relating to that transfer, such as requiring the accumulated gain or loss to be transferred to retained earnings upon derecognition of the equity investment, but did not adopt such an approach because of jurisdiction-specific restrictions on components of equity. For example, a transfer to retained earnings may give rise to tax consequences in some jurisdictions. However, additional disclosures are required about investments in equity instruments with fair value changes presented in other comprehensive income to provide useful information to users of financial statements about the effect of that presentation for instruments presented in that manner. For example, paragraph 11B of IFRS 7 requires an entity to disclose the cumulative gain or loss on disposal if the entity derecognised investments in equity instruments with fair value changes presented in other comprehensive income during the reporting period.

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Main changes to the approach to classifying and measuring financial liabilities

BCE.39 IFRS 9 carries forward almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities, including the bifurcation of particular embedded derivatives. As a result, most financial liabilities, apart from derivatives or financial liabilities that an entity designates under the fair value option, will continue to be measured at amortised cost.

BCE.40 The main concern that the IASB was asked to address in relation to financial liabilities was the so-called 'own credit' issue, whereby changes in the credit risk of a financial liability give rise to gains or losses in profit or loss. For financial liabilities designated under the fair value option, the requirements issued in IFRS 9 (2010) required an entity to present in other comprehensive income changes in the fair value of a financial liability that are attributable to changes in credit risk.[48]

BCE.41 Users of financial statements continued to support the measurement of financial liabilities on the balance sheet at fair value in accordance with the fair value option noting that this provided a useful source of information on a timely basis about changes in an entity's credit quality. However, the requirement to present these fair value changes in other comprehensive income addressed the concern raised by many, including users of financial statements, that reflecting these fair value changes in profit or loss is counterintuitive and does not result in useful information. In particular, the requirement addresses the concern that a gain is recognised in profit or loss as the credit risk on a financial liability increases (ie its credit quality deteriorates).

BCE.42 The requirements issued in IFRS 9 (2010) enabled entities to apply the change to the presentation of such fair value gains and losses only if all the requirements in that Standard for the classification and measurement of financial assets and liabilities were applied. However, the requirements issued in IFRS 9 (2013) changed this requirement. Consequently, prior to the mandatory effective date of IFRS 9 an entity is permitted to apply the requirements for the presentation of own credit in isolation; ie earlier than the other requirements in IFRS 9.

BCE.43 This allows entities to present the effects of own credit in other comprehensive income, thus improving their financial reporting, without also needing to make other changes to their accounting for financial instruments. It makes the own credit requirements available on a more timely basis, particularly because an entity will be able to make this change before undertaking the changes that would be required in order to implement the expected credit loss impairment model.

Early application

BCE.44 In order to address critical issues during the global financial crisis and to make improvements to financial reporting available more quickly, the IASB decided to replace IAS 39 in phases and to allow entities to early apply only some phases of IFRS 9 (although if a later phase was applied, earlier phases were also required to be applied). Consequently, entities had the option to apply only the requirements for financial assets (IFRS 9 (2009)), the requirements for financial assets and financial liabilities (IFRS 9 (2010)) or the requirements for financial assets, financial liabilities and hedge accounting (IFRS 9 (2013)). In contrast, six months from the issue in 2014 of the completed version of IFRS 9, an entity that newly elects to apply IFRS 9 must either apply the entire Standard (ie all of the classification and measurement, impairment and hedge accounting requirements in the completed version of IFRS 9) or apply only the own credit requirements.[49]

BCE.45 This means that before the mandatory effective date of the completed version of IFRS 9, fewer combinations of the accounting for financial instruments will be available than was previously the case. Having multiple versions of IFRS 9 available for early application (in addition to IAS 39) is complex and would significantly reduce the comparability of information that is provided to users of financial statements.

Comparability of financial information

BCE.46 At a high level, classification and measurement, in accordance with both IAS 39 and IFRS 9, requires consideration of similar aspects of financial instruments—their contractual cash flow characteristics and how they are managed. However, IAS 39 and IFRS 9 approach these aspects of financial instruments in very different ways. IAS 39 is complex and rule-based and the classification of financial assets places emphasis on an entity's intentions in respect of individual financial assets and also considers aspects such as the liquidity of the market for a financial asset. IAS 39 also involves an element of free choice. As discussed in the following paragraphs, IFRS 9 provides a logical structure and a clearer rationale for the classification and

[48] This applies unless that treatment would create or enlarge an accounting mismatch in profit or loss, in which case all changes in fair value are presented in profit or loss.

[49] However, entities have an accounting policy choice between applying the new hedge accounting requirements of IFRS 9 and retaining the existing requirements in IAS 39.

measurement of financial assets, with less accounting choice. Consequently, differences in financial reporting between reporting periods for an individual entity, and between different entities in a particular reporting period, will more often reflect the differences in underlying economics instead of resulting from differences in accounting choices. Or, put another way, similar financial assets managed in the same way should be classified in the same way for accounting purposes.

The business model assessment

BCE.47 In contrast to IAS 39, the business model assessment in IFRS 9 is determined by how financial assets are actually managed. This is not a question of intention for an individual instrument but is instead based on an assessment of objective evidence at a higher level of aggregation. As a result, the assessment is a matter of fact, which results in less accounting choice than is available in IAS 39.

BCE.48 The IASB was made aware of differences in the interpretation of these requirements as they were issued in IFRS 9 (2009) so the completed version of IFRS 9 (issued in 2014) reaffirms and supplements the business model principle. It emphasises that the business model assessment focuses on how the entity actually manages financial assets to generate cash flows. In addition, IFRS 9 (2014) enhances the application guidance for the 'hold to collect' business model, addressing particular application questions raised by interested parties since the issue of IFRS 9 in 2009. It expands the discussion about the activities that are commonly associated with the hold to collect business model, clarifying, for example, that entities do not need to hold all assets until maturity and that sales in themselves do not determine the objective of the business model (although information about sales can be useful in determining an entity's business model). The clarifications are expected to improve comparability by enhancing the consistency in how different entities apply the hold to collect business model and classify their financial assets.

BCE.49 As discussed in paragraph BCE.23, a fair value through other comprehensive income measurement category was introduced to IFRS 9 in 2014. The fair value through other comprehensive income measurement category will allow some business models to be better reflected in the financial statements, improving comparability between entities with economically similar instruments that are managed in a similar way.

Reclassifications

BCE.50 A further improvement to the comparability of financial information is that, compared to the complex rules for reclassification in IAS 39, IFRS 9 makes reclassifications between measurement categories mandatory when, and only when, there has been a change in the entity's business model.

BCE.51 The reclassification requirements will enhance comparability because an entity will generally account for its financial instruments consistently over time. The exception will be in the rare circumstance that an entity's business model changes, in which case the required reclassification strengthens comparability because financial assets will be accounted for consistently with how they are managed.

Usefulness of financial information in assessing the future cash flows of an entity

Financial assets

BCE.52 In the Basis for Conclusions on IFRS 9, the IASB acknowledges that some users of financial statements support a single measurement method—fair value—for all financial assets. However, the IASB continues to believe that both amortised cost and fair value can provide useful information to users of financial statements for particular types of financial assets in particular circumstances. In issuing IFRS 9, the IASB did not seek to increase or reduce the use of fair value measurement. Instead, it sought to ensure that information based on a specific measurement attribute is provided when it is relevant. The IASB decided that if the measurement attribute for financial assets and the assets' effect on profit or loss are aligned with both the business model for managing financial assets and their contractual cash flow characteristics, financial reporting will provide relevant information about the timing, amounts and uncertainty of an entity's future cash flows.

The business model

BCE.53 The business model for managing financial assets determines whether their cash flows are realised through the collection of contractual cash flows, the sale of financial assets or both. Consequently, the business model

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provides information that is useful in assessing the amounts, timing and uncertainty of the entity's future cash flows.

BCE.54 If the objective of an entity's business model is to collect contractual cash flows then, depending on the characteristics of the contractual cash flows, amortised cost measurement in both the statement of financial position and in profit or loss provides information about future cash flows. However, in contrast, if the objective of the business model is achieved by realising cash flows by selling financial assets, fair value measurement provides more relevant information about future cash flows in both the statement of financial position and in profit or loss.

BCE.55 IFRS 9 (2014) clarifies the application guidance for a hold to collect business model that results in financial assets being measured at amortised cost (depending on their contractual cash flow characteristics). The clarification will improve the quality of the financial information and its usefulness in assessing the amounts, timing and uncertainty of an entity's future cash flows by resulting in amortised cost measurement only for financial assets that are held with the objective of collecting contractual cash flows.

BCE.56 Usefulness of financial information will be further improved by the introduction of the fair value through other comprehensive income measurement category to IFRS 9. The fair value through other comprehensive income measurement category results in a fair value carrying amount in the statement of financial position, while the effect on profit or loss would be the same as if the financial assets were measured at amortised cost. This is considered appropriate for such a business model because, by design, both holding and selling activities are taking place, making both amortised cost and fair value information relevant to users of the financial statements. Due to the addition of the fair value through other comprehensive income measurement category, some question whether the classification and measurement approach will still be an improvement over IAS 39. However, in contrast to the available-for-sale measurement category in IAS 39, there is a clear business model in IFRS 9 that results in measurement at fair value through other comprehensive income. This will allow entities to better reflect the way in which financial assets are managed and improves the usefulness of the information provided for those business models in assessing the timing, amounts and uncertainty of an entity's future cash flows. Also, unlike the available-for-sale category in IAS 39, this measurement category has information content—it provides information about the entity's business model.

Contractual cash flow characteristics

BCE.57 Because the effective interest method is not an appropriate method for allocating 'complex' contractual cash flows, the contractual cash flow test in IFRS 9 ensures that amortised cost information is presented only for assets with simple contractual cash flows.

BCE.58 IFRS 9 (2014) makes a number of enhancements to the application guidance on the contractual cash flow characteristics. For example, it provides additional guidance about the attributes of cash flows that provide returns consistent with principal and interest and clarifies that interest is typically represented by a return for the time value of money and credit risk, but also can include other elements, such as a return for liquidity risk. In addition, it clarifies that a financial asset does not have cash flows that are solely payments of principal and interest if the effect of an interest rate tenor mismatch is significant, compared with the cash flows of an instrument that does not contain such a feature but is otherwise identical. In addition, IFRS 9 (2014) relaxes the original requirements in respect to contingencies. It eliminates the distinction between contingent prepayment and extension features and other types of contingent features, clarifying that all contingent features must be assessed in the same way and irrespective of the nature of the contingent event itself. As a result of these clarifications, the IASB expects that financial instruments considered to pay solely principal and interest will be better aligned with the economic concept of principal and interest.

BCE.59 The IASB was also made aware of regulated interest rates in some jurisdictions that are created with an objective of providing a return that is economically consistent with principal and interest, and that do not introduce volatility that is inconsistent with a basic lending arrangement. However, there is a mismatch between the interest rate set and the duration of the interest rate period. IFRS 9 (2014) provides explicit guidance for such financial instruments so that they are, in specific circumstances, considered to have payments that are solely principal and interest cash flows despite their structure. This will allow financial instruments that are considered 'simple' in the relevant jurisdiction to be measured other than at fair value through profit or loss, depending on an entity's business model. This is expected to provide relevant information for the entities that hold such financial assets.

BCE.60 In addition to these questions of clarity, after the publication of IFRS 9 in 2009 some interested parties suggested that bifurcation for financial assets should be reintroduced, partly because of a concern that some financial assets will be measured at fair value through profit or loss in their entirety, whereas under IAS 39 only the derivative component would have been measured at fair value through profit or loss. The IASB believes that the concern is addressed for some financial assets by the clarifications to the principal and interest criterion outlined above. This is because, despite the presence of embedded features, these financial

assets may economically have principal and interest cash flows. This is expected to be the case, for example, for many financial instruments with regulated interest rates and financial instruments with interest rate tenor mismatches. However, for other financial assets, for example, when the contractual cash flows are linked to an underlying that is unrelated to principal or interest, such as a commodity price, IFRS 9 (2014) will not change the requirements issued in IFRS 9 (2009). For the reasons discussed in detail in paragraphs BC4.88–BC4.89 and BC4.196–BC4.204, the IASB believes that classifying financial assets in their entirety instead of bifurcating them will result in financial information that is more useful in assessing the amounts, timing and uncertainty of future cash flows.

BCE.61 In addition to providing information that is more useful in assessing future cash flows, the elimination of bifurcation also simplifies the information about financial assets that is provided to users of financial statements. When a financial asset was bifurcated, the components of that financial asset were measured in different ways, and could also have been presented in different places in the financial statements. Consequently, although the settlement of the financial asset takes into consideration all of its contractual terms, it was difficult to understand that financial asset as a whole until settlement took place.

Financial liabilities

BCE.62 In IFRS 9, the IASB made fewer changes to the classification and measurement of financial liabilities than to financial assets. Views received from users of financial statements, and others, indicated that amortised cost is the most appropriate measurement attribute for many financial liabilities, because it reflects the issuer's legal obligation to pay the contractual amounts in the normal course of business (ie on a going concern basis) and, in many cases, the issuer plans to hold liabilities to maturity and pay the contractual amounts.

BCE.63 However, if a liability has structured features (for example, embedded derivatives), amortised cost is difficult to apply and understand because the cash flows can be highly variable. Consequently, the IASB decided to retain the bifurcation requirements in IAS 39 for financial liabilities. The views received by the IASB indicated that the bifurcation approach in IAS 39 is generally working well for financial liabilities and that a new bifurcation approach would most likely have the same classification and measurement outcomes as the approach in IAS 39. The bifurcation approach also reduces the incidence of fair value changes caused by the issuer's own credit risk.

BCE.64 Views received indicated, and the IASB agreed, that the effects of changes in a liability's credit risk ought not to affect profit or loss unless the liability is held for trading, because an entity will generally not realise the effects of changes in the liability's credit risk unless the liability is held for trading. However, many users of financial statements confirmed that fair value information on the balance sheet does provide useful information because, for example, it can provide early information about an entity's credit problems. The IASB thus decided that entities should continue to have the ability to measure their non-derivative liabilities at fair value (subject to the relevant criteria that are unchanged from IAS 39), but that the portion of the fair value change that is a consequence of changes in the financial instrument's credit risk should be recognised in other comprehensive income. The result of the IASB's decisions, including the own credit requirements for financial liabilities described in paragraphs BC5.35–BC5.64, result in information being reported for financial liabilities that is more useful in assessing the amounts, timing and uncertainty of the entity's future cash flows.

BCE.65 The IASB noted that *prima facie* it would seem preferable to eliminate bifurcation for financial liabilities if it was eliminated for financial assets. However, in discussions with users of financial statements they did not raise concerns regarding this apparent asymmetry in treatment.

Equity instruments

BCE.66 IFRS 9 removes the measurement exception for investments in unquoted equity instruments (and derivatives on them). Measuring those instruments at fair value provides the most relevant information to users of financial statements, because, although cost is a reliable and objective amount, it provides little, if any, information with predictive value about the timing, amount and uncertainty of future cash flows arising from the instrument.

BCE.67 The classification model for financial assets in IFRS 9 results in cost-based information when amortised cost is a relevant measure. Because equity instruments do not have cash flows that represent solely payments of principal and interest, the IASB believes that fair value information is always relevant, irrespective of the business model in which the asset is held. In addition, the IASB believes that changes in the fair value of equity investments usually provide relevant information about an entity's performance and should therefore be included in profit or loss. However, the IASB acknowledges that for some equity investments information about fair value may not be considered relevant to profit or loss, such as when an investment is held for

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strategic purposes. IFRS 9 therefore allows an entity to elect to present fair value changes on equity investments in other comprehensive income as long as the investment is not held for trading. Because this presentation choice was designed for circumstances in which these fair value changes were not relevant to profit or loss, even though the category is not expressly limited to these circumstances, the IASB decided that gains or losses would not be recycled to profit or loss. This decision was also made so that impairment accounting need not be reintroduced for investments in equity instruments to ensure that this complexity was not introduced in IFRS 9.

BCE.68 Accounting for impairment on equity investments, including assessing whether fair value changes are 'significant or prolonged', has been one of the most difficult application areas of IAS 39. Without an impairment model, recycling could not be allowed because of the risk of asymmetry caused by recognising gains in profit or loss with the risk that losses would be retained in other comprehensive income by avoiding derecognition. This would risk reducing the usefulness and representational faithfulness of the information provided.

BCE.69 Some have expressed concerns that this approach may create a disincentive for entities to invest in equity instruments. However, if an entity is of the view that the users of its financial statements need to see the effects in profit or loss of holding equity investments, they need not elect the other comprehensive income presentation. If the other comprehensive income presentation is elected, entities can choose to present the effects of realising fair value changes by, for example, transferring accumulated gains or losses from other comprehensive income to retained earnings.

Reclassifications

BCE.70 IAS 39 permits reclassifications at the entity's discretion in rare circumstances. Users of financial statements consistently commented that these reclassifications decreased the comparability and usefulness of financial reporting. In contrast, IFRS 9 makes reclassifications mandatory when, and only when, there has been a change in business model. The reclassification requirements will enhance useful and relevant information, because reclassification is based on changes in the entity's business model for managing financial assets. This ensures that financial statements always faithfully represent how those financial assets are managed at the reporting date, reflecting the amounts, timing and uncertainty of future cash flows.

Better economic decision-making as a result of improved financial reporting

BCE.71 The IASB believes that the requirements in IFRS 9 satisfy the fundamental qualitative characteristics of useful financial information as stated in Chapter 3 of the IASB's *Conceptual Framework*. That is, they would:

(a) provide information that is more useful in assessing the amounts, timing and uncertainty of an entity's future cash flows than the information reported in accordance with IAS 39 and is therefore more relevant and timely; and

(b) reduce accounting choice and instead require classifications that are consistent with economic substance. Consequently, the financial reporting is a more faithful representation than the financial reporting in accordance with IAS 39. It is also more complete and neutral and is supported by economic substance, which will help it to be free from error and verifiable.

In addition, the IASB notes that IFRS 9 enhances the comparability and understandability of the financial information relative to IAS 39.

BCE.72 In assessing whether IFRS 9 would improve financial reporting, the IASB considered the concerns voiced by some interested parties regarding the changes in accounting for financial assets. Some believe that IFRS 9 will result in more financial assets being reported at fair value compared to the requirements in IAS 39, and this concerns them for one or more of the following reasons:

(a) while fair value might be relevant during times of relative market stability, they considered that it lacks relevance and reliability during times of market instability.

(b) fair value reporting leads to procyclicality, meaning that it reflects or even magnifies economic or financial fluctuations. For example, in response to changes in fair value, entities may need, or choose, to sell different amounts of financial assets than they normally would, and the entity may have a different estimate of the present value of the future cash flows than is indicated by the fair value or market price; fair value amounts that are lower than the entity's estimate of future cash flows are of particular concern. (Such as when an entity intends to hold an asset to collect its contractual cash flows.)

(c) fair value reporting may impact the activities of regulated entities. Regulatory reporting uses some of the amounts reported in general purpose financial statements. Consequently, IFRS reporting may have effects for regulated entities. For example, regulated entities (especially banks) are often required to maintain a minimum level of capital reserves. Decreases in the fair value of some financial assets may impact the level of those capital reserves. As a consequence, some expressed concern that regulated entities may decrease lending during an economic downturn, which can further exacerbate the downturn.

BCE.73 Some are of the view that fair value information is less relevant for all financial instruments in times of relative market instability. Others, including the IASB, agree that fair value is not equally relevant for all financial instruments, but believe that fair value is relevant in all market conditions for some financial instruments. Consequently, the IASB believes that the new approach to classifying and measuring financial instruments will provide relevant information that will lead to better economic decision-making throughout economic cycles.

BCE.74 The IASB did not seek to increase or reduce the number of financial instruments that would be measured at fair value. For financial liabilities, the use of fair value is essentially unchanged in IFRS 9 relative to IAS 39 (and in fact, a portion of the fair value changes will now be recognised in other comprehensive income instead of profit or loss). In addition, financial assets are measured at fair value only when it is relevant because of the contractual cash flow characteristics of the asset and/or the entity's business model. Depending on the entity, its particular financial assets and how it manages them, IFRS 9 may actually result in fewer financial assets being measured at fair value than under IAS 39. For example, because of the rule-based criteria for amortised cost measurement under IAS 39, debt securities that are quoted in active markets are typically measured at fair value in accordance with IAS 39, even if they are held within a business model in which assets are managed to collect contractual cash flows. Such financial assets may be measured at amortised cost in accordance with IFRS 9.

BCE.75 The effect on the classification of an entity's financial assets will depend on the choices it made when applying IAS 39, its business models for managing its financial assets and the contractual cash flow characteristics of those financial assets. It is thus not possible to determine the overall changes in the classification of financial assets that will occur. However, the drivers of possible changes can be considered.

BCE.76 The following examples illustrate how the measurement of the financial assets may or may not change when IFRS 9 is first applied:

Example 1

Entity X invests in a portfolio of bonds that are quoted in an active market. The entity generally holds the investments in order to collect their contractual cash flows but would sell them if the instrument no longer meets the credit criteria specified in the entity's documented investment policy (for example, if a bond's credit risk increases so that it is higher than the credit limit as defined by the investment policy for that class of financial instruments at the reporting date).

Instrument A is a bond that pays principal and interest on the principal amount outstanding. In accordance with IAS 39, the entity classified Instrument A as available-for-sale because of the restrictions and tainting rules associated with the held-to-maturity category. At transition to IFRS 9, the entity reclassifies Instrument A to be measured at amortised cost because:

(a) the financial assets are held within a business model whose objective is to hold assets in order to collect contractual cash flows;[50] and

(b) the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. The contractual cash flows reflect a return that is consistent with a basic lending arrangement.

Example 2

In contrast, consider the same fact pattern except that the entity invests in the bonds to achieve the business model's objective by both collecting contractual cash flows and selling bonds. Accordingly, upon transition to IFRS 9 the entity reclassifies Instrument A from available-for-sale to the fair value through other comprehensive income measurement category. This is because:

(a) the financial assets are managed to achieve the business model's objective by both collecting contractual cash flows and selling financial assets; and

[50] Sales do not contradict the hold to collect business model if they are in response to the increase in the instrument's credit risk.

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(b) the contractual cash flows are solely payments of principal and interest on the principal amount outstanding. The contractual cash flows reflect a return that is consistent with a basic lending arrangement.

Example 3

Entity Y invests in bonds that are quoted in an active market. The bonds' contractual cash flows are linked to an equity index. The entity holds the bonds to collect the contractual cash flows. In accordance with IAS 39, Entity Y separated the embedded derivative from the financial asset host and measured the embedded derivative at fair value through profit or loss. The host financial asset was classified as available-for-sale. At transition to IFRS 9, Entity Y applies the classification approach to the hybrid financial instrument as a whole. Consequently, it measures the hybrid financial instrument in its entirety at fair value though profit or loss despite a business model that is a 'hold to collect' model. This is because the contractual cash flows introduce exposure to changes in equity prices that do not give rise to contractual cash flows that are solely payments of principal and interest on the principal amount outstanding. Thus, the contractual cash flows are inconsistent with a basic lending arrangement and the instrument must be measured at fair value through profit or loss.

Example 4

Entity Z invests in senior tranches of securitised bonds that are collateralised by mortgage loans. The underlying mortgage loans have payments that are solely payments of principal and interest. Entity Z invests in these senior tranches in order to collect contractual cash flows. The credit risk of the tranches is lower than that of the overall mortgage pool. In accordance with IAS 39, Entity Z determined that there is not an embedded derivative and classified its investment in these senior tranches as available-for-sale. At transition to IFRS 9, if the contractual terms of the senior tranches give rise to payments that are solely payments of principal and interest on the principal amount outstanding, Entity Z measures its investments at amortised cost. However, if the contractual payments are not solely payments of principal and interest on the principal amount outstanding (that is, they are inconsistent with a basic lending arrangement), the senior tranche must be measured at fair value through profit or loss.

BCE.77 The IASB acknowledges that the fair value through other comprehensive income measurement category may affect some regulated banks, because the Basel III regulatory framework removes the 'regulatory filter' for fair value gains or losses recognised in other comprehensive income.[51] Consequently, if this regulatory change remains in place, for those affected the fair value changes of financial assets that are measured at fair value through other comprehensive income will have a direct effect on regulatory capital. However, the addition of the fair value through other comprehensive income measurement category will only have this potential adverse effect on regulatory capital if those financial assets would otherwise have been measured at amortised cost. The objective of the hold to collect business model in IFRS 9 (as issued in 2009) has not been changed. Some financial assets held in business models that would have been measured at fair value through profit or loss can now be measured at fair value through other comprehensive income. In that case, the value changes in other comprehensive income could still affect regulatory capital but the effect on regulatory capital would be a neutral one relative to the requirements issued in IFRS 9 (2009).

BCE.78 The objective of financial reporting should be to provide transparent information that is useful for economic decision-making. The IASB notes that the objective of providing useful information does not contradict the objective of economic stability. Instead, the IASB believes that transparency is essential to maintain stability in the long term.

The likely effect on compliance costs for preparers, both on initial application and on an ongoing basis

BCE.79 As with all new requirements, the IASB acknowledges that different areas of the requirements will have different effects and hence different types of costs and benefits will arise when considering both preparers and users of financial statements. Given that the new classification model for financial assets is based on the entity's business model for managing its financial assets and those assets' contractual cash flow characteristics, it is reasonable to conclude that the costs incurred and the benefits obtained in complying with

[51] Footnote 10 of Basel III: A global regulatory framework for more resilient banks and banking systems ('Basel III'), published by the Basel Committee on Banking Supervision, states 'that '[t]here is no adjustment applied to remove from Common Equity Tier 1 unrealised gains or losses recognised on the balance sheet [the 'regulatory filter'] ... The Committee will continue to review the appropriate treatment of unrealised gains, taking into account the evolution of the accounting framework.' In contrast, Basel II did contain a regulatory filter.

the new requirements will depend on the entity's business model and the contractual cash flow characteristics of its financial assets.

BCE.80 Entities will incur a one-time cost on initial application such as costs for:

(a) developing new processes, systems and controls;

(b) undertaking the initial analysis of business models and contractual cash flows on transition;

(c) creating capabilities for new eligible presentations, if intended to be used (for example, the presentation of the change in the fair value of equity investments in other comprehensive income);

(d) educating accounting functions and obtaining expert advice for compliance; and

(e) explaining to users of financial statements the differences between the information produced under IAS 39 and IFRS 9.

BCE.81 The IASB believes that the transition to IFRS 9 and the associated costs (as well as the ongoing costs of applying IFRS 9) will depend on the individual circumstances of the entity, ie the type (and diversity of) business models for its financial assets as well as the contractual cash flow characteristics of the instruments. It is therefore difficult to generalise the likely impact on transition on preparers and on their costs.

BCE.82 However, the IASB does not expect preparers to incur significant incremental costs on an ongoing basis in comparison to applying IAS 39. The IASB notes the following initial and ongoing costs and factors that mitigate the ongoing costs of applying IFRS 9 in comparison to IAS 39:

(a) the need to assess the business model. The entity's business model is determined on a more aggregated basis than an individual financial instrument level that was the basis for classification under IAS 39. An entity's business model is a matter of fact that can be observed by the way in which an entity is managed and information is provided to its management. The assessment is based on, for example, business plans and internal reporting, which should be available. Thus, the reporting is in a manner consistent with the entity's actual business model and entities need not maintain dual reporting models for internal and external reporting.

(b) the need to assess the contractual cash flows of a financial asset. However:

(i) the contractual cash flows need not be analysed in all business models. They only need to be analysed to assess cash flows for the held to collect and the held to collect or sell business models.

(ii) financial assets with more complex cash flows are expected to already have an analysis in place to assess the need to bifurcate and to measure the fair value of the asset in its entirety (under the fair value option) or in part in accordance with IAS 39; and

(iii) in other cases an entity is expected to already analyse contractual cash flows in order to determine the fair value for disclosure purposes in accordance with IFRS 7, particularly for assets below Level 1 of the fair value hierarchy.

BCE.83 In addition, the IASB notes that eliminating bifurcation and tainting for financial assets measured at amortised cost, as well as introducing a single impairment method, will simplify compliance with the classification and measurement requirements for financial assets.

BCE.84 Furthermore, for financial liabilities, the classification and measurement model is largely unchanged from IAS 39, except for the own credit requirements for financial liabilities designated as at fair value through profit or loss under the fair value option. Entities are already required to disclose the gains or losses recognised for changes in own credit risk and therefore there should not be any incremental costs to preparers from this change.

BCE.85 Finally, IFRS 9 provides a number of illustrative examples and detailed application guidance that illustrate various aspects of the new Standard. In addition, the IASB has responded to the requests for clarifications and to the application questions raised since the issue of IFRS 9 in 2009. The IASB believes that this will help to reduce the initial and ongoing costs of compliance with the classification and measurement requirements.

BCE.86 For the reasons described in the preceding paragraphs, the IASB believes that the benefits of the improvements to financial reporting will justify the costs to implement and apply the classification and measurement requirements of IFRS 9.

The likely effect on costs of analysis for users of financial statements

BCE.87 The likely benefits of improved reporting are expected to outweigh the costs of analysis for users of financial statements. However, the extent of the benefit will depend on existing practices.

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BCE.88 Some of the complexity in IAS 39 is eliminated and it is therefore easier for users of financial statements to understand and use information about financial instruments. In addition, although some users of financial statements favour fair value as a primary measurement attribute for all financial assets, users of financial statements as a group have consistently said that both amortised cost information and fair value information are useful in particular circumstances. The IASB has developed IFRS 9 to provide information that is useful in predicting an entity's future cash flows. In addition, accompanying disclosures provide information that will enable users of financial statements to understand how financial instruments have been classified and measured, and supplementary information from disclosures is available to be used in their financial modelling (for example, the fair value of financial instruments measured at amortised cost).

Conclusion

BCE.89 The requirements result in more relevant and transparent information because they introduce a single classification approach for all financial assets, which always provides users of financial statements with information that reflects how the cash flows on financial assets are expected to be realised given the entity's business model and the nature of the contractual cash flows. In addition, they respond to long standing concerns about the volatility that occurs in profit or loss due to changes in an issuer's own credit risk that was not considered to provide useful information, when an entity elects to measure non-derivative financial liabilities at fair value.

Analysis of the effects: Impairment

Overview

BCE.90 During the global financial crisis, the delayed recognition of credit losses on loans and other financial instruments was identified as a weakness in the existing accounting standards. Specifically, concerns were raised about the timeliness of recognising credit losses because the existing 'incurred loss' model in IAS 39 delays the recognition of credit losses until there is evidence of a credit loss event. The Financial Crisis Advisory Group (FCAG) and others recommended exploring alternatives to the incurred loss model that would use more forward-looking information.

BCE.91 The complexity of having multiple impairment models for financial instruments was also identified as a major concern.

BCE.92 The impairment requirements in IFRS 9 are the IASB's response to the need to improve the accounting for impairment for financial instruments and to remove the complexity of multiple impairment models. The IASB believes that the new impairment requirements address the issue of delayed recognition of credit losses and the complexity of multiple impairment models for financial instruments.

BCE.93 Overall, the IASB's assessment is that the impairment requirements will bring significant and sustained improvements to the reporting of financial instruments because:

(a) the same impairment model applies to all financial instruments within the scope of IFRS 9 that are subject to impairment accounting. This removes a major source of current complexity.

(b) entities will be required to recognise a loss allowance at an amount equal to at least 12-month expected credit losses throughout the life of their financial instruments that are subject to impairment accounting. This reduces the systematic overstatement of interest revenue in IAS 39 and acts as a proxy for the recognition of initial expected credit losses over time.

(c) more timely information will be provided about expected credit losses. The requirements eliminate the threshold for recognising credit losses so that it would no longer be necessary for a credit event to have occurred before credit losses are recognised. Instead, expected credit losses and changes in expected credit losses are always recognised. In particular, IFRS 9 will require:

(i) earlier recognition of lifetime expected credit losses for financial instruments relative to IAS 39 (ie instruments with a significant increase in credit risk since initial recognition); and

(ii) in addition, 12-month expected credit losses for all other instruments. The amount of expected credit losses will be updated at each reporting date to reflect changes in credit risk since initial recognition. Consequently, the impairment model in IFRS 9 will be more responsive to changes in economic circumstances that affect credit risk.

(d) the requirements broaden the information that an entity is required to consider when accounting for credit losses. An entity is required to base its measurement of expected credit losses on relevant information about past events, including historical credit loss information for similar financial

instruments, current conditions and reasonable and supportable forecasts. Thus, the effects of future credit loss expectations need to be considered. As a result of the broadening of the information that is required to be considered, the impairment model will be more forward looking.

BCE.94 Some interested parties would prefer an impairment model that results in a 'conservative', or prudential, depiction of expected credit losses. Those parties are concerned about higher or lower loss allowances or the 'adequacy' of the loss allowance. They argue that such a depiction would better meet the needs of both the regulators who are responsible for maintaining financial stability and of investors. However, the debate about higher or lower loss allowances or the adequacy of the loss allowance in isolation is primarily a debate for prudential regulators instead of accounting standard-setters. The IASB's objective is not to require higher or lower loss allowances; instead it is to present information to users of financial statements that is neutral and portrays the economic characteristics of the financial instrument at the reporting date. This is consistent with the objectives of financial reporting and the qualitative characteristics in the *Conceptual Framework*. While the IASB does not have an objective to increase allowance balances, loss allowances may quite naturally be higher under IFRS 9 relative to IAS 39. This is because IFRS 9 requires earlier recognition of lifetime expected credit losses as significant increases in credit risk are expected to occur before there is objective evidence of impairment in accordance with IAS 39 and, in addition, 12-month expected credit losses are required to be recognised for all other instruments.[52]

BCE.95 The IASB expects that most costs for preparers will be incurred preparing to transition to the new impairment model. In particular, investments will be required in substantial system changes. The ongoing costs will be mitigated by the fact that several simplifications and clarifications have been put in place that reduce the operational burden of the impairment model in IFRS 9 (see paragraphs BCE.151–BCE.164). The IASB's assessment is that the significant improvements in terms of timeliness of information about expected credit losses and transparency will outweigh those costs.

Objective of the impairment requirements of IFRS 9

BCE.96 The IASB's main objective in developing the impairment model was to provide users of financial statements with more useful information about an entity's expected credit losses on its financial assets and its commitments to extend credit to facilitate their assessment of the amount, timing and uncertainty of future cash flows.

BCE.97 Conceptually, when an entity prices a financial instrument, the credit risk premium in the yield compensates the entity for the initial expected credit losses. For example, at the time of lending, the margin on a financial instrument compensates the lender for the credit risk of the borrower. This means that loss expectations do not give rise to an economic loss at initial recognition. In contrast, subsequent increases in the credit risk of the borrower represent an economic loss. These changes represent an economic loss because they are not priced into the financial instrument. Ideally, to reflect this an entity would include the initial estimate of the expected credit losses in determining the effective interest rate used to recognise interest revenue. Thus, the initial expected credit losses would adjust the interest revenue over the life of the financial asset. The entity would then recognise impairment gains or losses only when changes in the expected credit losses occur. This is what the IASB proposed in the 2009 Impairment Exposure Draft.

BCE.98 In the IASB's view, expected credit losses are most faithfully represented by the proposals in the 2009 Impairment Exposure Draft. Users of financial statements have told the IASB that they support an impairment model that distinguishes between the effect of initial estimates of expected credit losses and subsequent changes in those loss expectations. Many respondents, including the EAP, also supported the concepts in the 2009 Impairment Exposure Draft but said that the proposals would present significant operational challenges.

BCE.99 To overcome the operational challenges of the 2009 Impairment Exposure Draft, the IASB simplified the approach for the recognition of expected credit losses. The impairment model in IFRS 9 seeks to achieve a balance between the benefits of the faithful representation of expected credit losses and the operational cost and complexity. In other words, IFRS 9 seeks to approximate the 2009 Impairment Exposure Draft to the maximum extent possible in a way that is less operationally burdensome and more cost-effective.

BCE.100 IFRS 9 reflects the link between the pricing of financial instruments and the initial recognition of a loss allowance, generally separating the calculation of interest revenue and expected credit losses, by recognising a portion of expected credit losses from initial recognition as a proxy for the yield adjustment and lifetime

[52] Purchased credit-impaired assets will not have a 12-month allowance at inception. Instead, the effective interest rate will be adjusted to reflect initial loss expectations and then a loss allowance will be established for all changes in lifetime expected credit losses. Also lifetime expected credit losses are always recognised on trade receivables that do not have a significant financing element and instead of measuring 12-month expected credit losses on assets that have not significantly increased in credit risk, lifetime expected credit losses may be recognised at all times on other trade receivables, lease receivables and contract assets.

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expected credit losses after there has been a significant increase in the credit risk of a financial instrument. At each reporting date, expected credit losses are measured using updated information.

How activities would be reported in the financial statements of those applying IFRS 9

BCE.101 The analysis in paragraphs BCE.102–BCE.110 focuses on the key differences between the existing impairment model in IAS 39 and the new impairment model in IFRS 9 and how the new impairment model will affect financial reporting.

Single impairment model

BCE.102 IAS 39 requires different impairment assessments and methods for financial assets depending on their classification. Some of those financial asset impairments cannot be reversed. During the global financial crisis, some users of financial statements were confused because the same financial assets were impaired differently simply because they were classified differently for accounting purposes. In contrast, under IFRS 9 the same impairment model is applied to *all* financial instruments subject to impairment accounting. This addresses the criticism that having multiple impairment models in IAS 39 is confusing.

BCE.103 The impairment of debt instruments that are classified as available-for-sale financial assets under IAS 39 was criticised by some users of financial statements, because it is based on fair value fluctuations and is not aligned with the impairment model that is applied to similar financial assets measured at amortised cost. Some questioned the relevance of fair value-based impairment if a financial asset would not be realised through sale.

BCE.104 Similar to financial assets that are measured at amortised cost, in accordance with IFRS 9, the contractual cash flow characteristics of financial assets measured at fair value through other comprehensive income would solely represent payments of principal and interest. In addition, holding financial assets to collect contractual cash flows is an integral feature of the business model. The IASB therefore believes that an impairment model that is based on shortfalls in contractual cash flows and changes in credit risk, instead of changes in fair value, more faithfully reflects the economic reality of expected credit losses that are associated with these financial assets. It is also consistent with both amortised cost and fair value information about these financial assets being provided to the users of financial statements, which was the IASB's objective in introducing the fair value through other comprehensive income measurement category.

BCE.105 Previously, an entity that provided a loan commitment that was not accounted for at fair value through profit or loss and financial guarantee contracts to which IFRS 9 applies but that are not accounted for at fair value through profit or loss, were accounted for in accordance with IAS 37. This was the case even though exposure to credit risk on these instruments is similar to that on loans or other financial instruments and the credit risk is managed in the same way. The IASB therefore concluded that an entity shall apply the same impairment model to those loan commitments and financial guarantee contracts. Aligning the impairment requirements for all credit exposures irrespective of their type reduces operational complexity because, in practice, loan commitments and financial guarantee contracts are often managed using the same credit risk management approach and information systems.

Measurement of expected credit losses

BCE.106 In accordance with IFRS 9, expected credit losses are the present value of expected cash shortfalls over the remaining life of a financial instrument. It requires that the estimates of cash flows are expected values. Consequently, estimates of the amounts and timing of cash flows are the probability-weighted possible outcomes. In the IASB's view, an expected value measurement provides relevant information about the timing, amounts and uncertainty of an entity's future cash flows. It provides information about the risk that the investment might not perform. The amount of expected credit losses will reflect both the risk of a default occurring and the loss amount that would arise if a default were to occur. This is because all financial instruments have a risk of a default occurring. The measurement will therefore reflect that risk of default and not the most likely outcome, as is often the case in practice in accordance with IAS 39.

Timely recognition of expected credit losses

BCE.107 The impairment models in IAS 39 require the recognition of credit losses only once there is objective evidence of impairment or when a credit loss is incurred (thus the impairment model includes a 'recognition threshold'). As a result, the effect of future events, even when expected, cannot be considered. This recognition threshold

is perceived to have caused a delay in the recognition of credit losses and was identified during the global financial crisis as a weakness in accounting standards. It also resulted in differences in application because the recognition threshold was applied differently between entities.

BCE.108 IFRS 9 eliminates this threshold. Instead, expected credit losses would always be recognised and updated for changes in credit loss expectations using the best available information at the reporting date. This enables economic credit losses to be better reflected in the financial statements.

BCE.109 Consistent with the recommendations by the G20 Leaders, the FCAG and others, IFRS 9 is more forward-looking and considers a broader range of information than the existing incurred loss model. Such information includes reasonable and supportable forecast information that is available without undue cost or effort.

BCE.110 Consequently, the impairment model in IFRS 9 is expected to be more responsive to changing economic conditions than the existing IAS 39 incurred loss model and requires earlier recognition of expected credit losses.

Comparability of financial information

BCE.111 The IASB acknowledges that the more judgement that is required in the application of an expected credit loss approach, the more subjective the estimates will be, and that this subjectivity will affect the comparability of reported amounts between different entities. Despite the concerns about the application of judgement, in the IASB's view, the new impairment model will improve the comparability of reported amounts. This is because under the incurred loss model in accordance with IAS 39, increases in credit risk are not reported in the absence of a loss event, which limited the comparability of the reported amounts and the effective return on the financial assets. In addition, in practice, the point at which losses were considered to be incurred varied between entities.

BCE.112 In the IASB's view, considering the term structure and initial credit risk when assessing whether lifetime expected credit losses should be recognised will better reflect existing models for measuring credit risk and improve the comparability of the requirements for financial instruments with different maturities and different initial credit risk.

BCE.113 However, any approach that attempts to reflect expected credit losses will be subject to measurement uncertainty and will rely on management's judgement and the quality of the information used. Both qualitative and quantitative disclosures are necessary to assist users of financial statements in understanding and comparing different measures of expected credit losses. Consequently, disclosures are required by IFRS 7 to enable users of the financial statements to identify and understand the inputs, assumptions and techniques applied to identify significant increases in credit risk and measure expected credit losses, the amounts arising from the expected credit losses and the effect of changes in credit risk since initial recognition. The IASB believes that this will lead to greater comparability between different reporting periods of the same entity and assist in enabling comparisons to be made between entities.

Usefulness of financial information in assessing future cash flows of an entity

BCE.114 The IASB noted that the impairment model in IFRS 9 should reflect how an entity approaches credit risk management for different classes of financial instruments and provides information on the effect of the changes in the credit risk of financial instruments since initial recognition.

BCE.115 In assessing the usefulness of the information provided by this approach, the IASB has compared it to the information provided by a general provisioning approach and a fair value approach. In the IASB's view, a general provisioning approach, whereby entities build up reserves to absorb both expected and unexpected credit losses (without any reference to an increase in credit risk) lacks any measurement objective and fails to provide a link between the loss allowance that is recognised and the change in credit risk. Furthermore, a full fair value model does not provide explicit information on expected credit losses. Changes in the fair value of a financial instrument include changes in risks other than credit risk, such as interest rate risk, liquidity risk and market risk. The IASB believes that such an approach does not provide useful information for impairment purposes, because measuring expected credit losses using fair value information is inconsistent with a cost-based measurement that focuses on contractual cash flows.

BCE.116 In the IASB's view, the criterion that determines when lifetime expected credit losses shall be recognised, together with the related disclosure requirements, achieves the best balance between the benefits of distinguishing financial instruments for which there has been a significant increase in credit risk since initial recognition and the costs and complexity of making that assessment.

BCE.117 The IASB is aware that some interested parties favour a lifetime expected credit loss approach, whereby an entity recognises a loss allowance at an amount equal to lifetime expected credit losses from initial

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recognition, regardless of the credit risk and relative credit pricing of the financial instrument. Under such an approach, the recognition of initial lifetime expected credit losses is triggered by the initial recognition of a financial asset instead of by the increase in credit risk since initial recognition. The IASB believes that this is not appropriate because it would result in financial assets being recognised at a carrying amount that is significantly below fair value on initial recognition and would therefore be inconsistent with the economics of the asset. However, the IASB acknowledges that some users of financial statements find this information useful.

BCE.118 The IASB believes that the impairment requirements in Section 5.5 in IFRS 9 provide useful information by distinguishing between financial instruments for which the credit risk has increased significantly since initial recognition and those financial instruments for which this has not occurred. The feedback to the IASB from the majority of users of financial statements has been that this distinction provides useful information.

Modified financial instruments

BCE.119 As noted in paragraphs BC5.238–BC5.239, the IASB concluded that financial instruments with modified contractual cash flows should be permitted to revert to 12-month expected credit losses in the same way as unmodified financial instruments, if there is no longer a significant increase in credit risk since initial recognition. The IASB believes that such a symmetrical approach faithfully represents the economics of the transaction and that faithful representation should not be sacrificed for anti-abuse purposes.

BCE.120 Some users of financial statements were concerned that such a symmetrical approach would be more permissive than the current IAS 39 requirements. This is because currently in IAS 39 forbearance, as generally used in the regulatory sense, is regarded as an event that indicates objective evidence of impairment. The IASB however notes that because a significant increase in credit risk is determined by reference to the initial credit risk (on the original contractual terms), financial instruments will not necessarily revert to 12-month expected credit losses as a result of a modification of contractual cash flows. IFRS 9 requires an entity to base its assessment of significant increases in credit risk on the credit risk at initial recognition of the original financial instrument (assuming derecognition has not occurred), based on all reasonable and supportable information that is available without undue cost or effort. This includes historical, current and forward-looking information and an assessment of the credit risk over the remaining life of the instrument, which should include the circumstances that led to the modification.

BCE.121 Furthermore, while forbearance may provide objective evidence for the recognition of an incurred loss in accordance with IAS 39, the effect of the modification of contractual cash flows is reflected in the measurement of the impairment loss under that Standard. Consequently, if a modified financial instrument is not considered to have increased significantly in credit risk, it is likely that only a small incurred loss would currently be recognised under IAS 39. As a result, the IASB believes that even if, subsequent to a modification, a loss allowance at an amount equal to 12-month expected credit losses is recognised, it should not result in a smaller loss allowance than would be recognised under IAS 39. The IASB notes that entities are required to disclose the gross carrying amount for modified financial assets for which the loss allowance has reverted back to 12-month expected credit losses during the reporting period.

Better economic decision-making as a result of improved financial reporting

BCE.122 The IASB believes that the new impairment model provides information that is relevant for economic decision-making by depicting changes in the credit risk of financial instruments through the use of a broad range of information, including forward-looking information and the recognition of expected credit losses on a timelier basis. Users of financial statements will also be provided with more information to understand entities' credit risk management processes and the credit risk inherent in their financial instruments. The IASB is of the view that loss allowances should reflect credit loss expectations for financial instruments as at the reporting date.

BCE.123 The IASB acknowledges that the new impairment model would result in an overstatement of expected credit losses for financial assets, and a resulting understatement of the value of the related financial assets, through the recognition of a loss allowance for 12-month expected credit losses. However, the IASB has sought to provide a proxy for the 2009 Impairment Exposure Draft that is less operationally burdensome and more cost-effective. The IASB determined that the impairment requirements in IFRS 9 provides the best balance of the benefits of providing useful information and the costs of providing it. In addition, the overstatement will not be of the same magnitude as if full lifetime expected credit losses were to be recognised on initial recognition. For long-term financial assets and those with a high risk of default occurring as at initial recognition, the difference between a 12-month and lifetime expected credit loss measure can be significant.

BCE.124 Furthermore, relevant information is provided by updating expected credit loss estimates for changes in expectations, by updating the measurement of the loss allowance at each reporting date, and in particular

through the recognition of lifetime expected credit losses when there has been a significant increase in credit risk since initial recognition. In addition, information is provided by requiring the calculation of interest revenue on the amortised cost amount (ie net of the loss allowance) of a financial asset when it becomes credit-impaired subsequent to initial recognition.

Regulatory concept of expected credit losses

BCE.125 Some users of financial statements asked the IASB to ensure that the impairment model is both aligned to the prudential capital frameworks and is counter-cyclical, resulting in a loss allowance that is sufficient to absorb all credit losses.

BCE.126 Some prudential regulation and capital adequacy systems, such as the framework developed by the Basel Committee on Banking Supervision, already require financial institutions to calculate 12-month expected credit losses as part of their regulatory capital provisions. However, these estimates only use credit loss experience based on historical events to set out 'provisioning' levels over the entire economic cycle ('through-the-cycle'). Furthermore, through-the-cycle approaches consider a range of possible economic outcomes instead of those that are actually expected at the reporting date. This would result in a loss allowance that is not designed to reflect the economic characteristics of the financial instruments at the reporting date. In addition, the default measures used may be adjusted to reflect a more 'conservative' outlook instead of actual expectations.

BCE.127 The IASB notes that financial reporting, including estimates of expected credit losses, are based on information, circumstances and events at the reporting date. The IASB expects entities to be able to use the systems and processes in place to determine amounts for regulatory purposes as a basis for the application of the impairment requirements in IFRS 9. However, these calculations would have to be adjusted to meet the measurement requirements of IFRS 9.

BCE.128 The IASB acknowledges that any transition adjustments arising on the initial application of IFRS 9 will affect retained earnings, which potentially could have a negative impact on regulatory capital. However, the IASB believes that the objective of financial reporting should be to provide transparent information that is useful to a broad range of users of financial statements and that prudential regulators are best placed to consider how to address the interaction between IFRS and the regulatory requirements. The IASB has discussed the new impairment model and shared information with the Basel Committee on Banking Supervision—through its Accounting Experts Group—throughout the course of the project in order to enable the interaction of the new impairment model with relevant regulatory requirements to be considered. The actual effect on regulatory capital will depend on the decisions made by relevant regulators about the interaction between the IFRS impairment requirements and the prudential requirements.

BCE.129 Some are of the view that loss allowance balances should be used to provide a counter-cyclical effect by building up loss allowances in the good times, to be used in the bad times. This would, however, mask the effect of changes in credit loss expectations. The impairment model in IFRS 9 is based on reasonable and supportable information that is available without undue cost or effort at the reporting date and is designed to reflect economic reality, instead of adjusting the assumptions and inputs applied to achieve a counter-cyclical effect. When credit risk changes, the impairment model will faithfully represent that change. This is consistent with the objective of general purpose financial statements.

BCE.130 Also, because the objective of the new impairment model is to faithfully represent changes in credit risk since initial recognition, the IASB does not believe it would be consistent to also have an objective of ensuring that the recognition of a loss allowance will be sufficient to cover unexpected credit losses. Some users of financial statements would however prefer a representation of credit losses with a conservative or prudential bias, arguing that such a representation would better meet both the needs of regulators who are responsible for maintaining financial stability and those of investors. The majority of users of financial statements that the IASB discussed the impairment requirements with, however supported an impairment model that focuses on expected credit losses and the changes in credit risk since initial recognition.

Fieldwork

BCE.131 The IASB undertook detailed fieldwork during the comment period for the 2013 Impairment Exposure Draft. A key objective of the fieldwork was to understand how responsive the proposed impairment model was expected to be to changes in credit risk expectations over time. It was also designed to provide an understanding of the operational impact of the implementation of the proposals and to provide some directional information about the magnitude of the allowance balance on transition from IAS 39.

BCE.132 In order to understand the responsiveness of the proposed impairment model, the IASB asked participants to use real portfolio information and simulate changes in the credit risk of those portfolios based on a time series

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of macroeconomic information. To undertake this analysis properly was a very intensive exercise, because it required not only an understanding of existing data but also that entities analyse how they would expect the macroeconomic changes described to affect credit risk over time for their chosen portfolios.[53] Given the intensiveness of the exercise, the sample size was necessarily limited and only 15 participants took part in the fieldwork. However, in order to make the exercise as representative as possible, participants included both financial and non-financial (lessor) entities, multinational and regional (or country)-based businesses, Basel-regulated and non-Basel-regulated entities and entities with various levels of sophistication in credit risk management systems. There was also a mixture of the type of portfolios that participants selected, which in aggregate had a total carrying amount in excess of US$500 billion and included:[54]

(a) retail mortgages, including:

  (i) amortising loans;

  (ii) interest only loans; and

  (iii) equity-line loans.

(b) corporate (wholesale) loans;

(c) revolving credit products (for example, credit cards);

(d) lease receivables (for example, vehicle finance); and

(e) other unsecured lending, for example, personal loans/payday loans.

BCE.133 To meet the objective of the fieldwork, participants were asked to measure the loss allowance over a period of five years and apply different impairment requirements for their respective portfolios, including the requirements in IAS 39, the proposals in the 2013 Impairment Exposure Draft and full lifetime expected credit losses for all financial instruments.

BCE.134 While participants were generally able to operationalise the proposals of the 2013 Impairment Exposure Draft, it was not without obstacles. One of the reasons was that there was only a very limited time frame for the fieldwork to be completed in. In addition, by necessity participants could only use information provided as part of the fieldwork or that existed in their credit risk management systems. This meant that the approaches taken could not fully represent those which may ultimately be undertaken. So for retail portfolios, participants were often only able to identify significant increases in credit risk based on past due information plus some adjustments (for example, including restructurings). They found it difficult to incorporate more forward-looking data (for example, macroeconomic data) at a level that enabled them to identify specific financial assets for which there have been significant increases in credit risk since initial recognition.

BCE.135 As a result of this feedback, additional work was undertaken with participants to consider how to ensure that lifetime expected credit losses are recognised for *all* financial instruments for which there have been significant increases in credit risk, even if the significant increase in credit risk is not yet evident on an individual financial instrument level. This has led the IASB to emphasise the need for a portfolio perspective when significant increases in credit risk cannot be identified on an individual financial instrument level to ensure that IFRS 9 is applied on an appropriately forward-looking basis. The work with participants showed that statistical methods and techniques could be used to analyse subportfolios to capture significant increases in credit risk even when that is not evident based on customer-specific information at the level of individual financial instruments.

BCE.136 Nevertheless, participants in the fieldwork found that the impairment model proposed in the 2013 Impairment Exposure Draft was more responsive to changing economic circumstances in both downturn and upturn macroeconomic environments compared to the IAS 39 model.[55] During a downturn, the loss allowances increased quickly and reached their peak around a year before the lowest point in the economy (reflecting that the data provided was used as forecast data for a 12-month period). During an upturn, the loss allowances recovered faster than those under IAS 39, which often still had a lagging effect from the downturn in the economic cycle. Participants noted that the better an entity is able to incorporate forward-looking and macroeconomic data into its credit risk management models, the more responsive the loss allowance would be to changes in credit risk.

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[53] The man-hours invested during fieldwork were between 200–250 for smaller businesses, 400–450 for larger businesses and 500–550 for a few participants. The IASB staff invested approximately 400 man-hours, which involved the development of the fieldwork, meetings with participants and portfolio analysis.

[54] The portfolios excluded derivatives and financial guarantee contracts to make the calculations easier and to help participants meet the short deadline of the fieldwork.

[55] Participants were provided a series of economic information so their proxy forecasting was more accurate than it would be in reality. Although this assessment has imperfections, it nevertheless provided an estimate of the responsiveness of the impairment model.

BCE.137 In addition, almost all the participants observed a noticeable increase in the loss allowance on the hypothetical transition date and throughout the economic cycle as compared to IAS 39. For example, on transition, the loss allowance for portfolios other than mortgage portfolios was between 25 per cent and 60 per cent higher compared to the IAS 39 balance and the loss allowance for mortgage portfolios was between 30 per cent and 250 per cent higher compared to the IAS 39 balance. In addition, at the point in the economic cycle when the economic forecast was worst (ie when loss allowances were the highest), the loss allowance measured in accordance with the 2013 Impairment Exposure Draft was between 50 per cent and 150 per cent higher compared to the IAS 39 balance for portfolios other than mortgage portfolios and between 80 per cent and 400 per cent higher compared to the IAS 39 balance for mortgage portfolios.[56, 57]

BCE.138 In performing these calculations, participants that had higher 'incurred but not reported' allowances in accordance with IAS 39 because of longer emergence periods tended to see less of an impact when applying the 2013 Impairment Exposure Draft. In addition, participants that identified and recognised impairment losses on an individual level in a timelier manner under IAS 39 also saw a smaller impact. Finally, participants noted jurisdictional differences because of different macroeconomic factors that affect expected credit losses and therefore the loss allowance.

BCE.139 The IASB notes that it cannot quantify the magnitude of the impact of moving to the new impairment model on an entity's financial reporting. The magnitude of the impact from the requirements in IFRS 9 depends on the financial instruments that an entity holds, when the financial instruments were originally recognised, how the entity has applied the IAS 39 requirements, the sophistication of the entity's credit risk management systems and the availability of information about, for example, the probabilities of a default occurring, past due statuses and estimates of lifetime expected credit losses for all financial instruments (for example, products, geographical areas and vintages). While all entities will be required to meet the objective of the impairment requirements in Section 5.5 of IFRS 9, in practice, the loss allowance will depend in part on how entities operationalise IFRS 9. The IASB is aware that entities across different jurisdictions have applied the existing impairment requirements in IAS 39 differently, in part as a result of the interaction with local or jurisdictional regulatory definitions and requirements.

BCE.140 Finally, the magnitude of the impact will also depend on the prevalent economic conditions at the time of transitioning to the new requirements. The loss allowance always reflects expectations at the reporting date, so economic conditions at the date of initial application (including forecasts of economic conditions) will affect the loss allowance. The effect on transition will also depend on the information that an entity has available on transition. For example, if an entity is unable to determine the change in credit risk of a financial instrument since initial recognition and will not use past due information to apply the model to that instrument, if it is a low credit risk financial asset, it will have an allowance balance equal to 12-month expected credit losses; otherwise it will have a loss allowance equal to lifetime expected credit losses.

The likely effect on compliance costs for preparers, both at initial application and on an ongoing basis

BCE.141 IFRS 9 seeks to address the cost of identifying deteriorated financial instruments by using significant increases in credit risk as a basis for the distinction. This is intended to ensure that only meaningful changes in credit risk are captured that should align with changes that would be monitored for credit risk management.

BCE.142 The IASB acknowledges that the implementation and ongoing application of an impairment model based on expected credit losses is complex and costly. The costs resulting from the impairment model in IFRS 9 include:

(a) monitoring changes in credit risk of financial instruments since initial recognition and implementing processes to make that assessment; and

(b) calculating expected credit losses including lifetime expected credit losses.

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[56] The difference in percentages reflect the extreme effects of differences in expected lives between jurisdictions.

[57] This is reflective of the results of the majority of participants in the fieldwork. Excluded from the results, were the responses from participants based on:
(a) qualitative feedback due to timing requirements of the fieldwork; or
(b) the simplified approach (ie measured lifetime expected credit losses on all financial assets) or an absolute approach (for example, when lifetime expected credit losses were recognised on all financial assets of higher credit risk irrespective of whether the credit risk had increased significantly since initial recognition).

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Cost of initial application

BCE.143 The IASB acknowledges that the impairment model in IFRS 9 is different from a credit risk management perspective, because an entity needs to assess the change in credit risk since initial recognition, whereas credit risk managers assess credit risk at a particular date. For example, entities have raised concerns that two loans to the same entity could have different loss allowances when they are originated at different times. Although such a difference in perspective is likely to add cost and complexity to the impairment model, the IASB believes that it is justified because of the underlying concept that a loss only arises when the credit loss expectations on a financial instrument exceed those that are considered when pricing the instrument. Thus, this approach provides information that is useful for users of financial statements.

BCE.144 The implementation of the impairment model will require system changes that may be substantial, and time and resource commitments, resulting in significant costs for most entities with substantial amounts of financial instruments subject to impairment accounting including financial institutions that are already calculating expected credit losses for regulatory purposes. Entities will need to develop new systems and controls to integrate information produced for credit risk management purposes, or elsewhere in their business, into their accounting process. In addition, entities will incur one-time implementation costs to educate personnel in accounting functions to enable them to assess whether the information prepared for credit risk management would suffice to comply with the new impairment requirements. Finally, entities will need to explain to users of financial statements the new impairment model and how it differs from IAS 39 and from the information produced for credit risk management and regulatory purposes. However, these costs are mitigated because the impairment model is based upon changes in credit risk that should be monitored for credit risk management purposes and enables a variety of approaches to be taken to identify such changes, enabling entities to use credit risk information as a basis for implementation.

BCE.145 Participants in outreach activities, preparers responding to the 2013 Impairment Exposure Draft and participants in the fieldwork noted that the cost of implementing the proposed impairment model would depend on how entities segment their portfolios. An entity may, for example, in cases in which the credit risk at origination is similar for particular portfolios, segment its portfolios by credit risk at origination and assess increases in credit risk by comparing the credit risk at the reporting date with the initial credit risk for the relevant portfolio. Thus, the costs of applying the criteria to determine whether lifetime expected credit losses must be recognised would vary depending on the diversity of initial credit risk and the sophistication of credit risk management systems.

BCE.146 The IASB also clarified that a specific or mechanistic assessment is not required. This means that entities need not have explicit probability of default information to assess changes in credit risk, which will enhance the operability of the model and reduce the implementation and ongoing costs.

BCE.147 In addition, the IASB clarified that on initial application of the impairment requirements, entities are permitted to use reasonable and supportable information that is available without undue cost or effort to approximate the credit risk at initial recognition of a financial instrument. Participants in outreach activities and in the fieldwork noted that they would often not have the original credit risk information at transition, which could result in financial instruments being measured inappropriately at lifetime expected credit losses (ie when there have not been in fact a significant increase in credit risk). The IASB clarified the transition requirements because its intention is not to penalise those entities that could not obtain information about the initial credit risk without undue cost or effort. This clarification will enhance the operability of the impairment model and reduce preparers' costs on transition.

BCE.148 For the calculation of expected credit losses (and in particular for the calculation of lifetime expected credit losses), systems need to be updated or newly developed. Field participants used different methods to calculate expected credit losses and noted, for example, that current systems do not discount cash flows used to determine expected credit losses or may discount only to the date of expected default. As a result, systems would need to be modified to discount expected cash flows to the reporting date and to capture the expected timing of credit losses better.

BCE.149 The new disclosure requirements will result in the need to capture more data than under the current disclosure requirements in IFRS 7. Those costs arise on transition to establish the capability to provide those disclosures but will also include ongoing costs. However, if entities embed this in their systems that they use for preparing their financial statements, the ongoing costs can be reduced.

BCE.150 The IASB notes that significant implementation costs are not limited to the impairment model in IFRS 9 and that, regardless of which expected credit loss approach an entity implements, the cost and effort of implementation will be significant. The IASB believes that IFRS 9 appropriately balances the complex requirements of an impairment model based on expected credit losses, with simplifications designed to make the approach more operational, thereby reducing the cost of implementation.

Cost of ongoing application

Interest revenue recognition

BCE.151 The requirement to change the recognition of interest revenue from a gross basis to a net basis at a different level of increase in credit risk compared to when lifetime expected credit losses are recognised (ie when credit losses are incurred) adds a further level of complexity. However, the financial assets that are credit-impaired will be a subset of the financial assets for which lifetime expected credit losses are recognised in accordance with IFRS 9. In addition, because the criteria listed for an instrument to be credit-impaired are the same as the existing incurred loss criteria in IAS 39 (except for the exclusion of 'incurred but not reported'), the IASB believes that the application of these concepts should result in minimal change in practice and will therefore have no significant cost implications for existing IFRS preparers.[58]

Allowance for 12-month expected credit losses

BCE.152 The measurement of a loss allowance at an amount equal to 12-month expected credit losses adds costs and complexity to the impairment model. These costs will be less for financial institutions that are already required to calculate 12-month expected credit losses for prudential purposes; however, that measure would have to be adjusted to meet the measurement requirements of IFRS 9. In some cases, entities can use information such as loss rates to calculate 12-month expected credit losses, thus building on information that they already use for risk management purposes. However, the cost of measuring a loss allowance at an amount equal to 12-month expected credit losses will be higher for non-Basel II financial institutions and entities that are not financial institutions, because 12-month expected credit losses are a unique calculation that would not normally be required for other purposes. Participants in the fieldwork considered the 12-month allowance to be operational, because information on the 12-month risk of a default occurring is often readily available and already often used (albeit sometimes requiring adjustments) for internal credit risk or regulatory purposes. When information was not readily available internally, participants indicated that information is obtainable in the market to enable this to be determined. However, because of the uniqueness of the calculation, IFRS 9 also provides some relief; for example, the calculation of 12-month expected credit losses is not required for trade receivables, contract assets or lease receivables. In addition, as a result of the 12-month calculation, the lifetime expected credit losses are required to be recognised on fewer financial instruments. As this can be a complex exercise, (see further below in paragraph BCE.155) in effect the 12-month measure also is a source of cost mitigation.

Assessment of significant increases in credit risk

BCE.153 Respondents to the 2009 Impairment Exposure Draft highlighted that the proposals would have required entities to track the initial estimate of lifetime expected credit losses through the credit-adjusted effective interest rate and recognise subsequent changes in the lifetime expected credit losses. This would have led to significant operational challenges and substantial costs, because the effective interest rate information is not contained in the same systems as the credit risk information. To address this, IFRS 9 requires an assessment of the changes in credit risk that have occurred since initial recognition separately from the determination of the effective interest rate. It only requires the effective interest rate to be adjusted for a limited population of financial assets—those that are purchased or originated credit impaired. This reduces the cost of implementation and, in addition, this does not result in an incremental cost for IFRS preparers as this population is unchanged from IAS 39.

BCE.154 Some preparers, particularly credit risk managers, indicated that the tracking of credit risk, in most circumstances, is simpler and more closely aligned to credit risk management practices than the tracking of expected credit losses. To enable the model to be implemented more easily based on existing credit risk management systems, IFRS 9 therefore requires entities to measure and track the initial credit risk instead of changes in expected credit losses to determine whether there has been a significant increase in credit risk since initial recognition.

BCE.155 Some interested parties are concerned that the distinction between financial instruments whose credit risk has increased significantly since initial recognition and financial instruments for which this has not occurred will be operationally challenging. They would prefer lifetime expected credit losses to be measured for all financial instruments (ie also for those financial instruments that have a loss allowance measured at an amount

[58] Almost all participants in the fieldwork considered the proposal to measure interest revenue on the net basis for financial assets that are credit-impaired operable, because it is consistent with the current requirements in IAS 39.

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equal to 12-month expected credit losses in accordance with IFRS 9). However, any impairment model that is based on expected credit losses will require monitoring of changes in credit risk to update the expected credit loss amounts. Consequently, differentiating significant changes in credit risk from those that are not, is only an incremental cost to any other impairment model based on expected credit losses. Participants in the fieldwork and respondents to the 2013 Impairment Exposure Draft supported the operability of the impairment proposals for a model in which the measurement of the loss allowance changes when there is a significant increase in credit risk since initial recognition. They stated that this is similar to their credit risk management actions. In addition, it is also expected to be less costly compared to measuring lifetime expected credit losses for all financial instruments. This is because lifetime expected credit losses are most difficult to calculate for long-dated financial assets that are fully performing (ie the 'good' loans, which are measured at 12-month expected credit losses in accordance with IFRS 9), as noted by fieldwork participants. In addition, they observed that lifetime expected credit losses were more sensitive to the underlying assumptions. Their results from the fieldwork showed that updated macroeconomic forecasts led to more volatility in an impairment model based on lifetime expected credit losses for all financial instruments because of the extrapolation effects. They also observed that if lifetime expected credit losses were recognised for all financial instruments the allowance balances increased by at least 100 per cent compared to the 2013 Impairment Exposure Draft for both their mortgages and other portfolios. Finally, they stated that recognising lifetime expected credit losses for financial instruments that have not increased significantly in credit risk is not reflective of the economics of their business.

BCE.156 Some respondents to the 2013 Impairment Exposure Draft were concerned that the assessment of significant increases in credit risk as drafted in that Exposure Draft would require the explicit calculation and storage of the lifetime probability of default curve for a financial instrument to compare the expected remaining lifetime probability of default at inception with the remaining lifetime probability of default at the reporting date. However, the IASB had no intention to prescribe a specific or mechanistic approach to assess whether there has been a significant increase in credit risk. In fact, prescribing a specific method would be contrary to the approach taken by the IASB throughout the development of the new impairment requirements in IFRS 9, whereby the IASB took into account different levels of sophistication of entities and different data availability. Consequently, the IASB has clarified in IFRS 9 that an entity may apply different approaches when assessing whether the credit risk of a financial instrument has increased significantly since initial recognition for different financial instruments. This addresses different levels of sophistication and reduces the operational burden to assess whether a financial instrument shall be measured at lifetime expected credit losses.

BCE.157 In order to further reduce the operational burden of tracking the risk of a default occurring for all financial instruments since initial recognition, IFRS 9 does not require an entity to recognise lifetime expected credit losses on financial instruments with low credit risk at a reporting date, irrespective of the change in credit risk since initial recognition. Consequently, if an entity applies this simplification, it will not need to assess the change in credit risk from initial recognition for financial instruments that have low credit risk on a reporting date (for example, financial instruments whose credit risk is equivalent to investment grade).

BCE.158 The IASB acknowledges that not all entities have advanced credit risk management systems that will enable them to track the changes in credit risk over time. To further reduce the operational burden on such entities, IFRS 9 allows entities to use past due information to determine whether credit risk has increased significantly if information (either on an individual or a portfolio level) that is more forward-looking is not available without undue cost or effort, instead of requiring the implementation of more sophisticated credit risk management systems.

BCE.159 Some preparers were concerned that lifetime expected credit losses would need to be determined for each individual financial instrument, which would add to the operational burden of tracking. However, the IASB clarified that IFRS 9 does not require individual financial instruments to be identifiable as having significantly increased in credit risk in order to recognise lifetime expected credit losses. Financial instruments that share common risk characteristics can be assessed on a collective basis. In particular, IFRS 9 clarifies that the assessment of significant increases in credit risk could be implemented by establishing the maximum credit risk accepted for a particular portfolio on initial recognition (by product type and/or region; the 'origination' credit risk), and then comparing the credit risk of financial instruments in that portfolio at the reporting date with that origination credit risk.[59] In addition, it clarifies that in some cases the assessment of significant increases in credit risk can be implemented through a counterparty assessment instead of an assessment of each individual facility provided to the counterparty as long as such an assessment achieves the objectives of the impairment model and the outcome would not be different to what it would have been if financial

[59] Some of the participants in the fieldwork confirmed that this is a more practical way to implement the assessment of significant increases in credit risk for financial instruments, thus making the impairment model more operational.

instruments had been individually assessed.[60] Both of these clarifications are expected to reduce the operational burden of tracking.

Loan commitments and financial guarantee contracts

BCE.160 IFRS 9 requires the application of the impairment requirements to loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss. While respondents to the 2013 Impairment Exposure Draft widely supported the proposal to recognise a loss allowance for expected credit losses that result from these loan commitments and financial guarantee contracts when there is a present contractual obligation to extend credit, the majority of those respondents noted that expected credit losses on some loan commitments should not be estimated over the contractual commitment period. This is because it would be contrary to credit risk management and regulatory reporting, which could result in loss allowances that do not represent the credit losses expected on the off-balance sheet exposures resulting in outcomes for which no actual loss experience exists on which to base the estimates. Participants in the fieldwork who applied the proposed impairment model to credit cards also raised these concerns and suggested that the expected credit loss on these types of loan commitments should be estimated over the behavioural life instead of the contractual life of the instrument. IFRS 9 addresses these concerns and requires expected credit losses for revolving credit facilities, such as credit cards and overdraft facilities, to be measured over the period that the entity expects to be exposed to credit risk and not over the contractual commitment period. This change should enable the measurement of expected credit losses to be more closely aligned to credit risk management systems and enable the loss allowance to more faithfully represent expected credit losses on those exposures.

Simplified approach for trade receivables, contract assets and lease receivables

BCE.161 IFRS 9 addresses the costs and complexities for non-financial institutions and other entities through the simplified approach that removes the need to calculate 12-month expected credit losses and track the increase in credit risk for trade receivables, contract assets and lease receivables.[61]

The effect on entities with less sophisticated credit risk management systems

BCE.162 While a few interested parties have expressed concern that it would be costlier to implement the proposals in some jurisdictions, and for entities that have less sophisticated credit risk management systems, it is the IASB's view that systems and processes that would be required to apply IFRS 9 generally also would be required to manage the entity's business effectively.

BCE.163 However, in order to reduce the operational burden and cost of application for entities, IFRS 9:

(a) does not require lifetime expected credit losses to be determined for all financial instruments;

(b) has a 'low credit risk' simplification (see paragraph 5.5.10 of IFRS 9);

(c) allows entities to use past due information to implement the model (in conjunction with more forward-looking information that is reasonably available without undue cost or effort);

(d) does not require a specific approach for assessing whether there has been a significant increase in credit risk, thus enabling entities to build upon their credit risk management information;

(e) clarifies that significant increases in credit risk can be assessed on an individual instrument or a portfolio basis; and

(f) allows entities to use practical expedients when measuring expected credit losses (such as a provision matrix for trade receivables) if doing so is consistent with the principles of IFRS 9.

BCE.164 In addition, IFRS 9 emphasises that an exhaustive search for information is not required. For example, when assessing significant increases in credit risk, entities shall consider all internal and external information that

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[60] During the fieldwork, some participants were initially concerned that the assessment of significant increases in credit risk is not based on changes in the counterparty's credit risk. However, over the course of the fieldwork, a number of those participants found ways to deal with the difference between the change in the counterparty credit risk and the change in the credit risk of the instrument since origination and stated this to be no longer an area of concern.

[61] The non-financial institutions that participated in the fieldwork supported the accounting policy election for lease receivables. They applied the simplified approach because:
(a) the assets in the portfolio were short term in nature; and
(b) the simplified approach fitted better into their current credit risk systems, which were not sophisticated systems.
The majority of the respondents to the 2013 Impairment Exposure Draft also supported the accounting policy election for lease and trade receivables.

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is reasonably available without undue cost or effort. This may mean that entities with little historical information would draw their estimates from internal reports and statistics (which may, for example, have been generated when deciding whether to launch a new product), information that they have about similar products or from peer group experience for comparable financial instruments.

Disclosures

BCE.165 Disclosures are a major contributor to the overall benefits of the model. As mentioned in paragraph BCE.172, the IASB decided to include requirements that provide users of financial statements with information about how an entity manages its credit risk and estimates and measures expected credit losses. The IASB received feedback that a number of the disclosure requirements in the 2013 Impairment Exposure Draft were operationally challenging. With this in mind, the IASB decided on a number of changes and clarifications to reduce the burden of compliance while still providing the information needed by the users of the financial statements.

BCE.166 The IASB considers the requirement in the 2013 Impairment Exposure Draft to provide a reconciliation between the opening balance and the closing balance of the loss allowance and the gross carrying amount of financial assets as a core disclosure. Respondents to the 2013 Impairment Exposure Draft were concerned that this disclosure would be operationally too challenging. Given the feedback raised on operational concerns, the IASB made the disclosure less prescriptive and more principle-based by clarifying that its objective is to provide information about the significant changes in the gross carrying amount that contributed to changes in the loss allowance during the period. In particular, the disclosures are intended to enable users of the financial statements to differentiate between the effects of changes in the amount of exposure (for example, those due to increased lending) and the effect of changes in credit risk. The IASB considers that the requirement, as clarified, is less operationally burdensome but still provides useful information to users of financial statements.

BCE.167 Another important disclosure is the disclosure about modified financial assets. The requirement in the 2013 Impairment Exposure Draft to disclose the gross carrying amount of financial assets that have been modified resulted from a request from users of financial statements to understand the amount of assets that have been modified and subsequently improved in credit risk. The IASB addressed preparers' concerns that the disclosure of the gross carrying amount of modified financial assets for which the measurement objective has changed from lifetime to 12-month expected credit losses during the entire remaining lifetime of the asset (ie until derecognition) would be too onerous, because it would require the tracking of individual assets even after they have returned to a performing status and are no longer closely monitored for credit risk management purposes. Instead, entities shall now only disclose financial assets modified during the reporting period. This still provides an important source of information about the amount of restructuring activity being undertaken while being less burdensome.

The likely effect on costs of analysis for users of financial statements

BCE.168 The IASB believes that users of financial statements will benefit from the timelier information provided about credit risk and the changes in credit risk. The impairment model in IFRS 9 is in strong contrast to the incurred loss model in IAS 39, in which credit losses were only recognised once there was objective evidence that a loss event had occurred. In accordance with IFRS 9, a loss allowance at an amount equal to 12-month expected credit losses will be recognised for all financial instruments unless there has been a significant increase in credit risk since initial recognition, in which case a loss allowance at an amount equal to lifetime expected credit losses should be recognised. Lifetime expected credit losses are therefore recognised earlier than under the incurred loss model in IAS 39, because the credit risk will generally increase significantly before one or more credit loss events occur, particularly given the use of forward-looking information.

BCE.169 The IASB acknowledges that some users of financial statements might have preferred lifetime expected credit losses to be recognised for high credit risk financial instruments that are not purchased or originated credit impaired at initial recognition, whereas only 12-month expected credit losses will be recognised until there has been a significant increase in the credit risk since initial recognition. However, the IASB did not want to create an 'artificial' disincentive for entities to lend to customers with higher credit risk. Furthermore, the IASB believes that full lifetime expected credit losses should not be recognised on initial recognition irrespective of the initial credit risk because financial instruments are priced reflecting initial credit risk expectations. In particular, the IASB was concerned about the effect on the balance sheet carrying amount at initial recognition that would result if lifetime expected credit losses were recognised from inception.

BCE.170 The IASB noted that by reducing the effect on initial recognition by limiting the loss allowance to 12-month expected credit losses the risk of unintended consequences (such as reducing lending to higher risk customers

even when correctly priced or reducing lending as the economic environment weakens in order to enable loss allowances to run down creating a gain in profit or loss) would be reduced.

BCE.171 The IASB acknowledges that it would be preferable for users of financial statements if the accounting for expected credit losses was aligned between IFRS and US GAAP. At the time of completing IFRS 9 it appeared likely that accounting for impairment would not be converged despite the efforts of the IASB and the FASB. However, the IASB noted that it was important to improve impairment accounting in accordance with IFRS.

BCE.172 The IASB acknowledges that the assessment of changes in credit risk since initial recognition inherently involves a significant amount of subjectivity and therefore reduces the verifiability and comparability of reported amounts. This inevitably results in costs of analysis to users of financial statements. However, decisions about when credit losses are incurred and the measurement of impairment losses currently in accordance with IAS 39 also involve subjectivity and there is a lack of comparability because of the differences in the application of the incurred loss criteria. IFRS 9 mitigates these issues to some extent by expanding the disclosure requirements to provide users of financial statements with information about the inputs, assumptions and techniques that entities use when assessing the criteria for the recognition of lifetime expected credit losses and the measurement of expected credit losses. For example, a reconciliation is required between the opening balance and the closing balance of the loss allowance and the gross carrying amount of financial assets, which the IASB considers provides useful information about the development and evolution of expected credit losses. Disclosure is also required of information about financial assets with a loss allowance at an amount equal to lifetime expected credit losses that have been modified, including the gross carrying amount of the financial assets and the gain or loss resulting from the modification. Information on modifications is responsive to requests for enhanced information in this area from users of financial statements, because this information was found to be inadequate during the global financial crisis.

Conclusion

BCE.173 The IASB expects that the requirements will provide timelier and more representationally faithful information about an entity's current estimates of expected credit losses and the changes in those estimates over time for all financial instruments subject to impairment accounting. In addition, the requirements include a comprehensive package of disclosures that will help investors to understand the judgements, assumptions and information used by an entity in developing its estimates of expected credit losses. As a result, more relevant and transparent information will be provided to users of financial statements.

Analysis of the effects: Hedge Accounting

Introduction

BCE.174 Throughout the Hedge Accounting project, the IASB performed outreach and consulted with interested parties, with the largest outreach meeting being attended by over 200 participants. The IASB also had extensive discussions with regulators and audit firms worldwide. The analysis in paragraphs BCE.175–BCE.238 is based on the feedback received through this process. Overall, the IASB held over 145 outreach meetings in all the major jurisdictions and also evaluated 247 comment letters received in response to the Exposure Draft *Hedge Accounting*, which was published in 2010 ('2010 Hedge Accounting Exposure Draft'). The IASB also considered comments received on the draft Standard posted on its website in September 2012.

Overview

BCE.175 Financial reporting should provide transparent information to enable better economic decision-making. Hedge accounting relates to the reporting of risk management activities that entities enter into, to manage their exposures to the risks identified as relevant, from a business perspective.

BCE.176 Over the last decades, the extent and complexity of hedging activities have increased substantially. This has been caused not only by entities' increasing willingness and ability to manage their exposures, but also by the increased availability of financial instruments to manage those exposures.

BCE.177 The hedge accounting requirements in IAS 39 *Financial Instruments: Recognition and Measurement* were complex and rule-based. They involved trying to fit transactions that were originated for risk management purposes into an accounting framework that was largely divorced from the purpose of the transactions. This was pointed out by respondents to the Discussion Paper *Reducing Complexity in Reporting Financial*

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Instruments (published in 2008) and the sentiment has been confirmed in the outreach and feedback received by the IASB while developing the new hedge accounting requirements.

BCE.178 This also caused difficulties for users of financial statements when trying to understand the information reported in financial statements. Some users of financial statements regarded hedge accounting as being incomprehensible and often removed its effects from their various analyses. Users frequently argued that they had to request additional information (often on a non-GAAP basis) to be able to perform their analyses (for example, making forecasts), because the way in which the hedging activities were accounted for and the disclosures that were provided were often considered not to portray risk management in a useful way. The disclosures under IAS 39 were perceived as too accounting-centric and lacking transparency. This led to entities presenting non-GAAP information in various ways, with various levels of detail across different documents that range from the Management Discussion and Analysis to investor presentations.

BCE.179 The complexity of the hedge accounting model in IAS 39 and the resulting increased importance of non-GAAP information led preparers and users of financial statements to ask the IASB to develop a model that, instead of reporting the results of an accounting-centric exercise, would report the performance of an entity's hedging activities in the financial statements on a basis that was consistent with that entity's risk management activities.

BCE.180 The IASB believes that the new hedge accounting requirements address this issue. Under the new model, it is possible for the financial statements of an entity to reflect its risk management activities instead of simply complying with a rule-based approach, such as the approach in IAS 39.

BCE.181 Overall, the IASB's assessment is that these new requirements will bring significant and sustained improvements to the reporting of hedging activities. In addition, entities will be able to use information that they have prepared for the purpose of undertaking their hedging activities as the basis for demonstrating compliance with the hedge accounting requirements.

BCE.182 The hedge accounting requirements included in IFRS 9 reflect a substantial change from many aspects of hedge accounting in IAS 39. These amendments to hedge accounting will affect a variety of entities, including both financial and non-financial institutions. The new model will benefit from a more principle-based approach, including the revised eligibility criteria both for hedged items and hedging instruments, and a new objective-based hedge effectiveness assessment. In addition a targeted solution has been introduced for hedges of credit risk using credit derivatives. Entities dealing with hedging of non-financial items are likely to have significant benefits, albeit with some costs to be incurred when implementing the new model. Banks and other financial institutions will also benefit from the general hedge accounting model.

BCE.183 Areas in which it is expected that the new requirements will produce the greatest impact include: hedge effectiveness testing; eligibility of risk components of non-financial instruments; disclosures; accounting for the costs of hedging; aggregated exposures; groups and net positions; the rebalancing and discontinuation of hedging relationships; and hedges of credit risk using credit derivatives.

BCE.184 The IASB expects that most costs for preparers will be incurred at the transition date and will relate to the links that need to be created between the accounting and the risk management functions. Under the current model for hedge accounting such links have generally been weak or non-existent, reflecting the accounting-centric character of that model. Additional costs will be incurred in explaining to the users of financial statements the impact of the hedging activities. This cost will, however, be mitigated by the fact that, given the greater alignment with risk management, some of the information, although not used for accounting purposes, is already being produced for risk management purposes or is being produced for the reporting of alternative performance measures (the latter often being presented on a non-GAAP basis). In particular, the costs for the hedge effectiveness test for many hedging relationships, especially simple ones, should be reduced on an ongoing basis. The IASB's assessment is that the significant improvements in terms of comparability and transparency will outweigh those costs.

How activities would be reported in the financial statements of those applying IFRS 9

BCE.185 The analysis in paragraphs BCE.186–BCE.238 focuses on the key differences between the existing model in IAS 39 and the new hedge accounting model in this Standard and how the new model will impact financial reporting. In particular, an analysis of some of the key changes introduced by the IFRS 9 hedge accounting model that will change entities' ability to apply hedge accounting is included in paragraphs BCE.190–BCE.205.

Objective of the Standard

BCE.186 During its outreach activities the IASB learnt that both preparers and users of financial statements were frustrated about the lack of connection between actual risk management and the hedge accounting requirements. In particular, preparers found it difficult to reflect their risk management and users of financial statements found it difficult to understand the reflection of risk management on the basis of the hedge accounting requirements in IAS 39. In view of the criticisms received, the IASB, instead of merely considering improvements to the existing model, decided to rethink the entire paradigm of hedge accounting.

BCE.187 The IASB decided that the "objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments".[62] This is a principle-based instead of a rule-based approach that focuses on an entity's risk management. Almost all respondents to the 2010 Hedge Accounting Exposure Draft as well as participants in the IASB's outreach activities supported the objective of improving information about risk management through hedge accounting as proposed by the IASB.

BCE.188 Consequently, subject to qualifying criteria, the model developed by the IASB uses the risk management activities of an entity as the foundation for deciding what qualifies (or what does not qualify) for hedge accounting. The aim of the model is to faithfully represent, in the financial statements, the impact of the risk management activities of an entity.

Qualifying hedging instruments

BCE.189 IAS 39 imposed restrictions on what could and what could not be considered as hedging instruments. Respondents to the 2010 Hedge Accounting Exposure Draft questioned the logic behind the arbitrary disallowance of certain types of financial instruments as hedging instruments in IAS 39 even when such financial instruments provided an effective offset for risks managed under common risk management strategies. The key restriction in IAS 39 was the disallowance of designating non-derivative instruments as hedging instruments for hedges of risks other than foreign currency risk.

BCE.190 The IASB decided to expand the types of eligible financial instruments under the new hedge accounting model, to allow non-derivative financial assets and liabilities at fair value through profit or loss to be designated as hedging instruments, ie to acknowledge their effect also for accounting purposes.

BCE.191 The other key change brought in by the new hedge accounting model is the removal of the distinction between combinations of stand-alone written and purchased options and those combined in one contract. The IASB decided that the eligibility of an option contract to be designated as a hedging instrument should depend on its economic substance and risk management objectives instead of its legal form alone. Consequently, the IASB decided that a stand-alone written option would be eligible for designation as a hedging instrument if it is jointly designated with other hedging instruments so that, in combination, they do not result in a net written option.

Qualifying hedged items

BCE.192 A key change brought about by the Standard is the ability to hedge a risk component of a non-financial item. The IASB decided to align the treatment of financial and non-financial items to also allow the hedging of risk components in non-financial items, when they are separately identifiable and reliably measurable. This, as noted by many respondents, represents a key aspect of the new hedge accounting model as it allows the accounting to reflect the commercial reality in hedges of non-financial items because, in practice, components of non-financial items are often hedged because hedging the entire item is commercially not viable (because of, for example, a lack of availability of cost effective hedging instruments) or not desired (because, for example, the entity regards accepting the risk as more economical than transferring it to others using hedges). This change will enable such hedges to be reflected in the designation used for hedge accounting, thereby enabling preparers to better reflect, and users of financial statements to better understand, the actual risk management activity and the effectiveness of hedging strategies.

BCE.193 Under IAS 39 hedged items that together constitute an overall net position of assets and liabilities could only be designated in a hedging relationship with the gross position (a group) being the hedged item if certain restrictive criteria were met. These restrictions made achieving hedge accounting for items managed as part of a net position under IAS 39 difficult in practice and made it necessary to designate gross positions instead

[62] See paragraph 6.1.1 of IFRS 9.

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of the net position that is being economically hedged. This created a disconnect between the accounting and the actual risk management activity.

BCE.194 Consequently, the IASB decided that groups of items (including net positions) would be eligible for hedge accounting. In the case of foreign currency exposures this would mean that all of the actual cash flows included within the group of cash flows being hedged could be designated in line with actual risk management. However, the IASB also decided that for cash flow hedges such net position hedging would not be available for risks other than foreign currency exposures. However, the IASB noted that this did not prevent entities from getting hedge accounting through gross designations that are determined by the net exposure that is monitored for risk management purposes.

BCE.195 In the area of 'risk components', respondents believed that it should be possible to designate a risk component that assumes cash flows that would exceed the actual cash flows of the hedged item, as it reflects risk management in situations in which the hedged item has a negative spread to the benchmark rate. For example, being able to designate a full LIBOR component in a financial instrument that yields LIBOR less a spread (colloquially referred to as 'sub-LIBOR'). Such respondents believed that it should be possible to hedge the LIBOR risk as a benchmark component and treat the spread as a negative residual component, as they hedged their exposure to the variability of cash flows attributable to LIBOR (or a correlated index) using LIBOR swaps.

BCE.196 In its deliberations, the focus was primarily on the sub-LIBOR scenario although the issue is not unique to that situation (see paragraphs BC6.217–BC6.229). In that context, the IASB noted that, for risk management purposes, an entity normally does not try to hedge the entire interest rate of a financial instrument but instead the change in the variability of the cash flows attributable to LIBOR. Such a strategy protects an entity's exposure to benchmark interest rate risk and, importantly, the profit margin of the hedged items (ie the spread relative to the benchmark) is protected against LIBOR changes. This is, of course, only feasible if LIBOR does not fall below the absolute value of the negative spread. However, if LIBOR does fall below the absolute value of that negative spread it would result in 'negative' interest, or interest that is inconsistent with the movement of market interest rates. Consequently, in contrast to exposures with full LIBOR variability, hedging sub-LIBOR exposures means that the entity remains exposed to cash flow variability in some situations. The IASB noted that allowing a designation that ignores this fact would not faithfully represent the economic phenomenon.

BCE.197 Consequently, in the Standard the IASB retained the restriction in IAS 39 for the designation of risk components when the designated risk component exceeds the total cash flows of the hedged item. However, hedge accounting would still be available in such situations if all the cash flows hedged for a particular risk are designated as the hedged item.

Qualifying criteria for hedge accounting

BCE.198 As with the other aspects of the current hedge accounting model in IAS 39, the IASB received information during outreach and comments from respondents to the 2010 Hedge Accounting Exposure Draft about the hedge effectiveness requirements in IAS 39. The feedback received clearly showed that participants believed that the hedge effectiveness assessment in IAS 39 was formulaic, onerous and difficult to apply. As a consequence, there was often little or no link between the analysis undertaken by risk managers who hedge the risk and the analysis required to apply hedge accounting, and as a result between the hedge accounting and risk management operations. This was reflected, for example, in the fact that hedge accounting could be required to be discontinued in situations in which the hedging relationship was regarded as satisfactory and could be continued from a risk management perspective and for which the entity could achieve hedge accounting again—but only as a new hedging relationship. Also, given the specified bright lines for effectiveness and the accounting consequences of deviating from the same, it made hedge accounting difficult to understand and apply.

BCE.199 To address these concerns, the IASB decided to require an objective-based model for testing hedge effectiveness instead of the bright line test (80–125 per cent) in IAS 39. Instead of setting quantitative thresholds or bright lines, this approach focuses on the achievement of economic offset, a concept used by risk managers when designing and implementing hedging strategies. It also has the benefit of removing the burden of working out hedge effectiveness purely for accounting purposes and instead leverages the assessment done by risk management to ensure compliance with the hedge effectiveness requirements in the Standard. The principles and the concepts behind this change received widespread support.

BCE.200 In addition, IAS 39 did not allow adjustments in the hedging relationship subsequent to designation, except for rollover strategies documented at contract inception, to be treated as adjustments to a continuing hedging relationship. Consequently, IAS 39 treated such adjustments to an existing hedging relationship as a discontinuation of the original hedging relationship and the start of a new one. The IASB, in its deliberations, noted that this was inconsistent with risk management practices and did not represent the economic

phenomenon in practice. There are instances when, although the risk management objective remains the same, adjustments to an existing hedging relationship are made because of changes in circumstances related to the hedging relationship's underlyings or risk variables. The IASB concluded that, in situations in which the original risk management objective remained unaltered, the adjustment to the hedging relationship should be treated as the continuation of the hedging relationship. This will have the effect of enabling changes in risk management to be properly portrayed in hedge accounting.

BCE.201 Under IAS 39 an entity had to discontinue hedge accounting when the hedging relationship ceased to meet the qualifying criteria. Also, the entity had a free choice to discontinue hedge accounting by simply revoking the designation of the hedging relationship, irrespective of the reason behind it. The IASB noted that entities often voluntarily discontinued hedge accounting because of how the effectiveness assessment in IAS 39 worked. The IASB noted that, in some situations, the hedging relationship was discontinued and then restarted even though the risk management objective of the entity had not changed. In the IASB's view, this created a disconnect between the hedge accounting model in IAS 39 and hedging from a risk management perspective. In the light of this, the IASB decided that the ability of an entity to voluntarily revoke a hedge designation, even when all qualifying criteria are met, would no longer be available. However, if the risk management objective for the hedging relationship changes then hedge accounting needs to be discontinued. This will improve the link with risk management by ensuring that once hedge accounting commences it will continue as long as the hedge still qualifies for hedge accounting.

Mechanics of hedge accounting

BCE.202 The IASB considered the fact that the mechanics for hedge accounting in IAS 39 were well established and understood by most interested parties, and therefore decided to retain those hedge accounting mechanics in the new model. The IASB did, however, note that many users of financial statements were confused by the accounting distinction made between cash flow hedges and fair value hedges and how that distinction related to risk and the strategies for managing such risks. Consequently, the IASB decided to include new disclosure requirements in IFRS 7, whereby all disclosures for hedge accounting are presented in a single section in the financial statements with the objective of alleviating this confusion.

BCE.203 Under IAS 39 entities typically designated option-type derivatives as hedging instruments on the basis of their intrinsic value. This meant that the time value that was not designated was required to be presented similarly to financial instruments held for trading. This created a disconnect between the accounting treatment and the risk management view, whereby entities typically consider the time value of an option at contract inception (the premium paid) as a cost of hedging akin to a cost of buying protection (like insurance).

BCE.204 The IASB agreed that the time value of an option could be viewed as a premium paid for protection against risk and, consequently, decided to align the accounting for the time value with the risk management perspective. The IASB took the view that, like the distinction between the different types of costs related to insuring risk, the time value of options should be similarly distinguished. For transaction related hedged items the cumulative change in the fair value of the option's time value should be accumulated in other comprehensive income and should be reclassified in a similar way to that for cash flow hedges. In contrast, for time-period related hedged items the nature of the time value of the option used as the hedging instrument is that of a cost for obtaining protection against a risk over a particular period of time. Hence, the IASB considered that the cost of obtaining the protection should be allocated as an expense over the relevant period on a systematic and rational basis.

BCE.205 The effect of this change is that the time value paid is treated like a cost of hedging instead of as held for trading with the resulting volatility recognised in profit or loss. This enables the costs of such a hedging strategy to be presented in a manner that reflects the inter-relation with the hedging relationship in which the option's intrinsic value is designated, and is consistent with risk management. It also removes a potential disincentive against the use of options as hedging instruments and improves transparency of the costs of hedging.

BCE.206 The IASB made similar changes to the accounting for the forward element of forward contracts and the foreign currency basis spread of hedging instruments.

Accounting for macro hedging

BCE.207 In practice, risk management often considers exposures on an aggregated basis over time. Over time, exposures are either added or removed from the hedged portfolio resulting in what are generally called hedges of 'open positions'. Hedges of open positions introduce significant complexity in the accounting model as the continuous changes in the hedged item need to be monitored and tracked for accounting purposes. The

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continuous changes in the hedged item also mean there is no direct one-to-one relationship with particular hedges.

BCE.208 The IASB decided not to specifically address open portfolios or the accounting for 'macro hedging' as part of the new hedge accounting model. The IASB noted that under IAS 39 entities often already account for 'macro' activities by applying the general hedge accounting model. The IASB received feedback from financial institutions, as well as from entities outside the financial sector, that addressing situations in which entities use a dynamic risk management strategy was important. Given the nature and complexity of the topic, the IASB has decided to separately deliberate the accounting for macro hedging with the objective of issuing a Discussion Paper.

BCE.209 IFRS 9 (like IAS 39) does not allow cash flow hedges of interest rate risk to be designated on a net position basis but instead on the basis of gross designations. However, so called 'proxy hedging' (when, for example, the designation for hedge accounting purposes is on a gross position basis even though actual risk management typically manages on a net position basis) is still an eligible way to designate a hedged item as long as the designation reflects risk management in that it is related to the same type of risk that is being managed and the financial instruments used for that purpose. Thus, while the separate project continues to explore a more comprehensive model to address the accounting for macro hedging activities, the ability to apply hedge accounting is not expected to change as a result of applying IFRS 9.

BCE.210 In addition, entities can elect to continue to apply the IAS 39 hedge accounting requirements until completion of the project on accounting for macro hedging.

Hedges of credit risk

BCE.211 Financial institutions use credit derivatives to manage their credit risk exposures arising from their lending activities and also, on occasion, to reduce their regulatory capital requirements. However, the credit risk of a financial item is not a risk component that meets the eligibility criteria for hedged items. This is currently a significant issue, particularly for financial institutions because, by using derivatives to manage credit risk, an activity designed to reduce risk, volatility in profit or loss is increased, thereby creating the perception of increased risk.

BCE.212 Many respondents were of the view that the IASB should address the accounting for hedges of credit risk using credit derivatives. Most of them also believed that this is an important issue in practice that the IASB should address.

BCE.213 The IASB decided to use a targeted fair value option to reflect the management of credit risk. The IASB decided to allow the designation of financial instruments, both recognised and unrecognised, to be at fair value through profit or loss if the credit risk of those financial instruments is managed using a credit derivative that is also measured at fair value through profit or loss. This eliminates the accounting mismatch that would otherwise arise from measuring credit derivatives at fair value and hedged items (such as loans) at amortised cost. It also enables entities to appropriately reflect this risk management activity in their financial statements. By allowing entities to make this election also for a proportion of a financial instrument and after its initial recognition, and to subsequently discontinue the fair value measurement for the hedged credit exposure, this approach enables entities to reflect their risk management activity more effectively than using the fair value option (which is available only on initial recognition for the financial instrument in its entirety, and is irrevocable). This becomes important because entities often do not hedge items for their entire life. This targeted fair value option is also available for credit exposures that are outside the scope of this Standard, such as most loan commitments.

Comparability of financial information

BCE.214 The IASB decided that by its very essence, hedge accounting should continue to be voluntary. As a result, there will never be full comparability because, for example, despite identical risk management activity one entity may choose to apply hedge accounting whereas the other may not. However, by improving the link to risk management, which in itself makes hedge accounting less burdensome to apply and facilitates a more useful reflection of risk management activities, increased use of hedge accounting should occur thus improving comparability.

BCE.215 With this in mind the IASB discussed whether it should retain an entity's choice to revoke the designation of a hedging relationship. The IASB decided not to allow the discontinuation of hedge accounting when an entity's risk management objective is unchanged. This will assist in improving comparability.

BCE.216 One of the key contributors to comparability is disclosure. The IASB decided to retain the scope of the hedge accounting disclosures because it provides, to users of financial statements, information on exposures that an

entity hedges and for which hedge accounting is applied. For this population of hedging relationships, disclosure is required that will enable users of financial statements to better understand risk management (its effects on cash flows) and the effect of hedge accounting on financial statements. In addition, the IASB decided that all hedge accounting disclosures (ie irrespective of the type of hedge and the type of information required) should be presented in one location within an entity's financial statements. Hedge accounting has been difficult for users of financial statements to understand, which in turn has made risk management difficult to understand. These enhanced disclosures will assist in improving the ability of users of financial statements to compare entities' risk management activities.

Better economic decision making as a result of improved financial reporting

BCE.217 One of the fundamental changes introduced by the Standard is that the entire paradigm of hedge accounting has been changed to align more closely with the risk management activities of an entity. The IASB is of the view that this fundamental shift in focus—whereby the accounting and risk management objectives are brought in congruence—will result in better economic decision making through improved financial reporting. One such example is the accounting for options.

BCE.218 In the IASB's outreach some entities said that the accounting consequences of using options (non-linear instruments) were a consideration in their risk management activities. This was because the undesignated time value of the option was accounted for as at fair value through profit or loss, thereby resulting in significant profit or loss volatility. The IASB has addressed this issue and has better aligned the reported results with the risk management perspective. Time value is now considered to be a cost of hedging instead of a trading position. Similarly, the IASB addressed the accounting for the forward element of forward contracts and the foreign currency basis spread in instruments that hedge foreign currency risk and decided on a treatment similar to that of the time value of options. The latter issue was, for example, of particular concern to entities that raised funds in a currency other than their functional currency.

BCE.219 The IASB expects that these amendments will significantly reduce the accounting considerations affecting risk management decisions and also provide users of financial statements with more useful information about hedging activities, including the cost of such activities, resulting in better economic decision making.

BCE.220 As discussed previously (see paragraphs BCE.189–BCE.190) the IASB decided to expand the types of eligible financial instruments under the new hedge accounting model to allow non-derivative financial assets and liabilities at fair value through profit or loss as eligible hedging instruments. The IASB noted the comments received from respondents that such a treatment enables an entity to better capture its risk management activities in its financial statements. In the IASB's view this will significantly contribute to better economic decision making by capturing established risk management strategies in reported results through hedge accounting. It is particularly relevant for jurisdictions in which the use of derivatives is restricted.

BCE.221 Aligning the treatment of risk components for financial and non-financial items represents a fundamental change in the hedge accounting model, as this will allow entities to better represent their hedging and risk management activities for non-financial items in their financial statements. Entities will be able to more readily designate hedges in a manner that is consistent with risk management and to recognise hedge effectiveness on this basis. The IASB believes that this will significantly improve the usefulness of reported information for entities hedging non-financial items, which will enable preparers to better reflect their performance and result in better economic decision making.

BCE.222 The removal of the bright-line hedge effectiveness requirements will avoid discontinuation of hedging relationships in the financial statements under circumstances in which the hedge is still economically effective. Instead of a percentage-based test that does not meaningfully capture the characteristics of a hedging relationship in all situations, the effectiveness of hedging relationships will be evaluated on the basis of the features that drive their economic success. The new model will ensure that when the economics of a transaction demand that a hedge be rebalanced, such rebalancing does not lead to the hedging relationship being portrayed as discontinued. The IASB believes that such amendments will enable the economic success of an entity's hedging programme to be reflected in the financial statements, thereby leading to better decision making by both management and users of financial statements, because they will be in a better position to make informed judgements about an entity's hedging operations.

BCE.223 The IASB's decision to require the continuation of hedge accounting when a derivative is novated to effect clearing with a central clearing party also improves the usefulness of information for users of financial statements. This is achieved by preventing the discontinuation of hedge accounting and the ineffectiveness that would arise from a new hedging relationship being designated as a replacement.

BCE.224 Risk management also takes into consideration the risk positions that have been created by aggregating exposures that include derivative financial instruments. IAS 39 only allowed derivatives to be designated as hedging instruments, but not to be part of hedged items. Consequently, positions that are a combination of an exposure and a derivative (aggregated exposures) failed to qualify as hedged items. Under the new model an

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aggregated exposure (comprising a derivative and non-derivative) is an eligible hedged item. Similarly, by modifying the requirements for hedges of groups of items, the accounting for such hedges can now be better represented in the financial statements. Again, the IASB believes that, aligning the accounting model with risk management will result in better information for economic decision making.

BCE.225 This Standard also makes changes to aspects of the accounting for financial instruments outside hedge accounting that allow risk management to be more faithfully represented in the financial statements. One area is the accounting for contracts to buy or sell non-financial items, so called 'own use contracts'. Currently, those contracts are not treated as derivatives in particular circumstances (they are executory contracts that are off the statement of financial position). This can create an artificial perspective when they are measured as part of a portfolio that includes other items that are recognised in the statement of financial position and measured at fair value through profit or loss. By allowing entities to elect to measure own use contracts at fair value through profit or loss, entities are better able to provide information about their risk management activities in the financial statements. The IASB believes that these changes, along with those concerning the management of credit risk, will provide better information for economic decision making.

Compliance costs for preparers

BCE.226 As with all new requirements, the IASB acknowledges that different areas of the requirements will have different effects and hence different types of costs and benefits will arise when considering both preparers and users of financial statements. Given that the new model is based on an entity's risk management practices, it is reasonable to conclude that one of the key drivers of the costs incurred and the benefits obtained, in complying with the new requirements, will be the level of development and the sophistication of the entities' risk management functions.

BCE.227 Entities will incur a one-time cost on initial application to address:

(a) development of new processes, systems and controls to integrate information produced for risk management purposes into their accounting processes;

(b) creating accounting capabilities for some new eligible accounting treatments (if they are intended to be used—for example, the new accounting for costs of hedging);

(c) updating of the documentation for existing hedging relationships on transition to the new requirements;

(d) education of accounting functions to enable them to assess whether the information prepared for risk management purposes would suffice to comply with the new hedge accounting requirements; and

(e) the need to explain to users of financial statements the difference between the information produced for risk management purposes and the hedge accounting disclosures.

BCE.228 The IASB believes that the costs of the transition, as well as the ongoing costs of applying the new hedge accounting requirements, will very much depend on the individual circumstances of each entity—for example, what type of hedging instruments and hedged items it has, what types of hedges it uses, and how it has implemented hedge accounting in terms of processes and systems. It is therefore difficult to generalise the likely impact of costs on preparers. Broadly, the IASB expects:

(a) entities with more sophisticated risk management functions, that produce reliable information for the entity's own management, will have costs of initial application in establishing better links between those functions and their accounting function, but the ongoing costs of application should then be lower because of the new hedge effectiveness test.

(b) entities that have embedded hedge accounting in their accounting systems may have to adjust their systems, depending on the particular implementation of IAS 39 and what additional new accounting treatments the entity wants to use. Entities using bespoke or self-developed solutions are affected differently from those using standard software. In all cases, the costs are one-off transition costs.

(c) entities that use a master documentation approach, whereby the documentation of individual hedging relationships includes references to master documents that set out risk management strategies or effectiveness testing methods, will have lower costs of making the transition than entities that include that information in full in the documentation of each individual hedging relationship. Those costs are also one-off transition costs.

(d) the new disclosure requirements will result in the need to capture more data than under the current hedge accounting disclosures in IAS 39. Costs arise on transition when the capability to provide those disclosures is created but will also include ongoing costs. However, if entities embed this in their systems that they use for preparing their financial statements the ongoing costs can be significantly reduced.

BCE.229 Overall, given the fact that the new model developed by the IASB is more aligned with the day-to-day risk management activities of an entity, the IASB believes that the following benefits will outweigh the costs of initial implementation and on-going application:

(a) better consistency between accounting and risk management;

(b) better operational efficiency;

(c) less need for non-GAAP information to explain to users of financial statements the impact of hedging for which hedge accounting was not achieved;

(d) reduction in the costs of workarounds to deal with the restrictions in IAS 39; and

(e) standardised and more transparent information, resulting in a better understanding of the company's hedging performance.

BCE.230 In addition to those costs set out in paragraph BCE.228, the IASB notes that one of the key costs of compliance with the hedge accounting requirements of IAS 39 is the infrastructure and resources required to maintain the hedge documentation and effectiveness testing. Under the new model, linking the hedge documentation requirements with that of risk management systems will, in the IASB's view, bring in efficiencies and cost savings as entities integrate such systems. In addition, the new model includes an objective-based effectiveness assessment, which is linked to the way that the hedging relationship is designed and monitored for risk management purposes. This will substantially reduce the costs of ongoing compliance compared with IAS 39.

BCE.231 This will be further reinforced by the fact that the IASB, after due consideration, decided to keep the mechanics of hedge accounting for fair value, cash flow and net investment hedges the same. This will avoid any major costs involved with changing accounting systems both on initial application and on an ongoing basis.

BCE.232 One of the costs involved with the application of any new Standard is the cost of developing ways to implement it. One of the main requests that respondents made to the IASB was to provide examples that would illustrate the various aspects of the new proposals. In response, the IASB has provided detailed guidance whenever possible (for example, detail about the accounting mechanics for aggregated exposures). The IASB believes that this will help in reducing both the initial and ongoing cost of compliance.

BCE.233 The IASB always intended to retain the 'macro fair value hedge accounting model' in IAS 39 pending completion of the project on the accounting for macro hedging. In addition, as noted in paragraphs BCE.208–BCE.209, the IASB is of the view that those using the general requirements in IAS 39 to achieve hedge accounting for their macro hedging activities should be able to continue to do so under the IFRS 9 model. Thus, the ability to apply hedge accounting to macro hedging activities should not be adversely affected by the introduction of IFRS 9. However, the IASB acknowledged that some entities may want to migrate from accounting for their macro hedging activities using IAS 39 directly to any new model for accounting for macro hedging. Consequently, the IASB decided to provide an option to preparers to continue to apply hedge accounting under IAS 39 without requiring them to move to the new hedge accounting model in IFRS 9. This means that those who do not want to change their accounting for macro hedging need not do so until completion of the project on the accounting for macro hedging. This will, however, mean that all of their hedge accounting will continue to be in accordance with IAS 39 (ie the election is made for hedge accounting as a whole).

BCE.234 However, the IASB is of the view that the migration from the accounting for macro hedging using the cash flow hedge accounting requirements in IAS 39 to the accounting using IFRS 9 will not be unduly burdensome for preparers. This is because the new hedge accounting model does not change how risk components of financial items can be designated as hedged items. In addition, while there are changes to the hedge effectiveness requirements, these have introduced simplifications compared with IAS 39. Entities would need to update their documentation of their hedging relationships to reflect the new effectiveness assessment. However, if hedge accounting was applied under IAS 39, the sources of ineffectiveness should be known, and it should be possible to update documentation efficiently by using a master document approach for similar hedges. This can be achieved by one central document being included by a cross reference in the documentation of specific hedging relationships that includes the identification of the specific hedging instruments and hedged items.

Costs of analysis for users of financial statements

BCE.235 Given that the mechanics for hedge accounting were well established and understood by most interested parties, the IASB decided to retain the mechanics of hedge accounting that were in IAS 39 for fair value, cash flow and net investment hedges. Consequently, from the perspective of users of financial statements, the costs in educating themselves about these proposals will be reduced.

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BCE.236 The IASB also decided that it would require comprehensive information to be disclosed so that users of financial statements could understand the effects of hedge accounting on the financial statements and so that all hedge accounting disclosures are presented in a single note in the financial statements. This will enable users to access a set of information that is more relevant to their needs and will therefore reduce the need to rely on information prepared on a non-GAAP basis. In addition, they will also benefit from more meaningful information that is more closely linked to the decision making for risk management purposes.

BCE.237 Finally, the IASB expects that users of financial statements will obtain a higher level of transparency from the financial statements of entities applying hedge accounting. This will allow them to better form their own view of the entity's risk management and its effect on reported results. The opportunity for more extensive analyses would, of course, entail costs of performing those analyses, as with any use of financial reporting information.

Conclusion

BCE.238 The IASB expects that preparers will be able to better reflect their risk management activities using hedge accounting under the new model. This should facilitate an increased use of hedge accounting by preparers. In addition, because risk management can be better reflected, and as a result of enhanced disclosures, more relevant and transparent information will be provided to users of financial statements.

General

Summary of main changes from the Exposure Draft *Financial Instruments: Classification and Measurement*

BCG.1 The main changes made by IFRS 9 issued in 2009 from the 2009 Exposure Draft *Financial Instruments: Classification and Measurement* (the '2009 Classification and Measurement Exposure Draft') were:

(a) IFRS 9 dealt with the classification and measurement of financial assets only, instead of financial assets and financial liabilities as proposed in the 2009 Classification and Measurement Exposure Draft.

(b) IFRS 9 requires entities to classify financial assets on the basis of the objective of the entity's business model for managing the financial assets and the characteristics of the contractual cash flows. It points out that the entity's business model should be considered first, and that the contractual cash flow characteristics should be considered only for financial assets that are eligible to be measured at amortised cost because of the business model. It states that both classification conditions are essential to ensure that amortised cost provides useful information.

(c) Additional application guidance was added on how to apply the conditions necessary for amortised cost measurement.

(d) IFRS 9 requires a 'look through' approach for investments in contractually linked instruments that effect concentrations of credit risk. The 2009 Classification and Measurement Exposure Draft had proposed that only the most senior tranche could have cash flows that represented payments of principal and interest on the principal amount outstanding.

(e) IFRS 9 requires (unless the fair value option is elected) financial assets purchased in the secondary market to be recognised at amortised cost if the instruments are managed within a business model that has an objective of collecting contractual cash flows and the financial asset has only contractual cash flows representing principal and interest on the principal amount outstanding even if such assets were acquired at a discount that reflects incurred credit losses.

(f) IFRS 9 requires that when an entity elects to present gains and losses on equity instruments measured at fair value in other comprehensive income, dividends are to be recognised in profit or loss. The 2009 Classification and Measurement Exposure Draft had proposed that those dividends would be recognised in other comprehensive income.

(g) IFRS 9 requires reclassifications between amortised cost and fair value classifications when the entity's business model changes. The 2009 Classification and Measurement Exposure Draft had proposed prohibiting reclassification.

(h) For entities that adopt IFRS 9 for reporting periods before 1 January 2012, IFRS 9 provides transition relief from restating comparative information.

(i) IFRS 9 requires additional disclosures for all entities when they first apply the Standard.

Summary of main changes from the Exposure Draft Fair Value Option for Financial Liabilities

BCG.2 The main changes from the 2010 Exposure Draft *Fair Value Option for Financial Liabilities* (the '2010 Own Credit Risk Exposure Draft') are:

(a) For liabilities designated under the fair value option, IFRS 9 requires an entity to present the effects of changes in the liability's credit risk in other comprehensive income unless that treatment would create or enlarge an accounting mismatch in profit or loss. If that treatment would create or enlarge an accounting mismatch in profit or loss, the entire fair value change is presented in profit or loss. That was the alternative approach set out in the 2010 Own Credit Risk Exposure Draft. The proposed approach in the 2010 Own Credit Risk Exposure Draft had treated all liabilities designated under the fair value option in the same way and had not addressed cases in which the proposed treatment would create or enlarge an accounting mismatch in profit or loss.

(b) IFRS 9 requires a 'one-step' approach for presenting the effects of changes in a liability's credit risk in the performance statement. That approach requires the effects of changes in a liability's credit risk to be presented directly in other comprehensive income, with the remaining amount of fair value change presented in profit or loss. The 2010 Own Credit Risk Exposure Draft had proposed a 'two-step' approach, which would have required the total fair value change to be presented in profit or loss. The effects of changes in a liability's credit risk would have been backed out and presented in other comprehensive income.

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Dissenting opinions

Dissent of James J Leisenring from IFRS 9 *Financial Instruments* (issued 2009)

DO1 Mr Leisenring supports efforts to reduce the complexity of accounting for financial instruments. In that regard, he supports requiring all financial instruments to be measured at fair value, with that measurement being recognised in profit or loss. He finds no compelling reason related to improving financial reporting to reject that approach. It is an approach that maximises comparability and minimises complexity.

DO2 It maximises comparability because all financial instruments would be measured at one attribute within an entity and across entities. No measurement or presentation would change to reflect either arbitrary distinctions or management behaviour or intentions. IFRS 9 emphasises management intentions and behaviour, which substantially undermines comparability.

DO3 Complexity of accounting would be drastically reduced if all financial instruments were measured at fair value. The approach favoured by Mr Leisenring provides at least the following simplifications:

(a) no impairment model is necessary.

(b) criteria for when a given instrument must or can be measured with a given attribute are unnecessary.

(c) there is no need to bifurcate embedded derivatives or to identify financial derivatives.

(d) it eliminates the need for fair value hedge accounting for financial instruments.

(e) it eliminates the disparity in the measurement of derivatives within and outside the scope of IAS 39.

(f) it minimises the incentives for structuring transactions to achieve a particular accounting outcome.

(g) no fair value option would be needed to eliminate accounting mismatches.

(h) it provides a superior foundation for developing a comprehensive standard for the derecognition of financial instruments that is not present in a mixed attribute model.

DO4 Mr Leisenring accepts that measuring more instruments at fair value increases measurement complexity, but this increase is minimal compared with the reductions in complexity that would be otherwise achieved. There is no disagreement that derivatives must be measured at fair value. Those instruments raise the most difficult measurement issues, as cash instruments have many fewer problems. Indeed, some suggestions for an impairment model would measure at fair value the credit loss component of cash instruments. If that were to be the conclusion on impairment (an expected loss approach), it would minimise the incremental fair value measurement complexity of recording at fair value instruments now at amortised cost.

DO5 Mr Leisenring recognises that measuring all instruments at fair value through profit or loss raises presentation issues about disaggregation of fair value changes. However, he does not believe that these issues are insurmountable.

DO6 Investors have often told both the IASB and the FASB that fair value of financial instruments recognised in profit or loss provides the most useful information for their purposes. There is a worldwide demand for an improved and common solution to the accounting for financial instruments. Investors are disappointed that the Board will not take this opportunity to make, with other standard-setters, truly substantive changes rather than these minimal changes that perpetuate all the legitimate concerns that have been expressed about the mixed attribute model.

DO7 IFRS 9 does to some extent reduce complexity but that reduction is minimal. Certain measurement classifications are eliminated but others have been added. Mr Leisenring does not think that, on balance, this is an improvement over IAS 39.

DO8 Fundamental to IFRS 9 is the distinction between financial instruments measured at amortised cost and those at fair value. Mr Leisenring is concerned that neither of the two conditions necessary for that determination is operational. Paragraph BC4.86 criticises IAS 39 because the embedded derivative requirement of that Standard is based on a list of examples. However, the basic classification model of IFRS 9 is based on lists of examples in paragraphs B4.1.4, B4.1.13 and B4.1.14. The examples are helpful but are far from exhaustive of the issues that will be problematic in applying the two criteria for classification at amortised cost.

DO9 Mr Leisenring also thinks that the two criteria are inconsistently applied. When the objective of the entity's business model is to hold the assets to collect the contracted cash flows of an instrument there is no

requirement that the entity must actually do so. The cash flow characteristics of the instrument are also ignored when the guidance is applied to investments in contractually linked instruments (tranches). In those circumstances the contractual cash flows of the instrument are ignored and one is required to look through to the composition of assets and liabilities of the issuing entity. This 'look through' requirement is also potentially complex and in Mr Leisenring's opinion is likely to be not very operational. Mr Leisenring also objects to eliminating the requirement to bifurcate derivatives embedded in cash instruments. This objection is primarily because of concern that the two criteria to qualify for amortised cost will not be operational. The pressure on those two conditions will be enormous because there will be an incentive to embed derivatives in a cash instrument in anticipation that the instrument might qualify for amortised cost. Derivatives should be at fair value whether embedded or standing alone and a bifurcation requirement would achieve that accounting. If Mr Leisenring were confident that the criteria for amortised cost could be applied as intended he would not be as concerned because instruments with embedded derivatives would be at fair value in their entirety.

DO10 Mr Leisenring is concerned that, in the current crisis, instruments that have provided some of the most significant losses when measured at fair value would be eligible for amortised cost. That conclusion is not responsive to the present environment. The approach also allows actively traded debt instruments, including treasury securities, to be at amortised cost. These results are unacceptable and reduce the usefulness of reported information for investors.

DO11 The Board is required by its *Framework*[63] to be neutral in its decision-making and to strive to produce neutral information to maximise the usefulness of financial information. IFRS 9 fails in that regard because it produces information based on free choice, management intention and management behaviour. Reporting that will result from this approach will not produce neutral information and diminishes the usefulness of financial reporting.

DO12 The Board is insistent in paragraph BC4.20 that accounting based on a business model is not free choice but never explains why selection of a business model is not a management choice. The existence of a trading account, a fair value option and the objective of a business model are all free choices.

DO13 The classification of selected equity instruments at fair value with the result of the remeasurement reported outside profit or loss is also a free choice. The Board concludes that reporting fair value changes in profit or loss may not reflect the operating performance of an entity. Mr Leisenring could accept accounting for changes in fair value of some instruments outside profit or loss in other comprehensive income. That accounting, however, should not be a free choice and why that presentation is superior in defined circumstances should be developed. In addition, when these securities are sold any realised gains and losses are not 'recycled' to profit or loss. That conclusion is inconsistent with the Board's conclusion that dividends received on these instruments should be reported in profit or loss. Such dividends would represent a return on investment or a form of 'recycling' of changes in the value of the instruments.

DO14 Mr Leisenring believes that a business model is rarely relevant in writing accounting standards. Identical transactions, rights and obligations should be accounted for in the same way if comparability of financial information is to be achieved. The result of applying IFRS 9 ignores any concern for comparability of financial information.

DO15 The credit crisis has provided confirmation that a drastic change in accounting for financial instruments is desirable. However, many have said that while they agree that the approach suggested by Mr Leisenring would be superior, and a significant improvement, the world is not ready to embrace such change. It is unclear to Mr Leisenring what factors need to be present for the optimal solution to be acceptable. He has concluded that it is hard to envisage circumstances that would make the case any more compelling for fundamental change and improvement than the present circumstances. Therefore, IFRS 9 will inevitably preserve a mixed attribute model and the resulting complexity for a significant period of time.

DO16 An objective of replacing IAS 39 was to provide a basis for convergence with accounting standards issued by the FASB. Mr Leisenring is concerned that IFRS 9 does not provide such a basis. As a consequence, allowing early adoption of the IFRS is undesirable. For convergence to be achieved significant changes in the IFRS are inevitable. Early adoption of the IFRS will therefore necessitate another costly accounting change when convergence is achieved. Permitting early adoption of this IFRS is also undesirable as it permits a lack of comparability in accounting for many years due to the deferred required effective date.

DO17 Mr Leisenring would accept that if, for reasons other than the desire to provide useful information to investors, his approach is politically unattainable, an alternative could be developed that would be operational. That approach would require all financial assets and financial liabilities to be recorded at fair value through profit or loss except originated loans retained by the originator, trade receivables and accounts payable. If certain derivatives were embedded in an instrument to be accounted for at amortised cost the derivative would be

[63] The reference to the *Framework* is to the IASC's *Framework for the Preparation and Presentation of Financial Statements*, adopted by the Board in 2001 and in effect when the Standard was developed.

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either bifurcated and accounted for at fair value or the entire instrument would be measured at fair value. Either approach would be acceptable.

Dissent of Patricia McConnell from IFRS 9 *Financial Instruments* (2009)

DO1 Ms McConnell believes that fair value is the most relevant and useful measurement attribute for financial assets. However, she acknowledges that many investors prefer not to measure all financial assets at fair value. Those investors believe that both amortised cost and fair value can provide useful information for particular kinds of financial assets in particular circumstances. Therefore, in order to meet the objective of developing high quality, global accounting standards that serve the interests of all investors, Ms McConnell believes that no single measurement attribute should have primacy over another. Thus any new IFRS setting classification and measurement principles for financial assets should require disclosure of sufficient information in the primary financial statements to permit determination of profit or loss and financial position using both amortised cost and fair value. For example, when a measurement attribute other than fair value is used for financial assets, information about fair value should be displayed prominently in the statement of financial position. The Board did not adopt such disclosure in IFRS 9, as discussed in paragraphs BC4.9–BC4.11 of the Board's Basis for Conclusions.

DO2 As stated in paragraph BC4.1, an objective of the Board in developing IFRS 9 was to reduce the number of classification categories for financial instruments. However, Ms McConnell believes that IFRS 9 has not accomplished that objective. IFRS 9 would permit or require the following categories: (1) amortised cost, (2) a fair value option through profit or loss for financial assets that qualify for amortised cost but for which amortised cost would create an accounting mismatch, (3) fair value through profit or loss for debt instruments that fail to qualify for amortised cost, (4) fair value though profit or loss for trading securities, (5) fair value through profit or loss for equity securities not held for trading and (6) fair value through other comprehensive income for equity investments not held for trading. Ms McConnell does not view those six categories as a significant improvement over the six categories in IAS 39; like the categories in IAS 39, they will hinder investors' understanding of an already complex area of financial reporting.

DO3 IFRS 9 sets out two criteria for measuring financial assets at amortised cost: (1) the way the entity manages its financial assets ('business model') and (2) the contractual cash flow characteristics of its financial assets. On the surface, this appears to be an improvement over IAS 39's criterion that was based on management's intention to trade, hold available for sale, hold to maturity, or hold for the foreseeable future. However, Ms McConnell finds it difficult to see how IFRS 9's criterion based on the objective of the entity's business model differs significantly from management's intention. In her opinion selection of a business model is a management choice, as is the decision to have a trading account, use the fair value option for debt instruments or the fair value option for equity instruments with gains and losses reported in other comprehensive income. In paragraphs BC4.20 and BC4.21 the Board argues that selection of a measurement method based on an entity's business model is not a free choice. Ms McConnell does not find the arguments persuasive.

DO4 IFRS 9 permits an entity to make an irrevocable election to present in other comprehensive income changes in the value of any investment in equity instruments that is not held for trading. Ms McConnell could accept accounting for changes in fair value of some instruments outside profit or loss in other comprehensive income. However, that treatment should not be a free choice; criteria for that presentation should be developed. In addition, the Board decided that when those securities are sold any realised gains and losses are not 'reclassified' to profit or loss. That conclusion is inconsistent with the Board's decision to report dividends received on these investments in profit or loss. Such dividends represent a return on investment or a form of 'reclassifying' changes in the value of the instruments.

DO5 In addition, Ms McConnell believes the 'look through' guidance for contractually linked investments (tranches) is an exception to one of the criteria necessary for applying amortised cost, namely the contractual cash flow characteristics of the instrument. In those circumstances the contractual cash flows of the instrument are ignored. Instead an entity is required to 'look through' to the underlying pool of instruments and assess their cash flow characteristics and credit risk relative to a direct investment in the underlying instruments. Ms McConnell believes that this provision adds complexity to the IFRS and reduces the usefulness of the reporting for financial assets. Moreover, since an entity is required to 'look through' only upon initial recognition of the financial asset, subsequent changes in the relative exposure to credit risk over the life of a structured investment vehicle would be ignored. Consequently, Ms McConnell believes it is possible that highly volatile investments, such as those owning sub-prime residential mortgage loans, would be reported at amortised cost.

Dissent of Patricia McConnell from *Mandatory Effective Date of IFRS 9 and Transition Disclosures* (Amendments to IFRS 9 (2009), IFRS 9 (2010) and IFRS 7)

DO1 Ms McConnell concurs with the Board's decision to defer the mandatory effective date of IFRS 9 (2009) and IFRS 9 (2010), but not with its decision to set a mandatory effective date of 1 January 2015. She agrees with the Board that there are compelling reasons for all project phases to be implemented at the same time and, therefore, that the mandatory application of all phases of the project to replace IAS 39 should occur concurrently. However, Ms McConnell does not believe that a mandatory effective date for IFRS 9 (2009) and IFRS 9 (2010) should be established until there is more clarity on the requirements and completion dates of the remaining phases of the project to replace IAS 39, including possible improvements to existing IFRS 9.

DO2 Ms McConnell commends the Board for requiring modified transition disclosures and acknowledges that the modified disclosures will provide useful information that will enable users of financial statements to better understand the transition from IAS 39 to IFRS 9, just as they would provide useful information when financial assets are reclassified in accordance with IFRS 9.

DO3 Although Ms McConnell believes that the modified disclosures are useful, she does not believe that they are an adequate substitute for restated comparative financial statements. Ms McConnell believes that comparative statements are vitally important to users of financial statements. To the extent that the accounting policies applied in comparative financial statements are comparable period-to-period, comparative financial statements enable users to more fully understand the effect of the accounting change on a company's statements of comprehensive income, financial position and cash flows.

DO4 Ms McConnell agrees with the Board that the date of initial application should be defined as a fixed date. In the absence of a fixed date, entities would have to go back to the initial recognition of each individual instrument for classification and measurement. This would be very burdensome, if not impossible. Moreover, particularly because reclassifications in accordance with IFRS 9 only occur (and are required) upon a change in business model for the related group of instruments, reclassifications should be very rare. Consequently, the expected benefit of not naming a fixed date of initial application would not exceed the costs.

DO5 However, Ms McConnell disagrees with defining the date of initial application as the date that an entity first applies this IFRS. She believes that the date of initial application should be defined as the beginning of the earliest period presented in accordance with IFRS 9. This date of initial application would enable entities to compile information in accordance with IFRS 9 while still preparing their external financial reports in accordance with IAS 39. Ms McConnell does not consider that there is a significant risk that entities would use hindsight when applying IFRS 9 to comparative periods prior to those financial statements being reported publicly in accordance with IFRS 9. She also notes that, although it would be costly for entities to prepare financial reporting information in accordance with an extra set of requirements during the comparative period (or periods), this would address concerns on the part of preparers that it is overly burdensome for them to compile information in accordance with IFRS 9 before the date of initial application has passed.

DO6 Ms McConnell acknowledges that defining the date of initial application as the beginning of the earliest date presented would delay the release of financial statements prepared in accordance with IFRS 9 for at least one year, or longer, if the date of initial application were set as she believes it should be. Delays would also result if the mandatory effective date of IFRS 9 was set so that entities could prepare more than one comparative period under IFRS 9 on the basis of requirements in many jurisdictions. Ms McConnell has also considered that it is costly for entities to prepare financial reporting information in accordance with an extra set of requirements during the comparative period (or periods). However, Ms McConnell believes that the benefits to users of financial statements of restated comparative financial statements justify the costs.

Dissent of Patrick Finnegan from the issue in November 2013 of IFRS 9 *Financial Instruments* ('IFRS 9 (2013)')

DO1 Mr Finnegan dissents from the issue of the amendments to IFRS 9 (2013) due to the addition of the requirements related to hedge accounting (Chapter 6 of IFRS 9).

DO2 Mr Finnegan dissents because he disagrees with the decision to provide entities with an accounting policy choice between applying the new hedge accounting requirements of IFRS 9 and retaining the existing hedge accounting requirements in IAS 39 until the completion of the project on the accounting for macro hedging. He believes that such an accounting policy choice combined with the existing approach of replacing IAS 39 in phases creates an unacceptable level of complexity and cost for both preparers and users of financial statements when accounting for financial instruments.

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DO3 Mr Finnegan believes that a principal reason for the Board creating an option was to address the concerns of entities who believe that 'proxy hedging' (the use of designations of hedging relationships that do not exactly represent an entity's risk management) would be prohibited under IFRS 9. The Board has made it clear that this is not the case and, therefore, an option to continue to apply the hedge accounting requirements of IAS 39 creates the potential for the misunderstanding and misapplication of the new requirements in IFRS 9.

DO4 Mr Finnegan is concerned that the duration of the option to apply the new hedge accounting requirements is open-ended because it depends on the Board's ability to complete its project on the accounting for macro hedging. Consequently, the length of time that preparers and users of financial statements would be dealing with a variety of complex alternatives related to the accounting for financial instruments is also open-ended. Mr Finnegan believes that this outcome conflicts with the Board's stated goal of making timely improvements to simplify such accounting.

DO5 Mr Finnegan believes that the original goal of the Board to replace IAS 39 in phases was sound, given the initial expectation that a new comprehensive Standard would be completed expeditiously. However, the process of completing the three phases dealing with classification and measurement, impairment, and hedge accounting has proved to be thorny because of many complex and interrelated issues as well as its interaction with the project to create a new Standard for insurance contracts. In the light of that experience, Mr Finnegan believes that preparers and users of financial statements are better served by adopting a new IFRS dealing with all three phases simultaneously because it would involve substantially less cost and complexity and provide more useful information for users of financial statements.

DO6 Mr Finnegan believes that a principal reason for undertaking a fresh examination of the accounting for financial instruments was to achieve converged accounting with US GAAP. The IASB and the FASB are still examining ways of achieving convergence of the accounting for classification and measurement as well as impairment. Mr Finnegan believes that when a classification and measurement model is completed, a reporting entity may need to modify its application of the new requirements for hedge accounting, which would create unnecessary costs for such entities and additional complexity for users of financial statements in their analysis and use of financial statements.

Dissent of Stephen Cooper and Jan Engström from the issue in July 2014 of IFRS 9 *Financial Instruments* ('IFRS 9 (2014)')

DO1 Messrs Cooper and Engström dissent from the issue of IFRS 9 (2014) because of the limited amendments to the classification and measurement requirements for financial assets. They disagree with the introduction of the fair value through other comprehensive income measurement category. They believe that:

(a) this additional measurement category unnecessarily increases the complexity for the reporting of financial instruments;

(b) the distinction between the supposed different business models that justify measurement at fair value through other comprehensive income versus measurement at fair value through profit or loss is unclear and does not justify a difference in accounting treatment; and

(c) faithful representation of insurance contracts in the financial statements does not need the fair value through other comprehensive income measurement category for (some) assets that back insurance liabilities.

DO2 Messrs Cooper and Engström believe that the requirements in IFRS 9 (issued in 2009), which classified financial assets at either amortised cost or fair value through profit or loss, are preferable and should have been retained. However, they support the clarifications to the hold to collect business model and the amendments to the contractual cash flow assessment in IFRS 9 (2014).

Increased complexity that is undesirable and unnecessary

DO3 One of IASB's main objectives for replacing IAS 39 with IFRS 9 is to reduce the complexity of accounting for financial instruments. An important component of that is to reduce the number of categories of financial instruments and the even larger number of different measurement and presentation methods in IAS 39. Interested parties widely supported this objective and Messrs Cooper and Engström believe that it had been achieved in the classification and measurement requirements that were issued in IFRS 9 in 2009. They consider that the introduction of a fair value through other comprehensive income measurement category reverses a significant part of this improvement in reporting.

DO4 Messrs Cooper and Engström believe that, when amortised cost is judged to be the most appropriate basis for reporting, this measurement attribute should be applied consistently throughout the financial statements.

Likewise, if fair value provides more relevant information, it should be applied consistently. In their view the fair value through other comprehensive income measurement category provides a confusing mixture of amortised cost and fair value information that will make financial statements more complex and harder to understand. While they accept that in many cases fair value is an important additional piece of information for assets that are appropriately measured and reported at amortised cost, they believe that this fair value information should be provided as supplementary information in the notes, albeit with prominent and clear disclosure.

'A business model whose objective is achieved by both collecting contractual cash flows and selling financial assets' is not a distinct business model

DO5 The amendments are based on the assertion that there are distinct business models that justify accounting for qualifying debt instruments at either fair value through other comprehensive income or fair value through profit or loss. Messrs Cooper and Engström believe that, while the reasons for holding debt instruments outside a hold to collect business model can vary significantly, it is not possible to identify distinct business models or that these reasons justify different accounting. For example, managing assets with the objective of maximising the return on the portfolio through collecting contractual cash flows and opportunistic selling and reinvestment is given as an illustration of a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets (see Example 5 in paragraph B4.1.4C of IFRS 9). However, measurement at fair value through profit or loss is required when assets are managed, and their performance is evaluated, on a 'fair value basis' with collection of contractual cash flows being incidental (see paragraph B4.1.6 of IFRS 9). Messrs Cooper and Engström believe that managing to maximise the return on the portfolio and managing on a fair value basis is a distinction without a difference and is not a valid justification for a very different accounting treatment.

DO6 Messrs Cooper and Engström believe that if fair value is indeed the most appropriate measurement basis then the full fair value change is relevant in assessing overall performance and should be presented within profit or loss. If a portfolio of debt instruments is, for example, managed with the objective of maximising return, then showing in profit or loss only amortised cost-based interest revenue, expected credit losses and realised value changes fails to provide a faithful representation of this economic activity. Furthermore, the use of fair value through other comprehensive income provides an entity with significant freedom to manage profit or loss simply through the selective sale of assets. While Messrs Cooper and Engström believe that all fair value changes should be reported in profit or loss if assets are measured at fair value, they observe that an entity is able to disaggregate fair value gains and losses to highlight particular components (such as the interest yield) if this helps to provide relevant information about performance.

The fair value through other comprehensive income measurement category does not achieve improvements to insurance contracts accounting

DO7 The IASB's decision to introduce the fair value through other comprehensive income measurement category is related to its tentative decision in the Insurance Contracts project that some changes in insurance contract liabilities (ie those arising from changes in the discount rate) would be recognised in other comprehensive income. Messrs Cooper and Engström believe that the use of other comprehensive income for insurance contracts combined with measurement at fair value through other comprehensive income for (some) financial assets that back insurance contract liabilities would lead to unnecessary complexity, a lack of transparency in insurance accounting, and would create opportunities for earnings management through selective realisation of gains or losses on the sale of financial assets and would not faithfully represent the performance of entities engaged in this activity. Accordingly, they believe that the introduction of the fair value through other comprehensive income measurement category in IFRS 9, combined with the use of other comprehensive income for some changes in insurance contract liabilities, will undermine the potential improvements in the quality of financial reporting by entities engaged in issuing insurance contracts that would otherwise result from the introduction of a new insurance contracts Standard.

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Appendix A
Previous dissenting opinions

In 2003 and later some IASB members dissented from the issue of IAS 39 and subsequent amendments, and portions of their dissenting opinions relate to requirements that have been carried forward to IFRS 9. Those dissenting opinions are set out below.
Cross references that relate to the requirements that have been carried forward to IFRS 9 have been updated.

Dissent of Anthony T Cope, James J Leisenring and Warren J McGregor from the issue of IAS 39 in December 2003

DO1 Messrs Cope, Leisenring and McGregor dissent from the issue of this Standard.

DO2 Mr Leisenring dissents because he disagrees with the conclusions concerning derecognition, impairment of certain assets and the adoption of basis adjustment hedge accounting in certain circumstances.

DO3 The Standard requires in paragraphs 30 and 31 (now paragraphs 3.2.16 and 3.2.17 of IFRS 9) that to the extent of an entity's continuing involvement in an asset, a liability should be recognised for the consideration received. Mr Leisenring believes that the result of that accounting is to recognise assets that fail to meet the definition of assets and to record liabilities that fail to meet the definition of liabilities. Furthermore, the Standard fails to recognise forward contracts, puts or call options and guarantees that are created, but instead records a fictitious 'borrowing' as a result of rights and obligations created by those contracts. There are other consequences of the continuing involvement approach that has been adopted. For transferors, it results in very different accounting by two entities when they have identical contractual rights and obligations only because one entity once owned the transferred financial asset. Furthermore, the 'borrowing' that is recognised is not accounted for like other loans, so no interest expense may be recorded. Indeed, implementing the proposed approach requires the specific override of measurement and presentation standards applicable to other similar financial instruments that do not arise from derecognition transactions. For example, derivatives created by derecognition transactions are not accounted for at fair value. For transferees, the approach also requires the override of the recognition and measurement requirements applicable to other similar financial instruments. If an instrument is acquired in a transfer transaction that fails the derecognition criteria, the transferee recognises and measures it differently from an instrument that is acquired from the same counterparty separately.

DO4 Mr Leisenring also disagrees with the requirement in paragraph 64 to include an asset that has been individually judged not to be impaired in a portfolio of similar assets for an additional portfolio assessment of impairment. Once an asset is judged not to be impaired, it is irrelevant whether the entity owns one or more similar assets as those assets have no implications for whether the asset that was individually considered for impairment is or is not impaired. The result of this accounting is that two entities could each own 50 per cent of a single loan. Both entities could conclude the loan is not impaired. However, if one of the two entities happens to have other loans that are similar, it would be allowed to recognise an impairment with respect to the loan where the other entity is not. Accounting for identical exposures differently is unacceptable. Mr Leisenring believes that the arguments in paragraph BC115 are compelling.

DO5 Mr Leisenring also dissents from paragraph 98 which allows but does not require basis adjustment for hedges of forecast transactions that result in the recognition of non-financial assets or liabilities. This accounting results in always adjusting the recorded asset or liability at the date of initial recognition away from its fair value. It also records an asset, if the basis adjustment alternative is selected, at an amount other than its cost as defined in IAS 16 *Property, Plant and Equipment* and further described in paragraph 16 of that Standard. If a derivative were to be considered a part of the cost of acquiring an asset, hedge accounting in these circumstances should not be elective to be consistent with IAS 16. Mr Leisenring also objects to creating this alternative as a result of an improvement project that ostensibly had as an objective the reduction of alternatives. The non-comparability that results from this alternative is both undesirable and unnecessary.

DO6 Mr Leisenring also dissents from the application guidance in paragraph AG71[64] and in particular the conclusion contained in paragraph BC98. He does not believe that an entity that originates a contract in one market should measure the fair value of the contract by reference to a different market in which the transaction did not take place. If prices change in the transacting market, that price change should be recognised when

[64] IFRS 13 *Fair Value Measurement*, issued in May 2011, now contains the requirements for measuring fair value.

subsequently measuring the fair value of the contract. However, there are many implications of switching between markets when measuring fair value that the Board has not yet addressed. Mr Leisenring believes a gain or loss should not be recognised based on the fact a transaction could occur in a different market.

DO7 Mr Cope dissents from paragraph 64 and agrees with Mr Leisenring's analysis and conclusions on loan impairment as set out above in paragraph DO4. He finds it counter-intuitive that a loan that has been determined not to be impaired following careful analysis should be subsequently accounted for as if it were impaired when included in a portfolio.

DO8 Mr Cope also dissents from paragraph 98, and, in particular, the Board's decision to allow a free choice over whether basis adjustment is used when accounting for hedges of forecast transactions that result in the recognition of non-financial assets or non-financial liabilities. In his view, of the three courses of action open to the Board—retaining IAS 39's requirement to use basis adjustment, prohibiting basis adjustment as proposed in the June 2002 Exposure Draft,[65] or providing a choice—the Board has selected the worst course. Mr Cope believes that the best approach would have been to prohibit basis adjustment, as proposed in the Exposure Draft, because, in his opinion, basis adjustments result in the recognition of assets and liabilities at inappropriate amounts.

DO9 Mr Cope believes that increasing the number of choices in international standards is bad policy. The Board's decision potentially creates major differences between entities choosing one option and those choosing the other. This lack of comparability will adversely affect users' ability to make sound economic decisions.

DO10 In addition, Mr Cope notes that entities that are US registrants may choose not to adopt basis adjustment in order to avoid a large reconciling difference to US GAAP. Mr Cope believes that increasing differences between IFRS-compliant entities that are US registrants and those that are not is undesirable.

DO11 Mr McGregor dissents from paragraph 98 and agrees with Mr Cope's and Mr Leisenring's analyses and conclusions as set out above in paragraphs DO5 and DO8–DO10.

DO12 Mr McGregor also dissents from this Standard because he disagrees with the conclusions about impairment of certain assets.

DO13 Mr McGregor disagrees with paragraphs 67 and 69, which deal with the impairment of equity investments classified as available for sale. These paragraphs require impairment losses on such assets to be recognised in profit or loss when there is objective evidence that the asset is impaired. Previously recognised impairment losses are not to be reversed through profit and loss when the assets' fair value increases. Mr McGregor notes that the Board's reasoning for prohibiting reversals through profit or loss of previously impaired available-for-sale equity investments, set out in paragraph BC130 of the Basis for Conclusions, is that it '... could not find an acceptable way to distinguish reversals of impairment losses from other increases in fair value'. He agrees with this reasoning but believes that it applies equally to the recognition of impairment losses in the first place. Mr McGregor believes that the significant subjectivity involved in assessing whether a reduction in fair value represents an impairment (and thus should be recognised in profit or loss) or another decrease in value (and should be recognised directly in equity) will at best lead to a lack of comparability within an entity over time and between entities, and at worst provide an opportunity for entities to manage reported profit or loss.

DO14 Mr McGregor believes that all changes in the fair value of assets classified as available for sale should be recognised in profit or loss. However, such a major change to the Standard would need to be subject to the Board's full due process. At this time, to overcome the concerns expressed in paragraph DO13, he believes that for equity investments classified as available for sale, the Standard should require all changes in fair value below cost to be recognised in profit or loss as impairments and reversals of impairments and all changes in value above cost to be recognised in equity. This approach treats all changes in value the same way, no matter what their cause. The problem of how to distinguish an impairment loss from another decline in value (and of deciding whether there is an impairment in the first place) is eliminated because there is no longer any subjectivity involved. In addition, the approach is consistent with IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.

DO15 Mr McGregor disagrees with paragraph 106 of the Standard and with the consequential amendments to paragraph 27[66] of IFRS 1 *First-time Adoption of International Financial Reporting Standards*. Paragraph 106 requires entities to apply the derecognition provisions prospectively to financial assets. Paragraph 27 of IFRS 1 requires first-time adopters to apply the derecognition provisions of IAS 39 (as revised in 2003) prospectively to non-derivative financial assets and financial liabilities. Mr McGregor believes that existing IAS 39 appliers should apply the derecognition provisions retrospectively to financial assets, and that first-time adopters should apply the derecognition provisions of IAS 39 retrospectively to all financial assets and

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[65] Exposure Draft *Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement*.

[66] As a result of the revision of IFRS 1 in November 2008, paragraph 27 became paragraph B2.

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financial liabilities. He is concerned that financial assets may have been derecognised under the original IAS 39 by entities that were subject to it, which might not have been derecognised under the revised IAS 39. He is also concerned that non-derivative financial assets and financial liabilities may have been derecognised by first-time adopters under previous GAAP that would not have been derecognised under the revised IAS 39. These amounts may be significant in many cases. Not requiring recognition of such amounts will result in the loss of relevant information and will impair the ability of users of financial statements to make sound economic decisions.

Dissent of Mary E Barth, Robert P Garnett and Geoffrey Whittington from the issue in June 2005 of *The Fair Value Option* (Amendment to IAS 39)

DO1 Professor Barth, Mr Garnett and Professor Whittington dissent from the amendment to IAS 39 *Financial Instruments: Recognition and Measurement—The Fair Value Option*. Their dissenting opinions are set out below.

DO2 These Board members note that the Board considered the concerns expressed by the prudential supervisors on the fair value option as set out in the December 2003 version of IAS 39 when it finalised IAS 39. At that time the Board concluded that these concerns were outweighed by the benefits, in terms of simplifying the practical application of IAS 39 and providing relevant information to users of financial statements, that result from allowing the fair value option to be used for any financial asset or financial liability. In the view of these Board members, no substantive new arguments have been raised that would cause them to revisit this conclusion. Furthermore, the majority of constituents have clearly expressed a preference for the fair value option as set out in the December 2003 version of IAS 39 over the fair value option as contained in the amendment.

DO3 Those Board members note that the amendment introduces a series of complex rules, including those governing transition which would be entirely unnecessary in the absence of the amendment. There will be consequential costs to preparers of financial statements, in order to obtain, in many circumstances, substantially the same result as the much simpler and more easily understood fair value option that was included in the December 2003 version of IAS 39. They believe that the complex rules will also inevitably lead to differing interpretations of the eligibility criteria for the fair value option contained in the amendment.

DO4 These Board members also note that, for paragraph 9(b)(i) (now paragraphs 4.1.5 and 4.2.2(a) of IFRS 9), application of the amendment may not mitigate, on an ongoing basis, the anomaly of volatility in profit or loss that results from the different measurement attributes in IAS 39 any more than would the option in the December 2003 version of IAS 39. This is because the fair value designation is required to be continued even if one of the offsetting instruments is derecognised. Furthermore, for paragraphs 9(b)(i), 9(b)(ii) and 11A (now paragraphs 4.1.5, 4.2.2 and 4.3.5 of IFRS 9), the fair value designation continues to apply in subsequent periods, irrespective of whether the initial conditions that permitted the use of the option still hold. Therefore, these Board members question the purpose of and need for requiring the criteria to be met at initial designation.

Appendix B
Amendments to the Basis for Conclusions on other Standards

The amendments in this appendix to the Basis for Conclusions on other Standards are necessary in order to ensure consistency with IFRS 9 and the related amendments to other Standards.

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The amendments contained in this appendix when IFRS 9 was issued in 2014 have been incorporated into the Basis for Conclusons on the relevant Standards.

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IFRS 9 *Financial Instruments* Illustrative Examples

These examples accompany, but are not part of, IFRS 9.

Financial liabilities at fair value through profit or loss

IE1 The following example illustrates the calculation that an entity might perform in accordance with paragraph B5.7.18 of IFRS 9.

IE2 On 1 January 20X1 an entity issues a 10-year bond with a par value of CU150,000[67] and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.

IE3 The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:

(a) LIBOR has decreased to 4.75 per cent.

(b) the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent.[68]

IE4 The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.

IE5 The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

[paragraph B5.7.18(a)] First, the entity computes the liability's internal rate of return at the start of the period using the observed market price of the liability and the liability's contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return.	At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond's internal rate of return is 8 per cent. Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.
[paragraph B5.7.18(b)] Next, the entity calculates the present value of the cash flows associated with the liability using the liability's contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph B5.7.18(a).	The contractual cash flows of the instrument at the end of the period are: • interest: CU12,000[(a)] per year for each of years 2-10. • principal: CU150,000 in year 10. The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is the end of period LIBOR rate of 4.75 per cent, plus the 3 per cent instrument-specific component. This gives a present value of CU152,367.[(b)]
[paragraph B5.7.18(c)] The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph B5.7.18(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with paragraph 5.7.7(a).	The market price of the liability at the end of the period is CU153,811.[(c)] Thus, the entity presents CU1,444 in other comprehensive income, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.

(a) $CU150,000 \times 8\% = CU12,000$.
(b) $PV = [CU12,000 \times (1 - (1 + 0.0775)^{-9})/0.0775] + CU150,000 \times (1 + 0.0775)^{-9}$.
(c) market price $= [CU12,000 \times (1 - (1 + 0.076)^{-9})/0.076] + CU150,000 \times (1 + 0.076)^{-9}$.

[67] In this guidance monetary amounts are denominated in 'currency units' (CU).

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

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Impairment (Section 5.5)

Assessing significant increases in credit risk since initial recognition

IE6 The following examples illustrate possible ways to assess whether there have been significant increases in credit risk since initial recognition. For simplicity of illustration, the following examples only show one aspect of the credit risk analysis. However, the assessment of whether lifetime expected credit losses should be recognised is a multifactor and holistic analysis that considers reasonable and supportable information that is available without undue cost or effort and that is relevant for the particular financial instrument being assessed.

Example 1—significant increase in credit risk

IE7 Company Y has a funding structure that includes a senior secured loan facility with different tranches[69]. Bank X provides a tranche of that loan facility to Company Y. At the time of origination of the loan by Bank X, although Company Y's leverage was relatively high compared with other issuers with similar credit risk, it was expected that Company Y would be able to meet the covenants for the life of the instrument. In addition, the generation of revenue and cash flow was expected to be stable in Company Y's industry over the term of the senior facility. However, there was some business risk related to the ability to grow gross margins within its existing businesses.

IE8 At initial recognition, because of the considerations outlined in paragraph IE7, Bank X considers that despite the level of credit risk at initial recognition, the loan is not an originated credit-impaired loan because it does not meet the definition of a credit-impaired financial asset in Appendix A of IFRS 9.

IE9 Subsequent to initial recognition, macroeconomic changes have had a negative effect on total sales volume and Company Y has underperformed on its business plan for revenue generation and net cash flow generation. Although spending on inventory has increased, anticipated sales have not materialised. To increase liquidity, Company Y has drawn down more on a separate revolving credit facility, thereby increasing its leverage ratio. Consequently, Company Y is now close to breaching its covenants on the senior secured loan facility with Bank X.

IE10 Bank X makes an overall assessment of the credit risk on the loan to Company Y at the reporting date by taking into consideration all reasonable and supportable information that is available without undue cost or effort and that is relevant for assessing the extent of the increase in credit risk since initial recognition. This may include factors such as:

(a) Bank X's expectation that the deterioration in the macroeconomic environment may continue in the near future, which is expected to have a further negative impact on Company Y's ability to generate cash flows and to deleverage.

(b) Company Y is closer to breaching its covenants, which may result in a need to restructure the loan or reset the covenants.

(c) Bank X's assessment that the trading prices for Company Y's bonds have decreased and that the credit margin on newly originated loans have increased reflecting the increase in credit risk, and that these changes are not explained by changes in the market environment (for example, benchmark interest rates have remained unchanged). A further comparison with the pricing of Company Y's peers shows that reductions in the price of Company Y's bonds and increases in credit margin on its loans have probably been caused by company-specific factors.

(d) Bank X has reassessed its internal risk grading of the loan on the basis of the information that it has available to reflect the increase in credit risk.

IE11 Bank X determines that there has been a significant increase in credit risk since initial recognition of the loan in accordance with paragraph 5.5.3 of IFRS 9. Consequently, Bank X recognises lifetime expected credit losses on its senior secured loan to Company Y. Even if Bank X has not yet changed the internal risk grading of the loan it could still reach this conclusion—the absence or presence of a change in risk grading in itself is not determinative of whether credit risk has increased significantly since initial recognition.

[69] The security on the loan affects the loss that would be realised if a default occurs, but does not affect the risk of a default occurring, so it is not considered when determining whether there has been a significant increase in credit risk since initial recognition as required by paragraph 5.5.3 of IFRS 9.

Example 2—no significant increase in credit risk

IE12 Company C, is the holding company of a group that operates in a cyclical production industry. Bank B provided a loan to Company C. At that time, the prospects for the industry were positive, because of expectations of further increases in global demand. However, input prices were volatile and given the point in the cycle, a potential decrease in sales was anticipated.

IE13 In addition, in the past Company C has been focused on external growth, acquiring majority stakes in companies in related sectors. As a result, the group structure is complex and has been subject to change, making it difficult for investors to analyse the expected performance of the group and to forecast the cash that will be available at the holding company level. Even though leverage is at a level that is considered acceptable by Company C's creditors at the time that Bank B originates the loan, its creditors are concerned about Company C's ability to refinance its debt because of the short remaining life until the maturity of the current financing. There is also concern about Company C's ability to continue to service interest using the dividends it receives from its operating subsidiaries.

IE14 At the time of the origination of the loan by Bank B, Company C's leverage was in line with that of other customers with similar credit risk and based on projections over the expected life of the loan, the available capacity (ie headroom) on its coverage ratios before triggering a default event, was high. Bank B applies its own internal rating methods to determine credit risk and allocates a specific internal rating score to its loans. Bank B's internal rating categories are based on historical, current and forward-looking information and reflect the credit risk for the tenor of the loans. On initial recognition, Bank B determines that the loan is subject to considerable credit risk, has speculative elements and that the uncertainties affecting Company C, including the group's uncertain prospects for cash generation, could lead to default. However, Bank B does not consider the loan to be originated credit-impaired because it does not meet the definition of a purchased or originated credit-impaired financial asset in Appendix A of IFRS 9.

IE15 Subsequent to initial recognition, Company C has announced that three of its five key subsidiaries had a significant reduction in sales volume because of deteriorated market conditions but sales volumes are expected to improve in line with the anticipated cycle for the industry in the following months. The sales of the other two subsidiaries were stable. Company C has also announced a corporate restructure to streamline its operating subsidiaries. This restructuring will increase the flexibility to refinance existing debt and the ability of the operating subsidiaries to pay dividends to Company C.

IE16 Despite the expected continuing deterioration in market conditions, Bank B determines, in accordance with paragraph 5.5.3 of IFRS 9, that there has not been a significant increase in the credit risk on the loan to Company C since initial recognition. This is demonstrated by factors that include:

(a) Although current sale volumes have fallen, this was as anticipated by Bank B at initial recognition. Furthermore, sales volumes are expected to improve, in the following months.

(b) Given the increased flexibility to refinance the existing debt at the operating subsidiary level and the increased availability of dividends to Company C, Bank B views the corporate restructure as being credit enhancing. This is despite some continued concern about the ability to refinance the existing debt at the holding company level.

(c) Bank B's credit risk department, which monitors Company C, has determined that the latest developments are not significant enough to justify a change in its internal credit risk rating.

IE17 As a consequence, Bank B does not recognise a loss allowance at an amount equal to lifetime expected credit losses on the loan. However, it updates its measurement of the 12-month expected credit losses for the increased risk of a default occurring in the next 12 months and for current expectations of the credit losses that would arise if a default were to occur.

Example 3—highly collateralised financial asset

IE18 Company H owns real estate assets which are financed by a five-year loan from Bank Z with a loan-to-value (LTV) ratio of 50 per cent. The loan is secured by a first-ranking security over the real estate assets. At initial recognition of the loan, Bank Z does not consider the loan to be originated credit-impaired as defined in Appendix A of IFRS 9.

IE19 Subsequent to initial recognition, the revenues and operating profits of Company H have decreased because of an economic recession. Furthermore, expected increases in regulations have the potential to further negatively affect revenue and operating profit. These negative effects on Company H's operations could be significant and ongoing.

IE20 As a result of these recent events and expected adverse economic conditions, Company H's free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could become tight. Bank Z

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estimates that a further deterioration in cash flows may result in Company H missing a contractual payment on the loan and becoming past due.

IE21 Recent third party appraisals have indicated a decrease in the value of the real estate properties, resulting in a current LTV ratio of 70 per cent.

IE22 At the reporting date, the loan to Company H is not considered to have low credit risk in accordance with paragraph 5.5.10 of IFRS 9. Bank Z therefore needs to assess whether there has been a significant increase in credit risk since initial recognition in accordance with paragraph 5.5.3 of IFRS 9, irrespective of the value of the collateral it holds. It notes that the loan is subject to considerable credit risk at the reporting date because even a slight deterioration in cash flows could result in Company H missing a contractual payment on the loan. As a result, Bank Z determines that the credit risk (ie the risk of a default occurring) has increased significantly since initial recognition. Consequently, Bank Z recognises lifetime expected credit losses on the loan to Company H.

IE23 Although lifetime expected credit losses should be recognised, the measurement of the expected credit losses will reflect the recovery expected from the collateral (adjusting for the costs of obtaining and selling the collateral) on the property as required by paragraph B5.5.55 of IFRS 9 and may result in the expected credit losses on the loan being very small.

Example 4—public investment-grade bond

IE24 Company A is a large listed national logistics company. The only debt in the capital structure is a five-year public bond with a restriction on further borrowing as the only bond covenant. Company A reports quarterly to its shareholders. Entity B is one of many investors in the bond. Entity B considers the bond to have low credit risk at initial recognition in accordance with paragraph 5.5.10 of IFRS 9. This is because the bond has a low risk of default and Company A is considered to have a strong capacity to meet its obligations in the near term. Entity B's expectations for the longer term are that adverse changes in economic and business conditions may, but will not necessarily, reduce Company A's ability to fulfil its obligations on the bond. In addition, at initial recognition the bond had an internal credit rating that is correlated to a global external credit rating of investment grade.

IE25 At the reporting date, Entity B's main credit risk concern is the continuing pressure on the total volume of sales that has caused Company A's operating cash flows to decrease.

IE26 Because Entity B relies only on quarterly public information and does not have access to private credit risk information (because it is a bond investor), its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from rating agencies.

IE27 Entity B applies the low credit risk simplification in paragraph 5.5.10 of IFRS 9. Accordingly, at the reporting date, Entity B evaluates whether the bond is considered to have low credit risk using all reasonable and supportable information that is available without undue cost or effort. In making that evaluation, Entity B reassesses the internal credit rating of the bond and concludes that the bond is no longer equivalent to an investment grade rating because:

(a) The latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20 per cent and in operating profit by 12 per cent.

(b) Rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade. However, at the reporting date the external credit risk rating was unchanged.

(c) The bond price has also declined significantly, which has resulted in a higher yield to maturity. Entity B assesses that the bond prices have been declining as a result of increases in Company A's credit risk. This is because the market environment has not changed (for example, benchmark interest rates, liquidity etc are unchanged) and comparison with the bond prices of peers shows that the reductions are probably company specific (instead of being, for example, changes in benchmark interest rates that are not indicative of company-specific credit risk).

IE28 While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions have increased the risk of a default occurring on the bond. As a result of the factors described in paragraph IE27, Entity B determines that the bond does not have low credit risk at the reporting date. As a result, Entity B needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, Company B determines that the credit risk has increased significantly since initial recognition and that a loss allowance at an amount equal to lifetime expected credit losses should be recognised in accordance with paragraph 5.5.3 of IFRS 9.

Example 5—responsiveness to changes in credit risk

IE29 Bank ABC provides mortgages to finance residential real estate in three different regions. The mortgage loans are originated across a wide range of LTV criteria and a wide range of income groups. As part of the mortgage application process, customers are required to provide information such as the industry within which the customer is employed and the post code of the property that serves as collateral on the mortgage.

IE30 Bank ABC sets its acceptance criteria based on credit scores. Loans with a credit score above the 'acceptance level' are approved because these borrowers are considered to be able to meet contractual payment obligations. When new mortgage loans are originated, Bank ABC uses the credit score to determine the risk of a default occurring as at initial recognition.

IE31 At the reporting date Bank ABC determines that economic conditions are expected to deteriorate significantly in all regions. Unemployment levels are expected to increase while the value of residential property is expected to decrease, causing the LTV ratios to increase. As a result of the expected deterioration in economic conditions, Bank ABC expects default rates on the mortgage portfolio to increase.

Individual assessment

IE32 In Region One, Bank ABC assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process. Its scoring models are based on current and historical past due statuses, levels of customer indebtedness, LTV measures, customer behaviour on other financial instruments with Bank ABC, the loan size and the time since the origination of the loan. Bank ABC updates the LTV measures on a regular basis through an automated process that re-estimates property values using recent sales in each post code area and reasonable and supportable forward-looking information that is available without undue cost or effort.

IE33 Bank ABC has historical data that indicates a strong correlation between the value of residential property and the default rates for mortgages. That is, when the value of residential property declines, a customer has less economic incentive to make scheduled mortgage repayments, increasing the risk of a default occurring.

IE34 Through the impact of the LTV measure in the behavioural scoring model, an increased risk of a default occurring due to an expected decline in residential property value adjusts the behavioural scores. The behavioural score can be adjusted as a result of expected declines in property value even when the mortgage loan is a bullet loan with the most significant payment obligations at maturity (and beyond the next 12 months). Mortgages with a high LTV ratio are more sensitive to changes in the value of the residential property and Bank ABC is able to identify significant increases in credit risk since initial recognition on individual customers before a mortgage becomes past due if there has been a deterioration in the behavioural score.

IE35 When the increase in credit risk has been significant, a loss allowance at an amount equal to lifetime expected credit losses is recognised. Bank ABC measures the loss allowance by using the LTV measures to estimate the severity of the loss, ie the loss given default (LGD). The higher the LTV measure, the higher the expected credit losses all else being equal.

IE36 If Bank ABC was unable to update behavioural scores to reflect the expected declines in property prices, it would use reasonable and supportable information that is available without undue cost or effort to undertake a collective assessment to determine the loans on which there has been a significant increase in credit risk since initial recognition and recognise lifetime expected credit losses for those loans.

Collective assessment

IE37 In Regions Two and Three, Bank ABC does not have an automated scoring capability. Instead, for credit risk management purposes, Bank ABC tracks the risk of a default occurring by means of past due statuses. It recognises a loss allowance at an amount equal to lifetime expected credit losses for all loans that have a past due status of more than 30 days past due. Although Bank ABC uses past due status information as the only borrower-specific information, it also considers other reasonable and supportable forward-looking information that is available without undue cost or effort to assess whether lifetime expected credit losses should be recognised on loans that are not more than 30 days past due. This is necessary in order to meet the objective in paragraph 5.5.4 of IFRS 9 of recognising lifetime expected credit losses for all significant increases in credit risk.

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Region Two

IE38 Region Two includes a mining community that is largely dependent on the export of coal and related products. Bank ABC becomes aware of a significant decline in coal exports and anticipates the closure of several coal mines. Because of the expected increase in the unemployment rate, the risk of a default occurring on mortgage loans to borrowers who are employed by the coal mines is determined to have increased significantly, even if those customers are not past due at the reporting date. Bank ABC therefore segments its mortgage portfolio by the industry within which customers are employed (using the information recorded as part of the mortgage application process) to identify customers that rely on coal mining as the dominant source of employment (ie a 'bottom up' approach in which loans are identified based on a common risk characteristic). For those mortgages, Bank ABC recognises a loss allowance at an amount equal to lifetime expected credit losses while it continues to recognise a loss allowance at an amount equal to 12-month expected credit losses for all other mortgages in Region Two.[70] Newly originated mortgages to borrowers who rely on the coal mines for employment in this community would, however, have a loss allowance at an amount equal to 12-month expected credit losses because they would not have experienced significant increases in credit risk since initial recognition. However, some of these mortgages may experience significant increases in credit risk soon after initial recognition because of the expected closure of the coal mines.

Region Three

IE39 In Region Three, Bank ABC anticipates the risk of a default occurring and thus an increase in credit risk, as a result of an expected increase in interest rates during the expected life of the mortgages. Historically, an increase in interest rates has been a lead indicator of future defaults on mortgages in Region Three—especially when customers do not have a fixed interest rate mortgage. Bank ABC determines that the variable interest-rate portfolio of mortgages in Region Three is homogenous and that unlike for Region Two, it is not possible to identify particular sub portfolios on the basis of shared risk characteristics that represent customers who are expected to have increased significantly in credit risk. However, as a result of the homogenous nature of the mortgages in Region Three, Bank ABC determines that an assessment can be made of a proportion of the overall portfolio that has significantly increased in credit risk since initial recognition (ie a 'top down' approach can be used). Based on historical information, Bank ABC estimates that an increase in interest rates of 200 basis points will cause a significant increase in credit risk on 20 per cent of the variable interest-rate portfolio. Therefore, as a result of the anticipated increase in interest rates, Bank ABC determines that the credit risk on 20 per cent of mortgages in Region Three has increased significantly since initial recognition. Accordingly Bank ABC recognises lifetime expected credit losses on 20 per cent of the variable rate mortgage portfolio and a loss allowance at an amount equal to 12-month expected credit losses for the remainder of the portfolio.[71]

Example 6—comparison to maximum initial credit risk

IE40 Bank A has two portfolios of automobile loans with similar terms and conditions in Region W. Bank A's policy on financing decisions for each loan is based on an internal credit rating system that considers a customer's credit history, payment behaviour on other products with Bank A and other factors, and assigns an internal credit risk rating from 1 (lowest credit risk) to 10 (highest credit risk) to each loan on origination. The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. Loans in Portfolio 1 were only offered to existing customers with a similar internal credit risk rating and at initial recognition all loans were rated 3 or 4 on the internal rating scale. Bank A determines that the maximum initial credit risk rating at initial recognition it would accept for Portfolio 1 is an internal rating of 4. Loans in Portfolio 2 were offered to customers that responded to an advertisement for automobile loans and the internal credit risk ratings of these customers range between 4 and 7 on the internal rating scale. Bank A never originates an automobile loan with an internal credit risk rating worse than 7 (ie with an internal rating of 8–10).

IE41 For the purposes of assessing whether there have been significant increases in credit risk, Bank A determines that all loans in Portfolio 1 had a similar initial credit risk. It determines that given the risk of default reflected in its internal risk rating grades, a change in internal rating from 3 to 4 would not represent a significant increase in credit risk but that there has been a significant increase in credit risk on any loan in this portfolio

[70] Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognised on those mortgages.

[71] Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognised on those mortgages.

that has an internal rating worse than 5. This means that Bank A does not have to know the initial credit rating of each loan in the portfolio to assess the change in credit risk since initial recognition. It only has to determine whether the credit risk is worse than 5 at the reporting date to determine whether lifetime expected credit losses should be recognised in accordance with paragraph 5.5.3 of IFRS 9.

IE42 However, determining the maximum initial credit risk accepted at initial recognition for Portfolio 2 at an internal credit risk rating of 7, would not meet the objective of the requirements as stated in paragraph 5.5.4 of IFRS 9. This is because Bank A determines that significant increases in credit risk arise not only when credit risk increases above the level at which an entity would originate new financial assets (ie when the internal rating is worse than 7). Although Bank A never originates an automobile loan with an internal credit rating worse than 7, the initial credit risk on loans in Portfolio 2 is not of sufficiently similar credit risk at initial recognition to apply the approach used for Portfolio 1. This means that Bank A cannot simply compare the credit risk at the reporting date with the lowest credit quality at initial recognition (for example, by comparing the internal credit risk rating of loans in Portfolio 2 with an internal credit risk rating of 7) to determine whether credit risk has increased significantly because the initial credit quality of loans in the portfolio is too diverse. For example, if a loan initially had a credit risk rating of 4 the credit risk on the loan may have increased significantly if its internal credit risk rating changes to 6.

Example 7—counterparty assessment of credit risk

Scenario 1

IE43 In 20X0 Bank A granted a loan of CU10,000 with a contractual term of 15 years to Company Q when the company had an internal credit risk rating of 4 on a scale of 1 (lowest credit risk) to 10 (highest credit risk). The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. In 20X5, when Company Q had an internal credit risk rating of 6, Bank A issued another loan to Company Q for CU5,000 with a contractual term of 10 years. In 20X7 Company Q fails to retain its contract with a major customer and correspondingly experiences a large decline in its revenue. Bank A considers that as a result of losing the contract, Company Q will have a significantly reduced ability to meet its loan obligations and changes its internal credit risk rating to 8.

IE44 Bank A assesses credit risk on a counterparty level for credit risk management purposes and determines that the increase in Company Q's credit risk is significant. Although Bank A did not perform an individual assessment of changes in the credit risk on each loan since its initial recognition, assessing the credit risk on a counterparty level and recognising lifetime expected credit losses on all loans granted to Company Q, meets the objective of the impairment requirements as stated in paragraph 5.5.4 of IFRS 9. This is because, even since the most recent loan was originated (in 20X7) when Company Q had the highest credit risk at loan origination, its credit risk has increased significantly. The counterparty assessment would therefore achieve the same result as assessing the change in credit risk for each loan individually.

Scenario 2

IE45 Bank A granted a loan of CU150,000 with a contractual term of 20 years to Company X in 20X0 when the company had an internal credit risk rating of 4. During 20X5 economic conditions deteriorate and demand for Company X's products has declined significantly. As a result of the reduced cash flows from lower sales, Company X could not make full payment of its loan instalment to Bank A. Bank A re-assesses Company X's internal credit risk rating, and determines it to be 7 at the reporting date. Bank A considered the change in credit risk on the loan, including considering the change in the internal credit risk rating, and determines that there has been a significant increase in credit risk and recognises lifetime expected credit losses on the loan of CU150,000.

IE46 Despite the recent downgrade of the internal credit risk rating, Bank A grants another loan of CU50,000 to Company X in 20X6 with a contractual term of 5 years, taking into consideration the higher credit risk at that date.

IE47 The fact that Company X's credit risk (assessed on a counterparty basis) has previously been assessed to have increased significantly, does not result in lifetime expected credit losses being recognised on the new loan. This is because the credit risk on the new loan has not increased significantly since the loan was initially recognised. If Bank A only assessed credit risk on a counterparty level, without considering whether the conclusion about changes in credit risk applies to all individual financial instruments provided to the same customer, the objective in paragraph 5.5.4 of IFRS 9 would not be met.

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Recognition and measurement of expected credit losses

IE48 The following examples illustrate the application of the recognition and measurement requirements in accordance with Section 5.5 of IFRS 9, as well as the interaction with the hedge accounting requirements.

Example 8—12-month expected credit loss measurement using an explicit 'probability of default' approach

Scenario 1

IE49 Entity A originates a single 10 year amortising loan for CU1 million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and the economic outlook for the next 12 months, Entity A estimates that the loan at initial recognition has a probability of default (PD) of 0.5 per cent over the next 12 months. Entity A also determines that changes in the 12-month PD are a reasonable approximation of the changes in the lifetime PD for determining whether there has been a significant increase in credit risk since initial recognition.

IE50 At the reporting date (which is before payment on the loan is due[72]), there has been no change in the 12-month PD and Entity A determines that there was no significant increase in credit risk since initial recognition. Entity A determines that 25 per cent of the gross carrying amount will be lost if the loan defaults (ie the LGD is 25 per cent).[73] Entity A measures the loss allowance at an amount equal to 12-month expected credit losses using the 12-month PD of 0.5 per cent. Implicit in that calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12 month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

Scenario 2

IE51 Entity B acquires a portfolio of 1,000 five year bullet loans for CU1,000 each (ie CU1 million in total) with an average 12-month PD of 0.5 per cent for the portfolio. Entity B determines that because the loans only have significant payment obligations beyond the next 12 months, it would not be appropriate to consider changes in the 12-month PD when determining whether there have been significant increases in credit risk since initial recognition. At the reporting date Entity B therefore uses changes in the lifetime PD to determine whether the credit risk of the portfolio has increased significantly since initial recognition.

IE52 Entity B determines that there has not been a significant increase in credit risk since initial recognition and estimates that the portfolio has an average LGD of 25 per cent. Entity B determines that it is appropriate to measure the loss allowance on a collective basis in accordance with IFRS 9. The 12-month PD remains at 0.5 per cent at the reporting date. Entity B therefore measures the loss allowance on a collective basis at an amount equal to 12-month expected credit losses based on the average 0.5 per cent 12-month PD. Implicit in the calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12-month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

Example 9—12-month expected credit loss measurement based on a loss rate approach

IE53 Bank A originates 2,000 bullet loans with a total gross carrying amount of CU500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of CU200, for a total gross carrying amount of CU200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU300, for a total gross carrying amount of CU300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

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[72] Thus for simplicity of illustration it is assumed there is no amortisation of the loan.

[73] Because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money.

IE54 Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans. In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss[(a)]	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	4	CU800	CU600	0.3%
Y	1,000	CU300	CU300,000	2	CU600	CU450	0.15%

(a) In accordance with paragraph 5.5.17(b) expected credit losses should be discounted using the effective interest rate. However, for purposes of this example, the present value of the observed loss is assumed.

IE55 At the reporting date, Bank A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Bank A estimates five defaults in the next 12 months for loans in Group X and three for loans in Group Y. It estimates that the present value of the observed credit loss per client will remain consistent with the historical loss per client.

IE56 On the basis of the expected life of the loans, Bank A determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios. On the basis of its forecasts, Bank A measures the loss allowance at an amount equal to 12-month expected credit losses on the 1,000 loans in each group amounting to CU750 and CU675 respectively. This equates to a loss rate in the first year of 0.375 per cent for Group X and 0.225 per cent for Group Y.

	Number of clients in sample	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Expected defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C = A × B	D	E = B × D	F	G = F ÷ C
X	1,000	CU200	CU200,000	5	CU1,000	CU750	0.375%
Y	1,000	CU300	CU300,000	3	CU900	CU675	0.225%

IE57 Bank A uses the loss rates of 0.375 per cent and 0.225 per cent respectively to estimate 12-month expected credit losses on new loans in Group X and Group Y originated during the year and for which credit risk has not increased significantly since initial recognition.

Example 10—revolving credit facilities

IE58 Bank A provides co-branded credit cards to customers in conjunction with a local department store. The credit cards have a one-day notice period after which Bank A has the contractual right to cancel the credit card (both the drawn and undrawn components). However, Bank A does not enforce its contractual right to cancel the credit cards in the normal day-to-day management of the instruments and only cancels facilities when it becomes aware of an increase in credit risk and starts to monitor customers on an individual basis. Bank A therefore does not consider the contractual right to cancel the credit cards to limit its exposure to credit losses to the contractual notice period.

IE59 For credit risk management purposes Bank A considers that there is only one set of contractual cash flows from customers to assess and does not distinguish between the drawn and undrawn balances at the reporting date. The portfolio is therefore managed and expected credit losses are measured on a facility level.

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IE60 At the reporting date the outstanding balance on the credit card portfolio is CU60,000 and the available undrawn facility is CU40,000. Bank A determines the expected life of the portfolio by estimating the period over which it expects to be exposed to credit risk on the facilities at the reporting date, taking into account:

(a) the period over which it was exposed to credit risk on a similar portfolio of credit cards;

(b) the length of time for related defaults to occur on similar financial instruments; and

(c) past events that led to credit risk management actions because of an increase in credit risk on similar financial instruments, such as the reduction or removal of undrawn credit limits.

IE61 On the basis of the information listed in paragraph IE60, Bank A determines that the expected life of the credit card portfolio is 30 months.

IE62 At the reporting date Bank A assesses the change in the credit risk on the portfolio since initial recognition and determines in accordance with paragraph 5.5.3 of IFRS 9 that the credit risk on a portion of the credit card facilities representing 25 per cent of the portfolio, has increased significantly since initial recognition. The outstanding balance on these credit facilities for which lifetime expected credit losses should be recognised is CU20,000 and the available undrawn facility is CU10,000.

IE63 When measuring the expected credit losses in accordance with paragraph 5.5.20 of IFRS 9, Bank A considers its expectations about future draw-downs over the expected life of the portfolio (ie 30 months) in accordance with paragraph B5.5.31 and estimates what it expects the outstanding balance (ie exposure at default) on the portfolio would be if customers were to default. By using its credit risk models Bank A determines that the exposure at default on the credit card facilities for which lifetime expected credit losses should be recognised, is CU25,000 (ie the drawn balance of CU20,000 plus further draw-downs of CU5,000 from the available undrawn commitment). The exposure at default of the credit card facilities for which 12-month expected credit losses are recognised, is CU45,000 (ie the outstanding balance of CU40,000 and an additional draw-down of CU5,000 from the undrawn commitment over the next 12 months).

IE64 The exposure at default and expected life determined by Bank A are used to measure the lifetime expected credit losses and 12-month expected credit losses on its credit card portfolio.

IE65 Bank A measures expected credit losses on a facility level and therefore cannot separately identify the expected credit losses on the undrawn commitment component from those on the loan component. It recognises expected credit losses for the undrawn commitment together with the loss allowance for the loan component in the statement of financial position. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be presented as a provision (in accordance with IFRS 7 *Financial Instruments: Disclosure*).

Example 11—modification of contractual cash flows

IE66 Bank A originates a five-year loan that requires the repayment of the outstanding contractual amount in full at maturity. Its contractual par amount is CU1,000 with an interest rate of 5 per cent payable annually. The effective interest rate is 5 per cent. At the end of the first reporting period (Period 1), Bank A recognises a loss allowance at an amount equal to 12-month expected credit losses because there has not been a significant increase in credit risk since initial recognition. A loss allowance balance of CU20 is recognised.

IE67 In the subsequent reporting period (Period 2), Bank A determines that the credit risk on the loan has increased significantly since initial recognition. As a result of this increase, Bank A recognises lifetime expected credit losses on the loan. The loss allowance balance is CU30.

IE68 At the end of the third reporting period (Period 3), following significant financial difficulty of the borrower, Bank A modifies the contractual cash flows on the loan. It extends the contractual term of the loan by one year so that the remaining term at the date of the modification is three years. The modification does not result in the derecognition of the loan by Bank A.

IE69 As a result of that modification, Bank A recalculates the gross carrying amount of the financial asset as the present value of the modified contractual cash flows discounted at the loan's original effective interest rate of 5 per cent. In accordance with paragraph 5.4.3 of IFRS 9, the difference between this recalculated gross carrying amount and the gross carrying amount before the modification is recognised as a modification gain or loss. Bank A recognises the modification loss (calculated as CU300) against the gross carrying amount of the loan, reducing it to CU700, and a modification loss of CU300 in profit or loss.

IE70 Bank A also remeasures the loss allowance, taking into account the modified contractual cash flows and evaluates whether the loss allowance for the loan shall continue to be measured at an amount equal to lifetime expected credit losses. Bank A compares the current credit risk (taking into consideration the modified cash flows) to the credit risk (on the original unmodified cash flows) at initial recognition. Bank A determines that the loan is not credit-impaired at the reporting date but that credit risk has still significantly increased compared to the credit risk at initial recognition and continues to measure the loss allowance at an amount

equal to lifetime expected credit losses. The loss allowance balance for lifetime expected credit losses is CU100 at the reporting date.

Period	Beginning gross carrying amount	Impairment (loss)/gain	Modification (loss)/gain	Interest revenue	Cash flows	Ending gross carrying amount	Loss allowance	Ending amortised cost amount
	A	B	C	D Gross: A × 5%	E	F = A + C + D – E	G	H = F – G
1	CU1,000	(CU20)		CU50	CU50	CU1,000	CU20	CU980
2	CU1,000	(CU10)		CU50	CU50	CU1,000	CU30	CU970
3	CU1,000	(CU70)	(CU300)	CU50	CU50	CU700	CU100	CU600

IE71 At each subsequent reporting date, Bank A evaluates whether there is a significant increase in credit risk by comparing the loan's credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows), in accordance with paragraph 5.5.12 of IFRS 9.

IE72 Two reporting periods after the loan modification (Period 5), the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. An assessment of all reasonable and supportable information that is available without undue cost or effort indicates that the overall credit risk on the loan has decreased and that the risk of a default occurring over the expected life of the loan has decreased, so Bank A adjusts the borrower's internal credit rating at the end of the reporting period.

IE73 Given the positive overall development, Bank A re-assesses the situation and concludes that the credit risk of the loan has decreased and there is no longer a significant increase in credit risk since initial recognition. As a result, Bank A once again measures the loss allowance at an amount equal to 12-month expected credit losses.

Example 12—provision matrix

IE74 Company M, a manufacturer, has a portfolio of trade receivables of CU30 million in 20X1 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with IFRS 15 *Revenue from Contracts with Customers*. In accordance with paragraph 5.5.15 of IFRS 9 the loss allowance for such trade receivables is always measured at an amount equal to lifetime time expected credit losses.

IE75 To determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

IE76 On that basis, Company M estimates the following provision matrix:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

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IE77 The trade receivables from the large number of small customers amount to CU30 million and are measured using the provision matrix.

	Gross carrying amount	Lifetime expected credit loss allowance (Gross carrying amount x lifetime expected credit loss rate)
Current	CU15,000,000	CU45,000
1–30 days past due	CU7,500,000	CU120,000
31–60 days past due	CU4,000,000	CU144,000
61–90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	**CU580,000**

Example 13—debt instrument measured at fair value through other comprehensive income

IE78 An entity purchases a debt instrument with a fair value of CU1,000 on 15 December 20X0 and measures the debt instrument at fair value through other comprehensive income. The instrument has an interest rate of 5 per cent over the contractual term of 10 years, and has a 5 per cent effective interest rate. At initial recognition the entity determines that the asset is not purchased or originated credit-impaired.

	Debit	Credit
Financial asset—FVOCI[(a)]	CU1,000	
Cash		CU1,000
(To recognise the debt instrument measured at its fair value)		
(a) FVOCI means fair value through other comprehensive income.		

IE79 On 31 December 20X0 (the reporting date), the fair value of the debt instrument has decreased to CU950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that expected credit losses should be measured at an amount equal to 12-month expected credit losses, which amounts to CU30. For simplicity, journal entries for the receipt of interest revenue are not provided.

	Debit	Credit
Impairment loss (profit or loss)	CU30	
Other comprehensive income[(a)]	CU20	
Financial asset—FVOCI		CU50
(To recognise 12-month expected credit losses and other fair value changes on the debt instrument)		
(a) The cumulative loss in other comprehensive income at the reporting date was CU20. That amount consists of the total fair value change of CU50 (ie CU1,000 – CU950) offset by the change in the accumulated impairment amount representing 12-month expected credit losses that was recognised (CU30).		

IE80 Disclosure would be provided about the accumulated impairment amount of CU30.

IE81 On 1 January 20X1, the entity decides to sell the debt instrument for CU950, which is its fair value at that date.

	Debit	Credit
Cash	CU950	
Financial asset—FVOCI		CU950
Loss (profit or loss)	CU20	
Other comprehensive income		CU20
(To derecognise the fair value through other comprehensive income asset and recycle amounts accumulated in other comprehensive income to profit or loss)		

Example 14—interaction between the fair value through other comprehensive income measurement category and foreign currency denomination, fair value hedge accounting and impairment

IE82 This example illustrates the accounting relating to a debt instrument denominated in a foreign currency, measured at fair value through other comprehensive income and designated in a fair value hedge accounting relationship. The example illustrates the interaction with accounting for impairment.

IE83 An entity purchases a debt instrument (a bond) denominated in a foreign currency (FC) for its fair value of FC100,000 on 1 January 20X0 and classifies the bond as measured at fair value through other comprehensive income. The bond has five years remaining to maturity and a fixed coupon of 5 per cent over its contractual life on the contractual par amount of FC100,000. On initial recognition the bond has a 5 per cent effective interest rate. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1 on 1 January 20X0. At initial recognition the entity determines that the bond is not purchased or originated credit-impaired. In addition, as at 1 January 20X0 the 12-month expected credit losses are determined to be FC1,200. Its amortised cost in FC as at 1 January 20X0 is equal to its gross carrying amount of FC100,000 less the 12-month expected credit losses (FC100,000—FC1,200).

IE84 The entity has the following risk exposures:

(a) fair value interest rate risk in FC: the exposure that arises as a result of purchasing a fixed interest rate instrument; and

(b) foreign exchange risk: the exposure to changes in foreign exchange rates measured in LC.

IE85 The entity hedges its risk exposures using the following risk management strategy:

(a) for fixed interest rate risk (in FC) the entity decides to link its interest receipts in FC to current variable interest rates in FC. Consequently, the entity uses interest rate swaps denominated in FC under which it pays fixed interest and receives variable interest in FC; and

(b) for foreign exchange risk the entity decides not to hedge against any variability in LC arising from changes in foreign exchange rates.

IE86 The entity designates the following hedge relationship:[74] a fair value hedge of the bond in FC as the hedged item with changes in benchmark interest rate risk in FC as the hedged risk. The entity enters into an on-market swap that pays fixed and receives variable interest on the same day and designates the swap as the hedging instrument. The tenor of the swap matches that of the hedged item (ie five years).

IE87 For simplicity, in this example it is assumed that no hedge ineffectiveness arises in the hedge accounting relationship. This is because of the assumptions made in order to better focus on illustrating the accounting mechanics in a situation that entails measurement at fair value through other comprehensive income of a foreign currency financial instrument that is designated in a fair value hedge relationship, and also to focus on the recognition of impairment gains or losses on such an instrument.

[74] The cumulative loss in other comprehensive income at the reporting date was CU20. That amount consists of the total fair value change of CU50 (ie CU1,000 – CU950) offset by the change in the accumulated impairment amount representing 12-month expected credit losses that was recognised (CU30). This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 6.4.1 of IFRS 9). The following description of the designation is solely for the purpose of understanding this example (ie it is not an example of the complete formal documentation required in accordance with paragraph 6.4.1 of IFRS 9).

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IE88 The entity makes the following journal entries to recognise the bond and the swap on 1 January 20X0:

	Debit LC	Credit LC
Financial asset—FVOCI	100,000	
Cash		100,000
(To recognise the bond at its fair value)		
Impairment loss (profit or loss)	1,200	
Other comprehensive income		1,200
(To recognise the 12-month expected credit losses)[(a)]		
Swap	–	
Cash		–
(To recognise the swap at its fair value)		

(a) In case of items measured in the functional currency of an entity the journal entry recognising expected credit losses will usually be made at the reporting date.

IE89 As of 31 December 20X0 (the reporting date), the fair value of the bond decreased from FC100,000 to FC96,370 because of an increase in market interest rates. The fair value of the swap increased to FC1,837. In addition, as at 31 December 20X0 the entity determines that there has been no change to the credit risk on the bond since initial recognition and continues to carry a loss allowance for 12-month expected credit losses at FC1,200.[75] As at 31 December 20X0, the exchange rate is FC1 to LC1.4. This is reflected in the following table:

	1 January 20X0	31 December 20X0
Bond		
Fair value (FC)	100,000	96,370
Fair value (LC)	100,000	134,918
Amortised cost (FC)	98,800	98,800
Amortised cost (LC)	98,800	138,320
Interest rate swap		
Interest rate swap (FC)	–	1,837
Interest rate swap (LC)	–	2,572
Impairment – loss allowance		
Loss allowance (FC)	1,200	1,200
Loss allowance (LC)	1,200	1,680
FX rate (FC:LC)	1:1	1:1.4

IE90 The bond is a monetary asset. Consequently, the entity recognises the changes arising from movements in foreign exchange rates in profit or loss in accordance with paragraphs 23(a) and 28 of IAS 21 *The Effects of*

[75] For the purposes of simplicity the example ignores the impact of discounting when computing expected credit losses.

Changes in Foreign Exchange Rates and recognises other changes in accordance with IFRS 9. For the purposes of applying paragraph 28 of IAS 21 the asset is treated as an asset measured at amortised cost in the foreign currency.

IE91 As shown in the table, on 31 December 20X0 the fair value of the bond is LC134,918 (FC96,370 × 1.4) and its amortised cost is LC138,320 (FC(100,000–1,200) × 1.4).

IE92 The gain recognised in profit or loss that is due to the changes in foreign exchange rates is LC39,520 (LC138,320 – LC98,800), ie the change in the amortised cost of the bond during 20X0 in LC. The change in the fair value of the bond in LC, which amounts to LC34,918, is recognised as an adjustment to the carrying amount. The difference between the fair value of the bond and its amortised cost in LC is LC3,402 (LC134,918 – LC138,320). However, the change in the cumulative gain or loss recognised in other comprehensive income during 20X0 as a reduction is LC 4,602 (LC3,402 + LC1,200).

IE93 A gain of LC2,572 (FC1,837 × 1.4) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive income in the same period. For simplicity, journal entries for the recognition of interest revenue are not provided. It is assumed that interest accrued is received in the period.

IE94 The entity makes the following journal entries on 31 December 20X0:

	Debit LC	**Credit LC**
Financial asset—FVOCI	34,918	
Other comprehensive income	4,602	
Profit or loss		39,520
(To recognise the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)		
Swap	2,572	
Profit or loss		2,572
(To remeasure the swap at fair value)		
Profit or loss	2,572	
Other comprehensive income		2,572
(To recognise in profit or loss the change in fair value of the bond due to a change in the hedged risk)		

IE95 In accordance with paragraph 16A of IFRS 7, the loss allowance for financial assets measured at fair value through other comprehensive income is not presented separately as a reduction of the carrying amount of the financial asset. However, disclosure would be provided about the accumulated impairment amount recognised in other comprehensive income.

IE96 As at 31 December 20X1 (the reporting date), the fair value of the bond decreased to FC87,114 because of an increase in market interest rates and an increase in the credit risk of the bond. The fair value of the swap increased by FC255 to FC2,092. In addition, as at 31 December 20X1 the entity determines that there has been a significant increase in credit risk on the bond since initial recognition, so a loss allowance at an amount equal to lifetime expected credit losses is recognised.[76] The estimate of lifetime expected credit losses as at

[76] For simplicity this example assumes that credit risk does not dominate the fair value hedge relationship.

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31 December 20X1 is FC9,700. As at 31 December 20X1, the exchange rate is FC1 to LC1.25. This is reflected in the following table:

	31 December 20X0	31 December 20X1
Bond		
Fair value (FC)	96,370	87,114
Fair value (LC)	134,918	108,893
Amortised cost (FC)	98,800	90,300
Amortised cost (LC)	138,320	112,875
Interest rate swap		
Interest rate swap (FC)	1,837	2,092
Interest rate swap (LC)	2,572	2,615
Impairment – loss allowance		
Loss allowance (FC)	1,200	9,700
Loss allowance (LC)	1,680	12,125
FX rate (FC:LC)	1:1.4	1:1.25

IE97 As shown in the table, as at 31 December 20X1 the fair value of the bond is LC108,893 (FC87,114 × 1.25) and its amortised cost is LC112,875 (FC(100,000 – 9,700) × 1.25).

IE98 The lifetime expected credit losses on the bond are measured as FC9,700 as of 31 December 20X1. Thus the impairment loss recognised in profit or loss in LC is LC10,625 (FC(9,700 – 1,200) x 1.25).

IE99 The loss recognised in profit or loss because of the changes in foreign exchange rates is LC14,820 (LC112,875 – LC138,320 + LC10,625), which is the change in the gross carrying amount of the bond on the basis of amortised cost during 20X1 in LC, adjusted for the impairment loss. The difference between the fair value of the bond and its amortised cost in the functional currency of the entity on 31 December 20X1 is LC3,982 (LC108,893 – LC112,875). However, the change in the cumulative gain or loss recognised in other comprehensive income during 20X1 as a reduction in other comprehensive income is LC11,205 (LC3,982 – LC3,402 + LC10,625).

IE100 A gain of LC43 (LC2,615 – LC2,572) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive income in the same period.

IE101 The entity makes the following journal entries on 31 December 20X1:

	Debit LC	Credit LC
Financial asset—FVOCI		26,025
Other comprehensive income	11,205	
Profit or loss	14,820	
(To recognise the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)		

	Debit LC	Credit LC
Swap	43	
Profit or loss		43
(To remeasure the swap at fair value)		
Profit or loss	43	
Other comprehensive income		43
(To recognise in profit or loss the change in fair value of the bond due to a change in the hedged risk)		
Profit or loss (impairment loss)	10,625	
Other comprehensive income (accumulated impairment amount)		10,625
(To recognise lifetime expected credit losses)		

IE102 On 1 January 20X2, the entity decides to sell the bond for FC 87,114, which is its fair value at that date and also closes out the swap at fair value. The foreign exchange rate is the same as at 31 December 20X1. The journal entries to derecognise the bond and reclassify the gains and losses that have accumulated in other comprehensive income would be as follows:

	Debit LC	Credit LC
Cash	108,893	
Financial asset—FVOCI		108,893
Loss on sale (profit or loss)	1,367[(a)]	
Other comprehensive income		1,367
(To derecognise the bond)		
Swap		2,615
Cash	2,615	
(To close out the swap)		

(a) This amount consists of the changes in fair value of the bond, the accumulated impairment amount and the changes in foreign exchange rates recognised in other comprehensive income (LC2,572 + LC1,200 + LC43 + LC10,625 – LC4,602 – LC11,205 = -LC1,367, which is recycled as a loss in profit or loss).

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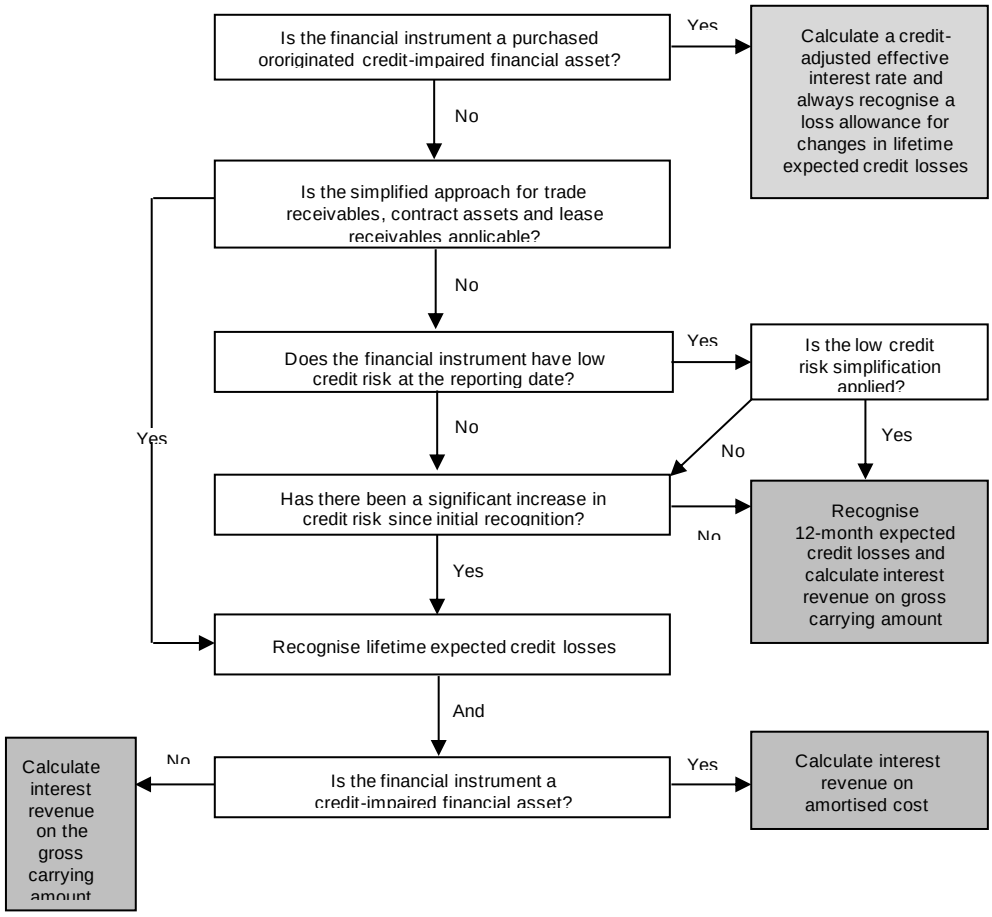
Application of the impairment requirements on a reporting date



Reclassification of financial assets (Section 5.6)

IE103 This example illustrates the accounting requirements for the reclassification of financial assets between measurement categories in accordance with Section 5.6 of IFRS 9. The example illustrates the interaction with the impairment requirements in Section 5.5 of IFRS 9.

Example 15—reclassification of financial assets

IE104 An entity purchases a portfolio of bonds for its fair value (gross carrying amount) of CU500,000.

IE105 The entity changes the business model for managing the bonds in accordance with paragraph 4.4.1 of IFRS 9. The fair value of the portfolio of bonds at the reclassification date is CU490,000.

IE106 If the portfolio was measured at amortised cost or at fair value through other comprehensive income immediately prior to reclassification, the loss allowance recognised at the date of reclassification would be CU6,000 (reflecting a significant increase in credit risk since initial recognition and thus the measurement of lifetime expected credit losses).

IE107 The 12-month expected credit losses at the reclassification date are CU4,000.

IE108 For simplicity, journal entries for the recognition of interest revenue are not provided.

Scenario 1: Reclassification out of the amortised cost measurement category and into the fair value through profit or loss measurement category

IE109 Bank A reclassifies the portfolio of bonds out of the amortised cost measurement category and into the fair value through profit or loss measurement category. At the reclassification date, the portfolio of bonds is measured at fair value. Any gain or loss arising from a difference between the previous amortised cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognised in profit or loss on reclassification.

	Debit	Credit
Bonds (FVPL assets)	CU490,000	
Bonds (gross carrying amount of the amortised cost assets)		CU500,000
Loss allowance	CU6,000	
Reclassification loss (profit or loss)	CU4,000	
(To recognise the reclassification of bonds from amortised cost to fair value through profit or loss and to derecognise the loss allowance.)		

Scenario 2: Reclassification out of the fair value through profit or loss measurement category and into the amortised cost measurement category

IE110 Bank A reclassifies the portfolio of bonds out of the fair value through profit or loss measurement category and into the amortised cost measurement category. At the reclassification date, the fair value of the portfolio of bonds becomes the new gross carrying amount and the effective interest rate is determined based on that gross carrying amount. The impairment requirements apply to the bond from the reclassification date. For the purposes of recognising expected credit losses, the credit risk of the portfolio of bonds at the reclassification date becomes the credit risk against which future changes in credit risk shall be compared.

	Debit	Credit
Bonds (gross carrying amount of the amortised cost assets)	CU490,000	
Bonds (FVPL assets)		CU490,000
Impairment loss (profit or loss)	CU4,000	
Loss allowance		CU4,000
(To recognise reclassification of bonds from fair value through profit or loss to amortised cost including commencing accounting for impairment.)		

Scenario 3: Reclassification out of the amortised cost measurement category and into the fair value through other comprehensive income measurement category

IE111 Bank A reclassifies the portfolio of bonds out of the amortised cost measurement category and into the fair value through other comprehensive income measurement category. At the reclassification date, the portfolio of bonds is measured at fair value. Any gain or loss arising from a difference between the previous amortised

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cost amount of the portfolio of bonds and the fair value of the portfolio of bonds is recognised in other comprehensive income. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. The credit risk at initial recognition continues to be used to assess changes in credit risk. From the reclassification date the loss allowance ceases to be recognised as an adjustment to the gross carrying amount of the bond and is recognised as an accumulated impairment amount, which would be disclosed.

	Debit	Credit
Bonds (FVOCI assets)	CU490,000	
Bonds (gross carrying amount of amortised cost assets)		CU500,000
Loss allowance	CU6,000	
Other comprehensive income[(a)]	CU4,000	
(To recognise the reclassification from amortised cost to fair value through other comprehensive income. The measurement of expected credit losses is however unchanged.)		

(a) For simplicity, the amount related to impairment is not shown separately. If it had been, this journal entry (ie DR CU4,000) would be split into the following two entries: DR Other comprehensive income CU10,000 (fair value changes) and CR other comprehensive income CU6,000 (accumulated impairment amount).

Scenario 4: Reclassification out of the fair value through other comprehensive income measurement category and into the amortised cost measurement category

IE112 Bank A reclassifies the portfolio of bonds out of the fair value through other comprehensive income measurement category and into the amortised cost measurement category. The portfolio of bonds is reclassified at fair value. However, at the reclassification date, the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the portfolio of bonds. As a result, the portfolio of bonds is measured at the reclassification date as if it had always been measured at amortised cost. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. The credit risk at initial recognition continues to be used to assess changes in the credit risk on the bonds. The loss allowance is recognised as an adjustment to the gross carrying amount of the bond (to reflect the amortised cost amount) from the reclassification date.

	Debit	Credit
Bonds (gross carrying value of the amortised cost assets)	CU490,000	
Bonds (FVOCI assets)		CU490,000
Bonds (gross carrying value of the amortised cost assets)	CU10,000	
Loss allowance		CU6,000
Other comprehensive income[(a)]		CU4,000
(To recognise the reclassification from fair value through other comprehensive income to amortised cost including the recognition of the loss allowance deducted to determine the amortised cost amount. The measurement of expected credit losses is however unchanged.)		

(a) The cumulative loss in other comprehensive income at the reclassification date was CU4,000. That amount consists of the total fair value change of CU10,000 (ie CU500,000 – 490,000) offset by the accumulated impairment amount recognised (CU6,000) while the assets were measured at fair value through other comprehensive income.

Scenario 5: Reclassification out of the fair value through profit or loss measurement category and into the fair value through other comprehensive income measurement category

IE113 Bank A reclassifies the portfolio of bonds out of the fair value through profit or loss measurement category and into the fair value through other comprehensive income measurement category. The portfolio of bonds continues to be measured at fair value. However, for the purposes of applying the effective interest method, the fair value of the portfolio of bonds at the reclassification date becomes the new gross carrying amount and the effective interest rate is determined based on that new gross carrying amount. The impairment requirements apply from the reclassification date. For the purposes of recognising expected credit losses, the credit risk of the portfolio of bonds at the reclassification date becomes the credit risk against which future changes in credit risk shall be compared.

	Debit	Credit
Bonds (FVOCI assets)	CU490,000	
Bonds (FVPL assets)		CU490,000
Impairment loss (profit or loss)	CU4,000	
Other comprehensive income[(a)]		CU4,000
(To recognise the reclassification of bonds from fair value through profit or loss to fair value through other comprehensive income including commencing accounting for impairment. The other comprehensive income amount reflects the loss allowance at the date of reclassification (an accumulated impairment amount relevant for disclosure purposes) of CU4,000.)		

Scenario 6: Reclassification out of the fair value through other comprehensive income measurement category and into the fair value through profit or loss measurement category

IE114 Bank A reclassifies the portfolio of bonds out of the fair value through other comprehensive income measurement category and into the fair value through profit or loss measurement category. The portfolio of bonds continues to be measured at fair value. However, the cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment (see IAS 1 *Presentation of Financial Statements*).

	Debit	Credit
Bonds (FVPL assets)	CU490,000	
Bonds (FVOCI assets)		CU490,000
Reclassification loss (profit or loss)	CU4,000	
Other comprehensive income		CU4,000
(To recognise the reclassification of bonds from fair value through other comprehensive income to fair value through profit or loss.)		
(a) The cumulative loss in other comprehensive income at the reclassification date was CU4,000. That amount consists of the total fair value change of CU10,000 (ie CU500,000 – 490,000) offset by the loss allowance that was recognised (CU6,000) while the assets were measured at fair value through other comprehensive income.		

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Hedge accounting for aggregated exposures

IE115 The following examples illustrate the mechanics of hedge accounting for aggregated exposures.

Example 16—combined commodity price risk and foreign currency risk hedge (cash flow hedge/cash flow hedge combination)

Fact pattern

IE116 Entity A wants to hedge a highly probable forecast coffee purchase (which is expected to occur at the end of Period 5). Entity A's functional currency is its Local Currency (LC). Coffee is traded in Foreign Currency (FC). Entity A has the following risk exposures:

(a) commodity price risk: the variability in cash flows for the purchase price, which results from fluctuations of the spot price of coffee in FC; and

(b) foreign currency (FX) risk: the variability in cash flows that result from fluctuations of the spot exchange rate between LC and FC.

IE117 Entity A hedges its risk exposures using the following risk management strategy:

(a) Entity A uses benchmark commodity forward contracts, which are denominated in FC, to hedge its coffee purchases four periods before delivery. The coffee price that Entity A actually pays for its purchase is different from the benchmark price because of differences in the type of coffee, the location and delivery arrangement.[77] This gives rise to the risk of changes in the relationship between the two coffee prices (sometimes referred to as 'basis risk'), which affects the effectiveness of the hedging relationship. Entity A does not hedge this risk because it is not considered economical under cost/benefit considerations.

(b) Entity A also hedges its FX risk. However, the FX risk is hedged over a different horizon—only three periods before delivery. Entity A considers the FX exposure from the variable payments for the coffee purchase in FC and the gain or loss on the commodity forward contract in FC as one aggregated FX exposure. Hence, Entity A uses one single FX forward contract to hedge the FX cash flows from a forecast coffee purchase and the related commodity forward contract.

IE118 The following table sets out the parameters used for Example 16 (the 'basis spread' is the differential, expressed as a percentage, between the price of the coffee that Entity A actually buys and the price for the benchmark coffee):

Example 16—Parameters

Period	1	2	3	4	5
Interest rates for remaining maturity [FC]	0.26%	0.21%	0.16%	0.06%	0.00%
Interest rates for remaining maturity [LC]	1.12%	0.82%	0.46%	0.26%	0.00%
Forward price [FC/lb]	1.25	1.01	1.43	1.22	2.15
Basis spread	-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
FX rate (spot) [FC/LC]	1.3800	1.3300	1.4100	1.4600	1.4300

[77] For the purpose of this example it is assumed that the hedged risk is not designated based on a benchmark coffee price risk component. Consequently, the entire coffee price risk is hedged.

Accounting mechanics

IE119 Entity A designates as cash flow hedges the following two hedging relationships:[78]

(a) A commodity price risk hedging relationship between the coffee price related variability in cash flows attributable to the forecast coffee purchase in FC as the hedged item and a commodity forward contract denominated in FC as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the end of Period 1 with a term to the end of Period 5. Because of the basis spread between the price of the coffee that Entity A actually buys and the price for the benchmark coffee, Entity A designates a volume of 112,500 pounds (lbs) of coffee as the hedging instrument and a volume of 118,421 lbs as the hedged item.[79]

(b) An FX risk hedging relationship between the aggregated exposure as the hedged item and an FX forward contract as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 2 with a term to the end of Period 5. The aggregated exposure that is designated as the hedged item represents the FX risk that is the effect of exchange rate changes, compared to the forward FX rate at the end of Period 2 (ie the time of designation of the FX risk hedging relationship), on the combined FX cash flows in FC of the two items designated in the commodity price risk hedging relationship, which are the forecast coffee purchase and the commodity forward contract. Entity A's long-term view of the basis spread between the price of the coffee that it actually buys and the price for the benchmark coffee has not changed from the end of Period 1. Consequently, the actual volume of hedging instrument that Entity A enters into (the nominal amount of the FX forward contract of FC140,625) reflects the cash flow exposure associated with a basis spread that had remained at -5 per cent. However, Entity A's actual aggregated exposure is affected by changes in the basis spread. Because the basis spread has moved from -5 per cent to -5.5 per cent during Period 2, Entity A's actual aggregated exposure at the end of Period 2 is FC140,027.

IE120 The following table sets out the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserves and hedge ineffectiveness:[80]

Example 16—Calculations

			Period	1	2	3	4	5
Commodity price risk hedging relationship (first level relationship)								
Forward purchase contract for coffee								
Volume (lbs)	112,500							
Forward price [FC/lb]	1.25	Price (fwd) [FC/lb]		1.25	1.01	1.43	1.22	2.15
			Fair value [FC]	0	(26,943)	20,219	(3,373)	101,250
			Fair value [LC]	0	(20,258)	14,339	(2,310)	70,804
			Change in fair value [LC]		(20,258)	34,598	(16,650)	73,114

continued…

[78] This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 6.4.1 of IFRS 9). The following description of the designation is solely for the purpose of understanding this example (ie it is not an example of the complete formal documentation required in accordance with IFRS 9.6.4.1(b)).

[79] In this example, the current basis spread at the time of designation is coincidentally the same as Entity A's long-term view of the basis spread (-5 per cent) that determines the volume of coffee purchases that it actually hedges. Also, this example assumes that Entity A designates the hedging instrument in its entirety and designates as much of its highly probable forecast purchases as it regards as hedged. That results in a hedge ratio of 1/(100%-5%). Other entities might follow different approaches when determining what volume of their exposure they actually hedge, which can result in a different hedge ratio and also designating less than a hedging instrument in its entirety (see paragraph 6.4.1 of IFRS 9).

[80] In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities, equity and profit or loss) are in the format of positive (plus) and negative (minus) numbers (eg a profit or loss amount that is a negative number is a loss).

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…continued

Example 16—Calculations

			Period	1	2	3	4	5
Hedged forecast coffee purchase								
Hedge ratio	105.26%	Basis spread		-5.00%	-5.50%	-6.00%	-3.40%	-7.00%
Hedged volume	118,421	Price (fwd) [FC/lb]		1.19	0.95	1.34	1.18	2.00
Implied forward price	1.1875	Present value [FC]		0	27,540	(18,528)	1,063	(96,158)
		Present value [LC]		0	20,707	(13,140)	728	(67,243)
		Change in present value [LC]			20,707	(33,847)	13,868	(67,971)
Accounting				*LC*	*LC*	*LC*	*LC*	*LC*
Derivative				0	(20,258)	14,339	(2,310)	70,804
Cash flow hedge reserve				0	(20,258)	13,140	(728)	67,243
Change in cash flow hedge reserve					(20,258)	33,399	(13,868)	67,971
Profit or loss					0	1,199	(2,781)	5,143
Retained earnings				0	0	1,199	(1,582)	3,561
FX risk hedging relationship (second level relationship)								
FX rate [FC/LC]			Spot	1.3800	1.3300	1.4100	1.4600	1.4300
			Forward	1.3683	1.3220	1.4058	1.4571	1.4300
FX forward contract (buy FC/sell LC)								
Volume [FC]	140,625							
Forward rate (in P_2)	1.3220	Fair value [LC]			0	(6,313)	(9,840)	(8,035)
		Change in fair value [LC]				(6,313)	(3,528)	1,805
Hedged FX risk								
Aggregated FX exposure		Hedged volume [FC]			140,027	138,932	142,937	135,533
		Present value [LC]			0	6,237	10,002	7,744
		Change in present value [LC]				6,237	3,765	(2,258)
Accounting					*LC*	*LC*	*LC*	*LC*
Derivative					0	(6,313)	(9,840)	(8,035)
Cash flow hedge reserve					0	(6,237)	(9,840)	(7,744)
Change in cash flow hedge reserve						(6,237)	(3,604)	2,096
Profit or loss						(76)	76	(291)
Retained earnings					0	(76)	0	(291)

IE121 The commodity price risk hedging relationship is a cash flow hedge of a highly probable forecast transaction that starts at the end of Period 1 and remains in place when the FX risk hedging relationship starts at the end of Period 2, ie the first level relationship continues as a separate hedging relationship.

IE122 The volume of the aggregated FX exposure (in FC), which is the hedged volume of the FX risk hedging relationship, is the total of:[81]

(a) the hedged coffee purchase volume multiplied by the current forward price (this represents the expected spot price of the actual coffee purchase); and

(b) the volume of the hedging instrument (designated nominal amount) multiplied by the difference between the contractual forward rate and the current forward rate (this represents the expected price differential from benchmark coffee price movements in FC that Entity A will receive or pay under the commodity forward contract).

IE123 The present value (in LC) of the hedged item of the FX risk hedging relationship (ie the aggregated exposure) is calculated as the hedged volume (in FC) multiplied by the difference between the forward FX rate at the measurement date and the forward FX rate at the designation date of the hedging relationship (ie the end of Period 2).[82]

IE124 Using the present value of the hedged item and the fair value of the hedging instrument, the cash flow hedge reserve and the hedge ineffectiveness are then determined (see paragraph 6.5.11 of IFRS 9).

IE125 The following table shows the effect on Entity A's statement of profit or loss and other comprehensive income and its statement of financial position (for the sake of transparency the line items[83] are disaggregated on the face of the statements by the two hedging relationships, ie for the commodity price risk hedging relationship and the FX risk hedging relationship):

Example 16—Overview of effect on statements of financial performance and financial position
[All amounts in LC]

Period	**1**	**2**	**3**	**4**	**5**
Statement of profit or loss and other comprehensive income					
Hedge ineffectiveness					
Commodity hedge		0	(1,199)	2,781	(5,143)
FX hedge		0	76	(76)	291
Profit or loss	0	0	(1,123)	2,705	(4,852)
Other comprehensive income (OCI)					
Commodity hedge		20,258	(33,399)	13,868	(67,971)
FX hedge		0	6,237	3,604	(2,096)
Total other comprehensive income	0	20,258	(27,162)	17,472	(70,067)
Comprehensive income	0	20,258	(28,285)	20,177	(74,920)
Statement of financial position					
Commodity forward	0	(20,258)	14,339	(2,310)	70,804
FX forward		0	(6,313)	(9,840)	(8,035)
Total net assets	0	(20,258)	8,027	(12,150)	62,769

continued…

[81] For example, at the end of Period 3 the aggregated FX exposure is determined as: 118,421 lbs × 1.34 FC/lb = FC159,182 for the expected price of the actual coffee purchase and 112,500 lbs × (1.25 [FC/lb] – 1.43 [FC/lb]) = FC(20,250) for the expected price differential under the commodity forward contract, which gives a total of FC138,932—the volume of the aggregated FX exposure at the end of Period 3.

[82] For example, at the end of Period 3 the present value of the hedged item is determined as the volume of the aggregated exposure at the end of Period 3 (FC138,932) multiplied by the difference between the forward FX rate at the end of Period 3 (1/1.4058) and the forward FX rate and the time of designation (ie the end of Period 2: 1/1.3220) and then discounted using the interest rate (in LC) at the end of Period 3 with a term of 2 periods (ie until the end of Period 5 – 0.46%). The calculation is: FC138,932 × (1/(1.4058[FC/LC]) – 1/(1.3220 [FC/LC]))/(1 + 0.46%) = LC6,237.

[83] The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IFRS 7 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

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…continued

Example 16—Overview of effect on statements of financial performance and financial position
[All amounts in LC]

Period	1	2	3	4	5
Equity					
Accumulated OCI					
Commodity hedge	0	20,258	(13,140)	728	(67,243)
FX hedge		0	6,237	9,840	7,744
	0	20,258	(6,904)	10,568	(59,499)
Retained earnings					
Commodity hedge	0	0	(1,199)	1,582	(3,561)
FX hedge		0	76	0	291
	0	0	(1,123)	1,582	(3,270)
Total equity	0	20,258	(8,027)	12,150	(62,769)

IE126 The total cost of inventory after hedging is as follows:[84]

Cost of inventory [all amounts in LC]	
Cash price (at spot for commodity price risk and FX risk)	165,582
Gain/loss from CFHR for commodity price risk	(67,243)
Gain/loss from CFHR for FX risk	7,744
Cost of inventory	106,083

IE127 The total overall cash flow from all transactions (the actual coffee purchase at the spot price and the settlement of the two derivatives) is LC102,813. It differs from the hedge adjusted cost of inventory by LC3,270, which is the net amount of cumulative hedge ineffectiveness from the two hedging relationships. This hedge ineffectiveness has a cash flow effect but is excluded from the measurement of the inventory.

Example 17—combined interest rate risk and foreign currency risk hedge (fair value hedge/cash flow hedge combination)

Fact pattern

IE128 Entity B wants to hedge a fixed rate liability that is denominated in Foreign Currency (FC). The liability has a term of four periods from the start of Period 1 to the end of Period 4. Entity B's functional currency is its Local Currency (LC). Entity B has the following risk exposures:

(a) fair value interest rate risk and FX risk: the changes in fair value of the fixed rate liability attributable to interest rate changes, measured in LC.

(b) cash flow interest rate risk: the exposure that arises as a result of swapping the combined fair value interest rate risk and FX risk exposure associated with the fixed rate liability (see (a) above) into a

[84] 'CFHR' is the cash flow hedge reserve, ie the amount accumulated in other comprehensive income for a cash flow hedge.

variable rate exposure in LC in accordance with Entity B's risk management strategy for FC denominated fixed rate liabilities (see paragraph IE129(a) below).

IE129 Entity B hedges its risk exposures using the following risk management strategy:

(a) Entity B uses cross-currency interest rate swaps to swap its FC denominated fixed rate liabilities into a variable rate exposure in LC. Entity B hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, Entity B enters into a cross-currency interest rate swap at the same time as it issues an FC denominated liability. Under the cross-currency interest rate swap Entity B receives fixed interest in FC (used to pay the interest on the liability) and pays variable interest in LC.

(b) Entity B considers the cash flows on a hedged liability and on the related cross-currency interest rate swap as one aggregated variable rate exposure in LC. From time to time, in accordance with its risk management strategy for variable rate interest rate risk (in LC), Entity B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate exposure in LC. Entity B seeks to obtain as a fixed rate exposure a single blended fixed coupon rate (ie the uniform forward coupon rate for the hedged term that exists at the start of the hedging relationship).[85] Consequently, Entity B uses interest rate swaps (denominated entirely in LC) under which it receives variable interest (used to pay the interest on the pay leg of the cross-currency interest rate swap) and pays fixed interest.

IE130 The following table sets out the parameters used for Example 17:

Example 17—Parameters

	t_0	Period 1	Period 2	Period 3	Period 4
FX spot rate [LC/FC]	1.2000	1.0500	1.4200	1.5100	1.3700
Interest curves (vertical presentation of rates for each quarter of a period on a p.a. basis)					
LC	2.50%	5.02%	6.18%	0.34%	[N/A]
	2.75%	5.19%	6.26%	0.49%	
	2.91%	5.47%	6.37%	0.94%	
	3.02%	5.52%	6.56%	1.36%	
	2.98%	5.81%	6.74%		
	3.05%	5.85%	6.93%		
	3.11%	5.91%	7.19%		
	3.15%	6.06%	7.53%		
	3.11%	6.20%			
	3.14%	6.31%			
	3.27%	6.36%			
	3.21%	6.40%			
	3.21%				
	3.25%				
	3.29%				
	3.34%				

continued…

[85] An entity may have a different risk management strategy whereby it seeks to obtain a fixed rate exposure that is not a single blended rate but a series of forward rates that are each fixed for the respective individual interest period. For such a strategy the hedge effectiveness is measured based on the difference between the forward rates that existed at the start of the hedging relationship and the forward rates that exist at the effectiveness measurement date for the individual interest periods. For such a strategy a series of forward contracts corresponding with the individual interest periods would be more effective than an interest rate swap (that has a fixed payment leg with a single blended fixed rate).

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…continued

Example 17—Parameters

	t_0	Period 1	Period 2	Period 3	Period 4
FC	3.74%	4.49%	2.82%	0.70%	[N/A]
	4.04%	4.61%	2.24%	0.79%	
	4.23%	4.63%	2.00%	1.14%	
	4.28%	4.34%	2.18%	1.56%	
	4.20%	4.21%	2.34%		
	4.17%	4.13%	2.53%		
	4.27%	4.07%	2.82%		
	4.14%	4.09%	3.13%		
	4.10%	4.17%			
	4.11%	4.13%			
	4.11%	4.24%			
	4.13%	4.34%			
	4.14%				
	4.06%				
	4.12%				
	4.19%				

Accounting mechanics

IE131 Entity B designates the following hedging relationships:[86]

(a) As a fair value hedge, a hedging relationship for fair value interest rate risk and FX risk between the FC denominated fixed rate liability (fixed rate FX liability) as the hedged item and a cross-currency interest rate swap as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the beginning of Period 1 (ie t_0) with a term to the end of Period 4.

(b) As a cash flow hedge, a hedging relationship between the aggregated exposure as the hedged item and an interest rate swap as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 1, when Entity B decides to lock in its interest payments and hence swaps its aggregated variable rate exposure in LC into a fixed rate exposure in LC, with a term to the end of Period 4. The aggregated exposure that is designated as the hedged item represents, in LC, the variability in cash flows that is the effect of changes in the combined cash flows of the two items designated in the fair value hedge of the fair value interest rate risk and FX risk (see (a) above), compared to the interest rates at the end of Period 1 (ie the time of designation of the hedging relationship between the aggregated exposure and the interest rate swap).

[86] This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 6.4.1 of IFRS 9). The following description of the designation is solely for the purpose of understanding this example (ie it is not an example of the complete formal documentation required in accordance with paragraph 6.4.1(b) of IFRS 9.

IE132 The following table[87] sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve and hedge ineffectiveness.[88] In this example, hedge ineffectiveness arises on both hedging relationships.[89]

Example 17—Calculations

	t_0	Period 1	Period 2	Period 3	Period 4
Fixed rate FX liability					
Fair value [FC]	(1,000,000)	(995,522)	(1,031,008)	(1,030,193)	(1,000,000)
Fair value [LC]	(1,200,000)	(1,045,298)	(1,464,031)	(1,555,591)	(1,370,000)
Change in fair value [LC]		154,702	(418,733)	(91,560)	185,591
CCIRS (receive fixed FC/pay variable LC)					
Fair value [LC]	0	(154,673)	264,116	355,553	170,000
Change in fair value [LC]		(154,673)	418,788	91,437	(185,553)
IRS (receive variable/pay fixed)					
Fair value [LC]		0	18,896	(58,767)	0
Change in fair value [LC]			18,896	(77,663)	(58,767)
CF variability of the aggregated exposure					
Present value [LC]		0	(18,824)	58,753	0
Change in present value [LC]			(18,824)	77,577	(58,753)
CFHR					
Balance (end of period) [LC]		0	18,824	(58,753)	0
Change [LC]			18,824	(77,577)	58,753

IE133 The hedging relationship between the fixed rate FX liability and the cross-currency interest rate swap starts at the beginning of Period 1 (ie t_0) and remains in place when the hedging relationship for the second level relationship starts at the end of Period 1, ie the first level relationship continues as a separate hedging relationship.

IE134 The cash flow variability of the aggregated exposure is calculated as follows:

(a) At the point in time from which the cash flow variability of the aggregated exposure is hedged (ie the start of the second level relationship at the end of Period 1), all cash flows expected on the fixed rate FX liability and the cross-currency interest rate swap over the hedged term (ie until the end of Period 4) are mapped out and equated to a single blended fixed coupon rate so that the total present value (in LC) is nil. This calculation establishes the single blended fixed coupon rate (reference rate) that is used at subsequent dates as the reference point to measure the cash flow variability of the aggregated exposure since the start of the hedging relationship. This calculation is illustrated in the following table:

[87] Tables in this example use the following acronyms: 'CCIRS' for cross-currency interest rate swap, 'CF(s)' for cash flow(s), 'CFH' for cash flow hedge, 'CFHR' for cash flow hedge reserve, 'FVH' for fair value hedge, 'IRS' for interest rate swap and 'PV' for present value.

[88] In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and equity) are in the format of positive (plus) and negative (minus) numbers (eg an amount in the cash flow hedge reserve that is in brackets is a loss).

[89] For a situation such as in this example, hedge ineffectiveness can result from various factors, for example credit risk, differences in the day count method or, depending on whether it is included in the designation of the hedging instrument, the charge for exchanging different currencies that is included in cross-currency interest rate swaps (commonly referred to as the 'currency basis').

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Example 17—Cash flow variability of the aggregated exposure (calibration)

		Variability in cash flows of the aggregated exposure							
		FX liability		CCIRS FC leg		CCIRS LC leg		Calibration	PV
		CF(s)	PV	CF(s)	PV	CF(s)	PV	1,200,000 Nominal 5.6963% Rate 4 Frequency	
		[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	[LC]	[LC]
	Time								
Period 1	t_0								
	t_1								
	t_2								
	t_3								
	t_4								
Period 2	t_5	0	0	0	0	(14,771)	(14,591)	17,089	16,881
	t_6	(20,426)	(19,977)	20,246	19,801	(15,271)	(14,896)	17,089	16,669
	t_7	0	0	0	0	(16,076)	(15,473)	17,089	16,449
	t_8	(20,426)	(19,543)	20,582	19,692	(16,241)	(15,424)	17,089	16,229
Period 3	t_9	0	0	0	0	(17,060)	(15,974)	17,089	16,002
	t_{10}	(20,426)	(19,148)	20,358	19,084	(17,182)	(15,862)	17,089	15,776
	t_{11}	0	0	0	0	(17,359)	(15,797)	17,089	15,551
	t_{12}	(20,426)	(18,769)	20,582	18,912	(17,778)	(15,942)	17,089	15,324
Period 4	t_{13}	0	0	0	0	(18,188)	(16,066)	17,089	15,095
	t_{14}	(20,426)	(18,391)	20,246	18,229	(18,502)	(16,095)	17,089	14,866
	t_{15}	0	0	0	0	(18,646)	(15,972)	17,089	14,638
	t_{16}	(1,020,426)	(899,695)	1,020,582	899,832	(1,218,767)	(1,027,908)	1,217,089	1,026,493
	Totals		(995,522)		995,550		(1,200,000)		1,199,971
	Totals in LC		(1,045,298)		1,045,327		(1,200,000)		1,199,971
PV of all CF(s) [LC]			0				Σ		

The nominal amount that is used for the calibration of the reference rate is the same as the nominal amount of aggregated exposure that creates the variable cash flows in LC (LC1,200,000), which coincides with the nominal amount of the cross-currency interest rate swap for the variable rate leg in LC. This results in a reference rate of 5.6963 per cent (determined by iteration so that the present value of all cash flows in total is nil).

(b) At subsequent dates, the cash flow variability of the aggregated exposure is determined by comparison to the reference point established at the end of Period 1. For that purpose, all remaining cash flows expected on the fixed rate FX liability and the cross-currency interest rate swap over the remainder of the hedged term (ie from the effectiveness measurement date until the end of Period 4) are updated (as applicable) and then discounted. Also, the reference rate of 5.6963 per cent is

applied to the nominal amount that was used for the calibration of that rate at the end of Period 1 (LC1,200,000) in order to generate a set of cash flows over the remainder of the hedged term that is then also discounted. The total of all those present values represents the cash flow variability of the aggregated exposure. This calculation is illustrated in the following table for the end of Period 2:

Example 17—Cash flow variability of the aggregated exposure (at the end of Period 2)

		Variability in cash flows of the aggregated exposure							
		FX liability		CCIRS FC leg		CCIRS LC leg		Calibration	PV
		CF(s)	PV	CF(s)	PV	CF(s)	PV	1,200,000 Nominal 5.6963% Rate 4 Frequency	
		[FC]	[FC]	[FC]	[FC]	[LC]	[LC]	[LC]	[LC]
	Time								
Period 1	t_0								
	t_1								
	t_2								
	t_3								
	t_4								
Period 2	t_5	0	0	0	0	0	0	0	0
	t_6	0	0	0	0	0	0	0	0
	t_7	0	0	0	0	0	0	0	0
	t_8	0	0	0	0	0	0	0	0
Period 3	t_9	0	0	0	0	(18,120)	(17,850)	17,089	16,835
	t_{10}	(20,426)	(20,173)	20,358	20,106	(18,360)	(17,814)	17,089	16,581
	t_{11}	0	0	0	0	(18,683)	(17,850)	17,089	16,327
	t_{12}	(20,426)	(19,965)	20,582	20,117	(19,203)	(18,058)	17,089	16,070
Period 4	t_{13}	0	0	0	0	(19,718)	(18,243)	17,089	15,810
	t_{14}	(20,426)	(19,726)	20,246	19,553	(20,279)	(18,449)	17,089	15,547
	t_{15}	0	0	0	0	(21,014)	(18,789)	17,089	15,280
	t_{16}	(1,020,426)	(971,144)	1,020,582	971,292	(1,221,991)	(1,072,947)	1,217,089	1,068,643
	Totals		(1,031,008)		1,031,067		(1,200,000)		1,181,092
	Totals in LC		(1,464,031)		1,464,116		(1,200,000)		1,181,092
	PV of all CF(s) [LC]		(18,824) ◄				Σ		

The changes in interest rates and the exchange rate result in a change of the cash flow variability of the aggregated exposure between the end of Period 1 and the end of Period 2 that has a present value of LC-18,824.[90]

[90] This is the amount that is included in the table with the overview of the calculations (see paragraph IE132) as the present value of the cash flow variability of the aggregated exposure at the end of Period 2.

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IE135 Using the present value of the hedged item and the fair value of the hedging instrument, the cash flow hedge reserve and the hedge ineffectiveness are then determined (see paragraph 6.5.11 of IFRS 9).

IE136 The following table shows the effect on Entity B's statement of profit or loss and other comprehensive income and its statement of financial position (for the sake of transparency some line items[91] are disaggregated on the face of the statements by the two hedging relationships, ie for the fair value hedge of the fixed rate FX liability and the cash flow hedge of the aggregated exposure):[92]

Example 17—Overview of effect on statements of financial performance and financial position
[All amounts in LC]

	t_0	Period 1	Period 2	Period 3	Period 4
Statement of profit or loss and other comprehensive income					
Interest expense					
FX liability		45,958	50,452	59,848	58,827
FVH adjustment		(12,731)	11,941	14,385	(49,439)
		33,227	62,393	74,233	9,388
Reclassifications (CFH)			5,990	(5,863)	58,982
Total interest expense		33,227	68,383	68,370	68,370
Other gains/losses					
Change in fair value of the CCIRS		154,673	(418,788)	(91,437)	185,553
FVH adjustment (FX liability)		(154,702)	418,733	91,560	(185,591)
Hedge ineffectiveness		0	(72)	(54)	(19)
Total other gains/losses		(29)	(127)	68	(57)
Profit or loss		33,198	68,255	68,438	68,313
Other comprehensive income (OCI)					
Effective CFH gain/loss			(12,834)	71,713	229
Reclassifications			(5,990)	5,863	(58,982)
Total other comprehensive income			(18,842)	77,577	(58,753)
Comprehensive income		33,198	49,432	146,015	9,560

continued…

[91] The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IFRS 7 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

[92] For Period 4 the values in the table with the overview of the calculations (see paragraph IE132) differ from those in the following table. For Periods 1 to 3 the 'dirty' values (ie including interest accruals) equal the 'clean' values (ie excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the fixed rate FX liability. At the end of Period 4 the table with the overview of the calculations uses clean values in order to calculate the value changes consistently over time. For the following table the dirty values are presented, ie the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts other than cash and retained earnings would be nil).

…continued

Example 17—Overview of effect on statements of financial performance and financial position
[All amounts in LC]

	t_0	Period 1	Period 2	Period 3	Period 4
Statement of financial position					
FX liability	(1,200,000)	(1,045,298)	(1,464,031)	(1,555,591)	(1,397,984)
CCIRS	0	(154,673)	264,116	355,553	194,141
IRS		0	18,896	(58,767)	(13,004)
Cash	1,200,000	1,166,773	1,098,390	1,030,160	978,641
Total net assets	0	(33,198)	(82,630)	(228,645)	(238,205)
Equity					
Accumulated OCI		0	(18,824)	58,753	0
Retained earnings	0	33,198	101,454	169,892	238,205
Total equity	0	33,198	82,630	228,645	238,205

IE137 The total interest expense in profit or loss reflects Entity B's interest expense that results from its risk management strategy:

(a) In Period 1 the risk management strategy results in interest expense reflecting variable interest rates in LC after taking into account the effect of the cross-currency interest rate swap, including a difference between the cash flows on the fixed rate FX liability and the fixed leg of the cross-currency interest rate swap that were settled during Period 1 (this means the interest expense does not exactly equal the variable interest expense that would arise in LC on a borrowing of LC1,200,000). There is also some hedge ineffectiveness that results from a difference in the changes in value for the fixed rate FX liability (as represented by the fair value hedge adjustment) and the cross-currency interest rate swap.

(b) For Periods 2 to 4 the risk management strategy results in interest expense that reflects, after taking into account the effect of the interest rate swap entered into at the end of Period 1, fixed interest rates in LC (ie locking in a single blended fixed coupon rate for a three-period term based on the interest rate environment at the end of Period 1). However, Entity B's interest expense is affected by the hedge ineffectiveness that arises on its hedging relationships. In Period 2 the interest expense is slightly higher than the fixed rate payments locked in with the interest rate swap because the variable payments received under the interest rate swap are less than the total of the cash flows resulting from the aggregated exposure.[93] In Periods 3 and 4 the interest expense is equal to the locked in rate because the variable payments received under the swap are more than the total of the cash flows resulting from the aggregated exposure.[94]

[93] In other words, the cash flow variability of the interest rate swap was lower than, and therefore did not fully offset, the cash flow variability of the aggregated exposure as a whole (sometimes called an 'underhedge' situation). In those situations the cash flow hedge does not contribute to the hedge ineffectiveness that is recognised in profit or loss because the hedge ineffectiveness is not recognised (see paragraph 6.5.11 of IFRS 9). The hedge ineffectiveness arising on the fair value hedge affects profit or loss in all periods.

[94] In other words, the cash flow variability of the interest rate swap was higher than, and therefore more than fully offset, the cash flow variability of the aggregated exposure as a whole (sometimes called an 'overhedge' situation). In those situations the cash flow hedge contributes to the hedge ineffectiveness that is recognised in profit or loss (see paragraph 6.5.11 of IFRS 9). The hedge ineffectiveness arising on the fair value hedge affects profit or loss in all periods.

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Example 18—combined interest rate risk and foreign currency risk hedge (cash flow hedge/fair value hedge combination)

Fact pattern

IE138 Entity C wants to hedge a variable rate liability that is denominated in Foreign Currency (FC). The liability has a term of four periods from the start of Period 1 to the end of Period 4. Entity C's functional currency is its Local Currency (LC). Entity C has the following risk exposures:

(a) cash flow interest rate risk and FX risk: the changes in cash flows of the variable rate liability attributable to interest rate changes, measured in LC.

(b) fair value interest rate risk: the exposure that arises as a result of swapping the combined cash flow interest rate risk and FX risk exposure associated with the variable rate liability (see (a) above) into a fixed rate exposure in LC in accordance with Entity C's risk management strategy for FC denominated variable rate liabilities (see paragraph IE139(a) below).

IE139 Entity C hedges its risk exposures using the following risk management strategy:

(a) Entity C uses cross-currency interest rate swaps to swap its FC denominated variable rate liabilities into a fixed rate exposure in LC. Entity C hedges its FC denominated liabilities (including the interest) for their entire life. Consequently, Entity C enters into a cross-currency interest rate swap at the same time as it issues an FC denominated liability. Under the cross-currency interest rate swap Entity C receives variable interest in FC (used to pay the interest on the liability) and pays fixed interest in LC.

(b) Entity C considers the cash flows on a hedged liability and on the related cross-currency interest rate swap as one aggregated fixed rate exposure in LC. From time to time, in accordance with its risk management strategy for fixed rate interest rate risk (in LC), Entity C decides to link its interest payments to current variable interest rate levels and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC. Consequently, Entity C uses interest rate swaps (denominated entirely in LC) under which it receives fixed interest (used to pay the interest on the pay leg of the cross-currency interest rate swap) and pays variable interest.

IE140 The following table sets out the parameters used for Example 18:

Example 18—Parameter overview

	t_0	Period 1	Period 2	Period 3	Period 4
FX spot rate [LC/FC]	1.2	1.05	1.42	1.51	1.37
Interest curves (vertical presentation of rates for each quarter of a period on a p.a. basis)					
LC	2.50%	1.00%	3.88%	0.34%	[N/A]
	2.75%	1.21%	4.12%	0.49%	
	2.91%	1.39%	4.22%	0.94%	
	3.02%	1.58%	5.11%	1.36%	
	2.98%	1.77%	5.39%		
	3.05%	1.93%	5.43%		
	3.11%	2.09%	5.50%		
	3.15%	2.16%	5.64%		
	3.11%	2.22%			
	3.14%	2.28%			
	3.27%	2.30%			
	3.21%	2.31%			
	3.21%				
	3.25%				
	3.29%				
	3.34%				
FC	3.74%	4.49%	2.82%	0.70%	[N/A]
	4.04%	4.61%	2.24%	0.79%	
	4.23%	4.63%	2.00%	1.14%	
	4.28%	4.34%	2.18%	1.56%	
	4.20%	4.21%	2.34%		
	4.17%	4.13%	2.53%		
	4.27%	4.07%	2.82%		
	4.14%	4.09%	3.13%		
	4.10%	4.17%			
	4.11%	4.13%			
	4.11%	4.24%			
	4.13%	4.34%			
	4.14%				
	4.06%				
	4.12%				
	4.19%				

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Accounting mechanics

IE141 Entity C designates the following hedging relationships:[95]

(a) As a cash flow hedge, a hedging relationship for cash flow interest rate risk and FX risk between the FC denominated variable rate liability (variable rate FX liability) as the hedged item and a cross-currency interest rate swap as the hedging instrument (the 'first level relationship'). This hedging relationship is designated at the beginning of Period 1 (ie t_0) with a term to the end of Period 4.

(b) As a fair value hedge, a hedging relationship between the aggregated exposure as the hedged item and an interest rate swap as the hedging instrument (the 'second level relationship'). This hedging relationship is designated at the end of Period 1, when Entity C decides to link its interest payments to current variable interest rate levels and hence swaps its aggregated fixed rate exposure in LC into a variable rate exposure in LC, with a term to the end of Period 4. The aggregated exposure that is designated as the hedged item represents, in LC, the change in value that is the effect of changes in the value of the combined cash flows of the two items designated in the cash flow hedge of the cash flow interest rate risk and FX risk (see (a) above), compared to the interest rates at the end of Period 1 (ie the time of designation of the hedging relationship between the aggregated exposure and the interest rate swap).

IE142 The following table[96] sets out the overview of the fair values of the derivatives, the changes in the value of the hedged items and the calculation of the cash flow hedge reserve.[97] In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made.[98]

Example 18—Calculations

	t_0	Period 1	Period 2	Period 3	Period 4
Variable rate FX liability					
Fair value [FC]	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)
Fair value [LC]	(1,200,000)	(1,050,000)	(1,420,000)	(1,510,000)	(1,370,000)
Change in fair value [LC]		150,000	(370,000)	(90,000)	140,000
PV of change in variable CF(s) [LC]	0	192,310	(260,346)	(282,979)	(170,000)
Change in PV [LC]		192,310	(452,656)	(22,633)	112,979
CCIRS (receive variable FC/pay fixed LC)					
Fair value [LC]	0	(192,310)	260,346	282,979	170,000
Change in fair value [LC]		(192,310)	452,656	22,633	(112,979)

continued…

[95] This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 6.4.1 of IFRS 9). The following description of the designation is solely for the purpose of understanding this example (ie it is not an example of the complete formal documentation required in accordance with paragraph 6.4.1(b) of IFRS 9).

[96] Tables in this example use the following acronyms: 'CCIRS' for cross-currency interest rate swap, 'CF(s)' for cash flow(s), 'CFH' for cash flow hedge, 'CFHR' for cash flow hedge reserve, 'FVH' for fair value hedge, 'IRS' for interest rate swap and 'PV' for present value.

[97] In the following table for the calculations all amounts (including the calculations for accounting purposes of amounts for assets, liabilities and equity) are in the format of positive (plus) and negative (minus) numbers (eg an amount in the cash flow hedge reserve that is a negative number is a loss).

[98] Those assumptions have been made for didactical reasons, in order to better focus on illustrating the accounting mechanics in a cash flow hedge/fair value hedge combination. The measurement and recognition of hedge ineffectiveness has already been demonstrated in Example 16 and Example 17. However, in reality such hedges are typically not perfectly effective because hedge ineffectiveness can result from various factors, for example credit risk, differences in the day count method or, depending on whether it is included in the designation of the hedging instrument, the charge for exchanging different currencies that is included in cross-currency interest rate swaps (commonly referred to as the 'currency basis').

…continued

Example 18—Calculations

	t_0	Period 1	Period 2	Period 3	Period 4
CFHR					
Opening balance	0	0	(42,310)	(28,207)	(14,103)
Reclassification FX risk		153,008	(378,220)	(91,030)	140,731
Reclassification (current period CF)		(8,656)	(18,410)	2,939	21,431
Effective CFH gain/loss		(186,662)	(479,286)	20,724	(135,141)
Reclassification for interest rate risk		0	(82,656)	67,367	(27,021)
Amortisation of CFHR		0	14,103	14,103	14,103
Ending balance		(42,103)	(28,207)	(14,103)	0
IRS (receive fixed/pay variable)					
Fair value [LC]		0	(82,656)	(15,289)	(42,310)
Change in fair value			(82,656)	67,367	(27,021)
Change in present value of the aggregated exposure					
Present value [LC]		(1,242,310)	(1,159,654)	(1,227,021)	(1,200,000)
Change in present value [LC]			82,656	(67,367)	27,021

IE143 The hedging relationship between the variable rate FX liability and the cross-currency interest rate swap starts at the beginning of Period 1 (ie t_0) and remains in place when the hedging relationship for the second level relationship starts at the end of Period 1, ie the first level relationship continues as a separate hedging relationship. However, the hedge accounting for the first level relationship is affected by the start of hedge accounting for the second level relationship at the end of Period 1. The fair value hedge for the second level relationship affects the timing of the reclassification to profit or loss of amounts from the cash flow hedge reserve for the first level relationship:

(a) The fair value interest rate risk that is hedged by the fair value hedge is included in the amount that is recognised in other comprehensive income as a result of the cash flow hedge for the first level hedging relationship (ie the gain or loss on the cross-currency interest rate swap that is determined to be an effective hedge).[99] This means that from the end of Period 1 the part of the effective cash flow hedging gain or loss that represents the fair value interest rate risk (in LC), and is recognised in other comprehensive income in a first step, is in a second step immediately (ie in the same period) transferred from the cash flow hedge reserve to profit or loss. That reclassification adjustment offsets the gain or loss on the interest rate swap that is recognised in profit or loss.[100] In the context of accounting for the aggregated exposure as the hedged item, that reclassification adjustment is the equivalent of a fair value hedge adjustment because in contrast to a hedged item that is a fixed rate debt instrument (in LC) at amortised cost, the aggregated exposure is already remeasured for changes regarding the hedged risk but the resulting gain or loss is recognised in other comprehensive income because of applying cash flow hedge accounting for the first level relationship. Consequently, applying fair value hedge accounting with the aggregated exposure as the hedged item does not result in changing the hedged item's measurement but instead affects where the hedging gains and losses are recognised (ie reclassification from the cash flow hedge reserve to profit or loss).

[99] As a consequence of hedging its exposure to cash flow interest rate risk by entering into the cross-currency interest rate swap that changed the cash flow interest rate risk of the variable rate FX liability into a fixed rate exposure (in LC), Entity C in effect assumed an exposure to fair value interest rate risk (see paragraph IE139).

[100] In the table with the overview of the calculations (see paragraph IE142) this reclassification adjustment is the line item "Reclassification for interest rate risk" in the reconciliation of the cash flow hedge reserve (eg at the end of Period 2 a reclassification of a gain of LC82,656 from the cash flow hedge reserve to profit or loss—see paragraph IE144 for how that amount is calculated).

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(b) The amount in the cash flow hedge reserve at the end of Period 1 (LC42,310) is amortised over the remaining life of the cash flow hedge for the first level relationship (ie over Periods 2 to 4).[101]

IE144 The change in value of the aggregated exposure is calculated as follows:

(a) At the point in time from which the change in value of the aggregated exposure is hedged (ie the start of the second level relationship at the end of Period 1), all cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the hedged term (ie until the end of Period 4) are mapped out and their combined present value, in LC, is calculated. This calculation establishes the present value that is used at subsequent dates as the reference point to measure the change in present value of the aggregated exposure since the start of the hedging relationship. This calculation is illustrated in the following table:

Example 18—Present value of the aggregated exposure (starting point)

		Present value of the aggregated exposure					
		FX liability		CCIRS FC leg		CCIRS LC leg	
		CF(s) [FC]	PV [FC]	CF(s) [FC]	PV [FC]	CF(s) [LC]	PV [LC]
	Time						
Period 1	t_0						
	t_1						
	t_2						
	t_3						
	t_4						
Period 2	t_5	(11,039)	(10,918)	11,039	10,918	(9,117)	(9,094)
	t_6	(11,331)	(11,082)	11,331	11,082	(9,117)	(9,067)
	t_7	(11,375)	(11,000)	11,375	11,000	(9,117)	(9,035)
	t_8	(10,689)	(10,227)	10,689	10,227	(9,117)	(9,000)
Period 3	t_9	(10,375)	(9,824)	10,375	9,824	(9,117)	(8,961)
	t_{10}	(10,164)	(9,528)	10,164	9,528	(9,117)	(8,918)
	t_{11}	(10,028)	(9,307)	10,028	9,307	(9,117)	(8,872)
	t_{12}	(10,072)	(9,255)	10,072	9,255	(9,117)	(8,825)

continued…

[101] In the table with the overview of the calculations (see paragraph IE142) this amortisation results in a periodic reclassification adjustment of LC14,103 that is included in the line item "Amortisation of CFHR" in the reconciliation of the cash flow hedge reserve.

…continued

Example 18—Present value of the aggregated exposure (starting point)

		Present value of the aggregated exposure					
		FX liability		CCIRS FC leg		CCIRS LC leg	
		CF(s) [FC]	PV [FC]	CF(s) [FC]	PV [FC]	CF(s) [LC]	PV [LC]
Period 4	t_{13}	(10,256)	(9,328)	10,256	9,328	(9,117)	(8,776)
	t_{14}	(10,159)	(9,147)	10,159	9,147	(9,117)	(8,727)
	t_{15}	(10,426)	(9,290)	10,426	9,290	(9,117)	(8,678)
	t_{16}	(1,010,670)	(891,093)	1,010,670	891,093	(1,209,117)	(1,144,358)
	Totals		(1,000,000)		1,000,000		(1,242,310)
	Totals in LC		(1,050,000)		1,050,000		(1,242,310)
PV of aggregated exposure [LC]			(1,242,310) ◄ Σ				

The present value of all cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the hedged term at the end of Period 1 is LC-1,242,310.[102]

(b) At subsequent dates, the present value of the aggregated exposure is determined in the same way as at the end of Period 1 but for the remainder of the hedged term. For that purpose, all remaining cash flows expected on the variable rate FX liability and the cross-currency interest rate swap over the remainder of the hedged term (ie from the effectiveness measurement date until the end of Period 4) are updated (as applicable) and then discounted. The total of those present values represents the present value of the aggregated exposure. This calculation is illustrated in the following table for the end of Period 2:

[102] In this example no hedge ineffectiveness arises on either hedging relationship because of the assumptions made (see paragraph IE142). Consequently, the absolute values of the variable rate FX liability and the FC denominated leg of the cross-currency interest rate are equal (but with opposite signs). In situations in which hedge ineffectiveness arises, those absolute values would not be equal so that the remaining net amount would affect the present value of the aggregated exposure.

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Example 18—Present value of the aggregated exposure (at the end of Period 2)

		Present value of the aggregated exposure					
		FX liability		CCIRS FC leg		CCIRS LC leg	
		CF(s) [FC]	PV [FC]	CF(s) [FC]	PV [FC]	CF(s) [LC]	PV [LC]
	Time						
Period 1	t_0						
	t_1						
	t_2						
	t_3						
	t_4						
Period 2	t_5	0	0	0	0	0	0
	t_6	0	0	0	0	0	0
	t_7	0	0	0	0	0	0
	t_8	0	0	0	0	0	0
Period 3	t_9	(6,969)	(6,921)	6,969	6,921	(9,117)	(9,030)
	t_{10}	(5,544)	(5,475)	5,544	5,475	(9,117)	(8,939)
	t_{11}	(4,971)	(4,885)	4,971	4,885	(9,117)	(8,847)
	t_{12}	(5,401)	(5,280)	5,401	5,280	(9,117)	(8,738)
Period 4	t_{13}	(5,796)	(5,632)	5,796	5,632	(9,117)	(8,624)
	t_{14}	(6,277)	(6,062)	6,277	6,062	(9,117)	(8,511)
	t_{15}	(6,975)	(6,689)	6,975	6,689	(9,117)	(8,397)
	t_{16}	(1,007,725)	(959,056)	1,007,725	956,056	(1,209,117)	(1,098,568)
	Totals		(1,000,000)		1,000,000		(1,159,654)
	Totals in LC		(1,420,000)		1,420,000		(1,159,654)
PV of aggregated exposure [LC]			(1,159,654) ◄		Σ		(1,159,654)

The changes in interest rates and the exchange rate result in a present value of the aggregated exposure at the end of Period 2 of LC-1,159,654. Consequently, the change in the present value of the aggregated exposure between the end of Period 1 and the end of Period 2 is a gain of LC82,656.[103]

IE145 Using the change in present value of the hedged item (ie the aggregated exposure) and the fair value of the hedging instrument (ie the interest rate swap), the related reclassifications from the cash flow hedge reserve to profit or loss (reclassification adjustments) are then determined.

[103] This is the amount that is included in the table with the overview of the calculations (see paragraph IE142) as the change in present value of the aggregated exposure at the end of Period 2.

IE146 The following table shows the effect on Entity C's statement of profit or loss and other comprehensive income and its statement of financial position (for the sake of transparency some line items[104] are disaggregated on the face of the statements by the two hedging relationships, ie for the cash flow hedge of the variable rate FX liability and the fair value hedge of the aggregated exposure):[105]

Example 18—Overview of effect on statements of financial performance and financial position
[All amounts in LC]

	t_0	Period 1	Period 2	Period 3	Period 4
Statement of profit or loss and other comprehensive income					
Interest expense					
FX liability		45,122	54,876	33,527	15,035
FVH adjustment		0	(20,478)	16,517	(26,781)
		45,122	34,398	50,045	(11,746)
Reclassifications (CFH)		(8,656)	(18,410)	2,939	21,431
		36,466	15,989	52,983	9,685
Amortisation of CFHR		0	14,103	14,103	14,103
Total interest expense		36,466	30,092	67,087	23,788
Other gains/losses					
IRS		0	82,656	(67,367)	27,021
FX gain/loss (liability)		(150,000)	370,000	90,000	(140,000)
FX gain/loss (interest)		(3,008)	8,220	1,030	(731)
Reclassification for FX risk		153,008	(378,220)	(91,030)	140,731
Reclassification for interest rate risk		0	(82,656)	67,367	(27,021)
Total other gains/losses		0	0	0	0
Profit or loss		36,466	30,092	67,087	23,788
Other comprehensive income (OCI)					
Effective gain/loss		186,662	(479,286)	(20,724)	135,141
Reclassification (current period CF)		8,656	18,410	(2,939)	(21,431)
Reclassification for FX risk		(153,008)	378,220	91,030	(140,731)
Reclassification for interest rate risk		0	82,656	(67,367)	27,021
Amortisation of CFHR		0	(14,103)	(14,103)	(14,103)
Total other comprehensive income		42,310	(14,103)	(14,103)	(14,103)
Comprehensive income		78,776	15,989	52,983	9,685

continued…

[104] The line items used in this example are a possible presentation. Different presentation formats using different line items (including line items that include the amounts shown here) are also possible (IFRS 7 sets out disclosure requirements for hedge accounting that include disclosures about hedge ineffectiveness, the carrying amount of hedging instruments and the cash flow hedge reserve).

[105] For Period 4 the values in the table with the overview of the calculations (see paragraph IE142) differ from those in the following table. For Periods 1 to 3 the 'dirty' values (ie including interest accruals) equal the 'clean' values (ie excluding interest accruals) because the period end is a settlement date for all legs of the derivatives and the fixed rate FX liability. At the end of Period 4 the table with the overview of the calculations uses clean values in order to calculate the value changes consistently over time. For the following table the dirty values are presented, ie the maturity amounts including accrued interest immediately before the instruments are settled (this is for illustrative purposes as otherwise all carrying amounts other than cash and retained earnings would be nil).

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…continued

Example 18—Overview of effect on statements of financial performance and financial position
[All amounts in LC]

	t_0	Period 1	Period 2	Period 3	Period 4
Statement of financial position					
FX liability	(1,200,000)	(1,050,000)	(1,420,000)	(1,510,000)	(1,375,306)
CCIRS	0	(192,310)	260,346	282,979	166,190
IRS		0	(82,656)	(15,289)	(37,392)
Cash	1,200,000	1,163,534	1,147,545	1,094,562	1,089,076
Total net assets	0	(78,776)	(94,765)	(147,748)	(157,433)
Accumulated OCI	0	42,310	28,207	14,103	0
Retained earnings	0	36,466	66,558	133,645	157,433
Total equity	0	78,776	94,765	147,748	157,433

IE147 The total interest expense in profit or loss reflects Entity C's interest expense that results from its risk management strategy:

(a) In Period 1 the risk management strategy results in interest expense reflecting fixed interest rates in LC after taking into account the effect of the cross-currency interest rate swap.

(b) For Periods 2 to 4, after taking into account the effect of the interest rate swap entered into at the end of Period 1, the risk management strategy results in interest expense that changes with variable interest rates in LC (ie the variable interest rate prevailing in each period). However, the amount of the total interest expense is not equal to the amount of the variable rate interest because of the amortisation of the amount that was in the cash flow hedge reserve for the first level relationship at the end of Period 1.[106]

[106] See paragraph IE143(b). That amortisation becomes an expense that has an effect like a spread on the variable interest rate.

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APPENDIX
Amendments to guidance on other Standards

Guidance on implementing IFRS 9 *Financial Instruments*

This guidance accompanies, but is not part of, IFRS 9. The numbers used for the questions are carried forward from the implementation guidance accompanying IAS 39 Financial Instruments: Recognition and Measurement.

Section A Scope

A.1 Practice of settling net: forward contract to purchase a commodity

Entity XYZ enters into a fixed price forward contract to purchase 1 million kilograms of copper in accordance with its expected usage requirements. The contract permits XYZ to take physical delivery of the copper at the end of twelve months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract accounted for as a derivative?

While such a contract meets the definition of a derivative, it is not necessarily accounted for as a derivative. The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper, and it is to be settled at a future date. However, if XYZ intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under IFRS 9. Instead, it is accounted for as an executory contract (unless the entity irrevocably designates it as measured at fair value through profit or loss in accordance with paragraph 2.5 of IFRS 9).

A.2 Option to put a non-financial asset

Entity XYZ owns an office building. XYZ enters into a put option with an investor that permits XYZ to put the building to the investor for CU150 million. The current value of the building is CU175 million.[107] The option expires in five years. The option, if exercised, may be settled through physical delivery or net cash, at XYZ's option. How do both XYZ and the investor account for the option?

XYZ's accounting depends on XYZ's intention and past practice for settlement. Although the contract meets the definition of a derivative, XYZ does not account for it as a derivative if XYZ intends to settle the contract by delivering the building if XYZ exercises its option and there is no past practice of settling net (paragraph 2.4 of IFRS 9; but see also paragraph 2.5 of IFRS 9).

The investor, however, cannot conclude that the option was entered into to meet the investor's expected purchase, sale or usage requirements because the investor does not have the ability to require delivery (IFRS 9, paragraph 2.7). In addition, the option may be settled net in cash. Therefore, the investor has to account for the contract as a derivative. Regardless of past practices, the investor's intention does not affect whether settlement is by delivery or in cash. The investor has written an option, and a written option in which the holder has a choice of physical settlement or net cash settlement can never satisfy the normal delivery requirement for the exemption from IFRS 9 because the option writer does not have the ability to require delivery.

However, if the contract were a forward contract instead of an option, and if the contract required physical delivery and the reporting entity had no past practice of settling net in cash or of taking delivery of the building and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin, the contract would not be accounted for as a derivative. (But see also paragraph 2.5 of IFRS 9).

[107] In this guidance, monetary amounts are denominated in 'currency units' (CU).

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Section B Definitions

B.1 Definition of a financial instrument: gold bullion

Is gold bullion a financial instrument (like cash) or is it a commodity?

It is a commodity. Although bullion is highly liquid, there is no contractual right to receive cash or another financial asset inherent in bullion.

B.2 Definition of a derivative: examples of derivatives and underlyings

What are examples of common derivative contracts and the identified underlying?

IFRS 9 defines a derivative as follows:

A derivative is a financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

(a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').

(b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

(c) It is settled at a future date.

Type of contract	Main pricing-settlement variable (underlying variable)
Interest rate swap	Interest rates
Currency swap (foreign exchange swap)	Currency rates
Commodity swap	Commodity prices
Equity swap	Equity prices (equity of another entity)
Credit swap	Credit rating, credit index or credit price
Total return swap	Total fair value of the reference asset and interest rates
Purchased or written treasury bond option (call or put)	Interest rates
Purchased or written currency option (call or put)	Currency rates
Purchased or written commodity option (call or put)	Commodity prices
Purchased or written stock option (call or put)	Equity prices (equity of another entity)
Interest rate futures linked to government debt (treasury futures)	Interest rates
Currency futures	Currency rates
Commodity futures	Commodity prices
Interest rate forward linked to government debt (treasury forward)	Interest rates
Currency forward	Currency rates
Commodity forward	Commodity prices
Equity forward	Equity prices (equity of another entity)

The above list provides examples of contracts that normally qualify as derivatives under IFRS 9. The list is not exhaustive. Any contract that has an underlying may be a derivative. Moreover, even if an instrument meets the definition of a derivative contract, special provisions may apply, for example, if it is a weather derivative (see paragraph B2.1 of IFRS 9), a contract to buy or sell a non-financial item such as commodity (see paragraphs 2.5–2.7 and BA.2 of IFRS 9) or a contract settled in an entity's own shares (see paragraphs 21–24 of IAS 32). Therefore, an entity must evaluate the contract to determine whether the other characteristics of a derivative are present and whether special provisions apply.

B.3 Definition of a derivative: settlement at a future date, interest rate swap with net or gross settlement

For the purpose of determining whether an interest rate swap is a derivative financial instrument under IFRS 9, does it make a difference whether the parties pay the interest payments to each other (gross settlement) or settle on a net basis?

No. The definition of a derivative does not depend on gross or net settlement.

To illustrate: Entity ABC enters into an interest rate swap with a counterparty (XYZ) that requires ABC to pay a fixed rate of 8 per cent and receive a variable amount based on three-month LIBOR, reset on a quarterly basis. The fixed and variable amounts are determined on the basis of a CU100 million notional amount. ABC and XYZ do not exchange the notional amount. ABC pays or receives a net cash amount each quarter based on the difference between 8 per cent and three-month LIBOR. Alternatively, settlement may be on a gross basis.

The contract meets the definition of a derivative regardless of whether there is net or gross settlement because its value changes in response to changes in an underlying variable (LIBOR), there is no initial net investment, and settlements occur at future dates.

B.4 Definition of a derivative: prepaid interest rate swap (fixed rate payment obligation prepaid at inception or subsequently)

If a party prepays its obligation under a pay-fixed, receive-variable interest rate swap at inception, is the swap a derivative financial instrument?

Yes. To illustrate: Entity S enters into a CU100 million notional amount five-year pay-fixed, receive-variable interest rate swap with Counterparty C. The interest rate of the variable part of the swap is reset on a quarterly basis to three-month LIBOR. The interest rate of the fixed part of the swap is 10 per cent per year. Entity S prepays its fixed obligation under the swap of CU50 million (CU100 million × 10% × 5 years) at inception, discounted using market interest rates, while retaining the right to receive interest payments on the CU100 million reset quarterly based on three-month LIBOR over the life of the swap.

The initial net investment in the interest rate swap is significantly less than the notional amount on which the variable payments under the variable leg will be calculated. The contract requires an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, such as a variable rate bond. Therefore, the contract fulfils the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' provision of IFRS 9. Even though Entity S has no future performance obligation, the ultimate settlement of the contract is at a future date and the value of the contract changes in response to changes in the LIBOR index. Accordingly, the contract is regarded as a derivative contract.

Would the answer change if the fixed rate payment obligation is prepaid subsequent to initial recognition?

If the fixed leg is prepaid during the term, that would be regarded as a termination of the old swap and an origination of a new instrument that is evaluated under IFRS 9.

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B.5 Definition of a derivative: prepaid pay-variable, receive-fixed interest rate swap

If a party prepays its obligation under a pay-variable, receive-fixed interest rate swap at inception of the contract or subsequently, is the swap a derivative financial instrument?

No. A prepaid pay-variable, receive-fixed interest rate swap is not a derivative if it is prepaid at inception and it is no longer a derivative if it is prepaid after inception because it provides a return on the prepaid (invested) amount comparable to the return on a debt instrument with fixed cash flows. The prepaid amount fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' criterion of a derivative.

To illustrate: Entity S enters into a CU100 million notional amount five-year pay-variable, receive-fixed interest rate swap with Counterparty C. The variable leg of the swap is reset on a quarterly basis to three-month LIBOR. The fixed interest payments under the swap are calculated as 10 per cent times the swap's notional amount, ie CU10 million per year. Entity S prepays its obligation under the variable leg of the swap at inception at current market rates, while retaining the right to receive fixed interest payments of 10 per cent on CU100 million per year.

The cash inflows under the contract are equivalent to those of a financial instrument with a fixed annuity stream since Entity S knows it will receive CU10 million per year over the life of the swap. Therefore, all else being equal, the initial investment in the contract should equal that of other financial instruments that consist of fixed annuities. Thus, the initial net investment in the pay-variable, receive-fixed interest rate swap is equal to the investment required in a non-derivative contract that has a similar response to changes in market conditions. For this reason, the instrument fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' criterion of IFRS 9. Therefore, the contract is not accounted for as a derivative under IFRS 9. By discharging the obligation to pay variable interest rate payments, Entity S in effect provides a loan to Counterparty C.

B.6 Definition of a derivative: offsetting loans

Entity A makes a five-year fixed rate loan to Entity B, while B at the same time makes a five-year variable rate loan for the same amount to A. There are no transfers of contractual par amount at inception of the two loans, since A and B have a netting agreement. Is this a derivative under IFRS 9?

Yes. This meets the definition of a derivative (that is to say, there is an underlying variable, no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and future settlement). The contractual effect of the loans is the equivalent of an interest rate swap arrangement with no initial net investment. Non-derivative transactions are aggregated and treated as a derivative when the transactions result, in substance, in a derivative. Indicators of this would include:

- they are entered into at the same time and in contemplation of one another
- they have the same counterparty
- they relate to the same risk
- there is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

The same answer would apply if Entity A and Entity B did not have a netting agreement, because the definition of a derivative instrument in IFRS 9 does not require net settlement.

B.7 Definition of a derivative: option not expected to be exercised

The definition of a derivative in IFRS 9 requires that the instrument 'is settled at a future date'. Is this criterion met even if an option is expected not to be exercised, for example, because it is out of the money?

Yes. An option is settled upon exercise or at its maturity. Expiry at maturity is a form of settlement even though there is no additional exchange of consideration.

B.8 Definition of a derivative: foreign currency contract based on sales volume

Entity XYZ, whose functional currency is the US dollar, sells products in France denominated in euro. XYZ enters into a contract with an investment bank to convert euro to US dollars at a fixed exchange rate. The contract requires XYZ to remit euro based on its sales volume in France in exchange for US dollars at a fixed exchange rate of 6.00. Is that contract a derivative?

Yes. The contract has two underlying variables (the foreign exchange rate and the volume of sales), no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and a payment provision. IFRS 9 does not exclude from its scope derivatives that are based on sales volume.

B.9 Definition of a derivative: prepaid forward

An entity enters into a forward contract to purchase shares of stock in one year at the forward price. It prepays at inception based on the current price of the shares. Is the forward contract a derivative?

No. The forward contract fails the 'no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors' test for a derivative.

To illustrate: Entity XYZ enters into a forward contract to purchase 1 million T ordinary shares in one year. The current market price of T is CU50 per share; the one-year forward price of T is CU55 per share. XYZ is required to prepay the forward contract at inception with a CU50 million payment. The initial investment in the forward contract of CU50 million is less than the notional amount applied to the underlying, 1 million shares at the forward price of CU55 per share, ie CU55 million. However, the initial net investment approximates the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors because T's shares could be purchased at inception for the same price of CU50. Accordingly, the prepaid forward contract does not meet the initial net investment criterion of a derivative instrument.

B.10 Definition of a derivative: initial net investment

Many derivative instruments, such as futures contracts and exchange traded written options, require margin accounts. Is the margin account part of the initial net investment?

No. The margin account is not part of the initial net investment in a derivative instrument. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified a ssets, typically liquid assets. Margin accounts are separate assets that are accounted for separately.

B.11 Definition of held for trading: portfolio with a recent actual pattern of short-term profit-taking

The definition of a financial asset or financial liability held for trading states that 'a financial asset or financial liability is classified as held for trading if it is … part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking'. What is a 'portfolio' for the purposes of applying this definition?

Although the term 'portfolio' is not explicitly defined in IFRS 9, the context in which it is used suggests that a portfolio is a group of financial assets or financial liabilities that are managed as part of that group (Appendix A of IFRS 9). If there is evidence of a recent actual pattern of short-term profit-taking on financial instruments included in such a portfolio, those financial instruments qualify as held for trading even though an individual financial instrument may in fact be held for a longer period of time.

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B.24 Definition of gross carrying amount: perpetual debt instruments with fixed or market-based variable rate

Sometimes entities purchase or issue debt instruments that are required to be measured at amortised cost and in respect of which the issuer has no obligation to repay the gross carrying amount. The interest rate may be fixed or variable. Would the difference between the initial amount paid or received and zero ('the maturity amount') be amortised immediately on initial recognition for the purpose of determining amortised cost if the rate of interest is fixed or specified as a market-based variable rate?

No. Since there are no repayment of the gross carrying amount, there is no amortisation of the difference between the initial amount and the maturity amount if the rate of interest is fixed or specified as a market-based variable rate. Because interest payments are fixed or market-based and will be paid in perpetuity, the amortised cost (the present value of the stream of future cash payments discounted at the effective interest rate) equals the gross carrying amount in each period.

B.25 Definition of gross carrying amount: perpetual debt instruments with decreasing interest rate

If the stated rate of interest on a perpetual debt instrument decreases over time, would the gross carrying amount equal the contractual par amount in each period?

No. From an economic perspective, some or all of the contractual interest payments are repayments of the gross carrying amount. For example, the interest rate may be stated as 16 per cent for the first 10 years and as zero per cent in subsequent periods. In that case, the initial amount is amortised to zero over the first 10 years using the effective interest method, since a portion of the contractual interest payments represents repayments of the gross carrying amount. The gross carrying amount is zero after Year 10 because the present value of the stream of future cash payments in subsequent periods is zero (there are no further contractual cash payments in subsequent periods).

B.26 Example of calculating the gross carrying amount: financial asset

How is the gross carrying amount calculated for financial assets measured at amortised cost in accordance with IFRS 9?

The gross carrying amount is calculated using the effective interest method. The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows associated with the financial instrument through the expected life of the instrument or, where appropriate, a shorter period to the gross carrying amount at initial recognition. The computation includes all fees and points paid or received that are an integral part of the effective interest rate, directly attributable transaction costs and all other premiums or discounts.

The following example illustrates how the gross carrying amount is calculated using the effective interest method. Entity A purchases a debt instrument with five years remaining to maturity for its fair value of CU1,000 (including transaction costs). The instrument has a contractual par amount of CU1,250 and carries fixed interest of 4.7 per cent that is paid annually (CU1,250 × 4.7% = CU59 per year). The contract also specifies that the borrower has an option to prepay the instrument at par and that no penalty will be charged for prepayment. At inception, the entity expects the borrower not to prepay (and, therefore, the entity determines that the fair value of the prepayment feature is insignificant when the financial asset is initially recognised).

It can be shown that in order to allocate interest receipts and the initial discount over the term of the debt instrument at a constant rate on the carrying amount, they must be accrued at the rate of 10 per cent annually. The table below provides information about the gross carrying amount, interest revenue and cash flows of the debt instrument in each reporting period.

Year	(a) Gross carrying amount at the beginning of the year	(b = a × 10%) Interest revenue	(c) Cash flows	(d = a + b – c) Gross carrying amount at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086	109	59	1,136
20X3	1,136	113	59	1,190
20X4	1,190	119	1,250 + 59	–

On the first day of 20X2 the entity revises its estimate of cash flows. It now expects that 50 per cent of the contractual par amount will be prepaid at the end of 20X2 and the remaining 50 per cent at the end of 20X4. In accordance with paragraph B5.4.6 of IFRS 9, the gross carrying amount of the debt instrument in 20X2 is adjusted. The gross carrying amount is recalculated by discounting the amount the entity expects to receive in 20X2 and subsequent years using the original effective interest rate (10 per cent). This results in the new gross carrying amount in 20X2 of CU1,138. The adjustment of CU52 (CU1,138 – CU1,086) is recorded in profit or loss in 20X2. The table below provides information about the gross carrying amount, interest revenue and cash flows as they would be adjusted taking into account the change in estimate.

Year	(a) Gross carrying amount at the beginning of the year	(b = a × 10%) Interest revenue	(c) Cash flows	(d = a + b – c) Gross carrying amount at the end of the year
20X0	1,000	100	59	1,041
20X1	1,041	104	59	1,086
20X2	1,086 + 52	114	625 + 59	568
20X3	568	57	30	595
20X4	595	60	625 + 30	–

B.27 Example of calculating the gross carrying amount: debt instruments with stepped interest payments

Sometimes entities purchase or issue debt instruments with a predetermined rate of interest that increases or decreases progressively ('stepped interest') over the term of the debt instrument. If a debt instrument with stepped interest is issued at CU1,250 and has a maturity amount of CU1,250, would the gross carrying amount equal CU1,250 in each reporting period over the term of the debt instrument?

No. Although there is no difference between the initial amount and maturity amount, an entity uses the effective interest method to allocate interest payments over the term of the debt instrument to achieve a constant rate on the carrying amount.

The following example illustrates how the gross carrying amount is calculated using the effective interest method for an instrument with a predetermined rate of interest that increases or decreases over the term of the debt instrument ('stepped interest').

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On 1 January 20X0, Entity A issues a debt instrument for a price of CU1,250. The contractual par amount is CU1,250 and the debt instrument is repayable on 31 December 20X4. The rate of interest is specified in the debt agreement as a percentage of the contractual par amount as follows: 6.0 per cent in 20X0 (CU75), 8.0 per cent in 20X1 (CU100), 10.0 per cent in 20X2 (CU125), 12.0 per cent in 20X3 (CU150), and 16.4 per cent in 20X4 (CU205). In this case, the interest rate that exactly discounts the stream of future cash payments through maturity is 10 per cent. Therefore, cash interest payments are reallocated over the term of the debt instrument for the purposes of determining the gross carrying amount in each period. In each period, the gross carrying amount at the beginning of the period is multiplied by the effective interest rate of 10 per cent and added to the gross carrying amount. Any cash payments in the period are deducted from the resulting number. Accordingly, the gross carrying amount in each period is as follows:

Year	(a)	(b = a × 10%)	(c)	(d = a + b – c)
	Gross carrying amount at the beginning of the year	Interest revenue	Cash flows	Gross carrying amount at the end of the year
20X0	1,250	125	75	1,300
20X1	1,300	130	100	1,330
20X2	1,330	133	125	1,338
20X3	1,338	134	150	1,322
20X4	1,322	133	1,250 + 205	–

B.28 Regular way contracts: no established market

Can a contract to purchase a financial asset be a regular way contract if there is no established market for trading such a contract?

Yes. IFRS 9 refers to terms that require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned. Marketplace is not limited to a formal stock exchange or organised over-the-counter market. Instead, it means the environment in which the financial asset is customarily exchanged. An acceptable time frame would be the period reasonably and customarily required for the parties to complete the transaction and prepare and execute closing documents.

For example, a market for private issue financial instruments can be a marketplace.

B.29 Regular way contracts: forward contract

Entity ABC enters into a forward contract to purchase 1 million of M's ordinary shares in two months for CU10 per share. The contract is with an individual and is not an exchange-traded contract. The contract requires ABC to take physical delivery of the shares and pay the counterparty CU10 million in cash. M's shares trade in an active public market at an average of 100,000 shares a day. Regular way delivery is three days. Is the forward contract regarded as a regular way contract?

No. The contract must be accounted for as a derivative because it is not settled in the way established by regulation or convention in the marketplace concerned.

B.30 Regular way contracts: which customary settlement provisions apply?

If an entity's financial instruments trade in more than one active market, and the settlement provisions differ in the various active markets, which provisions apply in assessing whether a contract to purchase those financial instruments is a regular way contract?

The provisions that apply are those in the market in which the purchase actually takes place.

To illustrate: Entity XYZ purchases 1 million shares of Entity ABC on a US stock exchange, for example, through a broker. The settlement date of the contract is six business days later. Trades for equity shares on US exchanges customarily settle in three business days. Because the trade settles in six business days, it does not meet the exemption as a regular way trade.

However, if XYZ did the same transaction on a foreign exchange that has a customary settlement period of six business days, the contract would meet the exemption for a regular way trade.

B.31 Regular way contracts: share purchase by call option

Entity A purchases a call option in a public market permitting it to purchase 100 shares of Entity XYZ at any time over the next three months at a price of CU100 per share. If Entity A exercises its option, it has 14 days to settle the transaction according to regulation or convention in the options market. XYZ shares are traded in an active public market that requires three-day settlement. Is the purchase of shares by exercising the option a regular way purchase of shares?

Yes. The settlement of an option is governed by regulation or convention in the marketplace for options and, therefore, upon exercise of the option it is no longer accounted for as a derivative because settlement by delivery of the shares within 14 days is a regular way transaction.

B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting

IFRS 9 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. IFRS 9 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in paragraphs 3.1.1 and 3.3.1 of IFRS 9 apply. Paragraph 3.1.1 of IFRS 9 states that financial liabilities are recognised on the date the entity 'becomes a party to the contractual provisions of the instrument'. Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IFRS 9. Paragraph 3.3.1 of IFRS 9 specifies that financial liabilities are derecognised only when they are extinguished, ie when the obligation specified in the contract is discharged or cancelled or expires.

Section C Embedded derivatives

C.1 Embedded derivatives: separation of host debt instrument

If an embedded non-option derivative is required to be separated from a host debt instrument, how are the terms of the host debt instrument and the embedded derivative identified? For example, would the host debt instrument be a fixed rate instrument, a variable rate instrument or a zero coupon instrument?

The terms of the host debt instrument reflect the stated or implied substantive terms of the hybrid contract. In the absence of implied or stated terms, the entity makes its own judgement of the terms. However, an entity may not identify a component that is not specified or may not establish terms of the host debt instrument in a manner that would result in

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the separation of an embedded derivative that is not already clearly present in the hybrid contract, that is to say, it cannot create a cash flow that does not exist. For example, if a five-year debt instrument has fixed interest payments of CU40,000 annually and a contractual payment at maturity of CU1,000,000 multiplied by the change in an equity price index, it would be inappropriate to identify a floating rate host contract and an embedded equity swap that has an offsetting floating rate leg in lieu of identifying a fixed rate host. In that example, the host contract is a fixed rate debt instrument that pays CU40,000 annually because there are no floating interest rate cash flows in the hybrid contract.

In addition, the terms of an embedded non-option derivative, such as a forward or swap, must be determined so as to result in the embedded derivative having a fair value of zero at the inception of the hybrid contract. If it were permitted to separate embedded non-option derivatives on other terms, a single hybrid contract could be decomposed into an infinite variety of combinations of host debt instruments and embedded derivatives, for example, by separating embedded derivatives with terms that create leverage, asymmetry or some other risk exposure not already present in the hybrid contract. Therefore, it is inappropriate to separate an embedded non-option derivative on terms that result in a fair value other than zero at the inception of the hybrid contract. The determination of the terms of the embedded derivative is based on the conditions existing when the financial instrument was issued.

C.2 Embedded derivatives: separation of embedded option

The response to Question C.1 states that the terms of an embedded non-option derivative should be determined so as to result in the embedded derivative having a fair value of zero at the initial recognition of the hybrid contract. When an embedded option-based derivative is separated, must the terms of the embedded option be determined so as to result in the embedded derivative having either a fair value of zero or an intrinsic value of zero (that is to say, be at the money) at the inception of the hybrid contract?

No. The economic behaviour of a hybrid contract with an option-based embedded derivative depends critically on the strike price (or strike rate) specified for the option feature in the hybrid contract, as discussed below. Therefore, the separation of an option-based embedded derivative (including any embedded put, call, cap, floor, caption, floortion or swaption feature in a hybrid contract) should be based on the stated terms of the option feature documented in the hybrid contract. As a result, the embedded derivative would not necessarily have a fair value or intrinsic value equal to zero at the initial recognition of the hybrid contract.

If an entity were required to identify the terms of an embedded option-based derivative so as to achieve a fair value of the embedded derivative of zero, the strike price (or strike rate) generally would have to be determined so as to result in the option being infinitely out of the money. This would imply a zero probability of the option feature being exercised. However, since the probability of the option feature in a hybrid contract being exercised generally is not zero, it would be inconsistent with the likely economic behaviour of the hybrid contract to assume an initial fair value of zero. Similarly, if an entity were required to identify the terms of an embedded option-based derivative so as to achieve an intrinsic value of zero for the embedded derivative, the strike price (or strike rate) would have to be assumed to equal the price (or rate) of the underlying variable at the initial recognition of the hybrid contract. In this case, the fair value of the option would consist only of time value. However, such an assumption would not be consistent with the likely economic behaviour of the hybrid contract, including the probability of the option feature being exercised, unless the agreed strike price was indeed equal to the price (or rate) of the underlying variable at the initial recognition of the hybrid contract.

The economic nature of an option-based embedded derivative is fundamentally different from a forward-based embedded derivative (including forwards and swaps), because the terms of a forward are such that a payment based on the difference between the price of the underlying and the forward price will occur at a specified date, while the terms of an option are such that a payment based on the difference between the price of the underlying and the strike price of the option may or may not occur depending on the relationship between the agreed strike price and the price of the underlying at a specified date or dates in the future. Adjusting the strike price of an option-based embedded derivative, therefore, alters the nature of the hybrid contract. On the other hand, if the terms of a non-option embedded derivative in a host debt instrument were determined so as to result in a fair value of any amount other than zero at the inception of the hybrid contract, that amount would essentially represent a borrowing or lending. Accordingly, as discussed in the answer to Question C.1, it is not appropriate to separate a non-option embedded derivative in a host debt instrument on terms that result in a fair value other than zero at the initial recognition of the hybrid contract.

C.4 Embedded derivatives: equity kicker

In some instances, venture capital entities providing subordinated loans agree that if and when the borrower lists its shares on a stock exchange, the venture capital entity is entitled to receive shares of the borrowing entity free of charge or at a very low price (an 'equity kicker') in addition to the contractual payments. As a result of the

equity kicker feature, the interest on the subordinated loan is lower than it would otherwise be. Assuming that the subordinated loan is not measured at fair value with changes in fair value recognised in profit or loss (paragraph 4.3.3(c) of IFRS 9), does the equity kicker feature meet the definition of an embedded derivative even though it is contingent upon the future listing of the borrower?

Yes. The economic characteristics and risks of an equity return are not closely related to the economic characteristics and risks of a host debt instrument (paragraph 4.3.3(a) of IFRS 9). The equity kicker meets the definition of a derivative because it has a value that changes in response to the change in the price of the shares of the borrower, it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and it is settled at a future date (paragraph 4.3.3(b) and Appendix A of IFRS 9). The equity kicker feature meets the definition of a derivative even though the right to receive shares is contingent upon the future listing of the borrower. Paragraph BA.1 of IFRS 9 states that a derivative could require a payment as a result of some future event that is unrelated to a notional amount. An equity kicker feature is similar to such a derivative except that it does not give a right to a fixed payment, but an option right, if the future event occurs.

C.6 Embedded derivatives: synthetic instruments

Entity A issues a five-year floating rate debt instrument. At the same time, it enters into a five-year pay-fixed, receive-variable interest rate swap with Entity B. Entity A regards the combination of the debt instrument and swap as a synthetic fixed rate instrument. Entity A contends that separate accounting for the swap is inappropriate since paragraph B4.3.8(a) of IFRS 9 requires an embedded derivative to be classified together with its host instrument if the derivative is linked to an interest rate that can change the amount of contractual interest that would otherwise be paid or received on the host debt contract. Is the entity's analysis correct?

No. Embedded derivative instruments are terms and conditions that are included in non-derivative host contracts. It is generally inappropriate to treat two or more separate financial instruments as a single combined instrument ('synthetic instrument' accounting) for the purpose of applying IFRS 9. Each of the financial instruments has its own terms and conditions and each may be transferred or settled separately. Therefore, the debt instrument and the swap are classified separately. The transactions described here differ from the transactions discussed in Question B.6, which had no substance apart from the resulting interest rate swap.

C.7 Embedded derivatives: purchases and sales contracts in foreign currency instruments

A supply contract provides for payment in a currency other than (a) the functional currency of either party to the contract, (b) the currency in which the product is routinely denominated in commercial transactions around the world and (c) the currency that is commonly used in contracts to purchase or sell non-financial items in the economic environment in which the transaction takes place. Is there an embedded derivative that should be separated under IFRS 9?

Yes. To illustrate: a Norwegian entity agrees to sell oil to an entity in France. The oil contract is denominated in Swiss francs, although oil contracts are routinely denominated in US dollars in commercial transactions around the world, and Norwegian krone are commonly used in contracts to purchase or sell non-financial items in Norway. Neither entity carries out any significant activities in Swiss francs. In this case, the Norwegian entity regards the supply contract as a host contract with an embedded foreign currency forward to purchase Swiss francs. The French entity regards the supply contact as a host contract with an embedded foreign currency forward to sell Swiss francs. Each entity includes fair value changes on the currency forward in profit or loss unless the reporting entity designates it as a cash flow hedging instrument, if appropriate.

C.8 Embedded foreign currency derivatives: unrelated foreign currency provision

Entity A, which measures items in its financial statements on the basis of the euro (its functional currency), enters into a contract with Entity B, which has the Norwegian krone as its functional currency, to purchase oil in six months for 1,000 US dollars. The host oil contract is not within the scope of IFRS 9 because it was entered into and continues to be for the purpose of delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements (paragraphs 2.4 and BA.2 of IFRS 9) and the entity has not irrevocably

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designated it as measured at fair value through profit or loss in accordance with paragraph 2.5 of IFRS 9. The oil contract includes a leveraged foreign exchange provision that states that the parties, in addition to the provision of, and payment for, oil will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars. Under paragraph 4.3.3 of IFRS 9, is that embedded derivative (the leveraged foreign exchange provision) regarded as closely related to the host oil contract?

No, that leveraged foreign exchange provision is separated from the host oil contract because it is not closely related to the host oil contract (paragraph B4.3.8(d) of IFRS 9).

The payment provision under the host oil contract of 1,000 US dollars can be viewed as a foreign currency derivative because the US dollar is neither Entity A's nor Entity B's functional currency. This foreign currency derivative would not be separated because it follows from paragraph B4.3.8(d) of IFRS 9 that a crude oil contract that requires payment in US dollars is not regarded as a host contract with a foreign currency derivative.

The leveraged foreign exchange provision that states that the parties will exchange an amount equal to the fluctuation in the exchange rate of the US dollar and Norwegian krone applied to a notional amount of 100,000 US dollars is in addition to the required payment for the oil transaction. It is unrelated to the host oil contract and therefore separated from the host oil contract and accounted for as an embedded derivative under paragraph 4.3.3 of IFRS 9.

C.9 Embedded foreign currency derivatives: currency of international commerce

Paragraph B4.3.8(d) of IFRS 9 refers to the currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world. Could it be a currency that is used for a certain product or service in commercial transactions within the local area of one of the substantial parties to the contract?

No. The currency in which the price of the related goods or services is routinely denominated in commercial transactions around the world is only a currency that is used for similar transactions all around the world, not just in one local area. For example, if cross-border transactions in natural gas in North America are routinely denominated in US dollars and such transactions are routinely denominated in euro in Europe, neither the US dollar nor the euro is a currency in which the goods or services are routinely denominated in commercial transactions around the world.

C.10 Embedded derivatives: holder permitted, but not required, to settle without recovering substantially all of its recognised investment

If the terms of a combined contract permit, but do not require, the holder to settle the combined contract in a manner that causes it not to recover substantially all of its recognised investment and the issuer does not have such a right (for example, a puttable debt instrument), does the contract satisfy the condition in paragraph B4.3.8(a) of IFRS 9 that the holder would not recover substantially all of its recognised investment?

No. The condition that 'the holder would not recover substantially all of its recognised investment' is not satisfied if the terms of the combined contract permit, but do not require, the investor to settle the combined contract in a manner that causes it not to recover substantially all of its recognised investment and the issuer has no such right. Accordingly, an interest-bearing host contract with an embedded interest rate derivative with such terms is regarded as closely related to the host contract. The condition that 'the holder would not recover substantially all of its recognised investment' applies to situations in which the holder can be forced to accept settlement at an amount that causes the holder not to recover substantially all of its recognised investment.

Section D Recognition and derecognition

D.1 Initial recognition

D.1.1 Recognition: cash collateral

Entity B transfers cash to Entity A as collateral for another transaction with Entity A (for example, a securities borrowing transaction). The cash is not legally segregated from Entity A's assets. Should Entity A recognise the cash collateral it has received as an asset?

Yes. The ultimate realisation of a financial asset is its conversion into cash and, therefore, no further transformation is required before the economic benefits of the cash transferred by Entity B can be realised by Entity A. Therefore, Entity A recognises the cash as an asset and a payable to Entity B while Entity B derecognises the cash and recognises a receivable from Entity A.

D.2 Regular way purchase or sale of a financial asset

D.2.1 Trade date vs settlement date: amounts to be recorded for a purchase

How are the trade date and settlement date accounting principles in IFRS 9 applied to a purchase of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in IFRS 9 for a purchase of a financial asset. On 29 December 20X1, an entity commits itself to purchase a financial asset for CU1,000, which is its fair value on commitment (trade) date. Transaction costs are immaterial. On 31 December 20X1 (financial year-end) and on 4 January 20X2 (settlement date) the fair value of the asset is CU1,002 and CU1,003, respectively. The amounts to be recorded for the asset will depend on how it is classified and whether trade date or settlement date accounting is used, as shown in the two tables below.

Settlement date accounting			
Balances	**Financial assets measured at amortised cost**	**Financial assets measured at fair value through other comprehensive income**	**Financial assets measured at fair value through profit or loss**
29 December 20X1			
Financial asset	–	–	–
Financial liability	–	–	–
31 December 20X1			
Receivable	–	2	2
Financial asset	–	–	–
Financial liability	–	–	–
Other comprehensive income (fair value adjustment)	–	(2)	–
Retained earnings (through profit or loss)	–	–	(2)

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Settlement date accounting			
Balances	**Financial assets measured at amortised cost**	**Financial assets measured at fair value through other comprehensive income**	**Financial assets measured at fair value through profit or loss**
4 January 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Other comprehensive income (fair value adjustment)	–	(3)	–
Retained earnings (through profit or loss)	–	–	(3)

Trade date accounting			
Balances	**Financial assets measured at amortised cost**	**Financial assets measured at fair value through other comprehensive income**	**Financial assets measured at fair value through profit or loss**
29 December 20X1			
Financial asset	1,000	1,000	1,000
Financial liability	(1,000)	(1,000)	(1,000)
31 December 20X1			
Receivable	–	–	–
Financial asset	1,000	1,002	1,002
Financial liability	(1,000)	(1,000)	(1,000)
Other comprehensive income (fair value adjustment)	–	(2)	–
Retained earnings (through profit or loss)	–	–	(2)
4 January 20X2			
Receivable	–	–	–
Financial asset	1,000	1,003	1,003
Financial liability	–	–	–
Other comprehensive income (fair value adjustment)	–	(3)	–
Retained earnings (through profit or loss)	–	–	(3)

D.2.2 Trade date vs settlement date: amounts to be recorded for a sale

How are the trade date and settlement date accounting principles in IFRS 9 applied to a sale of a financial asset?

The following example illustrates the application of the trade date and settlement date accounting principles in IFRS 9 for a sale of a financial asset. On 29 December 20X2 (trade date) an entity enters into a contract to sell a financial asset for its current fair value of CU1,010. The asset was acquired one year earlier for CU1,000 and its gross carrying amount

is CU1,000. On 31 December 20X2 (financial year-end), the fair value of the asset is CU1,012. On 4 January 20X3 (settlement date), the fair value is CU1,013. The amounts to be recorded will depend on how the asset is classified and whether trade date or settlement date accounting is used as shown in the two tables below (any loss allowance or interest revenue on the financial asset is disregarded for the purpose of this example).

A change in the fair value of a financial asset that is sold on a regular way basis is not recorded in the financial statements between trade date and settlement date even if the entity applies settlement date accounting because the seller's right to changes in the fair value ceases on the trade date.

Settlement date accounting

Balances	Financial assets measured at amortised cost	Financial assets measured at fair value through other comprehensive income	Financial assets measured at fair value through profit or loss
29 December 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Other comprehensive income (fair value adjustment)	–	10	–
Retained earnings (through profit or loss)	–	–	10
31 December 20X2			
Receivable	–	–	–
Financial asset	1,000	1,010	1,010
Other comprehensive income (fair value adjustment)	–	10	–
Retained earnings (through profit or loss)	–	–	10
4 January 20X3			
Other comprehensive income (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10

Trade date accounting

Balances	Financial assets measured at amortised cost	Financial assets measured at fair value through other comprehensive income	Financial assets measured at fair value through profit or loss
29 December 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Other comprehensive income (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10

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Trade date accounting

Balances	Financial assets measured at amortised cost	Financial assets measured at fair value through other comprehensive income	Financial assets measured at fair value through profit or loss
31 December 20X2			
Receivable	1,010	1,010	1,010
Financial asset	–	–	–
Other comprehensive income (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10
4 January 20X3			
Other comprehensive income (fair value adjustment)	–	–	–
Retained earnings (through profit or loss)	10	10	10

D.2.3 Settlement date accounting: exchange of non-cash financial assets

If an entity recognises sales of financial assets using settlement date accounting, would a change in the fair value of a financial asset to be received in exchange for the non-cash financial asset that is sold be recognised in accordance with paragraph 5.7.4 of IFRS 9?

It depends. Any change in the fair value of the financial asset to be received would be accounted for under paragraph 5.7.4 of IFRS 9 if the entity applies settlement date accounting for that category of financial assets. However, if the entity classifies the financial asset to be received in a category for which it applies trade date accounting, the asset to be received is recognised on the trade date as described in paragraph B3.1.5 of IFRS 9. In that case, the entity recognises a liability of an amount equal to the carrying amount of the financial asset to be delivered on settlement date.

To illustrate: on 29 December 20X2 (trade date) Entity A enters into a contract to sell Note Receivable A, which is measured at amortised cost, in exchange for Bond B, which meets the definition of held for trading and is measured at fair value. Both assets have a fair value of CU1,010 on 29 December, while the amortised cost of Note Receivable A is CU1,000. Entity A uses settlement date accounting for financial assets measured at amortised cost and trade date accounting for assets that meet the definition of held for trading. On 31 December 20X2 (financial year-end), the fair value of Note Receivable A is CU1,012 and the fair value of Bond B is CU1,009. On 4 January 20X3, the fair value of Note Receivable A is CU1,013 and the fair value of Bond B is CU1,007. The following entries are made:

29 December 20X2

Dr	Bond B		CU1,010	
	Cr	Payable		CU1,010

31 December 20X2

Dr	Trading loss		CU1	
	Cr	Bond B		CU1

4 January 20X3				
Dr	Payable		CU1,010	
Dr	Trading loss		CU2	
	Cr	Note Receivable A		CU1,000
	Cr	Bond B		CU2
	Cr	Realisation gain		CU10

Section E Measurement

E.1 Initial measurement of financial assets and financial liabilities

E.1.1 Initial measurement: transaction costs

Transaction costs should be included in the initial measurement of financial assets and financial liabilities other than those at fair value through profit or loss. How should this requirement be applied in practice?

For financial assets not measured at fair value through profit or loss, transaction costs are added to the fair value at initial recognition. For financial liabilities, transaction costs are deducted from the fair value at initial recognition.

For financial instruments that are measured at amortised cost, transaction costs are subsequently included in the calculation of amortised cost using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.

For financial instruments that are measured at fair value through other comprehensive income in accordance with either paragraphs 4.1.2A and 5.7.10 or paragraphs 4.1.4 and 5.7.5 of IFRS 9, transaction costs are recognised in other comprehensive income as part of a change in fair value at the next remeasurement. If the financial asset is measured in accordance with paragraphs 4.1.2A and 5.7.10 of IFRS 9, those transaction costs are amortised to profit or loss using the effective interest method and, in effect, amortised through profit or loss over the life of the instrument.

Transaction costs expected to be incurred on transfer or disposal of a financial instrument are not included in the measurement of the financial instrument.

E.3 Gains and losses

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

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

It is the difference between the amortised cost of the financial asset[108] and the fair value of the financial asset in the functional currency of the reporting entity. For the purpose of applying paragraph 28 of IAS 21 the asset is treated as an asset measured at amortised cost in the foreign currency.

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

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To illustrate: on 31 December 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a contractual par amount of FC1,250, carries fixed interest of 4.7 per cent that is paid annually (FC1,250 × 4.7% = FC59 per year), and has an effective interest rate of 10 per cent. Entity A classifies the bond as subsequently measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9, and thus recognises gains and losses in other comprehensive income. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 (= FC1,000 × 1.5).

Dr	Bond		LC1,500	
	Cr	Cash		LC1,500

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

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

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

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

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

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

E.3.3 IFRS 9 and IAS 21—exchange differences arising on translation of foreign entities: other comprehensive income or profit or loss?

Paragraphs 32 and 48 of IAS 21 state that all exchange differences resulting from translating the financial statements of a foreign operation should be recognised in other comprehensive income until disposal of the net investment. This would include exchange differences arising from financial instruments carried at fair value, which would include both financial assets measured at fair value through profit or loss and financial assets that are measured at fair value through other comprehensive income in accordance with IFRS 9.

IFRS 9 requires that changes in fair value of financial assets measured at fair value through profit or loss should be recognised in profit or loss and changes in fair value of financial assets measured at fair value through other comprehensive income should be recognised in other comprehensive income.

If the foreign operation is a subsidiary whose financial statements are consolidated with those of its parent, in the consolidated financial statements how are IFRS 9 and paragraph 39 of IAS 21 applied?

IFRS 9 applies in the accounting for financial instruments in the financial statements of a foreign operation and IAS 21 applies in translating the financial statements of a foreign operation for incorporation in the financial statements of the reporting entity.

To illustrate: Entity A is domiciled in Country X and its functional currency and presentation currency are the local currency of Country X (LCX). A has a foreign subsidiary (Entity B) in Country Y whose functional currency is the local currency of Country Y (LCY). B is the owner of a debt instrument, which meets the definition of held for trading and is therefore measured at fair value through profit or loss in accordance with IFRS 9.

In B's financial statements for year 20X0, the fair value and carrying amount of the debt instrument is LCY100 in the local currency of Country Y. In A's consolidated financial statements, the asset is translated into the local currency of Country X at the spot exchange rate applicable at the end of the reporting period (2.00). Thus, the carrying amount is LCX200 (= LCY100 × 2.00) in the consolidated financial statements.

At the end of year 20X1, the fair value of the debt instrument has increased to LCY110 in the local currency of Country Y. B recognises the trading asset at LCY110 in its statement of financial position and recognises a fair value gain of LCY10 in its profit or loss. During the year, the spot exchange rate has increased from 2.00 to 3.00 resulting in an increase in the fair value of the instrument from LCX200 to LCX330 (= LCY110 × 3.00) in the currency of Country X. Therefore, Entity A recognises the trading asset at LCX330 in its consolidated financial statements.

Entity A translates the statement of comprehensive income of B 'at the exchange rates at the dates of the transactions' (paragraph 39(b) of IAS 21). Since the fair value gain has accrued through the year, A uses the average rate as a practical approximation ([3.00 + 2.00] / 2 = 2.50, in accordance with paragraph 22 of IAS 21). Therefore, while the fair value of the trading asset has increased by LCX130 (= LCX330 – LCX200), Entity A recognises only LCX25 (= LCY10 × 2.5) of this increase in consolidated profit or loss to comply with paragraph 39(b) of IAS 21. The resulting exchange difference, ie the remaining increase in the fair value of the debt instrument (LCX130 – LCX25 = LCX105), is accumulated in other comprehensive income until the disposal of the net investment in the foreign operation in accordance with paragraph 48 of IAS 21.

E.3.4 IFRS 9 and IAS 21—interaction between IFRS 9 and IAS 21

IFRS 9 includes requirements about the measurement of financial assets and financial liabilities and the recognition of gains and losses on remeasurement in profit or loss. IAS 21 includes rules about the reporting of foreign currency items and the recognition of exchange differences in profit or loss. In what order are IAS 21 and IFRS 9 applied?

Statement of financial position

Generally, the measurement of a financial asset or financial liability at fair value or amortised cost is first determined in the foreign currency in which the item is denominated in accordance with IFRS 9. Then, the foreign currency amount is translated into the functional currency using the closing rate or a historical rate in accordance with IAS 21 (paragraph B5.7.2 of IFRS 9). For example, if a monetary financial asset (such as a debt instrument) is measured at

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amortised cost in accordance with IFRS 9, amortised cost is calculated in the currency of denomination of that financial asset. Then, the foreign currency amount is recognised using the closing rate in the entity's financial statements (paragraph 23 of IAS 21). That applies regardless of whether a monetary item is measured at amortised cost or fair value in the foreign currency (paragraph 24 of IAS 21). A non-monetary financial asset (such as an investment in an equity instrument) that is measured at fair value in the foreign currency is translated using the closing rate (paragraph 23(c) of IAS 21).

As an exception, if the financial asset or financial liability is designated as a hedged item in a fair value hedge of the exposure to changes in foreign currency rates under IFRS 9 (or IAS 39 if an entity chooses as its accounting policy to continue to apply the hedge accounting requirements in IAS 39), the hedged item is remeasured for changes in foreign currency rates even if it would otherwise have been recognised using a historical rate under IAS 21 (paragraph 6.5.8 of IFRS 9 or paragraph 89 of IAS 39), ie the foreign currency amount is recognised using the closing rate. This exception applies to non-monetary items that are carried in terms of historical cost in the foreign currency and are hedged against exposure to foreign currency rates (paragraph 23(b) of IAS 21).

Profit or loss

The recognition of a change in the carrying amount of a financial asset or financial liability in profit or loss depends on a number of factors, including whether it is an exchange difference or other change in carrying amount, whether it arises on a monetary item (for example, most debt instruments) or non-monetary item (such as most equity investments), whether the associated asset or liability is designated as a cash flow hedge of an exposure to changes in foreign currency rates, and whether it results from translating the financial statements of a foreign operation. The issue of recognising changes in the carrying amount of a financial asset or financial liability held by a foreign operation is addressed in a separate question (see Question E.3.3).

Any exchange difference arising on recognising *a monetary item* at a rate different from that at which it was initially recognised during the period, or recognised in previous financial statements, is recognised in profit or loss in accordance with IAS 21 (paragraph B5.7.2 of IFRS 9, paragraphs 28 and 32 of IAS 21), unless the monetary item is designated as a cash flow hedge of a highly probable forecast transaction in foreign currency, in which case the requirements for recognition of gains and losses on cash flow hedges apply (paragraph 6.5.11 of IFRS 9 or paragraph 95 of IAS 39). Differences arising from recognising a monetary item at a foreign currency amount different from that at which it was previously recognised are accounted for in a similar manner, since all changes in the carrying amount relating to foreign currency movements should be treated consistently. All other changes in the statement of financial position measurement of a monetary item are recognised in profit or loss in accordance with IFRS 9. For example, although an entity recognises gains and losses on financial assets measured at fair value through other comprehensive income in other comprehensive income (paragraphs 5.7.10 and B5.7.2A of IFRS 9), the entity nevertheless recognises the changes in the carrying amount relating to changes in foreign exchange rates in profit or loss (paragraph 23(a) of IAS 21).

Any changes in the carrying amount of a *non-monetary item* are recognised in profit or loss or in other comprehensive income in accordance with IFRS 9. For example, for an investment in an equity instrument that is presented in accordance with paragraph 5.7.5 of IFRS 9, the entire change in the carrying amount, including the effect of changes in foreign currency rates, is presented in other comprehensive income (paragraph B5.7.3 of IFRS 9). If the non-monetary item is designated as a cash flow hedge of an unrecognised firm commitment or a highly probable forecast transaction in foreign currency, the requirements for recognition of gains and losses on cash flow hedges apply (paragraph 6.5.11 of IFRS 9 or paragraph 95 of IAS 39).

When some portion of the change in carrying amount is recognised in other comprehensive income and some portion is recognised in profit or loss, for example, if the amortised cost of a foreign currency bond measured at fair value through other comprehensive income has increased in foreign currency (resulting in a gain in profit or loss) but its fair value has decreased in foreign currency (resulting in a loss recognised in other comprehensive income), an entity cannot offset those two components for the purposes of determining gains or losses that should be recognised in profit or loss or in other comprehensive income.

Section G Other

G.2 IFRS 9 and IAS 7—hedge accounting: statements of cash flows

How should cash flows arising from hedging instruments be classified in statements of cash flows?

Cash flows arising from hedging instruments are classified as operating, investing or financing activities, on the basis of the classification of the cash flows arising from the hedged item. While the terminology in IAS 7 has not been updated to reflect IFRS 9, the classification of cash flows arising from hedging instruments in the statement of cash flows should be consistent with the classification of these instruments as hedging instruments under IFRS 9.

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Appendix
Amendments to guidance on other Standards

The amendments in this appendix to the guidance on other Standards are necessary in order to ensure consistency with IFRS 9 and the related amendments to other Standards.

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The amendments contained in this appendix when IFRS 9 was issued in 2014 have been incorporated into the guidance on the relevant Standards.