



Università
Ca' Foscari
Venezia

Master's Degree programme – Second Cycle
(*D.M. 270/2004*)
in Amministrazione, Finanza e Controllo

Final Thesis

—
Ca' Foscari
Dorsoduro 3246
30123 Venezia

IFRS 9 “Financial Instruments”
Background, Development and Expected Impact

Supervisor

Ch. Prof. Carlo Marcon

Co-Supervisor

Ch. Prof. Moreno Mancin

Graduand

Alberto Emanuele Sichirollo
Matriculation Number 832347

Academic Year

2014 / 2015

IFRS 9 “Financial Instruments”

Background, Development and Expected Impact

Introduction

1. Chapter I - The starting point: IAS 39	1
1.1. Overview	1
1.2. Scope	1
1.3. Recognition and derecognition	3
1.3.1. Initial recognition	3
1.3.2. Derecognition of financial assets	4
1.3.3. Derecognition of financial liabilities	7
1.4. Classification and measurement	7
1.4.1. Initial measurement of financial instruments	7
1.4.2. Subsequent measurement of financial assets	8
1.4.3. Subsequent measurement of financial liabilities	12
1.4.4. Embedded derivatives	14
1.4.5. Reclassifications	16

1.5. Impairment	18
1.5.1. Impairment of financial assets at amortized cost	19
1.5.2. Impairment of financial assets at cost	20
1.5.3. Impairment of available-for-sale financial assets	20
1.6. Hedge accounting	21
1.6.1. Types of hedging relationships	21
1.6.2. Hedging instruments	22
1.6.3. Hedged items	23
1.6.4. Qualifying criteria for hedge accounting	25
1.6.5. Accounting for fair value hedges	26
1.6.6. Accounting for cash flow hedges	27
1.6.7. Accounting for hedges of a net investment in a foreign operation	29
2. Chapter II - The development of IFRS 9	31
2.1. Overview	31
2.2. Lack of convergence with US GAAPs	32
2.3. Pros and cons of the incremental approach	33
2.4. Mar. 2008 – DP <i>Reducing Complexity in Reporting Financial Instruments</i>	34
2.5. Mar. 2009 – ED/2009/3 <i>Derecognition: Proposed Amendments to IAS 39 and IFRS 7</i>	35
2.6. Jun. 2009 – DP/2009/2 <i>Credit Risk in Liability Management</i>	36
2.7. Jul. 2009 – ED/2009/7 <i>Financial Instruments: Classification and Measurement</i>	38
2.8. Nov. 2009 – IFRS 9 (2009) <i>Classification and Measurement of Financial Assets</i>	40
2.9. Nov. 2009 – ED/2009/12 <i>Financial Instruments: Amortized Cost and Impairment</i>	41
2.10. May 2010 – ED/2010/4 <i>Fair Value Option for Financial Liabilities</i>	43
2.11. Oct. 2010 – IFRS 9 (2010) <i>Classification and Measurement of Financial Liabilities</i>	45
2.12. Dec. 2010 – ED/2010/13 <i>Financial Instruments: Hedge Accounting</i>	45
2.13. Jan. 2011 – Supplement to ED/2009/12 <i>Financial Instruments: Impairment</i>	51

2.14.	Nov. 2012 – ED/2012/4 <i>Classification and Measurement: Limited Amendments to IFRS 9</i>	52
2.15.	Feb. 2013 – ED/2013/2 <i>Novation of Derivatives and Continuation of Hedge Accounting</i>	55
2.16.	Mar. 2013 – ED/2013/3 <i>Financial Instruments: Expected Credit Losses</i>	56
2.17.	Jun. 2013 – Amendments to IAS 39: <i>Novation of Derivatives and Continuation of Hedge Accounting</i>	58
2.18.	Nov. 2013 – IFRS 9 (2013) <i>General Hedge Accounting</i>	59
2.19.	Jul. 2014 – IFRS 9 (2014) <i>FVTOCI Category and Impairment</i>	62
3.	Chapter III - The complete IFRS 9	63
3.1.	Effective date and transition	63
3.2.	Objective and scope	64
3.3.	Recognition and derecognition	65
3.4.	Classification and measurement	65
3.4.1.	Initial measurement of financial instruments	66
3.4.2.	Classification and subsequent measurement of financial assets	66
3.4.3.	Classification and subsequent measurement of financial liabilities	70
3.4.4.	Embedded derivatives	72
3.4.5.	Reclassifications	73
3.5.	Impairment	74
3.5.1.	General approach	74
3.5.2.	Determining significant increases in credit risk	76
3.5.3.	1 st special case: purchased or originated credit-impaired financial assets	77
3.5.4.	2 nd special case: trade receivables, contract assets and lease receivables	77
3.5.5.	Guidance on expected credit losses	78
3.5.6.	Modifications	79
3.6.	Hedge accounting	80
3.6.1.	Types of hedging relationships	80
3.6.2.	Hedging instruments	81

3.6.3. Hedged items	83
3.6.4. Qualifying criteria for hedge accounting	85
3.6.5. Accounting for fair value hedges	86
3.6.6. Accounting for cash flow hedges	87
3.6.7. Accounting for hedges of a net investment in a foreign operation	88
3.6.8. Discontinuation of hedge accounting	88
4. Chapter IV - IFRS 9: a change for the better?	91
4.1. Technical assessment of IFRS 9	91
4.2. Extent of improvements over IAS 39	94
4.3. Costs for preparers and users	97
4.4. Impact on banks	97
4.5. Impact on insurers	99
4.6. Conclusions	100

Bibliography

Introduction

The accounting for financial instruments is among the most complex areas of financial reporting. The manifold flaws of IAS 39 *Financial Instruments: Recognition and Measurement* became all the more clear with the onset of the global financial crisis, and the International Accounting Standard Board has worked for several years toward its replacement with a new Standard. IFRS 9 *Financial Instruments* was at last completed in July 2014 and will become effective on 1 January 2018. The new Standard represents a major overhaul of financial instrument accounting and is widely seen in most of its areas as an improvement.

This work begins with a detailed portrait of IAS 39 to inform the reader of its requirements and underlying issues. The second chapter then retraces the milestones in the development of IFRS 9 (i.e. Discussion Papers and Exposure Drafts), aiming to provide further insight into the debate that led to its final content. Next, we move on to analyzing the requirements and guidance of the final version of IFRS 9. Lastly, the fourth chapter assesses to what extent IFRS 9 represents an improvement over IAS 39, in light of its usefulness for users of financial statements as well as its expected impact on businesses (above all, financial institutions).

Chapter I – The starting point: IAS 39

1.1. Overview

IAS 39 *Financial Instruments: Recognition and Measurement* lays out requirements for the recognition, measurement, impairment, and hedge accounting of financial assets, financial liabilities, and some contracts to buy or sell non-financial items. The Standard was originally issued in 1999 by the International Accounting Standard Committee (IASC), the predecessor of the International Accounting Standard Board (IASB), in substitution of a previous Standard. The IASB adopted it in 2001, amended its requirements several times over a few years, and in 2008 began a momentous project to overhaul the accounting for financial instruments by replacing IAS 39 with IFRS 9 *Financial Instruments* (whose effective date is 1 January 2018, with earlier application permitted). This chapter presents an outline of the version of IAS 39 in force in 2008, i.e. the starting point from which the IASB developed the above-mentioned project.¹ The main weaknesses of IAS 39 and its similarities with IFRS 9 are briefly pointed to the reader's attention, but will be discussed in the next chapters.

1.2. Scope

The scope of IAS 39 (which was entirely carried forward into IFRS 9, with some additions) includes all financial instruments, except the following [IAS39.2]:

¹ NB: the 2008 version of IAS 39 is almost the same as the one currently applicable until the effective date of IFRS 9, except for the amendments approved during the project, in particular an amendment relative to the treatment of novated derivatives in a hedging relationship.

- a) interests in subsidiaries, associates, and joint ventures, to which IFRS 10 *Consolidated Financial Statements*, IAS 27 *Separate Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures* apply. Derivatives on such items are instead under the scope IAS 39.
- b) Rights and obligations under leases, to which IAS 17 *Leases* applies. However, lease receivables (recognized by a lessor), lease payables (recognized by a lessee), and derivatives embedded in leases are subject to the requirements of IAS 39 relative to derecognition, impairment and embedded derivatives, as applicable.
- c) Employers' rights and obligations under employee benefit plans, to which IAS 19 *Employee Benefits* applies.
- d) Equity instruments issued by the reporting entity (but those held fall within its scope).
- e) Rights and obligations under insurance contracts as defined in IFRS 4 *Insurance Contracts*. However, financial guarantee contracts² issued by the entity are within the scope of IAS 39, unless the issuer has explicitly asserted that it regards such contracts as insurance contracts and treated them accordingly. Held financial guarantee contracts instead are always outside the scope of IAS 39.
- f) Forward contracts to buy or sell an entity that will result in a business combination within the scope of IFRS 3 *Business Combinations*.
- g) Loan commitments issued by the entity, to which IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* applies (although they are subject to the derecognition provisions of IAS 39). However, issued loan commitments shall be accounted for according to IAS 39 if they [IAS39.4]:
 - can be settled net in cash;
 - are commitments to provide a loan below-market rate;
 - are designated as financial liabilities at fair value through profit or loss (FVTPL);

² I.e. a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due. Financial guarantees can have the legal form of a guarantee, a letter of credit, a credit default contract, or an insurance contract.

- the entity has the past practice of selling the resulting assets (i.e. the loans) shortly after origination.
- h) Rights to reimbursement payments for expenditures that the entity is required to make to settle liabilities recognized as provisions.
- i) Financial instruments, contracts and obligations under share-based payment transactions, to which IFRS 2 *Share-based Payment* applies, except for those that meet the description below.

IAS 39 shall be applied to those contracts to buy or sell non-financial items that can be settled net in cash or another financial instrument, or by exchanging financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of actual receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale, or usage requirements (the so-called 'own use' exemption) [IAS39.5].³

1.3. Recognition and derecognition

In a 2009 Exposure Draft (ED), the IASB acknowledged that the recognition and derecognition requirements in IAS 39 were too complex and in need of change. However, one year later the Board revised its work plan to focus on more urgent matters, and ended up carrying forward all those requirements unchanged to IFRS 9, albeit enhancing the related requirements in IFRS 7 *Financial Instruments: Disclosures*.

1.3.1. Initial recognition

An entity shall recognize a financial instrument, be it an asset or a liability, only when the entity becomes a party to the contractual provisions of the instrument [IAS39.14]. A regular

³ Under IFRS 9, a contract to buy or sell a non-financial item that can be settled net may be irrevocably designated as measured at FVTPL even if it was entered into for the purpose of receipt or delivery, if such designation eliminates or significantly reduces an accounting mismatch.

way purchase or sale of financial assets⁴ shall be recognized and derecognized using either trade date accounting or settlement date accounting [IAS39.38].

1.3.2. Derecognition of financial assets

An entity normally applies the derecognition requirements to a financial asset (or a group of similar financial assets) in its entirety. However, it shall apply the requirements to part of a financial asset (or part of a group of similar financial assets) when one the three following conditions is met [IAS39.16]:

- a) the part being considered for derecognition comprises only specifically identified cash flows (e.g. the interest payments) from a financial asset (or a group of similar financial assets).
- b) The part comprises only a specific portion of the cash flows (e.g. 90% of all cash flows) from a financial asset (or a group of similar financial assets).
- c) The part comprises only a specific portion of specifically identified cash flows (e.g. 90% of the interest payments) from a financial asset (or a group of similar financial assets).

IAS 39 requires that an entity derecognize a financial asset⁵ only in two occasions [IAS39.17]:

- when the contractual rights to the cash flows from the asset expire; or
- when the entity transfers the financial asset and, as a separate condition, the transfer qualifies for derecognition.

With reference to the second point above, a transfer of a financial asset is said to occur [IAS39.18]:

- when the entity transfers the contractual rights to receive the cash flows from the financial asset; or

⁴ I.e. a purchase or sale of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the marketplace concerned.

⁵ For simplicity's sake, the term 'financial asset' will now refer to either a financial asset in its entirety (or a group of similar financial assets) or part of a financial asset (or part of a group of similar financial assets).

- when the entity retains the contractual rights to receive the cash flows from the financial asset (the ‘original asset’) but assumes the obligation to pay those cash flows to one or more entities (the ‘eventual recipients’). In this case, the transaction needs to meet three further conditions to be considered a transfer of a financial asset, namely that the entity [IAS39.19]:
 - a) has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset;
 - b) is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as a security to the eventual recipients for the obligation to pay them cash flows; and
 - c) has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.

Even when a transfer has actually occurred, it has yet to qualify for derecognition. The entity proceeds as follows [IAS39.20]:

- a) if the entity has transferred substantially all the risks and rewards of ownership of the financial asset,⁶ it shall derecognize the financial asset and recognize separately as assets or liabilities at fair value any rights and obligations created or retained in the transfer.
- b) If instead the entity has retained substantially all the risks and rewards of ownership,⁷ it shall continue to recognize the asset and shall recognize a liability for the consideration received. In subsequent periods, the entity shall recognize any income on the transferred asset and any expense incurred on the financial liability.

⁶ An entity has transferred substantially all the risks and rewards if its exposure to the variability in the present value of the future net cash flows from the financial asset is no longer significant in relation to the asset’s total variability.

⁷ An entity has retained substantially all the risks and rewards if the exposure mentioned above does not significantly change as a result of the transfer.

- c) In those cases in which the entity has neither transferred nor retained substantially all the risks and rewards of ownership, it shall determine whether it has retained control of the financial asset,⁸ and behave as follows:
- if the entity has not retained control, it shall derecognize the financial asset and recognize separately as assets or liabilities any rights and obligations created or retained in the transfer.
 - If the entity has retained control, it shall continue to recognize the financial asset to the extent of its continuing involvement in the asset.⁹ The entity shall also recognize an associated liability, measured in such a way that the net carrying amount of the transferred asset and associated liability is equal to the amortized cost or fair value of the retained asset (depending on whether the transferred asset was measured at amortized cost or fair value). The entity shall continue to recognize any income arising on the transferred asset to the extent of its continuing involvement and shall recognize any expense incurred on the associated liability.

In the case of transfers that qualify for derecognition, the difference between 1) the financial asset's carrying amount and 2) the sum of 2_a) the consideration received and 2_b) any cumulative gain or loss that had been recognized in OCI, shall be recognized in profit or loss [IAS39.26].

However, if the qualifying transfer (or the continuing involvement) involves only part of a financial asset, the previous carrying amount of the entire financial asset shall be allocated between the part that continues to be recognized and the part that is derecognized, based on their relative fair values on the date of the transfer. Then, the difference between 1) the carrying amount allocated to the part derecognized and 2) the sum of 2_a) the consideration received and 2_b) any cumulative gain or loss previously recognized in OCI shall be recognized in profit or loss [IAS39.27].

⁸ An entity has not retained control if the transferee has the practical ability to sell the asset in its entirety to an unrelated third party and can do so unilaterally.

⁹ I.e. the extent to which it is exposed to changes in the value of the transferred asset.

1.3.3. Derecognition of financial liabilities

An entity shall derecognize a financial liability (or part thereof) only when it is extinguished, i.e. it is transferred, cancelled or expired [IAS39.39]. The difference between the carrying amount of a financial liability that has been transferred or cancelled and the consideration paid (including any non-cash assets transferred or liabilities assumed) shall be recognized in profit or loss [IAS39.41].

An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability [IAS39.40]. Similarly, a substantial modification of the terms of an existing financial liability or part thereof shall be accounted for as an extinguishment of the original financial liability and the recognition of a new one [IAS39.40].

1.4. Classification and measurement

1.4.1. Initial measurement of financial instruments

At initial recognition, an entity shall measure a financial instrument (asset or liability) at its fair value plus, in the case of a financial instrument not at FVTPL, transaction costs that are directly attributable to the acquisition or issue of the instrument [IAS39.43].

However, if an entity determines that at initial recognition the financial instrument's fair value differs from the transaction price (which normally constitutes the best evidence of fair value), it shall behave as follows [IAS39.43A]:

- a) if the fair value is evidenced by a quoted price in an active market for an identical asset or liability (Level 1 input of the fair value hierarchy), or is based on a valuation technique that uses only data from observable markets (Level 2 input), the entity shall recognize the difference between the fair value at initial recognition and the transaction price as a gain or loss [IAS39.AG.76].

- b) The Board affirmed in the Basis for Conclusions [IAS39.BC.104] that in all cases different from a), the transaction price gives the best evidence of fair value and shall be the basis of initial measurement. However, the Board appears to contradict itself by stating in the Application Guidance [IAS39.AG.76] that in all cases different from point a) above, the entity shall recognize after initial recognition the difference between the 'fair value' at initial recognition and the transaction price, to the extent that such difference arises from a change in a factor (including time) that market participants would take into account when pricing the asset or liability. In addition to the ambiguous practical application of such requirement, it appears to contradict the position stated in the Basis for Conclusions, i.e. it appears to be using the term 'fair value' in a different way, thereby confusing the reader.

1.4.2. Subsequent measurement of financial assets

The measurement categories for financial assets in IAS 39 were criticized as being too numerous, complex, and rule-based. Consequently, the IASB discarded them entirely and introduced in IFRS 9 fewer and more principle-based categories.

IAS 39 classifies financial assets in the following categories [IAS39.45]:

- a) *financial assets at FVTPL*. A financial assets is measured in this category when [IAS39.9]:
- it is classified as held-for-trading. A financial asset is held for trading in three cases: 1) it is acquired principally for the purpose of selling it in the near term; 2) on initial recognition it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit-taking; 3) it is a derivative, unless it is accounted for as a hedging instrument.
 - Upon initial recognition, it is designated by the entity in such category via the fair value option. An entity may use this designation 1) when allowed by the requirements for embedded derivatives or 2) when doing so results in more relevant information, either because it eliminates or significantly reduces an

accounting mismatch,¹⁰ or because a group of financial instruments is managed and its performance is evaluated on a fair value basis and so presented to key management personnel. However, investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be estimated reliably cannot be designated under the fair value option.

Financial assets in this category shall be subsequently measured at their fair values, without any deduction for transaction costs incurred on sale or other disposal [IAS39.46], and gains or losses arising from changes in their fair value shall be recognized in profit or loss [IAS39.55].

- b) *Held-to-maturity investments*. These are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention¹¹ and ability to hold to maturity, other than those designated as at FVTPL or as available for sale or that meet the definition of loans and receivables [IAS39.9].

A so-called tainting provision [IAS39.9] forbids the entity from classifying financial assets as held to maturity if it has, during the current financial year or the two preceding ones, sold or reclassified more than an insignificant amount (in relation to their total amount) of held-to-maturity investments before maturity, other than sales or reclassifications that: 1) are so close to maturity that changes in market interest rate would not have a significant effect on the asset's fair value; 2) occur after the entity has collected substantially all of the asset's original principal; or 3) are attributable to an isolated event that is beyond the entity's control, is not recurring, and could not have been reasonably anticipated by the entity.¹²

¹⁰ I.e. a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases.

¹¹ The circumstances in which an entity does not have such positive intention include when: a) it intends to hold the asset for an undefined period; b) it stands ready to sell asset in response to changes in market interest rates or other risks, liquidity needs, etc.; c) the issuer (counterparty) has the right to settle the debt instrument (asset) at an amount significantly below its amortized cost.

¹² Sales before maturity are compatible with the entity's positive intention to hold other investments until maturity if they are attributable to the following: a) disaster scenarios such as a bank run; b) a significant deterioration in the issuer's creditworthiness; c) a change in tax-law that eliminates or significantly reduces

Financial assets in this category shall be subsequently measured at amortized cost using the effective interest method [IAS39.46].¹³ Gains or losses are recognized in profit or loss through the amortization process and when the financial asset is derecognized or impaired [IAS39.56].

- c) *Loans and receivables*. [IAS39.9] These are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market (and that may or may not have fixed maturity, and only in the latter case the entity may plan to hold them until maturity), other than the financial assets:
- that are held for trading;
 - that are designated at initial recognition as at FVTPL;
 - that are designated at initial recognition as available for sale; or
 - for which the holder may not recover substantially all of its initial investment (other than because of credit deterioration) which shall be classified as available for sale.

Note that loans and receivables may or may not have fixed maturity, and only in the latter case may the entity plan to hold them until maturity (otherwise they would meet the definition of held-to-maturity). In fact, a financial asset with fixed maturity will be classified into held-to-maturity investments or into loans and receivable depending on the entity's intentions about the holding period. Put it differently, an entity may have the positive intention of holding until maturity an instrument measured in loans and receivables only if that instrument has no fixed maturity. In fact, if such instrument had fixed maturity along with the entity's positive intention, it would be by definition a held-to-maturity investment.

Loans and receivables, like held-to-maturity investments, shall be subsequently measured at amortized cost using the effective interest method [IAS39.46]. Gains or

the tax-exempt status of interest on the investment; d) a major disposition or business combination; e) changes in statutory or regulatory requirements that causes an entity to dispose of the investment.

¹³ The effective interest rate inherent in a financial instrument is the rate that exactly discounts the estimated cash flows through the instrument's expected life. The computation includes all fees and points paid or received, directly attributable transaction costs, and all other premiums or discounts.

losses are recognized in profit or loss through the amortization process and when the financial asset is derecognized or impaired [IAS39.56].

- d) *Available-for-sale financial assets*. These are non-derivative financial assets that are designated as available for sale or that are not classified as 1) loans and receivables, 2) held-to-maturity investments or 3) financial assets at FVTPL. Investments in equity instruments normally belong to this category, unless they are designated as at FVTPL or they are measured at cost [IAS39.9].

Gains or losses arising from changes in the fair value of available-for-sale financial assets are recognized in equity in other comprehensive income (OCI), except for impairment losses¹⁴ and certain foreign exchange gains and losses [IAS39.46].¹⁵ In addition, any interest calculated using the effective interest rate method (e.g. on loans measured as available for sale) is recognized in profit or loss. Dividends on an available-for-sale equity instrument are recognized in profit or loss when the entity's right to receive payment is established [IAS39.55]. When the financial asset is derecognized, the cumulative gains and losses in OCI shall be reclassified from equity to profit or loss.

- e) Some *investments in equity instruments* are *measured at cost*¹⁶ if they do not have a quoted price in an active market and their fair value cannot be estimated reliably; such equity instruments cannot be designated under the fair value option [IAS39.9].

For *financial assets recognized using settlement date accounting* that are carried at cost or amortized cost, any change in fair value during the period between the trade date and the settlement date is not recognized, except for impairment losses. If they are carried at fair

¹⁴ Despite the fact that available-for-sale financial assets are measured at fair value through OCI, they are subject to the impairment requirements of IAS 39, which will be explained shortly.

¹⁵ [AG83] For the purpose of recognizing foreign exchange gains and losses, a monetary available-for-sale financial asset is treated as if it were carried at amortized cost in the foreign currency. Accordingly, for such a financial asset exchange differences resulting from changes in amortized cost are recognized in profit or loss. For available-for-sale financial assets that are not monetary items (e.g. equity instruments), the gain or loss that is recognized in OCI according to the default method includes any related foreign exchange component.

¹⁶ NB: under cost measurement, the difference between the value at initial recognition and the value at disposal (or other derecognition) is not subject to accrual accounting, whereas under amortized cost measurement such amount is accrued by using the effective interest rate method. Only the former type of measurement is applicable to equity instruments.

value, however, the change in fair value shall be recognized in profit or loss or in OCI [IAS39.57].

Notwithstanding the above requirements, financial assets that are designated as hedged items are subject to measurement under the hedge accounting requirements. Furthermore, all financial assets other than those measured at FVTPL are subject to the impairment requirements [IAS39.46].

1.4.3. Subsequent measurement of financial liabilities

The measurement requirements for financial liabilities in IAS 39 were usually not considered very problematic. A conspicuous exception was the fair value option for financial liabilities (known as the ‘own credit’ issue), which counter-intuitively led to accounting for a gain when a liability’s fair value declined (hence likely obfuscating the worsening credit standing of the entity) and, vice versa, to a loss when a liability’s fair value increased. The IASB eventually decided to carry forward all IAS 39 requirements for the measurement of financial liabilities unchanged to IFRS 9 except for the fair value option, which was modified to solve the own credit issue. The requirements of IAS 39 are the following.

Under IAS 39, after initial recognition an entity measures by default all *financial liabilities at amortized cost* using the effective interest method [IAS39.47]. In this case, gains or losses are recognized in profit or loss through the amortization process and when the financial liability is derecognized. However, if specific criteria are met, financial liabilities shall be measured in the following categories:

- a) *financial liabilities at FVTPL*. A financial liability is measured in this category if it meets any of the following conditions [IAS39.9]:
 - it is classified as held for trading. A financial liability is held for trading in four cases: 1) it is incurred principally for the purpose of repurchasing it in the near term; 2) on initial recognition, it is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; 3) it is a derivative, except if it is accounted for as a hedging instrument or if it is linked to and must be settled

by delivery of an equity instrument that does not have a quoted price in an active market for an identical instrument and whose fair value cannot be reliably measured; 4) it is an obligation to deliver financial assets borrowed but not yet owned by the seller (i.e. short-selling).

- It is contingent consideration of an acquirer in a business combination that is under the scope of IFRS 3 *Business Combinations*.¹⁷
- Upon initial recognition, it is designated by the entity in such category under the fair value option. An entity may use this designation 1) when allowed by the requirements for embedded derivatives or 2) when doing so results in more relevant information, either because it eliminates or significantly reduces an accounting mismatch, or because a group of financial instruments is managed and its performance is evaluated on a fair value basis and so presented to key management personnel.

Financial liabilities in this category shall be subsequently measured at their fair values [IAS39.47], and gains or losses arising from changes in their fair value shall be recognized in profit or loss [IAS39.55].

- b) *Derivative liabilities measured at cost*. A derivative liability is normally measured at FVTPL, but it shall be measured at cost if it is linked to and must be settled by delivery of an equity instrument that does not have a quoted price in an active market for an identical instrument and its fair value cannot be reliably measured [IAS39.47].
- c) Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies [IAS39.47] (see paragraph 1.3.2).
- d) *Financial guarantee contracts*. After initial recognition, an issuer of such a contract shall measure it at the higher of a) the amount determined in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and b) the amount initially recognized less, when appropriate, cumulative amortization recognized in accordance with IAS 18 *Revenue* [IAS39.47].

¹⁷ Contingent consideration is an obligation of the acquiring entity to transfer additional assets or equity interests to the former owners of the acquiree.

- e) *Commitments to provide a loan at below-market interest rate*, which shall be measured in the same way as financial guarantee contracts [IAS39.47].

Notwithstanding the above requirements, financial liabilities that are designated as hedged items are subject to measurement under the hedge accounting requirements [IAS39.47].

1.4.4. Embedded derivatives

IAS 39 lays out specific requirements for the splitting of hybrid (combined) contracts containing an embedded derivative component,¹⁸ mainly to prevent entities from circumventing the recognition and measurement requirements for derivatives simply by embedding one in a non-derivative contract [IFRS9.BCZ4.89,90]. Much of the so-called bifurcation approach in IAS 39 was criticized as being complex and rule-based, and thus the IASB decided not to include it in IFRS 9 with regard to hybrid contracts with a financial asset host, but kept it for hybrid contracts with other host.

Under IAS 39, an embedded derivative shall be separated from the host contract and accounted for as a derivative if all the following conditions are met [IAS39.11]:

- a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;¹⁹
- b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- c) the hybrid instrument is not measured at fair value with changes in fair value recognized in profit or loss (i.e. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated). The problematic nature of this condition is discussed in the last paragraph of this section.

¹⁸ An embedded derivative is a component of a hybrid instrument that also contains a non-derivative host contract, with the effect some of the cash flows of the hybrid instrument vary in a way similar to a standalone derivative [IAS39.10].

¹⁹ See the Application Guidance on IAS 39 para. AG30 and AG33 for many examples of when such condition is or is not met.

Notwithstanding the above requirements, if the entity is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent reporting period, it shall designate the entire hybrid contract as at FVTPL [IAS39.12].

If an embedded derivative is separated, the host contract shall be accounted for under IAS 39 if it is a financial instrument, or in accordance with other Standards if it is not a financial instrument, while the separated derivative shall be measured as a normal derivative [IAS39.11].

The confusing way in which condition c) is spelled out in IAS 39 (above reported *verbatim* from the Standard) seems to mean that hybrid contracts whose host contract is a financial instrument not measured at FVTPL or a non-financial item are subject to bifurcation (provided the other conditions are met), but hybrid contracts whose host contract is a financial asset or financial liability measured at FVTPL are never subject to bifurcation requirements. This interpretation (which seems the only logical one) would render such requirement incoherent with other parts of IAS 39. To understand why, let us remember that the Standard states that a financial instrument is measured at FVTPL either because it is held for trading, or because the entity elected the fair value option [IAS39.9]. It also states that an entity may use the fair value option 1) when allowed by the requirements for embedded derivatives or 2) when doing so results in more relevant information (either because it avoids an accounting mismatch, or because a group of financial instruments is managed at fair value). Eligibility criterion no. 1 refers to the following requirements [IAS39.11A]:

- if a contract contains one or more embedded derivatives, an entity may designate the entire hybrid contract as a financial asset or financial liability at FVTPL unless: i) the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract, and ii) when it is clear with little or no analysis that separation of the embedded derivative is prohibited (e.g. by law).

First, according to a recommendation by the (IFRIC),²⁰ the scope of para. 11A is unclear as to whether such fair value option is applicable only to hybrid contracts that have financial hosts or also to hybrid contracts that have non-financial hosts. However, even leaving that

²⁰ Reported in the footnote of IAS39.11A

problem aside and assuming that the former restrictive interpretation is correct, para. 11A apparently allows any hybrid contract (with financial host) to be elected under the fair value option unless condition i) or ii) occur. A question thus arises: whether a hybrid contract that fits either condition i) or ii) above is still eligible for the fair value option under eligibility criterion no. 2 or not. In other words, it is unclear whether eligibility criteria no. 1 and 2 are mutually exclusive or can be used interchangeably. For instance, consider a hybrid instrument whose cash flows are not significantly influenced by the embedded derivative component. Para. 11A would prevent such contract from being measured under the fair option, yet it appears possible for an entity to simply measure the financial host under the fair value option (provided it is part of a group of financial instruments managed at fair value or if doing so avoids an accounting mismatch). Then, condition c) above explicitly states that a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated. Therefore, the embedded derivative requirements in IAS 39 either contain a loophole or severely lack clarity. However, much of this discussion is rendered moot by the fact that IFRS 9 dispensed with large part of these requirements.

1.4.5. Reclassifications

The reclassification requirements for financial assets in IFRS 9 obviously do not bear much resemblance to those in IAS 39, since measurement categories for assets in the two Standards are very different. On the other hand, IFRS 9 carries forward the prohibition of IAS 39 to reclassify financial liabilities; this is coherent with the decision to retain most of the classification and measurement requirements for financial liabilities from IAS 39.

Under IAS 39 [IAS39.50], an entity:

- a) shall never reclassify a derivative out of the FVTPL category.
- b) Shall never reclassify a financial instrument out of the FVTPL category if it has been so designated with the fair value option.
- c) Shall never reclassify a financial instrument into the FVTPL category.
- d) May reclassify a held-for-trading financial asset out of the FVTPL category if it is no longer held for the purpose of selling or repurchasing it in the short term. The Standard specifies that such reclassifications (for instance, into the amortized cost or

available-for-sale categories) should only take place in rare circumstances [IAS39.50B]. However, such limitation of frequency does not apply to a held-for-trading financial asset that is compatible with the definition of loans and receivables, if the entity reclassifies it out of the FVTPL category with the intention and ability to hold it for the foreseeable future or until maturity [IAS39.50D].²¹ The new cost or amortized cost of financial asset reclassified out of the FVTPL category shall be measured as its fair value at the date of reclassification, and any gains or losses already recognized in profit or loss shall not be reversed [IAS39.50C].

- e) May reclassify a financial asset that is compatible with the definition of loans and receivables out of the available-for-sale category and into loans and receivables, if the entity has the intention and ability to hold it for the foreseeable future or until maturity [IAS39.50E]. The new amortized cost of such financial asset shall be its fair value at the date of reclassification.
- f) May reclassify a held-to-maturity investment into the available-for-sale category if a change in intention or ability make the original classification no longer appropriate [IAS39.51]. Whenever sales or reclassifications of more than a significant amount of held-to-maturity investments do not meet the conditions in para. IAS39.9, all the remaining held-to-maturity investments shall be reclassified as available for sale (tainting provision) [IAS39.52].

If, as a result of a change in intention or ability, or in the rare circumstance that a reliable measure of fair value is no longer available, or because ‘two of the preceding financial years’ referred to in IAS39.9 have passed, it becomes appropriate to carry a financial asset or financial liability at cost or amortized cost rather than fair value, the fair value carrying amount of that financial instrument on that date becomes its new cost or amortized cost [IAS39.54]. Any previously recognized gains or losses in OCI shall be accounted for as follows:

²¹ NB: in the latter case the instrument should not have fixed maturity, otherwise it would meet the definition of held-to-maturity investment. Unfortunately, this part of the Standard appears rather confused.

- in the case of a financial asset with a fixed maturity, the gain or loss shall be amortized over the remaining life of the held-to-maturity investment using the effective interest method. Any difference between the new amortized cost and the maturity amount shall also be amortized over the remaining life of the financial asset using the effective interest rate method, similar to the amortization of a discount or premium. If the financial asset is subsequently impaired, any gain or loss that has been recognized in OCI is reclassified to profit or loss.
- In the case of a financial asset that does not have a fixed maturity, the gain or loss shall be recognized in profit or loss when the financial asset is sold or otherwise disposed of. If the financial asset is subsequently impaired, any previous gain or loss that has been recognized in OCI is reclassified to profit or loss.

The following changes in circumstances are not considered reclassifications [IAS39.50A]:

- a derivative that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such.
- A derivative becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge.
- A financial asset that is reclassified when an insurance company changes its accounting policies in accordance with para. 45 of IFRS 4 *Insurance Contracts*.

1.5. Impairment

The 'incurred loss' model for impairment in IAS 39 has been heavily criticized for systematically delaying the recognition of impairment losses until after the credit loss event has actually occurred. Another major complaint was the complexity arising from having to apply the impairment model to the many categories of financial assets. With IFRS 9, the IASB introduced a more principle-based and forward-looking impairment model that is conceptually superior and more dependent on judgment.

Under IAS 39, an entity shall assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired [IAS39.58].

Objective evidence of impairment results from a 'loss event(s)' that has occurred since initial recognition financial asset, with an impact on the asset's estimated future cash flows that is reliably estimated. Importantly, losses expected as a result of future events, no matter how likely, are not recognized. Examples of objective evidence of impairment include observable data about the following events [IAS39.59]:

- a) a significant financial difficulty of the issuer or obligor emerges.
- b) There is a breach of contract.
- c) The entity (lender) grants a concession to the counterparty (borrower) due to financial difficulty of the latter.
- d) It becomes probable that the borrower will enter bankruptcy.
- e) The active market for that financial asset disappears because of financial difficulty.
- f) There is a measurable decrease in the estimated future cash flows from a group of financial assets, even though such decrease cannot yet be identified with individual financial assets.
- g) Relatively to equity instrument, there are significant adverse changes in the technological, market, economic, or legal environment in which the issuer operates indicating that the cost of the investment may not be recovered.
- h) There is a significant or prolonged decline in the fair value of an investment in equity below its cost.

It is important to note that a decline in the fair value of a financial asset below its carrying amount (cost or amortized cost) is not necessarily evidence of impairment (e.g. a decline in the fair value of a bond that results from an increase in the risk-free interest rate) [IAS39.60].

1.5.1. Impairment of financial assets at amortized cost

If there is objective evidence that an impairment loss has been incurred on an asset carried at amortized cost (i.e. loans and receivables or held-to-maturity investments), the amount of the loss is measured as the difference between a) the asset's carrying amount and b) the present value of estimated future cash flows (excluding future losses that have not been incurred) discounted at the asset's original effective interest rate. The carrying amount shall be reduced

either directly or through use of an allowance account, and the amount of the loss shall be recognized in profit or loss [IAS39.63].

If the amount of the impairment loss decreases in a subsequent period (i.e. fair value increases) for a reason that can be objectively related to an event occurring after the impairment was recognized, the previous impairment loss shall be reversed either directly or by adjusting the allowance account, with the reversal amount recognized in profit or loss. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been, had the impairment not been recognized, at the date the impairment is reversed [IAS39.65].

1.5.2. Impairment of financial assets at cost

If there is objective evidence that an impairment loss has been incurred on an equity instrument measured at cost (i.e. that is not quoted in an active market nor its fair value is reliably measured), or on a derivative asset that is linked to and must be settled by delivery of such equity instrument, the amount of the impairment loss is measured as the difference between a) the asset's carrying amount and b) the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment loss shall not be reversed. [IAS39.66]

1.5.3. Impairment of available-for-sale financial assets

When a decline in the fair value of an available-for-sale financial asset has been recognized in OCI and objective evidence that the asset is impaired emerges, an amount of accumulated losses shall be reclassified from equity to profit or loss as a reclassification adjustment, even though the asset has not been derecognized [IAS39.67]. Such amount shall be the difference between i) the acquisition cost (net of any principal repayment and amortization) and ii) current fair value, less any impairment loss on that financial asset previously recognized in profit or loss [IAS39.68].

If in a subsequent period the amount of the impairment loss on an available-for-sale debt instrument decreases (i.e. its fair value increases) for a reason that can be objectively related

to an event occurring after the impairment was recognized, the previously recognized impairment loss shall be reversed, with the reversal amount recognized in profit or loss [IAS39.70]. On the other hand, if impairment is recognized for an available-for-sale equity investment and the fair value subsequently increases, the increase in value shall be recognized in OCI and not as a reversal of the impairment loss through profit or loss [IAS39.69].

1.6. Hedge accounting

The hedge accounting requirements in IAS 39 have been criticized for being complex and at times arbitrary, and for not representing actual risk management activities. Consequently, the IASB introduced a new general hedge accounting model in IFRS 9, which maintained the general concepts from the previous one but loosened the eligibility and effectiveness criteria in order to reflect more closely risk management practices.

IAS 39 does not specify how an entity should manage its risk, but lays out a series of requirements for hedge accounting to take place, i.e. there must be an eligible hedging instrument and an eligible hedged item, and the hedging relationship must satisfy certain qualification criteria.

1.6.1. Types of hedging relationships

IAS 39 presents the following types of possible hedging relationships (which must meet further criteria in order to qualify for hedge accounting) [IAS39.86]:

- a) fair value hedge, which offsets an exposure to changes in fair value that is attributable to a specific risk of a recognized asset or liability or an unrecognized firm commitment (or an identified portion of those items) and could affect profit or loss.
- b) Cash flow hedge, which offsets the exposure to variability in cash flows that is attributable to a specific risk of a recognized asset or liability or a highly probably forecast transaction (or an identified portion of those items) and could affect profit or loss.

- c) A hedge of a net investment in a foreign operation as defined in IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

A hedge of the foreign currency risk of a firm commitment may be accounted for as either a cash flow hedge or a fair value hedge [IAS39.87].

1.6.2. Hedging instruments

An entity may designate a derivative as hedging instrument in any qualifying hedging relationships, with the exception of some written options. On the other hand, an entity may designate a non-derivative financial asset or liability as hedging instrument only in a hedge of foreign currency risk [IAS39.72].

Written options are problematic instruments for hedging purposes, because their potential loss may be significantly greater than the potential gain in value of a related hedged item. Therefore, a written option is not usually considered an effective hedging instrument. Furthermore, interest rate collars or other derivatives that combine a written option with a purchased option cannot be designated as hedging instruments if they are a net written option (for which a net premium is received). However, a written option does qualify as a hedging instrument if it is designed to offset a purchased option, including one that is embedded in another financial instrument. [IAS39.AG94]

For hedge accounting purposes, only instruments that involve a party external to the reporting entity can be designated as hedging instruments, whereas internal hedges normally cannot. Intragroup hedging transactions that transfer risk between different companies within a group are not reported in the consolidated financial statement, although they may be reported in the separate financial statement of an individual entity of the group. Intra-entity hedging transactions between different divisions within the same company are not reported in the entity's financial statements. [IAS39.73]

An entity normally designates a hedging instrument in its entirety for a hedging relationship. Exceptions are permitted if the entity [IAS39.74]:

- a) separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value;
- b) separates the interest element and the spot price of a forward contract and designates as the hedging instrument only the spot element;²² or
- c) designates as the hedging instrument only a proportion of the entire instrument, such as 50% of the notional amount. However, a hedging relationship may not be designated for only a portion of the time of the instrument's life. [IAS39.75]

Furthermore, an entity may designate a single hedging instrument as a hedge for multiple types of risk provided that a) the risks hedged can be identified clearly, b) the effectiveness of the hedge can be demonstrated, and c) it is possible to ensure that there is specific designation of the hedging instrument and the different risk positions. [IAS39.76]

An entity may also view in combination multiple derivatives, or proportions of them (or, in the case of a hedge of currency risk, multiple non-derivatives or proportions of them, or a combination of derivatives and non-derivatives), and jointly designate them as one hedging instrument [IAS39.77]. The Standard then affirms that none of the individual derivatives jointly designed can be a written option or a net written option. The rationale of this restriction seems at odds with the previously stated possibility for the entity to designate as a hedging instrument an interest rate collar or an other derivative that combines a written option with a purchased option (unless it is a net written option). There does not seem to be any relevant difference between such derivative (that contains a written option) and a combination of multiple derivatives (that contains a written option), yet the Standard allows only the former to be designated as a hedging instrument.

1.6.3. Hedged items

A hedged item can be [IAS39.78]:

- a) a single recognized asset or liability, an unrecognized firm commitment, a highly probable forecast transaction or a net investment in a foreign operation.

²² Exceptions a) and b) are permitted because the intrinsic value of an option and the premium on a forward contract (and hence its spot value) can generally be measured separately.

- b) A group of assets, liabilities, firm commitments, highly probable forecast transactions or net investments in foreign operations, all with similar risk characteristics. The change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in the fair value of the group attributable to the hedged risk [IAS39.83].²³
- c) For a portfolio hedge of interest rate risk only, a portfolio portion made up of financial assets or financial liabilities that share the risk being hedged.

A firm commitment to acquire a business combination cannot be a hedged item except for foreign currency risk, because the other risks cannot be specifically identified and measured since they are general business risks [IAS39.AG98]. In addition, an equity method investment cannot be a hedged item in a fair value hedge because the equity method recognizes in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. The same applies to an investment in a consolidated subsidiary [IAS39.AG99].

Unlike loans and receivables, a held-to-maturity investment cannot be a hedged item with respect to interest rate risk or prepayment risk given that such designation requires the intention to hold the investment until maturity [IAS39.79].

For hedge accounting purposes, assets, liabilities, firm commitments, or highly probable forecast transactions that involve a party internal to the entity cannot be designated as hedged items. As an exception, the foreign currency risk of an intragroup monetary item (e.g. payable/receivable between two subsidiaries) may qualify as a hedged item in the consolidated financial statements if it results in an exposure to foreign exchange rate gains or losses that would not be fully eliminated on consolidation (because the monetary item is transacted between two sub-entities with different functional currencies). [IAS39.80]

With respect to a financial asset or liability, the entity may choose to designate as a hedged item just a portion of its cash flows or fair value, provided that effectiveness can be measured

²³ This restrictive condition was criticized for being often impossible to satisfy, thereby making such hedging strategy unavailable.

[IAS39.81]. Exclusively in a fair value hedge of interest rate exposure on a portfolio of either financial assets or financial liabilities, the hedged portion may be designated in terms of an amount of currency rather than individual instruments [IAS39.81A]. Inflation components of financial instruments that are not contractually specified are assumed to not be separately identifiable and reliably measurable, and hence can never be separately designated as the hedged item [IAS39.AG99F(b)]. Conversely, a contractually-specified inflation portion of an inflation-linked bond (assuming bifurcation does not take place) is separately identifiable and reliably measurable provided the other cash flows from the instruments are not affected by inflation, and hence may be designated as the hedged item [IAS39.AG99F(c)].

A hedge of a net position (e.g. the net of all fixed rate assets and fixed rate liabilities with similar maturities) does not qualify for hedge accounting [IAS39.81A, IAS39.AG101].

Non-financial assets and non-financial liabilities may be designated as hedged items in its entirety for all risks or just for foreign currency risk, because cash flows or fair value changes attributable to other risks are too difficult to isolate and measure [IAS39.82].

1.6.4. Qualifying criteria for hedge accounting

A hedging relationship qualifies for hedge accounting if all the following conditions are met [IAS39.88]:

- a) at the inception of the hedge there is formal designation and documentation of the hedging relationship and of the entity's risk management objective and strategy for undertaking the hedge.²⁴
- b) The hedge is highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management objective for that particular hedging relationship. A hedge qualifies as highly effective if: 1) at inception and at least annually, the hedge is assessed prospectively as highly effective and such expectation can be reliably explained (e.g.

²⁴ The documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness.

through comparison with past changes or statistical correlation), and 2) the actual results of the hedge have been within a range of 80-120 percent throughout the financial reporting periods for which the hedge was designated.²⁵ [IAS39.AG105]

- c) The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be measured reliably.
- d) For cash flow hedges, the hedged forecast transaction must be highly probable and potentially affect profit or loss.

1.6.5. Accounting for fair value hedges

A qualifying fair value hedge shall be accounted for as follows [IAS39.89]:

- a) the gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount (for a non-derivative hedging instrument) shall be recognized in profit or loss.
- b) For hedged items otherwise measured at cost, the gain or loss on the hedged item attributable to the hedged risk shall adjust the item's carrying amount and be recognized in profit or loss. If the hedged item is an available-for-sale financial asset, such gain or loss shall be recognized in profit or loss.
- c) Any adjustment arising from point b) above to the carrying amount of hedged financial instrument for which the effective interest method is used shall be amortized to profit or loss. The adjustment is based on a recalculated effective interest rate at the date amortization begins. However, exclusively in the case of a fair value hedge of interest rate exposure on a portfolio of financial assets or liabilities, the adjustment may be amortized using a straight-line method if the using a recalculated effective interest rate is not practical. [IAS39.92]
- d) In case the hedged item is an unrecognized firm commitment, its subsequent cumulative change in fair value attributable to the hedged risk is recognized as an

²⁵ For instance, if the loss on the hedging instrument is €110 and the gain on the hedged item is €100, hedge effectiveness can be calculated as either $€110/€100=110\%$ or $€100/110€=91\%$, both within the allowed range.

asset or liability with a corresponding gain or loss recognized in profit or loss.
[IAS39.93]

The entity shall discontinue prospectively a fair value hedge in any of the following circumstances [IAS39.91]:

- the hedging instrument expires or is sold, terminated or exercised. However, the replacement or roll-over of a hedging instrument is not considered an expiration or termination if it is part of the entity's documented hedging strategy;²⁶
- the hedge no longer meets the qualifying criteria for hedge accounting; or,
- the entity revokes the designation.

1.6.5. Accounting for cash flow hedges

A qualifying cash flow hedge shall be accounted for as follows:

- a) the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized in OCI, whereas the ineffective portion shall be recognized in profit or loss [IAS39.95].
- b) The separate component of equity associated with the hedged item is adjusted to the lesser of i) the cumulative gain or loss on the hedging instrument from inception of the hedge and ii) the cumulative change in fair value (present value) of the expected future cash flows on the hedged item from inception [IAS39.96].

If a hedge of a forecast transaction subsequently results in the recognition of a financial asset or financial liability, the associated gain or loss that were recognized in OCI according to point a) above shall be reclassified to profit or loss as a reclassification adjustment in the same period(s) during which the hedged forecast cash flows affect profit or loss. However, the entity shall reclassify into profit or loss as a reclassification adjustment any portion of a loss recognized in OCI that it expects not to recover in future periods [IAS39.97].

²⁶ In June 2013, the IASB amended this requirement introducing an exception for derivative instruments that are novated to a central counterparty as a consequence of laws or regulations.

If instead a hedge of a forecast transaction subsequently results in the recognition of a non-financial asset or non-financial liability, or a forecast transaction for such items becomes a firm commitment for which fair value hedge accounting is applied, the entity shall consistently behave in one of the following ways [IAS39.98]:

- it can reclassify the associated gains and losses recognized in OCI in accordance with para. IAS39.95 to profit or loss as a reclassification adjustment in the same period(s) during which the asset acquired or liability assumed affects profit or loss. However, the entity shall reclassify into profit or loss as a reclassification adjustment any portion of a loss recognized in OCI that it expects not to recover in future periods.
- It can remove the associated gains and losses recognized in OCI in accordance with para. IAS39.95 and include them in the initial carrying amount of the asset or liability.

For all other cash flow hedges, the entity shall reclassify the amounts recognized in OCI to profit or loss as a reclassification adjustment in the same period(s) during which the hedged forecast cash flows affect profit or loss [IAS39.100].

The entity shall discontinue prospectively a cash flow hedge in any of the following circumstances [IAS39.101]:

- a) the hedging instrument expires or is sold, terminated or exercised. In this case, the amount that was previously accumulated in OCI shall remain separately in equity until the forecast transaction occurs. However, the replacement or roll-over of a hedging instrument is not considered an expiration or termination if it is part of the entity's documented hedging strategy.
- b) The hedge no longer meets the qualifying criteria for hedge accounting. Again, the amount that was previously accumulated in OCI shall remain separately in equity until the forecast transaction occurs.
- c) The forecast transaction is no longer expected to occur, in which case the amount that was previously accumulated in OCI shall be reclassified to profit or loss as a reclassification adjustment.

- d) The entity revokes the designation, in which case the amount that was previously accumulated in OCI shall remain separately in equity until the forecast transaction occurs or is no longer expected to occur.

1.6.5. Accounting for hedges of a net investment in a foreign operation

Such hedges shall be accounted for similarly to cash flow hedges [IAS39.102]:

- the portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized in OCI, whereas the ineffective portion shall be recognized in profit or loss.
- The gain or loss on the hedging instrument that has been recognized in OCI shall be reclassified to profit or loss as a reclassification adjustment on the disposal of the investment in a foreign operation.

Chapter II – The development of IFRS 9

2.1. Overview

The final version of IFRS 9 *Financial Instruments*, issued in July 2014, is the culmination of the IASB's profound revision of the accounting for financial instruments. The former Standard IAS 39 *Financial Instruments: Recognition and Measurement* had long been criticized for several reasons, such as lack of relevance and understandability of the information provided, but it was only after the global financial crisis had struck that the IASB decided to replace IAS 39 altogether. In response to recommendations of the G20 and other international bodies, the Board decided to renovate financial instrument accounting expeditiously. As mentioned, the goal was to address stakeholder concerns that the requirements in IAS 39 were difficult to understand, apply and interpret, and to create a more principle-based Standard instead of a rule-based one.

The IASB divided the project in three phases, which brought the following innovations:

- 1) a reformed model for classification and measurement of financial assets, introduced with the first version of IFRS 9 of November 2009, to which in October 2010 were added requirements for financial liabilities almost unchanged from IAS 39.
- 2) A forward-looking impairment model that applies to all items subject to impairment, included in the Standard in July 2014 as the result of three previous exposure documents.
- 3) A new model for general hedge accounting that is more closely aligned with actual risk management practices, included in the Standard in November 2013.

The specific requirements of the final Standard are discussed in the next chapter, while the following paragraphs retrace the stepping stones of the revision of financial instruments accounting. The reader will often find that requirements proposed in the IASB's exposure documents, and sometimes even in allegedly finalized chapters of the Standard, are subsequently modified by the IASB in light of information arising from additional feedback. It is therefore recommended to use this chapter only as a guide in understanding the gradual emergence of the concepts and requirements that eventually crystalized in IFRS 9.

2.2. Lack of convergence with US GAAPs

The IASB's extensive project for the reformation of financial instruments accounting began in concert with the Financial Accounting Standards Board (FASB), the U.S.-specific standard setter. The two Boards had set up together the Financial Crisis Advisory Group (FCAG) in October 2008 in a cooperative effort to improve and possibly converge the reporting of financial instruments.²⁷ Initially, the FASB decided to work toward the introduction of new requirements in one solution, whereas the IASB opted for a piecemeal approach aimed at ensuring as a prompt response as possible to the crisis, dividing the project in three main phases. To the dismay of many, the two Boards eventually parted ways, the widespread desire for convergence giving way to divergent preferences of the two Boards and part of their constituency, and also to differences in the existing legal frameworks. In the 2014 Global IFRS Banking Survey by Deloitte, over half of the respondent banks said they were disappointed by the lack of convergence (Deloitte, Jun. 2014). In fact, investors and other users of financial statements are confused by the lack of comparability, while preparers (above all, banks with global operations) incur higher compliance costs. The FASB is expected to issue its new Standard for financial instruments in the fourth quarter of 2015 (FASB, Technical Agenda), which will:

²⁷ The long-term objective of convergence was first affirmed in the Memorandum of Understanding known as "Norwalk Agreement" in 2002, and consequently in "A Roadmap for Convergence between IFRSs and US GAAP2006-2008" and later updates.

- 1) make targeted improvements to existing classification and measurement (which are similar to those in IAS 39) requirements;
- 2) introduce an impairment model in which lifetime expected losses are recognized for all instruments;
- 3) make targeted improvements to their existing hedge accounting requirements (which are similar to those in IAS 39), although not in the same direction as IFRS 9.

Although the lack of convergence is a disappointment to many, investors and preparers in the EU may find solace in the assessment in the Draft Endorsement Advice by European Financial Reporting Advisory Group (EFRAG) that IFRS 9 will lead to higher quality financial reporting than the corresponding US GAAP [DEA.A2.57,66,73].

2.3. Pros and cons of the incremental approach

As the IASB began to issue the first exposure documents of the project, part of its constituency suggested that the IASB's preferred approach of incremental changes may cause more complexity than the single issuing of a fully-formed Standard (IASB, Mar. 2008). Their concerns mainly related to the uncertainty that would stem from pending requirements as well as the difficulty of evaluating parts of the Standard absent the whole picture. Later in the process, many also voiced concerns about the Board's rapid pace in the process, noting that revisions of so complex a topic needed more time to be properly considered both by the Board and its constituents (IASB, Jul. 2009). The difficulty of handling the large number of documents issued and of analyzing and commenting on each proposal was also highlighted.

On the other hand, the prospect of improving expeditiously the accounting for financial instruments, and especially its most problematic areas, was widely supported by constituents such as the G20 and other international bodies. Furthermore, a more flexible approach would allow the Board to receive detailed feedback and change the direction of future deliberations accordingly. The IASB thus decided not to change its approach, also confident that the process was going to be quick. However, the Board failed repeatedly to finalize the project as expeditiously as promised. In fact, the complete Standard was initially meant to become

effective on 1 January 2013. Yet, in December 2011 the effective date was postponed to 1 January 2015. But in November 2013, when the new general hedge accounting model was released, that effective date was simply removed. The definitive effective date, included in the final Standard, is 1 January 2018.

2.4. Mar. 2008 - DP *Reducing Complexity in Reporting Financial Instruments*

Following the steps of the IASB's rigorous due diligence process,²⁸ the first document we encounter is the Discussion Paper (DP) *Reducing Complexity in Reporting Financial Instruments*, jointly issued by the IASB and FASB in March 2008. The excessive number of ways for measuring financial instruments (considering both the IASB and the FASB Standards) was identified as a paramount cause of complexity in reporting financial instruments. Under IAS 39 alone, financial instruments were being measured in at least four categories, namely, fair value through profit or loss (FVTPL), held-to-maturity investments, available-for-sale financial assets, and loans and receivables. Many other topics were identified as problematic, most prominently hedge accounting and the impairment models, but also several other requirements (definitions, scope of Standards, derecognition rules, presentation, disclosure, etc.).

The DP laid out suggestions as to which intermediate and long-term solutions to the plethora of possible accounting treatments were available. The DP affirmed that the best ultimate solution would be the introduction of a single measurement category for all financial instruments, namely fair value. However, the Boards admitted that addressing all the concerns arising from having this single measurement category could require large systemic adjustments of highly uncertain prospects. The DP therefore presented a number of

²⁸ As described in the IFRS Foundation Constitution and the Due Diligence Handbook, the steps in the due diligence process are the following.

- 1) Research program: gaining knowledge on a problematic topic through a DP.
- 2) Developing a proposal for publication via internal consultation and publication of ED(s).
- 3) Consideration of feedback received, further internal improvement, and possible re-exposure.
- 4) Final internal consultation and publication of the Standard and accompanying material.
- 5) Post-implementation review after the Standard has been applied for about two years.

intermediate solutions that, in line with the long-term objective of increasing fair value use, could decrease complexity and enhance usefulness and understandability. Some solutions envisioned imposing narrower measurement requirements, introducing a single fair value measurement principle with exceptions, or eliminating or simplifying hedge accounting.

The Boards received many comment letters, which were considered in the deliberations leading to the ensuing EDs. Most users of financial statements supported the long-term solution of a single fair value category, holding it as more relevant in understanding an entity's current economic conditions, while promoting consistency and comparability (IASB, Mar. 2008). Conversely, most preparers and auditors did not support the single fair value category, arguing that an exit price (as fair value is) is not relevant for financial instruments that an entity intends to hold until maturity. They argued that in these cases amortized cost is the best reflection of future cash flows. Many preparers were also concerned about the unreliability of fair value when markets are not fully developed or suddenly become illiquid, or when it cannot be determined reliably. On the other hand, respondents were unanimous in objecting the proposed elimination hedge accounting, arguing that the resulting increased volatility in earnings would not reflect the economics of risk management.

2.5. Mar. 2009 – ED/2009/3 *Derecognition: Proposed Amendments to IAS 39 and IFRS7*

The Derecognition ED was published in order to abate the complexity of derecognition requirements in IAS 39, and simultaneously progress toward convergence with U.S. GAAPs. Previous amendments to IAS 39 earlier in the decade had already improved the original derecognition requirements without radically modifying them. A 2002 ED clarified topics including derecognition concepts (risks and rewards of ownership, control and continuing involvement), partial derecognition, pass-through arrangements, and transfers not qualifying for derecognition [IFRS9.BCZ3.1-29]. In spite of all efforts, the 2009 ED pointed out that there was still much complexity arising from the derecognition requirements in IAS 39, which were even deemed internally inconsistent (IASB, Mar. 2009). The ED proposed a new

derecognition approach that would place greater importance on the element of control rather than on the combination of several concepts, and simplify other requirements.

Despite all the problems highlighted above, in 2010 the IASB revised its work plan and decided to abandon any major modifications of the derecognition requirements. Even though the relevant disclosure requirements were improved via amendments to IFRS 7, all derecognition requirements of IAS 39 were carried forward unchanged to IFRS 9. With this decision, the IASB has left unaddressed an accounting area that many perceived as problematic.

2.6. Jun. 2009 – DP/2009/2 *Credit Risk in Liability Management*

This DP and a related Staff Paper explored one of the most problematic areas of IAS 39, namely how a liability's credit risk (i.e. the probability that an entity will fail to perform as required) influences its measurement, known as the 'own credit' issue. Under IAS 39, financial liabilities are normally measured at amortized cost, but an entity can measure a financial liability under the 'fair value option', which requires presenting the entire fair value change (including from changes in its credit risk) in profit or loss. In this case, a decrease in the liability's credit quality and hence in its market price (fair value) would translate in a gain in the borrower's income statement. Conversely, if the financial liability's credit quality improved, a loss would be recorded, leading once again to a potentially counterintuitive outcome. This DP reported the best arguments for and against incorporating credit risk in the current measurement of financial liabilities, soliciting feedback on the proposed measurement approaches to deal with the own credit issue. Briefly, the main arguments in favor of continuing to reflect a liability's changes in credit risk in profit or loss ran as follows:

- Consistency. A loan liability is initially measured at fair value, given that the proceeds from the loan represent the fair value of the future payments promised to the debt holders. This includes the effects of the borrower's credit risk, as well as of other things such as collateral and guarantees. It is therefore consistent to include fair value also in subsequent measurements.

- Wealth transfer. Equity and liabilities represent claims on an entity's assets. When, for any reason, the fair value of liabilities decreases (increases), then a greater (lesser) share of the entity's assets is allocated to the equity holders, and thus a gain (loss) ensues.²⁹
- Accounting mismatch. Changes in credit spreads may simultaneously affect certain financial liabilities and financial assets measured at fair value. Preventing the measurement of financial liabilities from incorporating changes in credit spreads may create an accounting mismatch.

On the other hand, the arguments against were:

- Counter-intuitive results. This aspect generated great interest due to the general deterioration in credit quality during the global financial crisis. Reporting a gain (loss) from a decline (improvement) in a liability's credit quality was seen as counter-intuitive and potentially disguising deteriorated economic conditions. In fact, the position of the borrowing entity (or the wealth of its shareholders) has hardly improved, seeing that its contractual obligations have not changed and that future borrowing may become more expensive after a deterioration in credit quality.
- Accounting mismatch. The same line of argument can also be used against the recognition of own credit risk. A decline in an entity's credit standing may well derive from value changes that do not appear in financial statements, such as changes in the value of assets measured at amortized cost (e.g. fixed assets and goodwill), unrecognized intangible assets, or simply in the case of declining market confidence in the entity's management. Recognizing a liability's credit-related changes in profit or loss may therefore create an accounting mismatch.
- Realization. Measuring assets at fair value can be informative because the management is usually able to sell them when it desires. Conversely, many liabilities are never transferred, because it is unpractical to do so or counterparty permission is required. It would be reasonable to measure a liability at fair value if the entity could benefit from changes in its value (i.e. if it is held for trading). However, this is rarely the case when

²⁹ A liability's fair value may change because of a change in: the estimated cash flows (e.g. worsening of the liability's credit risk), the entity's credit standing, interest rates, credit spreads from similar liabilities, exchange rates.

credit-related changes occur: repurchasing the loans (even at the lower price) may be hard precisely because the entity has lower credit standing. If instead the liability's credit quality has increased along with its fair value, the entity of course has no incentive to repurchase its own more-costly loans.

Most respondents strongly agreed that the effects of a liability's credit risk ought not to affect profit or loss (unless the liability is held for trading), although none of the proposed measurement approaches received support [IFRS9.BC4.48-53]. The IASB later decided to carry forward most of the requirements unchanged from IAS 39 to IFRS 9. The Board believed that financial liabilities measured at amortized cost did not pose any problem, nor did those held for trading. The Board dealt with the only group of financial liabilities for which credit-related changes remained an issue (i.e. those designated under the fair value option) in its 2010 Own Credit Risk ED, which proposed to present such changes in OCI.

2.7. Jul. 2009 – ED/2009/7 *Financial Instruments: Classification and Measurement*

This ED proposed new requirements for the classification and measurement of financial assets and financial liabilities in order to eliminate the complexity arising from the many categories and relative impairment methods in IAS 39. According to proposed 'mixed attribute' approach, a financial asset or liability would be measured at amortized cost when the following conditions are met:

- the instrument has only basic loan features, i.e. it gives rise on specific dates to cash flows that are payments of principal and interest on the principal outstanding. Other contractual terms that change the timing or amount of those payments are not basic loan features, unless they protect the creditor or debtor.³⁰
- The instrument is managed on a contractual yield basis, which depends on whether, at a business-unit level, management focuses on the cash flows contractually generated by

³⁰ As in the case of contractual features that limit the variability (e.g. caps and floors), or permit the issuer to prepay or the holder to put the instrument if such option is not contingent on future events and the prepaid amount substantially represents unpaid principal and interest.

the instrument rather than the cash flows that could arise from its sale (asset) or repurchase (liability).³¹

Any financial instrument that does not meet both conditions would be measured at FVTPL.

As under IAS 39, the proposal would allow a fair value option to designate at initial recognition any financial instrument as measured at FVTPL if doing so eliminates an accounting mismatch.

The ED would also continue to allow entities to designate irrevocably at initial recognition equity investments that are not held for trading as at fair value through other comprehensive income (FVTOCI). On the other hand, the ED proposed that unquoted equity instruments with unreliable fair value should to still be measured at the best fair value estimate rather than, as under IAS 39, at cost less impairment.

While IAS 39 always required the separation of embedded derivatives from their host contracts, the proposals in the ED would require such operation only for certain hybrid contracts where the host is a non-financial instrument, and never if the host is a financial instrument. The IASB believed that eliminating the bifurcation requirements at least for hybrid contracts with financial hosts would reduce the complexity in financial reporting by eliminating yet another classification approach [IFRS9.BC4.89].

The ED proposed to prohibit reclassification of both financial assets and financial liabilities between the categories of amortized cost and fair value. The IASB would consequently be convinced by respondents that such prohibition should not take place for financial assets because it is inconsistent with their actual management [IFRS9.BC4.114].

Finally, the ED proposed to eliminate the so-called tainting provision of IAS 39, i.e. the restriction from measuring financial assets at amortized cost if the entity has sold any of them before maturity.

³¹ The IASB recognized the importance of an entity's business model in predicting how a financial instrument would originate cash flows, i.e. whether contractually or via sale (asset) or repurchase (liability).

Almost all respondents to the ED supported the direction of the proposed changes. Yet, many said that more application guidance was needed, especially on the concepts of ‘basic loan features’ and ‘managed on a contractual yield basis’. Many pointed out that the Board’s fast pace could impair the quality of the resulting Standard; these respondents encouraged the Board to slow down, perhaps addressing financial assets first and financial liabilities later, since the latter had not been a major source of concern.

2.8. Nov. 2009 – IFRS 9 (2009) *Classification and Measurement of Financial Assets*

In November 2009, the IASB finalized the first chapters of IFRS 9 on the classification and measurement of financial assets. The Board heeded to the feedback from the previous ED by prioritizing the classification and measurement of financial assets over that of financial liabilities. This decision was meant to allow entities to move away expeditiously (through early adoption) from the inadequate requirements in IAS 39, as well as to lay the foundation for the other requirements being developed.

IFRS 9 (2009) prescribed only two alternative measurement categories for all financial assets: amortized cost and fair value (but a third one would be introduced in the final version of IFRS 9). A debt instrument that is held within a business model whose objective is to collect contractual cash flows (the business model test)³² and has contractual cash flows that are solely payments of principal and interest (the SPPI criterion)³³ must be measured at amortized cost. A fair value option (as in IAS 39) allows entities to designate at initial recognition debt instruments meeting both criteria at FVTPL if doing so eliminates or significantly reduces an accounting mismatch. All other financial assets (e.g. equity investment, derivatives) must be measured at FVTPL. One exception is made for equity instruments that are not held for trading, which can be irrevocably designated at initial recognition as at FVTOCI, with only dividend income being recognized in profit or loss.

³² Similar to the vaguer concept of assets measured ‘on a contractual yield basis’ in the 2009 Classification and Measurement ED.

³³ Similar to the vaguer concept of ‘basic loan features’ in the 2009 Classification and Measurement ED.

Reclassification of financial assets between amortized cost and FVTPL is required if the relevant business model objective has changed. Such changes are expected to be infrequent.

The tainting provision of IAS 39 is removed, meaning that sales of financial assets measured at amortized cost, even for reasons other than credit deterioration (e.g. to fund capital expenditure), do not invalidate that measurement method for similar instruments, provided they are occasional and non-significant in amount (either individually and in aggregate). To ensure proper disclosure, IAS 1 *Presentation of Financial Statements* and IFRS 7 *Financial Instruments: Disclosures* have been enhanced, requiring among other things that when a debt instrument measured at amortized cost is derecognized prior to maturity the gain or loss on disposal be presented separately in the statement of comprehensive income.

Finally, with regard to embedded derivatives, IFRS 9 (2009) adopted the approach proposed in the preceding ED, whereby a hybrid contract should always be measured as a whole if the host contract is a financial instrument. If the host is not a financial item, separation is only required for non-closely related embedded derivatives.

2.9. Nov. 2009 – ED/2009/12 *Financial Instruments: Amortized Cost and Impairment*

This ED proposed modification to the requirements for the amortized cost measurement category and the impairment of financial assets. This document related to the second phase of the financial instruments project, which was initiated just as the classification and measurement of financial asset drew to a close with the issue of IFRS 9 (2009), on which it logically had to be based. The goal of this phase was to develop an impairment model in order to replace the incurred loss model in IAS 39, whose weaknesses had starkly emerged during the global financial crisis. In fact, such model would systematically delay the recognition of impairment losses to when a credit loss event occurred, forbidding any insight on future losses from being reflected in financial statements. Another weakness was the complexity arising from the different impairment applied to amortized cost assets and available-for-sale assets measured at FVTOCI. The FCAG recommended finding a simpler impairment model that would take account of forward-looking information.

In the lead up to this ED, the IASB discussed two possible impairment models for assets measured at amortized cost, one based on fair value and the other on expected losses. According to the former, a financial asset's impairment loss would be measured by reference to its fair value at the date of impairment testing, resulting in immediate recognition of economic losses. This approach was considered too complex and inconsistent with the cost-based approach, and thus rejected by the IASB (IASB, Nov. 2009). The 2009 Impairment ED proposed requirements for a forward-looking impairment model for financial assets measured at amortized cost. The objective of amortized cost measurement was for the first time³⁴ clearly stated as "to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument" (IASB, Nov. 2009). Amortized cost is the present value of the expected cash flows over the remaining life of the financial instrument discounted using the effective interest rate.

The proposed approach consisted in measuring a financial asset's current amortized cost at the expected credit-adjusted cash flows discounted at the original credit-adjusted effective interest rate, accounting for any difference as an impairment loss. An entity would recognize:

- at initial recognition, lifetime expected credit losses through the credit-adjusted effective interest rate; and
- subsequent changes in expected credit losses. A favorable change in the estimate of expected credit losses would result in a reversal of an impairment loss. Since the initial estimate of expected credit losses is included in determining the effective interest rate, the proposal allowed a favorable change in such estimate to increase the carrying amount of a financial asset above its initial value.

Respondents overall supported the proposals because they would result in earlier recognition of credit losses compared to the existing incurred loss model and hence avoid the systematic bias toward late recognition. Nonetheless, many were concerned about the significant operational challenges that the new method posed, such as maintaining information about expected credit losses for a large number of financial instruments [IFRS9.BC5.89]. The IASB

³⁴ IAS 39 offered only general guidance rather than a clear definition.

(aided by the Expert Advisory Panel) later modified its proposals twice, in a Supplementary Document to this ED in 2011 and again in the final model issued in July 2014.

2.10. May 2010 – ED/2010/4 *Fair Value Option for Financial Liabilities*

Based on the feedback from the Credit Risk DP, the Board concluded that proposed measurement approaches for financial liabilities would not be a worthwhile improvement over the existing requirements in IAS 39, which overall had never posed significant problems. However, whether to recognize credit-related changes in fair value for liabilities under the fair value option was still an unsolved problem. The so-called ‘own credit’ issue was the subject of this ED.

For a liability under the fair value option, IAS 39 required to recognize in profit or loss the changes in fair value arising from changes in its credit risk. As explained previously, this requirement was regarded as not providing useful information and potentially misleading, unless the liability is held for trading. This is because an entity whose liability’s credit quality falls would record a gain in profit or loss as the fair value of a liability decreases, potentially hiding deterioration in the creditworthiness of the entity. On the other hand, improvements in its credit standing may result in the recognition of losses in profit or loss, possibly offsetting the entity’s gains that led to the improvement in credit quality.

The present ED distinguished between financial liabilities held for trading and those designated at FVTPL under the fair value option. The former would continue to be measured at fair value with changes in the credit risk recognized in profit or loss. For the latter, the ED proposes a two-step approach so that changes in credit risk would not affect profit or loss. An entity would first present the entire fair value change in profit or loss, and then translate the portion relating to changes in credit risk into OCI. The IASB recognized that a one step-approach where credit risk changes go directly into OCI, albeit less transparent, could have the advantage of being less complicated (and in fact that is how it was eventually implemented).

A potential drawback is to create an accounting mismatch when the entity is offsetting liabilities under the fair value option with financial assets also measured at FVTPL. Such problem could be avoided by mandating the proposals *unless* they create an accounting mismatch, but the Board did not offer this possibility in the present ED, believing such instances to be rare and not outweighing the benefits of consistency.

In order to determine the amount of change in fair value of a financial liability that is attributable to changes in its credit risk, entities would need to follow the preexisting disclosure guidance in IFRS 7. Under the ‘proxy method’ in IFRS 7, changes in a fair value that are not attributable to changes in market risk (by default identified with changes in the benchmark interest rate) are attributed to its credit risk.³⁵ Entities would be allowed to use any proxy for market risk (e.g. the price another entity’s financial instruments, a currency exchange rate, a commodity price, etc.) if it provides a more faithful representation of the change in credit risk.

Finally, the ED proposed to prohibit recycling (i.e. reclassifying) the amounts from OCI to profit or loss, but allowing recycling to other components of equity (e.g. retained earnings). Note that if the entity repays the liability according to the contractual terms, the cumulative effect of changes in the liability’s credit risk eventually net to zero, and with no amounts left to recycle. Conversely, if the liability is settled before maturity (e.g. repurchased) there could be amounts in accumulated OCI which would be realized when the liability is derecognized. The IASB proposed not to reclassify such amounts to profit or loss, consistently with its view that a gain or loss should be recognized only once [IFRS9.BC5.52-57].

³⁵ The IASB specified that a change in a liability’s credit risk does not include changes in asset-specific performance risk, i.e. the risk arising when an obligation is linked to the performance of single assets or a group thereof.

2.11. Oct. 2010 – IFRS 9 (2010) *Classification and Measurement of Financial Liabilities*

As thoroughly explained, the IASB concluded that the general requirements of IAS 39 for financial liabilities accounting, excluding the own credit issue, were not in need of change. Hence, the IAS 39 classification categories of amortized cost and FVTPL were carried forward unchanged to IFRS 9, thus completing the first phase (classification and measurement) of the project.

As a slight modification of the proposals in the Fair Value Option ED, the IASB decided that for a financial liability under the fair value option, changes in the liability's credit risk shall be recognized directly in OCI (a one-step rather than two-step approach). As the ED proposed, amounts recognized in OCI are not recycled to profit or loss when the liability is settled or otherwise derecognized, but transfers to other components of equity are allowed.

Financial liabilities held for trading (e.g. derivatives), along with loan commitments and financial guarantee contracts³⁶ that are designated under the fair value option continue to be measured entirely at FVTPL. The IASB did not eliminate the IAS 39 bifurcation requirements for derivatives embedded in financial liabilities (as opposed to financial assets, which shall be treated as a whole).

2.12. Dec. 2010 – ED/2010/13 *Financial Instruments: Hedge Accounting*

With this lengthy ED, the IASB began addressing the third phase of the project. The hedge accounting requirements in IAS 39 had been criticized as rule-based and complex, and for not reflecting actual risk management activities. The ED proposed a new general hedge accounting model that retained the basic concepts in IAS 39 of fair value hedge, cash flow hedges, and hedges of net investments, but relaxed the rules relating to eligibility and effectiveness, thus making hedge accounting available for more types of hedging relationships.

³⁶ A financial guarantee contract is a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due.

Given the complexity of the topic, the IASB decided to focus this ED on requirements for hedging relationships in the context of closed portfolios. In such portfolios, hedged items are individually identified, with changes accounted for in the same way as for single hedging relationships. The IASB decided to separate the topic of open portfolios and in particular of portfolio fair value hedges of interest rate risk (so-called 'macro-hedge' accounting) from the IFRS 9 project and is still currently deliberating on the matter.

According to the ED, the objective of hedge accounting is to reflect the effects of an entity's risk management activities which employ financial instruments to manage risk exposures that could affect profit or loss.

Eligible hedging instruments. The ED proposed that an entity might designate as a hedging instrument any financial asset or liability (both derivative and non-derivative) that is measured at FVTPL other than a net written option. For a hedge of foreign currency risk, also financial instrument measured at amortized cost could be an eligible hedging instrument. Seeing that under IFRS 9 (2009) embedded derivatives are not bifurcated (i.e. accounted separately) from the host asset, they are not eligible as hedging instruments in their own right but only as part of the entire hybrid contract.

Equity instruments designated as at FVTOCI. The proposals would prohibit equity investments designated under the FVTOCI option from being designated as hedged items, seeing that all their fair value changes are permanently recognized in OCI and never affect profit or loss. Only dividend income received on such investments, which is measured through profit or loss, would be an eligible hedged item (e.g. for foreign currency risk). Respondents criticized this proposal as not representing the reality of risk management. Consequently, the IASB did not include it in the final version of the general hedge accounting model.

Hedges of aggregate exposures. The ED proposed that an aggregate (or synthetic) exposure (i.e. a combination of an exposure and a derivative) may be designated as an item in a hedging relationship and hedged with a further derivative. Synthetic exposures commonly arise when

an entity hedges different risks (e.g. commodity risk and foreign currency risk in a forecast purchase) at different times.

Hedges of risk components. IAS 39 allowed any risk component of a financial item (i.e. changes in its cash flows or fair value attributable to a specific risk) to be eligible for hedge accounting, provided it is separately identifiable and reliably measured. On the other hand, the only eligible component for non-financial items was foreign currency risk. The ED proposed that an entity may designate as hedged items the risk components of *any* item (both financial and non-financial) provided they meet the above mentioned criteria. Despite the more relaxed requirement, hedge accounting would seldom be available to the specific practice of managing credit risk exposure with derivatives, because of the notorious difficulty of identifying and measuring credit risk. In the lead up to this ED, the IASB explored numerous approaches to accommodate hedges of credit risk using credit derivatives, but none was considered appropriate due to their complexity [IFRS9.BC6.474-490]. However, following strong criticism in the feedback to the 2010 ED, the IASB reconsidered the pros and cons of the approaches and included one in the final hedge accounting model.

Designation of a layer component of the nominal amount. The ED proposed that a layer component of the nominal amount of an item should be eligible for designation as a hedged item, unless the contract includes a prepayment option whose fair value is influenced by changes in the hedged risk. In that case, the risk component would not be separately identifiable, because the change in value of prepayment option due to the hedged risk would be included in the hedging relationship.

Hedge effectiveness. IAS 39 allowed hedge accounting only for hedge relationships that were both prospectively and retrospectively ‘highly effective’, defined as giving rise to offset within the range of 80-125 percent. Instead of such ‘bright line’, the ED proposed a forward-looking assessment performed at inception and on an ongoing basis³⁷ and based on the following hedge effectiveness criteria:

³⁷ I.e. at least at each reporting date or upon a significant change in the circumstances relevant to the hedging relationship.

- the hedging relationship will produce an unbiased result and minimize expected hedge ineffectiveness; and
- other than accidental offsetting is expected to originate from such relationship.

As under IAS 39, any observed hedge ineffectiveness would have to be immediately recognized in profit or loss.

Rebalancing the hedging relationship. The ED proposed that when the hedging relationship ceases to meet the hedge effectiveness requirements but the risk management objectives for that relationship remain the same, the entity should rebalance the relationship and restore hedge effectiveness. The rebalanced hedging relationship should be accounted for as a continuation of the existing hedge, rather than as a discontinuation as under IAS 39. The entity may also attempt to preempt expected hedge ineffectiveness by proactively rebalancing the hedging relationship.

Discontinuing hedge accounting. Under the proposals, an entity would discontinue hedge accounting for the hedging relationship (or part thereof) when it no longer meets the effectiveness criteria (after taking account of any rebalancing). Discontinuation would also take place when the hedging instrument expires or is sold, exercised, or otherwise terminated, unless it is simultaneously rolled over. In contrast to IAS 39, an entity would not be permitted to discontinue voluntarily hedge accounting if no change has occurred in the hedging relationship nor in the risk management objective.

Accounting for qualifying hedges.

- a) *Fair value hedges.* The ED proposed two changes to fair value hedge accounting.³⁸ First, the entire gain or loss on the hedging instrument and the hedged item would be presented in OCI, with any hedge ineffectiveness being immediately transferred to profit or loss; under IAS 39 all amounts are instead recognized in profit or loss. Secondly, the change in fair value of the hedged item due to changes in the hedged risk would be presented as a separate line item next to hedged item in the statement of financial position. Under IAS

³⁸ The IASB dropped these proposals from the final hedge accounting model, retaining all IAS 39 mechanics for fair value hedge accounting in IFRS 9.

39, the hedge adjustment is instead recorded as part of the carrying value of the hedged item, potentially resulting in a mix of amortized cost and fair value.

b) *Cash flow hedges*. The ED retains the ‘lower of’ test of IAS 39, meaning that the amount of the hedging instrument’s cumulative fair value change that can be deferred in equity (the effective part) is the lower of:

- the cumulative gain or loss of hedging instrument since inception of the hedge, and
- the cumulative change in the fair value (present value) of the hedged item since inception.

The only proposed aspect of cash flow hedge accounting different from IAS 39 regarded the so-called ‘basis adjustment’, which under IAS 39 was a choice rather than a requirement. Under the proposal, when a forecast transaction in a cash flow hedge leads to the recognition of a non-financial asset or liability or a firm commitment, the entity would have to apply a basis adjustment. That is, the amount accumulated in the cash flow hedge reserve would be reclassified as part of the recognized non-financial item. IAS 39 instead let an accounting choice to proceed with basis adjustment or retain the accumulated gain or loss in equity and only reclassify to profit or loss when the hedged item affects profit or loss.

c) *Hedges of net investments in a foreign operation*. The ED did not propose any changes to the accounting of the so-called ‘net investment hedges’, except for changes to the general model that would also affect them.

Accounting for the time value of options. When, as it is generally the case, an entity recognizes as a hedging instrument the intrinsic value of an option but not its time value component, IAS 39 required to measure the latter as at FVTPL, contributing to volatility in earnings. However, from a risk management perspective an option’s time value (usually equal to the initial premium) is usually regarded as a ‘cost of hedging’, i.e. the cost to obtain protection against changes of prices or rates. In order to align hedge accounting with risk management practices, the IASB proposed that the undesignated time value of an option should be accounted for in profit or loss on a cost basis rather than on a fair value basis, thus reducing volatility. The ED proposed to account for the time value in two steps:

1. The entity would first defer in OCI (over the life of the hedge) the change in fair value of the time value component to the extent that it relates to the hedged item. This amount would be determined with reference to a hypothetical option that matches the terms of the hedged item.
2. Secondly, the entity would recycle the accumulated amounts from equity (OCI) to profit or loss, with a specific procedure depending on the nature of the hedged item. For *transaction related* hedged items (e.g. a forecast transaction), the cumulative change in fair value deferred in OCI would be recognized in profit or loss at the same time as that of the hedged item.³⁹ For *time-period related* hedged items (e.g. an inventory over a period of time), the cumulative change deferred in OCI would be amortized to profit or loss on a rational basis over the term of the hedging relationship.

Hedging groups of items. Entities often analyze risk on a portfolio basis in order to take advantage of naturally offsetting risk positions. IAS 39 restricted the application of hedge accounting for groups of items and net positions in various ways.⁴⁰ To better align accounting with management practices, the ED proposed that groups of items (e.g. a group of assets) and a net risk exposure (e.g. the net of assets and liabilities, or net forecast transactions) may be eligible as a hedged item when:

- the individual items of the group (or components of items) are eligible hedge items themselves;
- the items are managed together for risk management purposes; and
- for cash flow hedge accounting only, any offsetting cash flows affect profit or loss in the same period. This restriction was aimed at avoiding the accounting anomaly of a

³⁹ But if the hedged item gives rise to the recognition of a non-financial asset or liability or a firm commitment, the amount from OCI would be reclassified as part of the carrying amount of the hedged item. This amount would be recognized in profit or loss at the same time as the hedged item affects profit or loss in accordance with the normal accounting for hedge items.

⁴⁰ A net position arising from a number of naturally offsetting hedged items was not eligible as a further hedged item. Furthermore, groups of items were eligible only if all individual items had similar risk characteristics and share the risk exposure designated as being hedged, with the fair value change attributable to the hedged risk for each item having to be approximately proportional to the overall change in the fair value of the group for the hedged risk.

net gain or loss on a single hedging instrument being grossed up and recognized in different periods.⁴¹

Hedges of contracts to buy or sell non-financial items. Under IAS 39, contracts to buy or sell a non-financial item that can be settled net in cash were subject to derivative accounting (and hence measured at FVTPL). However, thanks to the so-called ‘own use’ scope exception, such contracts were excluded from the scope of IAS 39 when they were held (since inception and on a continuous basis) for the purpose of the receipt or delivery of the non-financial item in accordance with the entity’s expected purchase, sale or usage requirements. In this case, they were treated as normal sales or purchase contracts, and thus not recognized. The IASB noted that this accounting treatment could lead to an accounting mismatch if an entity entered into a derivative contract to hedge changes in the fair value or cash flows of contract subject to the own use exception (e.g. a commodity supply contract). To address this problem, the ED proposed to require measuring at fair value contracts that would otherwise be subject to the scope exception if such accounting is in line with the entity’s business model and how it actually manages those contracts (i.e. on a fair value basis). However, feedback on the ED showed concerns about potential unintended consequences of this requirement. Consequently, the final hedge accounting model dealt with the issue by allowing the use of the fair value option.

2.13. Jan. 2011 - Supplement to ED/2009/12 *Financial Instruments: Impairment*

This Supplementary Document (SD) focused on developing a model for open portfolios of financial assets measured at amortized cost (i.e. portfolios to which financial assets are added and removed during on a regular basis), seeing that this was an operationally complex area. Beware that the requirements in the final impairment model bear no resemblance to those proposed in this SD.

⁴¹ Following criticism, the third restriction was not included in the final version of the general hedge accounting model.

Very briefly, the SD proposed a revised impairment model with a two-tier loss allowance, where financial assets managed in an open portfolio would be placed in two groups according to their credit characteristics. In a so-called ‘good book’ group, the impairment model would recognize the higher of a time-proportional amount of remaining lifetime expected credit losses (the time proportionate allowance, TPA) or all expected credit losses for the foreseeable future (the ‘floor’ amount, being a minimum of twelve months unless the remaining expected life is shorter). For the ‘bad book’, the model would recognize the full amount of remaining lifetime expected credit losses. Financial assets or groups of financial assets would be included and transferred between the two groups in accordance with the entity’s internal risk management, i.e. depending on whether the management objective changes from receiving the regular payments from the debtor (good book) to just attempting recovery under highly uncertain collectability.

Respondents did not strongly support the proposals in the SD [IFRS9.BC5.100]. A first concern was the dual calculation (i.e. the ‘higher of’ test) for determining the allowance for financial assets in the good book: such calculation was seen as operationally difficult, conceptually weak, and confusing for users. Many also thought that some methods of calculating the impairment allowance and the criteria for transferring assets between the two books had not been explained clearly.

2.14. Nov. 2012 – ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*

The proposals of this ED were introduced unchanged in the final version of IFRS 9 in July 2014. The ED proposed the introduction of a FVTOCI measurement category for financial assets containing cash flows that are solely payments of principal and interests (the SPPI criterion) and are held in a business model in which assets are managed both to collect contractual cash flows and for sale (‘hold to collect and sell’). Interest revenue, foreign currency gains or losses, and impairment losses would be recognized in profit or loss. All other gains or losses would be instead accumulated in OCI, from which they would

eventually be reclassified to profit or loss upon derecognition or earlier in the case of reclassifications. The FVTPL option would still be available on the usual terms, i.e. if such designation eliminates or significantly reduces an accounting mismatch.

The FVTOCI category would thus provide the same information in profit or loss as when the items are measured at amortized cost, but the asset would be reported at its fair value in the statement of financial position. From another angle, the new category would provide the same measurement outcome as the available-for-sale category for debt instruments in IAS 39, the only differences arising from the new impairment requirements.

Requirements would be added for the reclassification of financial assets between measurement categories, which previously was limited to debt instruments held at amortized cost and FVTPL. When a financial asset is reclassified from amortized cost to FVTOCI, the entity shall measure it at its fair value at the reclassification date, with any difference from the amortized cost being recognized in OCI and no adjustment to the effective interest rate. If the reclassification flows from FVTOCI to amortized cost, the asset is reclassified at its fair value, adjusted with any accumulated gain or loss in OCI, and again with no adjustment to the effective interest rate. If the asset is reclassified out of FVTPL to FVTOCI, its current fair value becomes the new carrying amount. The same happens when an asset is reclassified from FVTOCI to FVTPL, with any amount accumulated in OCI being reclassified to profit or loss.

According to the proposal, sales of financial assets in the FVTOCI category would be consistent with the objective of collecting contractual cash flows as long as such sales are infrequent (even if significant) or insignificant in amount (even if frequent). Sales would also be consistent with such business model if they are made close to maturity and the proceeds amount approximately to the remaining contractual cash flows. If instead sales were both frequent and significant in value, an assessment would be needed to determine whether such sales are consistent with the objective of collecting contractual cash flows.⁴²

⁴² With the removal of the tainting provision of IAS 39, sales of financial assets measured at amortized cost category can be consistent with such category as long as they are both occasional and non-significant

Following the publication of the classification and measurement chapters of IFRS 9, the IASB was demanded to give guidance on how to apply the contractual cash flow characteristics test to debt instruments with an altered economic relationship between principal and consideration for the time value and credit risk. This notably occurs in instruments that contain an interest rate mismatch feature, i.e. an interest rate that is reset at a frequency that does not match the tenor of the interest rate. This ED proposed to require an entity to assess individually the assets with these features in order to determine whether the contractual cash flows meet the SPPI criterion. The results of the assessment may be clear with little or no analysis (e.g. if the contractual payments are indexed to variable not related to time value of money or credit risk). In other cases, the entity should consider the cash flows (benchmark cash flows) on a contract of the same credit quality and with the same contractual terms but without the interest mismatch feature (the comparable instrument may be real or hypothetical). If the asset under assessment results having cash flows that are more than insignificantly different from the benchmark cash flows, then it does not meet the SPPI criterion, and the entity could only measure it at FVTPL.

The ED also proposed clarifications for contractually linked instruments (tranches). First, even if one such instrument is prepayable contingent on a specific event occurring in the underlying pool of instruments, the ED suggests that its cash flows would still qualify for the contractual cash flow characteristics test if they substantially represent unpaid amounts of principal and interest. Secondly, even if the underlying pool includes instruments that are collateralized by assets that do not meet the SPPI criterion, the contractually linked instrument itself may still meet such criterion.

in amount. Note that the relative provisions for the FVTOCI measurement category discussed above are broader (e.g. non-significant sales can be frequent).

2.15. Feb. 2013 – ED/2013/2 *Novation of Derivatives and Continuation of Hedge Accounting*

This ED came as a response to the wave of legislative changes prompted by the G20 across many jurisdictions. The common thread was to improve transparency and regulatory oversight of OTC derivatives by requiring entities to clear all standardized OTC derivatives contracts through a central counterparty (CCP) interposed between the original counterparties. Under the proposals of the 2010 Hedge Accounting ED (and IAS 39), entities would be required to discontinue hedge accounting if the hedging instrument was an OTC derivative being novated to a CCP (unless this was contemplated in the original hedging strategy), because the novation involves the termination of the original instrument. The IASB believed that discontinuing such existing hedging relationships would not provide useful information, seeing that the imposed legislation would not modify the economic relationship of the hedge. This ED proposed that the novation of a derivative instrument to a CCP should not entail the discontinuation of hedge accounting when the following conditions are met:

- the novation is required by law or regulation;
- the CCP becomes the new counterparty to each of the original parties; and
- the changes in terms of the derivative are limited to those strictly necessary to validate the novation. For instance, adjustment of collateral arrangements and of the charges levied by the CCP would be allowed, while changes to the maturity date or contractual cash flows would not.

The vast majority of respondents agreed with the proposed revisions [IFRS9.BC6.344]. Many suggested widening the scope of the exception to novation not required by law or regulation. The IASB later confirmed that voluntary novation to a CCP should not be granted the relief, unless done in anticipation of regulatory changes. Other respondents believed that relief should be allowed not only to novation directly to a CCP, but also in the common case of ‘indirect clearing’ to the CCP through one of its clearing members. This argument convinced the IASB, who eventually allowed relief in such instances.

2.16. Mar. 2013 – ED/2013/3 *Financial Instruments: Expected Credit Losses*

The Expected Credit Losses ED built on and superseded the two previous proposals for a forward-looking impairment model (the 2009 Amortized Cost and Impairment ED and its 2011 Supplementary Document), which focused on the impairment of financial assets measured at amortized cost and open portfolios of such assets. Many of the requirements proposed in this ED flowed into the final IFRS 9. The ED proposed a comprehensive impairment model that would be applied to all items subject to impairment accounting, meaning to:

- financial assets measured at amortized cost or mandatorily measured at FVTOCI.
- Loan commitments with an obligation to extend credit (unless measured at FVTPL).
- Financial guarantee contracts to which IFRS 9 is applied (unless measured at FVTPL).
- Lease receivables within the scope of IAS 17 *Leases*.
- Contract assets within the scope of ED/2010/6 *Revenue from Contracts with Customers*.⁴³

Under the proposals, an entity would recognize expected credit losses as a loss allowance (for financial assets) or as a provision (for commitments to extend credit) with one of the following approaches:

- at an amount equal to 12-month expected credit losses (i.e. potential losses from a default occurring in the next 12-months); or
- at an amount equal to lifetime expected credit losses (i.e. potential losses from a default occurring during the remaining life of the instrument).

An entity would be required to apply the latter to financial assets that have deteriorated significantly in credit quality since initial recognition, purchased or originated credit-impaired financial assets, and contract assets (e.g. trade receivable) that do not constitute a financing transaction. An entity could also elect to apply such approach to trade receivables

⁴³ By the time the impairment model was finalized in July 2014, the Revenue Recognition ED had been finalized into the new IFRS 15 *Revenue from Contracts with Customers*.

that do constitute a financing transaction as well as to lease receivable. The first approach would be applied to all other financial instruments.

Expected credit losses consist of the average of possible credit loss from default (even if unlikely) weighted by the respective probabilities of occurrence and incorporating the time value of money, informed by data that is available to the entity without undue cost or effort, including past events, current conditions, and forecasts.

In order to reflect the time value of money, expected credit losses would be discounted to the reporting date using a reasonable rate determined at initial recognition between the risk-free rate and the asset's effective interest rate or, in the case of a credit-impaired financial asset, using its credit-adjusted effective interest rate.⁴⁴ The effective interest rate is the rate that discounts the expected cash flows back to the amortized cost at initial recognition (hence it reflects expected cash flows that ignore expected credit losses), while the credit-adjusted effective interest rate is calculated including expected credit losses.

Significant increase in credit risk. Under the proposals, an entity must recognize lifetime expected credit losses on an item that has significantly increased in credit risk since initial recognition. Nonetheless, if that item's credit risk is still low at the reporting date, the entity shall continue to measure only 12-month expected credit losses. Credit risk is low when there is a low risk of default in the near term but adverse change in long-term circumstances may, but not necessarily will, reduce the borrower's ability to meet its contractual cash flows.⁴⁵ Furthermore, for items other than purchased or originated credit-impaired instruments, the entity can revert back to measuring 12-month expected credit losses if the significant increase in credit risk has reversed in a subsequent reporting period. In addition, the ED includes a rebuttable presumption that the credit risk has significantly increased when contractual payments are more than 30 days past due.

⁴⁴ The possibility to use any reasonable discount rate between the risk free rate and the asset's effective interest rate would not be included in the final impairment model in IFRS 9. Instead, IFRS 9 requires using the asset's effective interest rate or an approximation thereof.

⁴⁵ The ED suggests that 'investment grade' rating may be an indicator of low credit risk.

Purchased or originated credit-impaired financial assets are those assets that have objective evidence of impairment on initial recognition.⁴⁶ Under the proposals, an entity would record favorable changes in the credit risk of such assets as impairment gains even when the resulting expected cash flows exceed those estimated at initial recognition.

Presentation of interest revenue. The ED proposed that for accounting purposes interest revenue would be calculated differently depending on the impairment approach applied to the asset. In the case of a financial asset that is credit-impaired when purchased or originated, interest revenue is calculated by applying the credit-adjusted effective interest rate to the amortized cost balance at initial recognition. For an instrument that is not credit-impaired when purchased or originated and for which there is no objective evidence of impairment at the reporting date, interest revenue is calculated by applying the effective interest rate to the gross carrying amount (the 'gross method'). If instead for such instrument there is objective evidence of impairment, the effective interest rate is applied to the amortized cost balance (the 'net method').⁴⁷ If following a period of using the net method there is an improvement of credit quality objectively related to the event which triggered the net method, the calculation of interest revenue reverts to the gross method.

Disclosure. The proposals also included extensive disclosure requirements to be added to IFRS 7 *Financial Instruments: Disclosures*, ensuring that an entity provide information about its risk management practices and credit exposures.

2.17. Jun. 2013 - *Novation of Derivatives and Continuation of Hedge Accounting (Amendments to IAS 39)*

Building on the knowledge of the ED issued earlier in the year and the feedback received, the IASB issued an amendment to IAS 39, also applying to the relative chapter of IFRS 9

⁴⁶ Such evidence includes information about significant financial difficulty of the issuer or borrower, purchase of the asset at a deep discount, a breach of contract, fading of active market for that asset, etc.

⁴⁷ Note that which of these interest rate methods (net or gross) is applied depends simply on the existence of objective evidence of impairment (i.e. a deterioration in credit risk), whereas the divide between the two impairment measurements (12-month or lifetime expected credit losses) is the existence of a *significant* deterioration in credit risk.

proposed in the 2010 Hedge Accounting ED. The amendment stated that hedge accounting should not be discontinued when the derivative hedging instrument is novated to one or more clearing counterparties (CCP), who can be a central counterparty (sometimes called a 'clearing organization' or 'clearing agent'), or one or more entities acting as indirect counterparties to the central counterparty. The following conditions must be satisfied:

- the instrument is novated in consequence of laws or regulations, or the introduction of laws and regulations; and
- the changes in terms of the derivative are limited to those strictly necessary for the novation to occur.

The changes from the relative ED relate to when the novation is exempted from discontinuation (i.e. not only when it is required by law or regulation, but also in anticipation thereof), and with whom it can be undertaken (i.e. not only directly with a CCP, but also indirectly).

2.18. Nov. 2013 - IFRS 9 (2013) *General Hedge Accounting*

The IASB finalized the third part of the project by issuing the chapter on hedge accounting, as a matter of fact before the second part on impairment had been completed. Until the finalization of the separate project on macro hedge accounting, which is still pending, entities that apply IFRS 9 (both early adopters and not) are given an accounting policy choice as to whether to apply the hedge accounting model of IAS 39 or IFRS 9.

Leaving the details of the general hedge accounting model to the next chapter, an outline of its main aspects is briefly presented. The model maintains the three types of hedge accounting in IAS 39 (cash flow, fair value, and net investment hedges), but the eligibility criteria for both hedging instruments and hedging items have been broadened. The effectiveness test has been transformed into a principle-based assessment. Other areas that underwent changes are the accounting of forward contracts and derivative options. In general, the new model reflects more closely risk management practices by allowing more judgment, and this greater flexibility is counterbalanced by enhanced disclosure requirements.

Many of the hedge accounting requirements proposed in the 2010 ED transitioned unchanged into the finalized version. The main modifications to the previous proposals involved the following topics.

Accounting for the forward elements of derivatives. Feedback on the 2010 Hedge Accounting ED convinced the IASB to extend the accounting treatment for the time value of options to the accounting of the forward component of a derivative contract when only the spot element of such contract is designated as the hedging instrument [IFRS9.BC6.414].⁴⁸ Under IAS 39, the changes in fair value of the undesignated forward element had to be recognized in profit or loss on a fair value basis, thus giving rise to volatility. The IASB decided to provide an alternative treatment similar to that for the time value of options, i.e. to allow the forward element to be amortized, with the difference that here it is a choice rather than a requirement.⁴⁹

Note that depending on the type of forward contract, the forward element can have different meanings. In a forward exchange contract, the so-called ‘forward points’ (i.e. the difference of basis points between the spot rate and the forward rate) represent the interest differential between the two currencies. In a forward interest rate agreement, the forward element reflects the term structure of interest rates. In a commodity forward contract, the forward element reflects the so-called ‘cost of carry’ (storage costs and the like) [IFRS9.BC6.416].

Hedging groups and net positions. All the relative amendments to IAS 39 proposed in the 2010 Hedge Accounting ED were adopted in the final hedge accounting model, short of the restriction specific to cash flow hedge accounting. The proposed requirement (i.e. that hedge accounting be available only if all offsetting cash flows affect profit or loss in the same period) was criticized by many for not representing risk management practices. The IASB

⁴⁸ It may be appropriate to designate only the spot element when the forward contract is used to hedge an existing asset, for example inventory, which is exposed to changes in the spot price but not to forward rate risk.

⁴⁹ The reason for this difference is that options are typically used to hedge transactions that do not have a time value component, whereas forward contracts are used to hedge items that typically have a corresponding forward element. Hence, in the latter cases an entity may well desire to designate the forward contract in its entirety (the so-called ‘forward rate method’). [IFRS0.BC6.418]

agreed to lift this requirement from the final model, but limited the use of cash flow hedges of net positions to foreign currency risk.

Equity investments designated as at FVTOCI. The proposal to prohibit equity investments designated as at FVTOCI from being elected as hedged items received criticism by respondents. The IASB agreed that such restriction would not reflect actual risk management practices and decided not to include it in the general hedge accounting model. Given that all changes in fair value for these equity investments are permanently recognized in OCI, IFRS 9 requires that any hedge ineffectiveness be recognized in OCI too, with no reclassification in profit or loss (this represent the only case where hedge ineffectiveness is allowed out of profit or loss). Therefore, for such hedges both effective and ineffective fair value changes are recognized in OCI.

Fair value hedge accounting. Due to lack of support, the proposals relative to fair value hedging made in the 2010 Hedge Accounting ED (related to the presentation in OCI of the effective portion of the hedge) were excluded from the final model, thus retaining the requirement of IAS 39 to present all changes in profit or loss.

Hedging the credit risk component. Following feedback on the Hedge Accounting ED, the IASB reconsidered the problems arising from not allowing hedge accounting for hedges of credit risk components, on the basis that they would not meet the eligibility requirements proposed in said ED. To solve such issue the IASB discussed several alternatives, and settled on the one that allows entities to elect fair value accounting for the hedged credit exposure [IFRS9.BC6.499-545]. The final hedge accounting model permits an entity to elect FVTPL accounting for a credit exposure (for instance on loans, bonds, or loan commitments, otherwise measured at amortized cost) that is hedged with a credit derivative (e.g. a credit default swap) if certain qualifying criteria are met.⁵⁰ An entity can elect the FVTPL option for the entire nominal amount or for a component of nominal amounts, at inception or

⁵⁰ The criteria are the following. 1) The name of the credit exposure matches the reference entity of the credit derivative ('name matching'); index-based credit default swaps do not meet this criterion. 2) The seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative.

subsequently; in the latter case, the difference between the carrying amount and fair value is recognized in profit or loss.

Hedging contracts to buy or sell a non-financial item. The final hedge accounting model allows entities to use the fair value option also for contracts that meet the ‘own use’ scope exception, if doing so eliminates or significantly reduces an accounting mismatch. This is different from how the 2010 Hedge Accounting ED had proposed to solve the issue, i.e. by requiring entities to measure such contracts at fair value if that reflected their risk management practices.

2.19. Jul. 2014 - IFRS 9 (2014) *Introduction of FVTOVI measurement and expected credit losses model*

The IASB issued the final version of IFRS 9 containing amendments to the measurement of financial instruments and a new impairment model. The effective date is set on 1 January 2018, with early application allowed. Previous versions of IFRS 9 are superseded and may no longer be early-adopted after 1 January 2015.

All content of the 2012 Limited Amendments ED was included unchanged in the final Standard. The same is true for the 2013 Expected Credit Losses ED, except for a minor change requiring that expected credit losses be discounted to the reporting date using the asset’s effective interest rate or an approximation thereof instead of a reasonable rate between the risk-free rate and the asset’s effective interest rate. The details will be discussed in the next chapter.

Chapter III – The complete IFRS 9

The following paragraphs explain the requirements of the complete IFRS 9 *Financial Instruments*, as issued in July 2014. References to the first chapter of this work are used where the requirements of IAS 39 have been carried to the new Standard unchanged.

3.1. Effective date and transition

The Standard is effective for annual periods beginning on or after 1 January 2018, with early application permitted. Early adopters shall apply all of the Standard's requirements at the same time; however, exceptions to this rule allow an entity to:

- early-adopt only the own-credit requirements for financial liabilities;
- early-adopt IFRS 9 but continue to apply the hedge accounting requirements from IAS 39;
- continue to apply a previous version of IFRS 9 if it has been early-adopted before 1 January 2015.

In practice, the possibility of early adoption is going to depend on local jurisdiction, for instance, entities in the EU will have to wait for the final EU endorsement, which involves deliberations by EFRAG, Accounting Regulatory Committee (ARC), EU Parliament and EU Council. The final EU endorsement is expected to arrive in early 2016 (Il Sole 24 Ore, Sep. 2015).

In accordance with the transition requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, entities shall apply IFRS 9 retrospectively, meaning that

the new requirements apply to existing items, transactions, and other events as if they had always been applied.

Although the effective date is 1 January 2018, the transition date depends on whether the entity opts to restate the comparatives in financial statements (i.e. the data that show the results from the previous year). If in fact an entity decides to restate comparatives, it will have to show financial information for 2017, so that will be the actual year of transition. It is thought that most entities who make extensive use of financial instruments are unlikely to engage in early application of the Standard [DEA.A2.168], although that will also depend on what the market and competitors will do. Early application will be probably used by non-financial entities eager to simplify hedge accounting practices.

3.2. Objective and scope

The objective of IFRS 9 is to establish principles for reporting of financial assets and financial liabilities that will present relevant information and useful information to users of financial statements for the assessment of the amounts, timing and uncertainty of an entity's future cash flows [IFRS9.1.1].

All financial instruments under the scope of IAS 39 (see Chp I - para 1.2) are also under the scope of IFRS 9. In addition, the following provisions expand the scope of IFRS 9:

- contracts to buy or sell non-financial items that can be settled net in cash (or another financial instrument, or by exchanging financial instruments) and that were entered into and continue to be held for the purpose of actual receipt or delivery of a non-financial item (in accordance with the entity's expected purchase, sale, or usage requirements) may be irrevocably designated as measured at FVTPL [IFRS9.2.4].⁵¹ Such fair value option is available only at inception and only if it eliminates or significantly reduces an accounting mismatch [IFRS9.2.5].

⁵¹ Such contracts were outside the scope of IAS 39 due to the so-called 'own use' exemption.

- The impairment requirements of IFRS 9 apply to all loan commitments, even those that are otherwise outside the scope of IFRS 9 [IFRS9.2.1].
- The impairment requirements of IFRS 9 apply to rights and obligations within the scope of newly-issued IFRS 15 *Revenue from Contracts with Customers* that are financial instruments ('contract assets'), when IFRS 15 so requires [IFRS9.2.1].

3.3. Recognition and derecognition

The recognition and derecognition requirements of IAS 39 are carried forward to IFRS 9 unchanged (see Chp I - para 1.3). However, IFRS 9 adds the following indications:

- a write-off of a financial asset or portion thereof constitutes a derecognition event. An entity shall directly reduce the gross carrying amount of a financial asset when it has no reasonable expectation of recovering a financial asset or part thereof. [IFRS9.5.5.4]
- A renegotiation or modification of the terms of a financial asset in some circumstances may lead to the derecognition of the existing financial asset and the recognition of a new financial asset [IFRS9.B.5.5.25]. Substantial modification of a distressed asset is given an example of a modification resulting in derecognition, whereas the modification of the gross carrying amount of a loan by less than 30% is an example of modification not resulting in derecognition. When the renegotiation or modification does not result in the derecognition of the financial asset, the entity shall recalculate the asset's gross carrying amount and recognize a modification gain or loss in profit or loss [IFRS9.5.4.3,5.5.12].

3.4. Classification and measurement

The requirements for the classification and subsequent measurement of financial assets (and hence also the reclassification rules) are radically different from the corresponding requirements in IAS 39. On the other hand, requirements for the initial measurement of financial instruments, the subsequent treatment of financial liabilities, and the treatment of

embedded derivatives have been largely transposed to IFRS 9 with few (yet not insignificant) modifications.

3.4.1. Initial measurement of financial instruments

The requirements for the initial measurement of financial instruments under IFRS 9 are the same as under IAS 39 (see Chp I - para 1.4.1). The only novelty in IFRS 9 is that an entity shall measure trade receivables at their transaction price (as defined in IFRS 15) if they do not contain a significant financing component, or if the entity applies the ‘practical expedient’ in accordance with IFRS 15 [IFRS9.5.1.3].

3.4.2. Classification and subsequent measurement of financial assets

Financial assets within the scope of IFRS 9 are classified on the basis of both the entity’s business model for managing the financial assets and their contractual cash flow characteristics [IFRS9.4.1.1]. The three main measurement categories are:

- a) *amortized cost*. A financial asset is subsequently measured at amortized cost if both the following conditions are met [IFRS9.4.1.2]:
 - the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows (‘hold to collect’);
 - the contractual terms of the financial asset give rise on specific dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (the ‘SPPI’ criterion).

Financial assets measured at amortized cost are subject to impairment [IFRS9.5.2.2]. A gain or loss on financial assets measured at amortized cost shall be recognized when the asset is derecognized, reclassified, or is subject to amortization or impairment [IFRS9.5.7.2].

- b) *Fair value through other comprehensive income (FVTOCI)*. A financial asset is subsequently measured at FVTOCI if both the following conditions are met [IFRS9.4.1.2A]:

- the financial asset is held within a business model whose objective is achieved by *both* collecting contractual cash flows and selling financial assets ('hold to collect and sell');
- the SPPI criterion is met.

Gains and losses on assets in this category shall be recognized in OCI, except for those arising for impairment or foreign exchange fluctuations, until the asset is derecognized or reclassified. At that point, the cumulative gain or loss previously recognized in OCI is reclassified to profit or loss as a reclassification adjustment [IFRS9.5.7.10].

In addition, an entity may make at initial recognition an irrevocable election to measure at FVTOCI an investment in an equity instrument otherwise measured at FVTPL, provided that such instrument is neither held for trading nor contingent consideration of an acquirer in a business combination to which IFRS 3 applies [IFRS9.5.7.5]. Gains and losses on that instrument are presented in OCI; such amounts may subsequently be transferred within equity, but never to profit or loss [IFRS9.5.7.1, B5.7.1]. However, dividends on an equity instrument elected at FVTOCI are recognized in profit or loss [IFRS9.5.7.6]. The general rule is that dividends are recognized in profit or loss when all the following conditions are met: 1) the entity's right to receive the payment is established, 2) it is probable that such economic benefits will flow to the entity, and 3) their amount can be established reliably [IFRS9.5.7.1A].

Financial assets measured at FVTOCI are subject to impairment [IFRS9.5.2.2].

- c) *Fair value through profit or loss (FVTPL)*. Any financial asset that is not measured at amortized cost or FVTOCI shall be measured at FVTPL [IFRS9.4.1.4]. Additionally, in spite of previous requirements, an entity may irrevocably designate any financial asset as measured at FVTPL under the fair value option, if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities, or recognizing the gains and losses on them,

on different bases [IFRS9.4.1.5].⁵² An example of accounting mismatch is when an asset and a liability that the entity considers related (i.e. whose risks give rise to opposite changes in fair value) would be measured at amortized cost and at FVTPL, respectively. In that case, the fair value option may be used to provide a common measurement basis when, for instance, hedge accounting happens to not be available [IFRS9.B4.1.29,B4.1.30].

Gains and losses on such assets are presented in profit or loss [IFRS9.5.7.1].

For financial assets that are initially recognized using settlement date accounting, any change in fair value of the asset to be received during the period between the trade date and the settlement date is not recognized for assets measured at amortized cost. For assets measured at fair value, however, the change in fair value shall be recognized in profit or loss or in OCI. [IFRS9.5.7.4]

Guidance on the business model criterion. An entity's business model is not determined by management's intentions for an individual instrument, but rather by how groups of financial assets are managed together to achieve a particular business objective [IFRS9.B4.1.2]. In other words, the business model refers to how the entity in practice manages (and not merely asserts to manage) groups or portfolios of financial assets in order to generate cash flows, i.e. by collecting contractual cash flows, selling the assets, or both. Classification need not be determined at the reporting entity level, and thus a single entity may use multiple business models across its organization. The assessment of the business model is based on scenarios that the entity reasonably expects to occur, thus not necessarily considering 'worst case' or 'stress case' scenarios [IFRS9.B4.1.2a]. The fact that the actual realization of the cash flows differs from the entity's expectations (as characterized in its business model) does not give rise to a prior period error in the entity's financial statements nor does it necessarily trigger

⁵² NB: under IAS 39 an entity can use the fair value option for financial assets when doing so provides more useful information, because either i) it eliminates or significantly reduces an accounting mismatch, or ii) a group of financial assets or 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 via which key management personnel is informed. However, in IFRS 9, point ii) and the reference to 'more useful information' are not present for financial assets, although they have been maintained in the fair value option for financial liabilities.

any change to the classification of the remaining financial assets held in that business model (like the ‘tainting provision’ under IAS 39) [IFRS9.B4.1.2a]. In particular, sales can be consistent with a ‘hold to collect’ business model if they are infrequent (even if significant in value) or insignificant in value both individually and in aggregate (even if frequent). If those sales are both frequent and significant, the entity must assess their consistency with the business model. In any case, the entity will take account of such events and all other relevant information when it assesses the business model for new financial assets [IFRS9.B4.1.3b].

Guidance on the SPPI criterion: the principal is the fair value of a financial asset at initial recognition, minus any principal repayments. Interest is the consideration for the time value of money, credit risk, other lending risks (e.g. liquidity risk) and costs (e.g. administrative costs) associated with holding the financial asset for a particular period of time, and it can also include a profit margin. [IFRS9.4.1.3,B4.1.7]

Interest revenue is normally calculated by applying the effective interest rate⁵³ to the gross carrying amount⁵⁴ (before deducting the provision) of the financial asset [IFRS9.5.4.1].

There are two exceptions:

- for purchased or originated credit-impaired financial assets, the entity shall apply the credit-adjusted effective interest rate⁵⁵ to the amortized cost of the financial asset since initial recognition.
- For financial assets that have become credit-impaired after initial recognition, the entity shall apply the effective interest rate to the amortized cost (i.e. the net amount) of the financial asset in subsequent reporting periods. In this second case only, if the credit risk on the financial asset improves (and the improvement can be related objectively to an event occurring after the credit-impairment event) so that the

⁵³ I.e. the rate that exactly discounts the estimated future cash flows through the expected life of a financial asset or financial liability (considering all contractual terms, transaction costs, and all other premiums or discounts, but not the expected credit losses) to the gross carrying amount of the financial asset or to the amortized cost of the financial liability. [IFRS9.A]

⁵⁴ I.e. the amortized cost of a financial asset, before adjusting for any loss allowance. [IFRS9.A]

⁵⁵ I.e. the rate that exactly discounts the estimated future cash flows through the financial asset’s expected life (considering all contractual terms, transaction costs, and all other premiums or discounts, as well as expected credit losses) to the amortized cost of the asset. [IFRS9.A]

instrument is no longer credit-impaired, the entity shall return to measuring the interest rate on the basis of the asset's gross carrying amount [IFRS9.5.4.2].

3.4.3. Classification and subsequent measurement of financial liabilities

The classification and subsequent measurement requirements for financial liabilities under IFRS 9 are almost identical to those in IAS 39 (see Chp I - para 1.4.3), with some minor modification to adjust for changes in other requirements or Standards [IFRS9.4.2.2]:

- there is no reference to derivative liabilities that are linked to and must be settled by delivery of an equity instrument with no quoted market price (which under IAS 39 shall be measured at cost), given that such measurement category has been removed.
- References to IAS 18 *Revenue* are instead made to the new IFRS 15 *Revenue*.
- References to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are instead made to the new impairment section within IFRS 9.

The sole important modification relates to the fair value option for financial liabilities. The eligibility conditions for the election remain the same, i.e. it is permitted when it results in more useful information either:

- because it eliminates an accounting mismatch that would otherwise arise; or
- because a group of financial liabilities or a mixed group financial assets and financial liabilities is managed and its performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy via which key management personnel is informed.

On the other hand, the way in which under IFRS 9 an entity shall present a gain or loss on financial liabilities designated under the fair value option is new [IFRS9.5.5.7]:

- the amount of change in fair value that is attributable to changes in credit risk of that liability shall be presented in OCI. Such amounts may subsequently be transferred within equity, but never to profit or loss [IFRS9.B5.7.9].
- The remaining amount of change in the liability's fair value shall be presented in profit or loss.

However, if measuring the changes in a liability's credit risk through OCI would create or enlarge an accounting mismatch in profit or loss, an entity shall instead present all changes in that liability's fair value (including those arising from changes in credit risk) in profit or loss [IFRS9.5.7.7,5.7.8]. Such assessment is made at initial recognition and cannot be revised. For practical purposes, the entity need not enter into all of the assets and liabilities giving rise to the mismatch at exactly the same time; a reasonable delay is permitted as long as any remaining transaction is expected to occur [IFRS9.B5.7.7].

Despite the above requirements, all gains and losses on loan commitments and financial guarantee contracts that are designated under the fair value option shall be presented solely in profit or loss [IFRS9.5.7.9].

Guidance on credit risk. Credit risk, as defined in IFRS 7, is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. It does not necessarily relate to the creditworthiness of the issuer of the liability; for instance, a collateralized liability has lower credit risk than a non-collateralized one from the same issuer [IFRS9.B5.7.13]. Similarly, credit risk is not the same as the performance risk on a specific asset(s) related to the liability (e.g. when the contractual amount due on a liability is determined on the basis of the performance of specific assets). In fact, asset-specific performance risk is simply the risk that a specific asset or group of assets related to a liability will perform poorly, but this need not influence the entity's behavior on a particular obligation (i.e. credit risk). The link between the asset(s) and the liability is established contractually, and the entity's ability to discharge its obligations is not influenced by events contingent to such asset(s) [IFRS9.B5.7.14,B5.7.15].

The amount of change in the fair value of a financial liability that is attributable to changes in its credit risk (which corresponds to the amount of change that is not attributable to changes in market conditions that give rise to market risk) is determined either [IFRS9.B5.7.16,B5.7.17,B5.7.19]:

- using an internal rate of return calculation, when market risk for that liability is significantly influenced only by benchmark interest rates; or

- using an alternative method expected to represent more faithfully the change in credit risk, when market risk for that liability is influenced also by the price of financial instruments of other entities, commodity prices, foreign exchange rates, or indexes of prices or rates.

3.4.4. Embedded derivatives

Hybrid contracts hosted by a financial asset within the scope of IFRS 9 shall always be measured in their entirety according to the appropriate measurement requirements (rather than possibly being bifurcated as under IAS 39) [IFRS9.4.3.2]. Conversely, if the host contract is a financial asset outside the scope of IFRS 9 (e.g. insurance contract, lease receivable), a financial liability (e.g. debt securities, loans) or a non-financial asset (e.g. forward purchase contracts for goods and services), then the entity shall assess whether the embedded feature requires separation. That assessment is similar to that of IAS 39, that is, bifurcation must take place if all the following conditions are met [IFRS9.4.3.3]:

- a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;⁵⁶
- b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- c) the hybrid instrument is not measured at fair value with changes in fair value recognized in profit or loss (i.e. a derivative that is embedded in a financial liability at fair value through profit or loss is not separated)⁵⁷.

If an embedded derivative is separated, the host contract shall be accounted for in accordance with the appropriate Standards [IFRS9.4.3.4].

Notwithstanding the above requirements, if a contract contains one or more embedded derivatives and the host is not an asset within the scope of IFRS 9, an entity may designate the entire hybrid contract as at FVTPL, unless [IFRS9.4.3.5]:

⁵⁶ See the Application Guidance on IAS 39 para. AG30 and AG33 for many examples of when such condition is or is not met.

⁵⁷ Note that condition c) no longer refers to a derivative embedded in a financial asset at FVTPL, given that such financial asset would be within the scope of IFRS 9.

- the embedded derivative(s) does not significantly modify the cash flows that otherwise would be required by the contract, or
- it is clear with little or no analysis that separation of the embedded derivative is prohibited (e.g. by law).

Furthermore, if the entity is unable to measure the embedded derivative separately either at acquisition or at the end of a subsequent reporting period, it shall designate the entire hybrid contract as at FVTPL [IFRS9.4.3.6].

3.4.5. Reclassifications

Under IFRS 9, financial assets shall be reclassified only if the objective of the entity's business model for managing those financial assets changes [IFRS9.4.4.1]. Reclassifications only apply prospectively, and any previously recognized gains, losses or interest are not restated [IFRS9.5.6.1]. An entity shall report reclassification events as follows:

- a) if a financial asset is reclassified *out of the amortized cost category and into the FVTPL category*, its fair value is measured at the reclassification date and the difference between the previous amortized cost and the fair value shall be recognized in profit or loss [IFRS9.5.6.2].
- b) If a financial asset is reclassified *out of the FVTPL category and into the amortized cost category*, its fair value at the reclassification date becomes its new gross carrying amount. The effective interest rate is determined on the basis of the fair value at the reclassification date [IFRS9.5.6.3, B5.6.2].
- c) If a financial asset is reclassified *out of the amortized cost category and into the FVTOCI category*, its fair value is measured at the reclassification date and the difference between the previous amortized cost and the fair value shall be recognized in OCI. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. [IFRS9.5.6.4]
- d) If a financial asset is reclassified *out of the FVTOCI category and into amortized cost the category*, its new carrying amount is the fair value at the reclassification date plus or minus the cumulative gain or loss previously recognized in OCI (resulting in the asset being measured as if it had always belonged to the amortized cost category).

This adjustment does not affect profit or loss and therefore is not a reclassification adjustment. The effective interest rate and the measurement of expected credit losses are not adjusted as a result of the reclassification. [IFRS9.5.6.5]

- e) If a financial asset is reclassified *out of the FVTPL category and into the FVTOCI category*, it continues to be measured at fair value. The effective interest rate is determined based on the fair value at the reclassification date. [IFRS9.5.6.6,B5.6.2]
- f) If a financial asset is reclassified *out of the FVTOCI category and into the FVTPL category*, it continues to be measured at fair value. The cumulative gain or loss previously recognized in OCI is reclassified to profit or loss as a reclassification adjustment. [IFRS9.5.6.7]

Consistently with its decision to retain most of the requirements from IAS 39 for the measurement of financial liabilities, the IASB decided to retain also the prohibition to reclassify financial liability between amortized cost and fair value [IFRS9.4.4.2,BC4.121].

3.5. Impairment

IFRS 9 introduces a single general impairment model that applies to all assets subject to impairment. Only two special cases depart from the general impairment model, namely purchased or originated credit-impaired assets and the group composed of trade receivables, contract assets and lease receivables. The Standard requires entities to recognize impairment losses on all financial assets from the moment of initial recognition; this is very different from IAS 39, under which impairment losses were recognized only after the loss event had occurred.

3.5.1. General approach

Under the general impairment approach, an entity shall recognize a loss allowance for expected credit losses on [IFRS9.5.5.1]:

- a) financial assets measured at amortized cost;
- b) financial assets measured at FVTOCI;

- c) lease receivables within the scope of IAS 17;
- d) contract assets within the scope of IFRS 15;
- e) financial guarantees contracts that are within the scope of IFRS 9 and not measured at FVTPL;
- f) loan commitments (even outside the scope of IFRS 9) that are measured at FVTPL.

Equity investments, on the other hand, are no longer subject to impairment, because they are measured at either FVTOCI (with no reclassification of any fair value gains or losses to profit or losses) or FVTPL. The IAS 39 requirement for equity investments to be impaired if there is a significant and prolonged decline in their fair value below cost had in fact proved difficult to apply (KPMG, Dec. 2009).

At the reporting date, an entity shall assess whether the credit risk on an instrument has increased significantly since initial recognition and behave as follows:

- if lifetime credit risk (i.e. the likelihood or risk of a default occurring [IFRS9.B5.5.7]) has not increased significantly since initial recognition, the entity shall measure for that instrument a loss allowance at an amount equal to *12-month expected credit losses* [IFRS9.5.5.5], which are the portion of lifetime expected credit losses on the financial instrument that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring. Thus, 12-month expected credit losses are neither the losses on only the financial instruments expected to default within the next 12 months, nor the amount of cash shortfalls that are predicted over the next 12 months [IFRS9.B5.5.43].
- On the other hand, if the credit risk on the instrument did increase significantly since initial recognition, the entity shall measure the loss allowance at an amount equal to *lifetime expected credit losses* [IFRS9.5.5.3]. At a subsequent reporting date, the measurement of lifetime expected losses shall be discontinued and the 12-month measurement resumed if the entity determines that the increase in credit risk (if any) since initial recognition has reverted to non-significant levels [IFRS9.5.5.7].

For loan commitments and financial guarantee contracts, the relevant date for assessing the increase in credit risk is that when the entity took on the irrevocable commitment

[IFRS9.5.5.6]. For these two kinds of items, what is being assessed is, respectively, the changes in the risk of a default occurring on the loan toward which the entity is committed, and the changes in the risk that the guaranteed debtor will default [IFRS9.5.5.8].

As a simplifying provision, the Standard allows an entity to assume that the credit risk has not increased significantly if the credit risk is considered low at the reporting date [IFRS9.5.5.10]. On the other hand, a rebuttable presumption that credit risk has increased significantly since initial recognition shall operate when contractual payments are more than 30 days past due [IFRS9.5.5.11].

At each reporting date, the amount of the change in expected credit losses (whether measured at 12-month or over the instrument's lifetime) shall be recognized in profit or loss as an impairment loss or gain [IFRS9.5.5.8].

3.5.2 Determining significant increases in credit risk

The entity shall assess whether the instrument's lifetime credit risk has increased significantly since initial recognition by considering reasonable and supportable information about past events, current condition and forecasts of future economic conditions that is available without undue cost or effort [IFRS9.5.5.9,B5.5.49]. When evidence of significant increases in credit risk is not available at the individual instrument level, it may be appropriate to perform the assessment on a collective basis (e.g. on a group or sub-group of financial instruments) to ensure that any significant increase in credit risk does not go undetected [IFRS9.5.5.4,B5.5.1]. For the purpose of the assessment, the entity shall look at the change in the overall risk of a default occurring rather than the change in the amount of expected credit losses. It follows that the significance of the change in credit risk depends on the level of credit risk at initial recognition: the same increase in credit risk in absolute terms will be more significant for an item with a lower initial credit risk compared to one with a higher initial credit risk [IFRS9.B5.5.9]. The definition of default should be the one used by the entity for internal credit risk management purposes for the relevant financial instrument, although there is a rebuttable presumption that default has occurred when payments are 90 days past due [IFRS9.5.5.9,B5.5.37].

The change in credit risk over the next 12 months may be in some circumstances a reasonable proxy for the change in the instrument's lifetime credit risk. Instances in which such proxy may not be appropriate include when:

- recorded default patterns for similar instruments have been concentrated at a specific point during the instrument's expected life that is beyond the 12-month horizon.
- The financial instrument has significant payment obligations only beyond the 12-month horizon.
- Changes in relevant credit-related factors (e.g. macroeconomic changes) have an impact on the instrument's credit risk beyond 12 months [IFRS9.B5.5.13,B5.5.14].

It should finally be noted that, all other things being equal, the longer the instrument's expected life (i.e. the longer an entity expects to hold a financial instrument) the more risk there is of a default occurring over its expected life [IFRS9.B5.5.10]. Hence, as an instrument approaches maturity, its overall credit risk should diminish in absolute terms; if it does not, that may actually indicate an increase in credit risk since initial recognition [IFRS9.B5.5.11].

3.5.3. 1st special case: purchased or originated credit-impaired assets

For assets that are credit-impaired at initial recognition, an entity shall always measure the loss allowance at an amount equal to *lifetime expected credit losses* [IFRS9.5.5.13]. At each reporting date, the amount of the change in lifetime expected credit losses shall be recognized in profit or loss as an impairment loss or gain. Favorable changes in lifetime expected credit losses can fall below the amount of expected credit losses that was recognized initially [IFRS9.5.5.14].

3.5.4. 2nd special case: trade receivables, contract assets and lease receivables

According to the so-called 'simplified approach,' an entity shall always measure the loss allowance at an amount equal to *lifetime expected credit losses* for [IFRS9.5.5.15]:

- a) trade receivables or contract assets that result from transactions that are within the scope of IFRS 15 and that:

- do not contain a significant financing component, or when the entity uses a practical expedient in accordance with IFRS 15 (e.g. the calculation of expected credit losses on trade receivables using a provision matrix [IFRS9.B5.5.35]); or
 - contain a significant financing component, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied to all such trade receivables or contract assets but may be applied separately to trade receivables and contract assets.
- b) Lease receivables, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses. Such accounting policy may be applied separately to finance and operating lease receivables.

3.5.5. Guidance on expected credit losses

Expected credit losses are a probability-weighted estimate amount of cash shortfalls on the financial instrument, calculated by using a range of possible outcomes and taking account of the time value of money [IFRS9.5.5.17]. A credit loss on a financial asset is the present value of the difference between the cash flows contractually due to the entity and those expected to be actually received [IFRS9.B5.5.29]. For a loan commitment, a credit loss is the present value of the difference between the contractual cash flows that would be contractually due to the entity if the holder of the loan commitment draws down the loan and those expected to be actually received [IFRS9.B5.5.30]. For a financial guarantee contract, a credit loss is the expected payments to reimburse the holder in case it incurs in a loss, less any amounts the entity expects to receive from the holder's debtor or any other party [IFRS9.B5.5.32].

Expected credit losses shall be discounted to the reporting date, typically using the effective interest rate determined at initial recognition or an approximation thereof [IFRS9.B5.5.44]. However, expected losses shall be discounted differently in the following cases:

- a) for financial instruments with a variable interest rate, using the current (i.e. re-estimated) effective interest rate [IFRS9.B5.5.44].

- b) For purchased or originated credit-impaired financial assets, using the credit-adjusted interest rate determined at initial recognition [IFRS9.B5.5.45].
- c) For lease receivables, using the same discount rate used according with IAS 17 [IFRS9.B5.5.46].
- d) For loan commitments, using the effective interest rate, or approximation thereof, that would be applied on recognition of the asset [IFRS9.B5.5.47].
- e) For financial guarantee contracts or loan commitments for which the effective interest rate cannot be determined, using the discount rate that reflects the current market assessment of the time value of money and the risks specific to those cash flows, but only if and to the extent that the risks are taken into account by adjusting the discount rate instead of the cash flows being discounted [IFRS9.B5.5.48].

The estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements (if any) that are part of the contractual terms and are not recognized separately by the entity [IFRS9.B5.5.55].

The entity shall use reasonable and supportable information about past events, current conditions and forecasts of future economic conditions that is available without undue cost or effort. The range of possible outcomes does not include every possible scenario, but should always include at least one scenario in which a credit loss occurs (even if it is highly unlikely) and one in which no credit loss occurs. [IFRS9.5.5.18,B5.5.28]

3.5.6. Modifications

A modification or renegotiation of a financial asset's cash flows can lead to the derecognition of the existing financial asset and the recognition of a new one. The initial loss allowance for the new asset shall usually be measured at an amount equal to 12-month expected credit losses; in some unusual circumstances there may be evidence that the modified financial asset is credit-impaired at initial recognition, requiring lifetime expected credit losses to be measured. This might occur, for example, when the substantial modification involved a distressed financial asset. [IFRS9.B5.5.26]

3.6. Hedge accounting

IFRS 9 maintains the overall structure and several requirements from IAS 39, despite generally allowing hedge accounting under more circumstances. Unlike IAS 39, IFRS 9 explicitly states the objective of hedge accounting: it should represent in financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss, or OCI (in the case of investments in equity instruments that the entity elected as measured at FVTOCI). Allowing insight into the purpose and effect of actual risk management activities is therefore the main goal of these requirements [IFRS9.6.1.1]. Hedge accounting remains an accounting choice as under IAS 39.

3.6.1. Types of hedging relationships

IFRS 9 largely maintains unaltered the possible types of hedging relationships from IAS 39 (see Chp I – para 1.6.3) [IFRS9.6.5.2]:

- a) *fair value hedge*, which offsets an exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or a component of *any* such item⁵⁸, that is attributable to a particular risk that could affect profit or loss (or OCI, when the hedged item is an equity instrument elected at FVTOCI [IFRS9.6.5.3]).
- b) *Cash flow hedge*, which offsets an exposure to variability in cash flows that 1) is attributable to a specific risk of a recognized asset or liability or a highly probably forecast transaction (or an identified portion of those items) and 2) could affect profit or loss.
- c) *Hedge of a net investment in a foreign operation*, as defined in IAS 21.

As under IAS 39, a hedge of the foreign currency risk of a firm commitment may be accounted for as either cash flow hedge or a fair value hedge [IFRS9.6.5.4].

⁵⁸ IAS 39 allowed components only for assets.

3.6.2. Hedging instruments

Derivatives measured at FVTPL can normally be designated as hedging instruments, except for some written options (for the same reasons presented in IAS 39, see Chp I – para 1.6.1) [IFRS9.6.2.1]. Embedded derivatives cannot be designated as separate hedging instrument if they are not accounted for separately from the host contract [IFRS9.N6.2.1].

A non-derivative financial asset measured at FVTPL (i.e. a cash instrument) may also be designated as a hedging instrument.⁵⁹ For a hedge of foreign currency risk, the foreign currency component of a non-derivative financial asset may be designated as a hedging instrument unless it is an investment in an equity instrument that has been elected as at FVTOCI. [IFRS9.6.2.2]

A non-derivative financial liability measured at FVTPL (i.e. a cash instrument) may be designated as a hedging instrument unless it is a financial liability elected under the fair value option (for which changes in fair value attributable to changes credit risk are presented in OCI). For a hedge of foreign currency risk, the foreign currency component of a non-derivative financial liability may be designated as a hedging instrument. [IFRS9.6.2.2]

The designation of items relating to parties internal to the entity (internal derivatives) as hedging instruments is regulated in the same way as under IAS 39 (see Chp I – para 1.6.1) [IFRS9.6.2.3].

A derivative instrument that combines a written option and a purchased option (e.g. an interest rate collar) may be designated as a hedging instrument provided it is not, in effect, a net written option (unless it is designated as an offset to a purchased option, including one that is embedded in another financial instrument) [IFRS9.6.2.6,B6.2.4]. In addition, an entity may jointly designate as the hedging instrument any combination of derivatives and non-derivatives, or proportion of such items, provided they are not, in combination, a net written option (unless they are designated as an offset to a purchased option) [IFRS9.6.2.5,6.2.6].

⁵⁹ Under IAS 39, non-derivative financial assets or liabilities could be designated as hedging instruments only in hedges of foreign currency risk.

An entity normally designates a hedging instrument in its entirety in a hedging relationship. Exceptions are permitted when the entity separates [IFRS9.6.2.4]:

- a) the intrinsic value and time value of an option contract and designates as the hedging instrument only the intrinsic value, treating the time value as a 'cost of hedging';
- b) the forward element and the spot element of a forward contract and designates as the hedging instrument only the spot element;
- c) the foreign currency basis spread, excluding it from the designation of a financial instrument as the hedging instrument. Foreign currency basis spread are found in cross-currency swaps and can be considered a charge to convert one currency into another; or
- d) when it designates as the hedging instrument only a proportion of the entire instrument, such as 50% of its nominal amount. Designating only changes in fair value relating to a portion of the instrument's life is not permitted.

The way in which an entity accounts for the time value of options depends on whether the hedged item is transaction related or time-period related [IFRS9.6.5.15]:

- for *transaction related* hedged item, the change in the option's time value shall be recognized in OCI to the extent that it is effective (i.e. it relates to the hedged item) and shall be accumulated in a separate component of equity. The cumulative amount in equity shall be subsequently accounted for in the same way as the cumulative amount in the cash flow hedge reserve (see para 3.6.6).
- For *time-period related* hedged item, the change in the option's time value shall be recognized in OCI to the extent that it is effective and shall be accumulated in a separate component of equity. That amount shall be amortized to profit or loss as a reclassification adjustment on a systematic and rational basis over the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss (or OCI, when the hedged item is an equity instrument elected at FVTOCI).

The separate accounting of the forward element of forward contracts and of foreign currency basis spreads is similar to that relating to the time value of options [IFRS9.6.5.16].

3.6.3. Hedged items

A hedged item can be a recognized asset or liability, an unrecognized firm commitment, a forecast transaction or a net investment in a foreign operation. It can be a single item or a group of items, or a component of such item or group of items [IFRS9.6.3.1]. The hedged item must be reliably measurable, and if it is a forecast transaction it must also be highly probable [IFRS9.6.3.2,6.3.3]. In addition, an item or group of items and a derivative can be viewed as an aggregated exposure that may be designed as a hedged item; a forecast transaction of such aggregated exposure may also be designed as a hedged item [IFRS9.6.3.4]. As for hedging instruments, the designation of items relating to parties internal to the entity as hedged items is regulated in the same way as under IAS 39 (see Chp I – para 1.6.2) [IFRS9.6.3.5,6.3.6].

A firm commitment to acquire a business combination cannot be a hedged item except for foreign currency risk, because the other risks cannot be specifically identified and measured since they are general business risks [IFRS9.B6.3.1]. An equity method investment cannot be a hedged item in a fair value hedge because the equity method recognizes in profit or loss the investor's share of the associate's profit or loss, rather than changes in the investment's fair value. The same applies to an investment in a consolidated subsidiary [IFRS9.B6.3.2].

An entity may designate as the hedged item in a hedging relationship an item (or group of items) in its entirety or one of the following components [IFRS9.6.3.7]:

- only changes in the item's cash flows or fair value attributable to a specific risk or risks (i.e. a risk component), including changes above or below a specified price or other variable (i.e. a one-sided risk), provided that such risk component is separately identifiable and reliably measurable. This is now possible also for non-financial items, whereas under IAS 39 only their foreign currency risk can be separately designated as the hedged item.
- One or more selected contractual cash flows.
- A component of a nominal amount that is either a proportion of an entire item (e.g. 50% of the contractual cash flows of a loan) or a layer component (e.g. a bottom layer) [IFRS9.B6.3.16].

For the designation of a group of items (including one that constitutes a net position) as the hedged item to be possible, all the following conditions must be met [IFRS9.6.6.1]:

- a) it consists of items (including components of items) that are individually eligible as hedged items;
- b) the items in the group are managed as a group (or as a net position) for actual risk management purposes and not just to achieve a particular accounting outcome; and
- c) in the case of a cash flow hedge of a group of items whose variabilities in cash flows are not expected to be approximately proportional to the overall variability in cash flows of the group, so that offsetting positions arise, it can only be a hedge of foreign currency risk and the designation of that net position specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

For the designation of a component of nominal amount as the hedged item to be possible, it must be consistent with the entity's risk management objective [IFRS9.6.6.2]. A layer component of a group of items is eligible only if:

- a) it is separately identifiable and reliably measurable;
- b) the risk management objective is to hedge that layer component;
- c) the items in the overall group are all exposed to the same risk, so that the measurement of the hedged layer is not significantly affected by which particular item from the overall group form part of the hedged layer;
- d) for a hedge of existing items, the entity must be able to identify and track the overall group of items from which the hedged layer is defined; and
- e) any items in the group that contain prepayment options meet the requirements from components of a nominal amount.

IFRS 9 lifts the absolute ban in IAS 39 about separately designating as the hedged item a non-contractually specified inflation component of a financial instrument. Instead of the ban, the Standard places a rebuttable presumption that unless the inflation component is contractually specified, it cannot be designated as the hedged item [IFRS9.B6.3.13]. The assumption may be rebutted when there is a market for similar instruments with sufficient

volume, term structure and liquidity that allows constructing a term-structure of zero coupon real interest rates, which in turn allows measuring the inflation component of the instrument [IFRS9.B6.3.14].

3.6.4. Qualifying criteria for hedge accounting

A hedging relationship qualifies for hedge accounting under IFRS 9 if all the following criteria are met [IFRS9.6.4.1]:

- a) the hedging relationship consists only of eligible hedging instruments and eligible hedged items.
- b) At the inception of the hedge, there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge.⁶⁰
- c) The hedge must meet the hedge effectiveness requirements. The level of hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset the changes of the hedged item; hedge ineffectiveness is the reverse [IFRS9.B6.4.1]. The effectiveness requirements for hedge accounting, which must be assessed at inception of the relationship and on an ongoing basis (i.e. at each reporting date or upon a significant change in circumstances, if earlier) [IFRS9.B6.4.12], are the following:
 - there is an economic relationship between the hedged item and the hedging instrument, meaning that they have values that usually move in the opposite direction because of the same, hedged risk [IFRS9.B6.4.4]. Occasional movements in the same direction can be consistent with the existence of an economic relationship [IFRS9.B6.4.6].
 - The effect of credit risk does not dominate the value changes that result from that economic relationship. In fact, even if there is a an economic relationship between the hedged item and the hedging instrument, the level of offset might

⁶⁰ The documentation shall include identification of the hedging instrument, the hedged item or transaction, the nature of the risk being hedged and how the entity will assess the hedging instrument's effectiveness.

become erratic if the relevance of credit risk on any of those items is far greater than risk being hedged [IFRS9.B6.4.7].

- The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item actually hedged and the quantity of the hedging instrument actually used for hedging purposes. However, that designation shall not reflect an imbalance between the weightings of the hedged item and the hedging instrument that would create hedge ineffectiveness that could result in an accounting outcome inconsistent with the purpose of hedge accounting.

Rebalancing. If a hedging relationship ceases to meet the effectiveness requirement related to the hedge ratio, but the risk management objective for that designated hedging relationship remains the same, the entity shall adjust the hedge ratio so that it meets the qualifying criteria again [IFRS9.6.4.5]. It can do so by increasing the weighting of the hedged item or of the hedging instrument via modifications of their relative volumes [IFRS9.B6.5.16].

3.6.5. Accounting for fair value hedges

A qualifying fair value hedge shall be accounted for as follows [IFRS9.6.4.8].

- The gain or loss on the hedging instrument shall be recognized in profit or loss (or OCI, when the hedged item is an equity instrument elected at FVTOCI).
- The hedging gain or loss on the hedged item shall adjust the carrying amount of the hedged item (if applicable) and be recognized in profit or loss. If the hedged item is a financial asset (or a component thereof) measured at FVTOCI, those gain or loss shall be recognized in profit or loss. If the hedged item is an equity instrument elected at FVTOCI, the gain or loss shall remain in OCI. Finally, if the hedged item is an unrecognized firm commitment (or a component thereof), the cumulative change in its fair value is recognized as an asset or liability with a corresponding gain or loss recognized in profit or loss.

Any adjustment arising in the second case above shall be amortized to profit or loss if the hedged item is a financial instrument measured at amortized cost [IFRS9.6.4.10].

3.6.6. Accounting for cash flow hedges

A qualifying cash flow hedge shall be accounted for as follows [IFRS9.6.4.11].

- a) The separate component of equity associated with the hedged item (cash flow hedge reserve) is adjusted to the lower of 1) the cumulative gain or loss on the hedging instrument from inception of the hedge, and 2) the present value of the cumulative change in the hedged expected future cash flows.
- b) The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge (i.e. the portion that is offset by the change in the cash flow hedge reserve) shall be recognized in OCI.
- c) Any remaining gain or loss on the hedging instrument (or any amount required to balance the cash flow hedge reserve) is hedge ineffectiveness and shall be recognized in profit or loss.

The amount accumulated in the cash flow hedge reserve shall be accounted for as follows [IFRS9.6.4.11].

- If the hedged forecast subsequently results in the recognition of a non-financial asset or a non-financial liability, or it becomes a firm commitment to which fair value hedge accounting is applied, the entity shall remove the accumulated amount from the cash flow hedge reserve and include it directly in the initial cost or other carrying amount of the asset or liability. This is not considered a reclassification adjustment, and hence it does not affect OCI.
- For all other cash flow hedges, the cumulative amount shall be reclassified to profit or loss as a reclassification adjustment in the same period(s) during which the hedged expected cash flows affect profit or loss. However, if that amount is a loss which is not expected to be recovery entirely in future periods, the entity shall immediately reclassify the amount that is not expected to be recovered into profit or loss as a reclassification adjustment.

3.6.7. Accounting for hedges of a net investment in a foreign operation

These type of hedges, including hedges of a monetary item accounted for as part of the net investment, shall be accounted for similarly to cash flow hedges. The portion of the gain or loss on the hedging instrument that is determined to be an effective hedge shall be recognized in OCI, and the ineffective portion shall be recognized in profit or loss [IFRS9.6.5.13].

3.6.8. Discontinuation of hedge accounting

An entity shall discontinue hedge accounting prospectively only when the qualifying criteria are no longer met (after taking into account any rebalancing, if applicable) by a hedging relationship in its entirety or a portion of it [IFRS9.6.4.6]. This includes instances when the hedging instrument is sold, terminated or exercised. However, the rollover or replacement of a hedging instrument does not lead to the discontinuation of hedge accounting if such operation is part of the entity's documented risk management objective. In addition, there is no expiration or termination of the hedging instrument if both following conditions are met:

- as a consequence of laws or regulations or their forthcoming introduction, the parties to the hedging instrument agree to interpose between them one or more of clearing counterparties, i.e. a central counterparty (CCP, or 'clearing agency') or another entity (e.g. a clearing member of the CCP), provided the CCP is the ultimate clearing party.
- Changes to the hedging instrument are limited to those strictly necessary to effect the replacement of the counterparty, such as changes in collateral requirements, rights to offset receivables and payables balances, and charges levied.⁶¹

When hedge accounting is discontinued for a cash flow hedge, the entity shall account for the amount that has been accumulated in the cash flow hedge reserve as follows [IFRS9.6.5.12].

- If the (previously) hedged future cash flows are still expected to occur, that amount shall remain in the cash flow hedge reserve until the future cash flows occur or until the entity expects not to be able to recover the loss in future periods. When the future

⁶¹ Note that the entity is not allowed to simply revoke hedge accounting as was possible under IAS 39.

cash flows occur, the amount accumulated in the cash flow hedge reserve shall be accounted for as described in para 3.6.6.

- If the (previously) hedged future cash flows are no longer expected to occur, that amount shall be immediately reclassified to profit or loss as a reclassification adjustment.

On the total or partial disposal of a hedged net investment in a foreign operation, the cumulative gain or loss on the hedging instrument relating to the effective portion of the hedge shall be reclassified from OCI to profit or loss as a reclassification adjustment [IFRS9.6.5.14].

Chapter IV – IFRS 9: a change for the better?

4.1. Technical assessment of IFRS 9

A study of EFRAG assessed that IFRS 9 meets the technical criteria for EU endorsement⁶² for the adoption of international reporting Standards: “the information resulting from the application of IFRS 9 is appropriate both for making economic decisions and assessing the stewardship of managers” [DEA.A2.3]. IFRS 9 overall respects the true and fair view criterion across all areas,⁶³ leads to prudent accounting, and satisfies all technical criteria, including relevance, reliability, comparability, and understandability [DEA.A2.4].

More specifically, with respect to relevance,⁶⁴ EFRAG concluded that IFRS 9 overall leads to the provision of relevant information and generally endorsed the trade-offs made by the IASB between relevance and simplicity or reliability [DEA.A2.117]; nonetheless, EFRAG pointed out some parts where, in their opinion, IFRS 9 could have been better Standard. For instance:

- instruments for which under certain conditions (e.g. insolvency of the debtor) payments do not have to be made and no interest accrues on the deferred amount are not considered by IFRS 9 as satisfying the SPPI criterion. Some subordinated instruments may present such additional feature, but subordination alone does not preclude amortized cost measurement. EFRAG suggested that measuring those instruments at amortized cost would provide more relevant information, given that they are generally seen as basic lending agreements, at least until the conditions

⁶² As set out in the Regulation (EC) No 1606/2002.

⁶³ As set out in Art. 4(3) of Council Directive 2013/34/EU.

⁶⁴ Information is relevant when it helps users to make economic decisions.

referred to above occur, thence making fair value measurement more relevant [DEA.A2.14(b)].

- Under IFRS 9, modifications of contractual cash flows always lead to the recognition of any modification gain or loss in profit or loss, even when the terms are modified due to commercial reasons rather than credit deterioration. EFRAG believes that in some cases relevance could be enhanced by not recognizing modification gain or loss for commercial renegotiations, as this could be considered as accounting for an opportunity loss [DEA.A2.17,19].
- IFRS 9 offers the possibility to present changes in the fair value of equity instruments in OCI unless the instrument is held for trading. Under the election, gains and losses (including impairment) never enter profit or loss, except for dividends. According to EFRAG, this unique accounting treatment may limit the relevance of information provided, especially if such gains and losses would be viewed as indicative of the performance of the investor and useful for assessing stewardship, as may be the case for long-term investors [DEA.A2.36,37].
- It is important to highlight that the expected credit losses model clearly leans toward over-impairment in most circumstances, although EFRAG endorses such innovation as providing relevant information to users [DEA.A2.59].

With respect to reliability,⁶⁵ EFRAG assesses IFRS 9 as providing reliable information and improving disclosure requirements [DEA.A2.136]. Still, EFRAG highlights some circumstances requiring a high degree of judgment by the entity, thus possibly weakening the reliability of information. In particular:

- the classification of financial assets, which is based on the assessment of the business model for those assets and their cash flow characteristics, will often be unambiguous. However, in some cases the implementation of the SPPI criterion will require judgment to ensure that the proper measurement category (amortized cost or FVTOCI) is identified. This is the case where contractual provisions have the

⁶⁵ Information is reliable when it is free from material error and bias, it faithfully represents what is being described, and it is complete within the bounds of materiality.

potential to change the timing and/or amount of the contractual cash flows, even though the Standard does provide substantial guidance on the matter.

- Entities will have to use judgment to determine whether there has been a substantial increase in credit losses, i.e. the trigger event for the recognition of lifetime credit losses. Such assessment will also be influenced by what information is available to the entity without undue cost or effort.
- Although IFRS 9 states that the business model is based on facts, it also acknowledges that judgment is needed to assess the reasons, frequency, timing and significance of sales activity. Despite the guidance in IFRS 9 stating, among other things, that changes in business models are expected to be very rare, some authors argued that the 'business model' concept is too ambiguous and hence leaves too much judgment in the hands of preparers (Page, Oct. 2012).

With regard to comparability,⁶⁶ EFRAG affirmed that IFRS 9 on the whole will improve the comparability of information and endorsed the trade-offs made by the IASB between comparability and simplicity [DEA.A2.170]. Nonetheless, the considerations relative to reliability may affect the comparability of information as well. In addition, given that IFRS 9 maintains the previous derecognition requirements, it remains unclear exactly when the modification of financial assets leads to their derecognition; this fact could lead to different entities making different assessments [DEA.A2.146]. Furthermore, an entity's freedom to choose whether to apply hedge accounting, even when all the eligibility criteria would be met, may impair comparability across entities. As entities begin to implement the Standard, a level of consensus will likely emerge as to the range of acceptable interpretations and implementations, possibly within particular industries and geographic areas (Yin Toa, Oct. 2014). In the banking industry particularly, supervisors and auditors are expected to play a crucial role in influencing the interpretation of the new rules (Deloitte, Sep. 2015).

⁶⁶ The concept of comparability implies that similar items and events should be accounted for in a consistent way through time and by different entities, and unlike items and events should be accounted for differently.

Finally, EFRAG affirms that IFRS 9 fully satisfies the principles of understandability⁶⁷ and prudence [DEA.A2.184,191].

4.2. Extent of the improvements over IAS 39

Overall, IFRS 9 seems to be a significant improvement over IAS 39 [DEA.A3.52].

The new classification and measurement requirements of IFRS 9 may be considered on the whole as an improvement over the approach of IAS 39, but not necessarily in all areas. For instance, some criticize IFRS 9 for not allowing the business model to influence the measurement of financial assets other than basic lending instruments, although this is mitigated by the option to elect some equity instruments as at FVTOCI [DEA.A3.11]. In turn, such option is also criticized, because it does not allow the entity to recycle gains and losses from equity to profit or loss, thus possibly preventing the correct representation of the objective of long-term investors [DEA.A3.12].

On the other hand, IFRS 9 does resolve the ‘own credit’ issue for financial liabilities under the fair value option, by requiring to present fair value changes due to changes in credit risk into OCI. Among other positive effects, this change has been shown to improve the ability of non-professional investors to acquire information related to credit risk and to correctly evaluate overall firm performance (Lachmann et al., 2015).

The accounting for basic lending agreements has arguably improved too, because:

- a) the approach is based on the entity’s business model increases the relevance of information as it reflects more closely actual asset management practices.
- b) The business model should be based on facts, hence the approach is less based on management intent.
- c) The provision of information is set at a higher level of aggregation than an instrument-by-instrument basis.

⁶⁷ Financial information should be readily understandable by users with a reasonable knowledge of business, economic activity and accounting and the willingness to study the information with reasonable diligence.

Considering that under IFRS 9 all instruments other than basic lending agreements are measured at FVTPL, there is a single impairment model that applies to instruments measured at amortized cost and at FVTOCI. This will significantly reduce complexity in comparison with IAS 39, under which different impairment requirements and guidance apply to different measurement categories.

The use of unbiased, probability-weighted estimates to determine expected credit losses under IFRS 9 is arguably superior to the method in IAS 39 (which required the determination of the most likely outcome) and improves the reliability of the impairment amount calculated. Naturally, another reason why the ‘expected loss’ impairment model is seen as an improvement (first and foremost by regulators) is that it addresses the criticism of IAS 39 for recognizing impairment losses ‘too little, too late’.

On the other hand, it is clear that “estimating impairment is an art rather than a science” (KPMG, Sep. 2014), involving difficult judgments about when and to what extent contractual cash flows will be actually received, and IFRS 9 exponentially expands the scope of those judgments. In particular, judgment will be required to apply the concept of ‘significant increases’ in credit risk and of ‘default’, as well as to determine where lies the limit of reasonable and supportable information available to the entity without undue cost or effort. Lastly, it is interesting to note the discrepancy between the accounting outcome of the new impairment requirements and how the economics of market valuation should work (at least according to some form of Efficient Market Hypothesis). In principle, the fair value of a financial asset being recognized should reflect the estimate of all future cash flows on the asset (i.e. lifetime expected credit losses should be priced in the asset), yet in practice the expected loss model will almost always result in additional expected losses at initial recognition. According to EFRAG, such discrepancy may be due to a systematic mispricing of credit risk by the market, which the new impairment model might help reduce by making lenders more mindful of the actual credit risk being undertaken [DEA.A3.87,88].

With respect to hedge accounting, IFRS 9 basically relaxes the requirements of IAS 39. This is recognized as allowing entities to portray actual risk management practices more faithfully,

which is the stated goal of the new general hedge accounting model. Such goal is achieved by improving three areas:

- a) the effectiveness requirements are less strict and rule-based and more principle-based. Under IAS 39, in fact, in order to apply hedge accounting an entity has to demonstrate that the hedging relationship is effective, i.e. that the level of offset is within the 80-120% range both prospectively and retrospectively. In this way, until the end of the financial year, the entity is uncertain about the eligibility for hedge accounting. With IFRS 9, the main effectiveness requirement is the existence of an economic relationship between the hedged item and the hedging instrument.
- b) The range of eligible hedged items is expanded to include risk components of non-financial items, aggregated exposures, net positions, layer components.
- c) The range of eligible hedging instruments is also expanded, for instance by not limiting the use of non-derivative financial instruments at FVTPL to hedges of foreign currency risk.

The practice of rebalancing is also novel and will require judgment to establish when it is appropriate. All things considered, new possibilities emerge for risk management, including the following:

- a) non-financial items under IAS 39 may be designated as hedged items either in their entirety or for foreign currency risk, whereas under IFRS 9 any of their risk components (e.g. the crude oil component of jet fuel) may be designated, if such component is separately identifiable and reliably measurable.
- b) Cash instruments (i.e. non-derivative financial assets and liabilities) under IAS 39 may only be designated as hedging instruments in hedges of foreign currency risk, whereas under IFRS 9 they can be designated in any hedging relationship.
- c) Aggregated exposures (i.e. combination of a derivative and a non-derivative exposure) under IAS 39 may not be designated as hedged items, whereas IFRS 9 they may. The same is true for net positions (e.g. the net of all fixed rate assets and fixed rate liabilities with similar maturities).
- d) Under IFRS 9, it is possible to separate the foreign currency basis spread of a hedging instrument and exclude it from the designation in the hedging relationship.

4.3. Costs for preparers and users

Preparers of financial statement will incur in significant one-off costs at initial application and ongoing costs for subsequent compliance, for instance when they develop and later implement the following functions:

- a) analysis of business models and contractual cash flows.
- b) Processes and systems for the classification and measurement of financial instruments.
- c) Processes and systems for collecting data, tracking credit risk and calculating expected credit losses.
- d) Processes and systems for tracking hedging relationship for rebalancing purposes, implementing qualitative hedge effectiveness assessments.
- e) Internal coordination between finance, credit, risk, and IT functions.
- f) Disclosures related to transition, classification, impairment and hedge accounting.
- g) Training for personnel and other new procedures.

Users are likely to incur in significant costs only at initial in relation to understanding the effects of IFRS 9. Subsequent costs related to interpreting the accounting decisions made by preparers may also be incurred, but should not to be significant.

4.4. Impact on banks

Banks are very much under pressure to adopt IFRS 9 within the mandatory timeframe, as initial implementation time is estimated at around three years (Deloitte, Jun. 2014). A recent survey of more than 30 large European financial institutions found that almost half risk missing the 1 January 2018 deadline, some with a significant delay (Accountancy Live, Jul. 2015).

Banks and other financial institutions that must comply with the Basel requirements may find that the new classification and measurement requirements affect differently the calculations of capital resources and capital requirements (KPMG, Dec. 2013). In addition, the new

measurement requirements may change the level of volatility in profit or loss and equity, which in turn may impact key performance indicators (KPIs) (KPMG, Dec. 2013).

The major source of concern from the banks' perspective is certainly the new impairment model. The new rules are expected to "have a massive impact on the way banks account for credit losses on their loan portfolios. Provisions for bad debts will be bigger and are likely to be more volatile" (KPMG, Jul. 2014). In particular, the initial application of the new requirements may have a large negative impact on the equity of banks and possibly insurers and other financial services entities given the crucial role of credit risk for such businesses (KPMG, Sep. 2014). Covenants and banks' regulatory capital may be affected, and the overall impact on KPIs is expected to be significant; stress testing outcomes may also be negatively affected. According to Deloitte's Global IFRS Banking Surveys, an increasing number of global banks anticipate that IFRS 9 loss provisions will be higher than the regulatory loss provisions calculated under Basel rules.⁶⁸ More importantly, over half of the banks surveyed believe that the expected loss approach will increase their provisions of up to 50% across all loan asset classes.⁶⁹

Volatility is also likely to increase for the following reasons:

- credit losses will be recognized since initial recognition for all financial assets within the scope of the impairment model.
- The data employed in predictions (e.g. ratings, credit spreads and economic forecasts) may be volatile.
- Moving from a 12-month to a lifetime expected credit loss measurement may result in a large change of the loss allowance.

In general, variability will increase more for entities with longer-term portfolios because of the higher lifetime expected credit losses which will be recognized or reversed in relation to the conditions in the economy [DEA.A3.92]

⁶⁸ Up from about 70% of the 54 global banks in the Jun. 2014 Deloitte survey to 85% of 59 global banks in the Sep. 2015 Deloitte survey.

⁶⁹ According to both the 2014 and 2015 Deloitte surveys.

An increasing number of banks deem likely that the accounting changes will set off a feedback loop impacting the pricing of financial products via changes in the cost of capital.⁷⁰ Similarly, some industry pundits speculate that the amount of lending could also be negatively affected by the new rules (Thomas, Jul. 2015). With regard to European banks, EFRAG noted that the immediate recognition of credit losses is already required for regulatory purposes and hence the impact on their pricing strategies or lending appetite should be limited [DEA.A3.86]. However, EFRAG acknowledged that banks might become more averse to providing loans with longer maturities (especially in times of financial turmoil) because expected losses will generally be higher for exposures with longer maturities [DEA.A3.90].

4.5. Impact on insurers

The IASB is currently developing a new insurance contracts Standard to replace the current IFRS 4. Although the new insurance Standard is expected to be issued in 2016 (hence before IFRS 9 becomes effective) insurers would not be able to implement IFRS 9 and simultaneously early-adopt the insurance Standard [DEA.A3.101]. EFRAG and other parties noted that such timing mismatch could significantly reduce the quality of information in financial reports by creating accounting mismatches, and therefore recommended that IFRS 9 adoption be delayed for insurers [DEA.A3.102,107]. In a recent press release, the IASB affirmed to be leaning toward giving insurance companies the option to defer IFRS 9 adoption until 2021 (IASB, Sep. 2015).

Given the pending decisions, predictions of the impact of IFRS 9 on insurers can be made only to a very limited extent. One consideration is that for insurers, equity instruments measured at FVTPL may result in profit or loss variability not reflecting their business model because the insurance liabilities backed by these assets are measured either at cost (based on the existing IFRS 4) or possibly at FVTOCI with the changes eventually reclassified in profit or loss (based on the proposals of the new insurance contracts Standard) [DEAA3.80].

⁷⁰ Up from about 9% of global banks in the 2011 Deloitte survey to 56% of those in the Sep. 2015 survey.

Insurers are unlikely to avail themselves of the FVTOCI option for equity investments because under such election any gains or losses are never reclassified to profit or loss. For this reason, the IASB has been asked to allow such reclassification [DEAA3.81]. Overall, however, EFRAG believes that insurers' investment behavior is unlikely to be significantly affected by IFRS 9, as the importance of investment decisions should outweigh any accounting concerns [DEAA3.82].

4.6. Conclusions

Overall, the requirements of IFRS 9 have been welcomed by users and preparers of financial statements, and by regulators. A cross-country event study found a positive abnormal market reaction in the EU to announcements (between July 2009 and December 2012) showing increased likelihood of the replacement of IAS 39 with IFRS 9 (Ginesti&Onali, 2014). These findings seem to corroborate the optimistic outlook expressed by EFRAG, who regards IFRS 9 as an improvement over IAS 39 and as conducive to the European public good [DEA.A3.52]. The EU Accounting Regulatory Committee is currently assessing the Standard, and then it will be the turn of the European Parliament and Council.

Based on the extensive literature regarding the serious shortcomings of IAS 39 and the likely net benefits of IFRS 9, it is reasonable to believe that the accounting for financial instruments has finally found, not without some complications, a new equilibrium which will, among other things, simplify the task of preparers in many areas, re-establish prudence in impairment accounting, and bring higher quality information to users of financial statements.

Bibliography

Institutional sources

EFRAG (May 2015). "Draft Endorsement Advice for IFRS 9 (DEA)."

FASB. Technical Agenda <http://www.fasb.org/Technical-Agenda>. Accessed: 20/09/2015.

IASB (Mar. 2008). "DP Reducing Complexity in Reporting Financial Instruments."

IASB (Mar. 2009). "ED/2009/3 Derecognition: Proposed Amendments to IAS 39 and IFRS 7."

IASB (Jun. 2009). "DP/2009/2 Credit Risk in Liability Management."

IASB (Jul. 2009). "ED/2009/7 Financial Instruments: Classification and Measurement."

IASB (Nov. 2009). "ED/2009/12 Financial Instruments: Amortized Cost and Impairment."

IASB (May 2010). "ED/2010/4 Fair Value Option for Financial Liabilities."

IASB (Dec. 2010). "ED/2010/13 Financial Instruments: Hedge Accounting."

IASB (Jan. 2011). "Supplement to ED/2009/12 Financial Instruments: Impairment."

IASB (Nov. 2012). "ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9."

IASB (Feb. 2013). "ED/2013/2 Novation of Derivatives and Continuation of Hedge Accounting."

IASB (Mar. 2013). "ED/2013/3 Financial Instruments: Expected Credit Losses."

IASB (Jun. 2013). "Amendments to IAS39: Novation of Derivatives and Continuation of Hedge Accounting."

IASB (Jul. 2014). "IFRS 9 Financial Instruments."

IASB (Sep, 2015). "IASB to consult on temporary measures relating to the effective dates for IFRS 9 and the new insurance contracts Standard." *Press release*.

Professional sources

Deloitte (Apr. 2009a). "G20: Implications for IFRSs." *IAS Plus Update*.

Deloitte (Apr. 2009b). "New derecognition model proposed for financial instruments." *IAS Plus Update*.

Deloitte (Jun. 2009). "IASB seeks views on the role of credit risk in liability measurement." *IAS Plus Update*.

Deloitte (Jul. 2009). "Exposure draft proposes new classification and measurement guidance for financial instruments." *IAS Plus Update*.

Deloitte (Nov. 2009a). "IFRS 9 Financial Instruments." *IAS Plus Update*.

Deloitte (Nov. 2009b). "Financial Instruments: Amortised Cost and Impairment." *IAS Plus Update*.

Deloitte (May 2010). "IASB issues proposals on the fair value option for financial liabilities." *IAS Plus Newsletter*.

Deloitte (Oct. 2010). "IASB amends disclosures about transfers of financial assets." *IFRS in Focus*.

Deloitte (Nov. 2010). "IASB issues revisions to IFRS 9 for financial liability accounting." *IFRS in Focus*.

Deloitte (Dec. 2010). "IASB issues exposure draft on hedge accounting." *IFRS in Focus*.

Deloitte (Feb. 2011). "IASB and FASB issue joint proposal on impairment of financial assets." *IFRS in Focus*.

Deloitte (Aug. 2011). "IASB proposes to defer the mandatory effective date of IFRS 9." *IFRS in Focus*.

Deloitte (Dec. 2011). “IASB defers the mandatory effective date and adds disclosure requirements.” *IFRS in Focus*.

Deloitte (Dec. 2012). “IASB issues proposals for limited amendments to IFRS 9.” *IFRS in Focus*.

Deloitte (Mar. 2013a). “IASB publishes exposure draft on novation of derivatives.” *IFRS in Focus*.

Deloitte (Mar. 2013b). “Expected Credit Losses – Exposure Draft.” *IFRS in Focus*.

Deloitte (Jul. 2013). “IASB publishes an amendment to IAS 39 on novation of derivatives.” *IFRS in Focus*.

Deloitte (Nov. 2013a). “Hedge accounting reforms: A closer reflection on risk management.” *IFRS in Focus*.

Deloitte (Nov. 2013b). “A new general hedge accounting model in IFRS 9.” *Robert Bruce Interviews*.

Deloitte (Jul. 2014). “IASB finalizes IFRS 9 which changes the classification and measurement of financial assets and introduces expected credit loss impairment model.” *IFRS in Focus*.

Deloitte (Jun. 2014). “Fourth Global IFRS Banking Survey.”

Deloitte (Jul. 2014a). “IFRS 9 Financial Instruments.” *Robert Bruce Interviews*.

Deloitte (Jul. 2014b). “Impact of IFRS 9 on the banking industry.” *Robert Bruce Interviews*.

Deloitte (Sep. 2015). “Fifth Global IFRS Banking Survey.”

KPMG (Dec. 2009). “IFRS 9 Financial Instruments.” *First Impressions*.

KPMG (Dec. 2010). “Additions to IFRS 9 Financial Instruments.” *First Impressions*.

KPMG (Dec. 2013). “IFRS 9 (2013) – Hedge accounting and transition.” *First Impressions*.

KPMG (Jul. 2014). “Financial Instruments – the complete standard.” *In the Headlines*.

KPMG (Sep. 2014). "IFRS 9 Financial Instruments." *First Impressions*.

EY (May 2015). "Classification of financial instruments under IFRS 9."

Journal and newspaper articles

Ginesti, G. e Onali, E (2014). "Pre-adoption market reaction to IFRS 9: A cross-country event-study." *Journal of Accounting and Public Policy* 33. Elsevier.

Lachmann et al. (2015). "Fair value accounting for liabilities: Presentation format of credit risk changes and individual information processing." *Accounting, Organizations and Society* 41. Elsevier.

Page, Michael (Oct. 2012). "Business models as a basis for regulation of financial reporting." *Journal of Management and Governance*. Springer.

Thomas, Paul (Jul. 2015). "New accounting rules to hit lending." *Money Marketing* Issue 1496.

Yin Toa, Lee (Oct. 2014). "Challenges of regulations: What the finalised IFRS 9 means to insurers." *Asia Insurance Review*.

"Banks fail to plan for IFRS 9 deadline." *Accountancy Live* Vol. 155 Issue 1463, Jul. 2015.

"Contabilità: Sì dell'EFRAG che chiede approfondimenti sul settore assicurativo. Via libera al nuovo principio IFRS 9." *Il Sole 24 Ore* 17 Sep. 2015.