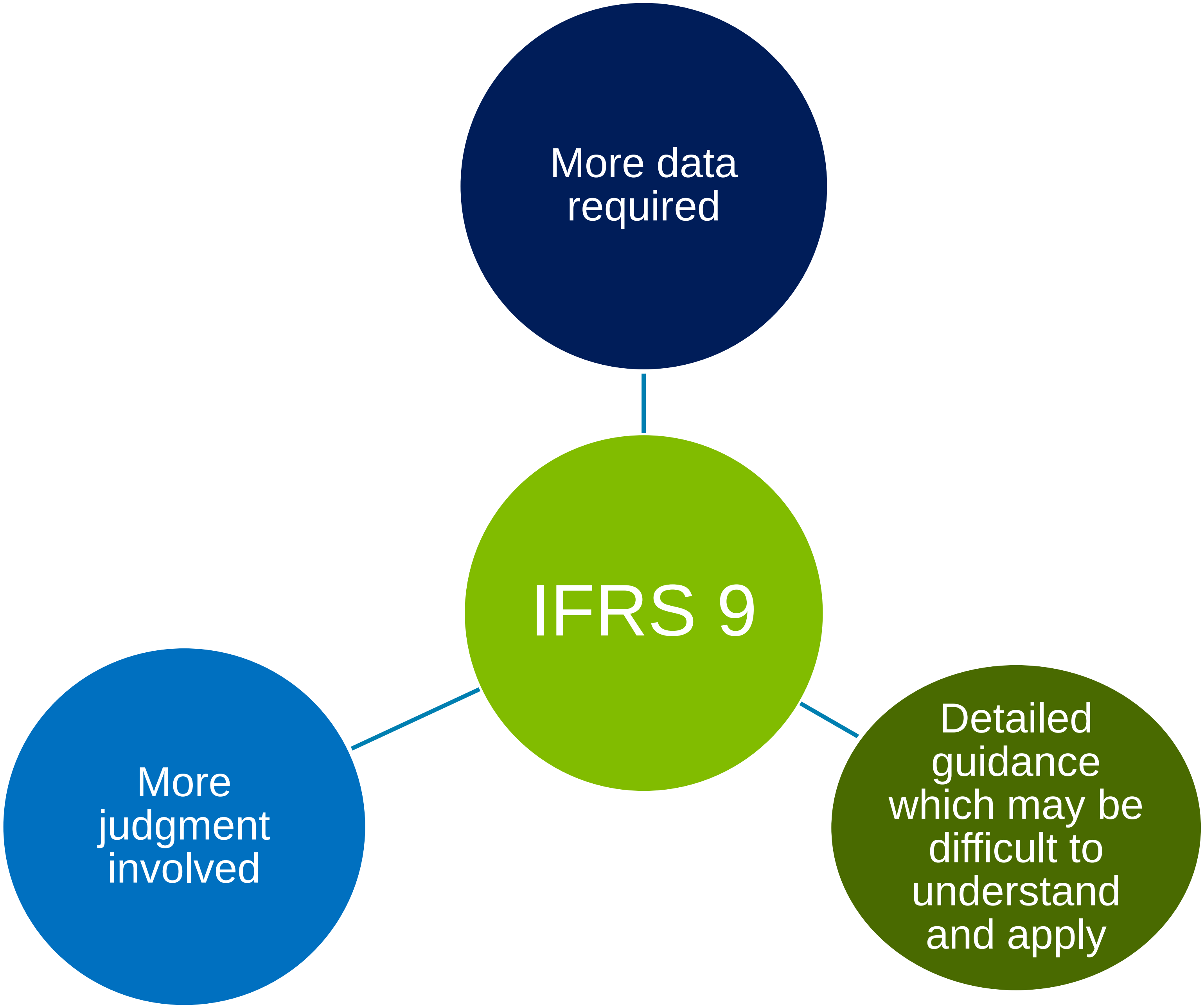
IFRS 9 Financial Instruments

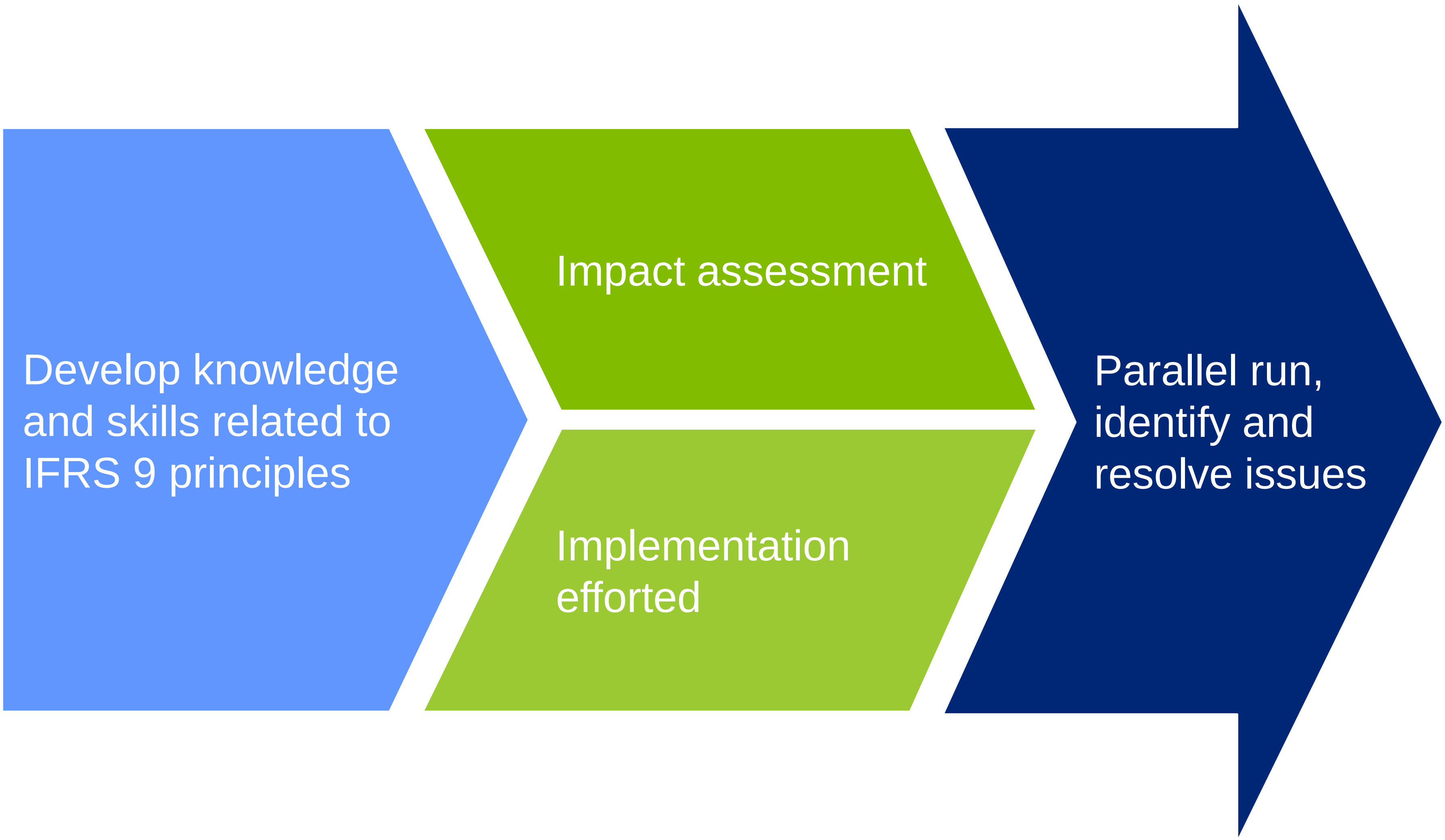
Thai General Assurance Association

9 March 2017

What impact will IFRS 9 have on your business?



Getting prepared for IFRS 9



Agenda

Session	
1	Overview of IFRS 9 and implementation plan in Thailand
2	IFRS 9 *Classification and Measurement*
3	IFRS 9 *Impairment*
4	IFRS 9 *Hedge accounting*
5	Transition requirements (with applying IFRS 9 with IFRS 4 phase II)
6	Concluding remark

IASB project on Financial Instruments

The IASB issued the final version of **IFRS 9 *Financial Instruments*** on July 24, 2014.

Classification and Measurement

Impairment

General Hedge Accounting

Macro Hedge Accounting

Separate project

Development of IFRS 9 *Financial Instruments*

IFRS 9 *Financial Instruments*

	Pre 2013	2013	2014	2018
Classification & Measurement	Phase Finalized + Limited Amendments ED		Limited Amendments	Effective 1/1/2018
Impairment	Exposure Draft		New Impairment Model	
General Hedge Accounting		Phase Finalized		
Macro Hedging			Discussion Paper	

Transition and Effective Date

In September 2016 the IASB issued amendments that insurers have the possibility to defer IFRS 9 to the earlier of the effective date of IFRS 4 Phase II or 1 January 2021.

Unless permitted or defer it IFRS 9 shall be applied for annual periods beginning on or after

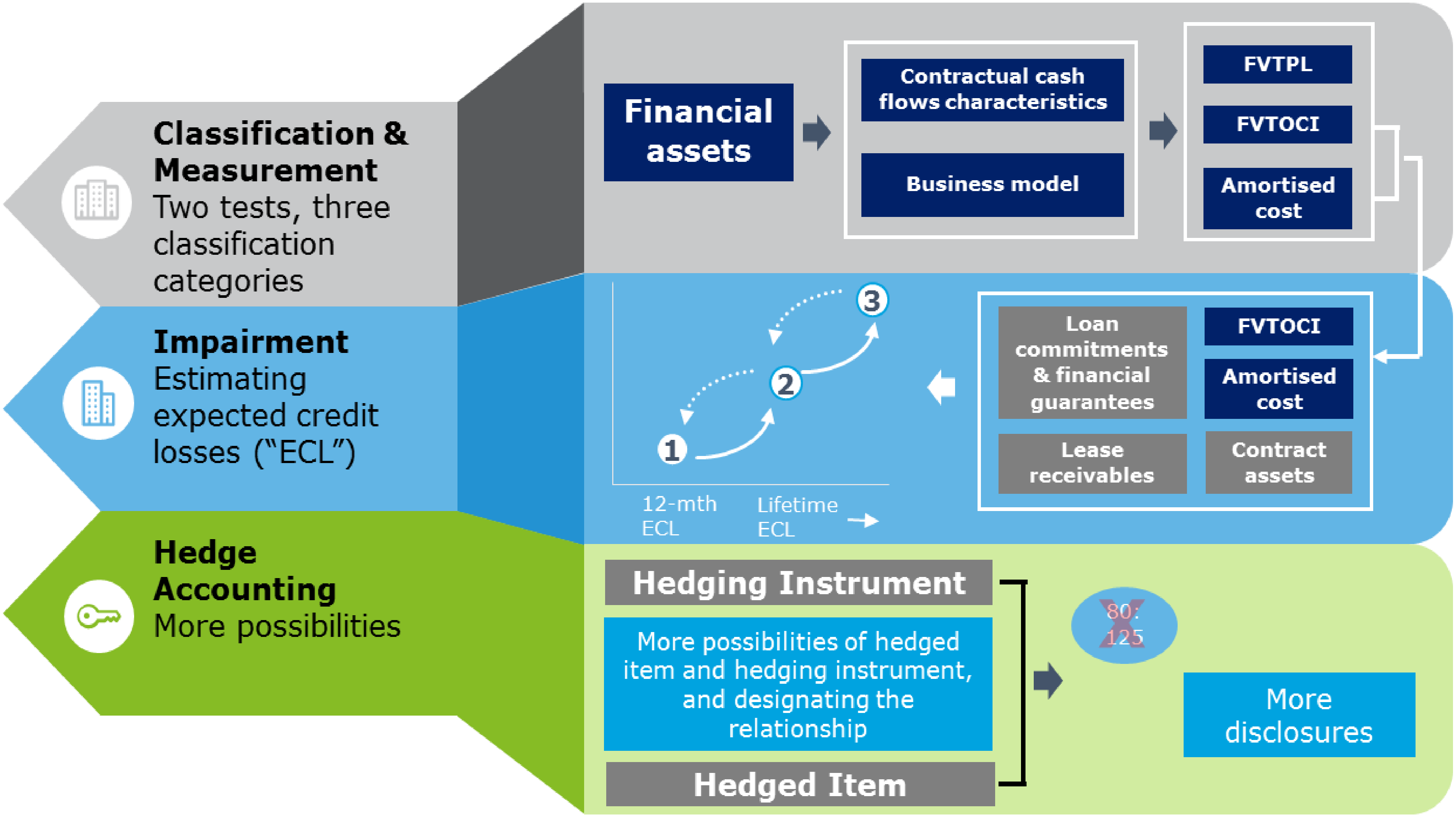
1 January 2018
Retrospective

- Restatement of prior periods has been simplified

Early application permitted

- Application of all requirements of IFRS 9 (2014)
- **Exemption:** Financial liabilities designated at fair value through profit or loss

IFRS 9 Overview



IFRS 9 key consideration

Major amendments

	Amendments compared to IAS 39?
Scope	None
Recognition & derecognition	None
⚠ **Classification and measurement of financial assets**	New model regarding the classification and measurement based on: • the entity's business model (portfolio perspective), and • the contractual cash flow characteristics (CCC criterion) of the individual financial asset
Classification and measurement of financial liabilities	• No amendments regarding classification • New requirements for the accounting of changes in the fair value of an entity's own debt where the FVO has been applied ("own credit issue")
Embedded derivatives	Bifurcation of embedded derivatives needs to be assessed for hybrid contracts containing a host that is a financial liability or a host that is not an asset within the scope of IFRS 9 (hybrid contracts with a financial asset as a host contract are classified in their entirety based on the CCC criterion)
Amortised cost measurement	None
⚠ **Impairment**	Change to expected loss model
⚠ **Hedge Accounting (HA)**	• New model more closely aligns HA with risk management activities • Accounting policy choice to apply the hedge accounting model in IAS 39 in its entirety or the accounting for portfolio fair value hedges under IAS 39 if applying IFRS 9 hedge accounting • Separate active project on accounting for macro hedging activities (currently not part of IFRS 9)

IFRS 9 *Classification and Measurement*

What will you learn?

Obtain a working knowledge of classifying financial instruments into the appropriate categories under IFRS 9

Identify and discuss the impact on clients related to the key provisions of C&M

Classification and Measurement

Obtain a working knowledge of measurement requirements under IFRS 9

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Why make changes to IFRS 9?
Classification and Measurement

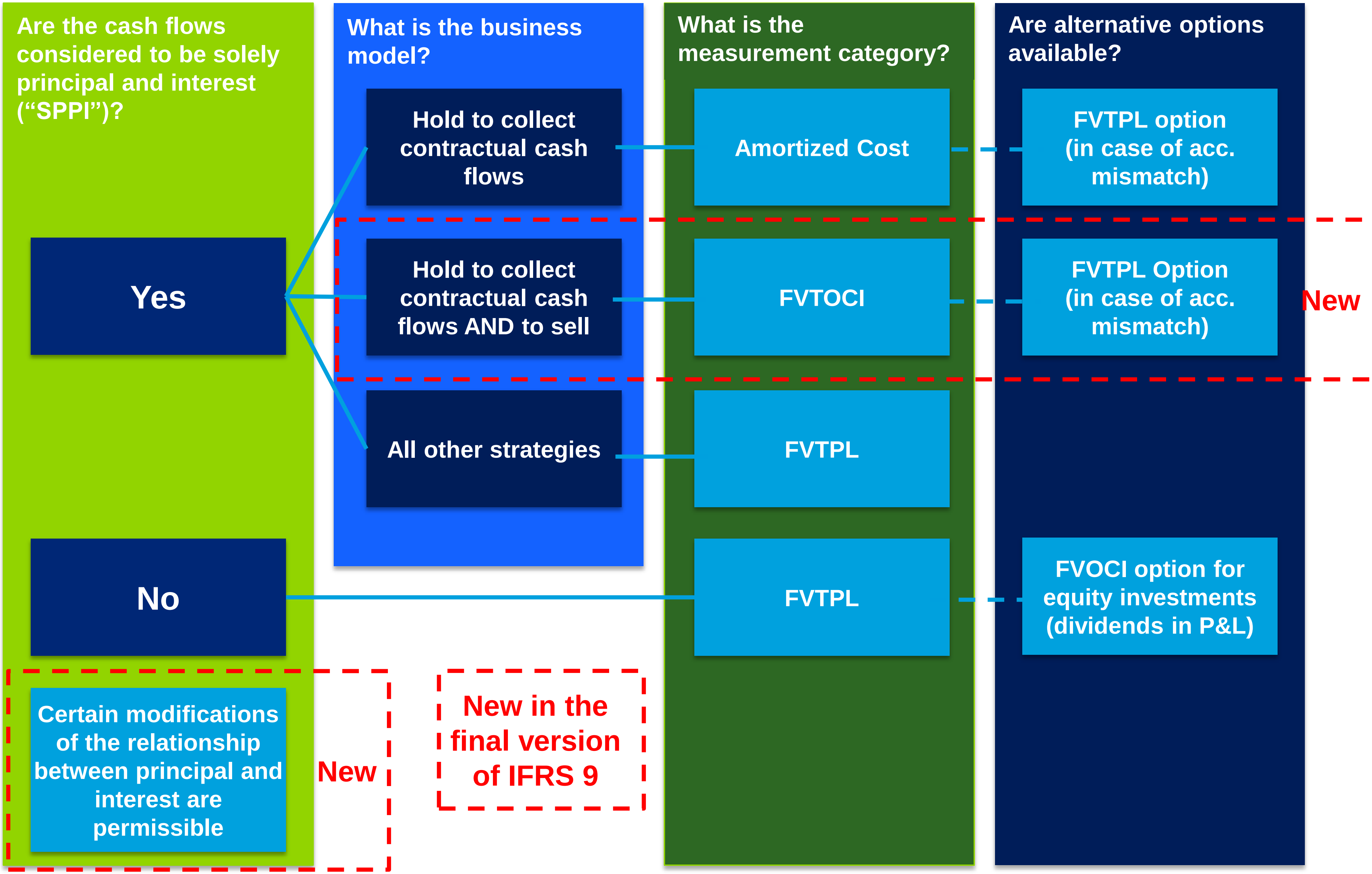
IAS 39	IFRS 9
• Contains many different classification categories and associated measurement and impairment requirements, reducing comparability • Application issues arose on classification and measurement of financial assets • Difficult to understand and apply in practice	• Reduces the complexity of classification categories and measurement requirements • Makes the classification and measurement model compatible to a single impairment model • Improves comparability and makes reporting easier to understand for readers

What are the differences?

IAS 39 Classification	IFRS 9 Classification
Rule-Based	Principle-based
Complex and difficult to apply	Classification based on business model and nature of cash flows
Own credit gains and losses recognized in P&L for fair value option (FVO) liabilities	Own credit gains and losses recognized in OCI for FVO liabilities
Complicated reclassification rules	Business model-driven classification

Classification and Measurement—overview

Financial assets



Contractual cash flow characteristics

Interest can comprise a return for:

- Time value of money
- Credit risk
- Liquidity risk
- Amounts to cover expenses and profit margin

Returns consistent with basic lending arrangement

Contractual cash flows are solely payments of principal and interest (SPPI) key characteristics

Assess on an asset by asset basis.

Contractual terms that change the timing or amount of cash flows

Modified time value of money (TVM)

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Contractual changes that meet the SPPI criterion

Prepayment feature

- Permits the issuer to prepay the debt instrument or the holder to put the debt instrument back to the issuer before maturity; **and**
- The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding–which may include reasonable additional compensation for the early termination of the contract.

Term extension feature

- Permits the issuer or the holder to extend the contractual term; **and**
- Results in contractual cash flows during the extension period that are SPPI on the principal amount outstanding.

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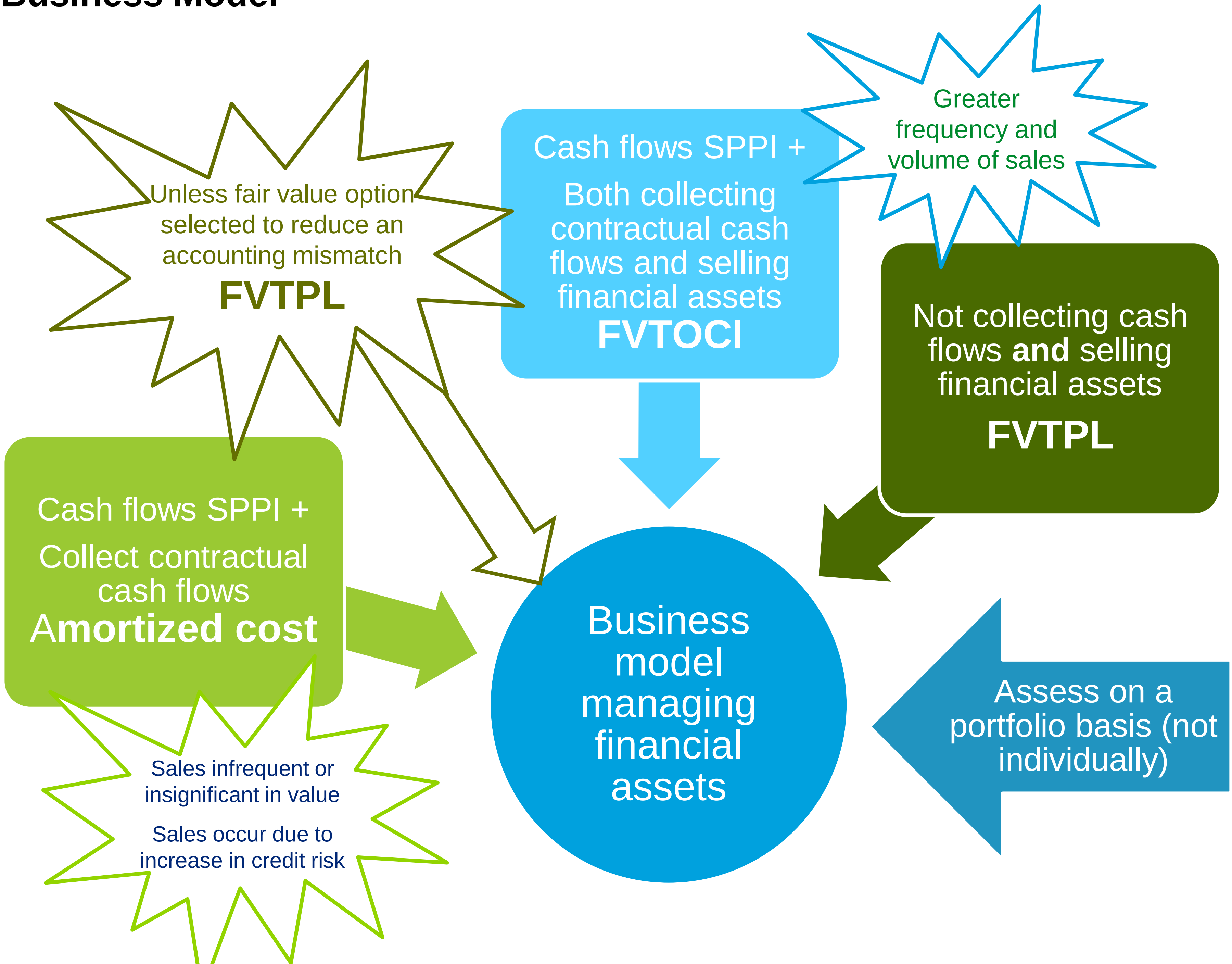
Business Model



Business model

Business model is determined by the entity's *key management personnel* (as defined in IAS 24)

Management of groups of financial assets to achieve a particular business model

Business model assessment according to IFRS 9

A business model can typically be observed through the activities that an entity undertakes to achieve its business objective, e.g.

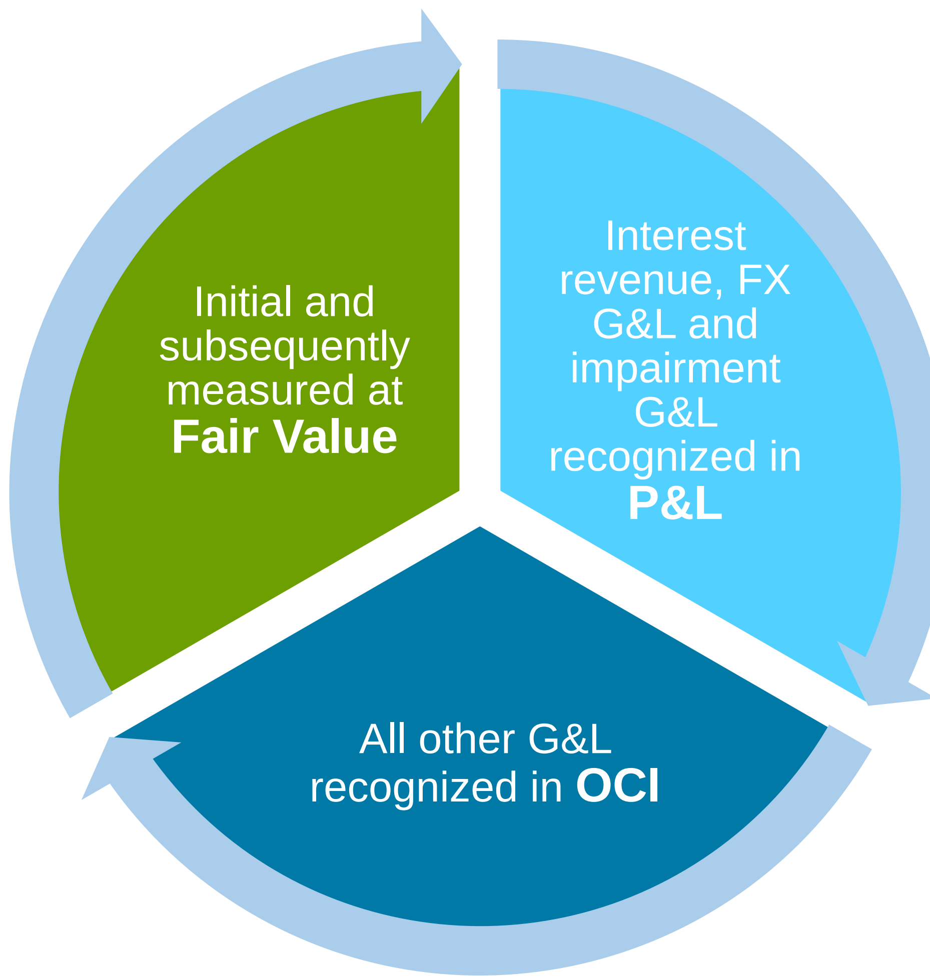
- Evaluation of performance of the business model and internal reporting
- Risk that affect the performance of the business model and management of those risks
- How managers are compensated (e.g. based on fair value)

Fair Value Through Other Comprehensive Income

A new measurement category Fair Value through Other Comprehensive Income (FVTOCI) has been introduced in July 2014.

Debt instruments measured at

FVTOCI



IFRS 9 requirements – Case study 1

Equity securities classified and measured at FVTOCI

First set of circumstances

- Contractual cash flows NOT solely payments of principle and interest
- Non-held for trading investment in an equity instrument that is designated at FVTOCI at initial recognition

Accounting

- Classified as FVTOCI
- Dividends recognized in profit or loss
- All other gains/losses recognized in OCI
- Upon de-recognition amount in OCI <u>are NOT</u> reclassified to profit or loss, but will be brought into tax when derecognized

IFRS 9 requirements – Case study 2

Debt securities classified and measured at FVTOCI (Cont'd)

Second set of circumstances

- Contractual cash flows solely payments of principle and interest
- Held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets
- NOT irrevocably designated at FVTPL at initial recognition

Accounting

- Classified as FVTOCI
- Interest, impairment and foreign currency gains/losses recognized in profit or loss
- All other gains/losses recognized in OCI
- Upon de-recognition amount in OCI <u>ARE</u> reclassified to profit or loss, but will then be brought into tax

Recap—other measurement models

FVTPL

- Initially and subsequently measured at **fair value.**
- All G&L recognized in **P&L.**

Amortized cost

- Initially measure at **fair value.**
- Calculate interest revenue using the **effective interest method,** applied to the gross carrying amount of the asset.
- Purchased or originated **credit-impaired** financial assets: apply the credit-adjusted effective interest rate to amortized cost from recognition.
- Subsequently **credit-impaired** financial assets: apply the credit-adjusted effective interest rate to the amortized cost of the financial asset.
- Instruments which meet the amortized cost criteria **must** be measured at amortized cost **unless** the fair value option is elected.

Measurement of equity instruments

not at cost

FVTPL

- Equity investments are typically held at **FVTPL** as they fail the contractual cash flow test.
- Derivative instruments linked to unquoted equity investments **must** be held at **FVTPL**.

FVTOCI

- **Irrevocable** option to elect to measure an equity investment at **FVTOCI**–make at initial recognition.
- Recognize dividend income through **P&L**.

Estimate FV

- **Cost** may be an appropriate estimation of FV for **unquoted** investments if there is insufficient recent info, or if there is a wide range of possible FVs.
- Indicators that this may **not** be appropriate are provided in **IFRS 9 B5.2.4.** (Be careful!)

including changes to market, performance, global economy, economic environment, competitors, technical progress

Recognition and measurement financial assets

Initial recognition	Fair Value according to IFRS 13			
	plus transactions costs	plus transactions costs		plus transactions costs
Subsequent measurement	Amortized cost	FVTOCI	FVTPL	FVTOCI (Equity Instrument)
Statement of financial position	Amortised cost	Fair value	Fair value	Fair value
P&L	Effective interest method, impairment & foreign exchange differences	Effective interest method, impairment & foreign exchange differences	(all) Fair value changes	Dividends
OCI	---	(other) Fair value changes	---	(all) Fair value changes
Recycling	---	Yes	---	No

Reclassification

1. External or internal changes which are significant to the entity's operations

demonstrable to external parties

2. **Entity's senior management changes business model**

3. Reclassification of financial assets prospectively from the **reclassification date**

The first day of the first reporting period following the change in business model

When is reclassification allowed?

Assets

When an entity changes its business model for managing financial assets.

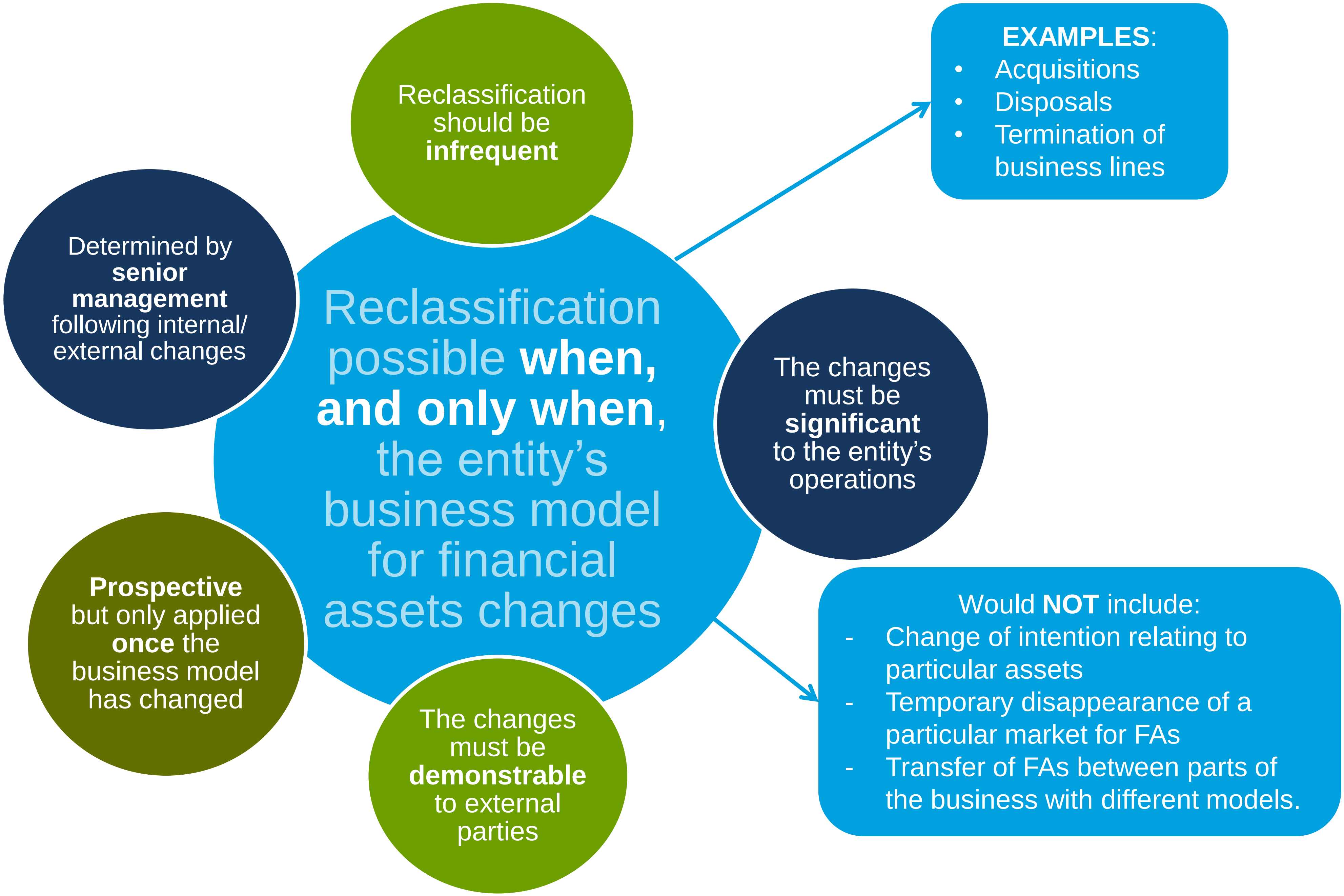
Liabilities

NEVER

Common examples of changes that are **not** reclassifications

- An item which was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge, that no longer qualifies;
- An item that becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and
- Changes in measurement–credit exposure designated as FVTPL

Reclassification of financial assets



Reclassification of financial assets

Amortized Cost to → **FVTOCI**

1. Recognize @ FV
2. Difference between previous carrying amount and FV recognized in OCI
3. No adjustment to effective interest rate

FVTOCI to → **Amortized Cost**

1. Recognize @ closing FV + amounts already in OCI
2. No adjustment to effective interest rate
3. Only impacts OCI, not P&L

No reclassification possible where investments in equity instruments have been designated FVTOCI at initial recognition

FVTOCI to → **FVTPL**

1. Continues to be measured at fair value
2. IAS 1 reclassification adjustment of cumulative amounts from OCI to P&L

Reclassification of financial assets

Amortized Cost to → **FVTPL**

1. Recognize @ FV
2. Difference between previous carrying amount and FV recognized in P&L.

FVTPL to → **Amortized Cost**

1. Closing FV becomes the new AC opening gross carrying amount.
2. A new EIR and measurement of loss allowance for expected credit losses will be required

No reclassification possible where assets have been designated FVTPL to prevent any accounting mismatches.

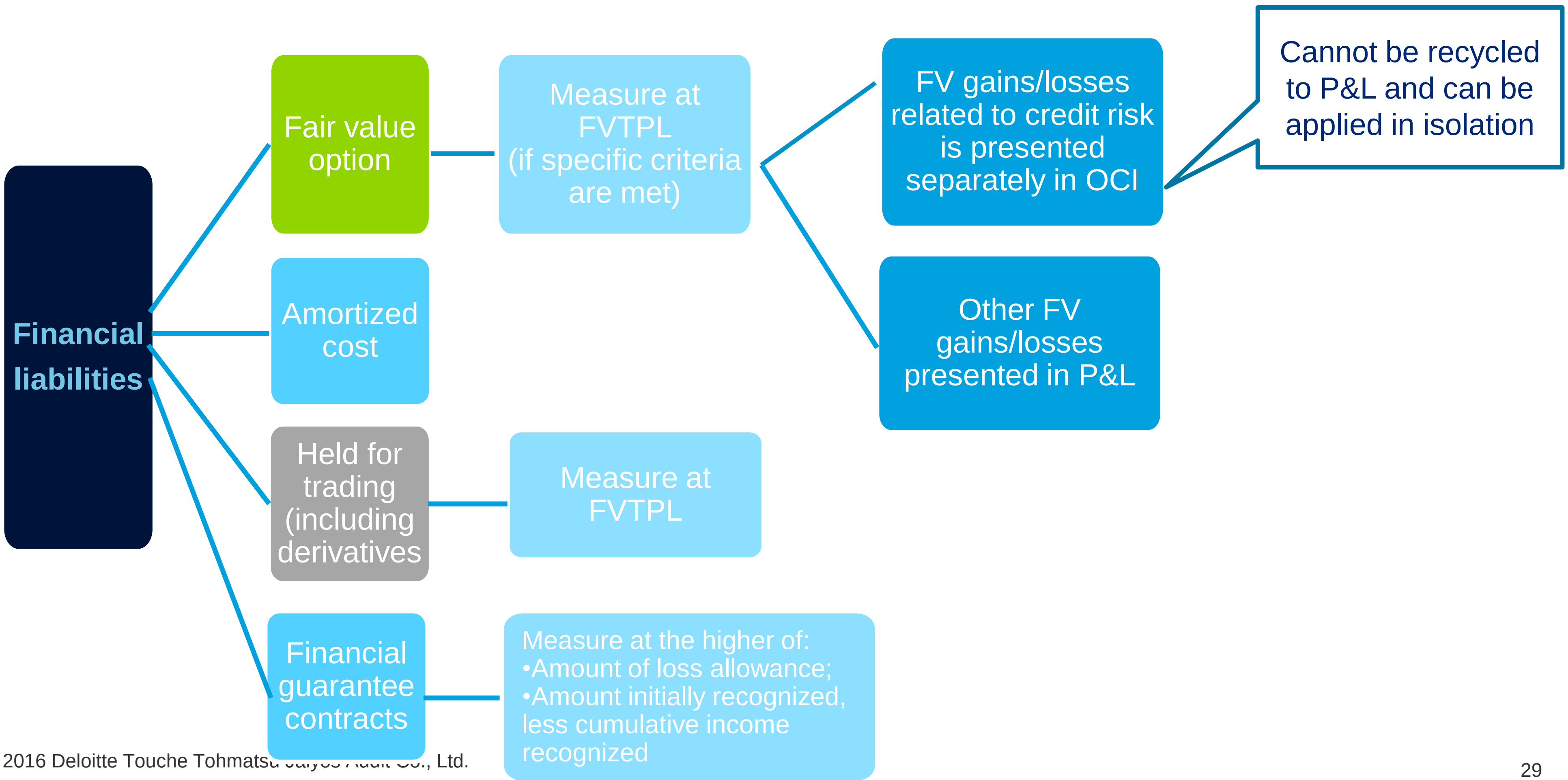
FVTPL to → **FVTOCI**

1. Continue to measure at fair value.
2. A new EIR and measurement of loss allowance for expected credit losses will be required

Classification and measurement of financial liabilities

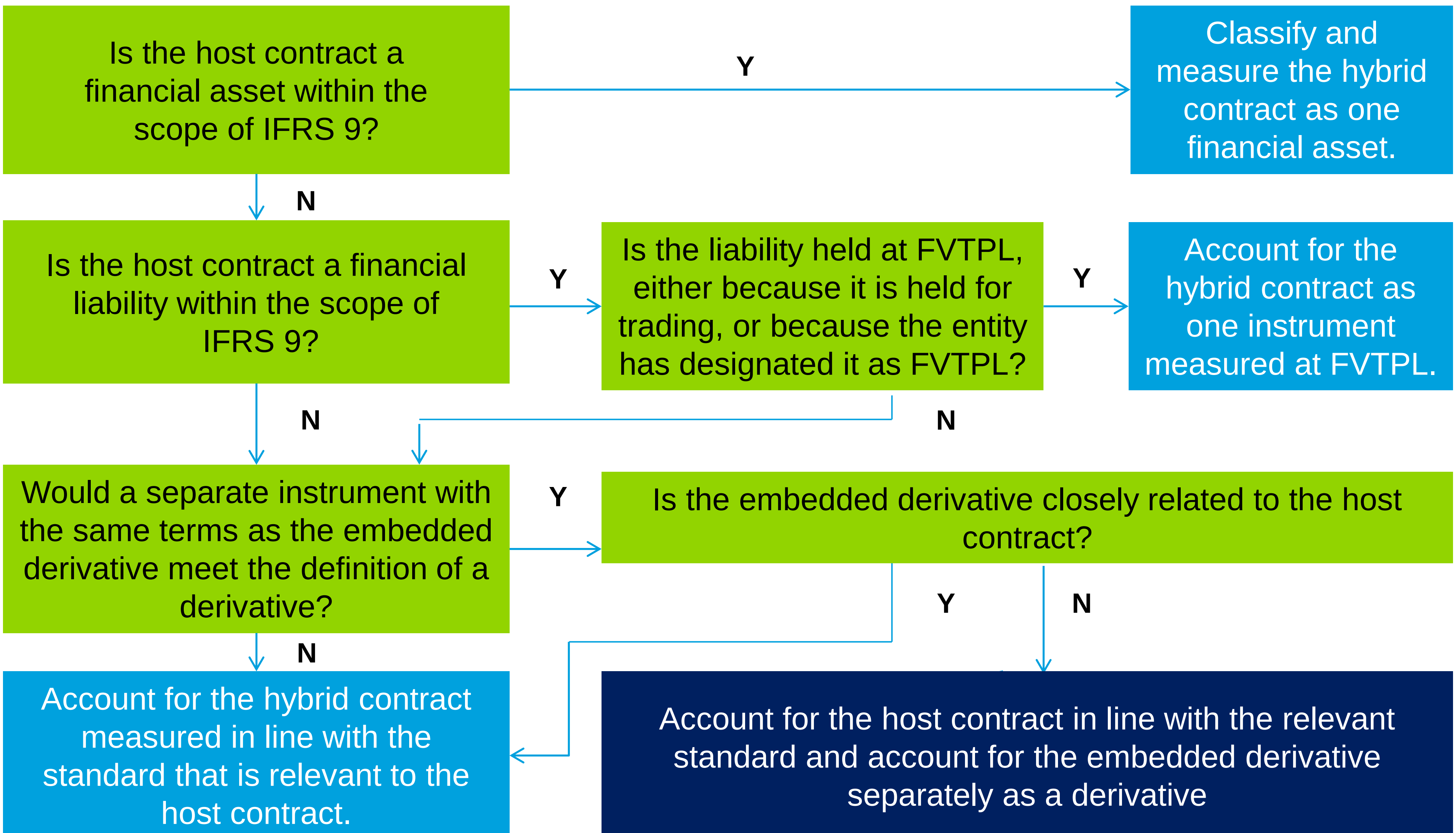
The IFRS 9 classification and measurement model for financial liabilities is the same as under IAS 39 except for the following:

- The presentation of fair value changes for own credit;
- Liabilities presented as equity (e.g., puttables) must be held at FVTPL; and
- Derivative liabilities over unquoted equities can no longer be measured at cost.



Embedded derivatives

Definition: a component of a hybrid contract that includes a non-derivative host.



Disclosures

Classification and Measurement

Information to be presented in the performance statement **(IAS 1.82)**	• When a financial asset is reclassified from amortized cost to FVTPL, recognize any gain or loss arising on revaluation as a separate line item in OCI • When a financial asset is reclassified from FVTOCI to FVTPL, disclose separately any transfers of amounts recognized in OCI to P&L
Financial liabilities designated at FVTPL **(IFRS 7.10-10A)**	• Transfers of gains or losses within equity, including the reason for transfer and the amounts involved • Amounts presented in OCI that were realized at derecognition during the reporting period (if any)
Investments in Equity instruments at FVTOCI **(IFRS 7.11A and 7.11B)**	• Disclose which investments in equity instruments that have been designated as FVTOCI and why • Fair value of each such investment at the reporting date • Dividends recognized during the reporting period • Any transfers of cumulative gains or losses within equity and reasons why • Disclose information about derecognized investments in equity instruments measured at FVTOCI, including the reasons for disposal, their FV at disposal, and the gain/loss on disposal

Discussion

Talking points

How? How should you address classification and measurement with your clients?

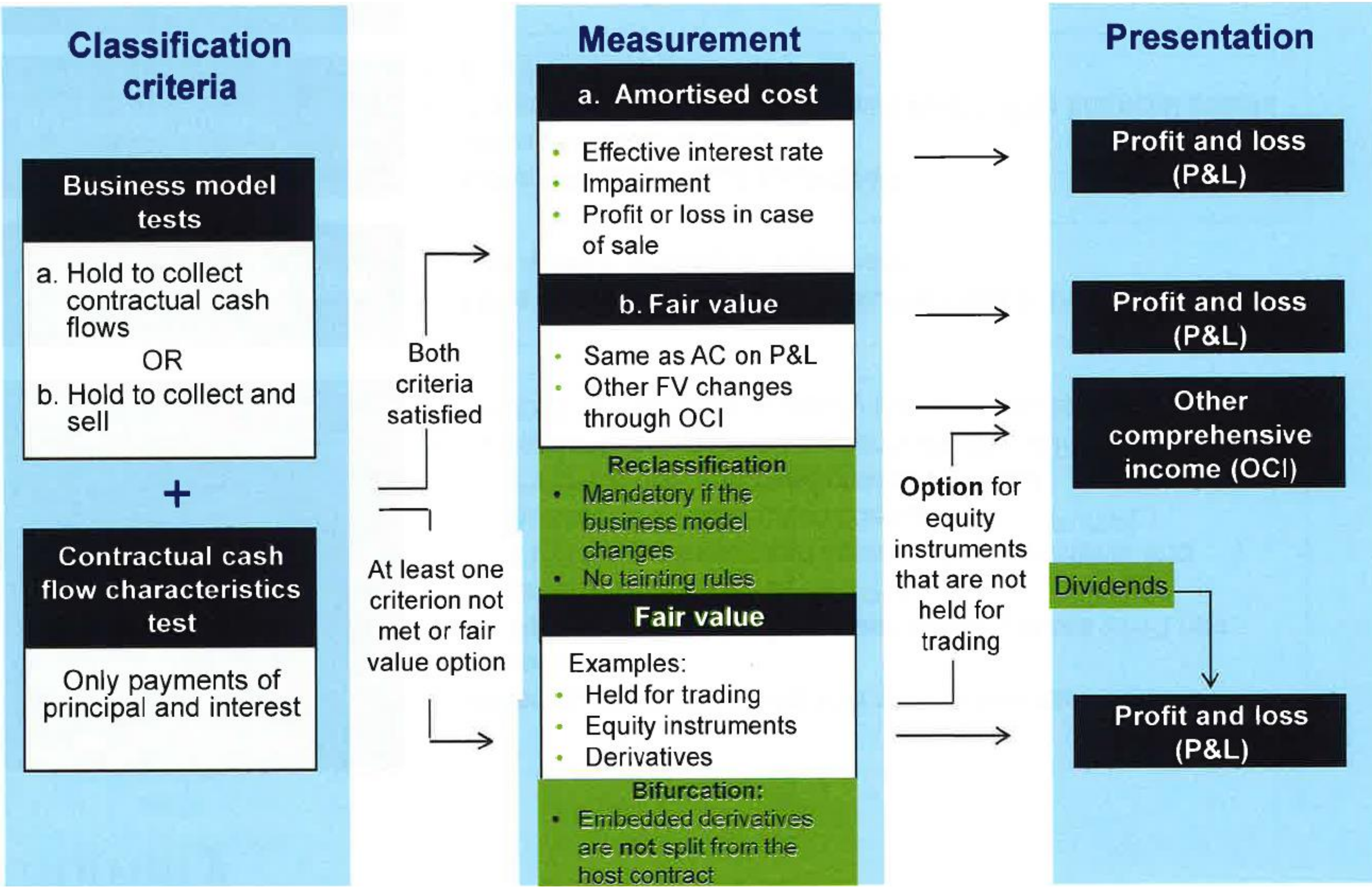
Where? Where should you start?

What? What information will you need?

When? When should you adopt IFRS 9?

IFRS 9 Classification and measurement

Choices insurers need to make



Summary

Classification and Measurement	• Driven by business model and contractual cash flow characteristics ○ Amortized cost (collects cash flows, passes SPPI test) ○ FVTOCI (collects cash flows, sells instruments and passes SPPI test)–or designated under FVO ○ FVTPL (not one of the above) • Investments in equity instruments always at FV • FVTOCI for non-trading equity investments by election
Contractual cash flow	• For a cash flow to be SPPI–returns need to be consistent with a basic lending arrangement
Business Model	• Collecting contractual cash flows • Selling financial assets • Collecting contractual cash flows **and** selling financial assets • Or other models
Own credit	• Changes in FV recognized in OCI for financial liabilities designated as at FVTPL

IFRS 9 *Impairment*

What will you learn?

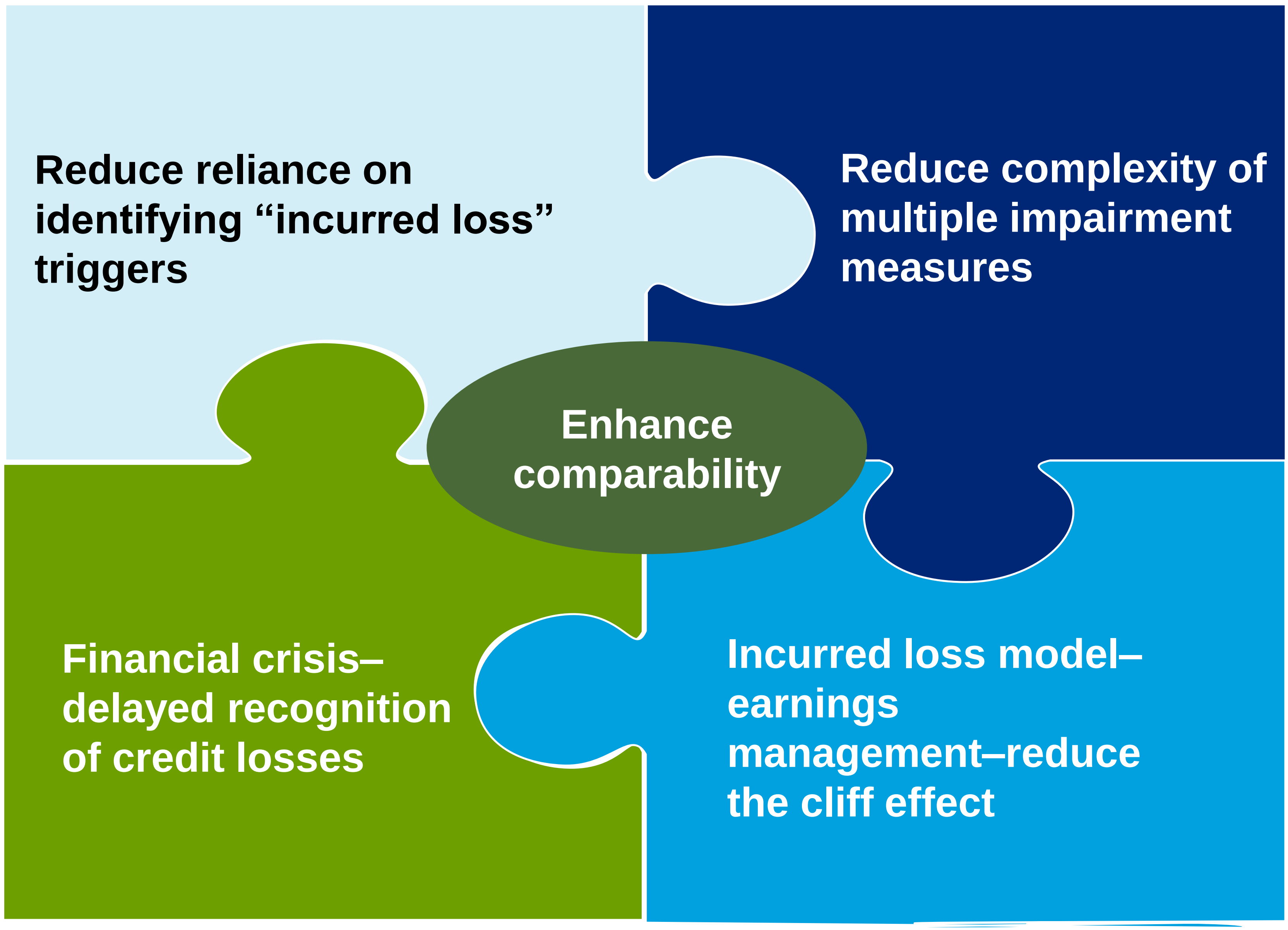
Obtain a working knowledge of the new impairment model under IFRS 9.

Identify the impact of the key provisions of Impairment.

Impairment model

Identify the key differences of the impairment model between the existing and new requirements.

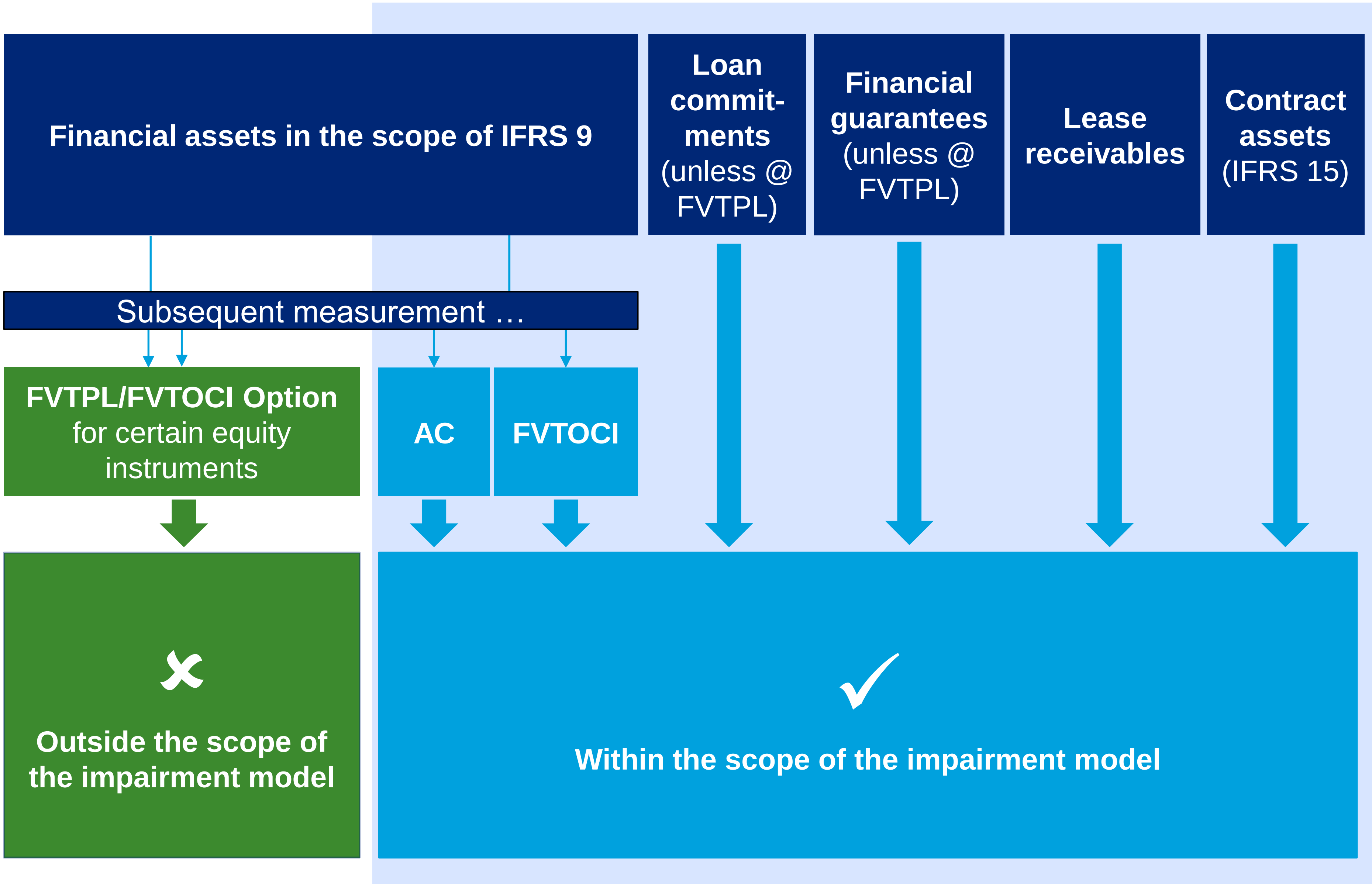
Why have changes been made to the impairment model under IFRS 9?



How is this different from existing practices?

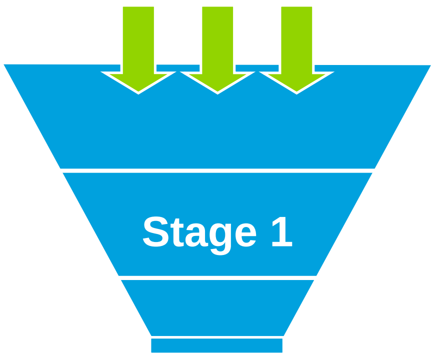
IAS 39	IFRS 9
Multiple impairment models –incurred loss	One impairment model –expected losses

Scope


Financial assets in the scope of IFRS 9
Loan commit-ments (unless @ FVTPL)
Financial guarantees (unless @ FVTPL)
Lease receivables
Contract assets (IFRS 15)
Subsequent measurement …
FVTPL/FVTOCI Option for certain equity instruments
AC
FVTOCI
Outside the scope of the impairment model
Within the scope of the impairment model

Expected credit loss (ECL) model

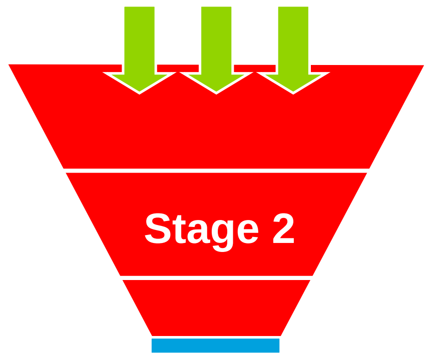
No **significant** increase in credit risk



12-month expected credit losses

interest calculated on **gross** carrying amount

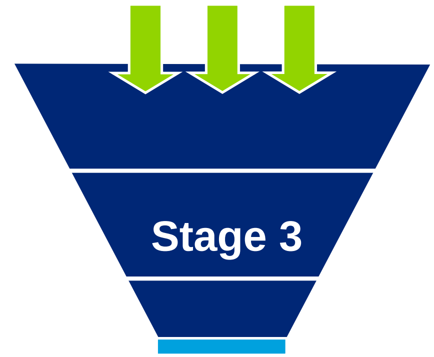
Significant increase in credit risk **and** greater than low credit risk **but** no objective evidence of impairment



lifetime expected credit losses

interest calculated on **gross** carrying amount

Objective evidence of impairment



lifetime expected credit losses

interest calculated on **net** carrying amount

Simplifications and exceptions:	• Low credit risk model • Purchased or originated credit-impaired financial assets • Trade receivables and contract assets

Expected loss allowance

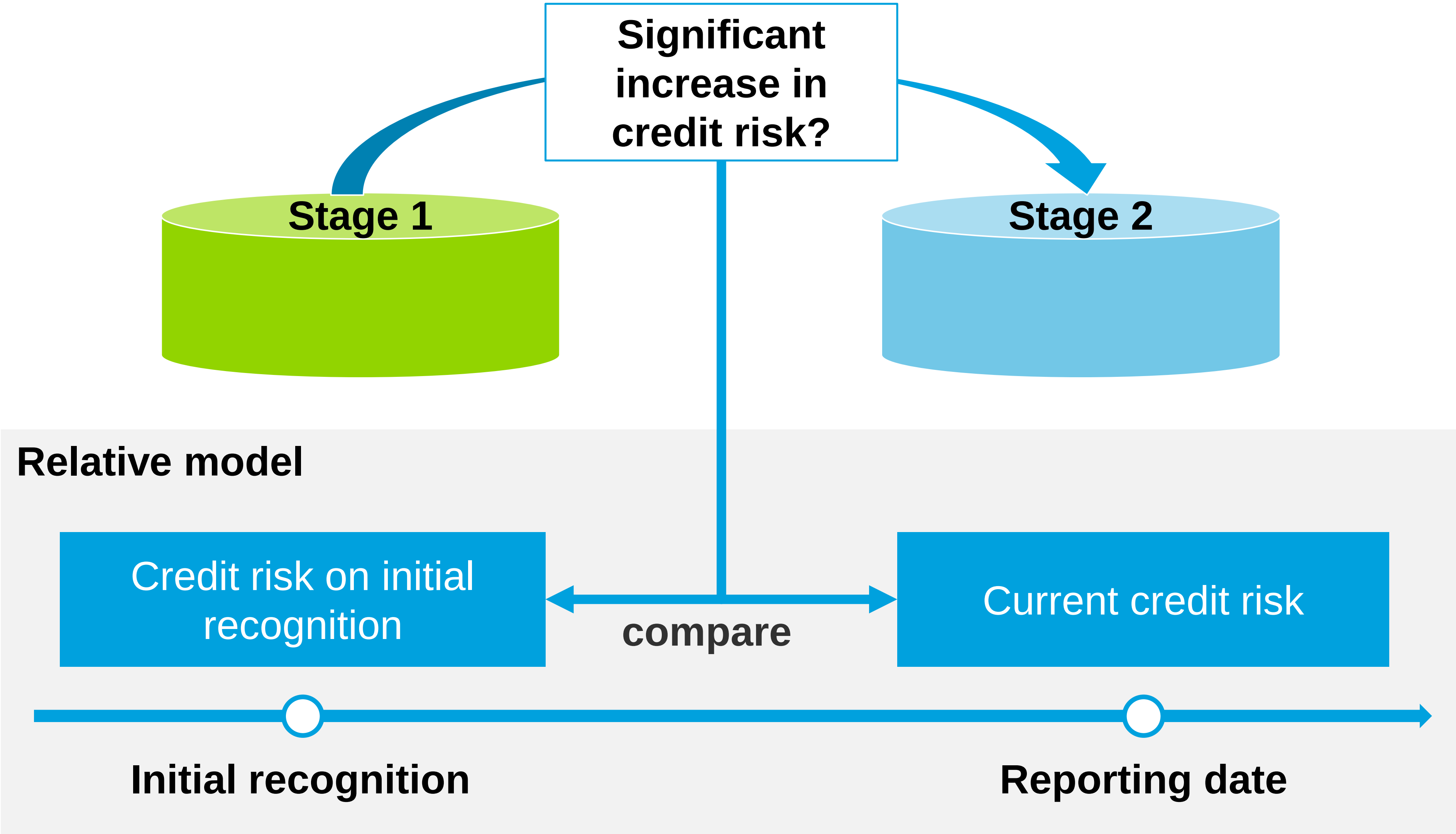
12-month vs. lifetime

12-month expected credit losses	Full lifetime expected losses
• 12-month ECLs are those that result from default events on the financial instrument that are possible within the 12 months after the reporting date. • The lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighted by the probability of that default occurring. • Do **not** confuse with the idea of the cash shortfalls expected in the next 12 months– these are different concepts.	• Full lifetime ECLs are those that result from all possible default events over the expected life of the financial instrument. • Impairment losses are measured at lifetime ECLs if an instrument's credit risk has increased significantly since initial recognition. • If a significant increase in credit risk reverses by a subsequent period, then measurement of the impairment allowances will revert to 12-month ECLs (**except** for purchased/originated credit-impaired instruments).

Significant Increase in Credit Risk

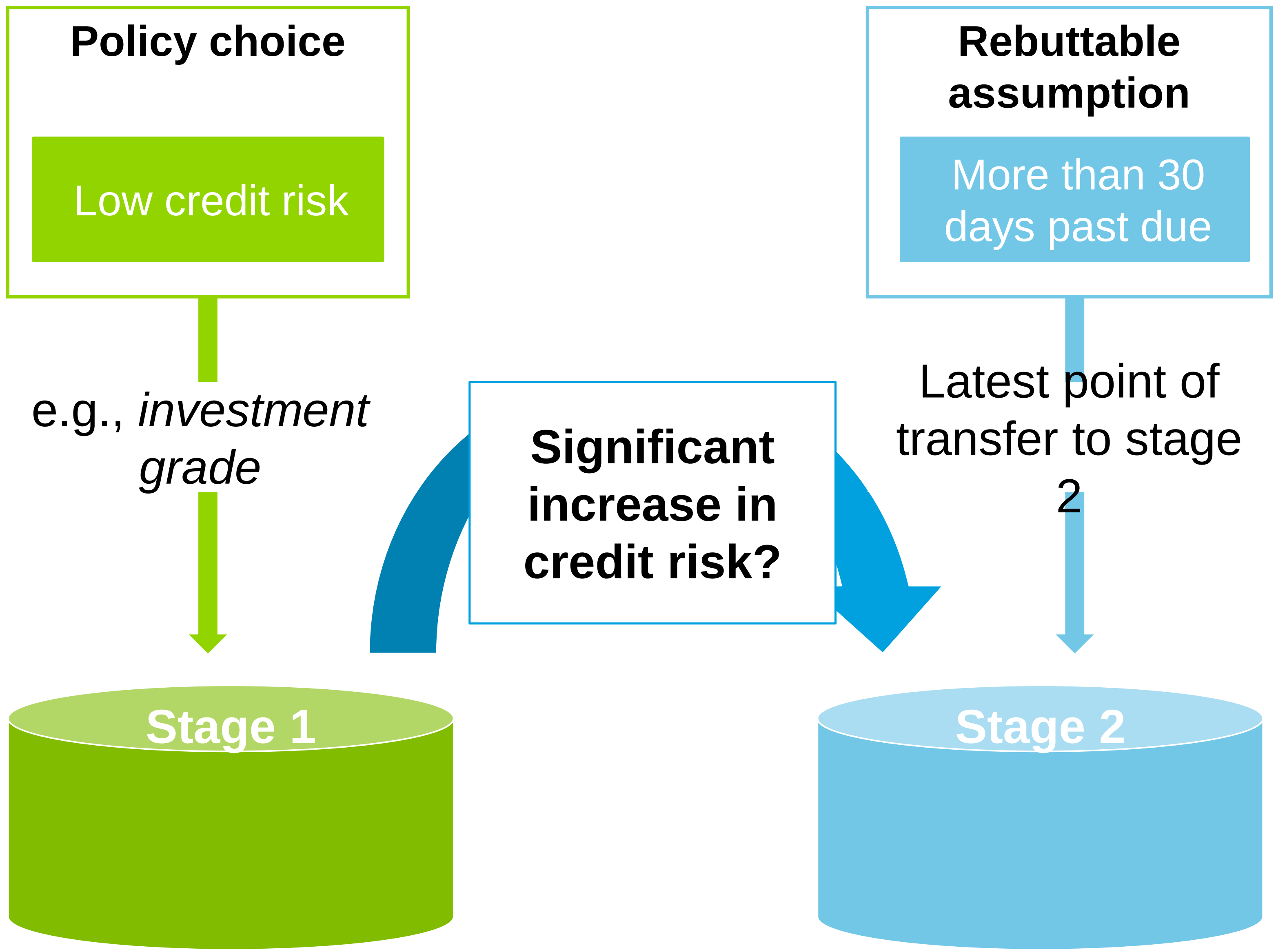
Transfer out of Stage 1

Significant increase in credit risk



Transfer out of Stage 1

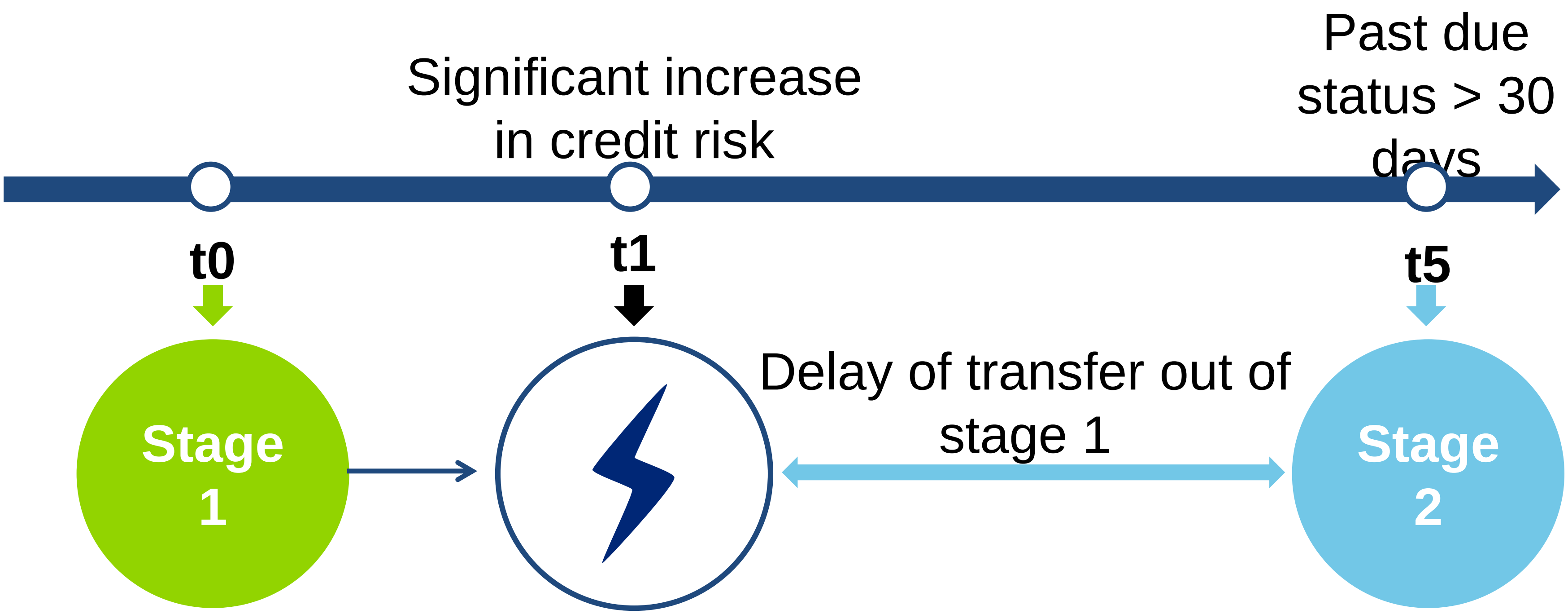
Assumptions and Approximations



Transfer out of Stage 1

Collective or individual assessment

If transfer out of stage 1 CANNOT be identified on a timely basis …



… assessment needs to be performed on a collective basis by considering information on portfolio or sub-portfolio level

Transfer out of Stage 1

Collective or individual assessment

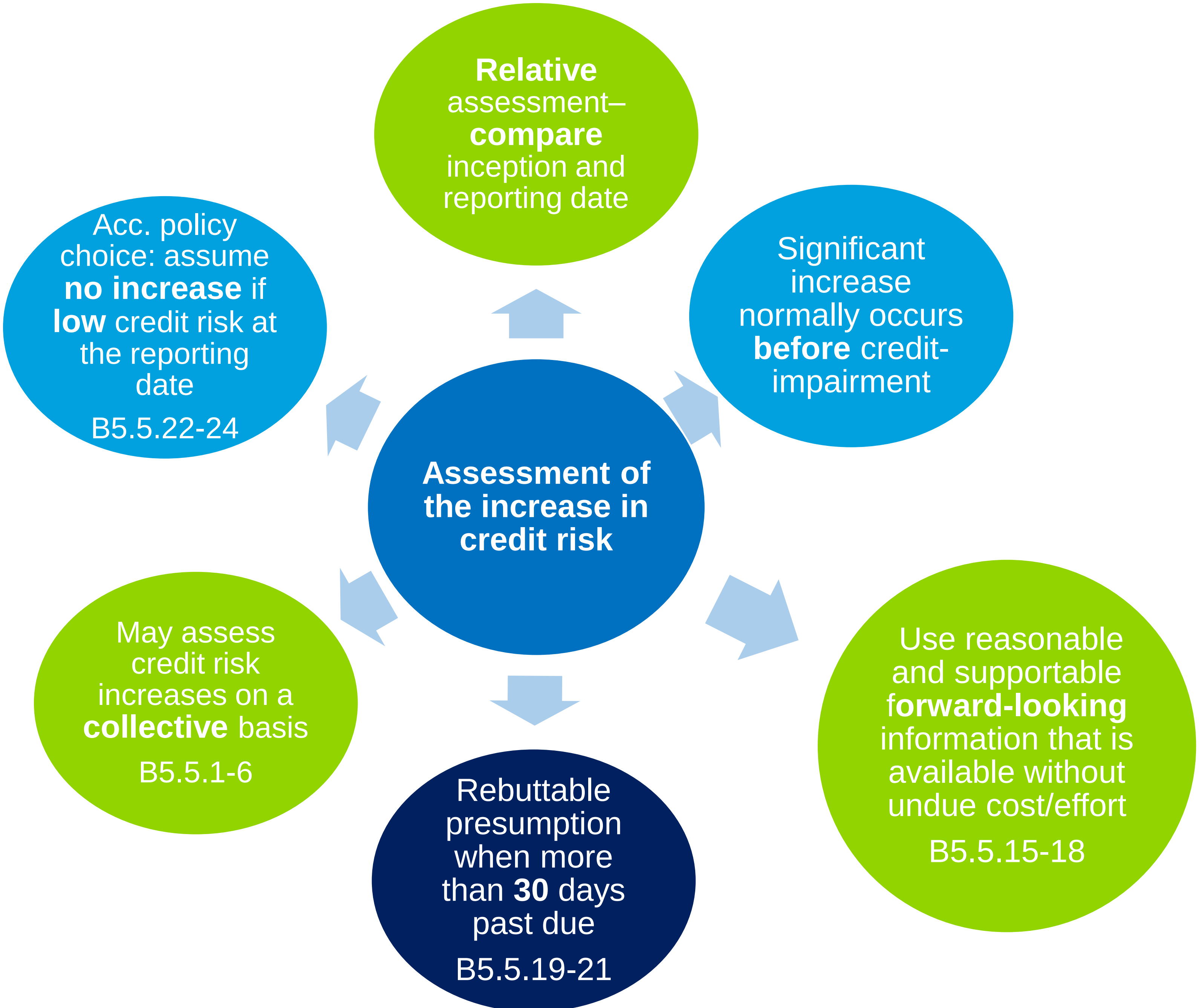
General principle
In order to meet the objective of recognising lifetime expected credit losses for significant increases in credit risk since initial recognition, it may be necessary to perform the assessment of significant increases in credit risk on a collective basis.

This is to ensure that lifetime expected credit losses are recognised when there are significant increases in credit risk, even if such information is not available at an individual instrument level.

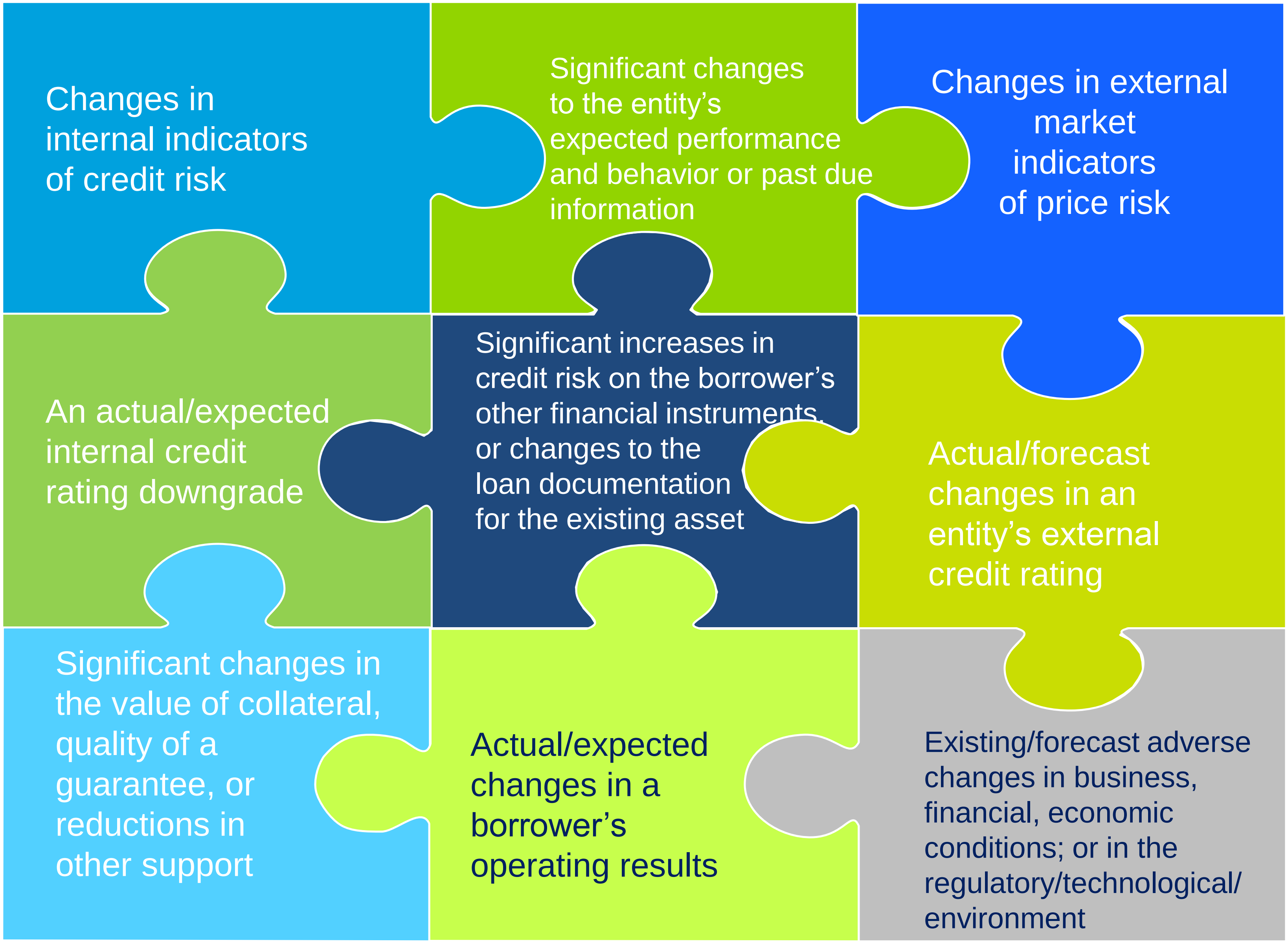
XYZ sector hit hard by new developments – job cuts expected!

Interest rates expected to rise!

Assessment of a significant increase in credit risk



Reasonable, supportable information—factors to consider



Transfer to Stage 3

Transfer out of Stage 2

Indicators that an instrument is Credit-impaired

Breach of contract (e.g. past due or default)

Lenders grant a **concession** relating to the borrower's financial difficulty

Credit-impaired

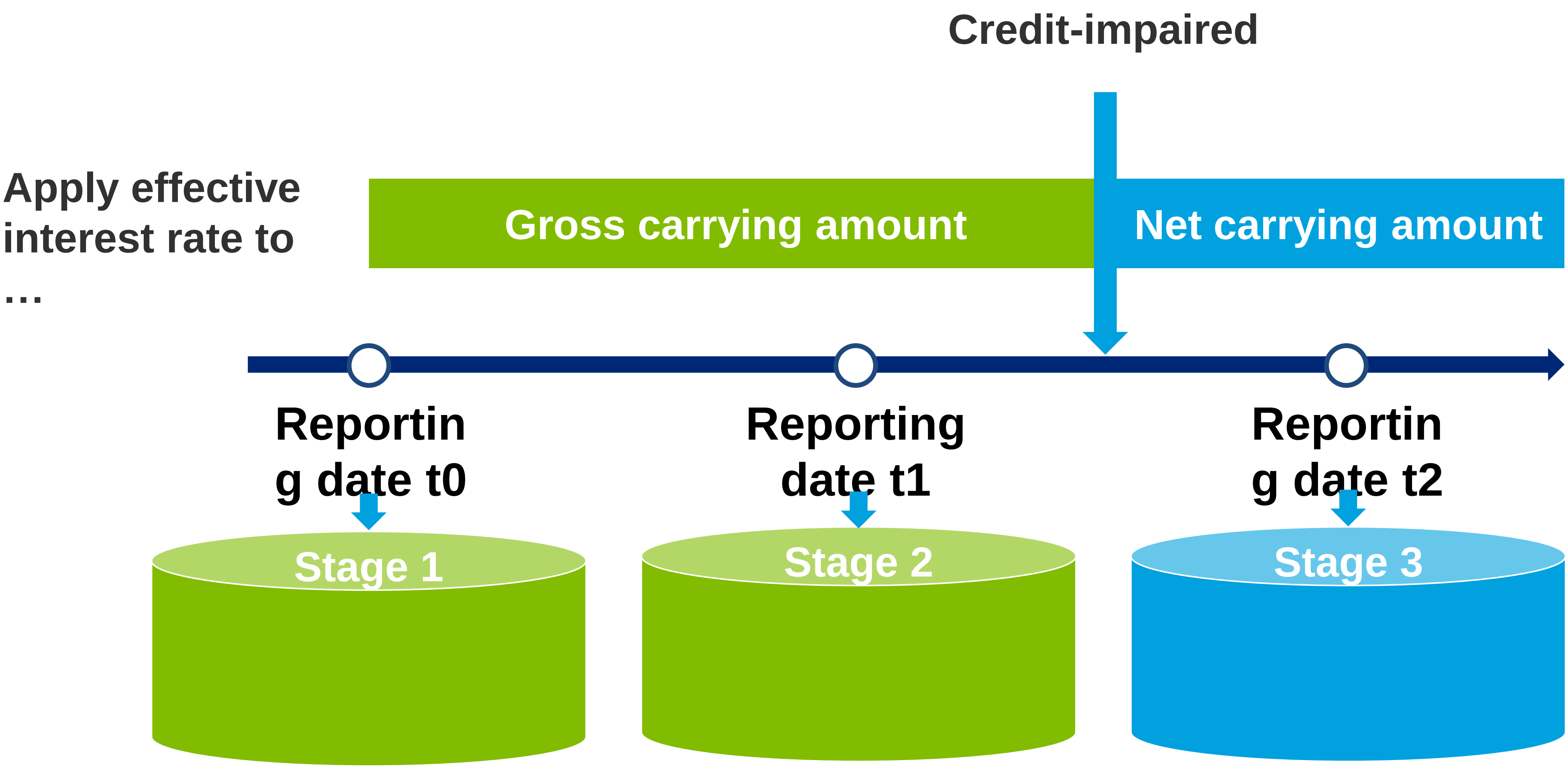
Significant **financial difficulty** of the borrower

Probable **bankruptcy** or other financial reorganisation

Disappearance of an active market for that financial asset because of financial difficulties

Transfer out of Stage 2

Interest Revenue



Impairment Focus Areas

Multiple challenges

1. Impairment Requirements

New general impairment model create the biggest challenge

Change in credit risk

Stage 1 Initial recognition	**Stage 2** Significant increase in credit risk	**Stage 3** Objective Evidence of Impairment

Loss Allowance

1 year EL	**Lifetime EL**

Interest revenue

Gross basis	**Net basis**

Accounting Treatment & Disclosure

Credit risk management

- Assumptions, methodologies, inputs, techniques and policies

Expected credit loss evaluations

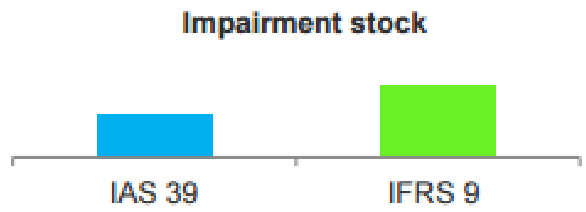
- Movements between stages
- Reconciliations

Credit risk profile

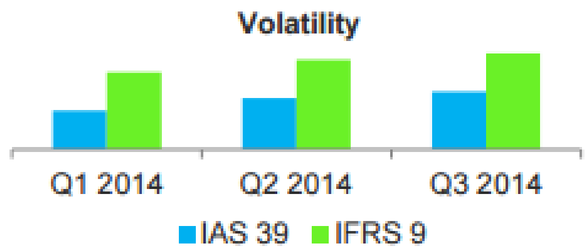
- Increased granularity

2. Financial Impact

Impairment stock anticipated to increase upon transition



Impairment volatility also to significantly increase post transition



Changes require early and ongoing quantitative impact assessment to:

- Prepare communication of change to key stakeholders and
- Inform key design choices including:
  - Model methodology
  - Stage 2 and 3 cut-offs

3. Implementation complexities

Complex implications across multiple dimensions of the Operating Model.

Models	• Scoring, pricing • PD, LGD EAD • Behavioral lifetime
Data	• Data history • Operational data
IT	• Source systems • Datamarts • Calculators
Controls	• Governance • Model governance • Process controls
Reports	• Internal & external • Quantitative & qualitative
People	• Risk & Finance roles & responsibilities • Skills and resources

Measurement of expected credit losses

Time value of money

Discounted to the reporting date using the effective interest rate at initial recognition or an approximation thereof.

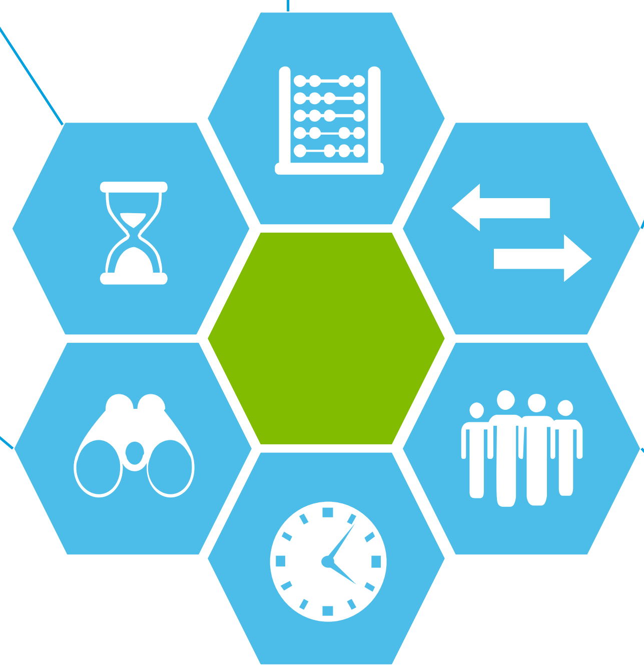
Information

All reasonable and supportable information, which is available without undue cost or effort including information about past events, current conditions, and forecasts of future economic conditions.

Expected value

The estimate shall always reflect:

- the possibility that a credit loss occurs; and
- the possibility that no credit loss occurs.



Cash shortfalls

Shortfalls of principal and interest as well as late payment without compensation.

Collective assessment

Measurement on individual instrument or on portfolio level.

Period

Maximum contractual period under consideration of extension options.

12-month Expected Credit Loss (ECL) Measurement

Probability of Default (POD) approach

Facts:

Entity as a lender - Single 10 year loan for CU1million

Assessment:

- At initial recognition, the POD over the next 12 months is 0.5%
- At reporting date, no change in 12-month POD; and entity assesses that no significant increase in credit risk since initial recognition – therefore Lifetime ECL is not required to be recognised
- Loss given default (LGD) is determined to be 25% of gross carrying amount

Loan	CU 1,000,000	A
LGD	25%	B
POD – 12 months	0.5%	C
Loss Allowance (for 12-month ECL)	**CU 1,250**	**A x B x C**

12-month Expected Credit Loss (ECL) Measurement

Loss Rate (LR) approach

Facts:

- Bank as a lender – 2,000 bullet loans with total gross carrying amount of CU500,000
- Portfolio segmented into borrower groups (X & Y) based on shared credit risk characteristics at initial recognition
- Historical defaults per 1000 loans sample: 4 defaults (Grp X) and 2 defaults (Grp Y)

Assessment:

- Bank considers forward looking information and expects an increase in defaults over the next 12 months compared to the historical rate: 5 defaults (Grp X) and 3 defaults (Grp Y)
- At the reporting date, the entity assesses that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios – therefore Lifetime ECL is not considered.

	# clients in sample	Estimated GCV per client	Expected defaults	Estimated GCV at default	PV of observed loss	Loss rate
Group	A	B	C	D= B x C	E	F = E / B
X	1,000	CU200	5	CU1,000	CU750	0.375%
Y	1,000	CU300	3	CU900	CU675	0.225%

These Loss Rates are then used to estimate 12- month ECL on new loans in Group X and Group Y that originated during the year and for which the credit risk has not increased significantly since initial recognition

Disclosures—new ECL impairment model

The disclosures shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. IFRS 7 disclosure requirements for credit risk are:

Credit risk management practices

- How these relate to recognition and measurement of ECL
- Methods, assumptions, information

Quantitative and qualitative information

- Amounts in FS arising from ECL
- Changes in amount of ECL
- Reason for changes

Entity's credit risk exposure

- Credit risk inherent in entity
- Credit risk concentrations

Disclosures—interest and loss allowances

Interest

- Stage 1&2 assets, apply EIR to **gross** carrying amount.
- Stage 3 assets, apply EIR to **net** carrying amount.
- Disclose total interest charge/income **separately** from FV gains/losses for each classification of financial instrument.

Loss allowances: FVTOCI

- Loss allowances do not affect the carrying amount of financial assets held at FVTOCI.
- Charge for loss allowances recognized in P&L “other gains and losses”. Corresponding credit taken to OCI.

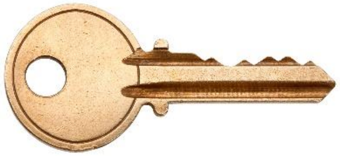
Loss allowances: amortized cost

- Loss allowances recognized within P&L–“other gains and losses”.

General disclosures: loss allowances

- For each class of financial instrument, disclosure of a reconciliation from the opening balance to the closing balance of loss allowances.
- Additionally disclose the total amount of undiscounted expected losses at initial recognition of financial assets recognized during the reporting period.

Summary

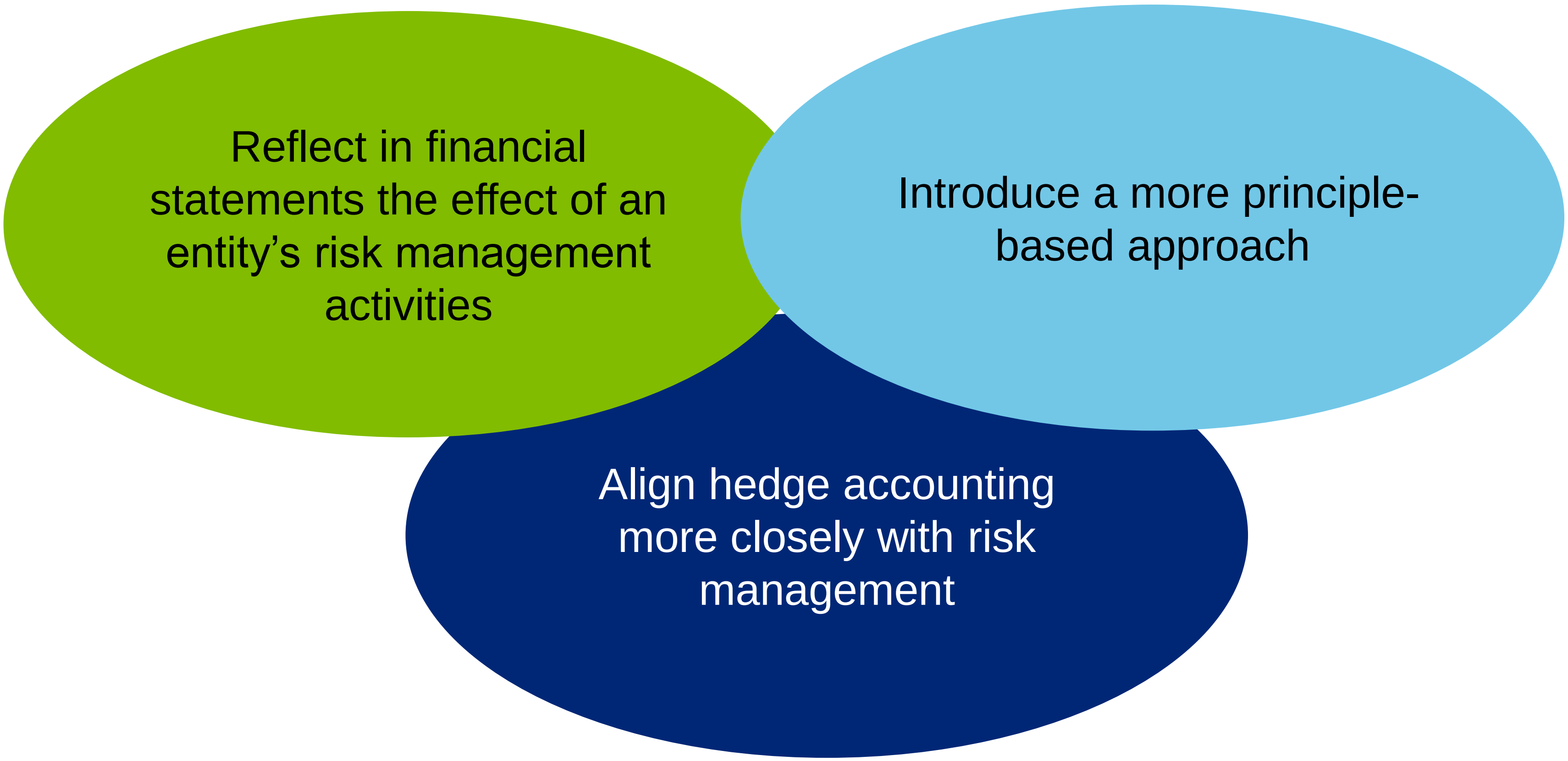


Expected credit loss model	• Forward-looking model
Three stages of impairment model	• Significant increase in credit risk • Presentation of interest: gross vs. net
Significant increase in credit risk	• 30 days rebuttal
Trade receivables	• Lifetime ECL not significant finance component • Accounting policy choice if significant finance component • Provision matrix for receivables
Disclosures	• Extensive disclosures required • ECL provision, assumptions and inputs

IFRS 9 *Hedge accounting*

Hedge Accounting Introduction

Objectives of IFRS 9 on hedge accounting



Objectives of hedge accounting

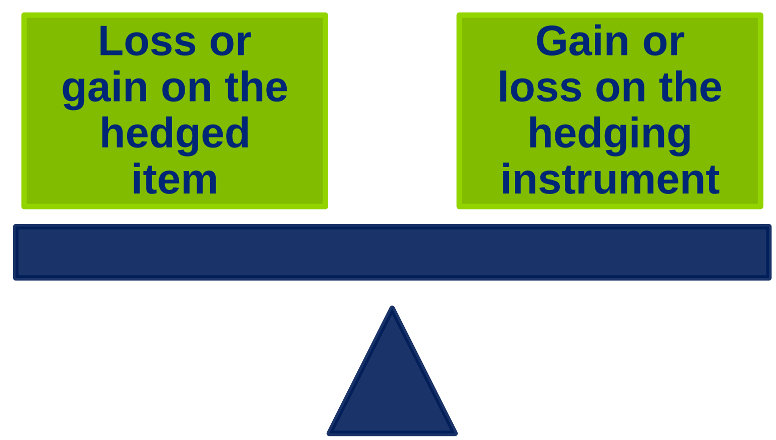
Ensure that the offsetting gains or losses on hedged item and hedging instrument affect P&L (or OCI in the case of hedges of equity investments at FVTOCI) at the same time

Without Hedge Accounting

Fixed rate debt	Interest rate swap
↓	↓
Amortised cost	Fair value

With Hedge Accounting

Fixed rate debt (hedged item)	Interest rate swap (hedging instrument)
↓	↓
Risk-adjusted value	Fair value



The Hedger's Dilemma

	Period 1	Period 2	Total
Exposure		30	30
Derivative	(30)		(30)
P&L	(30)	30	0

Hedge Basics—Objectives

	Period 1	Period 2	Total
Exposure		30	30
Derivative	(30)		(30)
P&L	(30)	30	0

Hedge Basics—Objectives (cont'd)

	Period 1	Period 2	Total
Exposure		30	30
Derivative	(30)		(30)
P&L	(30)	30	0

Hedge Basics—Objectives (cont’d)

Fair Value Hedge

	Period 1	Period 2	Total
Exposure		30	30
Derivative	(30)		(30)
P&L	(30)	30	0

Cash Flow Hedge

Session 1: Identifying hedging relationships

Criteria for hedge accounting

Criterion 1
Qualifying Hedged Items

Criterion 2
Qualifying Hedging instruments

Criterion 3
Formal Designation and Documentation

Criterion 4
Hedge Effectiveness

The hedging relationship qualifies for hedge accounting only if all of these criteria are met

Qualifying hedged items

Qualifying hedged items

- ✓ **Single or group of asset(s)/ group of liabilities**
- ✓ **Reliably measurable**

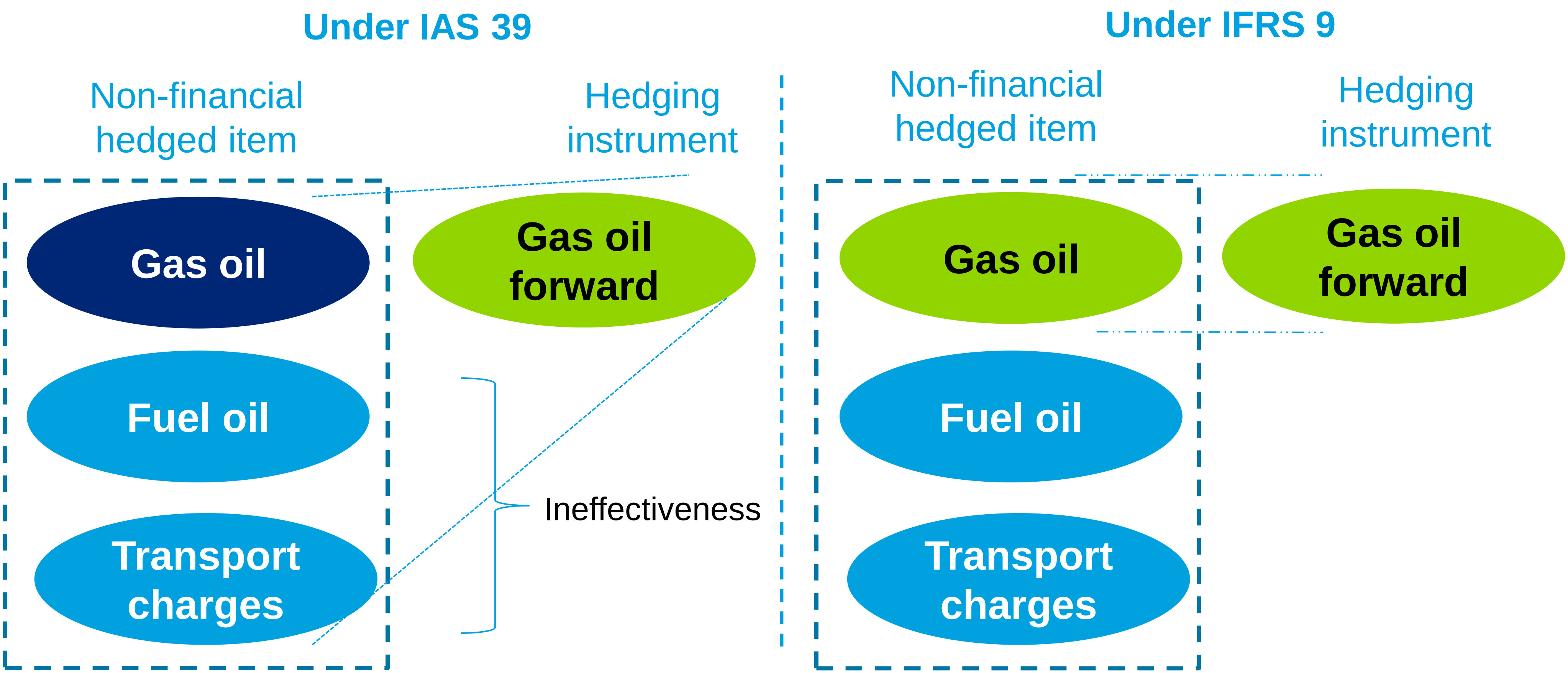
From IAS 39	**Recognised asset or liability**	**Unrecognised firm commitment**	**Highly probable forecast transaction**	**Net investment in a foreign operation**
New in IFRS 9	**Risk components of non financial items**	**Aggregated exposure**	**Groups (restrictions removed)**	**Net positions (with some restrictions)**

Non-qualifying items

- An entity's own equity instruments
- Most intragroup items
- Firm commitment to acquire a business in a business combination (except for FX risk)
- Fair value hedge of equity method investment
- Risks that have no impact on P&L (except for equity investments measured at FVTOCI)

Qualifying hedged items

Risk components of non-financial items



Risk components of non-financial items → **ONLY ELIGIBLE IF** → **Separately identifiable** + **Reliably measurable**

Qualifying hedged items

Aggregated exposure

Aggregated exposure = **An exposure** + **A derivative**

Example: On 01/01/13, Entity A (functional currency €) wants to hedge a highly probable forecast coffee purchase in $.

Two risk exposures	Features	Hedged item	Hedging instrument
Commodity price risk First level relationship	Designation **on 01/01/13** with the term ending **12/31/2015**	Forecast coffee purchase	Coffee forward contract
Foreign currency risk Second level relationship	Designation **on 01/01/14** with the term ending **12/31/2015**	Aggregated exposure	USD forward contract

Forecast coffee purchase at a fixed USD price

Qualifying hedging instruments

Qualifying hedging instruments

From IAS 39

- **Derivative instruments**
- **Non-derivative instruments (hedging foreign exchange risk)**
- **Designation of the instrument in its entirety (only two exceptions) or a proportion of it**

New in IFRS 9

- **Non-derivative financial instrument measured at FVTPL**
- **Additional exception to designation of the instrument in its entirety**
- **Different treatment for elements excluded from designations**

Non-qualifying instruments

- Net written option (unless designated against a purchased option)
- Internal contracts
- Financial liability designated at FVTPL for which changes in FV linked to credit risk are presented in OCI

Session 2: Qualifying hedging relationships and mechanics

Qualifying criteria for hedge accounting

In order to apply hedge accounting, the following criteria must be met from inception of the hedge and on an ongoing basis:

- the hedging instruments and eligible hedged items
- at inception of the hedging relationship there is formal designation and documentation of the hedging relationship and the entity’s risk management objective and strategy for undertaking the hedge
- the hedging relationship meets all of the hedge effectiveness requirements

Once these criteria are met, hedge accounting *must* be applied for the hedging relationship and can only be discontinued when the hedge cease to meet the qualifying criteria

Hedge accounting models

Fair Value Hedge (FVH):
A hedge of the exposure to **changes in fair value...**

Cash Flow Hedge (CFH):
A hedge of the exposure to **variability in cash flows...**

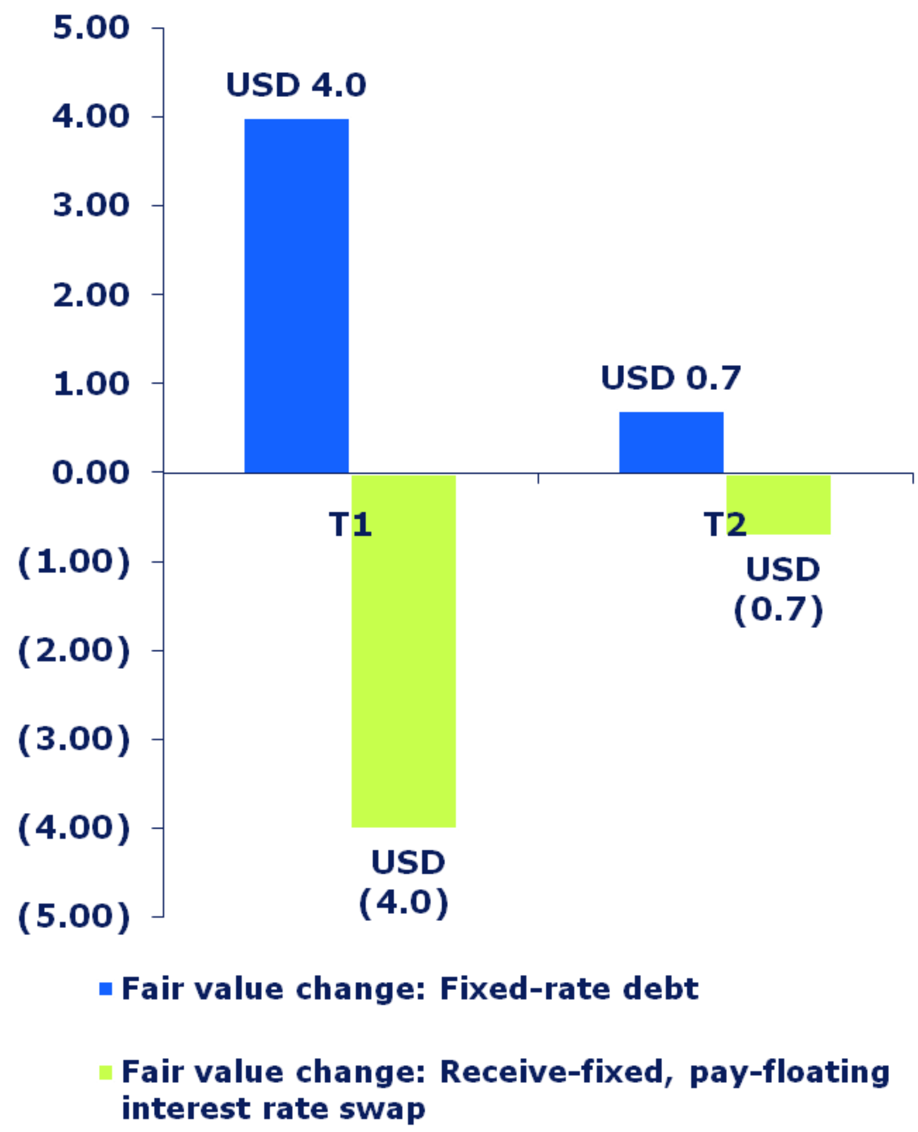
...that is attributable to a particular risk that could affect P&L (or OCI in the case of hedges of equity investments at FVTOCI)

Fair Value Hedge	Cash Flow Hedge	Net Investment Hedge
Recognised asset or liability	Cash flows of a recognised asset or liability	Net investment in a foreign operation (consolidate FS)
Firm commitment	Firm commitment (only FX risk)	
	Highly probable forecast transaction	

Fair Value Hedge

Definition

- A fair value hedge is a hedge of the exposure to changes in fair value of a recognized asset or liability or a previously unrecognized firm commitment to buy or sell an asset at a fixed price, or an identified portion of such an asset, liability, or firm commitment that is attributable to a **particular** risk and could affect reported profit or loss.



Fair Value Hedge (cont'd)

Measurement of derivative

Change in fair value

Measurement of hedged item

Offsetting gain or loss
attributable to risk being hedged

EARNINGS

Net effect — ineffectiveness will be seen in the P&L

Example 1—Background

- On January 1, 2011, Blackcomb AG (“Blackcomb”) issued $100 million of five-year, 8% fixed rate debt. Blackcomb has a BBB credit rating at the issuance date.
  - The fixed interest rate on the debt is 150 basis points higher than the five-year swap rate.
  - Interest on the debt is payable annually. Blackcomb’s interest rate risk policy requires that all debt be at variable rates, which is achieved either by issuing variable rate debt or by issuing fixed rate debt and swapping it into variable rates.
- To maintain compliance with this policy, Blackcomb entered into an interest rate swap on January 1, 2011, to swap the debt from fixed rate to variable rate.
- Blackcomb also designated the swap as a fair value hedge of interest rate risk on the fixed rate debt (the credit spread portion is purposely not part of the hedge relationship). The swap is a five-year, pay LIBOR, receive 6.50% fixed interest rate swap.

Example 1—Questions

1. Describe what type of hedge requirements must Blackcomb satisfy to apply hedge accounting.
2. Assuming that the fair value of the swap and the carrying amount of the debt after the adjustment for changes in fair value attributable to the hedged risk are as follows:

	01/01/11	06/30/11	12/31/11
Issued debt	$ (100,000,000)	$ (105,000,000)	$ (102,000,000)
Swap	$	$ 5,000,000	$ 2,000,000

3. Please provide the journal entries as of 01/01/11, 6/30/11, and 12/31/11.

Example 1—Solution

1. Describe what type of hedge requirements must Blackcomb satisfy to apply hedge accounting.

Answer:

- The fair value of Blackcomb's issued fixed rate debt will vary with changes in market interest rates. The debt is a qualifying hedged item in a fair value hedge accounting relationship.
- Blackcomb has formally documented the hedging relationship from inception, identifying all critical terms.
- The hedge is consistent with Blackcomb's risk management policy for that hedging relationship.

Example 1—Solution (cont'd)

Answer (cont'd):

- Blackcomb expects its hedge to be highly effective and has documented this assessment — the primary potential source of ineffectiveness in a fair value hedge of fixed rate debt is credit risk.
- Company C is using an interest rate swap to hedge interest rate risk only. Hence, changes in credit spreads between
  Company C's BBB rate and swap rates will not generate hedge ineffectiveness.

Example 1—Solution (cont'd)

2. Please provide the journal entries as of 1/1/08, 6/30/08, and 12/31/08.

Answer:

January 1, 2011

		Debit	Credit
Cash		$100M	
	Debt		$100M

June 30, 2011

		Debit	Credit
Profit or Loss		$5M	
	Debt		$5M
Swap		$5M	
	Profit or Loss		$5M

- **The net impact of P&L reflects that the changes in the fair value of the swap offset fully the changes in the fair value of the debt for the designated risk.**

Example 1—Solution (cont'd)

Answer (cont'd):

December 31, 2011

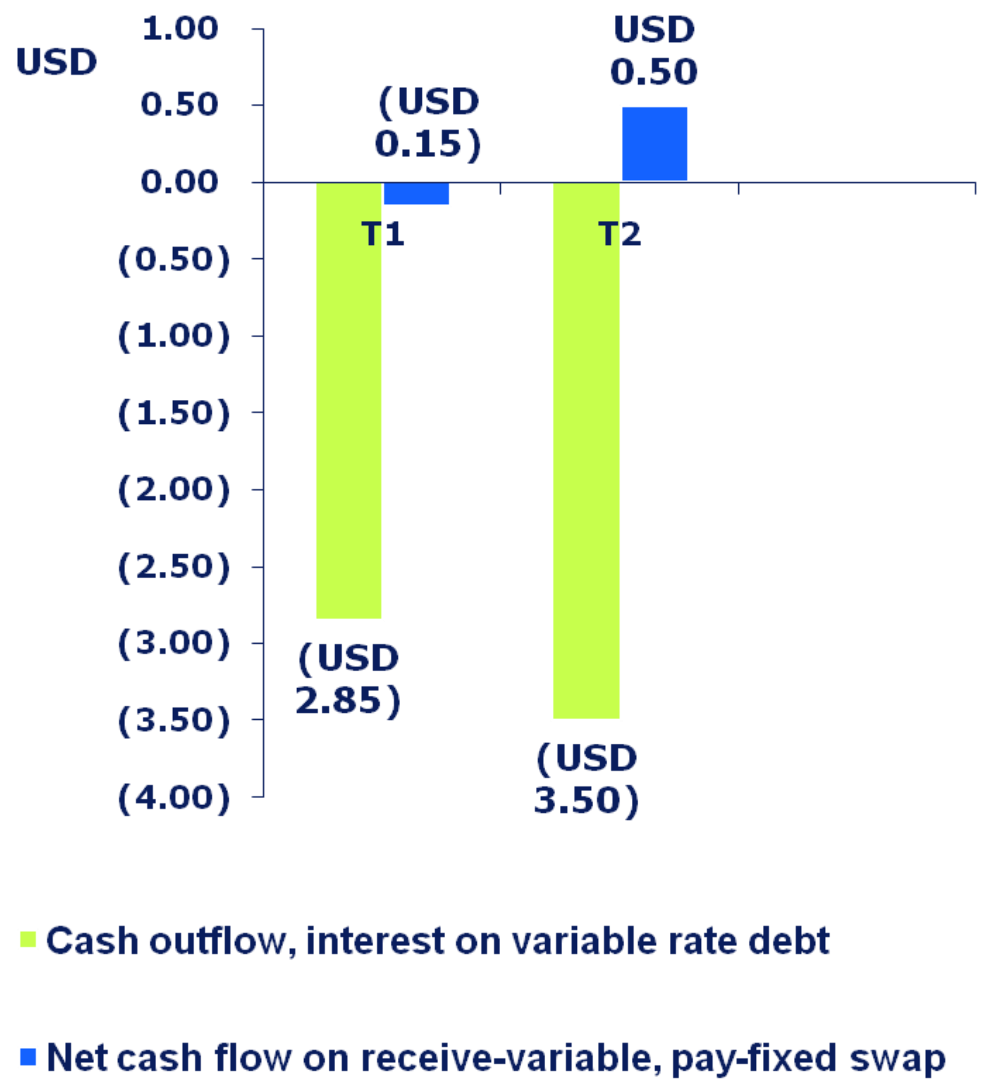
		Debit	Credit
Debt		$3M	
	Profit or Loss		$3M
Profit or Loss		$3M	
	Swap		$3M

The net impact of P&L reflects that the changes in the fair value of the swap offset fully the changes in the fair value of the debt for the designated risk.

Cash Flow Hedge

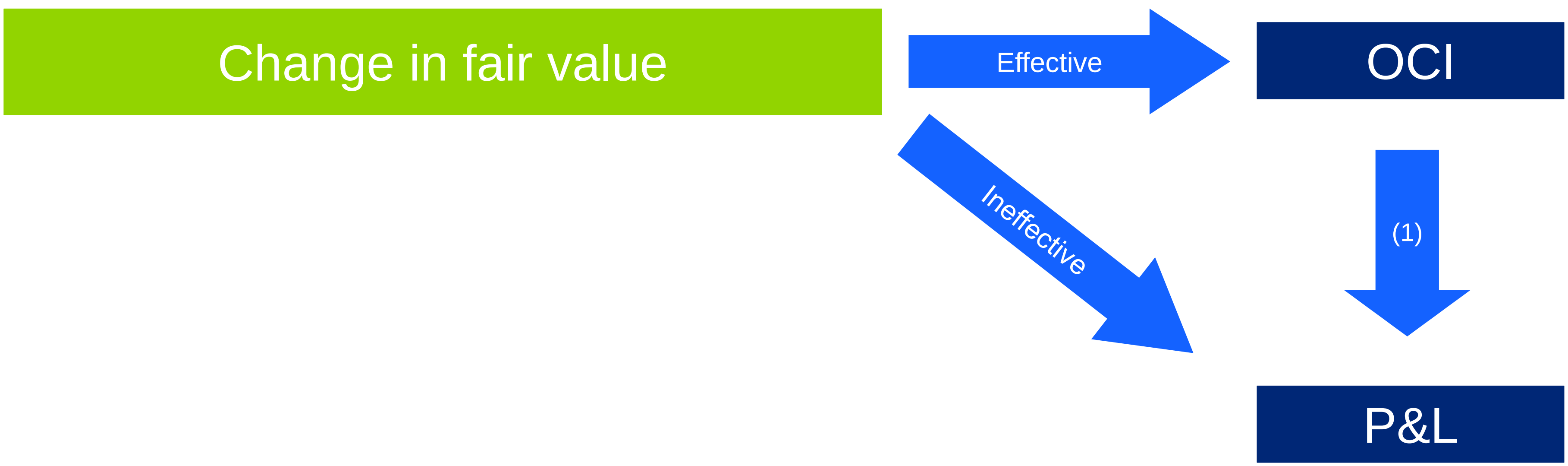
Definition

- A cash flow hedge is a hedge of the exposure to variability in cash flows that:
  - ➢ Is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction (such as an anticipated purchase or sale); and
  - ➢ Could affect reported profit or loss.



Cash Flow Hedge (cont’d)

Measurement of derivative



(1) Depends on recognition of hedged item in P&L (or basis adjustment)

Cash Flow Hedge (cont'd)

- Hedge reserve in equity is adjusted to the lesser (absolute) amount of:
  - Cumulative gain or loss on hedging instrument; and
  - Cumulative change in fair value of the expected cash flows on the hedged item.
- Any remaining gain or loss on the hedging instrument is recognized in profit or loss.
- If hedge of forecast transaction results in recognition of non-financial asset or non-financial liability, then associated gains/losses recognized in equity are included in the initial cost or other carrying amount of the asset or liability (basis adjustment).

Mechanics of hedge accounting

Cash flow hedge accounting - Impact of the basis adjustment

Example: Forecast purchase of cocoa hedged with a forward for the forex risk

Under IFRS 9	Cash	Derivative	Inventory	OCI
12/31/2012 FV of forward = 12 500	-	12 500	-	-12 500
12/31/2012 Receipt of cocoa =112 500	-112 500	-	112 500	-
12/31/2012 Settlement of forward	12 500	-12 500	-	-
12/31/2012 Basis adjustment	-	-	-12 500	12 500
Net	100 000	-	100 000	-

Under IAS 39	Choice of either reclassifying OCI ✓ To P&L when the hedged item affect P&L or ✓ As a basis adjustment

Example 2—Background

Dunbar Corp. (“Dunbar”) issued $100 million of five-year, variable rate debt on January 1, 2010.

- The variable rate on the debt is LIBOR plus a spread of 200 basis points. Initial LIBOR is 5%.
- The debt pays interest annually, and the swap resets annually on December 31.

On January 1, 2010, Dunbar entered into a five-year, pay-fixed, receive LIBOR interest rate swap with a notional amount of $100 million.

- The swap is designated as a cash flow hedge of the forecast interest payments on the LIBOR portion of the debt.
- The interest rate swap is at-market at inception and has a fair value of zero.

Example 2—Background (cont’d)

The terms of the interest rate swap are as follows:

Notional amount	$100 million
Trade date	January 1, 2010
Start date	January 1, 2010
Maturity date	December 31, 2014
Dunbar pays	5.50%
Dunbar receives	LIBOR
Pay and receive dates	Annually on the debt payment dates
Variable reset	Annually (on December 31)
Initial LIBOR	5.00%
First pay/receive date	December 31, 2010
Last pay/receive date	December 31, 2014

Hedge effectiveness will be assessed and measured, at a minimum, at each reporting date. For illustration purposes only, this hedge relationship is deemed fully effective.

Example 2—Question

1. Assuming that the fair values of the swap are as follows:

	LIBOR a inception and at each reset date	Fair Value of the interest rate swap
01/01/2010	5.00%	$ -
12/31/2010	6.57%	$4,068,000
12/31/2011	7.70%	$5,793,000

Please provide the journal entries as of 01/01/10, 12/31/10, and 12/31/11.

Example 2—Solution

1. Please provide the journal entries as of 01/01/10, 12/31/10, and 12/31/11.

Answer:

January 1, 2010

No entries are required for the interest rate swap since it has a fair value of zero at inception.

		Debit	Credit
Cash		$100M	
	Debt		$100M

December 31, 2010

Interest rates increased during the period ended December 31, 2010, resulting in a fair value of the interest rate swap of $4,068,000. Hedge ineffectiveness is assessed and measured at the reporting date (deemed to be zero), so the total change in fair value of the swap is recorded in equity. Dunbar paid $500,000 in net cash settlements on the swap at December 31, 2010. The LIBOR rate for the next period is 6.57%.

Example 2—Solution (cont'd)

Answer (cont'd):

		Debit	Credit
Swap Asset		**$4.068M**	
	OCI		**$4.068M**

		Debit	Credit
Interest Expense		**$7M**	
	Cash		**$7M**
Interest Expense		**$0.5M**	
	Cash		**$0.5M**

To record payment of LIBOR plus 200 basis points (5% plus 2%) on debt obligation and the net cash settlement payment on the swap as an adjustment to the yield on the debt. Effective yield is 7.50%.

Example 2—Solution (cont'd)

Answer (cont'd):

December 31, 2012

Interest rates increased further during the period ended December 31, 2011, resulting in a fair value of the interest rate swap of $5,793,000. Hedge ineffectiveness is assessed and measured at the reporting date (deemed to be zero), so the total change in fair value of the swap is recorded in equity. Dunbar received $1,070,000 in net cash settlements on the swap at December 31, 2011.

The LIBOR rate for the next period is 7.7%.

		Debit	Credit
Swap Asset		**$1.725M**	
	OCI		**$1.725M**

		Debit	Credit
Interest Expense		**$8.570M**	
	Cash		**$8.570M**
Cash		**$1.070M**	
	Interest Expense		**$1.070M**

Hedge accounting mechanics–Summary

	Hedged item	Hedging instrument
Fair Value Hedge Accounting	The gain or loss **attributable to the hedged risk** is recognised in **profit or loss** (except for FV hedges of equity investments measured at FVTOCI)	Recognition and measurement follows the general requirements applicable to the instrument
Cash Flow Hedge Accounting (and Net Investment Hedges)	Recognition and measurement follows the general requirements applicable to the item (except for basis adjustment on recognition of non-financial items)	The gain or loss **attributable to the hedged risk that is determined to be effective** is recognised in **other comprehensive income and reclassify to profit and loss** when hedged item affects **profit and loss.** Basis adjustment is **mandatory** for forecast transaction resulting in recognition of non-financial asset or liability.

Session 3: Hedge effectiveness assessment

Hedge effectiveness requirements

Three-part test

Economic relationship

Values of hedged item and hedging instrument generally move in opposite direction

Qualitative vs quantitative assessment (ineffectiveness still measured)

Prospective test only

Credit risk not dominate

Credit risk can negate economic relationship

Both own credit and counterparty credit

Consider both hedged item and hedging instrument

Hedge ratio

Generally the actual ratio

Cannot create ineffectiveness inconsistent with the purpose of hedge accounting

Rebalancing of hedge ratio may be required

Hedge effectiveness assessment

Definition	Extent to which: • Changes in fair value or cash flows of the hedging instrument **offset** changes in the fair value or cash flows of the hedged item
Criteria	• Economic relationship between the hedged item and the hedging instrument • The effect of credit risk does not dominate value changes • Same hedge ratio as the one used in entity's risk management provided no imbalance inconsistent with objective of hedge accounting
How?	• **Judgement = Quantitative vs qualitative assessment**
When?	• **Prospective hedge effectiveness assessment only** • At inception, at each closing and in case of significant events changing the balance of the hedge relationships

Assessment ≠ Measurement

Examples of methods of hedge effectiveness assessment

Qualitative assessment	**Critical term method** When the critical terms (such as the nominal amount, maturity and underlying) of the hedging instrument and the hedged item match or are closely aligned, it might be possible for an entity to conclude on the basis of a qualitative assessment of those critical terms that the hedging instrument and the hedged item have values that will generally move in the opposite direction because of the same risk and hence that an economic relationship exists between the hedged item and the hedging instrument.
Quantitative assessment	**Ratio analysis** Ratio analysis computes, as a percentage, the extent of the hedging instrument's effectiveness at offsetting changes in the hedged item for the designated risk over a defined period of time, i.e. the degree to which the changes in fair value of the hedging instrument and the hedged item are negatively correlated **Regression analysis** Statistical measurement technique for determining the validity and extent of a relationship between an independent and dependent variable

Discontinuation of hedge accounting

Expert

MUST discontinue

When?	• Qualifying criteria no longer met
	    • Hedging instrument expires or is sold, terminated or exercised
	    • Hedging effectiveness requirements no longer met (after rebalancing)
	• Forecast transaction is no longer highly probable

Impact	• CFH: amounts deferred in CFH should be recycled if the forecast transaction is no longer expected to occur (FVH: amortisation must begin when hedge accounting ceases) • Option to designate the hedged item and/or the hedging instrument in a new hedge relationship – prospective effect • Specific treatment for elements excluded from designation

Cannot discontinue hedge accounting
if the hedging relationship continues to meet the risk management objective

Rebalancing

Expert

What does "rebalancing" mean?	• Changes in the quantities of the hedged items or hedging instruments • Allows continuation of a hedging relationship by adjusting the hedge ratio
When?	• If changes in an economic relationship between the hedged item and the hedging instrument but without a change in the risk management objective • Mandatory

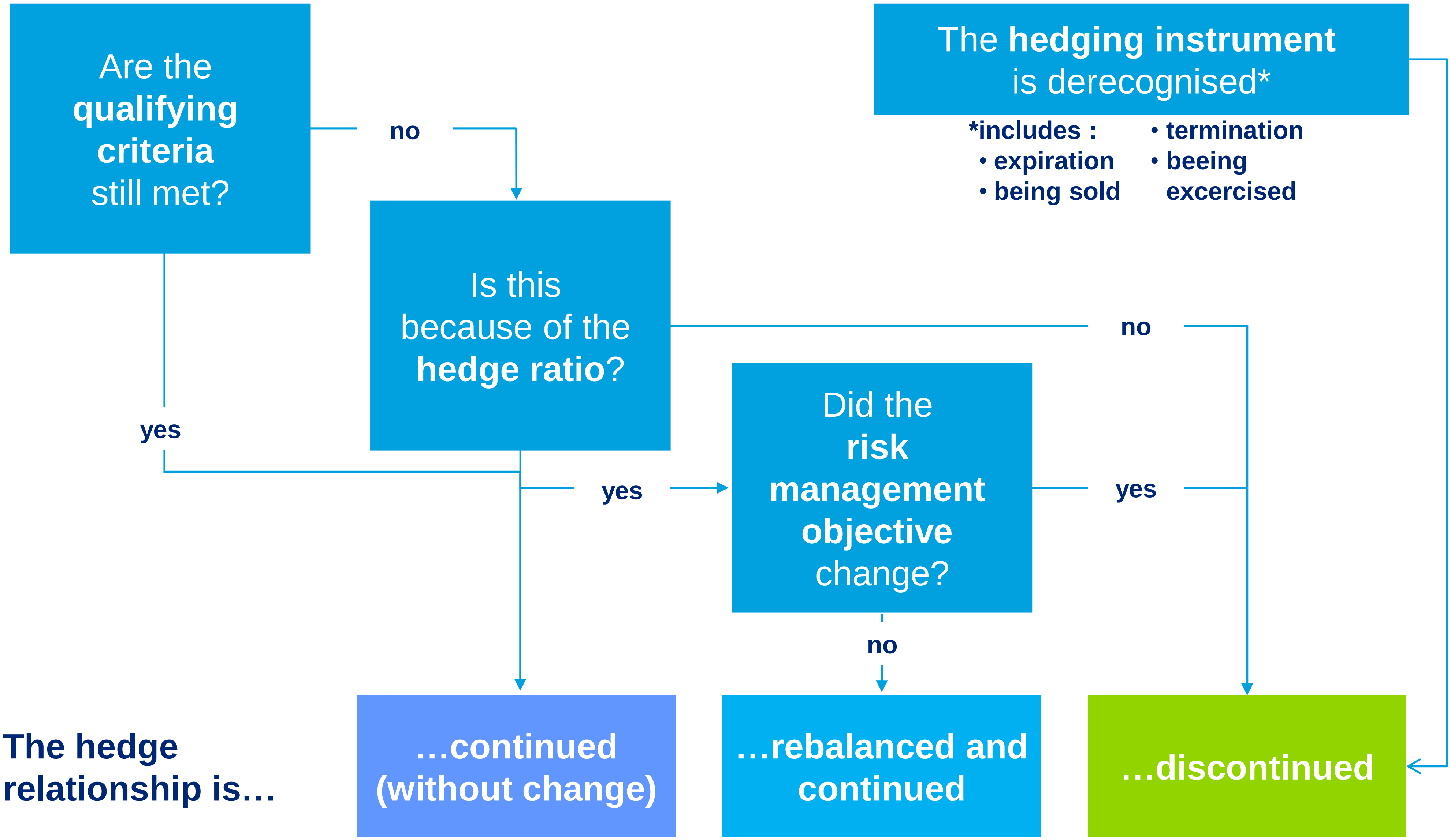
How?	• Continuation for the entire relationship BUT
	  • Ineffectiveness in P&L just before « rebalancing»
	  • Accounting treatment depends on whether the change in hedge ratio is achieved by adjusting the hedged item or the hedging instrument
	  • Update formal documentation of the hedging relationship

Rebalancing

Expert

		Measurement of fair value changes	
		Hedged item	**Hedging instrument**
Change in the volume of the hedged item	**Increase**	• Previously designated amount unchanged • Additional volume is included from date of rebalancing	• Unchanged
	Decrease	• Reduced volume unchanged • Decrease in volume is **discontinued** from date of rebalancing	• Unchanged
Change in the volume of the hedging instrument	**Increase**	• Unchanged	• Previously designated volume unchanged • Additional volume is included from date of rebalancing
	Decrease	• Unchanged	• Reduced volume unchanged • Decrease in volume is measured at FVTPL from date of rebalancing

Rebalancing and Discontinuation of Hedge Relationships



No voluntary de-designation permitted any longer!

Designation and documentation

At day 1 of hedge accounting

Formal designation and documentation required at inception

↓

- Type of the hedging relationship
- Entity’s risk management objective and strategy
- Nature of the risk being hedged
- Qualifying hedging instrument
- Qualifying hedged item
- Hedge effectiveness assessment and measurement
  - Economic relationship
  - Credit risk effect
  - Hedge ratio

Effective date and transition requirements

What will you learn?

Identify and reply transition provisions under IFRS 9

Transition

Identify the transition issues that are applicable to clients

Effective date of transition for IFRS 9 (2014)

Date of Initial Application–date when an entity first applies IFRS 9 (2014)

If an entity with a Dec 31 YE does not early adopt, DIA = January 1, 2018

Effective for annual periods beginning on or after January 1, 2018

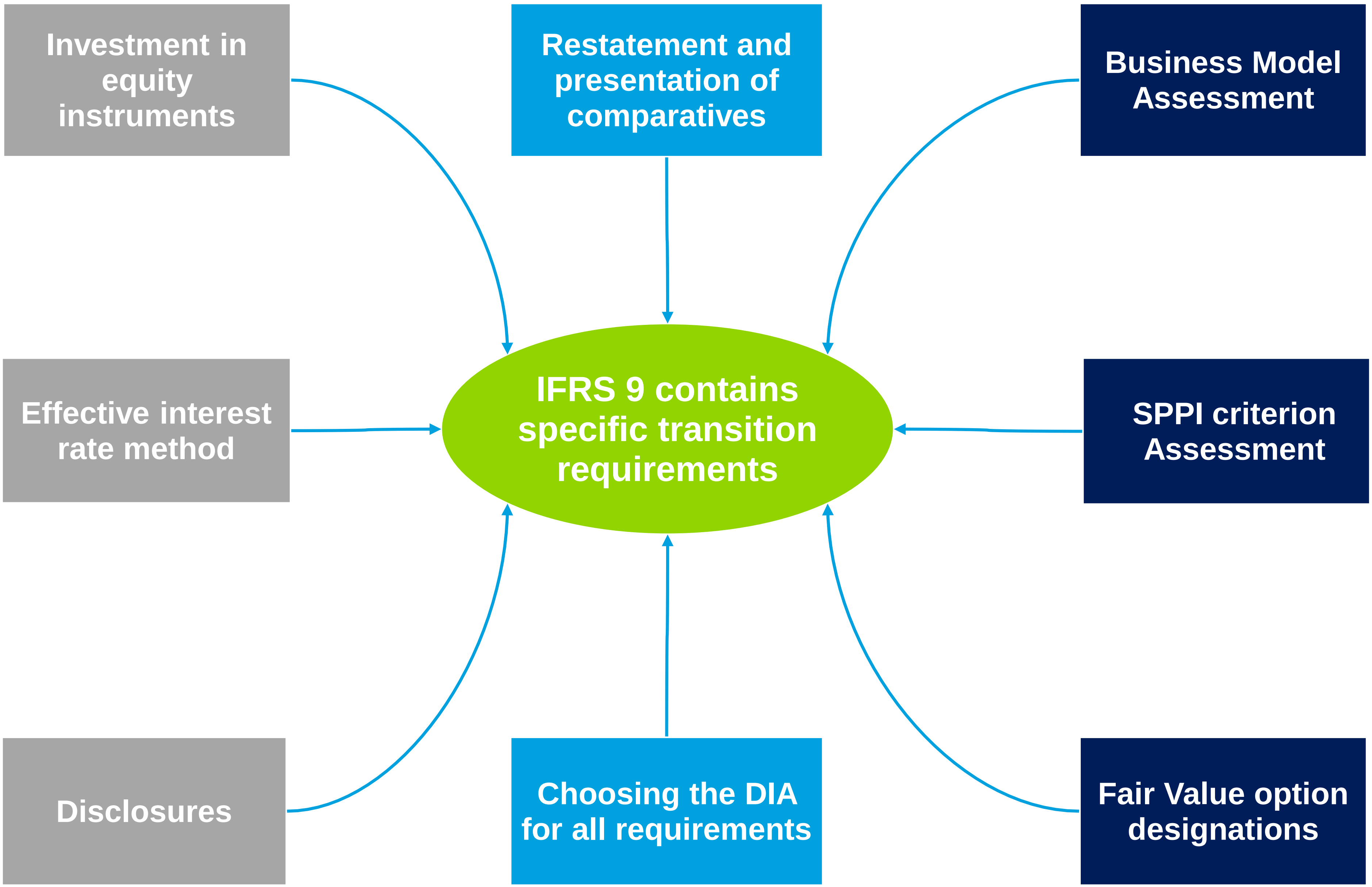
Retrospective application, with a number of practical elections and expedients available at transition.

IFRS 9:7.2.22: **hedge accounting** requirements will generally be applied **prospectively**

- Early application permitted.
- Concurrent application of all requirements ***with 3 exceptions.***

Choice of whether to restate comparatives, but restatement **not allowed** if this requires use of **hindsight**.

Date of initial application—key assessments



Transition requirements

Classification and measurement

depends on
facts and circumstances
at the date of initial application

- Restatement of PPs **only if no use** of hindsight
- If no PP restatement, then **adjust** opening balances **at DIA**

Restatement

(need to reflect all the requirements in IFRS 9)

IFRS 9 contains specific transition requirements

Choosing the DIA for all requirements

Normally 1 DIA, but three exceptions to this

Business Model Assessment

Amortized cost or FVTOCI
(retrospective application)

SPPI criterion Assessment

Based on facts and circumstances at initial recognition, unless impracticable to do so

Two exceptions:
- **modified time value of money element**
- **FV of prepayment feature**

Fair Value option designations

See next slide

Fair value option designations–Assets

Can an asset be designated as FVTPL under IFRS 9 (2014)?

Financial assets	**On transition to IFRS 9**	
	Qualifying criterion for fair value option based on reducing an accounting mismatch. **IFRS 9 4.1.5**	
Asset designated as fair value under IAS 39?	Criterion **met** at the DIA	Criterion **not met** at the DIA
Not designated	Designation is **permitted**.	Designation is **not possible.**
Designated: • reducing an accounting mismatch	Previous designation **may be** revoked or may continue.	Previous designation **has to be** revoked.
• a group of financial assets were managed on a fair value basis	Previous designation **has to be** revoked, leading to reassessing the classification of each instrument. Designation as FVTPL **permitted** if relevant under above criteria.	Previous designation **has to be** revoked.

All classification changes will be applied **retrospectively**

Consider whether or not the comparative period is being restated

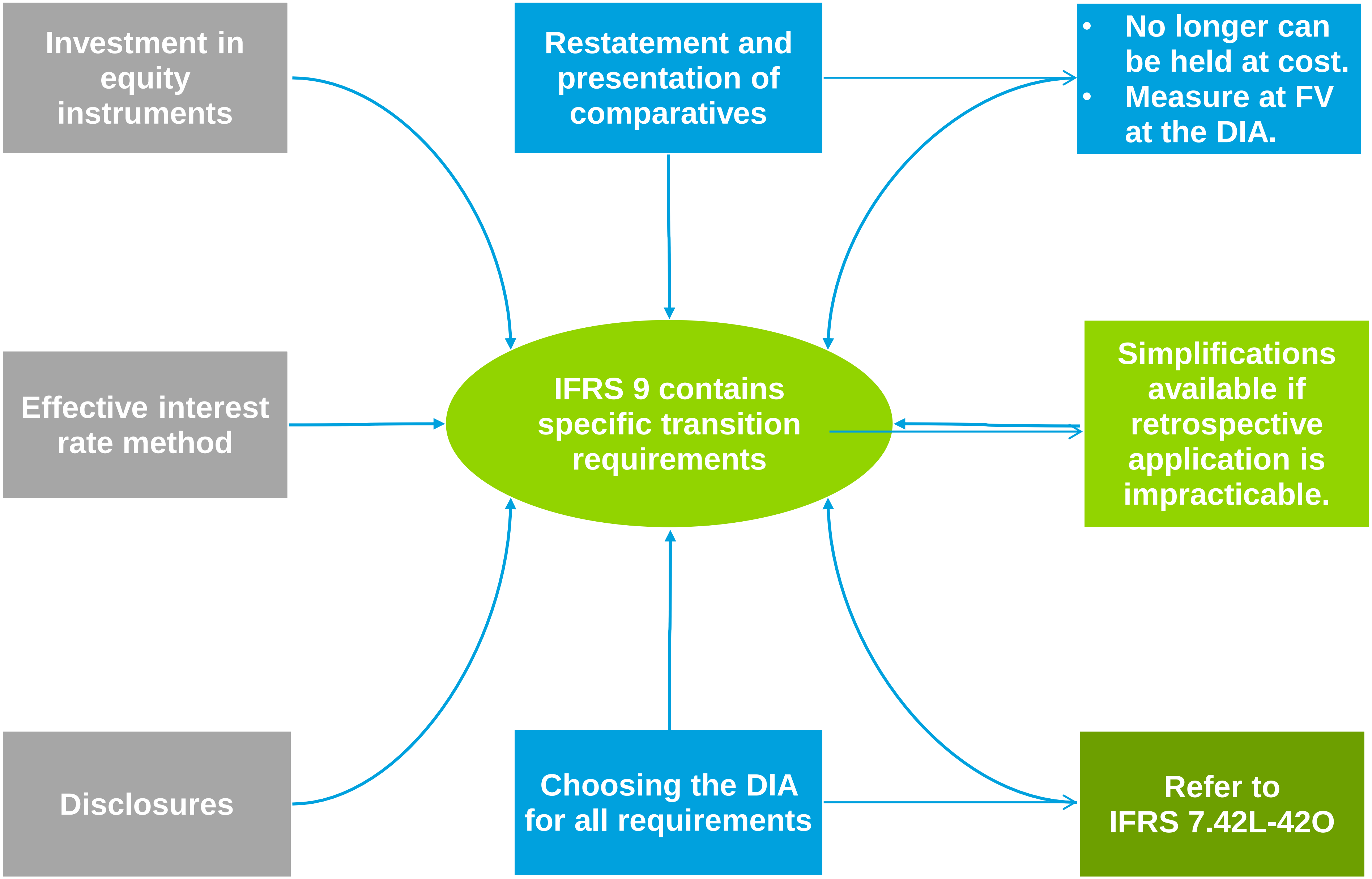
Fair value option designations—Liabilities

Financial liabilities	On transition to IFRS 9	
	Qualifying criterion for fair value option based on reducing an accounting mismatch. **IFRS 9 4.2.2A**	
Liability designated as fair value under IAS 39?	Criterion **met** at the DIA	Criterion **not met** at the DIA
Not designated	Designation is **permitted**.	Designation is **not possible.**
Designated: • reducing an accounting mismatch	Previous designation **may be** revoked ad may be continued.	Previous designation **has to be** revoked.
• a group of financial liabilities were managed on a fair value basis	Previous designation **may not be** revoked.	Previous designation **may not be** revoked.

All classification changes will be applied **retrospectively**

Consider whether or not the comparative period is being restated

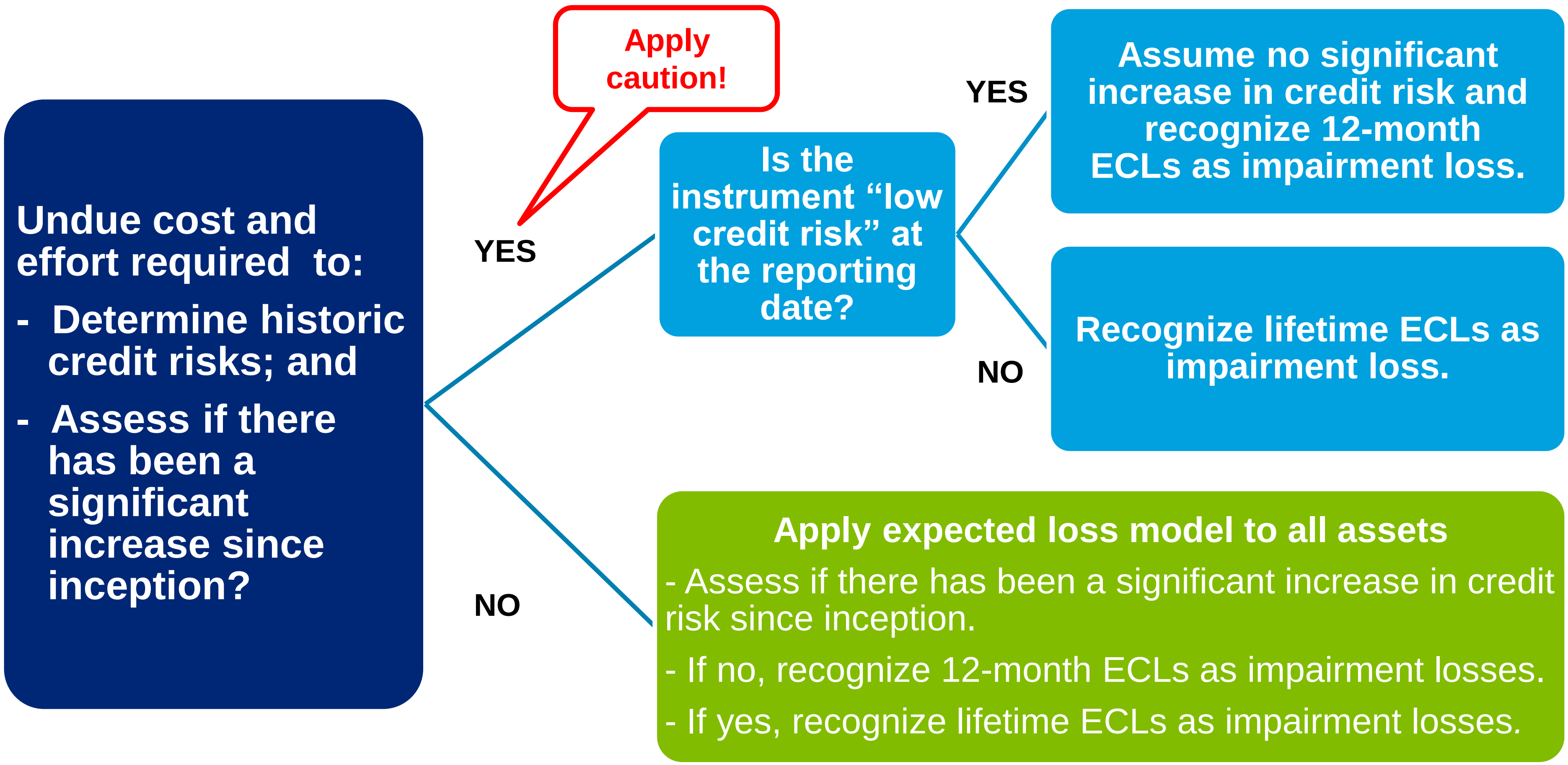
Date of initial application—key assessments



Transition requirements

Impairment—expected loss model

- **Retrospective application of impairment considerations.**
- **Option to restate comparatives ONLY if this can be done without hindsight.**



Example: applying transition requirements

- Alpha Corp is early-adopting IFRS 9 (2014) from a DIA of January 1, 2015.
- Alpha Corp holds corporate bonds in Omega, another entity, which was acquired in 2012. It has already assessed the classification of these bonds and concluded that they should be measured at FVTOCI under IFRS 9 (2014).
- When the bonds were issued, they had a credit rating of AAA. This has decreased to AA.
- Alpha has adopted the low credit risk practical expedient and this instrument has been assessed as being low credit risk, therefore impairment losses will be measured at 12-month ECLs.

Alpha has reversed all journals relating to its bond in Omega, except for its initial recognition. What double entries will be posted on transition, assuming that:

a) Alpha has chosen not to restate its comparative period

b) Alpha is able to restate its comparative periods without the use of hindsight and chooses to do so?

	January 1, 2014	December 31, 2014	December 31, 2015
12 month ECLs at reporting date	$40,000	$30,000	$45,000

Example: applying transition requirements

Solution A: January 1, 2015

Dr Opening Retained Earnings	$30,000
Cr Financial Asset	$30,000

Solution B: January 1, 2014

Dr Opening Retained Earnings	$40,000
Cr Financial Asset	$40,000

Transition requirements

Hedge Accounting

New requirements will apply prospectively…

Qualified hedging relationships under IAS 39 at the date of initial application	Qualified hedging relationships under IFRS 9 from the date of initial application	Transition requirements at the date of initial application
✓	✓	**Continuing hedging relationships** (after rebalancing on transition)
X	✓	**A new hedge relationship could be documented prospectively**
✓	X	**Mandatory discontinuation of the hedge relationship on transition**

With limited exceptions…

Summary

Effective date	• Entities may early adopt versions of IFRS 9 (2009-2014) • For periods beginning on or after February 1, 2015 entities can **only** early adopt IFRS 9 (2014)
Classification and measurement	• Specific requirements for Business Model, SPPI criterion, FVO and other items
Impairment	• If there would be undue cost or effort to determine whether there was a significant increase in credit risk at DIA, then the entity shall recognize lifetime ECLs until derecognition • If credit risk at the reporting date is low, apply the available exception and recognize 12-month expected credit losses
Hedge Accounting	• Prospective application for new hedges • Option to continue with IAS 39 hedge accounting on transition to IFRS 9 (until macro hedge accounting project completed) • Specific requirements for the time value of options, forward element of forward contracts and currency basis spreads

IFRS 9 and IFRS 4 Phase II

Background

- IFRS 9 set out financial reporting requirements for financial instruments and is effective from 1 January 2018.
- IASB is in process of finalizing insurance contracts standard which will set out how to measure and report insurance contracts liabilities.
  - These changes will not be effective before 2020, at the earliest.
- Concerns raised about the interaction between the financial instrument and insurance contracts accounting.
- Some suggest that the effective date of IFRS 9 should be deferred for insurers and aligned with the effective date of the forthcoming insurance contracts standard

IFRS 9 and IFRS 4 Phase II

Problem statement

Some preparers have raised the following concerns

1. If IFRS 9 is applied before new insurance contracts standard, it may lead to increased volatility in profit or loss
   - Greater use of fair value accounting for some insurers
   - Existing IFRS 4 accounting at cost for many
2. Complexity of understanding two significant accounting changes within a limited period of time
3. Potential cost for some of implementation two changes in accounting standards in a relatively short period of time

IFRS 9 and IFRS 4 Phase II

Proposed solution

IASB introduced new provisions to:

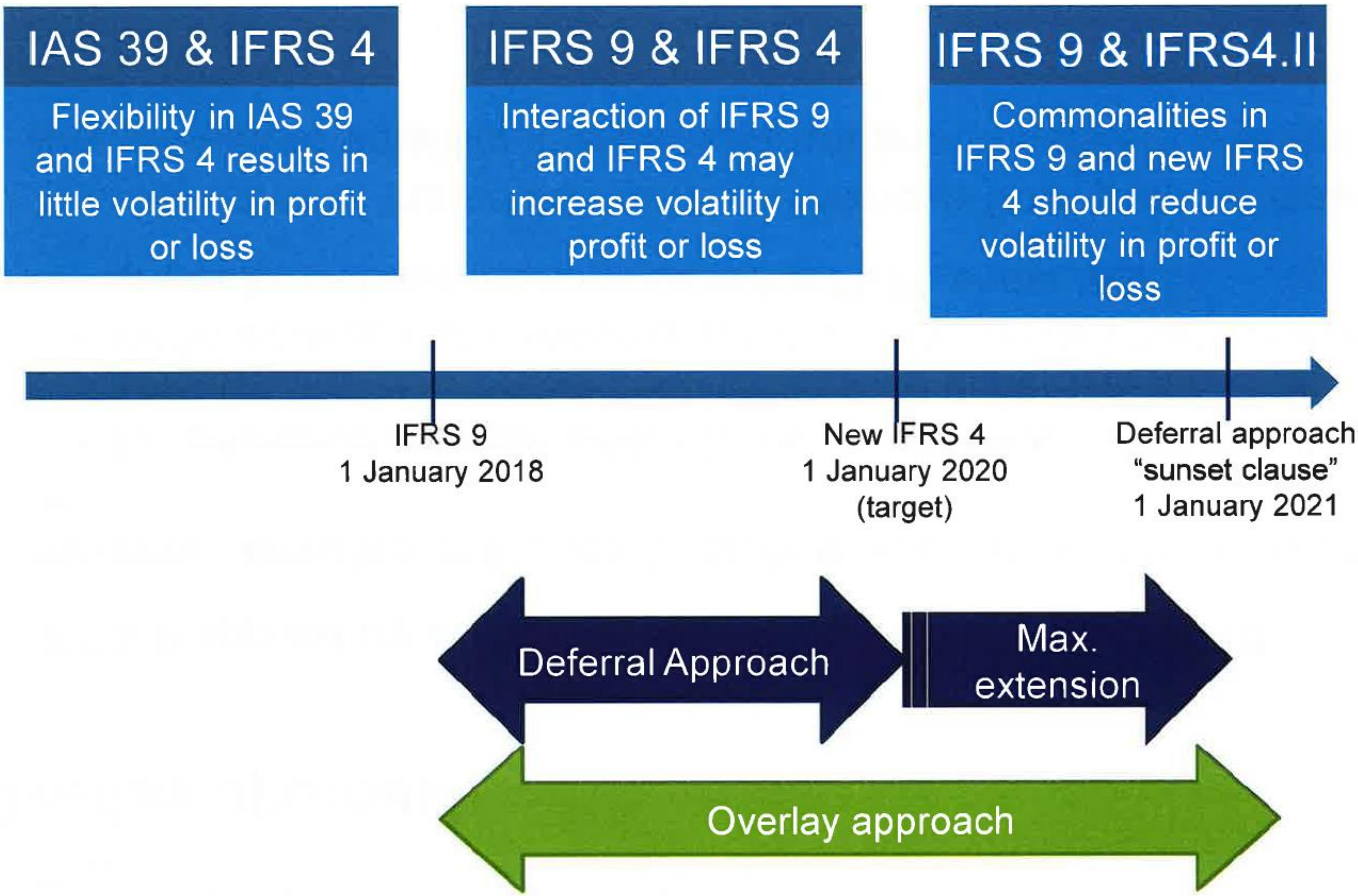
- Remove the increased volatility from profit or loss for certain financial assets that meet certain criteria (overlay approach); and
- Defer the effective date of IFRS 9 for insurers that meet certain criteria (deferral approach)
- The approaches are proposed to be mutually exclusive and optional

In addition:

- Additional transition relief on implementation of IFRS 4 phase II to mitigate the affects of ‘double implementation’

IFRS 9 and IFRS 4 Phase II

Timeline



IFRS 9 and IFRS 4 Phase II

Overlay approach

- IFRS 9 applied by all entities, including insurers from 2018
- Insurers permitted to include in profit or loss an a transfer to OCI of:
  - the difference between amounts recognized under IFRS 9 and amounts that would have been recognized under IAS 39
  - for financial assets measured at FVTPL under IFRS 9 that were not or would not have been measured at FVTPL under IAS 39
- The objective of the adjustment is to remove from profit or loss any increased volatility in a transparent and consistent manner

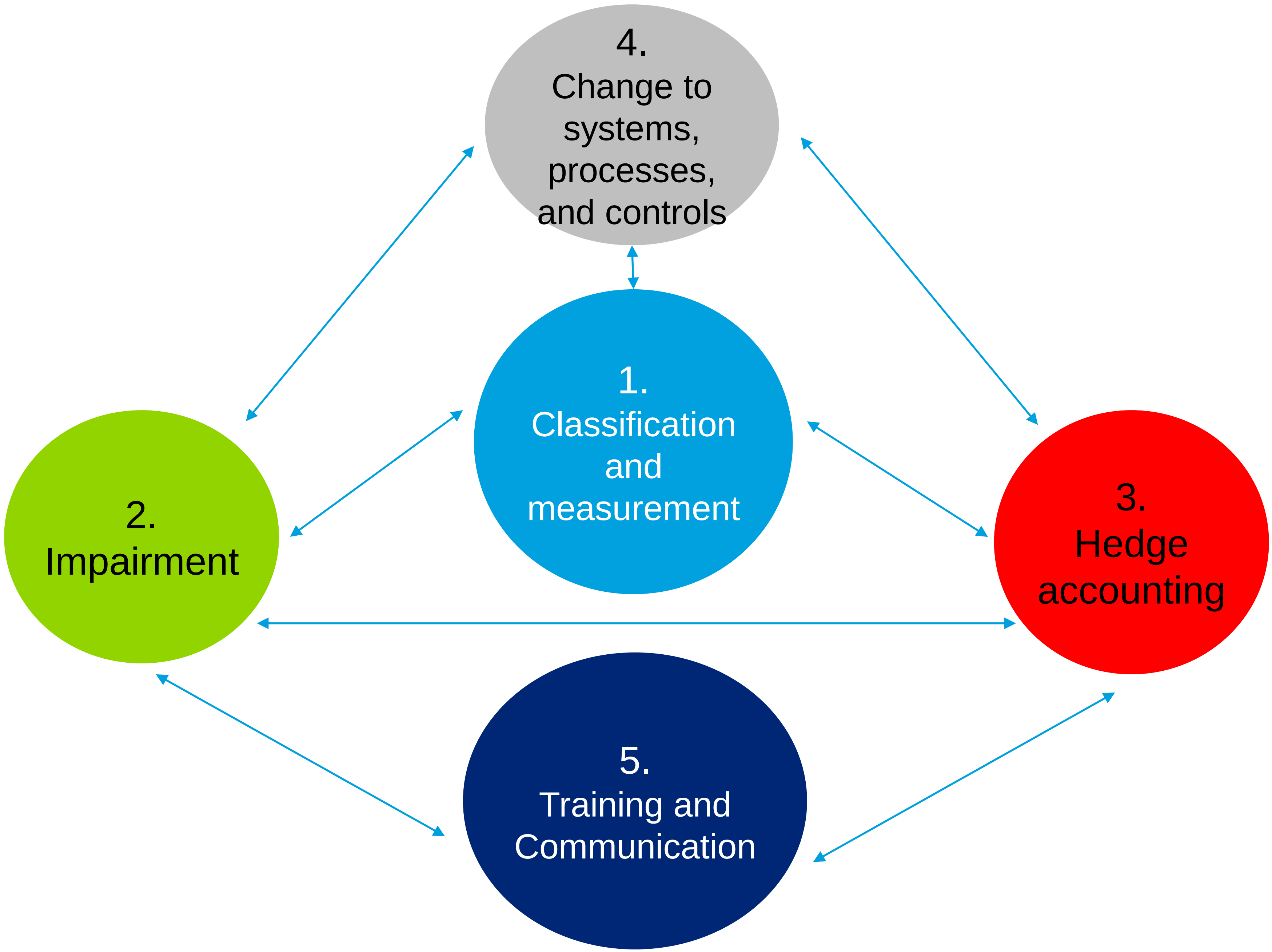
IFRS 9 and IFRS 4 Phase II

Deferral approach: reporting entity level

- If predominant activity of the conglomerate is insurance:
- Insurance activities predominant if predominant ratio (IFRS 4 liabilities over total liabilities of the reporting entity) is greater than 90%, or is greater than 80% and evidence that there is not a significant unrelated activity in the remaining 20%
- Entity has option to continue to apply IAS 39 to all financial assets in consolidated financial statements

Concluding remark

What should you consider?



What should you consider?

1 Classification and measurement

- Implement systems and controls to determine the business model applying to different classes of financial asset.
- Design impairment processes to measure both 12-month and lifetime expected credit losses (e.g. define default, low credit risk, significant increase in credit risk). Track historical levels of risk associated with financial assets.
- Consider the ability of existing systems and documentation to support the new hedge accounting requirements.
- Modify the current credit management system to cope with expanded disclosure requirements

2 Impairment

- Determine the impact on equity and regulated capital of changing from the current model to IFRS 9 expected loss model

3 Hedge accounting

- Opportunities for new hedging strategies

4 Change to systems, processes and controls

- Implementation of the new classification and measurement requirements may present a big challenges as management will need to reassess the classification of their financial assets and liabilities in light of the new business model and SPPI criteria.
- This may be a very challenging exercise for entities that are involved in more complex financial activities such as lending transactions, investment in debt securities held for treasury activities, insurance operations and trading in financial instruments.

5 Training and Communications

- Deliver training for employees (finance, IT, operations, sales and marketing, etc.)
- Develop a robust communication plan for affected internal functions and external stakeholders.
- Determine an approach to transition.