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IFRS 9, Financial Instruments

Understanding the basics

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Introduction

Revenue isn't the only new IFRS to worry about for 2018—there is IFRS 9, *Financial Instruments*, to consider as well. Contrary to widespread belief, IFRS 9 affects more than just financial institutions. Any entity could have significant changes to its financial reporting as the result of this standard. That is certain to be the case for those with long-term loans, equity investments, or any non-vanilla financial assets. It might even be the case for those only holding short-term receivables. It all depends.

Possible consequences of IFRS 9 include:

- ***More income statement volatility.*** IFRS 9 raises the risk that more assets will have to be measured at fair value with changes in fair value recognized in profit and loss as they arise.
- ***Earlier recognition of impairment losses on receivables and loans, including trade receivables.*** Entities will have to start providing for possible future credit losses in the very first reporting period a loan goes on the books – even if it is highly likely that the asset will be fully collectible.
- ***Significant new disclosure requirements***—the more significantly impacted may need new systems and processes to collect the necessary data.

IFRS 9 also includes significant new hedging requirements, which we address in a separate publication – *Practical guide – General hedge accounting*.

With careful planning, the changes that IFRS 9 introduces might provide a great opportunity for balance sheet optimization, or enhanced efficiency of the reporting process and cost savings. Left too long, they could lead to some nasty surprises. Either way, there's enough at stake that if you haven't begun assessing the implications of IFRS 9, now's the time to start—while you still can deal with its consequences to financial statements, systems, processes, controls, and so on in a measured and thoughtful way.

This publication summarizes the more significant changes that IFRS 9 introduces (other than hedging), explains the new requirements and provides our observations on their practical implications. If you have any questions, please don't hesitate to contact your engagement partner or other PwC contact.

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Overview

IFRS 9 generally is effective for years beginning on or after January 1, 2018, with earlier adoption permitted. However, in late 2016 the IASB agreed to provide entities whose predominate activities are insurance related the option of delaying implementation until 2021.

Why the new standard?

IFRS 9 responds to criticisms that IAS 39 is too complex, inconsistent with the way entities manage their businesses and risks, and defers the recognition of credit losses on loans and receivables until too late in the credit cycle.

IFRS 9 replaces IAS 39, *Financial Instruments – Recognition and Measurement*. It is meant to respond to criticisms that IAS 39 is too complex, inconsistent with the way entities manage their businesses and risks, and defers the recognition of credit losses on loans and receivables until too late in the credit cycle. The IASB had always intended to reconsider IAS 39, but the financial crisis made this a priority.

The IASB developed IFRS 9 in three phases, dealing separately with the classification and measurement of financial assets, impairment and hedging. Other aspects of IAS 39, such as scope, recognition, and derecognition of financial assets, have survived with only a few modifications. The IASB released updated versions of IFRS 9 as each phase was completed or amended, and, as each phase was finished, entities had the opportunity of adopting the updated version. The final standard was issued in July, 2014.

Comparison to US GAAP

The IFRS 9 project was originally part of the IASB's and FASB's joint convergence initiative. The Boards stopped working on the project except for impairment of loans and receivables because they were unable to reach agreement on certain key matters, and other projects took priority. Ultimately, the Boards did agree on common principles for measuring impairments of loans and receivables, but not on the timing of their recognition. The FASB's new impairment standard will be effective for SEC filers for years beginning on or after December 15, 2019 (with early adoption permitted one year earlier), and one year later for other entities.

A summary of the major changes

Classification and measurement of financial assets after initial recognition

IFRS 9 replaces IAS 39's patchwork of arbitrary bright line tests, accommodations, options and abuse prevention measures for the classification and measurement of financial assets after initial recognition with a single model that has fewer exceptions. The new standard is based on the concept that financial assets should be classified and measured at fair value, with changes in fair value recognized in profit and loss as they arise ("FVPL"), unless restrictive criteria are met for classifying and measuring the asset at either Amortized Cost or Fair Value Through Other Comprehensive Income ("FVOCI").

IFRS 9's new model for classifying and measuring financial assets after initial recognition

Loans and receivables "Basic" loans and receivables where the objective of the entity's business model for realizing these assets is either: • Collecting contractual cash flows; or • Both collecting contractual cash flows and selling these assets All other loans and receivables.	 Amortized Cost FVOCI FVPL
Mandatorily redeemable preferred shares and "puttable" instruments (e.g., investments in mutual fund units)	FVPL
Freestanding derivative financial assets (e.g., purchased options, forwards and swaps with a positive fair value at the balance sheet date)	FVPL
Investments in equity instruments Entity irrevocably elects at initial recognition to recognize only dividend income on a qualifying investment in profit and loss, with no recycling of changes in fair value accumulated in equity through OCI. Other	 FVOCI FVPL
Note: FVPL may be used if an asset qualifies for FVOCI or Amortized Cost to avoid an accounting mismatch.	

IFRS 9 replaces IAS 39's patchwork of arbitrary bright line tests, accommodations, options and abuse prevention measures with a single model that has only a few exceptions.

The IFRS 9 model is simpler than IAS 39 but at a price—the added threat of volatility in profit and loss. Whereas the default measurement under IAS 39 for non-trading assets is FVOCI, under IFRS 9 it's FVPL. As shown by the table, this can have major consequences for entities holding instruments other than plain vanilla loans or receivables, whose business model for realizing financial assets includes selling them, or which have portfolio investments in equity instruments.

The IFRS 9 model is simpler than IAS 39 but at a price—the added threat of volatility in profit and loss.

Another factor contributing to volatility is the treatment of derivatives embedded in financial assets. Under IAS 39, embedded derivatives not closely related to a non-trading host contract must be measured at FVPL, but the host contract often still can be measured at Amortized Cost. Under IFRS 9, the entire contract will have to be measured at FVPL in all but a few cases.

The new model can produce the same measurements as IAS 39, but one can't presume that this necessarily will be the case.

Effectively, therefore, changes in the fair value of both the host contract and the embedded derivative now will immediately affect profit and loss.

The fact that the model is simpler than IAS 39 doesn't necessarily mean that it is simple. For example, determining whether loans and receivables are sufficiently "basic" in their terms to justify measurement at Amortized Cost or FVOCI can be challenging. To get an appreciation of the complexities that can arise, and their implications for classification and measurement, take a quick look at the table on page 13, Illustrating the application of the Business Model and SPPI tests.

The chief takeaway here—the new model can produce the same measurements as IAS 39, but one can't presume this necessarily will be the case. The only time you can safely assume the classification and measurement of a financial asset always will be the same as IAS 39 is for freestanding non-hedging derivative financial assets which are, and forever will be, at FVPL.

Other classification and measurement changes

IFRS 9 makes other changes to the IAS 39 requirements for classifying and measuring financial assets and liabilities. These include:

- Allowing trade receivables that don't have a significant financing component to be measured at undiscounted invoice price rather than fair value.
- Eliminating the exemption allowing for measurement of investments in certain non-traded investments in equity instruments and derivatives settled by the delivery of those instruments at cost rather than fair value.
- Restricting optional FVPL and FVOCI designations.
- Permitting OCI treatment of changes in the fair value attributable to the issuer's credit risk for liabilities designated as FVPL.
- Setting new criteria for reclassifying of financial assets and liabilities.

While these other changes to classification and measurement requirements pale in significance in comparison to those discussed earlier, nevertheless they can affect some companies' financial statements and their implications need to be evaluated.

IFRS 9 eliminates impairment assessments for equity instruments and establishes a new approach for loans and receivables, an "expected loss" model.

Impairment of financial assets

Accounting for impairments is the second major area of fundamental change:

- **Investments in equity instruments.** On the one hand, IFRS 9 eliminates impairment assessment requirements for investments in equity instruments because, as indicated above, they now can only be measured at FVPL or FVOCI without recycling of fair value changes to profit and loss.
- **Loans and receivables, including short-term trade receivables.** On the other hand, IFRS 9 establishes a new approach for loans and receivables, including trade receivables—an "expected loss" model that focuses on the risk that a loan will default rather than whether a loss has been incurred.

Expected credit losses

Under the "expected credit loss" model, an entity calculates the allowance for credit losses by considering on a discounted basis the cash shortfalls it would incur in various default scenarios for prescribed future periods and multiplying the shortfalls by the probability of each scenario occurring. The allowance is the sum of these probability weighted outcomes. Because every loan and receivable carries with it some risk of default, every such asset has an expected loss attached to it—from the moment of its origination or acquisition.

The phrase "expected credit loss" to describe the new impairment model can be confusing. Because expected credit losses represent possible outcomes weighted by the probability of their occurrence, these amounts are not necessarily "expected" nor "losses", at least as those terms are generally understood. In effect, they represent measures of an asset's credit risk.

Expected credit losses are not necessarily "expected" nor "losses", at least as those terms are commonly understood.

IFRS 9 establishes not one, but three separate approaches for measuring and recognizing expected credit losses:

- A general approach that applies to all loans and receivables not eligible for the other approaches;
- A simplified approach that is required for certain trade receivables and so-called "IFRS 15 contract assets" and otherwise optional for these assets and lease receivables.
- A "credit adjusted approach" that applies to loans that are credit impaired at initial recognition (e.g., loans acquired at a deep discount due to their credit risk).

A distinguishing factor among the approaches is whether the allowance for expected credit losses at any balance sheet date is calculated by considering possible defaults only for the next 12 months ("12 month ECLs"), or for the entire remaining life of the asset ("Lifetime ECLs"). For those entities which have only short-term receivables less than a year in duration, the simplified and general approach would likely have little practical difference.

In all cases, the allowance and any changes to it are recognized by recognizing impairment gains and losses in profit and loss.

IFRS 9 approaches for measuring and recognizing expected credit losses

	General approach	Simplified approach	Credit adjusted approach
Timing of initial recognition	Same period as asset is recognized	Same as general approach	Cumulative change in Lifetime ECLs since initial recognition of the asset
Measurement basis of loss allowance	12 Month ECLs unless a significant increase in credit risk occurs, then Lifetime ECLs unless the increase reverses	Lifetime ECLs	

Hedging

The third major change that IFRS 9 introduces relates to hedging—IFRS 9 allows more exposures to be hedged and establishes new criteria for hedge accounting that are somewhat less complex and more aligned with the way that entities manage their risks than under IAS 39. Companies that have rejected using hedge accounting in the past because of its complexity, and those wishing to simplify, refine or extend their existing hedge accounting, may find the new hedging requirements more accommodating than those in IAS 39. For more information about the new hedging requirements, refer to our publication, *Practical guide – General hedge accounting*.

Disclosure

There are significant consequential amendments to IFRS 7, *Financial Instruments: Disclosures*, especially in respect of credit risk and expected credit losses.

Transition

There is no grandfathering for financial assets and liabilities existing at the date of initial recognition; i.e. the general requirement is that an entity must apply IFRS 9 retrospectively at the date of initial application (other than hedging).

Ultimately, the question of how an entity is affected by IFRS 9 is that "it depends". Some entities may find that classification and measurement of their financial assets will be substantially the same as they are currently under IAS 39, and that their impairment allowances may not be materially affected. Others will change substantially. Regardless, every entity will have to go through the process of re-evaluating their accounting policies, financial statement note disclosures and other areas affected by the new requirements, and making appropriate changes to their accounting systems and internal controls.

Classification and measurement

Measurement at initial recognition

IFRS 9 carries forward with one exception the IAS 39 requirement to measure all financial assets and liabilities at fair value at initial recognition (adjusted in some cases for transaction costs). The exception is for trade receivables that do not contain a significant financing component, as defined by IFRS 15, *Revenue from Contracts with Customers*. These are measured at the transaction price (e.g., invoice amount excluding costs collected on behalf of third parties, such as sales taxes). Determining whether a significant financing component exists involves considering things like the difference between the cash price for an asset and the transaction price in the contract, the term of the receivable and prevailing interest rates. As a practical expedient, entities can presume that a trade receivable does not have a significant financing component if the expected term is less than one year.

PwC observation. Under IAS 39 entities often measure non-interest bearing short-term trade receivables and payables at the invoice amount rather than fair value on the basis that any differences are immaterial, so we expect this change will have limited impact. However, as we discuss later, whether a loan or receivable includes a significant financing component will affect an entity's options for recognizing and measuring impairments. Also, an entity has to disclose whether it has elected to apply the practical expedient.

Classification and measurement of financial assets after initial recognition

Under IAS 39, how assets are classified generally determines the basis for their measurement. Under IFRS 9, the reverse is true—the basis on which assets are measured is the way they are classified.

Comparing IFRS 9 and IAS 39 classification and measurement categories

IFRS 9	IAS 39	
Classifications and measurement models	**Classifications**	**Measurement model**
Amortized Cost	Loans and receivables	Amortized Cost
FVPL	FVPL	FVPL
FVOCI	Available for sale	FVOCI
	Held to maturity	Amortized Cost

IFRS 9 classification and measurement categories

Category	Impact on financial statements
Amortized Cost	The asset is measured at the amount recognized at initial recognition minus principal repayments, plus or minus the cumulative amortization of any difference between that initial amount and the maturity amount, and any loss allowance. Interest income is calculated using the effective interest method and is recognized in profit and loss. Changes in fair value are recognized in profit and loss when the asset is derecognized or reclassified.
FVOCI	The asset is measured at fair value. **Loans and receivables.** Interest revenue, impairment gains and losses, and a portion of foreign exchange gains and losses, are recognized in profit and loss on the same basis as for Amortized Cost assets. Changes in fair value are recognized initially in Other Comprehensive Income (OCI). When the asset is derecognized or reclassified, changes in fair value previously recognized in OCI and accumulated in equity are reclassified to profit and loss on a basis that always results in an asset measured at FVOCI having the same effect on profit and loss as if it were measured at Amortized Cost. **Investments in equity instruments.** Dividends are recognized when the entity's right to receive payment is established, it is probable the economic benefits will flow to the entity and the amount can be measured reliably. Dividends are recognized in profit and loss unless they clearly represent recovery of a part of the cost of the investment, in which case they are included in OCI. Changes in fair value are recognized in OCI and are never recycled to profit and loss, even if the asset is sold or impaired.
FVPL	The asset is measured at fair value. Changes in fair value are recognized in profit and loss as they arise.

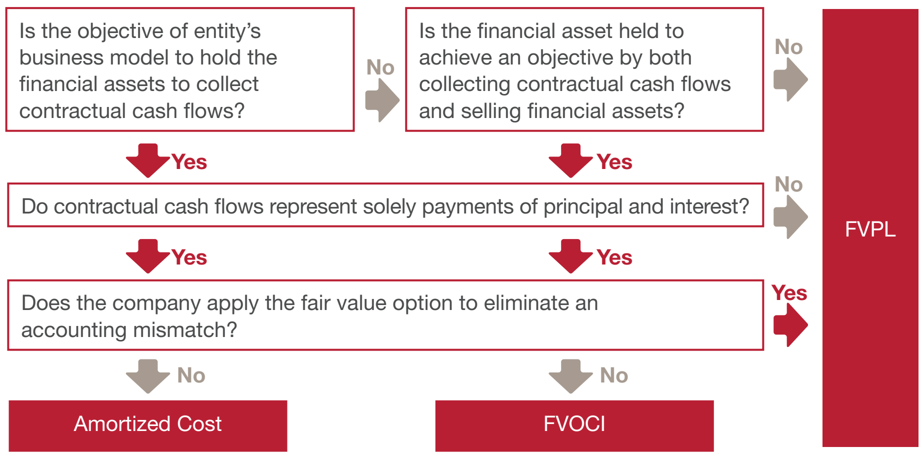
The accounting under each of these categories is the same as IAS 39 except that under IAS 39, changes in the fair value of investments in equity instruments measured at FVOCI always affect profit and loss when the asset is impaired or derecognized, and loans and receivables measured at FVOCI can impact profit and loss differently than those measured at Amortized Cost.

The table does not include the IAS 39 override under which equity instruments that are not traded in an active market and cannot be reliably measured at fair value are measured at cost, as well as derivative instruments that are linked to and settled by the delivery of such instruments. This exemption has been removed in IFRS 9.

PwC observation. The IASB eliminated the cost override on the basis that it should always be possible to estimate fair value. As the exemption was only applied in rare circumstances, we expect this may have a limited impact in practice.

Criteria for classifying and measuring financial assets

IFRS 9 establishes fundamentally different criteria than IAS 39 for determining when the Amortized Cost, FVOCI or FVPL categories apply:



The practical implication of these criteria is that, subject to a special FVOCI designation option for investments in equity instruments, only loans, receivables, investments in debt instruments and other similar assets (hereinafter referred to as "loans and receivables"), can qualify for measurement at Amortized Cost or FVOCI. The critical issues in these assessments are whether:

- The objective of the entity's business model is to hold assets only to collect cash flows, or to collect cash flows and to sell ("the Business Model test"), and
- The contractual cash flows of an asset give rise to payments on specified dates that are solely payments of principal and interest ("SPPI") on the principal amount outstanding ("the SPPI test").

Both of these tests have to be met in order to account for an instrument at Amortized Cost or FVOCI. In this publication, when we talk of passing or meeting one of these tests, we mean the asset can be measured at Amortized Cost or FVOCI as appropriate, assuming that the other test is met. When we talk of failing the test, we mean that the asset must be measured at FVPL. Applying the Business Model and SPPI tests is not necessarily straightforward and their outcomes sometimes can be surprising. Consider, for example, the following table, which illustrates how the tests can affect the classification and measurement of common types of financial assets.

Applying the Business Model and SPPI tests is not necessarily straightforward and their outcomes sometimes can be surprising.

Illustrating the application of the Business Model and SPPI tests

Amortized Cost or FVOCI possible	FVPL mandatory
Bank deposits repayable on demand, where interest, if payable, is at a fixed or floating market rate	Investments in common shares where the holder does not designate the asset as FVOCI
Trade receivables requiring payment only of fixed amounts on fixed dates	Investments in mandatorily redeemable preferred shares and puttable instruments (or instruments issued by entities having a limited life) such as mutual fund units where non-payment of dividends is not a breach of contract or the holder has no claim for a fixed amount in bankruptcy
Full recourse loans or investments in debt securities that require only fixed payments on fixed dates	Self-standing derivative financial assets such as purchased options, swaps and forward contracts
Full recourse floating rate loans requiring fixed payments on fixed dates of principal and bearing interest at a floating market rate (such as the BA rate) where the interest rate is for a period that is the same as the interest rate reset period (e.g., the interest rate is reset every three months based on the 3 month BA rate)	Floating rate loans where the interest rate is for a period that does not correspond to the interest reset period (e.g., interest is reset every 3 months based on the 6 month BA rate) and the impact on cash flows is significant
Non-recourse loans (i.e., those where recourse is limited to specific assets) where at initial recognition the lender has an economic exposure to the underlying asset's value and cash flows that is consistent with a basic lending arrangement	Non-recourse loans where at initial recognition the lender has an economic exposure to the underlying asset's value and cash flows greater than that of a basic lender
Trade receivables, loans and investments in debt securities, having the attributes described above but that can be prepaid, subject to meeting certain criteria	Fixed or floating rate loans including terms where payments are based on factors such as equity or commodity prices, unless the terms are not genuine or their effect is de minimis

We explain the mechanics of the Business Model and SPPI tests in the chapters that follow.

Embedded derivatives

IAS 39 requires an entity to measure derivative financial assets embedded in non-trading financial assets separately at FVPL if the economic risks and characteristics of the derivative are not closely related to the host contract and the entire contract is within the scope of IAS 39. Under IFRS 9, there is no special treatment for these arrangements—the entire contract is to be classified as Amortized Cost, FVPL or FVOCI following the basic criteria discussed above. (The IAS 39 embedded derivative classification and measurement requirements continue to apply to financial liabilities and non-financial contracts.)

PwC observation. If an entity is measuring a derivative embedded in a financial asset at FVPL under IAS 39, the entity usually can expect that it will have to measure the entire asset at FVPL under IFRS 9. This is because the contractual cash flows generally will not represent solely payments of principal and interest on the principal outstanding (i.e., the SPPI test will not be met). The result will be to increase income statement volatility.

If an entity is measuring a derivative embedded in a financial asset at FVPL under IAS 39, the entity usually can expect that it will have to measure the entire asset at FVPL under IFRS 9.

Optional FVOCI designation for qualifying investments in equity instruments

At initial recognition an entity at its sole option may irrevocably designate an investment in an equity instrument as FVOCI, unless the asset is:

- Held for trading, or
- Contingent consideration in a business combination.

Under this option, only qualifying dividends are recognized in profit and loss. Changes in fair value are recognized in OCI and never reclassified to profit and loss, even if the asset is impaired, sold or otherwise derecognized.

PwC observation. The IASB provided the FVOCI option in response to objections that some investments are made primarily for non-financial benefits (e.g., strategic alliances). Rather than trying to define the term "strategic alliance" or a general principle for identifying such assets the IASB decided to make FVOCI classification optional. Entities should carefully consider the implications of designating a particular investment as FVOCI considering that changes in fair value of the investment will never find their way to profit and loss. An entity that decides to designate an investment at FVOCI will have to disclose the reasons for doing this.

Entities should carefully consider the implications of designating a particular investment as FVOCI considering that changes in fair value will never find their way to profit and loss.

Definition of equity investment

The special FVOCI designation option for equity investments means that distinguishing these investments from other financial assets can be important. IFRS 9 defines an equity investment as one meeting the definition of an equity instrument in IAS 32, *Financial Instruments: Presentation*; i.e., any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Count on puttable instruments usually being classified and measured as FVPL.

PwC observation. IAS 32 includes special exceptions that result in certain instruments that do not meet its definition of an equity instrument nevertheless being classified by the issuer as such. Referred to as "puttable instruments", examples include mutual fund units, REIT units, and investments in entities that have a limited life that provide for the distribution of assets to investors at the end of the life. Because equity classification for these instruments under IAS 32 is by exception rather than by definition, they do not qualify as equity investments from the holder's perspective under IFRS 9 and thus the option to classify and measure these assets at FVOCI is not available. These investments must be evaluated as loans and receivables. Count on them usually being classified and measured at FVPL because the SPPI test rarely will be met.

Definition of dividends

IFRS 9 defines dividends as "distributions of profits to holders of equity instruments in proportion to their holdings of a particular class of capital".

PwC observation. IFRS 9 does not address the question of whether a "distribution of profits" means that the distribution has to be paid from the investor's share of post-acquisition earnings to justify its recognition in the investor's profit and loss. In the absence of further clarification on this matter, entities may have to establish an accounting policy that defines "profit" and "cost of the investment" before they can assess whether a distribution "clearly represents recovery of a part of the cost of the investment" and thus should be excluded from profit and loss.

Optional reclassification of gains and losses within equity

While an entity is precluded from recognizing changes in fair value of a FVOCI equity instrument in profit and loss IFRS 9 permits changes in the fair value of investments in equity instruments designated as FVOCI to be transferred directly from the equity account in which other comprehensive income is accumulated to other equity accounts, such as retained earnings (e.g., on the sale of the investment).

Other optional designations

As compared to IAS 39, IFRS 9 significantly restricts an entity's ability to elect to measure financial assets at FVPL or FVOCI, as shown in the table below:

Fair value designation options under IFRS 9

		Option available?	
Option	**Condition for applying**	**IFRS 9**	**IAS 39**
FVPL	Eliminates or significantly reduces a measurement or recognition inconsistency, sometimes known as an 'accounting mismatch', that otherwise would arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases.	Yes	Yes
FVPL	A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management strategy, and information about the group is provided internally on that basis to key management personnel.	No	Yes
FVPL	Contract contains one or more embedded derivatives not closely related to the economic risks and characteristics of the host contract.	No	Yes
FVOCI	Any asset that otherwise would qualify for measurement at Amortized Cost.	No	Yes

However, IFRS 9 extends the "accounting mismatch" designation option to contracts for the purchase or sale of non-financial items that may be settled net in cash or another financial instrument and that were entered into for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. This option must be made only at the inception of the contract and only if it eliminates or significantly reduces a recognition inconsistency.

PwC observation. The IASB eliminates most of the options in IAS 39 to designate an instrument as FVPL or FVOCI because they are either not necessary or not appropriate under the IFRS 9 classification and measurement model; that is, either IFRS 9 will require FVPL measurement or preclude it in the circumstances contemplated by the options.

The IASB eliminated most of the options in IAS 39 to designate an instrument as FVPL or FVOCI because they are either not necessary or not appropriate under IFRS 9.

We expect that the circumstances where cost might provide an appropriate estimate of fair value will be very rare indeed.

Cost as the basis for estimating fair value

IFRS 9 observes that in limited circumstances, cost may provide an appropriate estimate of fair value. This would be the case if insufficient more recent information is available to measure fair value or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. Indicators that cost might not be representative of fair value include: (a) significant change in the performance of the investee compared with budget, plans or milestones; (b) changes in expectations that investee's technical product milestones will be achieved; (c) a significant change in the market for the investee's products, global economy, economic environment in which the entity operates; (d) performance of competitors, matters such as fraud, commercial disputes, litigation, changes in management or strategy; or (e) evidence of external transactions in the investee's equity.

PwC observation. We expect that the circumstances where cost might provide an appropriate estimate of fair value will be very rare.

Financial liabilities designated at FVPL

Under IAS 39, the entire change in the fair value of financial liabilities designated as FVPL always are recognized in profit and loss. IFRS 9 modifies this requirement to specify that the portion of the change attributable to changes in the entity's own credit risk is recognized in OCI, with no recycling, unless:

- OCI presentation would create or enlarge an accounting mismatch in profit and loss; or
- The liability is a loan commitment or financial guarantee contract.

PwC observation. This applies only to financial instruments that have been designated optionally by the entity at FVPL, not to those which are required to be carried at FVPL (such as freestanding derivatives). All other guidance in IAS 39 related to the recognition and measurement of financial liabilities has been carried forward into IFRS 9.

Reclassification of financial assets and liabilities

IAS 39 includes complex provisions governing when it is appropriate and not appropriate to reclassify financial instruments from one classification and measurement category to another. IFRS 9 replaces these requirements with two general requirements:

- In the rare circumstances when an entity changes its business model for managing financial assets, it must reclassify all affected financial assets according to the basic classification and measurement criteria discussed earlier.
- An entity cannot reclassify financial liabilities.

In general, reclassifications of financial assets are accounted for prospectively under IFRS 9; i.e., they do not result in restatements of previously recognized gains, losses or interest income.

Accounting for asset reclassifications

From	To	Requirement
Amortized Cost	FVPL	Measure fair value at reclassification date and recognize difference between fair value and Amortized Cost in profit and loss
FVPL	Amortized Cost	Fair value at the reclassification date becomes the new gross carrying amount
Amortized Cost	FVOCI	Measure fair value at reclassification date and recognize any difference in OCI
FVOCI	Amortized Cost	Cumulative gain or loss previously recognized in OCI is removed from equity and applied against the fair value of the financial asset at the reclassification date
FVPL	FVOCI	Asset continues to be measured at fair value but subsequent gains and losses are recognized in OCI rather than profit and loss
FVOCI	FVPL	Asset continues to be recognized at fair value and the cumulative gain or loss previously recognized in other comprehensive income is reclassified from equity to profit and loss

The Business Model test

Under IFRS 9, a necessary condition for classifying a loan or receivable at Amortized Cost or FVOCI is whether the asset is part of a group or portfolio that is being managed within a business model whose objective is to collect contractual cash flows (Amortized Cost), or to both collect contractual cash flows and to sell (FVOCI). Otherwise, the asset is measured at FVPL. We discuss the key elements of this test below.

PwC observation. While IAS 39 focuses on how the entity intends to realize individual assets in classifying financial assets, IFRS 9 focuses on the business model or models the entity uses to realize them. IFRS 9 recommends applying the Business Model test before applying the SPPI test because this may eliminate the need to apply the more detailed SPPI test, which is applied at a more granular level. However, the ordering of the tests will not change the outcome.

The basic steps

Applying the Business Model test involves four basic steps:

- Subdividing as necessary loans and receivables into separate groups or portfolios according to the way they are managed.
- Identifying the objectives the entity is using in the course of its business to manage each grouping or portfolio.
- Based on those objectives, classifying each group or portfolio as being "held to collect", "held to collect and to sell", or "other".
- For assets classified as being held to collect, evaluating the appropriateness of the classification by back-testing against past activities.

The following table summarizes the key factors and other guidance in IFRS 9 for classifying assets as held for collection, held for collection and sale, and other.

IFRS 9 business model classifications – key considerations

	Holding to collect contractual cash flows	Holding to collect contractual cash flows and sell	Other
Over-arching objective	Collecting cash flows is integral, sales are incidental	Collecting cash flows and selling assets are both integral	Sales are integral, collecting cash flows is incidental
Examples of why sales happen in each category	Sales are made in response to increase in asset's credit risk or to manage credit concentration risk	Sales are made as part of managing everyday liquidity needs, maintaining a particular interest yield profile or matching the duration of financial assets and liabilities	Sales are made within a program of active buying and selling to realize fair values
Illustrative examples in IFRS 9	IFRS 9, B4.1.4	IFRS 9, B4.1.4C	IFRS 9, B4.1.5

Classifying business models

IFRS 9 states that identifying business models is a matter of fact that is typically observable through an entity's activities, not merely an assertion. Relevant evidences that entities should consider include:

- How information about financial assets and their performance is evaluated by the entity's key management personnel.
- The risks that affect the performance of the group and the way which those risks are managed.
- How managers are compensated (e.g., whether the compensation is based on the fair value of the assets or the contractual cash flows that are collected).

PwC observation. While determinations should be made based on the facts, judgment as to which classification is appropriate often still will be necessary. The basis for those judgments should be documented.

Consideration of historical sales

In considering whether an entity's business model is holding to collect contractual cash flows, IFRS 9 requires entities to consider the frequency, value and timing of any sales in prior periods, the reasons for them and the conditions under which they are made. The purpose is to establish whether sales continue to be only an incidental part of the entity's business model, and thus that Amortized Cost classification continues to be appropriate.

It is possible that assets that are subject to factoring and securitization programs that are being measured at Amortized Cost under IAS 39 may have to be measured at FVPL under IFRS 9.

Nevertheless, such sales must be considered in assessing the business model for new instruments.

PwC observation. Unlike IAS 39's 'held-to-maturity' category, there are no "tainting" provisions whereby sales out of a portfolio can automatically result in an entity losing the right to apply the Amortized Cost model.

Factoring and securitization of trade receivables

Many entities realize contractual cash flows from trade receivables through factoring or securitization programs. The classification of the related assets under the Business Model test may depend on whether the factoring or securitization will be accounted for as a sale or a financing. If the former, classification as other than holding for collection, or holding for collection and sale, would likely be appropriate.

PwC observation. For factoring or securitization transactions that are accounted for as a financing, companies should establish an accounting policy as to whether the fact that they are a legal sale is a relevant factor in deciding the classification of the assets under the Business Model test. Also, companies that participate in securitization or factoring programs may originate receivables that do not meet eligibility requirements and so are not included in the program. In applying the Business Model test, these assets ordinarily would constitute a separate portfolio and should be classified independently of the eligible assets. In some situations, one entity within the consolidated group may sell receivables to another entity within the group, which will undertake the factoring or securitization. In these circumstances, the classification of the assets under the Business Model test may be different in the separate financial statements of the two subsidiaries, depending on their terms of the sale. It is possible that assets that are subject to factoring and securitization programs that are being measured at Amortized Cost under IAS 39 may have to be measured at FVPL under IFRS 9. However, materiality considerations would be relevant in assessing these programs (e.g., short-term receivables where the difference between invoice price and fair value is insignificant).

The SPPI test

Under IFRS 9 a necessary condition for classifying loans and receivables at Amortized Cost or FVOCI is that the contractual payments give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding. We discuss the key aspects the SPPI test below.

PwC observation. In its Basis for Conclusions, the IASB explains the rationale for limiting the use of Amortized Cost and FVOCI to financial assets that meet the SPPI test. The IASB considers that these bases of accounting are meaningful only for "basic" or "simple" loans and receivables. More complex arrangements must be measured at FVPL.

Meaning of principal and interest

IFRS 9 defines principal as the fair value of a financial asset at initial recognition, which may change over the life of a financial instrument (for example, if there are repayments of principal). Interest is the consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks (e.g., liquidity risks) and costs (e.g., administrative costs), as well as a profit margin.

The objective of the SPPI test is to determine whether an arrangement pays only interest and principal, as defined, not to quantify their respective amounts.

PwC observation. The objective of the SPPI test is to determine whether an arrangement pays only interest and principal, as defined, not to quantify their respective amounts. Ordinarily, it should be possible to establish this by considering the nature of the lender's rights to cash flows, and the cash flows risks and volatility to which the lender is exposed. IFRS 9 provides general guidance, discussed below, to assist in this evaluation. As a general rule, loans and receivables that require only fixed payments on fixed dates, or only fixed and variable payments where the amount of the variable payment for a period is determined by applying a floating market rate of interest for that period (e.g., the BA rate, the prime rate, or LIBOR) plus a fixed spread to a specified reference amount (such as a stated maturity amount) will have payments that meet the SPPI test. IFRS 9 states that in concept, instruments which are not loans and receivables in legal form still might pass the SPPI test.

Factors to consider in applying the SPPI test

IFRS 9 identifies the following factors as being relevant in applying the SPPI test:

- Whether payment terms are "not genuine" or "de minimis"
- Rights in bankruptcy or when non-payment happens
- Arrangements denominated in a foreign currency
- Prepayment and term extending options
- Other contingent payment features
- Non-recourse arrangements
- The time value of money element of interest
- Contractually linked instruments (tranches) and negative interest rates

We discuss each of these factors below.

Whether payment terms are "not genuine" or "de minimis"

Contract terms that are not genuine or de minimis should not be considered in applying the SPPI test. A payment term is not genuine if it affects an instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur. It is de minimis only if it is de minimis in every reporting period and cumulatively over the life of the financial instrument.

PwC observation. The Basis for Conclusions for IFRS 9 indicates that in order to meet the "not genuine" test, the probability that a payment will occur has to be more than "remote". How much more it needs to be is a matter of judgment.

Rights in bankruptcy or when non-payment happens

Investments in mandatorily redeemable preferred shares ordinarily must be measured at FVPL.

An instrument has contractual cash flows that are solely payments of interest and principal only if the debtor's non-payment is a breach of contract and the holder has a contractual right to unpaid amounts of principal and interest in the event of the debtor's bankruptcy.

PwC observation. Consider an investment in preferred shares that is mandatorily redeemable at par plus accrued dividends. Typically on bankruptcy such shares are entitled to a priority claim in any remaining net assets up to their preference amount, but not a fixed legal claim on the preference amount itself. Accordingly, investments in mandatorily redeemable preferred shares ordinarily must be measured at FVPL.

Arrangements denominated in a foreign currency

Principal and interest determinations should be assessed in the currency in which loan payments are denominated.

PwC observation. This guidance applies only to lending arrangements where all payments are denominated in the same foreign currency. It is not relevant to arrangements with what would have been considered embedded foreign currency derivatives under IAS 39.

Prepayment and term extending options

IFRS 9 states that a contract term that permits the issuer to prepay a debt instrument, or the holder to put a debt instrument back to the issuer before maturity, does not violate the SPPI test in the following situations:

- The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding; or
- The prepayment amount substantially represents the contractual par amount and accrued but unpaid contractual interest, the instrument was acquired or originated at a premium or discount to the contractual par amount, and when the instrument is initially recognized, the fair value of the prepayment feature is insignificant.

In both cases, the prepayment amount can include reasonable additional compensation for the early termination of the contract.

Similarly, the SPPI test is not violated if an arrangement includes an option that allows the issuer or borrower to extend the contractual term of a debt instrument and the terms of the option result in contractual cash flows during the extension period that are solely payments of principal and interest on the principal amount outstanding. Payments may include a reasonable amount of additional compensation for the extension of the contract.

PwC observation. Often under IAS 39 entities did not compute the fair value of prepayment options where loans were pre-payable at par because generally such prepayment options were considered closely related to the host contract and thus not an embedded derivative that has to be measured at FVPL. By contrast, IFRS 9 requires that the entity assess whether the fair value of the prepayment feature is significant for loans acquired or issued at a premium or discount and therefore adds to the complexity of the analysis for the classification of such instruments. Entities will need to develop a policy to assess “significance” in this context.

IFRS 9 adds complexity to the classification of instruments that can be prepaid.

Other contingent payment features

Lending agreements often include contingent payment terms, which could change the timing or amount of contractual cash flows for reasons other than changes in market rates of interest, prepayments or term extensions. IFRS 9 gives two such examples:

- A contractual term where the interest rate specified in the arrangement resets to a higher rate if the debtor misses a particular number of payments.
- A contractual term where the specified interest rate resets to a higher rate if a specified equity index reaches a particular level.

For such features, IFRS 9 states that an entity must assess whether the contractual cash flows that could arise both before, and after, such a change to determine whether the contract terms give rise to cash flows that are solely payments of principal and interest. It also states that while the nature of the contingent event (i.e., the trigger) is not a determinative factor, it may be an indicator. For example, it is more likely that the interest rate reset in the first case results in payments that are solely payments of principal and interest because of the relationship between the missed payments and an increase in credit risk.

PwC observation. In the Basis for Conclusions, the IASB emphasizes that all contingent payment features should be assessed the same way; that is, there should be no difference in the way prepayment and other contingent payment features are evaluated. As a result, it is always appropriate to consider whether a contingent payment feature has a significant impact on cash flows. We expect that it rarely will be the case that an entity will be able to form a judgment whether the SPPI test is met in contingent payments arrangements without considering the nature of the contingent event. In the second case in the IASB example, for instance, the increase in the interest rate as the result of the change in the equity index would most likely be viewed as a return for accepting equity price exposure rather than interest income, notwithstanding that it only changes the interest rate. In effect, the lender is taking a position on the future direction of equity prices, which is not consistent with a basic lending arrangement.

Non-recourse arrangements

For non-recourse arrangements, the lender must "look through" to the underlying assets or cash flows.

IFRS 9 emphasizes that the fact that a financial asset may have contractual cash flows that in form qualify as principal and interest does not necessarily mean that the asset will pass the SPPI test. Lending arrangements where a creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (so-called "non-recourse" financial assets) may not, for example. For such arrangements, the lender must "look through" to the underlying assets or cash flows in making this determination. If the terms of the financial asset give rise to any other cash flows or otherwise limit the cash flows, the asset does not meet the SPPI test.

PwC observation. Consider a non-recourse loan whose principal amount finances 100% of the cost of a portfolio of equity instruments that will be sold when the loan is due. In this situation, a decline in the value of the portfolio below its cost will reduce the cash flows available to repay the lender; i.e., under the terms of the arrangement the lender is exposed to changes in the value of the equity portfolio (in effect, the lender has written a put option on the portfolio). The SPPI test thus is not met.

The time value of money element of interest

IFRS 9 states that in determining whether a particular interest rate provides consideration only for the passage of time, an entity applies judgment and considers relevant factors such as the currency in which the financial asset is denominated and the period for which the interest rate is set.

IFRS 9 addresses the example where the tenor of a floating rate loan is modified so that it does not correspond exactly to the interest rate reset period. For example, the interest rate resets every month to a one year rate or to an average of particular short- and long-term rates rather than the one month rate. It states that this feature introduces a variability in cash flows that is not consistent with a basic lending arrangement. In such circumstances, the entity must consider whether the modification is significant by performing a qualitative or quantitative assessment. The objective is to establish on an undiscounted basis how different the asset's contractual cash flows could be from the cash flows that would arise if there was a perfect link between the interest rate and the period for which the rate is set. A difference may be significant if it could be significant in a single reporting period or cumulatively over the life of the instrument. If a difference is significant, the SPPI test is not met.

Contractually linked instruments (tranches) and negative interest rates

IFRS 9 contains 1) complex requirements for debt instruments issued in tranches whose terms create concentrations of credit risk (i.e., lower ranking tranches absorb the first dollars of credit risk before higher ranking tranches often occurring in interests held in securitizations; and 2) a special exception for loans that pay a negative interest rate.

Impairment

IFRS 9 establishes a new model for recognition and measurement of impairments in loans and receivables that are measured at Amortized Cost or FVOCI—the so-called "expected credit losses" model. This is the only impairment model that applies in IFRS 9 because all other assets are classified and measured at FVPL or, in the case of qualifying equity investments, FVOCI with no recycling to profit and loss.

Expected credit losses

Because every loan and receivable has some risk of defaulting in the future, every loan or receivable has an expected credit loss associated with it—from the moment of its origination or acquisition.

Expected credit losses are calculated by: (a) identifying scenarios in which a loan or receivable defaults; (b) estimating the cash shortfall that would be incurred in each scenario if a default were to happen; (c) multiplying that loss by the probability of the default happening; and (d) summing the results of all such possible default events. Because every loan and receivable has at least some probability of defaulting in the future, every loan or receivable has an expected credit loss associated with it—from the moment of its origination or acquisition.

PwC observation. The IASB chose to describe its new impairment model as the "expected credit loss" model because this is the term used in statistics to describe the weighted average of outcomes weighted by the probability of their occurrence. Because the result is an average, expected credit losses are neither necessarily "expected" nor "losses", at least as those terms are commonly understood. Rather, they are a measure of the asset's credit risk.

Expected Credit Losses – A simple illustration

Estimated future cash flows at initial recognition assuming borrower pays as anticipated, discounted at the loan's effective interest rate	1,000
Estimated future cash flows if default occurs, discounted	100
Cash shortfall	900
Probability of default	1%
Expected credit loss	9

For ease of illustration this example assumes only one default scenario, refer to discussion below for requirements for multiple scenarios. See the following chapter for the rate to be used to discount future cash flows.

Recognition and measurement of expected credit losses

Expected losses are recognized and measured according to one of three approaches—a general approach, a simplified approach and the so-called "credit adjusted approach":

	General approach	Simplified approach	Credit adjusted approach
Applies to	All other loans and receivables not covered by another approach	Qualifying trade receivables, IFRS 15 contract assets and lease receivables	Assets that are credit impaired at initial recognition – see page 34
Timing of initial recognition	Same period as asset is acquired	Same as general approach	Cumulative change in Lifetime ECLs since initial recognition
Measurement basis of the loss allowance	12 month ECLs (or Lifetime ECLs if the term of the asset is shorter) unless a significant increase in credit risk occurs, then Lifetime ECLs unless the increase reverses	Lifetime ECLs	

The general and simplified approaches represent approximations of a new concept of impairment the IASB would have preferred to apply in all situations, but which it decided to apply only to assets that are credit impaired at initial recognition because of practical and other concerns. In what follows, we use a simple example to illustrate this concept and then review the adjustments the IASB made to it in adapting the general and simplified approaches.

The general and simplified approaches represent practical approximations of a basic concept the IASB would have preferred to apply in all situations.

The new concept of impairment

Assume a lender loans $100,000 for two years, at a rate of 5% compounded annually, with both interest and principal payable only at maturity. The total cash flow to be received thus amounts to $110,250. Under traditional loan accounting principles, interest income would be recognized at the constant effective rate in the loan, i.e., 5%, $5,000 in year one and $5,250 in year two. Under the IASB's new impairment concept, however, interest income would be recognized at a rate that excludes the premium that the lender demands for the risk that the loan will default. Let's say that rate is 3%. Under this concept only $6,090 of interest income would be recognized over the term of the loan, $3,000 in year one and $3,090 in year two. The difference of $4,160 is a loan impairment allowance. At initial recognition, the carrying value of the loan under both models is the same but its composition is very different, as shown in the following table.

	Traditional approach	New concept
Total cash flows	110,250	110,250
Unearned interest income	(10,250)	(6,090)
Loan impairment allowance	0	(4,160)
Carrying value of loan	100,000	100,000

Under the concept, expected credit losses are used as the basis for calculating the impairment allowance and the risk adjusted interest. After initial recognition, the impairment allowance is adjusted, up or down, through profit or loss at each balance sheet date as the probabilities of collection and recoveries change. If the loan turns out to be fully collectible, expected losses eventually would fall to zero as the probability of non-payment declines and "impairment gains" would be recognized in profit and loss. If the loan grows more risky, the probability that a default will occur and thus expected credit losses will increase. If a default happens, and the lender suffers an actual cash shortfall, expected credit losses will equal that shortfall.

The modifications – the general and simplified approaches

The IASB introduced the general and simplified approaches in response to concerns about the impact on interest revenue, the systems implications, and cost and complexity.

The IASB introduced the general and simplified approaches in response to concerns about the impact of the new impairment concept on the interest revenue line, the systems implications, and cost and complexity. The major modifications to the concept the Board made in developing these approaches include:

- Interest income continues to be recognized based on total cash flows, rather than net of expected credit losses (in our example, for instance, interest income would still be reported based on an effective rate of 5% not 3% – $10,250 instead of $6,090 over the life of the loan).
- An impairment loss is recognized at the first balance sheet date on which the loan or receivable is recognized.

PwC observation. Continuing to recognize income at the higher rate under traditional loan accounting principles means that there is no alternative to recognizing this initial allowance except by charging expense. While it would be more faithful to the concept to amortize the initial allowance to offset the higher revenue over the life of the loan, the IASB required immediate recognition to accommodate systems concerns.

- Under the general approach, an entity calculates expected credit losses for long-term loans and receivables at initial recognition by considering the consequences and probabilities of possible defaults only for the next 12 months, rather than the life of the asset. It continues to apply this method until a significant increase in credit risk has occurred, at which point the loss allowance is measured based on Lifetime ECLs.

PwC observation. The cumulative probability that a long-term loan or receivable will default at any time within 12 months usually will be substantially lower than the cumulative probability it will default at any time over its remaining expected life. As a result, 12 month ECLs usually will be lower, often substantially so, than Lifetime ECLs. The IASB chose the 12 month ECL basis for a number of reasons, including to mitigate cost and complexity.

The IASB retained the credit adjusted approach for loans and receivables that are credit impaired at the date of initial recognition (e.g., loans acquired at a deep discount due to credit quality) because neither the general nor the simplified approach can appropriately portray the economics of these arrangements.

Comparison to IAS 39 impairment requirements

	IFRS 9—Amortized Cost and FVOCI assets	IAS 39	
		Amortized Cost assets	FVOCI assets
Method of recognition	Loss allowance	Either by direct reduction of the asset or an allowance	Decline in fair value recognized in OCI transferred to profit and loss
Basis for recognition	Expected credit losses	Objective evidence of impairment	Objective evidence of impairment
Basis for measurement	12 month or Lifetime ECLs, as applicable	Difference between asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate	Difference between acquisition cost (net of any principal repayment and amortization) and current fair value, less any previously recognized impairments
Restrictions on recognition of reversal of impairment losses in profit and loss	None	Reversal can be related objectively to an event occurring after the impairment, subject to a limit	Reversal can be objectively related to an event occurring after the impairment (applies only to debt instruments)

Calculating expected credit losses

Basic principles

IFRS 9 provides that in measuring expected credit losses an entity must reflect:

- An unbiased evaluation of a range of possible outcomes and their probabilities of occurrence.
- Discounting for the time value of money.
- Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Estimating expected credit losses may not necessarily need to be a complex process.

IFRS 9 emphasizes that estimating expected credit losses may not necessarily need to be a complex process and that an entity need not identify every possible scenario. In some cases, relatively simple modelling may be sufficient without the need for a large number of detailed simulations or scenarios. In others, entities will need to determine how many more scenarios are required.

IFRS 9 also permits the use of models for estimating expected losses that do not require explicit scenario and probability analysis. For example, it states that the average credit losses for a large group with shared risk characteristics may be a reasonable estimate of the probability-weighted amount.

As a general rule, the maximum period to consider in measuring expected credit losses is the maximum contractual period (including extension options).

PwC observation. Calculating expected credit losses requires information that is relevant in the management of credit risk and entities therefore should be looking to integrate accounting and credit risk management systems and processes rather than treating the calculation as an independent accounting exercise. IFRS 9 thus provides an opportunity for reassessing whether existing credit management systems could, or should, be improved.

Meaning of default

A key issue in measuring expected losses is identifying when a “default” may occur. IFRS 9 does not define the term. Instead, an entity must apply a definition that is consistent with the definition it uses for internal credit risk management purposes and considers qualitative indicators (e.g., financial covenants).

There is a rebuttable presumption that a default does not occur later than when a financial asset is 90 days past due.

The general approach

Identifying whether a significant increase in credit risk has occurred

A critical factor in applying the general approach is whether the credit risk of a loan or receivable has increased significantly relative to the credit risk at the date of initial recognition. This is the trigger which causes the entity to change the basis of its calculation of the loss allowance from 12 month ECLs to Lifetime ECLs. To determine whether such an increase has occurred, an entity must consider reasonable and supportable information that is available without undue cost or effort, including information about the past and forward-looking information. Certain key presumptions apply in performing this test:

- An entity may assume that credit risk has not increased significantly if a loan or receivable is determined to have "low credit risk" at the reporting date; e.g., the risk of default is low, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. An example of a loan that has a low credit risk is one that has an external "investment grade" rating. An entity may use internal credit ratings or other methodologies to identify whether an instrument has a low credit risk, subject to certain criteria.
- If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information.
- There is a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due.

PwC observation. Determining whether a significant increase in credit risk has occurred can require considerable judgment. While IFRS 9 provides extensive guidance on factors that should be considered, we expect that entities often will have to establish an accounting policy as to when an increase in credit risk is significant within the context of its own internal credit risk management and reporting.

Determining whether a significant increase in credit risk has occurred can require considerable judgment.

The simplified approach

When it applies

IFRS 9 establishes a simplified impairment approach for qualifying trade receivables, contract assets within the scope of IFRS 15 and lease receivables (see table below). For these assets an entity can, or in one case must, recognize a loss allowance based on Lifetime ECLs rather than the two step process under the general approach. The simplified approach does not apply to intercompany loans.

Scope of the simplified approach

Trade receivables and contract assets within the scope of IFRS 15	**Basis of application**
Do not contain a significant financing component, or the entity applies the practical expedient to measure the asset at the transaction price under IFRS 15 – see page 10	Mandatory
Contains a significant financing component	Policy choice
Lease receivables	
Finance leases	Policy choice
Operating leases	Policy choice
An entity may select its accounting policy for trade receivables, lease receivables and contract assets independently of one another.	

PwC observation. The general and simplified approaches can result in a different pattern of recognition of impairment losses for long-term loans and receivables. Entities should carefully consider the pros and cons of choosing a policy to apply the simplified approach to these assets.

There is a practical expedient for short-term trade receivables.

Calculating expected losses for trade receivables

IFRS 9 allows an entity to use a simplified “provision matrix” for calculating expected losses as a practical expedient (e.g., for trade receivables), if consistent with the general principles for measuring expected losses. The provision matrix is based on an entity’s historical default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates.

Example of a provision matrix approach

	Current	1-30 days past due	31-60 days past due	61-90 days past due	90 days past due or more
Default rate (A)	0.3%	1.6%	3.6%	6.6%	10.6%
Gross carrying amount ($ 000's) (B)	15,000	7,500	4,000	2,500	1,000
Lifetime expected credit loss (A x B)	45	120	144	165	106

The credit adjusted approach

The credit adjusted approach applies only rarely when an entity acquires or originates a loan or receivable that is "credit impaired" at the date of its initial recognition (e.g., when a loan is acquired at a deep discount due to credit concerns via a business combination). An asset is credit impaired when one or more events that have a detrimental effect on the estimated future cash flows of the asset have occurred.

For most entities, the credit adjusted approach will apply only rarely.

Examples in IFRS 9 of evidence that an asset is credit-impaired

- Significant financial difficulty of the issuer or borrower
- A breach of contract, such as a default or past due event (i.e., a borrower has failed to make a payment when contractually due)
- The lender, for economic or contractual reasons relating to the borrower's financial difficulty, has granted a concession that the lender would not otherwise consider
- It is becoming probable that the borrower will enter bankruptcy or other financial reorganization
- The disappearance of an active market for that financial asset because of financial difficulties
- The purchase or origination of a financial asset at a deep discount that reflects incurred credit losses

PwC observation. The examples in IFRS 9 of when an asset is credit impaired are identical to the examples that IAS 39 uses to indicate that an impairment loss should be recognized because "objective evidence of impairment" exists.

Write offs

For assets classified as Amortized Cost, an entity must write off a loan or receivable when no reasonable expectation of recovering the asset or a portion thereof (e.g., a specified percentage) exists.

Commitments and financial guarantees

IFRS 9 modifies the basic requirement in IAS 39 for measuring commitments to provide loans at a below-market interest rate, and financial guarantee contracts when those instruments are not measured at FVPL.

Under both standards, the basic requirement is to measure such liabilities at the higher of the amount initially recognized less the cumulative amount of income recognized or any loss accruing under these arrangements. However, under IAS 39, the loss amount is determined in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. Under IFRS 9, it is determined by the amount of the loss allowance determined under the expected credit loss impairment requirements.

Interest income

The calculation of interest income for a period under IFRS 9 depends on whether a loan or receivable is accounted for under the general or simplified approaches, on the one hand, or the credit adjusted approach on the other, and, if it is the former, whether the asset becomes credit impaired after initial recognition (i.e., objective evidence of impairment as defined by IAS 39 exists – see page 34).

Entities will have to continue to assess whether objective evidence of impairment exists under IAS 39 in order to recognize interest income under IFRS 9.

Calculating interest income under IFRS 9

	General or simplified approach		
	No objective evidence of impairment exists	**Objective evidence of impairment**	**Credit adjusted approach**
Base on which interest income is calculated	Carrying amount of the asset at the beginning of the period **before** allowance for ECLs	Carrying value of the asset at the beginning of the period, **after** allowance for ECLs	Carrying value of the asset at the beginning of the period after allowance for ECLs
Interest rate to apply to base	Effective interest rate	Effective interest rate	Credit adjusted effective interest rate

The effective interest rate is the rate that discounts the estimated future cash flows from the asset to the asset's Amortized Cost before any allowance for expected credit losses. The credit adjusted effective interest rate differs from the effective interest rate in that estimates of future cash flows includes an adjustment for expected credit losses.

PwC observation. The practical implication of the new requirements is that entities will have to continue to assess whether objective evidence of impairment exists using criteria similar to IAS 39 in order to recognize interest income under IFRS 9. Accordingly, the systems, processes and controls that are in place to identify impaired loans under IAS 39 need to be carried forward to IFRS 9.

Presentation and disclosure

Presentation

The IASB amends IAS 1, *Presentation of Financial Statements*, to require presentation of the following amounts as separate line items in the statement of profit and loss for the period:

- Revenue calculated using the effective interest method
- Gains and losses arising from derecognition of financial assets measured at Amortized Cost
- Impairment losses (including reversals)
- If an asset is reclassified from the Amortized Cost category to FVPL, any gain or loss arising there from
- If an asset is reclassified from FVOCI to FVPL, any cumulative gain or loss previously recognized in OCI transferred to profit and loss

Disclosure

The changes to disclosure range from updating of cross-references and making consequential changes to existing requirements to significant new requirements, especially relating to impairment and expected credit losses

The introduction of IFRS 9 has triggered consequential changes to requirements for disclosures about financial instruments in IFRS 7, *Financial Instruments: Disclosure*. The changes range from updating of cross-references and making consequential changes to existing requirements, to significant new requirements. Major changes include those relating to:

Classification and measurement

- Disclosing carrying values under the new measurement classifications
- Investments in equity instruments designated as FVOCI
- Liabilities designated at FVPL
- Reclassifications
- Gains and losses relating to derecognized assets measured at Amortized Cost

Credit risk

- General disclosure
- Credit risk management practices
- Qualitative disclosure about expected credit losses
- Quantitative disclosure about expected credit losses
- Roll-forward reconciliation of expected losses
- Explanation of how significant changes in gross carrying amounts of financial instruments contributed to changes in the loss allowance
- Modifications of instruments subject to lifetime expected credit loss
- Collateral disclosures for instruments subject to the impairment requirements of IFRS 7
- Written off assets
- Purchased or originated credit impaired financial assets

PwC observation. In transitioning to IFRS 9, entities should ensure that systems, processes, etc., are revised as necessary to capture the information necessary to meet the revised disclosure requirements. Disclosure will be challenging in complex situations.

Entities may also need to update their disclosure of significant estimates and judgements under IAS 1 – *Presentation of Financial Statements* to take into account the different estimates and judgments applied under the new standard.

To the extent more financial instruments are categorized at FVPL or FVOCI subsequent to adoption of IFRS 9, entities will also need to consider the more extensive disclosures required under IFRS 13 – *Fair value measurement* for instruments measured at fair value on a recurring basis.

We recommend that entities looking for more detailed information and examples of the disclosure impact arising from IFRS 9 refer to the PwC global firm's illustrative disclosures.

Effective date and transition

Our discussion of the transition provisions of the final version IFRS 9 assumes that an entity is adopting all of its requirements at the same time; i.e., that the entity is transitioning from IAS 39 to the final version of IFRS 9 in one step. Special transition rules apply to entities that have adopted earlier versions of IFRS 9, which are not discussed here.

Effective date

An entity must apply IFRS 9 effective for annual periods beginning on or after January 1, 2018. Earlier application is permitted. In late 2016, the IASB delayed the mandatory effective date of IFRS 9 until 2021 for entities whose predominant activities are insurance related.

The general requirement in IFRS 9 is that an entity must apply IFRS 9 at the date of initial adoption retrospectively.

Method of transition

The general requirement in IFRS 9 is that an entity must apply IFRS 9 at the date of initial adoption retrospectively (i.e., as if the new requirements had always been in effect) in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. However, IFRS 9 includes certain special transition provisions designed to make the crossover to IFRS 9 easier. We discuss these, other than those related to hedging, below.

Comparative financial statements

IFRS 9 does not require an entity to restate prior periods. Restatement is permitted, if and only if, it is possible without the use of hindsight and the restated financial statements reflect all of the requirements of IFRS 9.

If the entity does not restate prior periods, any difference between previous carrying amounts and those determined under IFRS 9 at the date of initial application should be included in opening retained earnings (or other equivalent component of equity).

IFRS 9 also provides that an entity need not apply IFRS 9 to interim periods prior to the date of initial application if this is impracticable. "Impracticable" for this purpose has the meaning attributed to it in IAS 8; i.e., the entity cannot apply the requirement after making every reasonable effort to do so.

Special transitional provisions

- Liabilities derecognized under IAS 39 before the date of initial application
- The Business Model test
- Certain aspects of the SPPI test
- FVOCI designations of investments in equity instruments
- Accounting mismatch designations
- The effective interest method
- Hybrid contracts
- Instruments measured at cost
- Own use contracts
- Liabilities designated at FVPL
- Assessing credit risk at initial recognition

PwC observation. In general, these transition provisions require an entity to make an assessment or determination at the date of initial application and either (a) apply that determination retrospectively notwithstanding that a different assessment or determination might have been made in prior periods based on the facts and circumstances prevailing at that date, or (b) recognize any change in net assets in opening retained earnings at the initial date of application.

Summary of special transition provisions

	Special transition provisions
Liabilities derecognized under IAS 39 before the initial date of application	IAS 39 continues to apply.
Business Model test	Apply the test only at the date of the initial application based on existing facts and circumstances. Apply the outcome retrospectively to all prior periods irrespective of the facts and circumstance existing in those periods.
SPPI test	In applying the SPPI test, if it is impracticable to do so, do not apply the special provisions in IFRS 9 regarding whether (a) a mismatch between the tenor of a floating rate loan or receivable and the interest rate reset period has a significant impact on cash flows; and (b) the fair value of a prepayment feature is insignificant.
FVOCI designations of equity investments	Make the designation at the date of initial application. Apply the designation retrospectively.
Accounting mismatch designations	Broadly, these provisions allow entities to make IFRS 9 designations at the date of initial application and to revoke prior IAS 39 designations, including mandatory revocation for IAS 39 designations that do not qualify under IFRS 9. These should be applied retrospectively.

Summary of special transition provisions (continued)

	Special transition provisions
Effective interest method	If applying the effective interest method on a retrospective basis is impracticable, consider the fair value of the asset or liability at the date of initial application (or the end of each comparative period if the entity restates prior periods) as being the carrying amount determined by applying the effective interest method.
Hybrid contracts	If at the date of initial application, contracts contain embedded derivatives that are measured at FVPL under IFRS 9, but which had been bifurcated under IAS 39, measure the fair value of the contract at the end of the date of initial application (and the end of each comparative reporting period if the entity is restating prior periods) as the sum of the fair values of the host contract and the embedded derivative. Also measure the fair value of the contract as a whole and recognize any difference between the two measurements in opening retained earnings. No retrospective restatement.
Instruments measured at cost	Measure investments in equity instruments at fair value at the date of initial recognition (or derivative asset or liability that is linked to and must be settled by the delivery of an equity instrument) that were previously measured at cost under IAS 39 and recognize any difference in opening retained earnings at the date of initial application. No retrospective application.
Own use contracts	At the date of initial application, “own use contracts” otherwise outside the scope of IFRS 9 may be designated as FVPL provided all similar contracts are so designated. The change in net assets shall be recognized in retained earnings at the date of initial recognition. No retrospective application.
Liabilities designated at FVPL	At the date of initial application, for liabilities designated at FVPL, determine whether presenting changes in fair value attributable to changes in the credit risk of that liability would create or enlarge an accounting mismatch. Apply this determination retrospectively.

	Special transition provisions
Assessing credit risk at initial recognition	At the date of initial application, use reasonable and supportable information that is available without undue cost or effort to determine the credit risk of a financial instrument at the date it was initially recognized and compare it to the credit risk at the date of initial application. An entity may assume that: (a) The credit risk of an instrument has not increased significantly since initial recognition if the financial instrument is determined to have a low credit risk. (b) The credit risk of an instrument has increased significantly if a payment is more than 30 days past due if an entity will apply the impairment requirements for identifying significant increases in credit risk on the basis of past due information. If determining whether there has been a significant increase in credit risk would require undue cost or effort, the entity should recognize a loss allowance equal to lifetime expected losses at the date of initial recognition and subsequently, until the asset is derecognized (unless the financial instrument is low credit risk at a reporting date, in which the entity should assume that there has not been a significant increase in credit risk).

Transition disclosures

There are exhaustive transition disclosure requirements, examples of which can be found in the *PwC Manual of Accounting*.