

Understanding IFRS 9₍₂₀₁₄₎ for Directors

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1. Introduction

Many preparers and users of financial statements and other interested parties have expressed concerns that the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* are rule-based, difficult to understand, apply and interpret. They have urged the IASB to develop a new standard of financial reporting for financial instruments that is principle-based and less complex. To improve and simplify the accounting requirements for financial instruments, the IASB undertook a project in 2008 to replace IAS 39 in its entirety. The project was divided into three phases covering: (a) classification and measurement of financial assets and financial liabilities, (b) impairment methodology and (c) hedge accounting. The first part of Phase 1 was completed in November 2009 and it resulted in the issuance IFRS 9₍₂₀₀₉₎ to provide guidance on the classification and measurement of financial assets only. The second part of Phase 1 was completed in November 2010 and it resulted in a revised version of IFRS 9₍₂₀₁₀₎ that included measurement of financial liabilities. In July 2014, the complete version of IFRS 9₍₂₀₁₄₎ was issued and it now includes impairment methodology and hedge accounting i.e. the completion of Phases 2 and 3 respectively. However, the effective date of this new IFRS is for annual periods beginning on or after 1 January 2018, with earlier application permitted.

IFRS 9 retains the scope, recognition and derecognition requirements of IAS 39 but made changes to the areas of classification and measurement of financial instruments, impairment methodology and hedge accounting.

This Article aims to assist directors of reporting entities better understand the rationale and significance of the new IFRS 9. As the new Standard adopts a business model approach to accounting for financial instruments, directors who are key management personnel of reporting entities would need to provide the foundation by setting an entity's business model objectives for managing financial assets, and for an entity's hedging objectives and strategies.

2. Debates on Which is the Best Measurement Model

There are diverse forms of financial instruments and the varied reasons for holding them often result in diverse accounting practices. This diversity is further compounded by the fact that some instruments are quoted (such as quoted shares) or have active traded markets (such as trading in commodities), while some others do not have an active traded market (such as unquoted shares). Thus, measurement has become an important consideration in accounting for these assets and liabilities. The academic and professional debates on measurement principles are mostly on cost model versus fair value model.

In a cost model, a financial asset, such as an investment, is stated at the historical cost and written down only for impairment losses. Changes in fair value are not recognised. A gain or loss is recognised in profit or loss only when the investment is impaired or sold. Proponents of this model argue that it is prudent and it reflects the "stewardship" of management for the resources entrusted to it. The reported results of an entity would not be affected by volatility of market prices. The model is also simple to apply as it does not rely on subjective fair value estimates. Opponents of this model argue that it does not reflect the true worth of investments when prices have changed. Also, an entity's results can be managed by "cherry-picking" or selective sales of investments.

In a fair value model, an investment is initially recorded at its fair value (which is generally the cost at initial recognition) and subsequently marked to its market price (fair value) at the end of each reporting period. Changes in fair value are recognised in profit or loss or other comprehensive

income (OCI). Proponents of this model argue that it reflects the economic reality i.e. a faithful representation, in that investments are subject to changes in market prices. Thus, gains or losses from changes in fair value should be reported in profit or loss (or in OCI) to reflect the changed condition of the investments, regardless of whether they have been sold. The transaction of selling an investment is not an income-generating activity, because a gain or loss arises from holding the investment for the fair value change (i.e. the accretion in wealth).

There are merits and demerits of each measurement model. The current IFRSs are of mixed measurement attributes, generally preferring the fair value model for most financial assets because investors, creditors and other users of financial statements rely more on fair value information in their investment or lending decisions. For some types of financial assets, cost-based models are preferred. However, for financial liabilities, the amortised cost model is preferred, with limited exceptions for the use of the fair value model in some circumstances. In issuing IFRS 9 to replace IAS 39, the IASB did not push for greater use of the fair value model for financial instruments, focusing instead on a user-friendly business model approach and simplifying the accounting requirements in some areas.

3. Accounting for Financial Assets

3.1 Classification Criteria

IFRS 9 uses a business model approach to classify a financial asset. The classification is based on how an entity manages its financial assets (i.e. its business model) and the contractual cash flow characteristics of the financial assets. In the final IFRS 9₍₂₀₁₄₎, a financial asset is classified in one of three measurement models: (a) at amortised cost (AC) model, (b) at fair value through other comprehensive income (FVOCI) model, or (c) at fair value through profit or loss (FVPL) model. An entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

- (a) the entity's business model for managing the financial assets; and
- (b) the contractual cash flow characteristics of the financial asset [IFRS 9.4.1.1]

The classification is premised on the difference between financial assets that have highly volatile cash flows (such as derivatives) or are part of a trading operation (debt or equity instruments held for trading) where fair value is argued as providing more useful information, as contrast to financial assets with principal amounts that are held for collection of contractual cash flows of interest and principal, where amortised cost information is considered more useful.

The AC Model

This amortised cost model can only be applied to debt instruments. An entity's business model for managing financial assets shall be considered first, and the contractual cash flows considered only for financial assets measured at amortised cost because of its business model. Financial assets shall be measured at amortised cost if both the following conditions are met:

- (a) the financial asset is held within a business model whose objective is to hold the asset in order to collect contractual cash flows; and
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on principal outstanding [IFRS 9.4.1.2].

The amortised cost of a financial asset or financial liability is the amount in which the financial asset or financial liability is measured at initial recognition minus principal repayment, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility. The effective interest method is a method of calculating the amortised cost of a financial asset or financial liability and of allocating the interest

income or interest expense over the relevant period. The *effective interest rate* is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

For a debt instrument, an entity that applies the amortised cost model would earn a constant rate of return or yield based on the effective interest rate determined at initial recognition. Changes in the fair value (or market price) of the instrument caused by e.g. changes in market interest rate are not recognised. In contrast, if the entity applies the fair value model for a debt instrument, the yield would consist of the coupon interest receivable plus or minus the change in the fair value of the instrument.

Example

On 1 January 20x1, Falcon Bhd purchases 1,000 units of a quoted bond at a price of RM875 per unit. The nominal value of the bond per unit is RM1,000. Transaction costs incurred amount to RM8,000 and a fee of RM2,000 is paid for advice received for the bond investment. The bond pays a fixed coupon interest rate of 5% annually on 31 December with the last coupon interest payable on 31 December 20x5. The bond is redeemable by the issuer on 31 December 20x5 at a premium of 10% over its nominal value. At 31 December 20x1, the market price of the bond is RM940 per unit.

If Falcon Bhd applies the amortised cost model, the effective interest rate is determined, using the discounted cash flow model, as follows:

$$875,000 + 10,000 = \sum_{t=1}^5 \frac{50,000}{(1+r)^t} + \frac{1,100,000}{(1+r)^5}$$

Where r = effective interest rate.

Using a spreadsheet, r is determined as follows:

Year	Cash Flows
0	(885,000)
1	50,000
2	50,000
3	50,000
4	50,000
5	1,150,000
r	=irr(Y0:Y5) = 9.6563%

The amortised cost carrying amounts of the investment and interest income (calculated at the effective interest rate), in each year before redemption, are as follows:

Year	Opening carrying amount RM (a)	Interest income at 9.6563% RM (b) = (a) x 9.6563%	Coupon interest received RM (c)	Closing carrying amount RM (d) = (a) + (b) – (c)
1	885,000	85,458	(50,000)	920,458
2	920,458	88,882	(50,000)	959,340
3	959,340	92,637	(50,000)	1,001,977
4	1,001,977	96,754	(50,000)	1,048,731
5	1,048,731	101,269	(50,000)	1,100,000
Total		465,000	(250,000)	

In the first year, interest income recognised in profit or loss is RM85,458 and this consists of the coupon interest received of RM50,000 and the accretion of RM35,458 in the amortised cost carrying amount.

The FVOCI Model

In the final IFRS 9₍₂₀₁₄₎, a third measurement category of financial assets is included for debt instruments measured at fair value through other comprehensive income (OCI) if both the following conditions are met:

- (a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
- (b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding [IFRS 9.4.1.2A].

This third category has a hybrid treatment for fair value changes whereby interest income, impairment losses and exchange gains or losses and any gain or loss on derecognition are recognised in profit or loss. All other gains or losses shall be recognised in other comprehensive income. These treatments are similar to debt instruments classified as available-for-sale investments under the current IAS 39.

In the Falcon Bhd Example above, if the FVOCI model is applied, interest income recognised in profit or loss in the first year would remain at RM85,458 calculated at the effective interest rate of 9.6563%. The adjusted amortised cost amount of RM920,458 is then marked to the market price (fair value) of RM940,000, and the difference of RM19,542 is a gain that shall be recognised in other comprehensive income.

In this third FVOCI model, a debt instrument is measured at fair value but the related interest income is calculated at the effective interest rate as if the instrument is measured at amortised cost. Some entities, such as insurers and banks, may have such a business model of holding debt instruments both for collecting contractual cash flows and for sale. The IASB believes that this hybrid treatment results in the amortised cost information being provided in profit or loss and the fair value information provided in the statement of financial position.

The FVPL Model

This is known as the residual class because, by default, if any of the above conditions specified for the AC Model or FVOCI Model is not met, the financial asset must be classified as measured at fair value through profit or loss. This means that for stand-alone derivatives and equity instruments, they must all be included in this category (the current IAS 39 requires the cost measurement for unquoted equity instruments if the fair value cannot be measured reliably). The classification of debt instruments would depend on meeting the business model and contractual cash flow characteristics conditions above. For example, a debt instrument held for trading must be measured at fair value through profit or loss even if it has contractual cash flows of principal and interest on principal.

In the Falcon Bhd Example above, if Falcon Bhd trades on the bond and applies the FVPL model, the bond would initially be recognised at its fair value of RM875,000. The transaction costs of RM10,000 shall be recognised as a expense in profit or loss. The bond would then be marked to its market price (fair value) at the end of each reporting period. For example, in Year 1, the total net income recognised in profit or loss is RM105,000, consisting of the coupon interest received of RM50,000 and the fair value gain of RM65,000 (i.e. RM940,000 – RM875,000) less transaction costs of RM10,000.

3.2 Some Exceptions to the Classification

IFRS 9 provides for two non-mandatory exceptions to the classification of financial assets and these are:

- (a) Option to designate particular financial assets at fair value through profit or loss; and
- (b) Option to present fair value changes of equity instruments in other comprehensive income.

3.2.1 Option to Designate Debt Instruments at Fair Value through Profit or Loss

IFRS 9 retains the option (non-mandatory) to designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces an accounting mismatch i.e. a measurement or recognition inconsistency that otherwise would arise from measuring assets or liabilities or recognising the gains or losses on different bases [IFRS 9.4.1.5]. The option of designating at fair value a hybrid instrument that contains an embedded derivative is no longer allowed as the entire hybrid instrument must be measured at amortised cost if the conditions are met, otherwise measured at fair value through profit or loss. Similarly, the fair value designation option based on internal fair value reporting is redundant because of the business model condition.

Example of a Mismatch

An entity invests in a quoted bond that pays market interest rate and is redeemable at its nominal value on maturity. The debt instrument meets the condition of solely payments of principal and interest on principal outstanding, and the entity's business model objective is to collect contractual cash flows of interest and principal. The entity uses a derivative instrument to hedge the interest rate risk and price risk of the investment, but chooses not to apply hedge accounting. In the absence of a designation, the bond would be measured at amortised cost (where fair value changes are not recognised) whilst the derivative must be measured at fair value with changes in fair value recognised in profit or loss. The entity concludes the resulting treatment is a mismatch in profit or loss. Hence, it may designate to measure the bond investment at fair value through profit or loss to match with the gains or losses of the derivative instrument.

Directors or other key management personnel need to decide whether to avail this designation option. For entities that hedge financial risks of debt instruments but are unable to meet the conditions specified for hedge accounting in IFRS 9, designating their debt instruments to be measured at fair value through profit or loss to correct an accounting mismatch may be a simpler and cheaper alternative to the hedge accounting requirements of the Standard if the concern is to reduce volatility in profit or loss.

3.2.2 Equity Investments Optionally Measured at Fair Value through OCI

For a financial asset measured at the fair value model, changes in fair value would generally be recognised as gains or losses in profit or loss. This includes fair value changes for all equity instruments, whether held for trading or otherwise. Some respondents have argued that for strategic equity investments held for the long-term or those invested to cement trading relationships with investees, recognising gains and losses from the fair value changes of their long-term equity investments would result in volatility in performance reporting, which may bear no resemblance to the long-term nature of those equity investments.

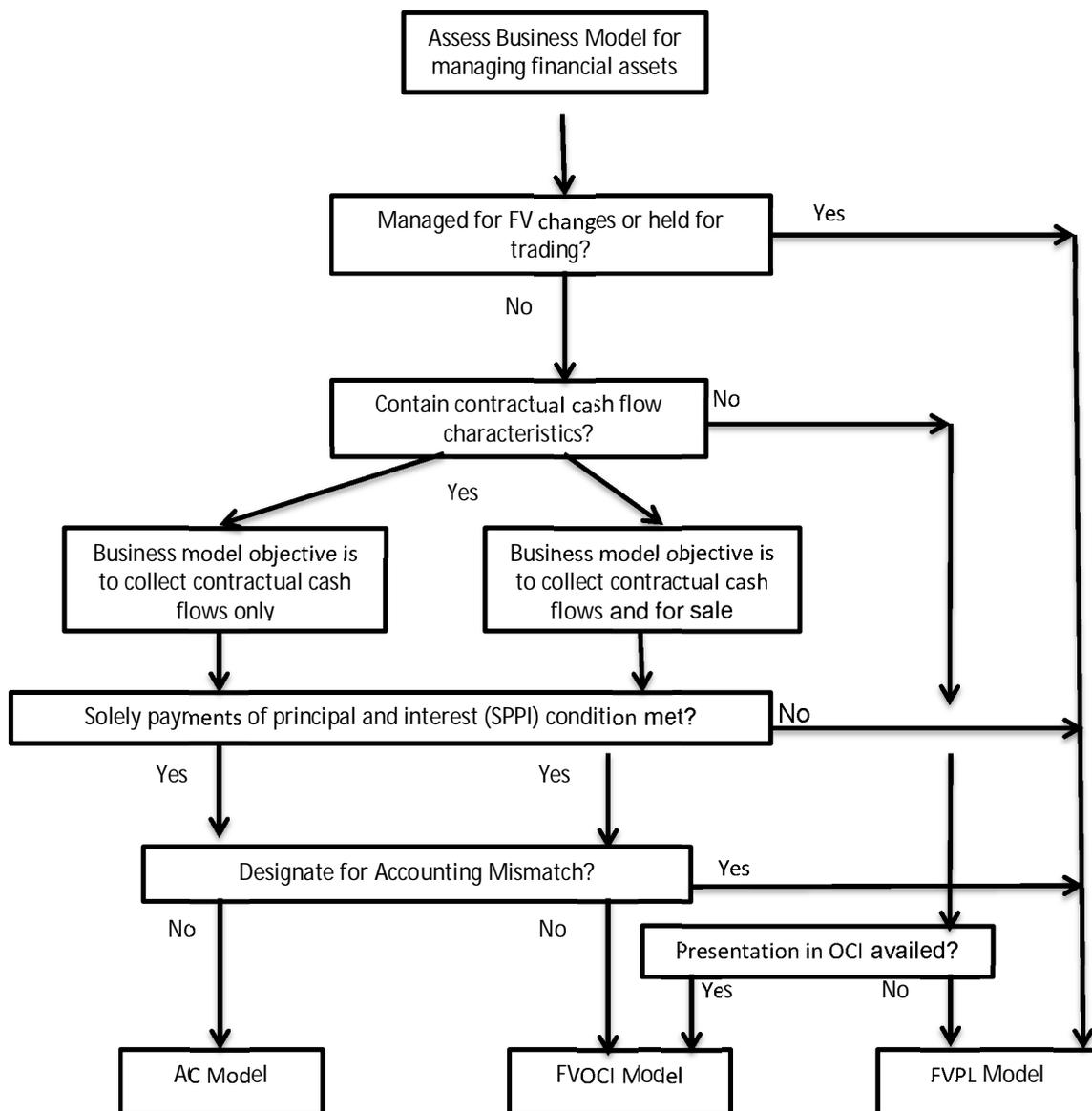
The Standard provides for a presentation option to allow an entity to present changes in fair value of *equity investments* (those not held for trading) in other comprehensive income. This option is not the same as equity investments classified as available-for-sale (AFS) assets under the current IAS 39. In this presentation option, all gains and losses, including impairment, would be recognised in other comprehensive income without any requirement to reclassify to profit or loss even if the

equity investments are subsequently derecognised. However, dividend income from such equity investments must be recognised in profit or loss.

This is an accounting policy choice (not mandatory), the election must be made on initial recognition and it is irrevocable [IFRS 9.4.1.4]. Hence, directors or other key management personnel must decide whether to avail this option for their entities. Other than dividend income, this option prevents any other changes in fair value, including gains or accretions in value of the equity investments, in profit or loss. However, the Standard does not preclude a transfer within equity components, such as a transfer from fair value reserve to retained earnings, upon derecognition of an equity investment in this classification.

The flowchart below may help you better understand the classification requirements of financial assets in IFRS 9.

Flowchart on the Classification of Financial Assets in IFRS 9



3.3 Assessing an Entity's Business Model for Managing Financial Assets

In IFRS 9, an entity assesses whether its financial assets meet the business model condition for classification on the basis of the objective of the business model as determined by the entity's key management personnel. Key management personnel, as defined in IAS 24 *Related Party Disclosures*, are those persons having authority and responsibility for planning, directing and controlling the activities of an entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

The business model is based on the way an entity manages its financial assets and is not dependent on management's intention for an individual instrument. The Application Guidance (AG) clarifies that this condition is not an instrument-by-instrument approach to classification and should be determined on a higher level of aggregation, for example, a portfolio of loans and receivables. An entity's business model for managing financial assets is not an accounting policy choice (i.e. it is not a voluntary designation) but rather, it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management.

An entity's business model is typically observable through the activities that the entity undertakes to achieve the objective of the business model. An entity needs to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. Instead, the entity must consider all relevant evidence that is available at the date of the assessment. The AG provides some examples of relevant evidence that includes, but is not limited to:

- (a) how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;
- (b) the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and
- (c) how managers of the business are compensated (for example, whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

However, an entity may have more than one business model for managing its financial assets. For example, an entity may hold a portfolio of quoted debt investments that it manages to collect contractual cash flows to earn a contractual yield or return and another portfolio of quoted debt investments that it manages for trading to realise fair value changes. It thus applies the amortised cost model for the first portfolio and the fair value model for the second portfolio.

The Amortised Cost Model Assessment

The AG clarifies that financial assets held within a business model whose objective is to hold assets in order to collect contractual cash flows are typically managed to realise cash flows by collecting contractual payments over the life of the instrument. The entity manages the assets held within the portfolio to collect those particular cash flows (instead of managing the overall return on the portfolio by both holding and selling assets). In determining whether cash flows are going to be realised by collecting the financial assets' contractual cash flows, it is necessary to consider: (i) the frequency, value and timing of sales in prior periods, (ii) the reasons for those sales and (iii) expectations about future sales activity.

Sales of financial assets in themselves do not determine the business model and therefore cannot be considered in isolation. Instead, information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved and, specifically, how cash flows are realised. An entity must consider information about past sales within the context of the reasons for those sales and the conditions that existed at that time as compared to current conditions.

The current IAS 39 has a “tainting rule” that precludes an entity from classifying debt instruments at the amortised cost model under the held-to-maturity (HTM) category if it sells or reclassifies more than an insignificant amount of the investments. In IFRS 9, an entity that holds financial assets to collect contractual cash flows is not precluded from classifying them as at amortised cost even if sales of some financial assets occur. In other words, so long as the business model objective is to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity. For example, the entity may sell a financial asset in a portfolio if:

- (a) the financial asset no longer meets the entity’s investment policy (e.g. when the credit rating of the asset declines below that required by the entity’s investment policy); and
- (b) the entity needs to fund capital expenditure.

Although the “tainting rule” of HTM investments in IAS 39 has been removed, the Application Guidance clarifies that if more than an infrequent number of sales are made out of a portfolio of financial assets, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows. Frequent buying and selling of financial assets in a portfolio would not be consistent with a business model of holding financial assets to collect contractual cash flows.

The FVOCI Model Assessment

An entity may hold financial assets in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. The AG clarifies that in this type of business model, the entity’s key management personnel have made a decision that both collecting contractual cash flows and selling financial assets are integral to achieving the objective of the business model. There are various objectives that may be consistent with this type of business model. For example, the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that fund those assets.

Compared to a business model whose objective is to hold financial assets to collect contractual cash flows only, this business model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the business model’s objective instead of being only incidental to it. The Standard does not specify a threshold for the frequency or value of sales that must occur in this business model because collecting contractual cash flows and selling financial assets are integral to achieving its objectives.

The FVPL Model Assessment

This FVPL model is a residual classification, which means that if financial assets are not held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets, they must be measured at fair value through profit or loss.

The AG provides an example of a business model that results in measurement at fair value through profit or loss, and it is one in which an entity manages the financial assets with the objective of realising cash flows through the sale of the assets. The entity makes decisions based on the assets’ fair values and manages the assets to realise those fair values. In this case, the entity’s objective will typically result in active buying and selling the financial assets. Even though the entity will collect contractual cash flows while it holds the financial assets, the objective of such a business model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the business model’s objective; instead, it is incidental to it.

The AG further clarifies that a portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. In addition, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets. For such portfolios, the collection of contractual cash flows is only incidental to achieving the business model's objective.

3.4 Contractual Cash Flows of Principal and Interest on Principal

The second condition for a financial asset to be classified as at amortised cost is the contractual cash flow characteristics of the instrument. The instrument must contain contractual terms that give rise on specified dates to cash flows that are *solely* payments of principal and interest on the principal outstanding (known as the SPPI condition). For the purpose of the Standard, interest is consideration for the *time value of money* and the *credit risk* associated with the principal amount outstanding during a particular period of time. In other words, the interest on principal to be collected must reflect the market interest rate or yield of the issuer at the time the investment was made.

For example, an entity invests in a quoted unconvertible bond that pays 7% coupon interest and redeemable at its nominal value at the end of Year 5. The 7% coupon interest represents the prevailing market interest rate of the issuer at the time of the issue and it comprises 3.2% risk-free rate and 3.8% risk premium. The bond instrument meets the condition of solely payments of principal and interest on the principal outstanding.

In contrast, assume the entity invests in a convertible bond of a similar risk-class as the quoted unconvertible bond. The convertible bond pays 3% coupon interest, may be converted into ordinary shares of the issuer at any time, and if not converted at the end of Year 5, redeemable at its nominal value. In this case, the convertible bond does not meet the condition of solely payments of principal and interest on principal outstanding because the 3% coupon interest alone does not compensate the investor for the market interest rate risk, the return on the investment is also linked to another component, which is the fair value of the conversion option.

The Standard requires that an entity shall assess whether contractual cash flows are solely payments of principal and interest on the principal outstanding for the currency in which the financial asset is denominated.

For example, a Malaysian entity with a functional currency of RM invests US\$10 million in a quoted US\$ debt instrument. The assessment of the condition of solely payments of principal and interest on principal outstanding is based solely on the US\$ interest and principal amount, notwithstanding that there is an element of currency risk in the investment.

A contractual cash flow characteristic in some financial assets is leverage, which increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Thus, stand-alone options, forward, futures and swap contracts (derivative assets) are assets with a leverage characteristic. They do not meet the condition of collecting contractual cash flows of principal and interest and cannot be subsequently measured at amortised cost.

3.5 Transfers and Reclassifications between Measurement Models

The current IAS 39 has various complex and rule-based requirements on the reclassifications of financial assets from one category into another category. IFRS 9 prescribes that an entity shall reclassify financial assets between fair value and amortised cost categories when, and only when,

there is a change in an entity's business model for managing financial assets. In all other circumstances, reclassification is prohibited. Financial assets shall be reclassified on the first day of the reporting period (i.e. the reclassification date) following the change in business model. In other words, a change in the objective of the entity's business model must be effected before the reclassification date.

For example, if an entity that reports on a quarterly basis changes its business model objective for managing financial assets on 18 February 2015, the reclassification date is 1 April 2015 (i.e. the first day of the entity's next quarterly reporting period).

Changes in business model must be determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Examples of a change in business model may include the following:

- (a) An entity has a portfolio of commercial loans that it holds to sell in the short-term. Following a business combination with another entity that also holds a portfolio of commercial loans, the business model objective of holding the combined portfolio of commercial loans is changed from trading to collecting of contractual cash flows; and
- (b) A financial services firm decides to sell its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

Also, for any reclassification, an entity shall disclose information about the effects of the change in classification. The limited exception to reclassification would reduce many of the complexities of reclassifications in the current IAS 39. As changes in business models are rare, reclassifications of financial assets under IFRS 9 would also be rare. The accounting treatment for a reclassification in IFRS 9 has also been simplified as there is no retrospective adjustment. If an entity reclassifies financial assets, it shall apply the reclassification prospectively from the reclassification date. The entity shall not restate any previously recognised gains, losses (including impairment gains or losses) or interest [IFRS 9.5.6.1].

3.6 Embedded Derivatives in Host Financial Assets

Under the current IAS 39, if a derivative is embedded in a host contract, an entity would need to make an assessment of whether the derivative is closely or not closely related to the host contract based primarily on the economic characteristics and risks of the embedded derivative in relation to the host contract. If not closely related, the embedded derivative shall be separated from the host contract and accounted for as a stand-alone derivative (except for some specified circumstances where separation is not required), which generally would be measured at fair value through profit or loss. For example, if an entity invests in a convertible bond, the conversion option would not be closely related to the underlying bond because the value of the option does not move in tandem with the price of bond. The conversion option must be separated and accounted as a stand-alone derivative, unless the entity designates the entire instrument to be measured at fair value through profit or loss.

IFRS 9 has simplified the accounting requirements for embedded derivatives if the host contract is a financial asset. If a derivative is embedded in a financial asset, the entire instrument is measured at amortised cost basis if the specified conditions (of business model objective and contractual cash flow characteristic) are met. Otherwise, the entire instrument shall be measured at fair value through profit or loss. There is no separation of embedded derivative if the host contract is a financial asset.

Example

An entity invests in a convertible bond for a consideration of RM10 million i.e. purchased at the nominal value of the bond. The bond pays a coupon interest of 3% per annum and has a term of five years. The bond can be converted into ordinary shares of the issuer at any time after issuance at a conversion price of RM2 per share. If the bond is not converted at the end of year 5, the issuer would redeem the bond at its nominal value. The prevailing market interest rate for a similar non-convertible risk-class debt instrument is 6.5% (comprising risk-free rate of 3.2% and credit spread of 3.3%).

For this bond investment, although it has contractual cash flow characteristics of principal and interest on principal, the coupon interest of 3% is not solely interest on principal that compensates an investor for the time value of money and the risk premium. The return is also linked to another component i.e. the fair value of the equity shares of the issuer. Hence, the convertible bond cannot be classified as measured at amortised cost. It must be measured at fair value through profit or loss in its entirety i.e. no separation of the embedded conversion option.

Example

An entity invests in a callable 10-year bond that pays 6.5% coupon interest at the end of each year. The prevailing market interest rate of the bond is 6.5%, comprising 3.2% risk-free rate and 3.3% risk premium. The issuer of the bond has a call option to redeem the bond at any time after the end of Year 5.

If the call option is exercised and the issuer repays at approximately the amortised cost carrying amount of bond, the entire instrument must be classified as measured at amortised cost. The condition of solely payments of principal and interest on principal is met in this case. The fact that the issuer might redeem the bond before the end of Year 10 simply means that the maturity date is accelerated.

However, if the call option is exercised and the issuer repays based on the then prevailing market value of the bond, the condition of solely payments of principal and interest on principal would not be met because there is a risk that the amount redeemed might be different from the carrying amount of the bond (a gain or loss may arise on redemption). In this case, the entire instrument must be measured at fair value through profit or loss. In either case, there is no separation of the embedded derivative in the host contract.

However, if derivatives are embedded in a host financial liability or in a non-financial host contract (such as manufacturing or sale contracts), IFRS 9 retains the requirements of IAS 39 for assessment of embedded derivatives and separation is applicable.

3.7 Impairment of Financial Assets

The current IAS 39 uses an incurred loss model to recognise impairment loss of a financial asset only after a trigger loss event has occurred. In this model, an entity initially recognises a financial asset (for example, a trade receivable or an investment) in its entirety i.e. without recognising an impairment loss upfront for the credit risk. Subsequently, when a "trigger" loss event occurs, the entity performs the impairment test and recognises an impairment loss when incurred, such as when there is a default in payment. During the global financial crisis which started in 2007, many constituents and users of financial statements have expressed concern that this incurred loss model reports loan losses "too little too late" because the model delays the recognition of a credit loss event until there is objective evidence of an impairment. They have urged the IASB to explore alternatives to the incurred loss model that would use more forward-looking information.

The complexity of the current accounting which uses different impairment methods for different financial assets was also identified as a concern. For example, in testing impairment for a financial

asset carried at amortised cost (debt instruments), the revised estimated cash flows must be discounted at the *original effective interest rate* whereas for a financial asset carried at cost (unquoted equity instruments), the discount rate applied is the *current market rate of return*. The use of a current market rate of return to discount the revised cash flows of a financial asset carried at cost is similar to a fair value measurement, which is inconsistent with the cost measurement model applied for that asset. For quoted equity investments classified as available-for-sale assets, any impairment loss is recognised in profit or loss but any subsequent recovery of the market prices cannot be reversed in profit or loss, a treatment that has been argued by many as too rule-based.

Furthermore, in applying the current IAS 39 in measuring credit losses, an entity may only consider those losses that arise from past events and current conditions. The effects of future credit loss events cannot be considered, even when they are expected. The concern then, when developing the incurred loss impairment model, was the possible creation of “secret or hidden reserve” if future loss events were allowed in the impairment measurement. It was designed to limit an entity’s ability to create hidden reserves that can be used to boost earnings during bad times. However, the IASB observed that as the global financial crisis unfolded, it became clear that the incurred loss model gave room to a different kind of earnings management, namely to postpone losses. Even though IAS 39 does not require waiting for actual default before impairment is recognised, in practice, this is often the case. Thus, the financial crisis had shown that the concern about hidden reserves is no longer supportable because future loss events when expected must be considered to prevent reporting loan losses too little too late.

IFRS 9 uses an “expected loss model” for all financial instruments that are subject to impairment accounting. It requires that an entity shall recognise a loss allowance for *expected credit losses* on a financial asset measured at amortised cost or at fair value through other comprehensive income, a lease receivable (in accordance with the draft Standard on *Leases*), a contract asset (in accordance with IFRS 15 *Revenue from Contracts with Customers*) or a loan commitment and a financial guarantee contract to which the impairment requirements of the Standard apply [IFRS 9.5.5.1].

Expected credit losses are an estimate of losses that an entity expects will result from a credit event, such as a payment default. Expected credit losses are costs of a lending activity. These costs are reflected through:

- (a) the pricing (yield) of financial instruments, which compensates the lender for the creditworthiness of the borrower at the time of lending or commitment to lend; and
- (b) changes in the creditworthiness of the borrower after lending or committing to lend (i.e. changes in expected credit losses). These changes in expected credit losses are not priced into the financial instruments, so give rise to an economic loss.

Under this new model, expected credit losses would be recognised from the point at which financial instruments are originated or purchased. There would no longer be a threshold (such as a trigger loss event of default) before expected credit losses would start to be recognised. With limited exceptions, a *12-month expected credit losses* must be recognised initially for all assets subject to impairment. For example, an entity recognises a loss allowance at the initial recognition of a purchased debt instrument rather than when an event of default by the issuer occurs.

The amount of expected credit losses that are recognised would depend on the change in the credit quality since initial recognition to reflect the link between expected credit losses and the pricing of the financial instrument. With limited exceptions, IFRS 9 requires that at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition [IFRS 9.5.5.3]. *Lifetime expected credit losses* are defined as the expected credit losses that result from all possible default events over the life of the financial instrument.

The requirements in IFRS 9 would result in *lifetime expected credit losses* being recognised only when the credit risk of a financial instrument is worse than that anticipated when the financial instrument was first originated or purchased. If, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to *12-month expected credit losses* [IFRS 9.5.5]. *12-month expected credit losses* are defined as the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date.

A portion of lifetime expected credit losses is recognised when financial instruments are first originated or purchased. This is a way to reflect that the yield on the instrument includes a return to cover those credit losses expected from when a financial instrument is first recognised. If this amount was not recognised the full yield would be recognised as interest revenue with no adjustment for credit losses that were always expected.

The IASB noted that the cost of determining whether to recognise 12-month or lifetime expected credit losses may not be justified for trade receivables, contract assets and lease receivables. Thus, IFRS 9 allows a simplified approach for the impairment accounting of such financial and non-financial assets. The Standard requires that an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables, contract assets and lease receivables.

4. Accounting for Financial Liabilities

4.1 Categories of Financial Liabilities in IFRS 9

During the development of IFRS 9, the IASB received feedback that the requirements for financial liabilities in IAS 39 had worked well. Most respondents did not think that a fundamental change was needed to the accounting for financial liabilities. Thus, IFRS 9 contains standards on financial liabilities that are broadly similar to those in IAS 39. Unlike for financial assets, an entity's business model objective is not a condition in the classification of financial liabilities. All financial liabilities shall be classified as subsequently measured at amortised cost, except for:

- (a) financial liabilities held for trading (including derivatives that are liabilities);
- (b) liabilities that arise when a transfer of a financial asset that does not qualify for derecognition or when the continuing involvement approach applies;
- (c) financial guarantee contracts;
- (d) loan commitments; and
- (e) contingent consideration in a business combination to which MFRS 3 applies [IFRS 9.4.2.1].

IFRS 9, like IAS 39, does not permit a reclassification of financial liabilities between the measurement models i.e. an entity is not permitted to reclassify a financial liability measured at amortised cost to measurement at fair value, and vice versa.

4.2 Option to Designate Financial Liabilities at Fair Value

IFRS 9 retains the option to designate a financial liability at fair value through profit or loss if the host contract is a financial liability that contains an embedded derivative or doing so results in more relevant information, because either:

- (a) It eliminates or significantly reduces an accounting mismatch that would otherwise arising from measuring assets and liabilities or recognising the gains and losses on them on different bases; or

- (b) A group of financial liabilities or financial assets and financial liabilities is managed and its performance is evaluated on the fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel [IFRS 9.4.2.2].

The conditions for designation of financial liabilities at fair value through profit or loss are the same as the current IAS 39.

4.3 Treatment for Own Credit Risk

In the current IAS 39, if an entity chooses to measure a financial liability at fair value, changes in fair value, including changes arising from own credit risk, are recognised as gains or losses in profit or loss. This treatment gives rise to volatility in performance reporting and has been argued as counter-intuitive because an entity would report a gain in profit or loss when its own credit rating has deteriorated. This issue was highlighted during the global financial crisis (which started in 2007) where entities with significant deterioration in their credit rating recognised exceptionally large amounts of gains in profit or loss under the fair value option for financial liabilities. Many users of financial statements have argued that gains should arise from improvements, not deteriorations in credit rating.

IFRS 9, in resolving the counter-intuitive result of the fair value option for financial liabilities, contains new provisions regarding the accounting for an entity's *own credit risk*. For an entity that opts to measure a financial liability at fair value, it shall present the portion of the change in fair value related to changes in the entity's own credit risk in other comprehensive income, whilst the remaining portion of the fair value change shall be recognised in profit or loss [IFRS 9.5.7.1(c)]. Also, there shall be no subsequent reclassification or recycling of the portion recognised in OCI to profit or loss even when the financial liability is subsequently derecognised.

There may be circumstances when recognising fair value change due to own credit risk directly in OCI would create an accounting mismatch. The Standard provides for an election to recognise the entire fair value change, including changes due to own credit risk, in profit or loss only if it is to correct for an accounting mismatch. The determination and election of this exception has to be made on initial recognition of the financial liability and the election is irrevocable.

Example

On 1 January 20x1, Entity P issues a 10-year bond with a nominal value of RM150 million. The bond pays a fixed coupon interest rate of 8%, which is the prevailing market interest rate for similar risk-class bonds at the time of the issue. The fair value of Entity P's bond on initial recognition is the issue price of RM150 million.

Entity P uses KLIBOR as its observable (benchmark) interest rate. At the date of issue of the bond, KLIBOR is 5.00%. At the end of the first year:

- (a) KLIBOR has decreased to 4.75%; and
(b) The market price (fair value) of the bond is RM153,811,000, consistent with a current market interest rate of 7.6%.

Entity P assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in KLIBOR are the only relevant changes in market conditions.

The total change in the fair value of the bond at the end year 1 is RM3,811,000. At initial recognition on 1 January 20x1, the internal rate of return of the 10-year bond is 8% (equal to the coupon interest rate). The observed (benchmark) interest (KLIBOR) is 5.00%. Hence, the instrument-specific component of the internal rate of return is 3.00%.

At the end of the first year KLIBOR decreases to 4.75%. Hence the remaining contractual cash flows of the bond should be discounted at 7.75% (i.e. current KLIBOR + 3% instrument-specific component), as follows:

Year	Cash Flows RM'000
2	12,000
3	12,000
4	12,000
5	12,000
6	12,000
7	12,000
8	12,000
9	12,000
10	162,000
=NPV(7.75%, Yrs2-10)	152,367

The market price of the bond at the end of Year 1 is RM153,811,000. Entity P shall present RM1,444,000 (i.e. RM153,811,000 – RM152,367,000) in other comprehensive income (attributable to own credit) and the balance of the fair value change recognised in profit or loss, as follows:

	RM'000	RM'000
Dr Fair value loss in OCI (own credit)	1,444	
Dr Fair value loss in profit or loss	2,367	
Cr Financial liability at fair value		3,811
<i>- to recognise fair value change of financial liability.</i>		

5. Hedge Accounting

Hedging of financial risks typically involves using financial instruments (usually derivatives) that provide offsetting effects to the volatility of the fair value or future cash flows of a hedged item. Hedging has become an important part of risk management strategies for many entities.

The relationship between items exposed to risks (hedged items) and hedging instruments can be portrayed by the diagram below:



The objective of hedging is usually to take a position (the hedging instrument) that neutralises the risk, as far as possible, in the hedged item. In a perfect hedge, the risk is eliminated completely (100%). However, in practice, it is rare to find hedges that are perfect.

Hedge accounting attempts to match the gain or loss of a hedged item (an item exposed to risk) with the corresponding loss or gain of its hedging instrument. It is thus concerned with the process of matching the offsetting effects of the hedging relationships in profit or loss. For example, if the gain or loss of the hedged item is taken to profit or loss, the loss or gain of the hedging instrument is also taken to profit or loss to provide the offsetting effect. However, if the hedge relates to a firm commitment to buy a property, plant and equipment, then the gain or loss of the hedging instrument is recognised in other comprehensive income and deferred in equity (a hedge reserve) until the property, plant or equipment is acquired. The hedge reserve may then be released as a

basis adjustment to the cost of the property, plant and equipment, or by reclassification adjustments to profit or loss based on the depreciation charged to income.

The ultimate aim in hedge accounting is to realise a “matched” timing of recognition of gains and losses (the offsetting effects) in profit or loss between the hedged item and the corresponding hedging instrument. The main concern is to reduce the volatility in performance reporting. This can be accomplished in two ways:

- (a) a change in the fair value of the hedging instrument is recognised in profit or loss when it occurs, and at the same time, a corresponding but opposite change in the value attributable to the hedged risk of the hedged item is recognised in profit or loss (this is known as fair value hedge accounting); or
- (b) a change in the fair value of the hedging instrument is initially recognised in other comprehensive income and retained in a hedge reserve (in equity). When the corresponding hedged item affects profit or loss, the hedge reserve is recycled (reclassified) to profit or loss to realise the matching or offsetting effect in profit or loss (this is known as cash flow hedge or net investment hedge accounting).

IFRS 9 introduces a new model for the optional (non-mandatory) hedge accounting. It specifies that the objective of hedge accounting is to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss (or other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in OCI) [IFRS 9 6.1.1]. This is a principle-based rather than a rule-based approach that focuses on an entity's risk management. The new hedge accounting model uses the risk management activities of an entity as the foundation for deciding what qualifies (or what does not qualify) for hedge accounting. The aim of the model is to faithfully represent, in the financial statements, the impact of the risk management activities of an entity.

5.1 Hedging Instruments

The current IAS 39 restricts certain instruments for qualifying as hedging instruments even when such financial instruments provide an effective offset for risks managed under common risk management strategies. A key restriction in IAS 39 is the disallowance of designating non-derivative instruments as hedging instruments for hedges of risks other than foreign currency risk.

IFRS 9 prescribes that a derivative measured at fair value through profit or loss may be designated as a hedging instrument, except for some written put options [IFRS 9.6.2.1]. It also specifies that a non-derivative financial asset or a non-derivative financial liability measured at fair value through profit or loss may be designated as a hedging instrument unless it is a financial liability designated at fair value through profit or loss for which the amount of its change in fair value that is attributable to changes in the credit risk of that liability is presented in OCI. For a hedge of foreign currency risk, the foreign currency risk component of a non-derivative financial asset or a non-derivative financial liability may be designated as a hedging instrument provided that it is not an investment in an equity instrument for which an entity has elected to present changes in fair value in OCI [IFRS 9.6.2.2]

The new hedge accounting model thus expands the types of eligible financial instruments to allow non-derivative financial assets and liabilities at fair value through profit or loss to be designated as hedging instruments, i.e. to acknowledge their effect also for accounting purposes. The other key change in the new hedge accounting model is the removal of the distinction between combinations of stand-alone written and purchased options and those combined in one contract. In the new model, the eligibility of an option contract to be designated as a hedging instrument should depend on its economic substance and risk management objectives rather than its legal form alone.

Consequently, a stand-alone written option would be eligible for designation as a hedging instrument if it is jointly designated with other hedging instruments so that, in combination, they do not result in a net written option.

5.2 Designation of Hedging Instruments

The conditions for designation of a hedging instrument in IFRS 9 are similar to those in IAS 39. IAS 39 requires that a qualifying instrument must be designated in its entirety as a hedging instrument. This condition remains the same in IFRS 9. For example, an option contract may be designated as a hedging instrument in its entirety without separating the intrinsic value and the time value of the option. Similarly, a forward contract may be designated as a hedging instrument in its entirety without separating the forward element and the spot element in the forward contract.

However, IFRS 9 provides for some exceptions (non-mandatory but permitted), such as designating as the hedging instrument only the change in intrinsic value of an option and not the change in its time value, designating as the hedging instrument only the change in the value of the spot element of a forward contract and not the forward element, and similarly, the foreign currency basis spread may be separated and excluded from the designation of a financial instrument as the hedging instrument.

5.3 Hedged Items

A key change introduced in the new model is to align the treatment of financial and non-financial items to allow the hedging of risk components in non-financial items, when they are separately identifiable and reliably measurable. This change will enable such hedges to be reflected in the designation used for hedge accounting, thereby enabling preparers to better reflect and users to better understand the actual risk management activity and the effectiveness of hedging strategies. Also, groups of items (including net positions) would be eligible for hedge accounting.

5.4 Qualifying Criteria for Hedge Accounting

The criteria for hedge accounting remain the same as in IAS 39, except that in assessing hedge effectiveness, an entity must ensure that: (i) there is an economic relationship between the hedged item and the hedging instruments; (ii) the effect of credit risk does not dominate the value of changes that result from that economic relationship; and (iii) the hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item [IFRS 9.6.4.1].

5.5 Accounting for Qualifying Hedging Relationships

The IASB was informed that the procedures for hedge accounting in IAS 39 are well understood by preparers and users. Thus, the treatments and the accounting mechanics for fair value hedges, cash flow hedges and hedges of net investments in IFRS 9 remain substantially the same as in IAS 39.

For the assessment of hedge effectiveness, there is no longer a rule-based accounting-centric threshold of a band of 80%-125%. If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that designated hedging relationship remains the same, an entity shall adjust the hedge ratio of the hedging relationship so that it meets the qualifying criteria again (this is referred to in the Standard as "rebalancing").

6. Implications and Conclusion

IFRS 9 is a principle-based standard that is built on a logical, single classification and measurement approach of financial assets that reflects the business model in which they are managed and their cash flow characteristics. There are three measurement models, namely, amortised cost (AC) model, fair value through other comprehensive income (FVOCI) model and fair value through profit or loss (FVPL) model. Directors and other key management personnel must take the lead in the implementation of IFRS 9 because the assessment of an entity's business model is judgmental as it depends on facts and circumstances. The cost exception for unquoted equity investments has been removed, and henceforth, entities that have previously availed that cost model must be prepared to fair value all their unquoted equity investments when IFRS 9 becomes effective in the near future. Guidance on fair value measurement, including techniques for fair valuing unquoted equity investments, is provided in IFRS 13 *Fair Value Measurement*.

The new impairment model in IFRS 9 would resolve many of the concerns raised by constituents and users of financial statements about the complexity, inconsistency and rule-based treatments in the current IAS 39 on impairment accounting. Instead of applying multiple impairment models for different financial assets, IFRS 9 uses a single forward-looking impairment model that eliminates the threshold for the recognition of expected credit losses, so that it is no longer necessary for a trigger loss event to have occurred before credit losses are recognised. IFRS 9 requires an entity to base its measurement of expected credit losses on reasonable and supportable information that is available without undue cost or effort and that includes not just historical loss experience and current conditions, but also forecast of future economic conditions. Consequently, more timely information about expected credit losses is provided and this would address the concern of reporting credit losses too little too late.

The requirement to recognise 12-month expected credit losses on the origination or purchase of a financial asset subject to impairment is conceptually sound as it is based on the notion that the losses are included in the pricing (yield) of financial instruments, which compensates the investor or lender for the creditworthiness of the issuer or borrower at the time of investing or lending. This requirement may work fine with banks, insurance entities and other financial institutions, who would typically have detailed credit risk management. A forward-looking impairment model would supplement prudence in the management of banks and insurance entities.

As this forward-looking expected credit loss model is a new requirement, reporting entities, particularly banks, insurers and other financial institutions, would need to prepare in advance for the adoption of the new model. There are likely to be changes in accounting systems to cater for the recognition and measurement of both the 12-month expected credit losses and the lifetime expected losses. For entities not in the financial services sectors, the new requirements may pose some difficulties.

IFRS 9 retains the accounting requirements for financial liabilities in IAS 39 but addresses the "own credit" issues under the fair value option, whereby own credit gains and losses shall be presented in other comprehensive income. This would eliminate the volatility in profit or loss that is caused by changes in an entity's own credit rating. For many entities that do not avail the fair value option for their financial liabilities, the accounting would remain largely unchanged with the adoption of IFRS 9.

IFRS 9 also includes an improved hedge accounting model that represents a major overhaul of hedge accounting and introduces significant improvements, principally by aligning more closely with risk management. This will enable a better link between the economics of risk management with the hedge accounting treatments.

In conclusion, there are significant improvements in the major areas of classification and measurement of financial instruments, impairment methodology and hedge accounting. The

requirements in IFRS 9 are easier to understand and apply compared to IAS 39. It is a business-friendly standard that aligns the accounting treatments with the economics and management of an entity. The biggest challenge posed by the Standard, particularly for banks, insurers and other financial institutions, is to develop an accounting system that can cater for the new forward-looking expected credit loss model.

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