IFRS 9: Navigating the Transition

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IFRS 9, *Financial Instruments*, as issued by the IASB on July 24, 2014 (IFRS 9 (2014), supersedes all other prior versions of IFRS 9. The standard is effective for annual periods beginning on or after January 1, 2018, with earlier adoption permitted. While IFRS 9 (2014) must be applied retrospectively in accordance with IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, the standard contains specific transition provisions. The purpose of this article is to provide an overview of IFRS 9 (2014)'s transition requirements.

Date of initial application

The transition requirements focus on the date of initial application (DIA), which is defined as the beginning of the reporting period in which an entity first applies IFRS 9 (2014). The DIA for IFRS 9 (2014) must be a date on or after July 24, 2014. The DIA is important as it is as of this date that several key assessments must be made, including:

- assessing the objective of the business model(s) within which financial assets are held;
- designating an investment in an equity instrument that is not held for trading as at fair value through other comprehensive income (FVOCI);
- designating or revoking designations for financial instruments as at fair value through profit or loss (FVTPL);
- assessing whether presenting the effects of changes in a financial liability's credit risk in other comprehensive income (OCI) would create or enlarge an accounting mismatch in profit or loss[1];
- as part of the assessment of impairment, determining whether there has been a significant increase in credit risk since initial recognition or whether that determination would require significant cost or effort; and
- assessing compliance with qualifying hedge accounting criteria.

Other assessments are generally made as of the date of initial recognition of the financial instrument rather than at the DIA (e.g., whether the instrument comprises solely payments of principal and interest).

[1] This provision can be adopted on a stand-alone basis prior to the adoption of IFRS 9 (2014) in its entirety.

Restatement of comparative periods

IFRS 9 (2014) does not require restatement of comparative period financial statements except in limited circumstances related to hedge accounting; however, entities may choose to restate. Here are a few considerations when deciding whether to restate prior periods:

- If an entity elects not to restate comparative periods, then it is important to remember that the quantification of adjustments is still necessary in order to determine the transition adjustment in opening retained earnings or other components of equity, as appropriate. That is, if comparative periods are not restated, the difference between the previous carrying amounts and the new carrying amounts at the DIA is recorded in opening retained earnings or other components of equity, as appropriate, of the annual period that includes the DIA.
- If an entity restates comparative periods, then it will also need to apply, IAS 1, *Presentation of Financial Statements*. IAS 1 requires a third balance sheet to be presented when an accounting policy is applied retrospectively and there is a material effect as a result of the change. As an example, if an entity restated comparative periods and the DIA is November 1, 2017, the following balance sheets may be required:
  - October 31, 2018
  - October 31, 2017
  - November 1, 2016.
- The needs and expectations of shareholders and other financial statement users should be considered in arriving at the decision. Without restatement, users may find it difficult to analyze the entity's financial statements results; however, given that not all of the standard's principles are applied retrospectively and IAS 39 continues to be applied for financial assets derecognized prior to DIA, results will not be comparable even if restated. An entity could consider providing pro forma comparative results to enhance comparability.

If an entity decides to restate comparative periods, the use of hindsight is prohibited. Regardless of whether an entity chooses to restate prior periods, there are transitional financial statement disclosures that are required; however, these do differ depending on the approach taken.

Classification and measurement

The business model in which financial assets are held is assessed in order to determine whether the instruments are to be classified as amortized cost or FVOCI; otherwise, they are accounted for as fair value through profit or loss (FVTPL). As noted above, as an exception to retrospective application, the assessment of whether the objective of the entity's business is to hold an asset and collect cash flows, or both collect cash flows and sell the asset, is based on facts and circumstances at the DIA. Business models that were applied to reporting periods prior to the DIA are not considered in the assessment of classification upon transition. The resulting classification is applied retrospectively.

There are no specific transition requirements for the date at which an entity determines whether the solely payments of principal and interest (SPPI) condition is met. Therefore, the assessment is made based on the facts and circumstances existing at the time of initial recognition of the financial asset. There are exceptions to this requirement: where it is impracticable to make the necessary assessments related to the modified time value of money element[2] or the fair value of a prepayment feature of a financial asset based on the facts and circumstances as they existed at the date of initial recognition of the financial asset, then these requirements are not taken into account in the assessment. However, in the case of the modified time value, the guidance in superseded IFRS 9 (2009) would be considered: this guidance suggests that a mismatch between interest rate tenors and reset periods would fail the SPPI criterion.

[2] In some cases, the time value of money element may be modified (i.e., imperfect): e.g., if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (e.g., the interest rate resets monthly, but to a one-year rate). In these instances, one must determine whether the contractual cash flows represent SPPI. The objective of the assessment is to determine how different the contractual cash flows could be from the cash flows that would arise if the time value of money element was not modified (the benchmark cash flows) over the life of the instrument. If the modified time value of money element could result in contractual and benchmark cash flows are significantly different, then financial asset does not meet the SPPI condition.

Fair value option (FVO)

The application of the fair value option for financial instruments is reconsidered based on the facts and circumstances at the DIA: an entity may elect to designate any financial asset or financial liability as at FVTPL if the accounting mismatch criterion is met. If a financial asset was designated at FVTPL under the superseded other FVO criteria[3] under IAS 39, then this financial asset no longer will be at FVTPL under IFRS 9 unless it is held in a held for sale business model at DIA or an accounting mismatch is identified as of the DIA. It should be noted that any previous FVTPL designation of a financial liability may only be revoked if the liability was originally designated on the basis of the accounting mismatch criterion. Hybrid financial liabilities previously designated as FVTPL must continue to be accounted for as FVTPL under IFRS 9 (2014).

While not explicit in IFRS 9 (2014), it appears that elective designations and revocations at the DIA are not required to be performed at the DIA. The physical act of designation or revocation under the FVO may be made at any time during the course of preparing the financial statements during the first reporting period under the standard.

Revised classification as a result of designation or revocation of FVTPL designation is applied retrospectively.

If the FVO is applied to financial liabilities, then changes in fair value due to changes in credit risk are recognized in OCI with all other changes in fair value recognized in earnings. IFRS 9 (2014) also appears to allow entities to revisit the IFRS 7 methodology used in identifying and measuring the effects of changes in the credit risk of liabilities that are designated under the fair value option because the standard:

- clarifies that the credit risk of a liability is different from that of the issuer, and different from asset-specific performance risk;
- emphasizes when the default method cannot be applied; and
- results in the calculation impacting on reported earnings.

However, the designation or revocation should be based on facts and circumstances at the DIA, and not on subsequent changes in facts and circumstances. Examples of these facts and circumstances include:

- ✓ whether a financial asset is held within a business model to hold assets to collect contractual cash flows or to both collect contractual cash flows and sell the financial assets;
- ✓ whether designation as at FVTPL would reduce or eliminate an accounting mismatch; and
- ✓ whether an equity investment is held for trading.

The method for measuring changes in credit risk, however, has to make maximum use of relevant observable inputs and minimum use of unobservable inputs.

[3] IAS 39 contained two additional FVOs for financial assets: the 'managed on a fair value basis' and the hybrid contract condition. Given that IFRS 9 generally would require instruments such as these to be accounted for as FVTPL, these FVOs were eliminated by IFRS 9.

Impairment

The new impairment requirements of IFRS 9 (2014) are applied retrospectively in accordance with IAS 8; however, there are certain exemptions to full retrospective application.

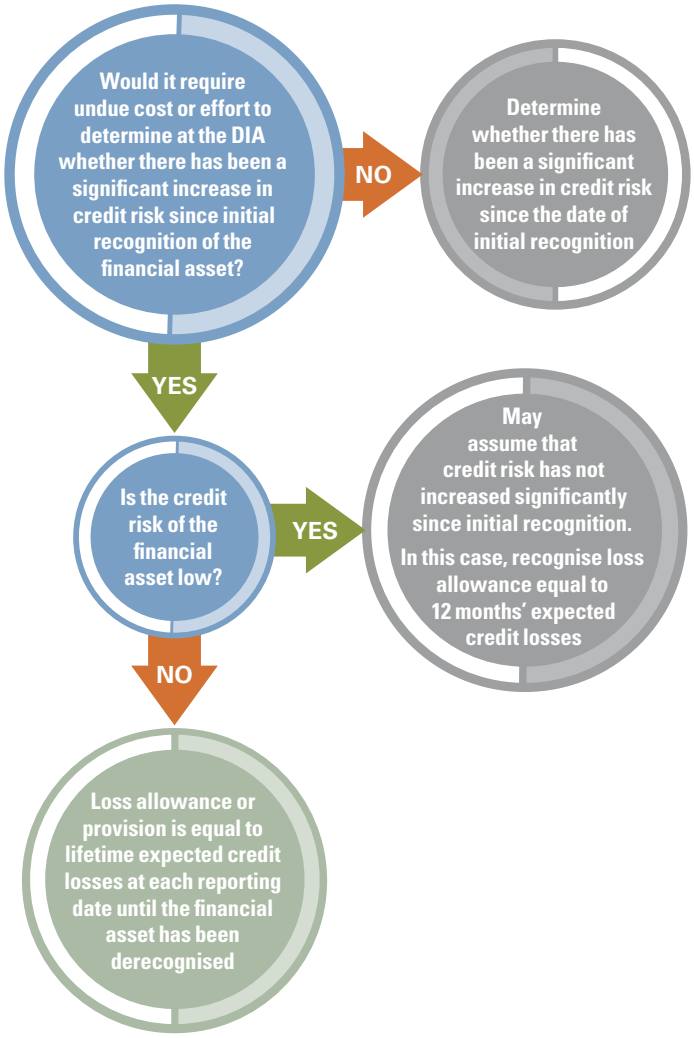
If determining at the DIA whether there has been a significant increase in the credit risk since the initial recognition of a financial asset would require undue cost or effort, then the impairment is measured at the lifetime expected credit loss at each reporting date until that financial instrument is derecognised unless the credit risk of the financial instrument is low.

IFRS 9 (2014) also includes another practical expedient: a rebuttable presumption that the condition for recognizing lifetime expected credit losses is met when payments are more than 30 days past due. Entities may also rely on this presumption on transition. Given that some regulators have expressed a preliminary view that IFRS 9 (2014)'s 30-day practical expedient should not be used, it is unclear whether this transition provision is also proscribed by these regulators.

Overall, an entity is not required to undertake an exhaustive search for information for determining, at the DIA, whether there has been a significant increase in credit risk since the initial recognition of a financial asset. Instead, the entity approximates the credit risk on initial recognition by considering information that is reasonably available without undue cost or effort. Such information comprises all internal and external information, including portfolio information.

Further, the following sources of information may be used when an entity has little historical information on which to rely:

- Information from internal reports and statistics – e.g. that may have been generated when deciding whether to launch a new product;
- Information about similar products; or
- Peer group experience for comparable financial instruments.



Investments in equity instruments

The IFRS 9 (2014) also includes an election to recognize in OCI changes in fair value (aside from dividend income) of an equity investment that is not held for trading. On transition, an entity applies the criteria for this election based on the facts and circumstances that exist at the DIA (e.g. determining whether the investment is held for trading).

An additional transition issue relates to unquoted equity investments (and derivatives thereon) previously measured at cost under IAS 39 because the FV was not reliably measurable: while these must be measured on a go forward basis at fair value, for purposes of reporting in the comparative period, these remain reported at cost.

Hedging

IFRS 9 (2014) contains its own hedging model (aside from macro hedging, which is the subject of a separate ongoing project). It, however, permits entities to continue to apply IAS 39 to all hedging relationships. If an entity chooses to apply IFRS 9 (2014), it must apply the standard prospectively, subject to some exceptions discussed later.

The DIA is important in this context as it is at this date as of which all criteria for qualifying for hedge accounting must be met in order to apply hedge accounting going forward. The following needs to be considered for any hedging relationship designated under IAS 39:

- Are both the hedging instrument and the hedged item eligible for hedging under IFRS 9?
- Does an economic relationship exist between the hedging instrument and hedged item?
- If yes, does the credit of risk dominate the value changes that result from the economic relationship? If it does, then the relationship is not eligible for hedge accounting.
- Does the hedging relationship reflect how management manages risk? Is the hedge ratio the same as that which the entity uses in its hedge?
- Does the previously designated hedging relationship require rebalancing to meet the IFRS 9 (2014) hedging criteria? If so, then any rebalancing adjustment is recognized in profit or loss (and not opening retained earnings upon transition).
- Does the existing IAS 39 hedge documentation require updating (e.g., to note how the entity will determine whether the hedging relationship meets the IFRS 9 (2014) effectiveness requirements; to identify new sources of ineffectiveness; to specify how to determine the hedge ratio)?

If an IAS 39 hedging relationship qualifies for hedge accounting under IFRS 9 (2014), it continues to be accounted for as a hedging relationship under IFRS 9 (2014) subject to the need to rebalance.

Although the transition requirements for hedging relationships are generally prospective, the standard does require/permit certain adjustments to be applied retrospectively for those hedges that existed at the beginning of the earliest comparative period or were designated thereafter:

- If only the change in intrinsic value of an option was designated as a hedging instrument, then time value of option must be accounted for retrospectively as a cost of the hedge; and
- If only the change in the spot element of a forward contract was designated as the hedging instrument, then the forward element may be accounted for retrospectively as a cost of the hedge (the "forward element election"). Similarly, the accounting for foreign currency basis spreads may also be applied retrospectively. Although it appears that entities that previously applied the forward rate method to hedges of financial instruments will need to change their hedge accounting at the DIA, it appears that entities may continue to applying accounting for such existing hedge relationships using the cost of hedging accounting permitted by the standard.

If the entity chooses to retrospectively apply the forward element election, it must apply this to all hedging relationships that qualify for this provision.

Last words

The transition provisions of IFRS 9 (2014) are voluminous. In planning for the adoption of IFRS 9 (2014), it is key that preparers have a good understanding of how IFRS 9 will impact them on both a go forward basis and on transition. Decisions made at the DIA will have ongoing repercussions.

Find out more

You can find out more detailed information about IFRS 9 (2014) in our publications **First Impressions: IFRS 9 Financial Instruments** and **First Impressions: Hedging**.

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