www.pwc.com

International Seminar

IFRS 9 Financial Instruments

March 2013

pwc

Agenda

1. Background
2. Phase 1: Classification
3. Phase 2: Amortised costs and impairment
4. Phase 3: Hedge accounting

Background – What is the issue?

- IAS 39 is difficult to understand, apply and interpret
- Since 2005 – IASB/FASB long-term objective to simplify and improve reporting of financial Instruments
- March 2008 – IASB Discussion paper on Reducing complexity
- Financial crisis heightened various concerns about IAS 39
- Pressure from Europe and G20 to improve and simplify the accounting for financial instruments by end of 2009

Background – IASB work plan

As of 26 February 2013

Project	Q4 2012	Q1 2013	Q2 2013	2015+
IFRS 9 Financial Instruments				
• Phase 1: Classification and Measurement	ED for comments (until 30 Apr 2013)		Redeliberations	Effective date*
• Phase 2: Amortised cost and Impairment		Target ED		Effective date
• Phase 3: General Hedge accounting	Review draft (Posted until December 2012)	Target IFRS		Effective date
• Accounting for macro hedges		Target DP		

* IFRS 9 amended in December 2011 to push effective date back from 1 Jan 2013 to 1 Jan 2015

Background – Who does it affect?

- An entity that holds financial assets or issues financial liabilities will be affected.
- Current scope of IAS 39 remains unchanged.
- Financial services entities are particularly affected as the majority of their balance sheet is comprised of financial instruments.

IFRS 9 Financial instruments

Phase I Classification and measurement

A comparison of IAS 39, IFRS 9 and IFRS 9R

4 2 3

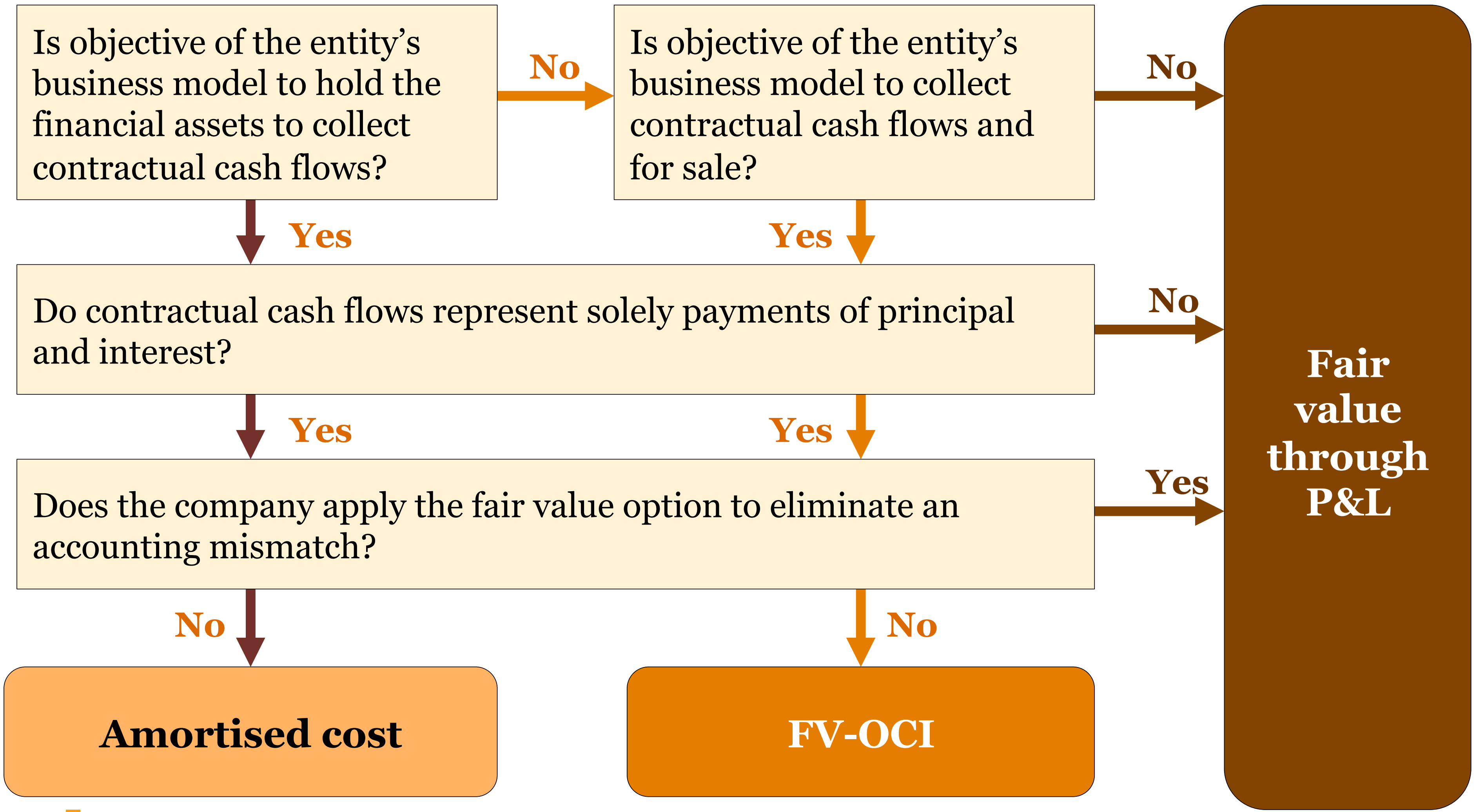
2 2 2

2 2 2

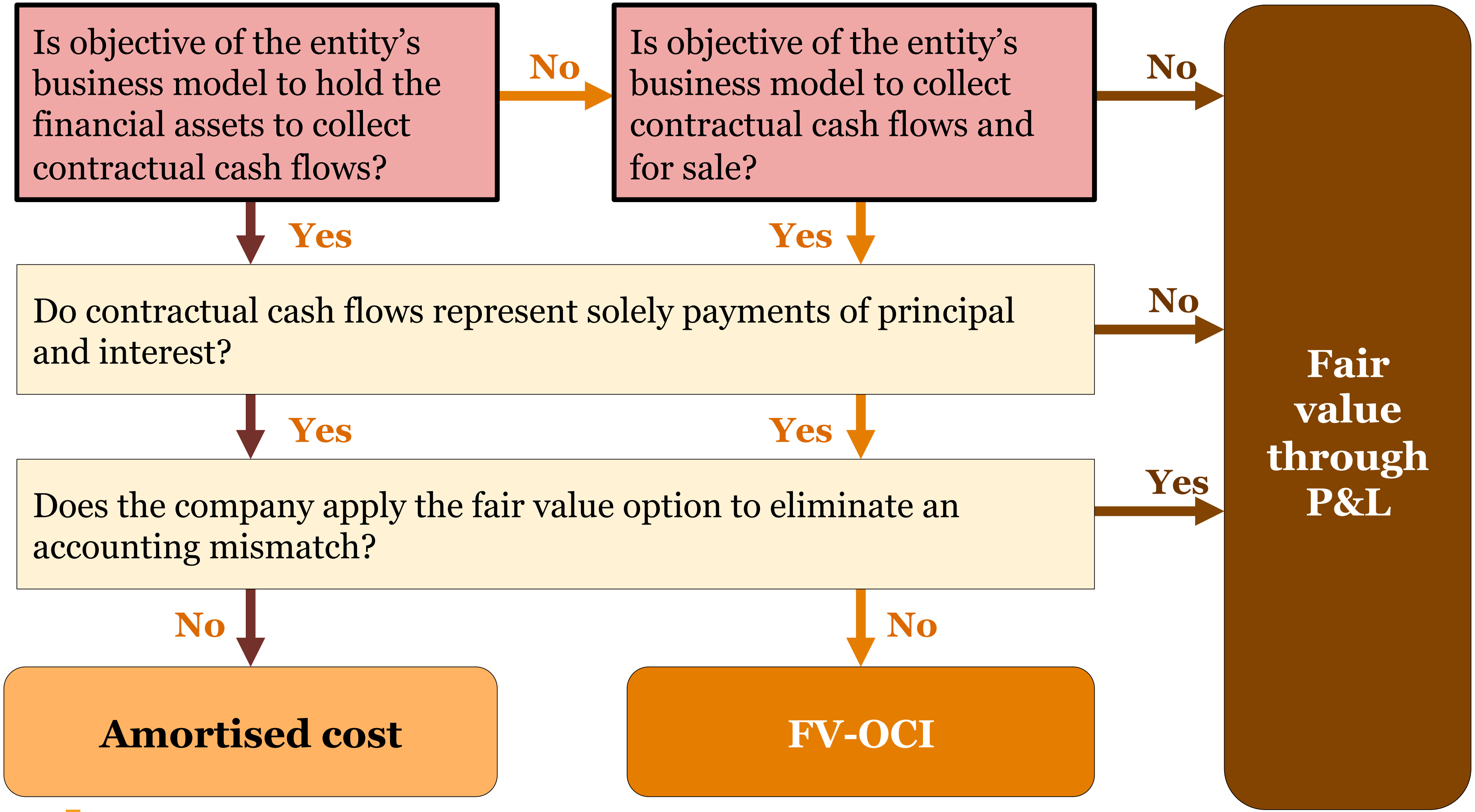
A comparison of IAS 39, IFRS 9 and IFRS 9R

	IAS 39	IFRS 9	IFRS 9 R
Financial asset - Debt	• FVTPL • AFS • L&R • HTM	• FVTPL • Amortised cost	• FVTPL • Amortised cost • FVOCI
Financial asset - Equity	• FVTPL • AFS	• FVTPL • FVOCI	• FVTPL • FVOCI
Financial liability	• FVTPL • Amortised cost	• FVTPL • Amortised cost	• FVTPL • Amortised cost

Overview of three categories

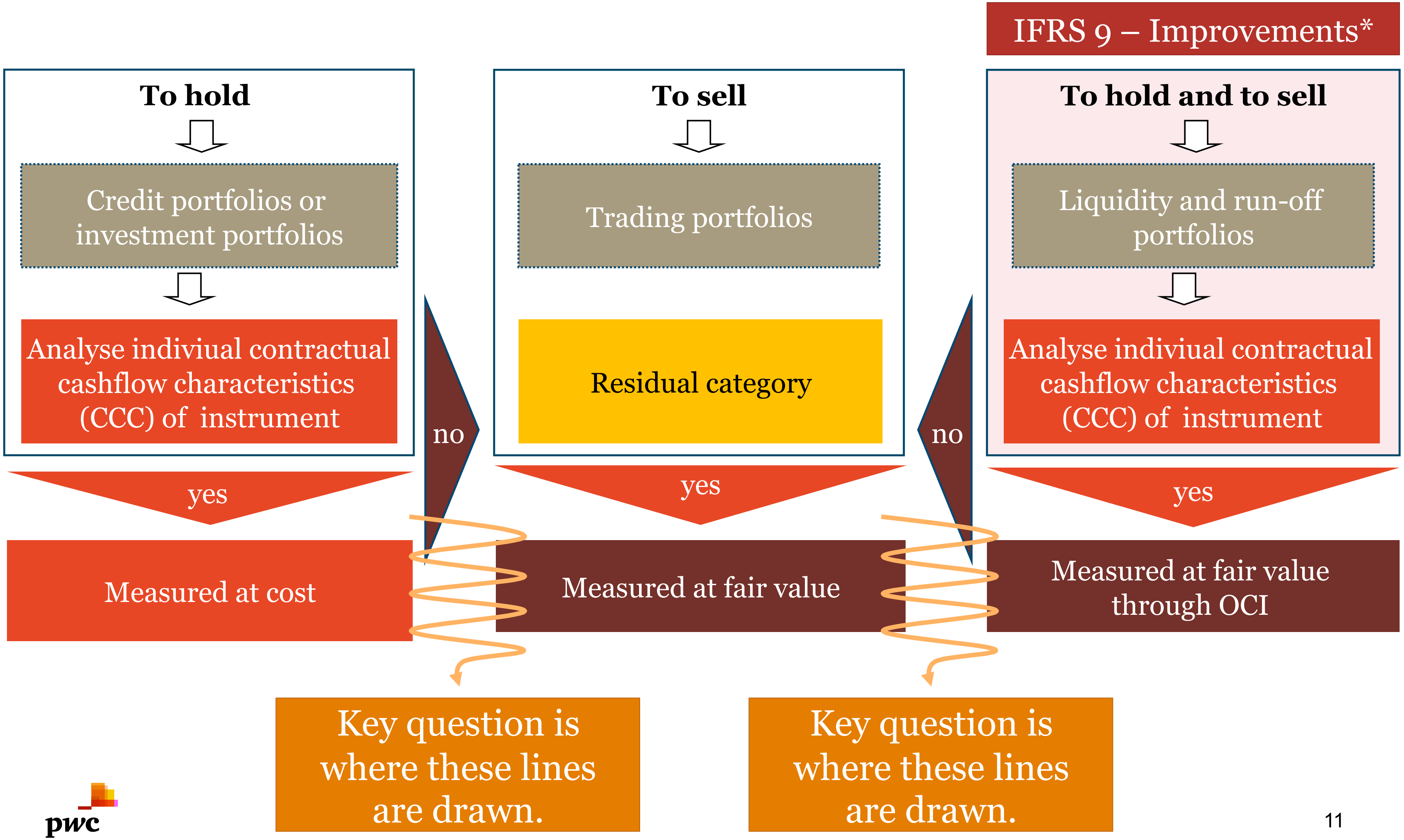


Overview of three categories



Business model test

Business model assessment on debt instruments



Business model test

Step 1 Determine the objective of the business model

Factors to consider in business model:

- The way financial assets are managed.
- How performance is reported.
- How management is compensated.
- Frequency, timing and volume of sales in prior periods.
- Expectations of sales activity in the future.
- Why such sales have occurred.

Business model test

Liquidity portfolio at amortised cost

Background

Financial institution holds financial assets to meet liquidity needs in 'stress case' scenario. Entity does not anticipate selling assets except in such scenarios.

Key considerations:

- Sales in 'stress case' scenarios do not disqualify hold to collect.
- Even if sales were significant in previous liquidity crisis.
- Entity forced by regulator to routinely sell significant volumes to demonstrate liquidity of assets, will fail hold to collect business model.

Business model test

Liquidity portfolio at FV-OCI

Background

Financial institution holds financial assets to meet its everyday liquidity needs and actively manages the contractual yield. There has been significant recurring sales activity in the past.

Key considerations:

- Dual objective of hold to collect and sell financial assets.

Business model test

Why sales have occurred - Credit deterioration

Background

Entity sells financial assets due to credit deterioration in an otherwise hold to collect business model.

Key considerations:

- Documented investment policy not required, but absence may cause difficulties in demonstrating that sales are necessary.

Business model test

Capital expenditure – Example

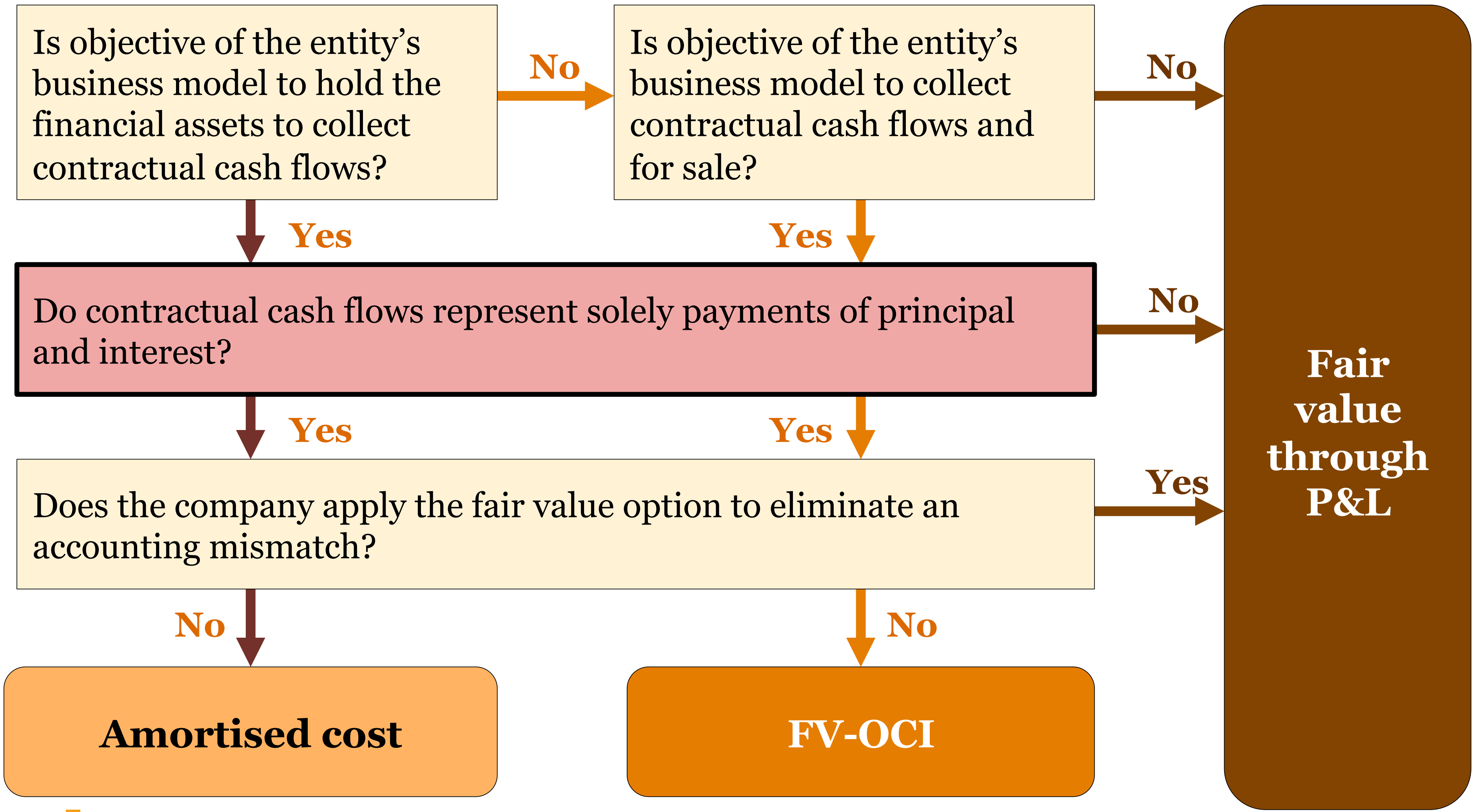
Background

Non-financial entity anticipates capital expenditure in 5 years and invests excess cash in financial assets to fund future expenditure. Objective is to maximise return on financial assets. Entity sells and re-invests cash when opportunities arise.

Key considerations:

- Entity makes decisions on ongoing basis about whether collecting cash flows or selling will maximise returns.
- In contrast, when entity invests excess cash in ST financial assets, reinvests in new ST financial assets and only insignificant sales occur, this may meet hold to collect business model.

Overview of three categories



Contractual cash flow characteristics - SPPI

Step 2 Assess the characteristics of the contractual cash flows

What can the cash flows **represent**?

OK	**NOT OK**
Principal	Leverage / multiples
Interest in principal outstanding	Non-financial variables
Time value of money	Conversion features
Credit risk	

Contractual cash flow characteristics - SPPI - Examples

An entity holds a number of financial assets:

1. Bond – convertible (At FVTPL)
2. Bond – inflation-linked (At amortised cost)
3. Bond – indexed to EBITDA (It depends, FVTPL or amortised cost)
4. Bond – variable interest (At Amortised cost)
5. Asset-backed securities (This can be a very complex analysis)

**Assume business model objective is to collect contractual cash flows

pwc

Contractual cash flow characteristics - Proposed SPPI clarification

Modification test

Cash flows may be ‘modified’ where there is leverage or interest reset features.

Instrument

Compare cash flows

Benchmark instrument

If ‘modification’ could result in cash flows more than insignificantly different from benchmark cash flows it fails SPPI test

Contractual cash flow characteristics - Proposed SPPI clarification

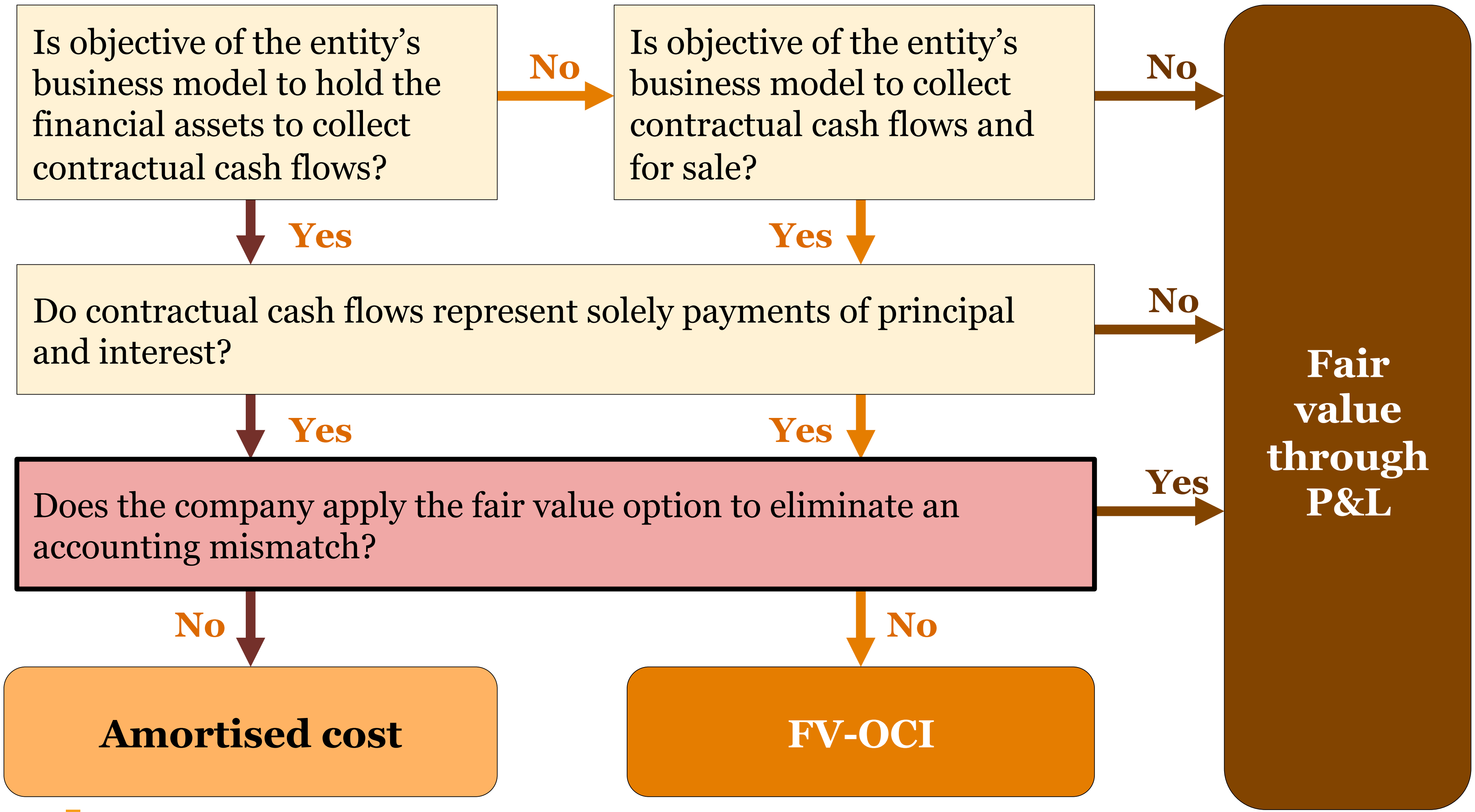
Constant maturity bond example

Debt investment maturing in ten years containing constant maturity swap reset feature where interest rate resets annually to ten year rate.

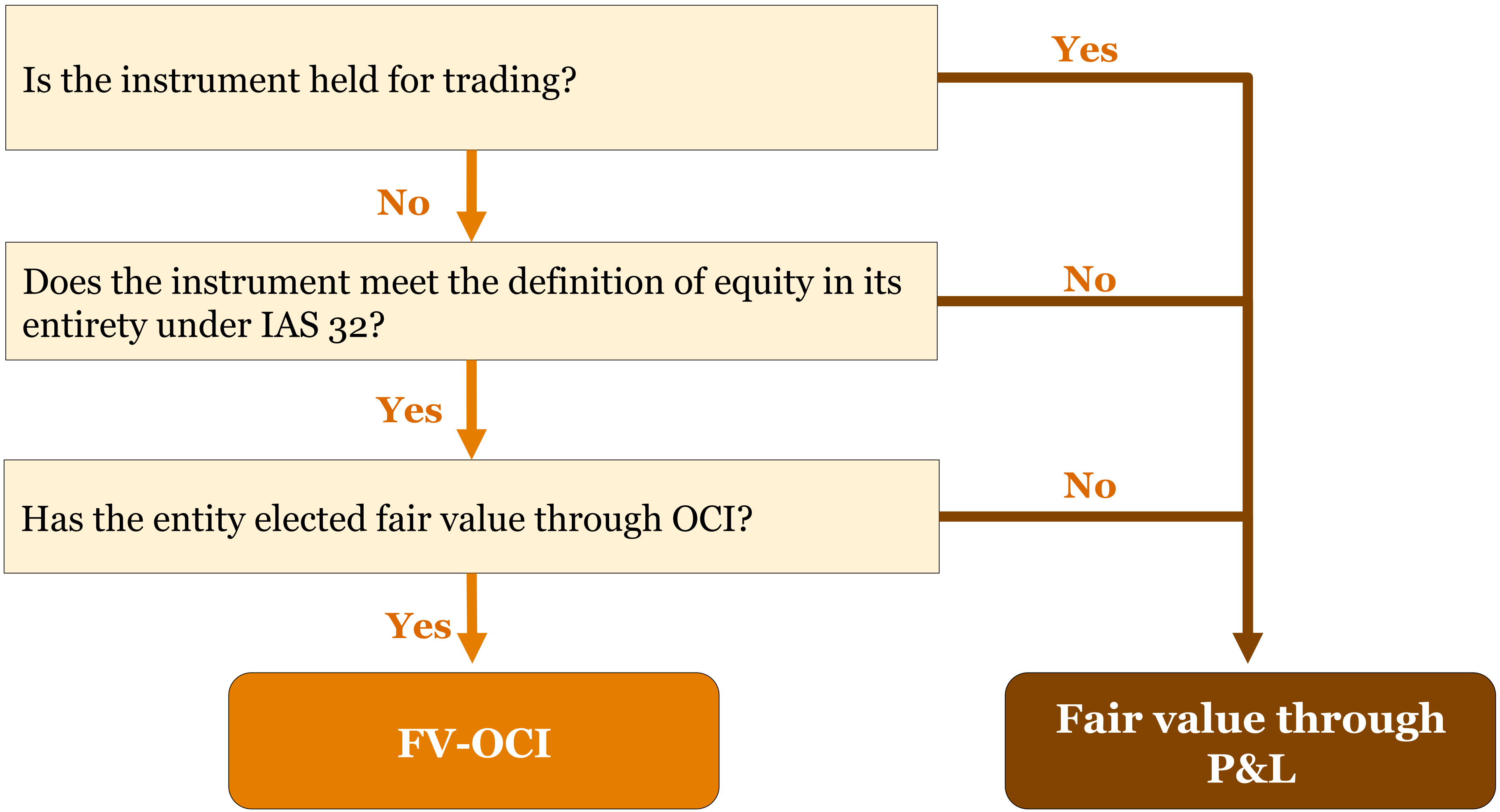
Does this instrument meet the SPPI-test?

No, it is likely this reset feature will result in more than an insignificant difference in cash flows compared to benchmark instrument.

Overview of three categories



Classification model for equity instruments



Equity instruments
- When classified as FV through OCI

What does electing FVOCI mean?

- All FV changes recorded in OCI
- All gains & losses on sale recorded in OCI
- All returns of capital recorded in OCI
- Dividends from equity investments recorded in P&L
- No more impairment

What do you need to know?

- Election must be made at initial recognition
- Election is irrevocable
- Additional disclosure

A comparison of IAS 39 and IFRS 9

Equity instruments – Unquoted equity investments

Cost exemption under IAS 39	Cost as fair value under IFRS 9
If the range of reasonable fair value estimates is significant + Probabilities of the various estimates cannot be reasonably assessed = precluded from measuring the instrument at fair value	If insufficient more recent information is available to determine fair value or a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. Standard lists some indicators that cost might not be representative of fair value. **Not available for financial institutions and investment funds.**

Revised transition guidance

New requirements

- Option to adopt in ‘phases’ is removed 6 months following finalisation of the amended IFRS 9 (including impairment and hedging).
  - All requirements of the revised standard must be applied together.
  - Existing versions of IFRS 9 will be removed.
- Exception for ‘own credit’ provisions to be early adopted separately from the revised standard.
- Separate requirements for companies already applying current phases of IFRS 9.

What do you need to know?

What will I need to think about when applying the new rules?

1 Impact on processes and systems

- The standard requires a complete reassessment of all financial assets
- How to practically assess business model and contractual terms
- Approach for fair value measurement necessary, particularly for unlisted equity investments previously accounted for at cost

What do you need to know?

What will I need to think about when applying the new rules?

2 Impact on financial statements and key financial rates

- The classification and measurement of financial assets will be simplified
- Some financial assets will move to fair value. Others will not
- No separation of embedded derivatives in financial assets
- No impairment of equity investments
- No further disposal results, if fair value changes in equity instruments are recognised in OCI
- No cost exemption for difficult-to-value instruments

IFRS 9 Financial instruments

Phase II Amortised cost and impairment

Timeline

November 2009:
IASB issues ED on impairment

May 2010:
FASB issues ED covering all aspects of financial instrument accounting

January 2011:
FASB and IASB issue supplementary document on impairment

Q3 2012:
FASB eliminates dual measurement (no Bucket 1)

Q4 2012
FASB to re-expose impairment-ED

Q1 2013?
IASB to re-expose impairment-different EDs?

2013?
FASB and IASB to finalise impairment?

Effective date TBD

IFRS 9 New impairment model - Moving from incurred loss to expected loss

On initial recognition (Bucket 1)

Interest revenue calculated on gross carrying amount

Reserve full lifetime expected losses associated with the probability of a loss in the 12 months after the reporting date.

Financial assets that were originated into investment grade and have deteriorated below investment grade since origination OR that were originated below investment grade and suffered a significant deterioration in credit quality since origination. (Bucket 2/3)

Interest revenue calculated on **gross** carrying amount

Lifetime expected loss allowance

If deteriorated to credit-impaired* (subset of Bucket 2/3)

* there is objective evidence of the criteria in paragraphs 59(a)-(e) of IAS 39

Interest revenue calculated on the **net** carrying amount

Lifetime expected loss allowance

Three-bucket approach

Different model for different portfolios

- Non credit-impaired on initial recognition
- Credit-impaired on initial recognition
- Loan commitments and guarantees
- Trade receivables, lease receivables and modified assets

Three-bucket approach

Trade receivables, lease receivables and modified assets

Class	Upon origination	Transfer in/out	Impairment
Trade receivables without significant financing	Bucket 2 or 3	No	Full lifetime losses
Trade receivables with significant financing	Accounting policy choice: • Bucket 1 if full 3 bucket approach; or • Bucket 2/3 if short-term trade receivables model is applied	Yes, if full 3 bucket model is applied; otherwise no	Depends on the accounting policy choice decision made
Lease receivables	As trade receivables with significant financing		
Modified assets	N/a	Yes	Depends on which bucket are classified in

pwc

Challenges

Strategic	Tactical	Operational
• Impact on Capital • Impact on earnings stability and other KPIs • Managing stakeholders' and market expectations	• Define indicators and thresholds for bucket migration, especially between bucket 1 and 2 • Define and identify key information to bridge current models to multi-year EL requirements • Align with peer group	• Data availability • Data quality • Financial reporting • Management reporting • Regulatory reporting • Impact on IT systems (model on model)

IFRS 9 Financial instruments

Phase III Hedge accounting

Challenges in the past

- Accounting rules have had significant influence on the strategies used to manage risk.
- Hedge accounting too complex for both users and preparers
- Trend towards the use of simpler derivatives to achieve hedge accounting, hence protecting income statement from volatility.
- For others, certain strategies were maintained due to their importance for risk management purposes, despite giving rise to significant volatility.
- Inconsistency between accounting outcome and risk management substance.

IASB's objectives for the new hedging rules

- "To improve the decision-usefulness of financial statements for users by fundamentally reconsidering the current hedge accounting requirements".
- "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".
- Better link to risk management and purpose for entering into a derivative.
- Many of the prohibitions/rules in IAS 39 proposed to be removed.

Hedging article in BT 24 February 2012 - Towards simpler hedge accounting rules

The Business Times, Friday, February 24, 2012

EDIT

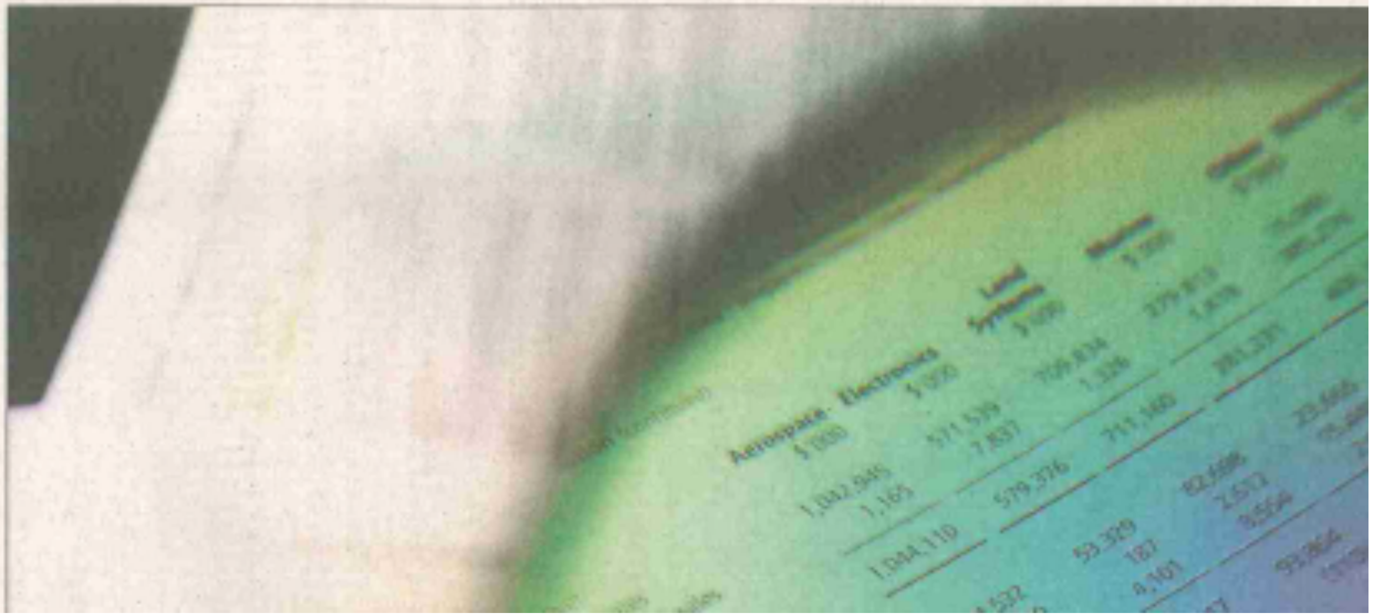
Towards simpler hedge accoun

International Accounting Standards Board's new hedging rules align accounting to risk ma

By CHEN VOON HOE and JASMINE TAN

THE intensifying debt crisis in Europe is sending another shockwave to an already wobbly global financial market. The crisis that began in 2008 has affected almost every aspect of treasury management – from funding and liquidity management to commodity, foreign exchange and counterparty risk management.

Managing such financial risks tops the agenda of most global and Singapore-based companies and these companies are hedging their exposures more actively. Take for instance shipping and airline companies hedging fuel oil purchases, commodity companies hedging price risks, and manufacturing and trading companies hedging foreign currency sales and purchases and interest rate risks.



Some of the proposed changes under the new hedging rules

Topic	IAS 39	IFRS 9 – Proposed changes
Effectiveness testing	80-125%	• No more threshold, hedge must be "unbiased" • Qualitative and/or quantitative assessment based on management's risk strategy
Hedging risk components of non-financial hedged items	Prohibited, except FX risk	Permitted as long as risk component is • separately identifiable and • reliably measureable
Derivatives as hedged items	Prohibited	Permitted
Hedging of net position of forecast transactions	Prohibited	Cash flow hedges of net positions are only be available for hedges of foreign currency risk as long as the items within the net position are specified in such a way that the pattern of how they will affect the income statement is set out as part of the initial hedge designation.
Basis adjustment	Choice	Mandatory

Some of the proposed changes under the new hedging rules

Topic	IAS 39	IFRS 9 – Proposed changes
Hedging a 'layer' of an entire item	Prohibited	Permitted
Accounting for time value of options	Prohibited	Based on the nature of the hedged item: • 'transaction related': to be recognised in OCI with reclassification to P/L • 'time period related': to be recognised in OCI and amortised
Fair value hedging	Changes in FV to P&L, adjustment to hedged item	• IAS 39 mechanics retained • Require single note about cash flow and fair value hedges • Disclosure of fair value hedge adjustment

pwc

Brightline Guidance

$$80\% < \frac{\text{Change in hedging instrument}}{\text{Change in hedged item}} < 125\%$$

Qualifying Criteria under IFRS 9

- Only eligible hedging instruments and hedged items
- At inception : formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy
- Effectiveness requirements met :
  - economic relationship
  - credit risk does not dominate
  - hedge ratio is appropriate

Qualifying Criteria under IFRS 9

Hedge ratio:

- ✓ Designation must not reflect an **imbalance** that would create hedge ineffectiveness in order to achieve an accounting outcome that is inconsistent with the purpose of hedge accounting

Example of inappropriate designation: Cash flow hedge

Hedging instrument: Forward contract USD 80

Hedged item: Future cash flow USD 100

Fair value changes on hedged item will always be larger than fair value changes on hedging instrument because of inappropriate designated hedge ratio

Qualifying Criteria under IFRS 9

Example: <u>What is appropriate accounting outcome?</u>

Hedging instrument:

Standard coffee futures
5 contracts = 85 tonnes *or*
6 contracts = 102 tonnes

Hedged item:

Future purchase of 100 tonnes of coffee

Using hedge ratio that results from the number of coffee futures actually used.

Mismatch in weightings is not created in order to achieve an accounting outcome inconsistent with the purpose of hedge accounting

Qualifying Criteria under IFRS 9

Discontinuation:

✓ De-designation **required** if hedge accounting objective is no longer met

✓ Voluntary de-designation **prohibited,** *i.e. if hedged item and hedging instrument still exist and the risk management strategy is unchanged*

What was allowed under IAS 39 is now prohibited,
but no major change in practice because:

Hedge accounting objective ≠ Hedging strategy

Mandatory Rebalancing

- Analyse sources of hedge ineffectiveness to evaluate whether changes in the extent of offset are :
    - ➢ fluctuations around a hedge ratio that remains valid.
    - ➢ an indication that hedge ratio no longer reflects the relationship between hedging instrument and hedged item.

- Change in risk management objective leads to discontinuance of hedge relationship rather than rebalancing.

- Rebalancing leads to update of hedge documentation –
    - ➢ Still considered a continuation of the original hedge relationship.

Hedging instruments

Forwards as hedging instruments – Hedging spot exchange risk

Under IAS 39 : Change in forward points to profit or loss

Additional Alternative Available

Under IFRS 9 : (a) Initial forward points to profit or loss on a rational basis

AND

(b) Changes in forward points after inception to Other Comprehensive Income

Hedging instruments

Options / forwards as hedging instruments - Summary

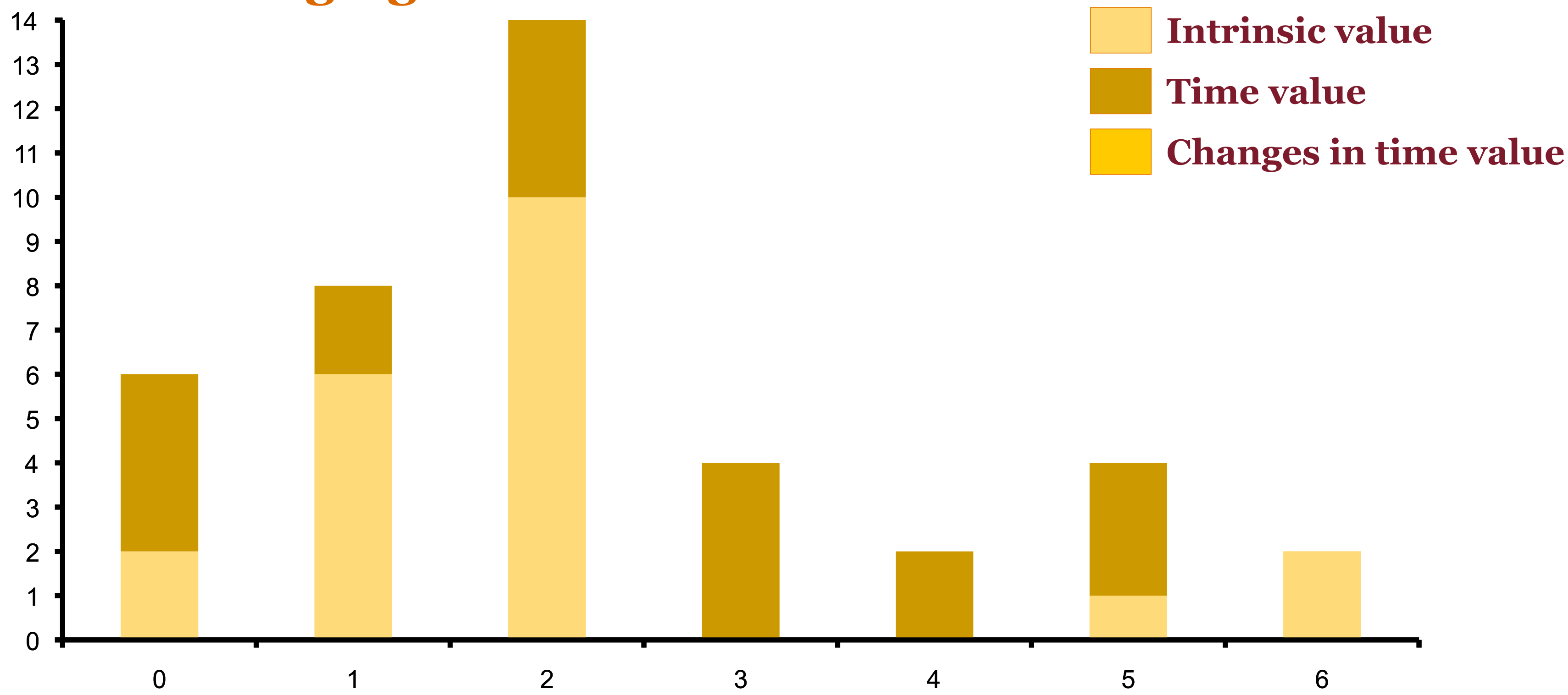
	IAS 39	IFRS 9
Options – time value:	Profit or Loss	<u>Transaction related</u> • Other Comprehensive Income <u>Time period related</u> • Initial to Profit or Loss over time • Subsequent to Other Comprehensive Income
Forwards – forward points *:	Profit or Loss	•Profit or Loss, OR •Initial to Profit or Loss over time •Subsequent to Other Comprehensive Income

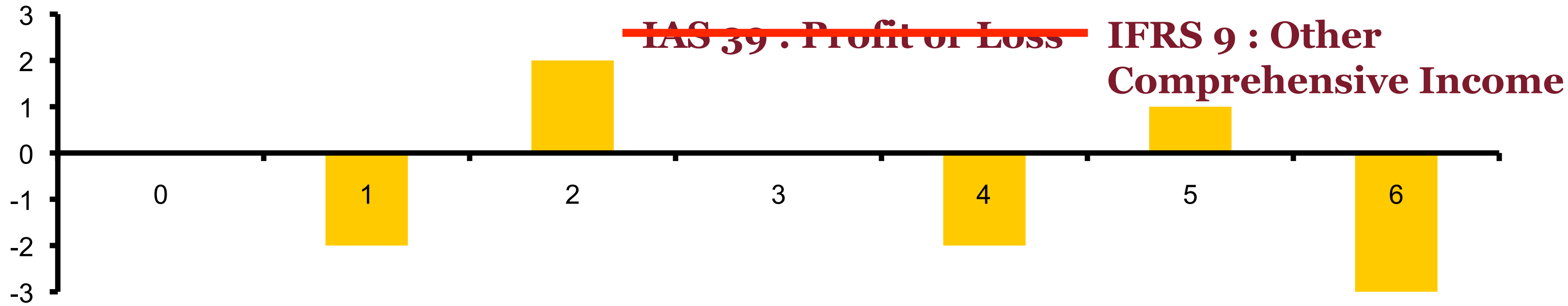
IFRS 9 impact - less volatility in Profit or Loss

**Assuming hedging spot FX risk only*

Hedging instruments

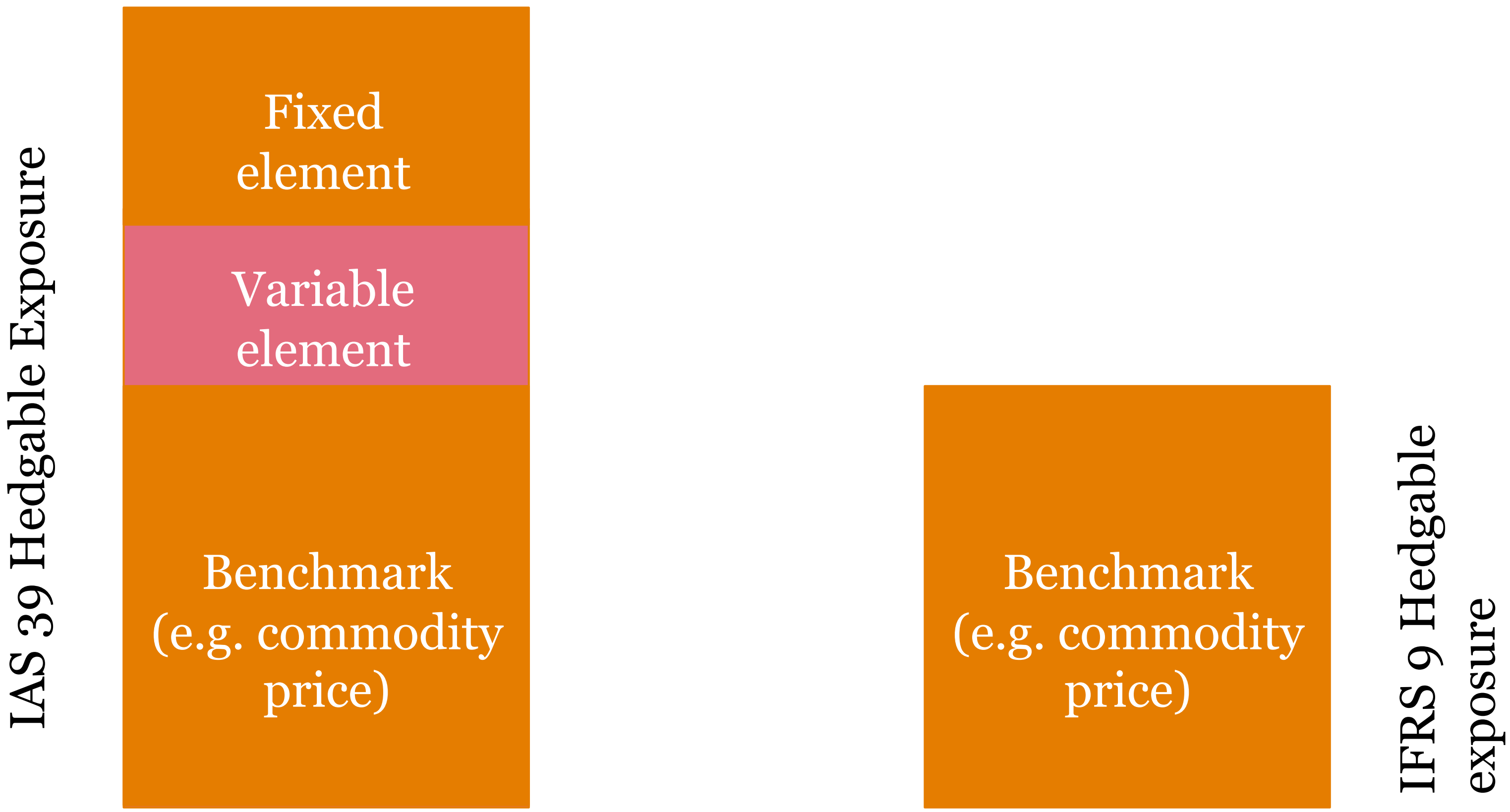
Options as hedging instruments





Hedged Items Permitted : Non-Financial Risk Components

Risk components of non-financial items



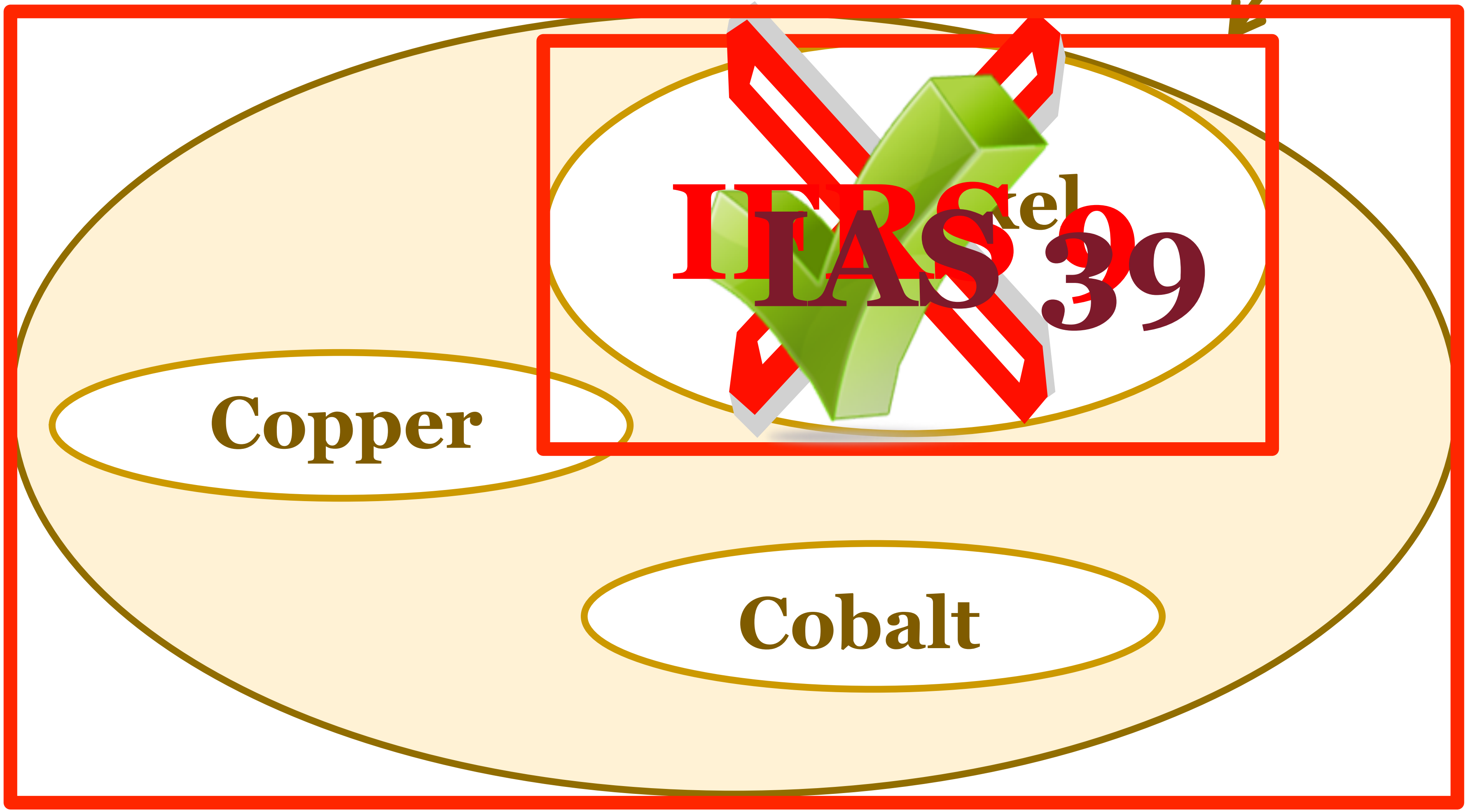
Alignment of risk management with hedge accounting

Hedged Items Permitted : Non-Financial Risk Components

- Risk components may be hedged if:
  - separately identifiable; and
  - changes in fair value or cash flows are reliably measurable

- These criteria may be met when risk components:
  - explicitly specified in a contract; or
  - implicit in the fair value or cash flows

Hedged Items Permitted : Non-Financial Risk Components



Sale Price = Nickel (P x Q) + Cobalt (P x Q) + Copper (P x Q) – Refining Charge

Hedged Items Permitted : Non-Financial Risk Components

Examples; Risk components of non-financial items

Example : Long-term supply contract for natural gas

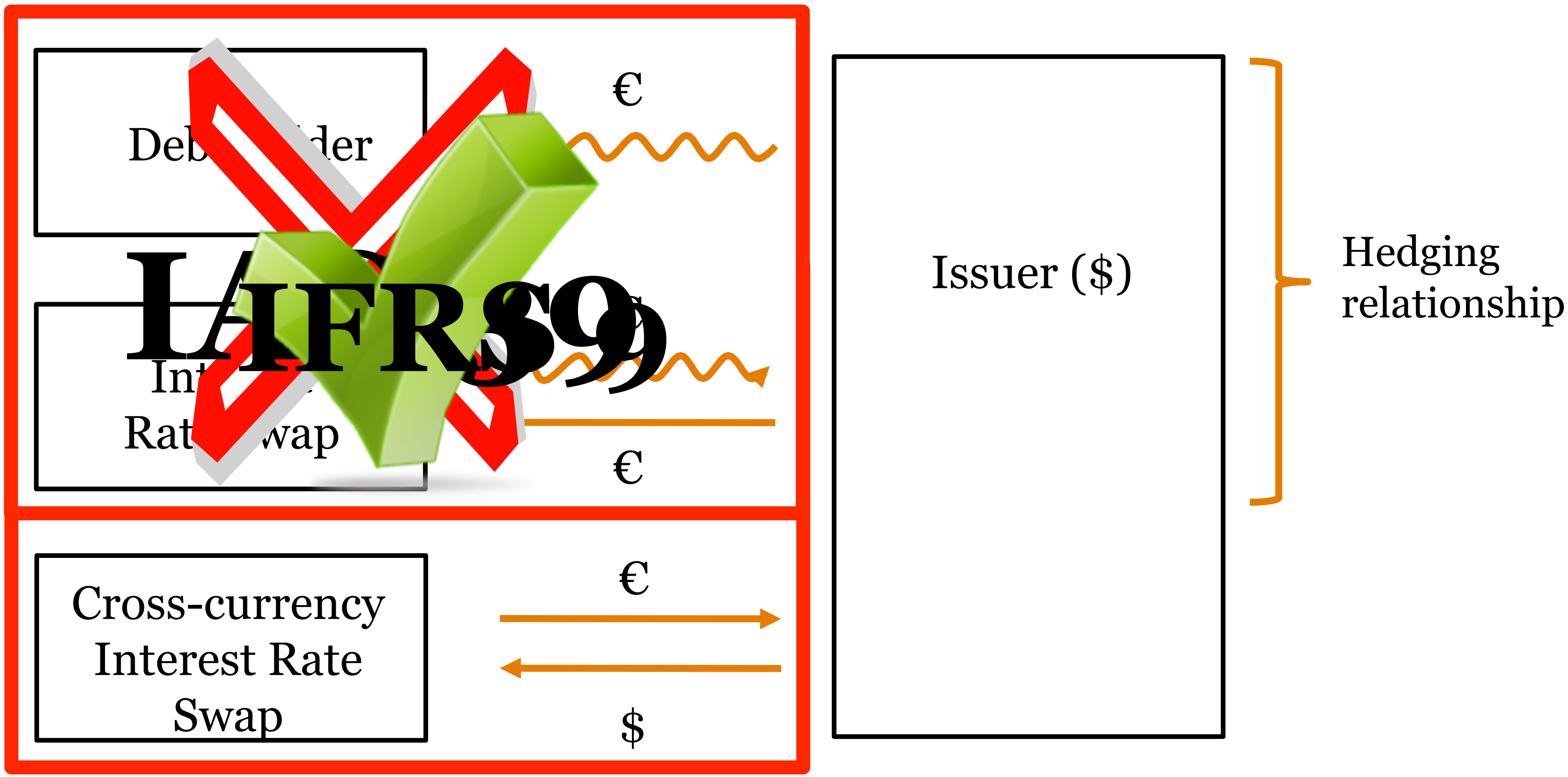
Pricing of natural gas according to contractually specified formula:

Gas oil + Fuel oil + Other components eg. transport charges = **Natural gas**

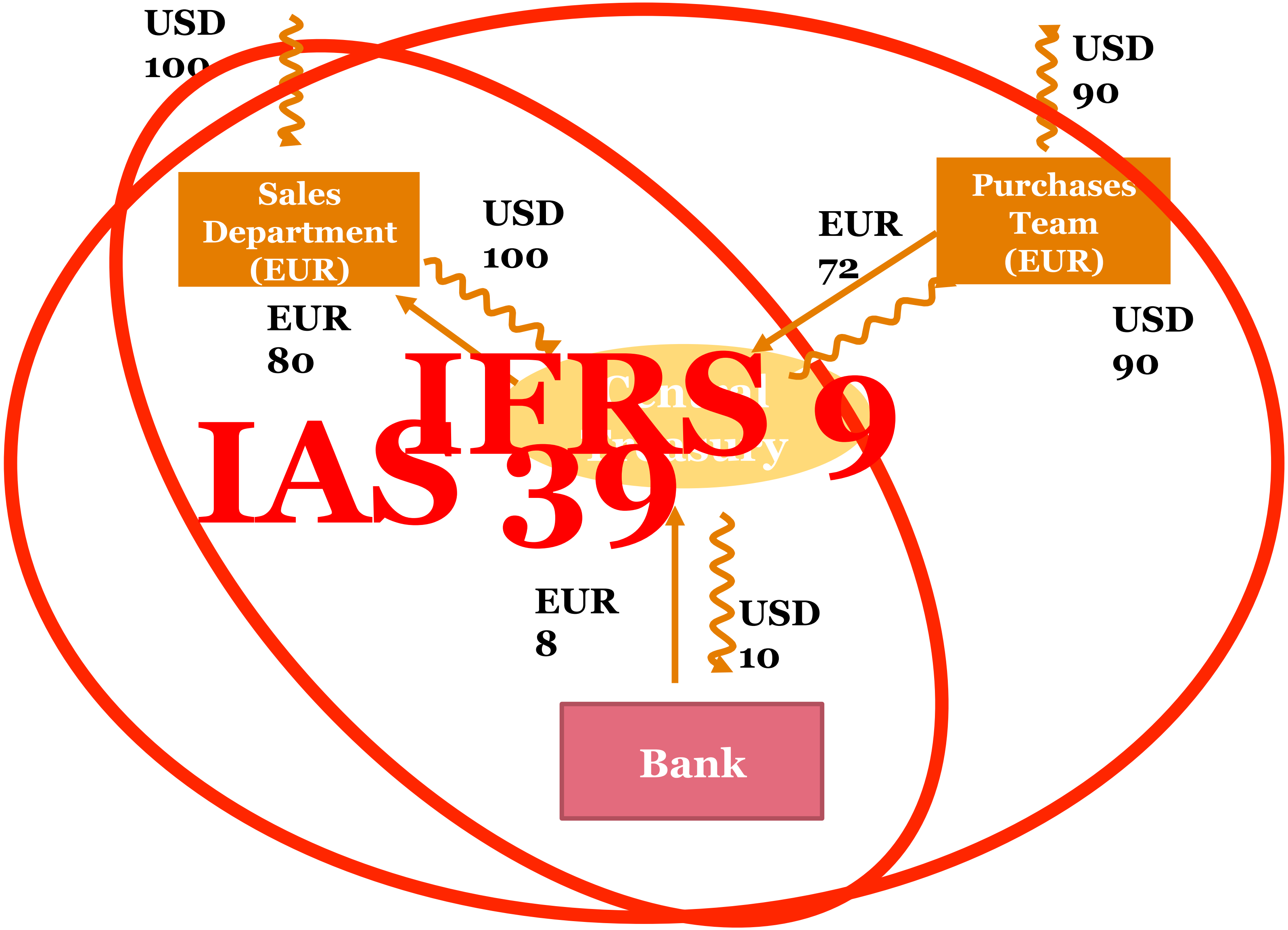
Hedged item

➢ **Component eligible as hedged item**

Hedged Items Permitted : Aggregated Exposures



Hedging Net Positions



Key opportunities

- Closer alignment between economic strategies and accounting outcome
- Designation of a component of commodity risks
- Hedging with purchased options will give less P&L volatility and greater flexibility
- Derivatives is permitted as part of hedged item, hence removing one of the most challenging impediments that currently exist to optimising funding.

Potential shortcoming

- Mandatory rebalancing is required
- Voluntary de-designation prohibited
- If the hedged net positions consist of forecasted transactions, hedge accounting on a net basis is now only available for foreign currency hedges.

Thinking ahead – Impact to financial statements and key financial ratios

- Profit or loss will be less volatile.
- Profit or loss will show separate line item for hedging gains/losses.
- Use of hedge accounting reserve will increase.
- Key financial ratios (EBITDA, Return on equity) will change.
- Presentation and extent of required disclosures in the notes to financial statements will change.
- Potential impact on tax.

Thinking ahead - Risk management policy

- Existing risk management policy or treasury policy needs to be revisited
- Approved hedging instruments, delegation of authority, bank mandate need to be reconsidered.

Thinking ahead - System, process and controls

- Test of existing hedging relationships for qualification under IFRS 9 including periodic rebalancing
- Modification of bookkeeping for purchased options
- Designation of new hedging relationships due to new parameters
- Re-aligning existing hedge accounting with risk management (especially effectiveness testing)
- Additional need for information due to new disclosure requirements
- System capability and functionality need to be evaluated for consistency with new rules.
- Internal processes and controls will have to change.

Transition requirements

- ✓ Effective from 1 January 2015?
  - ❑ early application permitted, if previous IFRS 9 phases also adopted
- ✓ Hedging relationships that qualified under IAS 39 and qualify under the new model will be treated as *continuing hedging relationships*
- ✓ Prospective application with limited exceptions
- ✓ No restatement of comparatives
- ✓ The moment IAS 39 ceases to apply is the moment when the new model applies

Thank you!