INTRODUCTION

The Mazars Insight series on IFRS aim at helping preparers, users and auditors of financial statements develop their theoretical and practical understanding of IFRSs. Our objective is to provide our readers, whether beginners or experts, with useful tools which provide clarity and insight on the challenging issues that may be encountered when applying IFRSs. Concepts are explained in a pedagogical way and illustrated by numerous practical examples.

This IFRS Insight addresses the accounting for financial instruments under IFRS. It draws on several relevant IFRS standards to tackle, in one manual, the entire range of challenges related to financial instruments among which: recognition and derecognition, classification and measurement, impairment for credit risk, derivatives and hedging, and related disclosures. It includes all the new requirements introduced by IFRS 9 and the related amendments to other standards such as IFRS 7.

After a two-pager providing an overview of IFRS requirements for financial instruments in 10 key points, a table of content shows the list of chapters. Each chapter starts with a detailed table of content to direct readers straight to the topic they are searching for. Many cross references have been inserted for improved reading experience. We draw specific attention to chapter 2 which comprises the definitions and the list of abbreviations and acronyms used in this manual.

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Vincent Guillard
IFRS Lead Partner for Financial Instruments
10 KEY POINTS TO REMEMBER

1. Scope
The accounting treatment of financial instruments under IFRS is defined by several standards. IFRS 9 – Financial Instruments provides requirements for recognition and derecognition, classification, measurement (including impairment) and hedge accounting. IAS 32 – Financial Instruments: Presentation provides principles for distinguishing issued debt and equity instruments as well as requirements for offsetting financial assets and financial liabilities. IFRS 7 – Financial Instruments: Disclosures deals with most of the disclosure requirements, and IFRS 13 – Fair Value Measurement provides guidance on fair value measurement and related disclosure requirements. Each of these standards has specific scope exclusions, even for items that meet the definition of financial instruments. (see chapter 1)

2. Initial recognition
All financial instruments are initially recognised when the entity becomes party to the contract. Financial assets or liabilities are initially measured at their fair value plus or minus transaction costs, except financial instruments classified at FV-PL for which transaction costs are directly expensed into profit or loss. However, trade receivables are initially measured at their transaction price if they do not contain a significant financing component in accordance with IFRS 15. When the transaction price differs from the initial fair value of that financial instrument, a so called “day one gain or loss” may need to be recognised upon initial recognition in profit or loss. (see chapter 6)

3. Classification of financial assets
Financial assets whose contractual cash flows are Solely Payments of Principal and Interest (the SPPI test) will be classified in accordance with the entity’s business model for managing the asset: Amortised Cost if they are subject to a Hold-To-Collect business model, FV-OCI if they are held within a Hold-To-Collect-and-Sell business model, or FV-PL in any other situation. Financial assets that do not pass the SPPI test (e.g. derivatives and equity instruments) must be classified in the FV-PL category, except for some equity instruments which the entity may irrevocably classify in FV-OCINR.

Subsequent reclassifications are limited to SPPI financial assets, upon a change in the entity’s business model and are thus expected to be very infrequent.

Subject to specific conditions (e.g. when a situation of an accounting mismatch would otherwise arise), an entity may irrevocably classify any financial asset as measured at FV-PL upon initial recognition. (see chapter 7)

4. Impairment for expected credit losses
Entities must recognise an allowance for expected credit losses for all financial assets classified in the Amortised Cost or FV-OCI category, as well as for most loan commitments and financial guarantees issued. Upon initial recognition of the instrument, the loss allowance is equal to the credit losses that the entity expects as a result from default events occurring within the next 12 months (12MECL). This amount is updated at each reporting date. When a Significant Increase in the Credit Risk (SICR) of the asset is identified, the loss allowance must be measured at an amount equal to the credit losses that the entity expects to occur over the full remaining life of the asset (LTECL).

Purchased or originated credit-impaired (POCI) assets (i.e. assets with existing incurred credit losses upon initial recognition) follow a separate impairment and revenue recognition model.
A simplified expected credit loss impairment approach is mandatory for short term trade receivables and contract assets, and optional for other trade receivables and contract assets, and lease receivables. (see chapter 9).

5. Classification of financial liabilities

Most financial liabilities are classified in the Amortised Cost category unless they are held for trading, or meet the conditions for a voluntarily classification in the FV-PL category upon their initial recognition. (see chapter 8)

6. Debt vs. Equity

Financial instruments issued that are in the scope of IAS 32 must be analysed to determine whether they meet the definition of an equity instrument or that of a financial liability. An instrument is generally classified as a financial liability if it requires the entity either to deliver cash or another financial asset, or to deliver a variable number of its own equity instruments. A derivative may qualify as an equity instrument if it will be settled only by the issuer exchanging a fixed amount of cash for a fixed number of own equity instruments. Compound instruments contain both a liability and an equity component which must be accounted for separately.

7. Embedded derivatives

Derivative instruments may be either stand-alone contracts, or a feature embedded in a financial liability host contract or a non-financial host contract. Embedded derivatives must be bifurcated and accounted for separately as a stand-alone derivative if they are not economically closely related to their host contract. (see chapter 13)

8. Hedge accounting

Under IAS 39 and IFRS 9, most derivatives are by default measured at FV-PL whereas non-derivative financial assets and financial liabilities are often measured at amortised cost or FV-OCI. This situation may trigger accounting mismatches in profit or loss despite a proper economic offset between the hedging derivative and the hedged exposure. To better reflect the hedging strategy of the entity, IFRS 9 provides specific and optional accounting treatments for hedging relationships. The accounting impact depends on the nature of the hedging relationship (fair value hedge, cash flow hedge or net investment hedge). Hedge accounting is subject to eligibility, effectiveness and documentation-related conditions. (see chapter 14)

9. Derecognition

A financial asset is derecognised when and only when the contractual rights to the cash flows expire, or when the asset is transferred and this transfer meets the derecognition requirements. This test relies mainly on two criteria: the transfer of the contractual rights to the cash flows, and the transfer of the risks and rewards of ownership of the financial asset.

A financial liability is removed from the statement of financial position when it is extinguished. An exchange or modification of debt instruments, between an existing lender and borrower, is considered as an extinguishment of the original instrument if the terms of the original and the “new” instrument are substantially different.

10. Disclosures on financial instruments

The disclosure requirements aim at enabling the users to assess the significance of financial instruments for the entity, the nature and extent of risks arising from them, and how the entity manages those risks. (see chapter 16)
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ON FINANCIAL INSTRUMENTS

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9.1. Introduction

After having detailed the recognition, initial measurement (see chapter 6) and the classification requirements of financial assets (see chapter 7), and financial liabilities (see chapter 8), this chapter will present the subsequent measurement requirements of IFRS 9.

9.2. Subsequent measurement and recognition of gains and losses

After having addressed the initial measurement of financial instruments (see section 6.3) and their classification (see section 7.4), the objective of this section is to describe the principles which apply to their subsequent measurement. These principles differ based on the classification of financial assets and liabilities: fair value through profit or loss, fair value through other comprehensive income or amortised cost.

This section will not address the subsequent measurement modifications implied by hedge accounting (see chapter 14). Nor will it address the accounting treatment of reclassifications that is further developed in section 7.5.

9.2.1. Financial Instruments at FV-PL

9.2.1.1. Financial assets and derivatives at FV-PL

9.2.1.1.1. General principle

The following measurement principles must be applied to:

- debt instruments at FV-PL that encompass instruments which have failed the SPPI test (see section 7.4.3) or that have been documented in portfolios managed with “other business models” including held for trading but not only (see section 7.4.2);

- equity instruments that have not been designated as FV-OCI (see section 7.3.2);

- derivatives that are not documented in a hedging relationship (for those specific derivatives see chapter 13).

All financial assets classified in the FV-PL category are measured at their fair value at reporting date. This fair value is determined in accordance with the principles described in chapter 3 (IFRS 9.5.2.1).

Changes in fair value of the financial asset are recognised in the profit or loss of the period. (IFRS 9.5.7.1).

When remeasuring the fair value of a financial asset, it can happen that this fair value becomes negative. In such a case, IFRS 9.B5.2.1 states that a financial asset measured at fair value through profit or loss whose fair value becomes negative is in fact a financial liability and is measured accordingly.
9.2.1.1.2. Unquoted equity instruments at FV-PL

Under IFRS 9, any financial asset classified as FV-PL is measured at fair value, even if it is an unquoted equity instrument for which fair value cannot be reliably estimated. The IAS 39 exemption for this kind of instrument was not retained in IFRS 9.

However, in limited circumstances, IFRS 9.B5.2.3 allows to retain the cost as “an appropriate estimate of fair value”. This means that, to measure such equity instrument at cost, the entity will have to demonstrate that the cost is the best estimate of its fair value.

IFRS 9 clarifies the expression “some limited circumstances” as follows:

— Cost will never be the best estimate of fair value for quoted equity instruments (IFRS 9.B5.2.6).
— Cost may be the best estimate of fair value when more recent information available is insufficient to measure fair value or when there is a wide range of possible fair values (IFRS 9.B5.2.3).

IFRS 9.B5.2.4 provides a non-exhaustive list of indicators that cost might not be the best estimate of the fair value:

— significant change in the performance of the investee compared with budgets, plans or milestones;
— changes in expectation that the investee’s technical product milestones will be achieved;
— a significant change in the market for the investee’s equity or its products or potential products;
— a significant change in the global economy or the economic environment in which the investee operates;
— a significant change in the performance of comparable entities, or in the valuations implied by the overall market;
— internal matters of the investee such as fraud, commercial disputes, litigation, changes in management or strategy;
— evidence from external transactions in the investee’s equity, either by the investee (such as a fresh issue of equity), or by transfers of equity instruments between third parties.

9.2.1.2. Financial liabilities at FV-PL

9.2.1.2.1. General principle

Financial liabilities measured at FV-PL encompass those classified as held for trading (see section 8.3.2), those designated at FV-PL (see section 8.3.3), derivatives except for those documented in a hedging relationship (see chapters 13 and 14), and contingent consideration recognised in a business combination in accordance with IFRS 3 (IFRS 9.4.2.1).

Fair value is determined in accordance with IFRS 13.

Any gains and losses resulting from a change in fair value are recognised in the profit or loss of the period (IFRS 9.5.7.1) except for financial liabilities designated at FV-PL (see section 8.3.3).
Even if IFRS 9.B5.2.1 does not explicitly address this case, we think that by analogy with the accounting treatment of financial assets at FV-PL with a negative fair value, a financial liability with a positive fair value for the entity ought to be accounted for as a financial asset rather than as a negative liability.

9.2.1.2.2. Liabilities designated at FV-PL

When a financial liability is designated at FV-PL (see section 8.3.3), the gains and losses resulting from change in fair value is split between (IFRS 9.B5.7.5):

— those related to changes in own credit risk: these impacts are accounted for in other comprehensive income unless such presentation would create or enlarge an accounting mismatch (see chapter 8); and,

— the remaining amount of change in fair value that are recognised in profit or loss.

Example 9.1: Financial liabilities through profit or loss (IFRS 9.IE1-5)

On 1 January 20X1 an entity issues a 10-year bond with a par value of CU150,000\(^1\) and an annual fixed coupon rate of 8 per cent, which is consistent with market rates for bonds with similar characteristics.

The entity uses LIBOR as its observable (benchmark) interest rate. At the date of inception of the bond, LIBOR is 5 per cent. At the end of the first year:

\(>\) LIBOR has decreased to 4.75 per cent.

\(>\) the fair value for the bond is CU153,811, consistent with an interest rate of 7.6 per cent\(^2\)

The entity assumes a flat yield curve, all changes in interest rates result from a parallel shift in the yield curve, and the changes in LIBOR are the only relevant changes in market conditions.

The entity estimates the amount of change in the fair value of the bond that is not attributable to changes in market conditions that give rise to market risk as follows:

\(^1\) In this guidance monetary amounts are denominated in ‘currency units’ (CU).

\(^2\) This reflects a shift in LIBOR from 5 per cent to 4.75 per cent and a movement of 0.15 per cent which, in the absence of other relevant changes in market conditions, is assumed to reflect changes in credit risk of the instrument.
First, the entity computes the liability’s internal rate of return at the start of the period using the observed market price of the liability and the liability’s contractual cash flows at the start of the period. It deducts from this rate of return the observed (benchmark) interest rate at the start of the period, to arrive at an instrument-specific component of the internal rate of return. (IFRS 9.B5.7.18(a)).

At the start of the period of a 10-year bond with a coupon of 8 per cent, the bond’s internal rate of return is 8 per cent. Because the observed (benchmark) interest rate (LIBOR) is 5 per cent, the instrument-specific component of the internal rate of return is 3 per cent.

Next, the entity calculates the present value of the cash flows associated with the liability using the liability’s contractual cash flows at the end of the period and a discount rate equal to the sum of (i) the observed (benchmark) interest rate at the end of the period and (ii) the instrument-specific component of the internal rate of return as determined in accordance with paragraph IFRS 9.B5.7.18(a). (IFRS 9.B5.7.18(b)).

The contractual cash flows of the instrument at the end of the period are:
- interest: CU12,000(a) per year for each of years 2–10.
- principal: CU150,000 in year 10.

The discount rate to be used to calculate the present value of the bond is thus 7.75 per cent, which is the end of period LIBOR rate of 4.75 per cent, plus the 3 per cent instrument-specific component. This gives a present value of CU152,367(b).

The difference between the observed market price of the liability at the end of the period and the amount determined in accordance with paragraph IFRS 9.B5.7.18(b) is the change in fair value that is not attributable to changes in the observed (benchmark) interest rate. This is the amount to be presented in other comprehensive income in accordance with IFRS 9.5.7.7(a). (IFRS 9 B5.7.18(c)).

The market price of the liability at the end of the period is CU153,811.(c) Thus, the entity presents CU1,444 in other comprehensive income, which is CU153,811 – CU152,367, as the increase in fair value of the bond that is not attributable to changes in market conditions that give rise to market risk.

(a) CU150,000 × 8% = CU12,000.
(b) $PV = [CU12,000 × (1 – (1 + 0.0775)-9)/0.0775] + CU150,000 × (1 + 0.0775)-9.$
(c) $market \ price = [CU12,000 × (1 – (1 + 0.076)-9)/0.076] + CU150,000 × (1 + 0.076)-9.$
9.2.2. Financial instruments at Amortised Cost

Financial assets and liabilities classified in this category are measured at their amortised cost determined using the effective interest rate method (see chapter 4).

For financial assets, amortised cost encompasses the credit loss allowance (see section 9.4.9).

Interest revenues or expenses of financial instruments carried at amortised cost are calculated by applying their effective interest rate to their gross carrying amount, except for:

- financial assets that becomes credit impaired subsequently to their acquisition or origination, for which the effective interest rate is applied to the amortised cost (i.e. an amount net of credit loss allowance); and
- purchased or originated credit-impaired financial assets for which the entity should apply the credit-adjusted effective interest rate to the amortised cost of the financial asset (see section 9.4.5).

Section 4.5 provides numerical examples of amortised cost and effective interest rate calculations.

9.2.3. Financial assets at FV-OCI

This financial asset category encompasses two types of instruments, respectively debt and equity instruments (see chapter 7), that are both measured at their fair value (determined in accordance with IFRS 13) in the statement of financial position. However, the impacts of the changes in such fair value in other comprehensive income and profit or loss will be different depending on the type of instrument.

9.2.3.1. Debt Instruments at FV-OCI Recyclable

In this measurement category, debt instruments are measured at their fair value, and any change in fair value is recognised in other comprehensive income except for (IFRS 9.5.7.10):

- interest revenues recognised in profit or loss, calculated using the effective interest rate method;
- impairment gains and losses that impact the profit or loss of the period.

When a debt instrument at FV-OCI is derecognised all gains or losses accumulated in other comprehensive income are recycled through profit or loss (IFRS 9.5.7.10) as a reclassification adjustment (see section 16 on disclosures).

In practice, this FV-OCI category aims at recognising:

- the asset at fair value in the statement of financial position,
- the effect of amortised cost measurement in the profit or loss of the period, and
- any residual change in value recognised in other comprehensive income.
9.2.3.2. Equity instruments at FV-OCI Non-Recyclable

In accordance with the requirements specified in section 7.3.2, an entity can choose to classify an equity instrument at fair value through other comprehensive income but without the possibility to later transfer the gain or loss realised upon sale into profit or loss (FV-OCINR).

Therefore, changes in the fair value of the equity instrument will impact other comprehensive income (IFRS 9.5.7.5) without any possibility of subsequently being recycled through profit or loss (IFRS 9.B5.7.1). However, the accumulated gains or losses may be transferred to equity (IFRS 9.B5.7.1).

One possibility for an entity would be to maintain the equity instrument’s accumulated gains or losses in other comprehensive income until the derecognition of the equity instrument. On derecognition, the entity could transfer the accumulated amount to equity. This could be a mean to continue to provide information on realised versus unrealised gains or losses.

Dividends received on equity instruments will impact the profit or loss of the period (IFRS 9.5.7.1; IFRS 9.5.7.6) unless they “clearly represent a recovery of part of cost of the investment” (IFRS 9.B5.7.1).

9.2.4. Specific financial commitments

9.2.4.1. Commitment to provide a loan at a below-market interest rate

As stated by IFRS 9.4.2.1(d), unless commitments to provide a loan at a below-market interest rate are measured at FV-PL, they are subsequently measured at the higher of:

— the amount of the loss allowance determined in accordance with section 9.4.6, and

— the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

9.2.4.2. Financial guarantee issued

Unless financial guarantees issued are measured at FV-PL or arise following a derecognition analysis, IFRS 9.4.2.1(c) requires to subsequently measure such contracts at the higher of:

— the amount of the loss allowance determined in accordance with section 9.4.6, and

— the amount initially recognised less, when appropriate, the cumulative amount of income recognised in accordance with the principles of IFRS 15.

9.3. Financial instruments denominated in Foreign Currencies

IAS 21 - *The effects of changes in foreign exchange rates* deals with the accounting consequences of changes of foreign exchange rates on financial instruments.

Any entity must first determine its functional currency in accordance with IAS 21. It follows that any currency which is different from the entity's functional currency is considered as a foreign currency.
IAS 21 defines two types of instruments to which different principles apply:

— **monetary instruments** that consist of cash in foreign currencies, assets and liabilities that are to be received or paid in a fixed or determinable number of units of currency (IAS 21.8 and IAS 21.16); and

— **non-monetary instruments** that do not meet the previous definition. Examples of non-monetary items are equity instruments, tangible and intangible assets, goodwill, etc.

Monetary instruments must be translated using the appropriate closing rate (IAS 21.28).

Non-monetary instruments are translated at their historical rate except when they are measured at fair value. In this last case, they must be translated at the exchange rates corresponding to the date of the fair value measurement i.e. the reporting date.

In practice, most financial instruments are monetary items, except equity instruments. However, all equity instruments held are measured at fair value under IFRS 9. Therefore, in practice, all financial instruments are translated at the closing rate at each reporting date.

At each reporting date financial instruments in foreign currencies are:

— initially accounted for in their foreign currency in accordance with their classification (i.e. Amortised Cost, FV-OCI or FV-PL), and

— subsequently translated in the entity’s functional currency as follows:

  > for monetary financial instruments measured at amortised cost and any financial instrument measured at FV-PL, through profit or loss;

  > for monetary financial assets measured at FV-OCI, any exchange differences are split into:

    — the part related to the amortised cost measurement that will impact profit or loss, and

    — the residual foreign currency translation effect that will be recorded in other comprehensive income (IFRS 9.5.7.10 and IFRS 9.B5.7.2 – 2A).

  > for equity instruments measured at FV-OCINR in accordance with IFRS 9.5.7.5 (see section 7.3.2), any exchange differences will impact other comprehensive income without any further recycling (IFRS 9.B5.7.3) and therefore will never impact profit or loss.

### Example 9.2: IFRS 9.IG.E.3.2 IFRS 9 and IAS 21—financial assets measured at fair value through other comprehensive income: separation of currency component

A financial asset measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9 is treated as a monetary item. Therefore, the entity recognises changes in the carrying amount relating to changes in foreign exchange rates in profit or loss in accordance with paragraphs 23(a) and 28 of IAS 21 and other changes in the carrying amount in other comprehensive income in accordance with IFRS 9. How is the cumulative gain or loss that is recognised in other comprehensive income determined?

It corresponds to the difference between the amortised cost of the financial asset and the fair value of the financial asset in the functional currency of the reporting entity. For the purpose of applying paragraph 28 of IAS 21 the asset is treated as an asset measured at amortised cost in the foreign currency.

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3 The objective of this example is to illustrate the separation of the currency component for a financial asset that is measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9. Consequently, for simplicity, this example does not reflect the effect of the impairment requirements in section 5.5 of IFRS 9.
To illustrate: on 31 December 20X1 Entity A acquires a bond denominated in a foreign currency (FC) for its fair value of FC1,000. The bond has five years remaining to maturity and a contractual par amount of FC1,250, carries fixed interest of 4.7 per cent that is paid annually (FC1,250 × 4.7% = FC59 per year), and has an effective interest rate of 10 per cent.

Entity A classifies the bond as subsequently measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9, and thus recognises gains and losses in other comprehensive income. The entity’s functional currency is its local currency (LC). The exchange rate is FC1 to LC1.5 and the carrying amount of the bond is LC1,500 (= FC1,000 × 1.5).

\[
\begin{align*}
\text{Dr Bond} & \quad \text{LC1,500} \\
\text{Cr Cash} & \quad \text{LC1,500}
\end{align*}
\]

On 31 December 20X2, the foreign currency has appreciated and the exchange rate is FC1 to LC2. The fair value of the bond is FC1,060 and thus the carrying amount is LC2,120 (= FC1,060 × 2). The amortised cost is FC1,041 (= LC2,082). In this case, the cumulative gain or loss to be recognised in other comprehensive income and accumulated in equity is the difference between the fair value and the amortised cost on 31 December 20X2, i.e. LC38 (= LC2,120 – LC2,082).

Interest received on the bond on 31 December 20X2 is FC59 (= LC118). Interest revenue determined in accordance with the effective interest method is FC100 (= FC1,000 × 10 per cent). The average exchange rate during the year is FC1 to LC1.75. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (see paragraph 22 of IAS 21). Thus, reported interest revenue is LC175 (= FC100 × 1.75) including accretion of the initial discount of LC72 (= [FC100 – FC59] × 1.75). Accordingly, the exchange difference on the bond that is recognised in profit or loss is LC510 (= LC2,082 – LC1,500 – LC72). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.00 – 1.75]).

\[
\begin{align*}
\text{Dr Bond} & \quad \text{LC620} \\
\text{Dr Cash} & \quad \text{LC118} \\
\text{Cr Interest revenue} & \quad \text{LC175} \\
\text{Cr Exchange gain} & \quad \text{LC525} \\
\text{Cr Fair value change in other comprehensive income} & \quad \text{LC38}
\end{align*}
\]

On 31 December 20X3, the foreign currency has appreciated further and the exchange rate is FC1 to LC2.50. The fair value of the bond is FC1,070 and thus the carrying amount is LC2,675 (= FC1,070 × 2.50). The amortised cost is FC1,086 (= LC2,715). The cumulative gain or loss to be accumulated in other comprehensive income is the difference between the fair value and the amortised cost on 31 December 20X3, i.e. negative LC40 (= LC2,675 – LC2,715). Thus, the amount recognised in other comprehensive income equals the change in the difference during 20X3 of LC78 (= LC60 + LC38).

Interest received on the bond on 31 December 20X3 is FC59 (= LC148). Interest revenue determined in accordance with the effective interest method is FC104 (= FC1,041 × 10%). The average exchange rate during the year is FC1 to LC2.25. For the purpose of this question, it is assumed that the use of the average exchange rate provides a reliable approximation of the spot rates applicable to the accrual of interest revenue during the year (see paragraph 22 of IAS 21). Thus, recognised interest revenue is LC234 (= FC104 × 2.25) including accretion of the initial discount of LC101 (= [FC104 – FC59] × 2.25). Accordingly, the exchange difference on the bond that is recognised in profit or loss is LC532 (= LC2,715 – LC2,082 – LC101). Also, there is an exchange gain on the interest receivable for the year of LC15 (= FC59 × [2.50 – 2.25]).
9.4. Impairment

This section deals with the new impairment model introduced by IFRS 9. This impairment model relies on an expected credit losses approach, as opposed to the IAS 39 incurred credit losses approach. Under IFRS 9, an entity does not wait for an incurred loss event to recognise an impairment allowance. Instead, it generally recognises an impairment allowance upon initial recognition to reflect the fact that it expects to experience credit losses in the future.

It is important to note that IFRS 9 was developed just after a financial crisis that occurred in 2008. One of the lessons learnt from this crisis was that the incurred loss model of IAS 39 often resulted in provisions that were “too little, too late”. This led the G20 Leaders and the Basel Committee on Banking Supervision to recommend that accounting standard setters consider modifying provisioning standards to incorporate forward looking assessments in the estimation of credit losses⁴. In response to this recommendation, the International Accounting Standards Board (IASB) developed a provisioning standard (IFRS 9 impairment requirements) that require the use of Expected Credit Loss (ECL) models rather than incurred loss models. IFRS 9 was finalised in July 2014.

In 2014, the IASB decided to create an Implementation Transition Group (ITG) that met three times between April and December 2015 to address implementation issues faced by preparers upon the first application of IFRS 9. The ITG provided a summary of their discussions that have been referred to the IASB. These discussions are not authoritative but can be considered as educational guidance. ITG conclusions will be mentioned in this section.

IFRS 9 relies to a large extent on the actual risk management practice of the entity. For regulated entities such as banks, this practice is significantly influenced by regulatory constraints. Therefore, even if IFRS 9 does not explicitly refer to them, its implementation often interacts significantly with other regulation guidance or requirements.

This section will first present the scope definition, followed by an overview of the three models proposed by IFRS 9 (general, simplified, POCI), each of which will then be further detailed and the core principles of these approaches....

Presentation and disclosure requirements specific to credit impairment losses are dealt with in chapter 16.

⁴ https://www.bis.org/bcbs/publ/d385.pdf
9.4.1. Scope definition

9.4.1.1. SPPI financial asset measured at Amortised Cost, or at Fair Value through Other Comprehensive Income

The requirements of the credit risk impairment calculation detailed in this section apply to all SPPI financial assets classified at Amortised Cost of Fair Value through Other Comprehensive Income. This may encompass various debt instruments irrespective of their legal form (e.g. debt securities, credits, loans, receivables, deposits, customer overdrafts, etc.) (IFRS 9.5.5.1).

Financial assets classified in the FV-PL category (Fair Value through Profit or Loss) are excluded from the scope of the impairment requirements of IFRS 9.

9.4.1.2. Loan commitments and financial guarantees

IFRS 9 impairment requirements apply to all financial guarantees and loan commitments, except those that are measured at Fair Value through Profit or Loss. Note that this even includes financial guarantees and loan commitments that are not in the classification scope of IFRS 9 (IFRS 9.2.1(g)).

ITG Discussions

Following its 22 April 2015 meeting, the ITG confirmed that commitments to extend credit are included in the impairment scope each time that:

> the agreement that contains the commitment complies with the definition of a financial instrument, and
> the agreement meets the definition of a loan commitment given by IFRS 9.BCZ.2.2: “a firm commitment to provide credit under pre-specified terms and conditions”.

9.4.1.3. Other contracts in the scope of IFRS 9 impairment requirements

Although specific requirements apply which are detailed in chapter 1, the impairment scope of IFRS 9 also includes:

— lease receivables recognised by a lessor (IFRS 9.2.1(b)(i)); and
— contract assets as defined by IFRS 15 (IFRS 9.5.5.15(a)).

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5 ITG 22 April 2015 Loan commitments - Scope (Agenda Paper 3).
9.4.2. IFRS 9 proposes three different impairment approaches

At each reporting date, an impairment is recorded for any financial instrument in the scope of IFRS 9 impairment requirements (please refer to section 9.4.6.1.3).

IFRS 9 defines three possible impairment models:
— the general approach that is applied by default (see section 9.4.3),
— the simplified approach, that is or may be applied subject to conditions (see section 9.4.4), and
— a third approach dedicated to Purchased or Originated Credit-Impaired (POCI) instruments (see section 9.4.5).

9.4.2.1. General approach

The general approach is the “by default” model that applies to financial instruments that neither qualify for the simplified approach nor for the definition of POCI.

This approach relies on a three-stage approach:
— Any instrument within the scope of the general approach is initially classified in Stage 1. Upon initial recognition, an impairment allowance is recognised for an amount equal to the 12-month expected credit losses (12MECL) (IFRS 9.5.5.5). 12MECL is the portion of lifetime expected credit losses that represents the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date (IFRS 9 Appendix A).
— Instruments are transferred to Stage 2 when a significant increase in credit risk has been identified since their initial recognition date (see section 9.4.3.2). In this case, the amount of credit impairment is equal to the expected credit loss that results from all possible default events over the expected life of the instrument (Lifetime Expected Credit Loss: LTECL) (IFRS 9.5.5.3).
Instruments are classified in Stage 3 when they become credit-impaired. Their impairment allowance continues to be recorded up to their LTECL but their interest revenue is determined by applying their effective interest rate to their amortised cost (i.e. net of impairment allowance) instead of to their gross carrying amount (IFRS 9.5.4.1(b)).

If the conditions for a Stage 2 or Stage 3 classification are no longer met, the entity transfers the instrument back to Stage 1 and recognises an impairment allowance equal to the 12MECL. (IFRS 9 5.5.7).

An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition (and must therefore stay in Stage 1) if the financial instrument is determined to have low credit risk at the reporting date (IFRS 9.5.5.10, please refer also to section 9.4.3.4.1).

Guidance for calculation of expected credit loss allowance is further developed in section 9.4.6.

### 9.4.2.2. Simplified approach

The simplified approach consists in always recognising an impairment allowance up to the LTECL of the instrument. This conservative shortcut allows the entity to avoid having to monitor the change in credit risk of the instrument since its initial recognition.

The simplified approach is:
- Mandatory for trade receivables or contract assets that do not contain a financing component in accordance with IFRS 15;
- Offered as an option for trade receivables or contract assets that contain a financing component in accordance with IFRS 15, receivables arising from operating lease contracts, and receivables arising from finance lease contracts (IFRS 9.5.5.15). Applying this option is an accounting policy choice that the entity may select separately for each of these four types of financial assets.

The simplified approach is further detailed in section 9.4.4.

### 9.4.2.3. Purchased or Originated Credit-Impaired (POCI)

IFRS 9 defines a specific approach for instruments acquired or originated with an incurred loss of credit. Such instruments are named “Purchased or Originated Credit Impaired” (POCI) instruments (IFRS 9.5.5.13).

Purchasing or originating a credit impaired instrument is generally not common. But this occurs in situations such as a distressed asset activity (acquired or originated), a purchase of portfolio of existing debt instruments, or in a business combination that includes the acquisition of already credit impaired portfolios. Some debt restructuring may also trigger the derecognition of an existing debt and the recognition of a new debt that may be considered as POCI.

POCI instruments are excluded from the general approach. Their interest revenues are recognised based on a credit adjusted effective interest rate, and only cumulative changes in lifetime expected credit losses since initial recognition are recognised as a loss allowance (IFRS 9.5.5.13).

This approach is further detailed in section 9.4.5.
9.4.3. General approach

9.4.3.1. Core principles

9.4.3.1.1. An impairment approach based on the IFRS 9 unit of account

The general approach was designed by the IASB to apply to each financial instrument, i.e. at a contract level (IFRS 9.5.5.1): “An entity shall recognise a Loss Allowance for ECL on a financial asset”.

9.4.3.1.2. Impairment relies on expected credit losses

Instead of recognising an impairment when an event of default occurs, IFRS 9 requires accounting for a loss allowance immediately on the financial asset’s initial recognition date. This loss allowance is called Expected Credit Loss and reflects (IFRS 9.5.5.17):
- an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- the time value of money; and
- reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

9.4.3.1.3. A three-stage approach

One of the core principles of the general impairment approach of IFRS 9 is the classification of financial assets in one of the three stages of the approach (“staging”). This classification drives the amount of impairment to be recognised.

Classification of a financial asset in one of the three stages is made on the basis of changes in its credit risk since its initial recognition date. This assessment is therefore not an absolute but a relative approach (see section 9.4.3.1.4).

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6 Note that for the purpose of impairment requirements, the initial recognition date of regular way transactions is always considered to be the trade date (IFRS 9.5.7.4)

7 Note that for the purpose of impairment requirements, the initial recognition date of regular way transactions is always considered to be the trade date (IFRS 9.5.7.4).
### Stage 1: Any instrument within the scope of the general approach is initially classified in Stage 1. Upon initial recognition, an impairment allowance is recognised for an amount equal to the 12-month expected credit losses (12MECL) (IFRS 9.5.5.5). 12MECL is the portion of lifetime expected credit losses that represents the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date (IFRS 9 Appendix A). Interest income is calculated based on the gross carrying amount. In other words, interest is calculated by applying the effective interest rate to the carrying amount of the asset, before any impairment allowance.

### Stage 2: Instruments are transferred to Stage 2 when a significant increase in credit risk (i.e. increase in probability of default) has been identified since their initial recognition date (see section 9.4.3.2). When assessing credit risk, an entity may use external ratings assigned by rating agencies and/or its own internal credit ratings (IFRS 9.B5.5.23). Collateral is not taken into account when assessing credit risk (IFRS 9.B5.5.22). For Stage 2 instruments, the amount of credit impairment equals the expected credit loss that results from all possible default events over the expected life of the instrument (Lifetime expected Credit Loss: LTECL) (IFRS 9.5.5.3). Interest income is calculated in the same way as for instruments in Stage 1.

### Stage 3: Instruments are classified in Stage 3 when they become credit-impaired. Their impairment allowance continues to be recorded up to their LTECL (as in Stage 2) but their interest revenue is determined by applying their effective interest rate to their amortised cost (i.e. net of impairment allowance) instead of their gross carrying amount (IFRS 9.5.4.1(b)).

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**Figure 9.2**

<table>
<thead>
<tr>
<th>Stage 1</th>
<th>Stage 2</th>
<th>Stage 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets whose credit risk has not increased significantly since their initial recognition</td>
<td>Assets whose credit risk has significantly increased since their initial recognition</td>
<td>Credit impaired</td>
</tr>
</tbody>
</table>

- **Level of the instrument’s credit risk deterioration since its initial recognition**
  - **Stage 1:** Financial assets whose credit risk has not increased significantly since their initial recognition.
  - **Stage 2:** Assets whose credit risk has significantly increased since their initial recognition.
  - **Stage 3:** Credit impaired.

- **Interest revenue calculation**
  - **Stage 1:** Interest revenue is calculated by applying the EIR (effective interest rate) to the asset’s gross carrying amount.
  - **Stage 2:** Interest revenue is calculated by applying the EIR to the asset’s carrying amount (net of impairment allowance).
  - **Stage 3:** Interest revenue is calculated by applying the EIR to the asset’s carrying amount (net of impairment allowance).

- **Impairment allowance calculation**
  - **Stage 1:** The impairment allowance is based on losses expected in 12 months (12M EL).
  - **Stage 2:** The impairment allowance is based on lifetime expected losses (LIFETIME EL).
  - **Stage 3:** When a significant increase in credit risk is identified, the instrument becomes credit impaired.

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An asset is defined as being **credit-impaired** when one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred (IFRS 9 Appendix A: credit-impaired).

Such events that may evidence a credit-impaired asset include:

- significant financial difficulty of the issuer or the borrower;
- a breach of contract, such as a default or past due event;
- the lender(s) of the borrower, for economic or contractual reasons relating to the borrower’s financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;
- it is becoming probable that the borrower will enter bankruptcy or another financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

Even if it is not possible to identify one single event, the combined effect of several events may have caused financial assets to become credit-impaired.

9.4.3.1.4. Staging is based on a relative credit risk approach

Instruments remain in Stage 1 from their origination date as long as a significant deterioration in their credit risk is not identified. This approach is a relative approach. Two similar instruments with exactly the same credit risk profile may be classified in different stages depending on their respective credit risk profile upon their acquisition (see instruments B and C in the figure below). The staging approach is not based on the absolute level of risk, but rather on the extent to which the risk profile has changed since its initial recognition. This relative approach requires to be able to follow the evolution of the credit quality over time.
Figure 9.3 Significant increase in credit risk: illustrative examples

Assumptions:
- A, B, C, D, E are loans
- t0: initial recognition date of a loan or a debt security
- t1: next reporting date

The credit risk of the loan E remains the same between t0 and t1.

When a financial asset is recognised following a drawdown on a loan commitment, the lender performs the SICR assessment considering the initial credit risk of the loan commitment from the date the entity became a party to the irrevocable commitment (IFRS 9.B5.5.47).

9.4.3.1.5. A symmetrical approach

The analysis of the change of the credit quality is symmetrical: when a significant increase in credit risk is identified, the asset is transferred from Stage 1 to Stage 2. If, later on, the asset credit quality improves in such a way that there is no longer any significant increase of the credit quality since its initial recognition, then the asset is transferred back to Stage 1 (IFRS 9.5.5.7).

IFRS 9.B5.5.27 specifies that a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed payments would not typically be erased by simply making one payment on time following a modification of the contractual term. Such period of time before effectively going back to Stage 1 is often called the probationary period.
9.4.3.2. Significant Increase in Credit Risk (SICR)

Identifying a Significant Increase in Credit Risk (SICR) on a financial asset will lead an entity to increase the asset impairment allowance from EL12M to LTEL. This may represent a significant jump in the impairment allowance. SICR is therefore a critical parameter of the IFRS 9 general impairment approach. Monitoring the credit quality of an instrument is therefore essential to a proper implementation of the IFRS 9 general impairment approach.

9.4.3.2.1. SICR is based on change in the risk of default occurring

An entity assesses whether a credit risk has increased significantly by comparing:

— the risk of a default occurring over the expected life of the financial instrument as at the reporting date; and
— the risk of a default occurring over the expected life of the financial instrument at its initial recognition date.

For the purposes of IFRS 9, an increase of credit risk is assessed on the basis of changes in the probability of default of the debtor since its initial recognition and over the estimated life of the contract. In practice this is performed based on change in the Lifetime probability of default (LT PD).

The SICR assessment must be performed by monitoring the change in the instrument’s probability of default rather than the change in the ECL amount (IFRS 9.B5.5.9). For example, if a collateralised debt asset has a significant increase in its probability of default, without a significant change to its ECL because the collateral is valuable enough to protect the lender against any loss, the entity will have to consider that a significant increase in credit risk occurred for the purpose of the staging process.

In order to assess these changes in the probability of default, an entity considers the characteristics of the financial instrument (or group of financial instruments) and the default patterns in the past for comparable financial instruments (IFRS 9.B5.5.13).

9.4.3.2.2. Factors or indicators of change in credit risk

Credit risk analysis is a “multifactor and holistic analysis” that will depend on the type of product, the characteristics of the financial instrument, the borrower risk profile as well as the geographical region of the transaction (IFRS 9.B5.5.16).

That is why the standard does not prescribe a specific methodology but rather requires entities to exercise their judgement in assessing the SICR according to facts and circumstances. For example, qualitative and non-statistical quantitative information available may sometimes be sufficient whilst in other cases it may be needed to consider information from statistical models or both types of information may be needed (IFRS 9.B5.5.18).

Several approaches are therefore possible as long as they comply with the following main principles (IFRS 9 B5.5.12):

— they allow to isolate the evolution of the probability of default from other factors of changes of the expected loss of credit (e.g. value of the collateral);
— they are based on the evolution of the probability of default since the financial instrument’s initial recognition date;
— they consider the expected maturity of the instrument;
— they are based on reasonable and supportable information (section 9.4.6.5, including forward-looking information – see section 9.4.7.2.2) obtained without undue costs or efforts and which may affect the credit risk of the instrument.

IFRS 9 provides a non-exhaustive list of information that may be relevant in the SICR assessment (IFRS 9. B5.5.17):

— significant changes in internal pricing indicators as a result of a change in the issuer’s credit risk since the inception of the instrument, including (but not limited to) an increase in the credit spread that would be applied if a similar loan with the same conditions and with the same counterparty was originated on the reporting date;
— other changes in the rates or terms of a financial instrument which would be materially different if the instrument had been created or issued at the balance sheet date (for example, more stringent covenants, to require more collateral or a higher income coverage) due to changes in the credit risk of the financial instrument since its initial recognition;
— significant changes in external credit risk market indicators (for an identical financial instrument or similar financial instruments with the same expected life). These changes in credit risk market indicators may include:
  > the credit spread,
  > CDS prices for the borrower,
  > the length of time or the extent of the decline in the fair value of the financial asset below its amortised cost,
  > other market information about the borrower, such as price changes in the borrower’s debt and equity instrument;
— a significant change, either occurred or expected, in the external credit rating of the financial instrument;
— an occurred or expected downgrade in the borrower’s internal credit rating. Internal financial ratings are more reliable when they can be corroborated by external ratings or default studies;
— actual or anticipated adverse changes in business, financial or economic conditions that could result in a material change in the borrower’s ability to meet its debt obligations, such as a known or expected increase in interest rates or a significant increase in expected or expected unemployment rates;
— a significant change, whether occurred or expected, in the borrower’s operating results, such as a decrease in sales or margins, increased operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity or management problems, or changes in the scope of the business or organisational structure of the business, that result in a significant change in the borrower’s ability to pay its debts;
— significant increases in credit risk on other financial instruments of the same borrower;
— a material adverse change (expected or occurred) in the regulatory, economic or technological environment of the borrower, which results in a significant change in the borrower’s ability to
honor his debts. For example, it can be a technological shift that has led to a decreasing demand for products sold by the borrower;

— significant changes in the value of collateral or in the quality of credit of guarantees or enhancements received by third parties, which may reduce the borrower’s economic motivation to make his contractual payments, or to influence the likelihood of failure. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages;

— a significant change in the quality of the guarantee provided by a shareholder (or by the parents of a borrower) if the shareholder has (or the parents) an incentive and financial ability to prevent default by capital or cash infusion;

— significant changes, such as a reduction in financial support from a parent or other affiliate, or a significant or expected change in the quality of credit enhancements, which may reduce the borrower’s economic incentive to make the scheduled contractual payments. Credit enhancement or financial support implies taking into account the financial condition of the guarantor and/or, in the case of interest in a securitisation, the possible ability of subordinate interests to absorb expected credit losses (for example, on the loans underlying the security);

— expected changes in the loan documentation, including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument;

— significant changes in the expected performance and behaviour of the borrower, including changes in the payment situation of the borrowers included in the group (for example, an increase in the number or amount expected of delayed contractual payments or significant increases in the expected number of credit card holders who are expected to approach or exceed their credit limit or who are expected to be paying the minimum;

— changes in the entity’s credit management approach dealing with the financial instrument, i.e. based on emerging indicators of changes in the credit risk of the financial instrument; this management practice is expected to become more active or to be focused on managing the instrument (more closely monitored or controlled) or the entity specifically intervening with the borrower;

— past due information.

The ITG members discussed how and to what extent behavioural measures of credit risk such as past due information could be taken into account in the SICR analysis.

**ITG Discussions**

Could some type of behavioural measures of credit risk (for example past due information) serve as a reasonable proxy for identifying SICR since initial recognition?

As a reminder, ITG members mentioned some principles among which the following principle: “a significant increase in credit risk is expected to occur prior to delinquency and consequently, when making this assessment, an entity is required to consider all reasonable and supportable information, including information that is forward-looking, that is available without undue cost and effort”.

When considering the use of behavioural indicators, it was noted that an entity:

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* ITG 16 September 2015: Issue N°2 of Significant increase in credit risk (Agenda Paper 1)
> focuses on identifying pre-delinquency behavioural indicators of increases in credit risk, for example increased utilisation rates or increased cash drawings on specific products;
> only uses indicators that are relevant to the risk of default occurring;
> establishes a link between the behavioural indicators of credit risk and changes in the risk of default occurring since initial recognition;
> are mindful that while behavioural indicators are often predictive of defaults in the short term, they are often less predictive of defaults in the longer term; and
> considers whether the use of behavioural indicators is appropriate for the type of product being assessed— for example, if a loan has only back-ended payments, behavioural indicators based on timeliness of payment will not be appropriate.

Some ITG members noted that when making the assessment of significant increases in credit risk, an entity considers the possibility of segmenting the portfolio into groups of financial instruments with shared credit characteristics in such a way that similar indicators of credit risk could be used to identify increases in credit risk for specific sub-portfolios.

9.4.3.2.3. The definition of “significant” is a relative definition

As seen previously in section 9.4.3.1.3, credit risk monitoring must be relative to its level at recognition date.

This principle implies that the determination of a significant increase in credit risk is going to be different for two financial instruments with different levels of credit risk at initial recognition. Thus, a given change in probability of default, in absolute terms, can be significant for a financial instrument with a low credit risk at initial recognition and not significant for another financial instrument with a higher credit risk at initial recognition. This implies also that, for two financial instruments with the same level of credit risk at a reporting date, one financial instrument can present a significant increase in credit risk whilst not the other: it will depend on their initial credit risk level (IFRS 9.B5.5.9).

The following example illustrates further this notion of “relative” (IFRS 9.IE12).

**Example 9.3: No significant increase in credit risk**

Company C is the holding company of a group that operates in a cyclical production industry. Bank B provided a loan to Company C. At that time, the prospects for the industry were positive, because of expectations of further increases in global demand. However, input prices were volatile and given the point in the cycle, a potential decrease in sales was anticipated.

In addition, in the past Company C had been focused on external growth, acquiring majority stakes in companies in related sectors. As a result, the group structure is complex and has been subject to change, making it difficult for investors to analyse the expected performance of the group and to forecast the cash that will be available at the holding company level. Even though leverage is at a level that is considered acceptable by Company C’s creditors at the time that Bank B originates the loan, its creditors are concerned about Company C’s ability to refinance its debt because of the short remaining life until the maturity of the current financing. There is also concern about Company C’s ability to continue to service interest using the dividends it receives from its operating subsidiaries.

At the time of the origination of the loan by Bank B, Company C’s leverage was in line with that of other customers with similar credit risk and based on projections over the expected life of the loan, the available capacity (i.e. headroom) on its coverage ratios before triggering a default event, was high. Bank B applies its own internal rating methods to determine credit risk and allocates a specific internal rating score to its
loans. Bank B’s internal rating categories are based on historical, current and forward-looking information and reflect the credit risk for the tenor of the loans. On initial recognition, Bank B determines that the loan is subject to considerable credit risk, has speculative elements and that the uncertainties affecting Company C, including the group’s uncertain prospects for cash generation, could lead to default. However, Bank B does not consider the loan to be originated credit-impaired because it does not meet the definition of a purchased or originated credit-impaired financial asset in Appendix A of IFRS 9.

Subsequent to initial recognition, Company C has announced that three of its five key subsidiaries had a significant reduction in sales volume because of deteriorated market conditions but sales volumes are expected to improve in line with the anticipated cycle for the industry in the following months. The sales of the other two subsidiaries were stable. Company C has also announced a corporate restructure to streamline its operating subsidiaries. This restructuring will increase the flexibility to refinance existing debt and the ability of the operating subsidiaries to pay dividends to Company C.

Despite the expected continuing deterioration in market conditions, Bank B determines that there has not been a significant increase in the credit risk on the loan to Company C since initial recognition. This is demonstrated by factors that include:

> (a) Although current sale volumes have fallen, this was as anticipated by Bank B at initial recognition. Furthermore, sales volumes are expected to improve, in the following months.

> (b) Given the increased flexibility to refinance the existing debt at the operating subsidiary level and the increased availability of dividends to Company C, Bank B views the corporate restructure as being credit enhancing. This is despite some continued concern about the ability to refinance the existing debt at the holding company level.

> (c) Bank B’s credit risk department, which monitors Company C, has determined that the latest developments are not significant enough to justify a change in its internal credit risk rating.

As a consequence, Bank B does not recognise a loss allowance at an amount equal to lifetime expected credit losses on the loan. However, it updates its measurement of the 12-month expected credit losses for the increased risk of a default occurring in the next 12 months and for current expectations of the credit losses that would arise if a default were to occur.

But the relative feature of this analysis was pushed one step further by IFRS 9: the determination of the SICR cannot be done only by comparing the change in the absolute risk of a default occurring over time (IFRS 9.B5.5.11). It means that, even if the probability of default remains the same, there may be an increase in credit risk. For example, if the risk of a default occurring for a financial instrument with an expected life of 10 years at initial recognition is identical to the risk of a default occurring on that financial instrument when its expected life in a subsequent period is only five years, that may indicate an increase in credit risk. This is because the risk of a default occurring over the expected life usually decreases as time passes if the credit risk is unchanged and the financial instrument is closer to maturity. However, for financial instruments that only have significant payment obligations close to the maturity of the financial instrument the risk of a default occurring may not necessarily decrease as time passes.

The SICR definition is both a highly sensitive parameter of any IFRS 9 impairment approach and a significant area of judgement. The SICR methodology must therefore be duly documented.

To help users of financial statements understand the approach retained, IFRS 7 requires specific disclosures on the definition of SICR (see chapter 16).
9.4.3.2.4. The 30 days past due rebuttable presumption

Behavioural indicators like past due status (delinquency) will rarely be the only indicator analysed if other reasonable and supportable forward-looking information on the borrower’s credit risk quality is available without undue cost and effort (IFRS 9.5.5.11).

However, IFRS 9.5.5.11 defines a presumption that the asset’s credit risk quality has decreased significantly if the past due status lasts for more than 30 days.

This presumption may be rebutted if the bank has reliable and justifiable information demonstrating that the credit quality has not deteriorated significantly despite this delinquency.

The main purpose of this presumption is to ensure that, in most situations, a significant degradation of credit quality will be identified and the related asset classified in Stage 2 before the default of the asset. Situations of “jumped to default” i.e. when an asset classified in Stage 1 goes straight to Stage 3 (without transiting by Stage 2) should remain exceptional.

9.4.3.2.5. SICR of a highly collateralised asset

As the SICR assessment is focused on the change in risk of default rather than on ECL, the existence or not of a collateral or a guarantee will generally not impact the assessment of the SICR.

This was confirmed by an IFRS 9 illustrative example presented hereafter (IFRS 9.IE18).

Example 9.4: Highly collateralised financial asset

Company H owns real estate assets which are financed by a five-year loan from Bank Z with a loan-to-value (LTV) ratio of 50 per cent. The loan is secured by a first-ranking security over the real estate assets. At initial recognition of the loan, Bank Z does not consider the loan to be originated credit-impaired as defined in Appendix A of IFRS 9.

Subsequent to initial recognition, the revenues and operating profits of Company H have decreased because of an economic recession. Furthermore, expected increases in regulations have the potential to further negatively affect revenue and operating profit. These negative effects on Company H’s operations could be significant and ongoing.

As a result of these recent events and expected adverse economic conditions, Company H’s free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could become tight. Bank Z estimates that a further deterioration in cash flows may result in Company H missing a contractual payment on the loan and becoming past due.

Recent third party appraisals have indicated a decrease in the value of the real estate properties, resulting in a current LTV ratio of 70 per cent.

At the reporting date, Bank Z needs to assess whether there has been a significant increase in credit risk since initial recognition, irrespective of the value of the collateral it holds. It notes that the loan is subject to considerable credit risk at the reporting date because even a slight deterioration in cash flows could result in Company H missing a contractual payment on the loan. As a result, Bank Z determines that the credit risk (i.e. the risk of a default occurring) has increased significantly since initial recognition. Consequently, Bank Z recognises lifetime expected credit losses on the loan to Company H.
Although lifetime expected credit losses must be recognised, the measurement of the expected credit losses will reflect the recovery expected from the collateral (adjusting for the costs of obtaining and selling the collateral) on the property as required by paragraph B5.5.55 of IFRS 9 and may result in the expected credit losses on the loan being very small.

9.4.3.2.6. Collective assessment of SICR

The IFRS 9 unit of account is the contract. This means that each financial asset is accounted for individually and distinctly. According to that, the preferred conceptual approach for the IFRS 9 impairment approach relies in the first place on an individual basis.

However, IFRS 9 acknowledges that it may be necessary to apply analysis on a collective basis especially when information relevant for the assessment of the SICR is available only on a portfolio level. This could be the case for example, by considering information on the credit risk situation of a portfolio of loans sharing a common characteristic (a geographical area, a line of business, etc.).

This collective assessment also ensures that all available information is included in the process even if the information is not yet available on an individual basis (i.e. it is not yet known which contract in the portfolio will be impacted). For example, if the only information available on an individual basis is the “past due” indicator, it is essential to complement this individual analysis with collective indicators to be able to monitor the evolution of the credit risk quality of the portfolio and not unduly delay the recognition of LTECL.

This collective approach applies to portfolios of instruments that share credit risk characteristics (e.g. type of collateral, generation, industry, geographical area, etc.). Each time that information on a dedicated sub-portfolio becomes available, it may be necessary to split this sub-portfolio in order to take it into account.

The following illustrative example of IFRS 9 illustrates further this SICR assessment on a portfolio basis (IFRS 9.IE29).

Example 9.5: Responsiveness to changes in credit risk

Bank ABC provides mortgages to finance residential real estate in three different regions. The mortgage loans are originated across a wide range of LTV criteria and a wide range of income groups. As part of the mortgage application process, customers are required to provide information such as the industry within which the customer is employed and the post code of the property that serves as collateral on the mortgage.

Bank ABC sets its acceptance criteria based on credit scores. Loans with a credit score above the ‘acceptance level’ are approved because these borrowers are considered to be able to meet contractual payment obligations. When new mortgage loans are originated, Bank ABC uses the credit score to determine the risk of a default occurring as at initial recognition.

At the reporting date Bank ABC determines that economic conditions are expected to deteriorate significantly in all regions. Unemployment levels are expected to increase while the value of residential property is expected to decrease, causing the LTV ratios to increase. As a result of the expected deterioration in economic conditions, Bank ABC expects default rates on the mortgage portfolio to increase.
Individual assessment

In Region One, Bank ABC assesses each of its mortgage loans on a monthly basis by means of an automated behavioural scoring process. Its scoring models are based on current and historical past due statuses, levels of customer indebtedness, LTV measures, customer behaviour on other financial instruments with Bank ABC, the loan size and the time since the origination of the loan. Bank ABC updates the LTV measures on a regular basis through an automated process that re-estimates property values using recent sales in each post code area and reasonable and supportable forward-looking information that is available without undue cost or effort.

Bank ABC has historical data that indicates a strong correlation between the value of residential property and the default rates for mortgages. That is, when the value of residential property declines, a customer has less economic incentive to make scheduled mortgage repayments, increasing the risk of a default occurring.

Through the impact of the LTV measure in the behavioural scoring model, an increased risk of a default occurring due to an expected decline in residential property value adjusts the behavioural scores. The behavioural score can be adjusted as a result of expected declines in property value even when the mortgage loan is a bullet loan with the most significant payment obligations at maturity (and beyond the next 12 months). Mortgages with a high LTV ratio are more sensitive to changes in the value of the residential property and Bank ABC is able to identify significant increases in credit risk since initial recognition on individual customers before a mortgage becomes past due if there has been a deterioration in the behavioural score.

When the increase in credit risk has been significant, a loss allowance at an amount equal to lifetime expected credit losses is recognised. Bank ABC measures the loss allowance by using the LTV measures to estimate the severity of the loss, i.e. the loss given default (LGD). The higher the LTV measure, the higher the expected credit losses all else being equal.

If Bank ABC was unable to update behavioural scores to reflect the expected declines in property prices, it would use reasonable and supportable information that is available without undue cost or effort to undertake a collective assessment to determine the loans on which there has been a significant increase in credit risk since initial recognition and recognise lifetime expected credit losses for those loans.

Collective assessment

In Regions Two and Three, Bank ABC does not have an automated scoring capability. Instead, for credit risk management purposes, Bank ABC tracks the risk of a default occurring by means of past due statuses. It recognises a loss allowance at an amount equal to lifetime expected credit losses for all loans that have a past due status of more than 30 days past due. Although Bank ABC uses past due status information as the only borrower-specific information, it also considers other reasonable and supportable forward-looking information that is available without undue cost or effort to assess whether lifetime expected credit losses must be recognised on loans that are not more than 30 days past due. This is necessary in order to meet the objective in paragraph 5.5.4 of IFRS 9 of recognising lifetime expected credit losses for all significant increases in credit risk.

Region Two

Region Two includes a mining community that is largely dependent on the export of coal and related products. Bank ABC becomes aware of a significant decline in coal exports and anticipates the closure of several coal mines. Because of the expected increase in the unemployment rate, the risk of a default occurring on mortgage loans to borrowers who are employed by the coal mines is determined to have increased significantly, even if those customers are not past due at the reporting date. Bank ABC therefore segments its mortgage portfolio by the industry within which customers are employed (using the information recorded as part of the mortgage application process) to identify customers that rely on coal mining as the dominant source of employment (i.e. a ‘bottom up’ approach in which loans are identified based on a common risk characteristic). For those mortgages, Bank ABC recognises a loss allowance at an amount equal to lifetime expected credit losses while it continues to recognise a loss allowance at an amount equal to 12-month expected credit losses for
all other mortgages in Region Two. Newly originated mortgages to borrowers who rely on the coal mines for employment in this community would, however, have a loss allowance at an amount equal to 12-month expected credit losses because they would not have experienced significant increases in credit risk since initial recognition. However, some of these mortgages may experience significant increases in credit risk soon after initial recognition because of the expected closure of the coal mines.

Region Three

In Region Three, Bank ABC anticipates the risk of a default occurring and thus an increase in credit risk, as a result of an expected increase in interest rates during the expected life of the mortgages. Historically, an increase in interest rates has been a lead indicator of future defaults on mortgages in Region Three—especially when customers do not have a fixed interest rate mortgage. Bank ABC determines that the variable interest-rate portfolio of mortgages in Region Three is homogenous and that unlike for Region Two, it is not possible to identify particular sub portfolios on the basis of shared risk characteristics that represent customers who are expected to have increased significantly in credit risk. However, as a result of the homogenous nature of the mortgages in Region Three, Bank ABC determines that an assessment can be made of a proportion of the overall portfolio that has significantly increased in credit risk since initial recognition (i.e. a ‘top down’ approach can be used). Based on historical information, Bank ABC estimates that an increase in interest rates of 200 basis points will cause a significant increase in credit risk on 20 per cent of the variable interest-rate portfolio. Therefore, as a result of the anticipated increase in interest rates, Bank ABC determines that the credit risk on 20 per cent of mortgages in Region Three has increased significantly since initial recognition. Accordingly, Bank ABC recognises lifetime expected credit losses on 20 per cent of the variable rate mortgage portfolio and a loss allowance at an amount equal to 12-month expected credit losses for the remainder of the portfolio.

9.4.3.2.7. Use of multi-scenarios for SICR assessment

This topic was discussed during an IASB Webcast in July 2016.

A multiple scenario approach can be a relevant means to identify a deterioration in the credit risk of an asset. If we consider the figure below, an entity that would focus on the most likely scenario only may come to the conclusion that the probability of default has not changed whereas a multi-scenario analysis would reveal that the situation has deteriorated.

**Figure 9.4**

<table>
<thead>
<tr>
<th></th>
<th>Upside</th>
<th>Most Likely</th>
<th>Downside</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probability of default in Year 0</td>
<td>10%</td>
<td>80%</td>
<td>10%</td>
</tr>
<tr>
<td>Probability of default in Year 1</td>
<td>10%</td>
<td>60%</td>
<td>30%</td>
</tr>
</tbody>
</table>

When performing a multi-scenario assessment, an entity may identify different scenarios leading to different SICR assessment outcomes. In such a case, if the scenarios are mutually exclusive (as it is generally the case), it is not possible to apply one scenario to part of an asset and another scenario to another part of the same asset. A single asset cannot be “split” between two different stages.

9 Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognised on those mortgages.

10 Except for those mortgages that are determined to have significantly increased in credit risk based on an individual assessment, such as those that are more than 30 days past due. Lifetime expected credit losses would also be recognised on those mortgages.

The question could be raised however in situations where the SICR assessment is performed collectively on a portfolio basis. Consider a situation where an entity estimates that there is an 85% probability that the portfolio assets remains in Stage 1, and a 15% probability that it be classified in Stage 2.

This situation was discussed at an ITG meeting and the ITG came to the conclusion that where the range of possible scenarios is mutually exclusive, they cannot be applied to part of a portfolio of assets. Therefore, in such a situation it would be inappropriate to put 15% of the portfolio in Stage 2 and keep the remaining 85% in Stage 1 as it represents a scenario probability rather than the proportion of the assets in the portfolio that have SICR.

Transferring assets representing 15% of the portfolio in Stage 2 would however be relevant if the entity is able to demonstrate that there are specific assets in the portfolio that share a specific risk profile that makes them react differently to a given economic scenario.

### 9.4.3.3. Default definition

#### 9.4.3.3.1. A definition that relies on a simple principle...

The definition of default is a key element of any IFRS 9 impairment approach as it both interacts with the SICR assessment and the ECL calculation methodology (see section 9.4.3.3).

However, rather than providing a positive definition of what is a defaulted asset, IFRS 9.B5.5.37 states that an entity “shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate”.

This definition applies consistently to all financial instruments unless information becomes available that demonstrates that another definition of the default is more relevant for a particular financial instrument.

IFRS 9 nevertheless defines a backstop to this principle that is further discussed in the next section.

#### 9.4.3.3.2. ... with a backstop: the rebuttable presumption of 90 days past due

IFRS 9.B5.5.37 states that if an amount has been past due for more than 90 days, the financial asset is presumed to be defaulted unless the entity has reasonable and supportable information to demonstrate otherwise.

If the presumption is rebutted, this must be properly documented. It is important and relevant to note that this topic is one of the areas of focus of banking regulators in their assessment of IFRS 9 implementation by banks.
9.4.3.4. Simplification options offered by IFRS 9

9.4.3.4.1. The "low credit risk" status

By simplification, an entity may assume that the credit risk on a financial asset has not increased significantly since initial recognition as long as the financial instrument is determined to have low credit risk at the reporting date (IFRS 9.5.5.10; IFRS 9.B5.5.22).

This low credit risk threshold is an absolute level of credit risk. It must be seen as an exception to the relative level approach that prevails in the general SICR assessment.

If an entity chooses to apply this simplification, no further analysis is required and the financial instrument is presumed not to be in a SICR situation. This simplification option can be applied instrument by instrument (IFRS 9.BC5.184).

The European Banking Authority considers that a high-quality application of the IFRS 9 impairment model by a bank would require not to apply this simplification to loans. This position is not an IFRS requirement. However, this probably explains why many European banks decided not to avail themselves of this option for their loan portfolios.

The figure below presents the consequences of the low credit risk simplification assuming that the entity elects to only apply it to debt securities.
Figure 9.5

Low Credit Risk | Credit Impaired
---|---

**Assumptions:**
- \( S, S' \) are debt securities
- \( A, B, C, D, E \) are loans

- The credit risk of the loan \( E \) remains the same between \( t_0 \) and \( t_1 \).

**Significant Increase in the Credit Risk (SICR)**
- The credit risk increase is not significant
- The assessment of the evolution of the credit risk since the initial recognition date of the asset is not performed

To be determined to have low credit risk and thus be eligible to this simplification option, a financial asset must meet the following cumulative conditions (IFRS 9.B5.5.22):

- it has a low risk of default;
- the borrower has a strong capacity to meet its contractual cash flow obligations in the near term; and
- this capacity may but will not necessarily be reduced by adverse changes in the longer-term economic and business conditions.

The low credit risk analysis is performed on the basis of the characteristics of the instrument. The instrument may not be considered as having a low credit risk solely because of the value of a collateral.

An instrument cannot be considered as having low credit risk simply because its credit risk is lower than other similar financial instruments in the local area within which an entity operates. (IFRS 9.B5.5.22).

To determine whether a financial asset has low credit risk an entity may rely on internal scoring methodologies. However, the threshold retained must be consistent with what is generally accepted as low credit risk. Therefore IFRS 9 quoted as an example the case of an asset with an external investment grade rating that may be considered a low credit risk instrument. This does not mean that the instrument must have external ratings to qualify as a low credit risk, but that it is necessary for it to present a risk profile such that a market player would be likely to assign it that status taking into account all the terms and conditions of the asset as well as relevant available information. (IFRS 9.B5.5.23).
If an instrument no longer qualifies for the low credit risk simplification, it must be treated like any other instrument in the general approach and a Significant Increase Credit Risk assessment must be performed. An instrument is not presumed to bear a SICR simply because it becomes ineligible to the low credit risk simplification (IFRS 9.B5.5.24).

Example 9.6: Public investment-grade bond (IFRS 9.IE24)

Company A is a large listed national logistics company. The only debt in the capital structure is a five-year public bond with a restriction on further borrowing as the only bond covenant. Company A reports quarterly to its shareholders. Entity B is one of many investors in the bond. Entity B considers the bond to have low credit risk at initial recognition. This is because the bond has a low risk of default and Company A is considered to have a strong capacity to meet its obligations in the near term. Entity B’s expectations for the longer term are that adverse changes in economic and business conditions may, but will not necessarily, reduce Company A’s ability to fulfil its obligations on the bond. In addition, at initial recognition the bond had an internal credit rating that is correlated to a global external credit rating of investment grade.

At the reporting date, Entity B’s main credit risk concern is the continuing pressure on the total volume of sales that has caused Company A’s operating cash flows to decrease.

Because Entity B relies only on quarterly public information and does not have access to private credit risk information (because it is a bond investor), its assessment of changes in credit risk is tied to public announcements and information, including updates on credit perspectives in press releases from rating agencies.

Entity B applies the low credit risk simplification. Accordingly, at the reporting date, Entity B evaluates whether the bond is considered to have low credit risk using all reasonable and supportable information that is available without undue cost or effort. In making that evaluation, Entity B reassesses the internal credit rating of the bond and concludes that the bond is no longer equivalent to an investment grade rating because:

- The latest quarterly report of Company A revealed a quarter-on-quarter decline in revenues of 20 per cent and in operating profit by 12 per cent.
- Rating agencies have reacted negatively to a profit warning by Company A and put the credit rating under review for possible downgrade from investment grade to non-investment grade. However, at the reporting date the external credit risk rating was unchanged.
- The bond price has also declined significantly, which has resulted in a higher yield to maturity. Entity B assesses that the bond prices have been declining as a result of increases in Company A’s credit risk. This is because the market environment has not changed (for example, benchmark interest rates, liquidity, etc. are unchanged) and comparison with the bond prices of peers shows that the reductions are probably company specific (instead of being, for example, changes in benchmark interest rates that are not indicative of company-specific credit risk).

While Company A currently has the capacity to meet its commitments, the large uncertainties arising from its exposure to adverse business and economic conditions have increased the risk of a default occurring on the bond. As a result of the factors described above, Entity B determines that the bond does not have low credit risk at the reporting date. As a result, Entity B needs to determine whether the increase in credit risk since initial recognition has been significant. On the basis of its assessment, Company B determines that the credit risk has increased significantly since initial recognition and that a loss allowance at an amount equal to lifetime expected credit losses should be recognised in accordance with IFRS 9.5.5.3.
9.4.3.4.2. SICR assessment: the 12M PD can be retained as an approximation of the LT PD

An entity may use the changes in the risk of a default occurring in the next 12 months as a reasonable proxy of change in the lifetime probability of default in the context of the SICR assessment. However, this approximation is subject to the following cumulative conditions (IFRS 9.B5.5.13):

— based on its experience for comparable financial instruments, the entity is able to demonstrate that default patterns are not concentrated at a specific point during the expected life of the financial instrument; and

— there are no identified circumstances that indicate that the use of a lifetime assessment is necessary.

— IFRS 9 further specifies that the use of the probability of default at 12 months as a proxy for the probability of default over the estimated residual life of the instrument is not appropriate when, for example:

— the financial instrument only has significant payment deadlines beyond the next 12 months (e.g., in fine);

— changes in macroeconomic factors (or other relevant credit-related factors) are not adequately reflected in the risk of failure for the next 12 months;

— changes in credit-related factors only have an impact (or a more pronounced effect) on the credit risk of the financial instrument beyond the next 12 months.

Considering the operational difficulties that may occur when assessing the probability of default over the expected life of an instrument for the SICR assessment, this simplification is often considered by financial institutions. This simplification is in practice all the more relevant as the bank will be able to leverage on available regulatory data that generally have a 12-month horizon.

ITG Discussions

ITG members noted that they would expect an entity to complete a robust analysis up front to support the conclusion that changes in the 12-month risk of a default occurring is a reasonable approximation for the assessment of changes in the lifetime risk of default occurring.

The level of initial analysis required would normally depend on the specific type of financial instrument being considered. Consequently, in some cases, a qualitative analysis could be enough whereas in less clear-cut cases, a quantitative analysis may be necessary.

The ITG members also noted that it may be appropriate to segregate portfolios (for example by maturity) to facilitate the analysis for groups of similar financial instruments.

12 ITG 16 September 2015: Use of changes in the risk of a default occurring over the next 12 months when assessing significant increases in credit risk (Agenda Paper 2)
9.4.3.5. Operational implementations

9.4.3.5.1. Assessment at counterparty level

The unit of account of IFRS 9 being the individual contract, the monitoring of credit quality is preferably carried out instrument by instrument rather than by counterparty. However, IFRS 9 does not prohibit the assessment of SICR at a counterparty level as long as it can be demonstrated that it leads to the same conclusion as an instrument by instrument assessment.

Example 9.7: Counterparty assessment of credit risk (IFRS 9.IE43)

Scenario 1

In 20X0 Bank A granted a loan of CU10,000 with a contractual term of 15 years to Company Q when the company had an internal credit risk rating of 4 on a scale of 1 (lowest credit risk) to 10 (highest credit risk). The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. In 20X5, when Company Q had an internal credit risk rating of 6, Bank A issued another loan to Company Q for CU5,000 with a contractual term of 10 years. In 20X7 Company Q fails to retain its contract with a major customer and correspondingly experiences a large decline in its revenue. Bank A considers that as a result of losing the contract, Company Q will have a significantly reduced ability to meet its loan obligations and changes its internal credit risk rating to 8.

Bank A assesses credit risk on a counterparty level for credit risk management purposes and determines that the increase in Company Q’s credit risk is significant. Although Bank A did not perform an individual assessment of changes in the credit risk on each loan since its initial recognition, assessing the credit risk on a counterparty level and recognising lifetime expected credit losses on all loans granted to Company Q, meets the objective of the impairment requirements of IFRS 9. This is because, even since the most recent loan was originated (in 20X7) when Company Q had the highest credit risk at loan origination, its credit risk has increased significantly. The counterparty assessment would therefore achieve the same result as assessing the change in credit risk for each loan individually.

Scenario 2

Bank A granted a loan of CU150,000 with a contractual term of 20 years to Company X in 20X0 when the company had an internal credit risk rating of 4. During 20X5 economic conditions deteriorate and demand for Company X’s products has declined significantly. As a result of the reduced cash flows from lower sales, Company X could not make full payment of its loan instalment to Bank A. Bank A re-assesses Company X’s internal credit risk rating, and determines it to be 7 at the reporting date. Bank A considered the change in credit risk on the loan, including considering the change in the internal credit risk rating, and determines that there has been a significant increase in credit risk and recognises lifetime expected credit losses on the loan of CU150,000.

Despite the recent downgrade of the internal credit risk rating, Bank A grants another loan of CU50,000 to Company X in 20X6 with a contractual term of 5 years, taking into consideration the higher credit risk at that date.

The fact that Company X’s credit risk (assessed on a counterparty basis) has previously been assessed to have increased significantly, does not result in lifetime expected credit losses being recognised on the new loan. This is because the credit risk on the new loan has not increased significantly since the loan was initially recognised. If Bank A only assessed credit risk on a counterparty level, without considering whether the conclusion about changes in credit risk applies to all individual financial instruments provided to the same customer, the objective of the SICR assessment would not be met.
Most financial institutions have been monitoring their credit risk exposure on a counterparty basis rather than on an instrument by instrument basis. The shortcut presented above therefore undeniably has significant operational merits. However, it should be used with caution, and documentation must be properly established to demonstrate that this approximation leads to outcomes similar to those of the IFRS 9 impairment requirements.

9.4.3.5.2. SICR: operational simplification to the relative assessment

One of the most complex operational issues in the implementation of IFRS 9 is to manage the relative feature of the SICR assessment. In fact, most financial institutions monitor their credit exposures on the basis of their absolute credit risk level. Therefore, the initial credit risk of a given contract is rarely stored in the IT systems so that a relative approach is operationally difficult to implement.

IFRS 9 does not prevent entities from using shortcuts in this regard. But they will have to demonstrate that the operational shortcut provides outcomes that are consistent with the IFRS 9 general impairment approach (e.g. recognising a LTECL for any instrument that has a SICR).

One of the commonly considered shortcuts is to leverage on the internal origination credit risk policy of the entity to demonstrate that, initially, loans that share specific characteristics also share a common initial credit risk. If this can be demonstrated, the SICR relative assessment may be approximated through an absolute threshold approach.

IFRS 9 provides an illustrative example to illustrate the benefits and the limits of such an approach (IFRS 9.IE40):

**Example 9.8: Comparison to maximum initial credit risk (IFRS 9.IE40)**

Bank A has two portfolios of automobile loans with similar terms and conditions in Region W. Bank A’s policy on financing decisions for each loan is based on an internal credit rating system that considers a customer’s credit history, payment behaviour on other products with Bank A and other factors, and assigns an internal credit risk rating from 1 (lowest credit risk) to 10 (highest credit risk) to each loan on origination. The risk of a default occurring increases exponentially as the credit risk rating deteriorates so, for example, the difference between credit risk rating grades 1 and 2 is smaller than the difference between credit risk rating grades 2 and 3. Loans in Portfolio 1 were only offered to existing customers with a similar internal credit risk rating and at initial recognition all loans were rated 3 or 4 on the internal rating scale. Bank A determines that the maximum initial credit risk rating at initial recognition it would accept for Portfolio 1 is an internal rating of 4. Loans in Portfolio 2 were offered to customers that responded to an advertisement for automobile loans and the internal credit risk ratings of these customers range between 4 and 7 on the internal rating scale. Bank A never originates an automobile loan with an internal credit risk rating worse than 7 (i.e. with an internal rating of 8–10).

For the purposes of assessing whether there have been significant increases in credit risk, Bank A determines that all loans in Portfolio 1 had a similar initial credit risk. It determines that given the risk of default reflected in its internal risk rating grades, a change in internal rating from 3 to 4 would not represent a significant increase in credit risk but that there has been a significant increase in credit risk on any loan in this portfolio that has an internal rating worse than 5. This means that Bank A does not have to know the initial credit rating of each loan in the portfolio to assess the change in credit risk since initial recognition. It only has to determine whether the credit risk is worse than 5 at the reporting date to determine whether lifetime expected credit losses must be recognised.
However, determining the maximum initial credit risk accepted at initial recognition for Portfolio 2 at an internal credit risk rating of 7, would not meet the objective of IFRS 9 requirements. This is because Bank A determines that significant increases in credit risk arise not only when credit risk increases above the level at which an entity would originate new financial assets (i.e. when the internal rating is worse than 7). Although Bank A never originates an automobile loan with an internal credit rating worse than 7, the initial credit risk on loans in Portfolio 2 is not of sufficiently similar credit risk at initial recognition to apply the approach used for Portfolio 1. This means that Bank A cannot simply compare the credit risk at the reporting date with the lowest credit quality at initial recognition (for example, by comparing the internal credit risk rating of loans in Portfolio 2 with an internal credit risk rating of 7) to determine whether credit risk has increased significantly because the initial credit quality of loans in the portfolio is too diverse. For example, if a loan initially had a credit risk rating of 4 the credit risk on the loan may have increased significantly if its internal credit risk rating changes to 6.

This illustrative example thus explicitly acknowledges that, under certain circumstances, an absolute approach may provide similar outcomes than a relative approach. However, it is important to stress two key elements in the assessment of the portfolio A methodology:

— only loans with an initial credit grade of 3 or 4 were considered, so that their initial credit risk can be considered as homogeneous; and
— the entity demonstrated that a movement from grade 3 to grade 4 did not represent a significant increase in credit risk whereas a movement from grade 4 to grade 5 would.

Please note that the ITG also further discussed on this topic during its September 2015 meeting.

**9.4.4. Simplified approach: scope and requirements**

To facilitate the implementation of the impairment requirements of IFRS 9, the Board has proposed a simplified approach that, although simplified, is nevertheless based on the expected credit loss model. This simplified approach is either, required for some instruments, or offered as an option for others. We will first present the principles applicable to the simplified approach and then present its scope requirements and options.

**9.4.4.1. Principles of the simplified approach**

The simplified approach consists simply in calculating the impairment allowance of a financial asset, at any time, on the basis of its LTECL (IFRS 9.5.5.15b). Requirements for LTECL calculations are identical for both the general and the simplified approach.

The main benefit of this simplified approach is therefore that the entity does not have to monitor the change in credit risk of each asset from its initial recognition date. The staging process and its SICR threshold do not apply in the simplified approach. Disclosure requirements are also simplified.

At first glance, this simplified approach may seem rather conservative as it will likely lead to the recognition of a greater amount of impairment than what would have been obtained by applying the general approach. In fact, under the simplified approach any asset will bear a LTECL impairment allowance upon initial recognition whereas the same asset under the general approach would have been classified in Stage 1 and impairment calculated only up to its 12MECL.
However, we will see in the next sections that the simplified approach is required only for relatively short-term instruments (e.g. less than 12 month) for which the difference between LTECL and 12MECL is not expected to be significant. It is also offered as an option for instruments that may present a longer maturity.

9.4.4.2. Scope of the simplified approach

The simplified approach is required for trade receivables and contract assets that:

— result from transactions that are within the scope of IFRS 15 - Revenue from contracts with customers; and
— do not contain a significant financing component in accordance with IFRS 15.

The simplified approach is offered as an accounting policy choice for:

— trade receivables arising from transactions that are within the scope of IFRS 15 and that contain a significant financing component in accordance with IFRS 15;
— contract assets arising from transactions that are within the scope of IFRS 15 and that contain a significant financing component in accordance with IFRS 15;
— operating lease receivables in the scope of IFRS 16 - Leases; and
— finance lease receivables in the scope of IFRS 16.

An entity will therefore potentially have four separate and independent accounting policy choices to perform. However, the accounting policy choice must be applied consistently to all financial assets that belong to the same above-mentioned category.

The figure below provides an overview of the scope of the simplified approach.
9.4.5. Purchased or Originated Credit Impaired assets (POCI)

9.4.5.1. When will an asset be considered as a POCI?

A Purchased or Originated Credit Impaired asset (POCI) is an asset that is already credit impaired at its initial recognition date whether it is originated or purchased (IFRS 9 Appendix A). A financial asset is credit impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred (see section 9.4.2.3).

Purchasing or originating a credit impaired instrument is generally not common. But this occurs in situations such as a distressed asset activity (acquired or originated), a purchase of a portfolio of existing debt instruments, or in a business combination that includes the acquisition of already credit impaired portfolios. Some debt restructuring may also trigger the derecognition of an existing debt and the recognition of a new debt that may be considered as POCI.

It is important to stress the fact that an asset may be considered as risky without necessarily meeting the definition of credit-impaired.

An asset acquired with a significant discount does not systematically bear credit losses. The significant discount can be caused by various other factors than credit risk, such as a bond paying a high fixed rate coupon in a decreasing interest rate environment (IFRS 9.B5.4.7).
9.4.5.2. Accounting for POCI instruments

The POCI accounting treatment is totally different from both the general and the simplified approaches for three main reasons:

— the amortised cost of POCI instruments is determined on the basis of a credit adjusted EIR (IFRS 9. B5.4.7);
— no impairment allowance is recognised upon initial recognition of the POCI instrument, only the cumulative change in the LTEL since initial recognition will be recognised as a loss allowance; and
— POCI are not subject to staging.

When calculating a credit-adjusted effective interest rate (CA EIR), an entity should consider all the contractual terms of the financial asset together with all expected credit losses (IFRS 9 Appendix A). This means that an entity must include the initially expected cash shortfall over the life of the contract in the cash flows used to calculate the CA EIR at its initial recognition (IFRS 9.B5.4.7 and IFRS 9.5.5.13).

**Example 9.9: Calculation of a credit-impaired EIR**

On 01/01/20X1, entity A buys a POCI asset for CU40. Its nominal is CU100 and its annual contractual interest rate is 5%.

The expected cash flows, taking into account the expected credit losses, are as presented hereunder:

<table>
<thead>
<tr>
<th></th>
<th>01/01/20X1</th>
<th>31/12/20X1</th>
<th>31/12/20X2</th>
<th>31/12/20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractual cash flows</td>
<td>(1)</td>
<td>-40</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Expected cash flows</td>
<td>(2)</td>
<td>5</td>
<td>5</td>
<td>45</td>
</tr>
<tr>
<td>Credit loss expected at maturity date</td>
<td>(1) - (2)</td>
<td>0</td>
<td>0</td>
<td>60</td>
</tr>
</tbody>
</table>

In the case of a non-POCI asset, the calculation of the initial EIR would have relied on the contractual cash flows.

Here, in the case of a POCI asset, the calculation of the initial credit-adjusted EIR (or CA-EIR) relies on the expected cash flows considering the expected credit losses.

\[ 40 = 5 \times (1+\text{CAEIR})^{-1} + 5 \times (1+\text{CAEIR})^{-2} + 45 \times (1+\text{CAEIR})^{-3} \]

Credit Adjusted EIR = 12.5%

As required by IFRS 9.5.5.13, an entity only recognises as loss allowance the cumulative changes in LTECL since initial recognition. Moreover, this LTECL is discounted with the credit-adjusted EIR (IFRS 9.B5.5.45). Any change in the loss allowance, either positive or negative, will impact the profit or loss of the period similarly to any change in impairment allowance.
Example 9.10: Accounting treatments depending on the evolution of the LTECL for a POCI asset

Proceeding with the example 9.9, we will consider several scenarios:

Scenario 1: the expected cash flows remain unchanged over the life of the POCI asset

In such a case, the gross carrying amount and the amortised cost of this POCI asset are the same. This is because the amortised cost relies on the expected cash flows that encompass the initially expected credit losses.

If the expected cash flows remain unchanged at each reporting date (because the expected cash flows include contractual interests):

<table>
<thead>
<tr>
<th>Date</th>
<th>Contractual cash flows</th>
<th>Expected cash flows</th>
<th>Credit loss expected at maturity date</th>
<th>Credit-Adjusted EIR</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/20X1</td>
<td>(1) -40</td>
<td>5</td>
<td>0</td>
<td>12,5%</td>
</tr>
<tr>
<td>31/12/20X1</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>12,5%</td>
</tr>
<tr>
<td>31/12/20X2</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>12,5%</td>
</tr>
<tr>
<td>31/12/20X3</td>
<td>5</td>
<td>45</td>
<td>60</td>
<td>12,5%</td>
</tr>
</tbody>
</table>

The figure below details the amortised cost:

<table>
<thead>
<tr>
<th>Date</th>
<th>Gross carrying amount = Amortised Cost</th>
<th>Interests CA EIR = 12.50%</th>
<th>Received cash flows = expected cash flows</th>
<th>Gross carrying amount End of period</th>
<th>Loss Allowance</th>
<th>Impact generated by the passage of time</th>
<th>Loss Allowance End of period</th>
<th>Amortised Cost end of period</th>
</tr>
</thead>
<tbody>
<tr>
<td>31/12/20X1</td>
<td>40</td>
<td>5</td>
<td>-5</td>
<td>40</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>40.0</td>
</tr>
<tr>
<td>31/12/20X2</td>
<td>40</td>
<td>5</td>
<td>-5</td>
<td>40</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>40.0</td>
</tr>
<tr>
<td>31/12/20X3</td>
<td>40</td>
<td>5</td>
<td>-45</td>
<td>0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date</th>
<th>Cash</th>
<th>POCI carrying amount = Amortised Cost</th>
<th>Loss Allowance</th>
<th>P&amp;L</th>
<th>P&amp;L Impairment gain or loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20X1</td>
<td>40</td>
<td>40</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31/12/20X1</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>31/12/20X2</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>31/12/20X3</td>
<td>45</td>
<td>45</td>
<td></td>
<td>5</td>
<td></td>
</tr>
<tr>
<td>55</td>
<td>40</td>
<td>55</td>
<td>0</td>
<td>0</td>
<td>15</td>
</tr>
</tbody>
</table>
**Scenario 2:** As of 31/12/20X2, the expected cash flows have decreased

The credit risk has increased meaning that the expected cash flows at maturity have fallen to CU35.

As of 31/12/20X2 reporting, the expected cash flows are revised as follows (credit-risk increasing):

<table>
<thead>
<tr>
<th>Contractual cash flows</th>
<th>01/01/20X1</th>
<th>31/12/20X1</th>
<th>31/12/20X2</th>
<th>31/12/20X3</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5</td>
<td>5</td>
<td>105</td>
<td></td>
</tr>
<tr>
<td>Expected cash flows</td>
<td>(2)</td>
<td>5</td>
<td>5</td>
<td>35</td>
</tr>
<tr>
<td>Credit loss expected at maturity date</td>
<td>(1) - (2)</td>
<td>0</td>
<td>0</td>
<td>70</td>
</tr>
<tr>
<td>Credit-Adjusted EIR</td>
<td>12.5%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss Allowance</td>
<td></td>
<td>8.9</td>
<td>10</td>
<td></td>
</tr>
</tbody>
</table>

Please note that the changes with the previous scenario are highlighted in **blue**.

The figure below details the amortised cost:

<table>
<thead>
<tr>
<th>Gross carrying amount = Amortised Cost</th>
<th>Interests CA EIR = 12.50%</th>
<th>Received cash flows = expected cash flows</th>
<th>Gross carrying amount End of period</th>
<th>Loss Allowance</th>
<th>Impact generated by the passage of time</th>
<th>Loss Allowance End of period</th>
<th>Amortised Cost end of period</th>
</tr>
</thead>
<tbody>
<tr>
<td>31/12/20X1</td>
<td>40</td>
<td>5</td>
<td>-5</td>
<td>40</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>31/12/20X2</td>
<td>40</td>
<td>5</td>
<td>-5</td>
<td>40</td>
<td>-8.9</td>
<td>0.0</td>
<td>-8.9</td>
</tr>
<tr>
<td>31/12/20X3</td>
<td>40</td>
<td>5</td>
<td>-35</td>
<td>10</td>
<td>-8.9</td>
<td>-1.1</td>
<td>-10.0</td>
</tr>
</tbody>
</table>

As of 31/12/20X2, a Loss Allowance of (CU8.9) is recognised. This corresponds to the decrease of the expected cashflows in year 20X3 (CU10 missing compared to the initial expected cashflows of CU45) discounted at the Credit Adjusted EIR.

In year 20X3, the expected losses are unchanged but the loss allowance discounting effect is reversed (i.e. the loss allowance is capitalised) generating an impact by the passage of time that increases the Loss Allowance (1.1 = 8.9 * 12.50%).
**Scenario 3**: As of 31/12/20X2, the expected cash flows have increased.

As of 31/12/20X2 reporting, the expected cash flows are revised as follows (credit-risk decreasing):

<table>
<thead>
<tr>
<th>Date</th>
<th>Contractual cash flows</th>
<th>Expected cash flows</th>
<th>Credit loss expected at maturity date</th>
<th>Credit-Adjusted EIR</th>
<th>New gross carrying amount as at 31/12/20X2</th>
</tr>
</thead>
<tbody>
<tr>
<td>01/01/20X1</td>
<td>(1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31/12/20X1</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>0</td>
<td>55</td>
</tr>
<tr>
<td>31/12/20X2</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>0</td>
<td>55</td>
</tr>
<tr>
<td>31/12/20X3</td>
<td>5</td>
<td>5</td>
<td>0</td>
<td>0</td>
<td>55</td>
</tr>
</tbody>
</table>

Please note that the changes with the previous scenario are highlighted in blue.
In the third scenario of example 9.10, when the LTECL decreases under its initial level (i.e. CU10 in the above example), we have presented the positive change in expected cash flows as a “negative” loss allowance. This accounting entry is in line with IFRS 9.5.5.14.

Another possible approach would be to adjust the gross carrying amount of the POCI asset. In fact, the LTECL used to determine the initial credit-adjusted EIR has been re-estimated. This change in estimates could be reflected as an adjustment to the gross carrying amount in accordance with IFRS 9.B5.4.6.

9.4.6. Measurement of ECL

9.4.6.1. Definitions and main principles

9.4.6.1.1. Definitions of Credit losses and Expected credit losses

Credit loss is defined as the present value of the difference between (i) the amount of contractual cash flows owed to an entity and (ii) the amount of cash flows that the entity expects to receive. This difference is discounted at the original effective interest rate of the instrument to obtain its present value (IFRS 9 Appendix A).

The cash flows that the entity expects to collect include the cash flows from the sale of collateral or other credit enhancements (example: sureties) that are integral to the contract.
To the extent that the definition of credit losses is sensitive both to default and payment dates (through the discount factor), an expected delay in payment will be included in the calculation of credit losses (IFRS 9 B5.5.28).

IFRS 9 impairment requirements are mainly principle-based. IFRS 9 is therefore not prescriptive in calculation methodology to be retained to determine a credit loss.

The Expected credit losses of an asset (ECL) are the average of the credit losses weighted by their probability of occurrence (IFRS 9 Appendix A).

The definition of ECL can be illustrated as shown in the figure below:

Figure 9.7

\[ ECL_t = \left( \frac{\text{Contractual cash flows} - \text{Expected cash flows}}{\text{Discount at EIR}} \right) \times \]

Weighted by probabilities and taking into account macroeconomic forecasts

9.4.6.1.2. Main principles

Expected Credit Losses are calculated in accordance with the following principles (IFRS 9.5.5.17):

— ECL is an unbiased amount determined on the basis of probability-weighted possible scenarios;
— ECL reflects the time value of money;
— ECL reflects reasonable and supportable information on past events, current circumstances and forecasts of future economic conditions (this last part is known as “forward looking information” and is further discussed in section 9.4.7), that is available, at the closing date, without having to incur undue cost or effort.

In the process of ECL calculation, an entity will have to use judgement based on relevant facts and circumstances. This judgement may have to be applied at several steps of the ECL calculation (probability of default, estimated recovery, information to take into account and its impact on the calculation...). It is important to keep in mind that all judgements and assumptions made in this ECL calculation process, taken as whole, must be internally consistent. Moreover, assumptions made, especially with regards to the general economic environment, must also be consistent with assumptions made by the entity in the general context of preparing its financial statements.

9.4.6.1.3. ECL is determined at each reporting date

The ECL calculation is required at each reporting date following the initial recognition of the financial instrument, up to its derecognition.
ITG Discussions

As regards the requirement to re-measure expected credit losses at the date of derecognition of a financial asset, it was highlighted that:

> IFRS 9.3.2.12 requires that expected credit losses must be re-measured at the date of derecognition in order to calculate the derecognition gain or loss; and
> IAS 1.82(aa) et (ba) require that separate line items must be presented for gains and losses arising from derecognition and impairment losses and reversals.

Consequently, ITG members noted that there was a requirement to re-measure expected credit losses at the date of derecognition of a financial asset (including on a derecognition arising as a result of a modification). However, it was highlighted that, as with the requirements of any IFRS, considerations of materiality in accordance with IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors would need to be taken into account.

9.4.6.1.4. A multi-scenario approach

Expected credit losses of an asset, ECL, are the average of the credit losses weighted by their probability of occurrence. This definition implies that it is necessary to use several scenarios. However, an entity need not necessarily identify all possible scenarios (IFRS 9.5.5.18).

The purpose of estimating ECL is neither to estimate a worst-case scenario nor a best-case scenario. Instead, ECL must always reflect both the possibility that a credit loss occurs and the possibility that no credit loss occurs even if this last possibility is very low (IFRS 9.B5.5.41).

In practice, it is not necessarily a complex analysis. In some cases, it may be enough to use a relatively simple model, which does not require a simulation based on a great number of scenarios.

For example, the average ECL of a large portfolio of financial instruments with similar risk characteristics may be a reasonable estimate of the weighted average of ECL. In other cases, it will probably be necessary to establish scenarios that imply to detail the amounts and timing of expected cash flows, as well as the probability of occurrence of each scenario. In this case, it is necessary to use a minimum of two scenarios (default and no default) (IFRS 9.5.5.18 et B5.5.42).

9.4.6.1.5. Contractual life vs. expected life

Maturity is an important parameter to consider when calculating ECL. IFRS 9 defines Lifetime ECL as the “expected credit losses that result from all possible default events over the expected life of a financial instrument.”

This implies therefore that the expected life used for the ECL calculation must take into account every specific contractual term such as, for example, a prepayment option or an extension option. This is confirmed by IFRS 9.B5.5.51 which clearly requires the inclusion of expected prepayments.

The maximum period to consider when measuring expected credit losses is the maximum contractual period (including any extension option) over which the entity is exposed to credit risk. It cannot be a longer period, even if that longer period is consistent with business practice (IFRS 9.5.5.19). As a result, if an entity

ITG 22 April 2015: Expected Credit Losses – Measurement Date (Agenda Paper 7).
is in practice exposed over a longer period than the contractual period, this will not be considered in the ECL calculation. However, please note that revolving instruments may have to apply different principles (see section 9.4.6.7).

To achieve this analysis, the ITG considered that one must consider only the option at the hand of the borrower as identified in the ITG discussions reported here after.

**ITG Discussions**

The question submitted to the ITG members on IFRS 9.5.5.19 requirements was about a portfolio composed of mortgage loans with the following features:

- the loans have a stated maturity of 6 months but contain a contractual extension option that applies automatically subject to the lender’s non-objection;
- this portfolio is managed on a collective level and an individual credit review is not performed;
- therefore, the lender will only object to the extension option when he has received a specific piece of information on the borrower.

In accordance with IFRS 9.5.5.19 requirements, 6 months should be considered as the maximum contractual period.

ITG members observed that IFRS 9 do not explain whether extensions options are analysed differently if they are at the hand of the borrower and/or of the lender. However, the standard requires entities to consider “the maximum contractual period (including extension options) over which the entity is exposed to credit risk”. This wording implies that only the extension option at the borrower’s hand is considered. In other words, if the lender cannot be forced to extend the credit, then the extension option is not taken into account in the maximum period of exposure to credit risk.

ITG members also clearly stated that it would not be appropriate to analyse this portfolio by analogy with the requirements that applies to certain revolving credit facilities that must be considered as an exception.

**9.4.6.1.6. 12MECL vs Lifetime ECL**

Under the general impairment approach, instruments for which there has been no significant deterioration of credit quality since their initial recognition date are classified in Stage 1 and their impairment allowance is calculated as the 12-month expected credit losses (12MECL).

Conversely, the instruments for which a significant deterioration in credit quality has been identified are classified in Stage 2 and must be impaired up to their Life Time expected Credit losses: LTECL. The LTECL will therefore correspond to the present value of all the credit losses the lender expects to bear until the maturity of the instrument.

12MECL is a portion of the LTECL. It represents the lifetime expected loss of credits due to a default event occurring within the next 12 months after the reporting date (IFRS 9.B5.5.43).

The main difference, on an operational level, between LTECL and 12MECL is therefore an adjustment of the probability of default parameter (PD). For LTECL the probability of default over the entire expected life of the instrument is considered, whereas for the purposes of calculating the 12MECL the probability of default will be limited to events expected to occur in the next 12 months.

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14 ITG 22 April 2015: The maximum period to consider when measuring ECL (Agenda Paper 1).
12MECL calculation is however not limited to the contractual cash flows scheduled over the next 12 months as the entity assesses the consequences that an event of default, expected in the next 12 months, may have on the remaining expected lifetime cash flows.

**Example 9.11**

A bank carries a loan granted to entity A, with a nominal amount of CU100 and a residual maturity of 5 years. The principal of the loan will be repaid fully in fine at the end of year 5. Interests are paid at the end of each year. The bank believes that the probability that entity A default within the next 12 months is 1%. In case of default, the bank estimates its recovery at 50% of principal amount. In this case the 12MECL will be equal to 1% x 100 x 50% = CU0.5. Thus, even if the analysis of the probability of default is limited to the next 12 months, the effect of this default on the final principal payment in year 5 is taken into account.

### 9.4.6.2. From IFRS 9 principles to most common ECL formulas

IFRS 9 does not prescribe a single methodology to determine ECL. In this section, we will illustrate how the IFRS 9 ECL calculation principles can be applied through the most common formula.

When measuring ECL, an entity need not identify every possible scenario (IFRS 9.5.5.18). However, at least two scenarios must be taken into account: one scenario reflecting the possibility of a credit loss occurring and one scenario reflecting the possibility of a credit loss not occurring.

**Figure 9.8**

The next figure illustrates further how the ECL definition may be transposed into a more statistical approach.
Figure 9.9

\[ ECL_t = \left( \frac{\text{Contractual cash flows}}{\text{Expected cash flows}} \right) \times \text{Discount at EIR} \]

Weighted by probabilities and taking into account macroeconomic forecasts

becomes

\[ ECL_t = (PD \times LGD \times \frac{\text{Contractual cash flows}}{\text{Discount at EIR}}) \]

Where:
- PD: Probability of Default
- LGD: Loss Given Default
- EAD: Exposure at Default

The last figure below presents an example of a formula that is commonly used for ECL calculation. The example is set for an instrument with a 3-year maturity.

Figure 9.10

That leads to the following common formula

\[ ECL_{\text{3 years}} = \sum_{i=1}^{3 \text{ years}} PD_i \times LGD_i \times \frac{EAD_j}{\text{CRD}_i \times (1 - \text{Prep}_i) + \text{CCF}_i} \times \frac{FA_j}{(1 + \text{EIR})^{t-1}} \]

- PD: Probability of default of the year i
- LGD: Loss Given Default of the year i
- EAD: Amortised cost of the year i
  - The amortised cost of the year i may be as at the mid-year or as at the beginning/end of the year
  - The OSP (Out Standing Principal Amount) is modified by taking into account the prepayments (i.e. 1 - Prep)
  - CCF or Credit Conversion Factor: it will be 100% for an asset and between 0 and 100% for an off-balance sheet instrument
- DF: Discounted Factor of the year i

The following example illustrates one way to calculate 12MECL using an explicit probability of default approach (IFRS 9.IE49).
Example 9.12

Scenario 1

Entity A originates a single 10-year amortising loan for CU1 million. Taking into consideration the expectations for instruments with similar credit risk (using reasonable and supportable information that is available without undue cost or effort), the credit risk of the borrower, and the economic outlook for the next 12 months, Entity A estimates that the loan at initial recognition has a probability of default (PD) of 0.5 per cent over the next 12 months. Entity A also determines that changes in the 12-month PD are a reasonable approximation of the changes in the lifetime PD for determining whether there has been a significant increase in credit risk since initial recognition.

At the reporting date (which is before payment on the loan is due), there has been no change in the 12-month PD and Entity A determines that there was no significant increase in credit risk since initial recognition. Entity A determines that 25 per cent of the gross carrying amount will be lost if the loan defaults (i.e. the LGD is 25 per cent). Entity A measures the loss allowance at an amount equal to 12-month expected credit losses using the 12-month PD of 0.5 per cent. Implicit in that calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12 month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

Scenario 2

Entity B acquires a portfolio of 1,000 five-year bullet loans for CU1,000 each (i.e. CU1 million in total) with an average 12-month PD of 0.5 per cent for the portfolio. Entity B determines that because the loans only have significant payment obligations beyond the next 12 months, it would not be appropriate to consider changes in the 12-month PD when determining whether there have been significant increases in credit risk since initial recognition. At the reporting date Entity B therefore uses changes in the lifetime PD to determine whether the credit risk of the portfolio has increased significantly since initial recognition.

Entity B determines that there has not been a significant increase in credit risk since initial recognition and estimates that the portfolio has an average LGD of 25 per cent. Entity B determines that it is appropriate to measure the loss allowance on a collective basis in accordance with IFRS 9. The 12-month PD remains at 0.5 per cent at the reporting date. Entity B therefore measures the loss allowance on a collective basis at an amount equal to 12-month expected credit losses based on the average 0.5 per cent 12-month PD. Implicit in the calculation is the 99.5 per cent probability that there is no default. At the reporting date the loss allowance for the 12-month expected credit losses is CU1,250 (0.5% × 25% × CU1,000,000).

9.4.6.3. Focus on most commonly used parameters of ECL calculation

9.4.6.3.1. Probability of Default (PD)

The probability of default is the probability that the debtor will:

— default in accordance with the definition retained by the entity (see section 9.4.3.3),
— within a given time horizon, usually, for IFRS 9 impairment purposes, over the next 12 months or over the lifetime of the instrument.

15 Thus for simplicity of illustration it is assumed there is no amortisation of the loan.
16 Because the LGD represents a percentage of the present value of the gross carrying amount, this example does not illustrate the time value of money.
9.4.6.3.2. Exposure At Default (EAD)

The EAD to be considered is generally the amortised cost of the instrument at the date of default considered in the ECL measurement.

9.4.6.3.3. Loss Given Default (LGD), impact of collateral and guarantees

Even if it is certain that a debtor will default (PD = 100%) with an exposure of CU100 identified (EAD = 100), a lender may estimate that its expected credit loss is lower than CU100 either:

— because the lender expects to recover a portion of its exposure (rights upon liquidation of debtor, sale of the loan to a third party as a recovery method...); and/or
— because the loss is fully or partially compensated by a collateral mechanism or other kind of guarantee.

The aim of the Loss Given Default (LGD) is to capture the percentage of the exposure that will be lost if a default occurs.

The estimate of expected cash shortfalls on a collateralised financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable (i.e. the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Consequently, any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract should be included in this analysis. Any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset (IFRS 9.B5.5.55).

ECL must to take into account the cash flows expected from collateral and other credit enhancements solely if they are:

— an integral part of the contractual terms of the instrument; and
— not separately recognised by the entity (to avoid any double counting).

Determining whether a collateral is an integral part of the contractual terms of the instrument may not be straightforward and will probably require to exercise judgement in many circumstances. An entity will also have to consider all relevant facts and circumstances.

Example 9.13

> In January N a bank grants a loan to entity A. The contract does not require any specific guarantee mechanism.
>
> In January N + 2, the bank chooses to purchase a credit protection against the risk of default of entity A (e.g. a financial guarantee). This credit protection is not disclosed to entity A and the contractual arrangement of the loan remains unchanged.
>
> In this case, it will probably be difficult to establish that this protection is an integral part of the loan contract. Therefore, its accounting treatment will have to be implemented separately from the loan, and the calculation of the loan impairment allowance will not consider the existence of this protection.

IFRS 7 requires specific disclosure on the effect of collateral and other credit enhancement on ECL (see chapter 16).
9.4.6.3.4. Time value of money

ECL are discounted to the reporting date using the effective interest rate of the instrument, or an approximation of the latter (IFRS 9.B5.5.44).

In the case of leasing receivables, the ECL are discounted using the same discount rate as that for the measurement of lease receivables in accordance with IFRS 16 (IFRS 9.B5.5.45).

In the case of POCI assets, ECL calculation uses the credit adjusted effective interest rate of the instruments as discount factor (IFRS 9.B5.5.46).

If a financial instrument has a variable interest rate, its EIR may change from time to time depending on the change in interest rate market conditions. In such cases, the ECL are determined using the current EIR as discount factor. This ensures consistency between the rate used to determine both the interest rate income, the amortised cost of the instrument and its impairment allowance.

Determining the EIR of financial guarantee contracts or loan commitments may be challenging. When such EIR cannot be determined, the entity must apply a discount factor for ECL calculations that reflects the current market assessment of the time value of money (such as a benchmark interest rate) and the risks that are specific to the cash flows (such as a credit margin). However the entity should pay attention that if a given risk is reflected in the discount factor, it must not be taken twice into account by also adjusting the cash shortfall for the ECL calculation (IFRS 9.B5.5.48).

9.4.6.4. Interaction with regulatory data

Regulated financial institutions such as banks have already developed models and collected data for regulatory requirements. Most of these entities will thus be able to leverage on synergies between regulatory and IFRS requirements. However, the objective of the IFRS impairment approach is, to some extent, different from the objectives of banking regulatory requirements. The IASB mentioned in IFRS 9.BC5.286 that “the impairment requirement in IFRS 9 are based on the information available at the reporting date and are designed to reflect economic reality, instead of adjusting the assumptions and inputs applied to achieve a counter-cyclical effect”.

Therefore, if there is obviously an opportunity to leverage on the regulatory experience in credit risk data and monitoring, financial entities need to be aware of the need to include the relevant adjustments to regulatory data/parameters to meet the requirements of IFRS 9.

9.4.6.5. Information to be considered

9.4.6.5.1. All reasonable and supportable information must be considered

The ECL estimates must rely on reasonable and supportable information dealing with past events, current circumstances and forecasts of the future economic situation (Forward-looking information see section 9.4.7.3), that is available at the closing date without having to incur unreasonable costs or efforts (undue cost or effort) (IFRS 9.5.5.17(c)).

All information satisfying the above requirement is used both in the assessment of the occurrence of a SICR and the ECL estimation.
An entity may use several sources of data, internal sources (internal historical credit loss experience, internal ratings, etc.) as well as external sources (IFRS 9.B5.5.51).

9.4.6.5.2. Meaning of “without undue cost and effort”

This notion is repeatedly affirmed by IFRS 9 but is not clearly defined. It is legitimate to think that this notion of cost and effort will be appreciated with a higher level of requirement for a significant banking institution than for an industrial company whose credit risk management is not the most critical part of business. It is also likely that banking regulator requirements in credit risk monitoring will lead larger banks to have access to a larger range of qualitative and quantitative information.

Likely, banks will use the data present in their information systems. However, as sophisticated as its models may be, it should not disregard observable market information that is relevant for the IFRS 9 impairment requirements for a particular financial instrument or instruments with similar characteristics (IFRS 9.B5.5.54).

9.4.6.5.3. Historical information

As stated by IFRS 9.B5.5.52, historical data is an “important anchor or base” for the ECL estimation. Nevertheless, this historical information must be adjusted with current observable data or current forecast conditions. This process aims both at adjusting historical data for situations that are currently existing but did not exist in the past, and removing from historical data the effect of situations that do not exist anymore.

IFRS 9 explicitly mentions that, in some cases, unadjusted historical information may be the best reasonable and supportable information available.

9.4.6.5.4. Point In Time (PIT) information

The estimate of expected credit losses must reflect the economic situation existing at the closing date. Such an approach is often referred to as “Point In Time” approach.

On the opposite, approaches relying on averaged data determined over an economic cycle (Through The Cycle (TTC)) are often favoured for regulatory purposes.

The IASB considered TTC approaches but explicitly rejected them (IFRS 9.BC5.282 and following). Consequently, entities relying on regulatory data for IFRS 9 SICR assessment and ECL calculations may have to make some adjustments to the parameters to move from a TTC approach to a PIT approach.

9.4.6.5.5. Back-testing

A back-testing process and regular review of the methodology and assumptions used for estimating ECL must be implemented to reduce any differences between estimates and actual credit loss experience. This will also ensure that the overall methodology for calculating expected credit losses, including reprocessing of historical data or economic forecasts, allows a good quality of forecasts in accordance with the principles of the standard (IFRS 9.B5.5.52).
9.4.6.6. Examples of “non-PD approaches”

IFRS 9 does not require a specific ECL methodology. We have discussed in sections 9.4.6.2 and 9.4.6.3 what we can call “PD-based” approaches. We will hereafter present examples of “non-PD approaches”.

9.4.6.6.1. A loss rate approach

Example 9.14: 12-month expected credit loss measurement based on a loss rate approach (IFRS 9.IE53)

Bank A originates 2,000 bullet loans with a total gross carrying amount of CU500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition. Group X comprises 1,000 loans with a gross carrying amount per client of CU200, for a total gross carrying amount of CU200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of CU300, for a total gross carrying amount of CU300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans. In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions. Historically, for a population of 1,000 loans in each group, Group X’s loss rates are 0.3 per cent, based on four defaults, and Group Y’s loss rates are 0.15 per cent, based on two defaults.

At the reporting date, Bank A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Bank A estimates five defaults in the next 12 months for loans in Group X and three for loans in Group Y. It estimates that the present value of the observed credit loss per client will remain consistent with the historical loss per client.

On the basis of the expected life of the loans, Bank A determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios. On the basis of its forecasts, Bank A measures the loss allowance at an amount equal to 12-month expected credit losses on the 1,000 loans in each group amounting to CU750 and CU675 respectively. This equates to a loss rate in the first year of 0.375 per cent for Group X and 0.225 per cent for Group Y.

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of clients in sample</th>
<th>Estimated per client gross carrying amount at default</th>
<th>Total estimated gross carrying amount at default</th>
<th>Historic per annum average defaults</th>
<th>Estimated total gross carrying amount at default</th>
<th>Present value of observed loss(a)</th>
<th>Loss rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>1,000</td>
<td>CU200</td>
<td>CU200,000</td>
<td>4</td>
<td>CU800</td>
<td>CU600</td>
<td>0.3%</td>
</tr>
<tr>
<td>Y</td>
<td>1,000</td>
<td>CU300</td>
<td>CU300,000</td>
<td>2</td>
<td>CU600</td>
<td>CU450</td>
<td>0.15%</td>
</tr>
</tbody>
</table>

(a) In accordance with paragraph 5.5.17(b) expected credit losses should be discounted using the effective interest rate. However, for purposes of this example, the present value of the observed loss is assumed.
Bank A uses the loss rates of 0.375 per cent and 0.225 per cent respectively to estimate 12-month expected credit losses on new loans in Group X and Group Y originated during the year and for which credit risk has not increased significantly since initial recognition.

### 9.4.6.6.2. Provision matrix for trade receivables

#### Example 9.15: Provision matrix

Company M, a manufacturer, has a portfolio of trade receivables of CU30 million in 20X1 and operates only in one geographical region. The customer base consists of a large number of small clients and the trade receivables are categorised by common risk characteristics that are representative of the customers’ abilities to pay all amounts due in accordance with the contractual terms. The trade receivables do not have a significant financing component in accordance with IFRS 15 - *Revenue from Contracts with Customers*. In accordance with paragraph 5.5.15 of IFRS 9 the loss allowance for such trade receivables is always measured at an amount equal to lifetime time expected credit losses.

To determine the expected credit losses for the portfolio, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

On that basis, Company M estimates the following provision matrix:

<table>
<thead>
<tr>
<th>Current</th>
<th>1–30 days past due</th>
<th>31–60 days past due</th>
<th>61–90 days past due</th>
<th>More than 90 days past due</th>
</tr>
</thead>
<tbody>
<tr>
<td>Default rate</td>
<td>0.3%</td>
<td>1.6%</td>
<td>3.6%</td>
<td>6.6%</td>
</tr>
</tbody>
</table>

The trade receivables from the large number of small customers amount to CU30 million and are measured using the provision matrix.
9.4.6.7. Revolving credit facilities and loan commitments specificities

9.4.6.7.1. SICR assessment, initial credit risk

When a financial asset is recognised following a draw-down on a loan commitment, the lender should perform the loan SICR assessment considering the initial credit risk of the loan commitment from the date that the entity became a party to the irrevocable commitment (IFRS 9.B5.5.47).

Revolving credit facilities may be partially drawn, reimbursed and then drawn again. Such agreement may also combine a drawn and an undrawn component. For the purpose of identifying the initial credit risk of both drawn and undrawn components, the entity applies the general principles mentioned above for loan commitments. Consequently, the initial credit risk of the contract is determined when the facility commitment becomes irrevocable; it will apply both to drawn and undrawn components, and should not change until the revolving facility is derecognised.

9.4.6.7.2. Estimating ECL beyond the maximum contractual period

When processing the ECL calculation, the general principle is to consider the maximum contractual period, including extension options, over which the entity is exposed to credit risk. Generally, this period cannot be longer than the contractual period even if the entity’s practice is different. This means that if a lender has a contractual feature that allows him to withdraw his commitment with a short notice period, ECL estimation will be limited to such maximum contractual exposure period, even if the lender has a past practice of not using this feature (IFRS 9.5.5.19).

During the IFRS 9 consultation process, some respondents raised concerns about the consequences of this principle on ECL estimates for revolving facilities with a contractual right to cancel the commitment with a one-day prior notice. In practice, banks bearing such commitments rarely exercise their right before a significant increase in credit risk already exists. This practice exposes them over a period which is significantly longer than the “one-day period” used for ECL calculation.

The Board acknowledged this particularity by designing an exception for those very specific instruments. This exception requires to consider, for ECL estimates, the behavioural maturity (i.e. the period over which the lender is actually exposed) instead of the contractual maturity (IFRS 9.BC5.255).

<table>
<thead>
<tr>
<th>Gross carrying amount</th>
<th>Lifetime expected credit loss allowance (Gross carrying amount \times lifetime expected credit loss rate)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current</td>
<td>CU15,000,000</td>
</tr>
<tr>
<td>1–30 days past due</td>
<td>CU45,000</td>
</tr>
<tr>
<td>31–60 days past due</td>
<td>CU7,500,000</td>
</tr>
<tr>
<td>61–90 days past due</td>
<td>CU120,000</td>
</tr>
<tr>
<td>More than 90 days past due</td>
<td>CU144,000</td>
</tr>
<tr>
<td></td>
<td>CU2,500,000</td>
</tr>
<tr>
<td></td>
<td>CU165,000</td>
</tr>
<tr>
<td></td>
<td>CU1,000,000</td>
</tr>
<tr>
<td></td>
<td>CU106,000</td>
</tr>
<tr>
<td></td>
<td>CU30,000,000</td>
</tr>
<tr>
<td></td>
<td>CU580,000</td>
</tr>
</tbody>
</table>
However, the wording of this exception is not very clear and it has generated several ITG discussions and a webcast issued by some Board members.17

**Scope of the exception:**

This exception concerns financial instruments that meet both of the following conditions. They are instruments:

- that include both a loan and an undrawn component; and
- for which the entity’s contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity’s exposure to credit losses to the contractual notice period. (IFRS 9.5.5.20).

ITG members considered in April 2015 that the “the borrower has flexibility in how frequently they make drawdowns on the facility and consequently it is possible that the facility could be fully drawn or fully undrawn at the reporting date”.

IFRS 9.B5.5.39 also lists characteristics that are generally shared by such instruments:

- the financial instruments do not have a fixed term or repayment structure and usually have a short contractual cancellation period (for example, one day);
- the contractual ability to cancel the contract is not enforced in the normal day-to-day management of the financial instrument and the contract may only be cancelled when the entity becomes aware of an increase in credit risk at the facility level; and
- the financial instruments are managed on a collective basis.

Products that are commonly considered to be in the scope of this exception include credit card facilities and retail overdrafts. However, attention must be paid to such contract to ensure they meet the above-mentioned scoping conditions.

The exception affects the maturity to be considered, not the credit limit

It is important to underline that this behavioural exception will impact only the maturity parameter of the ECL calculation and not the amounts. This was discussed by ITG members in September 2015. ITG members noted that:

- the impairment approach in IFRS 9 is based on the contractual terms of a financial instrument;
- the exception for some types of revolving credit facilities set out in paragraph 5.5.20 of IFRS 9 relates only to the contractual commitment period and does not address the contractual credit limit. ITG members noted that the Standard was clear in this regard and consequently, it would not be appropriate to analogue this specific exception to the contractual credit limit.

17 https://www.ifrs.org/webcast/?webcastid=1145211
Determining the period to be retained for ECL estimation purposes

An entity applies IFRS 9.B5.5.40 requirements to determine the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity’s normal credit risk management actions. An entity should consider factors such as historical information and experience about:

— the period over which the entity was exposed to credit risk on similar financial instruments;
— the length of time for related defaults to occur on similar financial instruments following a significant increase in credit risk; and
— the credit risk management actions that an entity expects to take once the credit risk on the financial instrument has increased, such as the reduction or removal of undrawn limits.

The figure below was presented during the IASB webcast to illustrate the relationship between management actions and the expected life to be considered for ECL estimation:

**Figure 9.11**

<table>
<thead>
<tr>
<th>Entity A</th>
<th>Entity B</th>
<th>Entity C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resulting actions</td>
<td>No mitigation actions</td>
<td>Mitigation actions taken for some facilities that increase in credit risk</td>
</tr>
<tr>
<td>Effect on the expected life</td>
<td>No limiting of the expected life</td>
<td>The expected life for some facilities shortened</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Mitigation actions taken for all increases in credit risk</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The expected life shortened for all facilities expected to increase in credit risk</td>
</tr>
</tbody>
</table>

ITG members considered in December 2015 how to determine the ending-point of the maximum period to consider when measuring expected credit losses in accordance with IFRS 9.B5.5.40 and more specifically which credit risk management actions are taken into account in making this determination.

An entity considers all credit management actions that the entity expects to really enforce and that serve to either terminate or limit the credit risk.

Therefore, it is not possible to consider all the legal or operationally possible actions if they are not enforced.

In determining which credit risk management actions an entity expects to take, ITG members observed that an entity’s expected actions must be based on reasonable and supportable information. In this regard, consideration should be given to an entity’s normal credit risk mitigation process, past practice and future intentions.

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98 IFRS 9.B5.5.40 when determining the period over which the entity is expected to be exposed to credit risk, but for which expected credit losses would not be mitigated by the entity’s normal credit risk management actions, ...
They explain that the entity’s next review process can be sustained as an expected limit only if the entity’s normal practice is to take credit risk mitigation actions as part of this process.

As the estimation of the maximum period to consider in accordance with IFRS 9.B5.5.40 would require judgement, IFRS 7-related disclosure requirements (such as explaining inputs, assumption and estimation techniques in relation to ECL) would be important.

The following example from IFRS 9 illustrate further the principles mentioned in this section (IFRS 9.IE58).

**Example 9.16**

Bank A provides co-branded credit cards to customers in conjunction with a local department store. The credit cards have a one-day notice period after which Bank A has the contractual right to cancel the credit card (both the drawn and undrawn components). However, Bank A does not enforce its contractual right to cancel the credit cards in the normal day-to-day management of the instruments and only cancels facilities when it becomes aware of an increase in credit risk and starts to monitor customers on an individual basis. Bank A therefore does not consider the contractual right to cancel the credit cards to limit its exposure to credit losses to the contractual notice period.

For credit risk management purposes Bank A considers that there is only one set of contractual cash flows from customers to assess and does not distinguish between the drawn and undrawn balances at the reporting date. The portfolio is therefore managed and expected credit losses are measured on a facility level.

At the reporting date the outstanding balance on the credit card portfolio is CU60,000 and the available undrawn facility is CU40,000. Bank A determines the expected life of the portfolio by estimating the period over which it expects to be exposed to credit risk on the facilities at the reporting date, taking into account:

- the period over which it was exposed to credit risk on a similar portfolio of credit cards;
- the length of time for related defaults to occur on similar financial instruments; and
- past events that led to credit risk management actions because of an increase in credit risk on similar financial instruments, such as the reduction or removal of undrawn credit limits.

On the basis of the information listed above, Bank A determines that the expected life of the credit card portfolio is 30 months.

At the reporting date Bank A assesses the change in the credit risk on the portfolio since initial recognition and determines that the credit risk on a portion of the credit card facilities representing 25 per cent of the portfolio, has increased significantly since initial recognition. The outstanding balance on these credit facilities for which lifetime expected credit losses should be recognised is CU20,000 and the available undrawn facility is CU10,000.

When measuring the expected credit losses in accordance with paragraph 5.5.20 of IFRS 9, Bank A considers its expectations about future drawdowns over the expected life of the portfolio (i.e. 30 months) in accordance with paragraph B5.5.31 and estimates what it expects the outstanding balance (i.e. exposure at default) on the portfolio would be if customers were to default. By using its credit risk models Bank A determines that the exposure at default on the credit card facilities for which lifetime expected credit losses should be recognised, is CU25,000 (i.e. the drawn balance of CU20,000 plus further drawdowns of CU5,000 from the available undrawn commitment). The exposure at default of the credit card facilities for which 12-month expected credit losses are recognised, is CU45,000 (i.e. the outstanding balance of CU40,000 and an additional drawdown of CU5,000 from the undrawn commitment over the next 12 months).

The exposure at default and expected life determined by Bank A are used to measure the lifetime expected credit losses and 12-month expected credit losses on its credit card portfolio.
Bank A measures expected credit losses on a facility level and therefore cannot separately identify the expected credit losses on the undrawn commitment component from those on the loan component. It recognises expected credit losses for the undrawn commitment together with the loss allowance for the loan component in the statement of financial position. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be presented as a provision (in accordance with IFRS 7 - Financial Instruments: Disclosure).

9.4.6.7.3. ECL calculation: drawdown expectations

Because the Board considers the consistency of application of the impairment approach as a priority, these instruments are analysed as “only one set of cash flows from the borrower that relates to both components” i.e. drawn and undrawn components (IFRS 9.BC244 & 259).

In other words, the ECL will be consistent with the entity’s expectations of drawdowns even if the Board acknowledged that it will comprise a certain level of complexity (IFRS 9.BC5.247).

Therefore, the credit loss will be the present value of the difference between (IFRS 9.B5.5.30):

- “the contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan”; and
- “the cash flows that the entity expects to receive if the loan is drawn down.”

For the 12 months ECL calculation, an entity estimates the expected drawdown within the next 12 months whereas for the Lifetime ECL, it estimates the expected drawdown over the expected life of the instrument (IFRS 9.B5.5.31).

Concerning the expectations of drawdowns, please note the approaches considered but rejected by the Board (IFRS 9.BC5.246):

- limiting the estimate of future drawdowns to the next 12 months;
- estimating the expected drawdowns only on the grounds of historical information. Relevant adjustments should be made for reflecting both the current and future economic conditions;
- using the credit conversion factor provided by prudential regulators as generally they are standardised parameters.

9.4.7. Forward-looking information

The use of forward-looking information is both a new concept and one of the most judgemental areas of the IFRS 9 impairment approach. The combination of these two facts explains why the implementation of this new concept has been largely discussed since the publication of IFRS 9. In this section, we present the main principles attached to this concept and some guidance on how to apply it. We refer for this to ITG discussions (April and September 2015) as well as to an IASB Webcast dedicated to this topic in 201619.

19 webcast IFRS 9 forward-looking information and multiple scenarios* July 2016.
9.4.7.1. When forward-looking information is needed and why

All along its impairment approach, IFRS 9 requires the consideration of all reasonable and supportable information that includes forecasts of future economic conditions often referred to as “forward-looking information”. The objective of the Board in introducing this forward-looking information into the impairment approach is to ensure that losses will be considered soon enough by taking into account the future macroeconomic evolutions the entity expects will occur.

Forward-looking information is used both for:
- the Significant Increase in Credit Risk assessment (see section 9.4.3.2), and
- the ECL estimation (see section 9.4.6).

9.4.7.2. Implementation methodology

9.4.7.2.1. IFRS 9 does not prescribe a specific method

In its webcast20, the Board clarified that IFRS 9 does not prescribe any specific approach to incorporate forward-looking scenarios in the SICR assessment process and ECL estimation.

Different approaches were mentioned. The list is not exhaustive, but it is interesting to note that not all are statistical approaches (no further details were provided):
- single scenario with a scalar adjustment,
- probability weighted ELC based on “n” number of scenarios,
- Monte Carlo simulation.

9.4.7.2.2. Differentiated incorporation of forward-looking information

ITG Discussions

The ITG considered in September 2015 whether forward-looking information, including macroeconomic information, should be incorporated into the determination of expected credit losses in a differentiated way for example, country by country and/or portfolio by portfolio.

ITG members confirmed that, as noted in (IFRS 9.B5.5.16), different factors may be relevant to different financial instruments depending on the specific drivers of credit relevant for this group.

For example, IFRS 9.IE29 and following, mentions a situation where expectations about future levels of unemployment in a specific industry and specific region are only relevant to a sub-portfolio of mortgage loans in which the borrowers work in that industry in that specific region.

Conversely, if different financial instruments or portfolios being assessed share some similar risk characteristics, then relevant forward-looking information is applied in a comparable and consistent manner to reflect those similar characteristics.

9.4.7.2.3. Need for a multi-scenario approach

During its Webcast, the Board explicated that the need for a multiple scenario approach depends on an assessment that relies on the concept of non-linearity.

A single forward-looking scenario is not sufficient when the relationship is not linear. This could happen when:

— the relationship between the forward-looking scenarios and the changes in credit risk is not linear.

As an example, depending on the initial level of unemployment rate, an increase of 1 bp implies a different increase in the credit risk; or

— when the relationship between the forward-looking scenarios and the changes in ECL measurement is not linear.

This second relationship is more complex to analyse because the non-linearity could result from one or from several key parameters of the ECL. As an example, a non-linear relationship can exist between the risk of a default occurring and the unemployment rate, or between credit losses arising on default and the House price index.

IFRS 9 does not provide information about how many scenarios should be considered.

We have generally seen in practice a three-scenario approach (one unfavourable scenario, a base scenario and a favourable scenario). However, some entities consider up to five scenarios.

When a multi-scenario approach is relevant, preparers must pay specific attention to the following steps:

— selection of the scenarios; and

— assessment of the probability of occurrence of each scenario.

9.4.7.2.4. Application to a non-PD SICR assessment approach

A non-PD approach is a SICR assessment approach which relies on non-statistical and/or qualitative factors.

In the case of such an approach, the IASB noted during its Webcast that an entity does not exclude qualitative forward-looking information when assessing the occurrence of SICR. SICR assessment could rely both on quantitative and qualitative information.

9.4.7.3. Information to be considered

9.4.7.3.1. Time horizon of economic forecast

When taking into account forward-looking information, it is not necessary to integrate economic forecasts over the entire life of the instrument. In fact, the more the forecasts are for distant periods, the less detailed information is available, and the more important the use of judgement is (IFRS 9.B5.5.50).
In practice, forward-looking information may be “observable” (IFRS 9.B5.5.54) and reliably estimated over the next 3 to 5 years. But these figures are highly dependent on the fact and circumstances and the economic environment of the transaction. Beyond that time horizon, the entity will generally adjust the effect of forward-looking parameters to progressively revert to current long-term average parameters.

9.4.7.3.2. Reasonable and supportable

ITG Discussions

The ITG members discussed in September 2015 how to determine whether forward-looking information is sufficiently reasonable and supportable to be included in an IFRS 9 impairment approach. The question is particularly relevant within the context of information about emerging issues and uncertain future events that is usually not included in an entity’s current budgeting and forecasting processes.

ITG members acknowledge that identifying reasonable and supportable relevant information and determining its impact on ECL measurement requires a high level of judgement and could be a challenging area. However, a piece of information must not be excluded simply because it has a low probability to occur, or the effect of that information on the credit risk or the amount of ECL is uncertain.

ITG members emphasised that an entity must make an effort in good faith to estimate the impact of uncertain future events, including second-order effects, on the credit risk of financial instruments and the measurement of expected credit losses.

ITG members made several observations on the importance of disclosures on relevant forward-looking information (see chapter 16).

9.4.7.3.3. Cut-off requirements

Economic forecasts used to satisfy forward-looking requirements are generally prepared some weeks before the end of the reporting period. The ITG discussed whether and how to incorporate events and forecasts that occur:

— after economic forecasts were made but before the end of the reporting period;
— between the reporting period end, and the publication date of the financial statements (i.e. when the financial statements are authorised for issue).

ITG members considered this issue in April 2015 and noted that reasonable and supportable new information that becomes available before the end of the reporting period must be taken into account in any case.

The second issue relates more to IAS 10 - Events after the Reporting Period, requirements. However, ITG members considered that IFRS 9 ECL are a probability-weighted estimate of credit losses at the reporting date. Accordingly, the determination of ECL takes into consideration relevant possible future scenarios based on a range of expectations at the reporting date, using the information available at that date. Hence, the movements in interest rates (or outcome of a public vote) are taken into consideration but with the probabilities attached to them at that date. These probabilities will rely on information available at the end of the reporting period.
9.4.7.3.4. Consistency of assumptions made

It is important to keep in mind that all judgements and assumptions made in the IFRS 9 impairment approach, taken as whole, must be internally consistent. Therefore, forward-looking assumptions used for the SICR assessment must be consistent with those used for the ECL calculation. Nevertheless, some circumstances could exist in which a macroeconomic parameter might have an impact in the measurement of ECL and not on the assessment of SICR (or vice-versa).

Moreover, assumptions made, especially with regards to the general economic environment, must also be consistent with assumptions made by the entity in the general context of preparing its financial statements. Other estimations requiring significant areas of judgement that may be influenced by macroeconomic parameters are

- Impairment of goodwill impairment,
- asset-Liability Management particularly concerning interest rate previsions, and
- deferred tax.

9.4.8. Modified financial assets

Any modification performed on a financial asset may have consequences on its contractual cash flows as well as on the credit risk profile of an entity. Therefore, situations of financial asset modifications must be carefully analysed to determine the appropriate consequences on the impairment allowance to be recognised under IFRS 9.

The accounting consequences are very different depending on whether the modification triggers asset derecognition or not.

9.4.8.1. Determining whether a financial asset modification triggers its derecognition

When the cash flows of a financial asset are modified or renegotiated, a derecognition analysis must be performed. The driving principle is that a financial asset must be derecognised if the contractual rights to the cash flows expire or if the terms of the financial asset have substantially changed. This analysis requires judgement and is further discussed in chapters 10 and 11.

9.4.8.2. Impacts when the modified asset is not derecognised

9.4.8.2.1. Accounting Impact at the modification date

When the modified asset is not derecognised, a new gross carrying amount is calculated by discounting the new contractual cash flows with the original EIR.

Any cost or fees incurred by this modification are amortised over the remaining term (IFRS 9.5.4.3) and therefore consequently adjust the new gross carrying amount.

The difference between the former and the new gross carrying amounts is recognised in profit or loss as a modification gain or loss (IFRS 9.5.4.3).
9.4.8.2.2. Impact on the SICR assessment

As the original asset is retained on the balance sheet, the SICR assessment is performed in relation to its initial level of credit risk, i.e. at its origination date (and not at the modification date). There are situations where due to the financial difficulties of the debtor, the amortisation profile of a debt instrument is modified to be more aligned to the debtor’s repayment capacity. This type of renegotiation may help to limit the risk of default of the debtor in relation to the situation before renegotiation. However, this renegotiation alone is not enough to justify that the credit quality of this instrument has improved significantly to trigger change of impairment stage.

9.4.8.3. Impacts when the modified asset is derecognised

When a new asset is recognised on the balance sheet following a cash flow modification, a specific analysis dealing with the existence or not of incurred credit loss is performed at that date. In other words, is the new asset an Originated Credit-Impaired asset (POCI) or not (see section 9.4.5)?

— If it appears that the new asset is not credit-impaired and therefore is not a POCI, then it will follow the rules of the general approach: The financial asset is classified in Stage 1 as any other newly recognised financial asset and the subsequent SICR analysis will be performed from the renegotiation date.

— If it appears that the new asset is credit-impaired (see section 9.4.8.3 for the criteria to be applied), it is accounted for as a POCI (see section 9.4.5).

As stated by IFRS 9.B5.5.26, the recognition of a POCI following a debt restructuring is not expected to be a frequent scenario. It may however occur when a distressed asset is significantly modified.
9.4.8.4. In a nutshell, what is the methodology in the case of a modification of the cash flows?

9.4.8.5. Illustrative Example N°11: modification of contractual cash flows

Example 9.17: Modification of contractual cash flows (IFRS 9.1E66)

Bank A originates a five-year loan that requires the repayment of the outstanding contractual amount in full at maturity. Its contractual par amount is CU1,000 with an interest rate of 5 per cent payable annually. The effective interest rate is 5 per cent. At the end of the first reporting period (Period 1), Bank A recognises a loss allowance at an amount equal to 12-month expected credit losses because there has not been a significant increase in credit risk since initial recognition. A loss allowance balance of CU20 is recognised.

In the subsequent reporting period (Period 2), Bank A determines that the credit risk on the loan has increased significantly since initial recognition. As a result of this increase, Bank A recognises lifetime expected credit losses on the loan. The loss allowance balance is CU30.

At the end of the third reporting period (Period 3), following significant financial difficulty of the borrower, Bank A modifies the contractual cash flows on the loan. It extends the contractual term of the loan by one year so that the remaining term at the date of the modification is three years. The modification does not result in the derecognition of the loan by Bank A.

As a result of that modification, Bank A recalculates the gross carrying amount of the financial asset as the present value of the modified contractual cash flows discounted at the loan’s original effective interest rate of 5 per cent. In accordance with paragraph 5.4.3 of IFRS 9, the difference between this recalculated gross carrying amount and the gross carrying amount before the modification is recognised as a modification gain or loss. Bank A recognises the modification loss (calculated as CU300) against the gross carrying amount of the loan, reducing it to CU700, and a modification loss of CU300 in profit or loss. Bank A also remeasures the loss allowance, taking into account the modified contractual cash flows and evaluates whether the loss allowance for the loan must continue to be measured at an amount equal to lifetime expected credit losses. Bank A compares the current credit risk (taking into consideration the modified cash flows) to the credit risk (on the original unmodified cash flows) at initial recognition. Bank A determines that the loan is not credit-impaired at the reporting date but that credit risk has still significantly increased compared to the credit risk at initial recognition and continues to measure the loss allowance at an amount equal to lifetime expected credit losses. The loss allowance balance for lifetime expected credit losses is CU100 at the reporting date.
<table>
<thead>
<tr>
<th>Period</th>
<th>Beginning gross carrying amount</th>
<th>Impairment (loss)/gain</th>
<th>Modification (loss)/gain</th>
<th>Interest revenue</th>
<th>Cash flows</th>
<th>Ending gross carrying amount</th>
<th>Loss allowance</th>
<th>Ending amortised cost amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>CU1,000</td>
<td>(CU20)</td>
<td>CU50</td>
<td></td>
<td></td>
<td>CU1,000</td>
<td>CU20</td>
<td>CU980</td>
</tr>
<tr>
<td>2</td>
<td>CU1,000</td>
<td>(CU10)</td>
<td>CU50</td>
<td></td>
<td></td>
<td>CU1,000</td>
<td>CU30</td>
<td>CU970</td>
</tr>
<tr>
<td>3</td>
<td>CU1,000</td>
<td>(CU70)</td>
<td>(CU300)</td>
<td></td>
<td></td>
<td>CU700</td>
<td>CU100</td>
<td>CU600</td>
</tr>
</tbody>
</table>

At each subsequent reporting date, Bank A evaluates whether there is a significant increase in credit risk by comparing the loan’s credit risk at initial recognition (based on the original, unmodified cash flows) with the credit risk at the reporting date (based on the modified cash flows), in accordance with paragraph 5.5.12 of IFRS 9.

Two reporting periods after the loan modification (Period 5), the borrower has outperformed its business plan significantly compared to the expectations at the modification date. In addition, the outlook for the business is more positive than previously envisaged. An assessment of all reasonable and supportable information that is available without undue cost or effort indicates that the overall credit risk on the loan has decreased and that the risk of a default occurring over the expected life of the loan has decreased, so Bank A adjusts the borrower’s internal credit rating at the end of the reporting period.

Given the positive overall development, Bank A re-assesses the situation and concludes that the credit risk of the loan has decreased and there is no longer a significant increase in credit risk since initial recognition. As a result, Bank A once again measures the loss allowance at an amount equal to 12-month expected credit losses.

### 9.4.9. Presentation of Expected Credit Loss (ECL) in the financial statements

#### 9.4.9.1. On the balance sheet, the presentation depends on the accounting category

The presentation of ECL on the balance sheet differs according to the accounting categories of the related financial instruments.

We recall some key definitions hereafter (IFRS 9 Appendix A):

- **Loss allowance**:
  - the allowance for ECL for instruments at amortised cost, lease receivables and contract assets;
  - the accumulated impairment amount for the instruments at FV-OCI; and
  - the provision for ECL on off-balance sheet items (loan commitments, financial guarantee contracts).

- **Gross carrying amount** is the amortised cost of a financial asset before adjustment for any loss allowance.

  - **Amortised cost** is the amount that is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the Effective Interest Method, **adjusted for any loss allowance** (see chapter 2).
9.4.9.1.1. Financial instruments at Amortised Cost (AC):

There is no requirement to present the loss allowance on a separate line in the statement of financial position. This was confirmed by the ITG discussions in December 2015.

**ITG Discussions**

The question submitted was whether it is required to present the loss allowance for financial assets measured at Amortised Cost (or trade receivables, contract assets or lease receivables) separately in the statement of financial position.

ITG members noted that neither IFRS 9 nor IFRS 7 contain any such requirement.

They noted also that IAS 1.54 does not list the loss allowance as an amount that is required to be separately presented on the face of the statement of financial position. Nevertheless, they insisted on the fact that the financial statements must present fairly the financial position of an entity.

9.4.9.1.2. Financial instruments at Fair Value Through OCI (FV-OCI)

The instruments recognised in this accounting category are measured at their fair value. Therefore, no loss allowance can reduce their carrying amount (IFRS 9.5.5.2). Instead, this loss allowance, so called “accumulated impairment amount” by IFRS 9, is recognised and presented separately in OCI.

**Example 9.18: Debt instrument measured at fair value through other comprehensive income (IFRS 9.
IE78)**

An entity purchases a debt instrument with a fair value of CU1,000 on 15 December 20X0 and measures the debt instrument at fair value through other comprehensive income. The instrument has an interest rate of 5 per cent over the contractual term of 10 years. Its effective interest rate is also 5 per cent. At initial recognition, the entity determines that the asset is not purchased or originated credit-impaired.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset—FVOCI(a)</td>
<td>CU1,000</td>
</tr>
<tr>
<td>Cash</td>
<td>CU1,000</td>
</tr>
</tbody>
</table>

(To recognise the debt instrument measured at its fair value)
(a) FVOCI means fair value through other comprehensive income.

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22 ITG 11 December 2015: Presentation of the loss allowance for financial assets measured at amortised cost (Agenda Paper 10)
On 31 December 20X0 (the reporting date), the fair value of the debt instrument has decreased to CU950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that expected credit losses should be measured at an amount equal to 12-month expected credit losses, which amounts to CU30. For simplicity, journal entries for the receipt of interest revenue are not provided.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impairment loss (profit or loss)</td>
<td>CU30</td>
</tr>
<tr>
<td>Other comprehensive income(a)</td>
<td>CU20</td>
</tr>
<tr>
<td>Financial asset—FVOCI</td>
<td>CU50</td>
</tr>
</tbody>
</table>

(To recognise 12-month expected credit losses and other fair value changes on the debt instrument)

(a) The cumulative loss in other comprehensive income at the reporting date was CU20. That amount consists of the total fair value change of CU50 (ie CU1,000 – CU950) offset by the change in the accumulated impairment amount representing 12-month expected credit losses that was recognised (CU30).

Disclosure would be provided about the accumulated impairment amount of CU30.

On 1 January 20X1, the entity decides to sell the debt instrument for CU950, which is its fair value at that date.

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>CU950</td>
</tr>
<tr>
<td>Financial asset—FVOCI</td>
<td>CU950</td>
</tr>
<tr>
<td>Loss (profit or loss)</td>
<td>CU20</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>CU20</td>
</tr>
</tbody>
</table>

(To derecognise the fair value through other comprehensive income asset and recycle amounts accumulated in other comprehensive income to profit or loss)

9.4.9.1.3. Off-balance sheet (OBS)

According to IFRS 9 Appendix A, ECL on the off-balance sheet items (for instance, loan commitment or financial guaranty) must be presented as a provision.

This is consistent with IAS 1.54 l) that requires separate presentation of provisions explicitly.

IFRS 7.B8E adds that an entity should disclose information about the changes in the loss allowance for financial assets separately from those for loan commitments and financial guarantee contracts. However, if a financial instrument includes both a loan (i.e. financial asset) and an undrawn commitment (i.e. loan commitment) component and the entity cannot separately identify the expected credit losses on the loan commitment component from those on the financial asset component, the expected credit losses on the loan commitment should be recognised together with the loss allowance for the financial asset. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be recognised as a provision.
9.4.9.2. Presentation in Profit or Loss

IFRS 9.5.5.8 states that any increase or decrease in the ECL that is required to adjust the loss allowance at the reporting date is recognised in profit or loss as an impairment gain or loss.

According to IAS 1.82(ba) these ECL impacts are disclosed on a dedicated line of the profit or loss.

For the banking sector, this means that the ECL allowance is presented in the cost of credit risk (subpart of the profit or loss) whereas the interest income of the Amortised Cost of a FV-OCI instrument will be presented separately within Net Banking Interests.

9.4.9.3. Focus on assets classified in Stage 3

For financial instruments that become credit impaired (to be distinguished from the financial instruments that are credit-impaired since their initial recognition) and that are therefore transferred to Stage 3, IFRS 9.5.4.1(b) requires that their interest revenue be calculated by applying the EIR to the amortised cost (i.e. net of impairment allowance) of the instrument.

In December 2015, the ITG further discussed how this principle interacts with the definition of gross carrying amount and loss allowance.

ITG Discussions

The issue relates to the measurement of gross carrying amount and loss allowance for financial instruments that are measured at amortised cost and that are credit impaired (but not purchased nor originated credit-impaired).

On such specific case, the submitter raised a potential implementation issue about how the interest revenue recognised interacts with the calculation of the gross carrying amount and the loss allowance.

This potential issue submitted was illustrated by the following example:

> An entity holds a financial asset (that is not a POCI) measured at amortised cost which the following characteristics:
  - Gross carrying amount (before deducting the ECL) = CU100 at 31 December 20X1
  - Its effective interest rate is 10%
  - On 31 December 20X1, this asset becomes credit-impaired and the ECL goes up to CU60
  - Accordingly, its amortised cost is CU40 at 31 December 20X1

At 31 December 20X2:
  - There are no cash settlements, no changes in the expected cashflows
  - In accordance with IFRS 9.5.4.1(b) the interest revenue for the year 20X2 is CU4 = CU40 x 10%
  - Therefore, the amortised cost at 31 December 20X2 will be CU44 = CU40 x (1 + 10%)

23 ITG 11 December 2015: Loss allowance for credit impaired financial assets (Agenda Paper 9)
Given all these elements, the calculation of the loss allowance and gross carrying amount at 31 December 20X2 can follow three possible approaches:

<table>
<thead>
<tr>
<th></th>
<th>Approach A</th>
<th>Approach B</th>
<th>Approach C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross carrying amount</td>
<td>110</td>
<td>104</td>
<td>100</td>
</tr>
<tr>
<td>Loss allowance</td>
<td>(66)</td>
<td>(60)</td>
<td>(56)</td>
</tr>
<tr>
<td>Amortised cost</td>
<td>44</td>
<td>44</td>
<td>44</td>
</tr>
</tbody>
</table>

In the view of the ITG members, Approach A is the only approach consistent with IFRS 9 on the following grounds:
> the gross carrying amount reflects the contractual cash flows discounted by the original EIR;
> the amortised cost reflects the expected cash flows discounted by the original EIR;
> hence, the Lifetime ECL as the difference between the gross carrying amount and the amortised cost represents the expected cash shortfalls discounted by the original EIR.

9.4.10. Interaction with hedge accounting

9.4.10.1. Technical and complex interactions

IFRS 9 does not explicitly address the issues raised by the interaction between hedge accounting and impairment. However, as both relate directly to future cash flows of the entities they arguably interact. Without claiming to be exhaustive, we list below some examples of such interactions.

9.4.10.1.1. Credit risk of a hedged financial asset and hedge effectiveness criterion

One of the effectiveness criteria that IFRS 9 requires in applying hedge accounting is that the effect of credit risk must not dominate the value changes attributable to the hedged risk (see section 14.5.3.2).

Once a financial asset becomes credit impaired (enters stage 3), the entity considers that one or several events have a detrimental impact on the estimated cash flows. Even though there is no direct link between this staging process and the hedge effectiveness requirement within IFRS 9, entities may in practice consider that the hedge effectiveness requirements are no longer met once an asset is classified in Stage 3. However, one must pay attention to the following:

— there may be situations where an asset classified in Stage 2 could fail the effectiveness requirement of hedge accounting;

— conversely, the staging approach relies solely on the probability of default without considering the loss given default (LGD). Therefore, if the LGD is very low, it could be demonstrated that, even for a Stage 3 asset, the credit risk component does not dominate the value change attributable to the hedged risk.
9.4.10.1.2. Impact of a fair value hedge relationship on EIR and amortised cost

IFRS 9.6.5.8(b) indicates that, in a fair value hedge relationship, the hedging gain or loss on the hedged item adjusts its carrying amount. IFRS 9.6.5.10 explains further that any adjustment arising from paragraph 6.5.8(b) is amortised to profit or loss if the hedged item is a financial instrument. Amortisation may begin as soon as an adjustment exists and must begin no later than when the hedged item ceases to be adjusted for hedging gains and losses. The amortisation is based on a recalculated EIR at the date that amortisation begins.

As discussed in section 9.4.6, EIR and the carrying amount of a debt instrument that is subject to impairment are key factors for ECL computation.

9.4.10.2. Interaction between the FV-OCI category and foreign currency denomination, fair value hedge accounting and impairment

The example below is based on illustrative example 14 of IFRS 9 (IFRS 9.IE82-102). It illustrates further the interaction between fair value hedge and impairment for a debt instrument denominated in a foreign currency, measured at fair value through other comprehensive income and designated in a fair value hedge accounting relationship.

Example 9.19: Interaction between the fair value through other comprehensive income measurement category and foreign currency denomination, fair value hedge accounting and impairment (IFRS 9.IE82)

An entity purchases a debt instrument (a bond) denominated in a foreign currency (FC) for its fair value of FC100,000 on 1 January 20X0 and classifies the bond as measured at fair value through other comprehensive income. The bond has five years remaining to maturity and a fixed coupon of 5 per cent over its contractual life on the contractual par amount of FC100,000. On initial recognition the bond has a 5 per cent effective interest rate. The entity's functional currency is its local currency (LC). The exchange rate is FC1 to LC1 on 1 January 20X0. At initial recognition the entity determines that the bond is not purchased or originated credit-impaired. In addition, as at 1 January 20X0 the 12-month expected credit losses are determined to be FC1,200. Its amortised cost in FC as at 1 January 20X0 is equal to its gross carrying amount of FC100,000 less the 12-month expected credit losses (FC100,000—FC1,200).

The entity has the following risk exposures:

> (a) fair value interest rate risk in FC: the exposure that arises as a result of purchasing a fixed interest rate instrument; and

> (b) foreign exchange risk: the exposure to changes in foreign exchange rates measured in LC.

The entity hedges its risk exposures using the following risk management strategy:

> (a) for fixed interest rate risk (in FC) the entity decides to link its interest receipts in FC to current variable interest rates in FC. Consequently, the entity uses interest rate swaps denominated in FC under which it pays fixed interest and receives variable interest in FC; and
(b) for foreign exchange risk the entity decides not to hedge against any variability in LC arising from changes in foreign exchange rates.

The entity designates the following hedge relationship: a fair value hedge of the bond in FC as the hedged item with changes in benchmark interest rate risk in FC as the hedged risk. The entity enters into an on-market swap that pays fixed and receives variable interest on the same day and designates the swap as the hedging instrument. The tenor of the swap matches that of the hedged item (i.e. five years).

For simplicity, in this example it is assumed that no hedge ineffectiveness arises in the hedge accounting relationship. This is because of the assumptions made in order to better focus on illustrating the accounting mechanics in a situation that entails measurement at fair value through other comprehensive income of a foreign currency financial instrument that is designated in a fair value hedge relationship, and also to focus on the recognition of impairment gains or losses on such an instrument.

The entity makes the following journal entries to recognise the bond and the swap on 1 January 20X0:

<table>
<thead>
<tr>
<th>Debit LC</th>
<th>Credit LC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset—FVOCI</td>
<td>100,000</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
<tr>
<td>(To recognise the bond at its fair value)</td>
<td></td>
</tr>
<tr>
<td>Impairment loss (profit or loss)</td>
<td>1,200</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>1,200</td>
</tr>
<tr>
<td>(To recognise the 12-month expected credit losses)(a)</td>
<td></td>
</tr>
<tr>
<td>Swap</td>
<td>0</td>
</tr>
<tr>
<td>Cash</td>
<td>0</td>
</tr>
<tr>
<td>(To recognise the swap at its fair value)</td>
<td></td>
</tr>
<tr>
<td>(a) In case of items measured in the functional currency of an entity the journal entry recognising expected credit losses will usually be made at the reporting date.</td>
<td></td>
</tr>
</tbody>
</table>

As of 31 December 20X0 (the reporting date), the fair value of the bond decreased from FC100,000 to FC96,370 because of an increase in market interest rates. The fair value of the swap increased to FC1,837. In addition, as at 31 December 20X0 the entity determines that there has been no change to the credit risk on the bond since initial recognition and continues to carry a loss allowance for 12-month expected credit losses at FC1,200\(^{25}\). As at 31 December 20X0, the exchange rate is FC1 to LC1.4. This is reflected in the following table:

\(^{24}\) This example assumes that all qualifying criteria for hedge accounting are met (see paragraph 6.4.1 of IFRS 9). The following description of the designation is solely for the purpose of understanding this example (i.e. it is not an example of the complete formal documentation required in accordance with paragraph 6.4.1 of IFRS 9).

\(^{25}\) For the purpose of simplicity the example ignores the impact of discounting when computing expected credit losses.
The bond is a monetary asset. Consequently, the entity recognises the changes arising from movements in foreign exchange rates in profit or loss in accordance with paragraphs 23(a) and 28 of IAS 21 - *The Effects of Changes in Foreign Exchange Rates*, and recognises other changes in accordance with IFRS 9. For the purposes of applying paragraph 28 of IAS 21 the asset is treated as an asset measured at amortised cost in the foreign currency.

As shown in the table, on 31 December 20X0 the fair value of the bond is LC134,918 (FC96,370 × 1.4) and its amortised cost is LC138,320 (FC(100,000–1,200) × 1.4).

The gain recognised in profit or loss that is due to the changes in foreign exchange rates is LC39,520 (LC138,320 – LC98,800), i.e. the change in the amortised cost of the bond during 20X0 in LC. The change in the fair value of the bond in LC, which amounts to LC34,918, is recognised as an adjustment to the carrying amount. The difference between the fair value of the bond and its amortised cost in LC is LC3,402 (LC134,918 – LC138,320). However, the change in the cumulative gain or loss recognised in other comprehensive income during 20X0 as a reduction is LC 4,602 (LC3,402 + LC1,200).

A gain of LC2,572 (FC1,837 × 1.4) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive income in the same period. For simplicity, journal entries for the recognition of interest revenue are not provided. It is assumed that interest accrued is received in the period.
The entity makes the following journal entries on 31 December 20X0:

<table>
<thead>
<tr>
<th>Debit LC</th>
<th>Credit LC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset—FVOCI</td>
<td>34,918</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>4,602</td>
</tr>
<tr>
<td>Profit or loss</td>
<td>39,520</td>
</tr>
</tbody>
</table>

(To recognise the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)

<table>
<thead>
<tr>
<th>Debit LC</th>
<th>Credit LC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Swap</td>
<td>2,572</td>
</tr>
<tr>
<td>Profit or loss</td>
<td>2,572</td>
</tr>
</tbody>
</table>

(To remeasure the swap at fair value)

<table>
<thead>
<tr>
<th>Debit LC</th>
<th>Credit LC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit or loss</td>
<td>2,572</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>2,572</td>
</tr>
</tbody>
</table>

(To recycle the change in fair value of the swap)

In accordance with paragraph 16A of IFRS 7, the loss allowance for financial assets measured at fair value through other comprehensive income is not presented separately as a reduction of the carrying amount of the financial asset. However, disclosure would be provided about the accumulated impairment amount recognised in other comprehensive income.

As at 31 December 20X1 (the reporting date), the fair value of the bond decreased to FC87,114 because of an increase in market interest rates and an increase in the credit risk of the bond. The fair value of the swap increased by FC255 to FC2,092. In addition, as at 31 December 20X1 the entity determines that there has been a significant increase in credit risk on the bond since initial recognition, so a loss allowance at an amount equal to lifetime expected credit losses is recognised. The estimate of lifetime expected credit losses as at 31 December 20X1 is FC9,700. As at 31 December 20X1, the exchange rate is FC1 to LC1.25. This is reflected in the following table:

26 For simplicity this example assumes that credit risk does not dominate the fair value hedge relationship.
### CHAPTER 9: SUBSEQUENT MEASUREMENT OF FINANCIAL INSTRUMENTS (INCLUDING IMPAIRMENT)

<table>
<thead>
<tr>
<th></th>
<th>31 December 20X0</th>
<th>31 December 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Bond</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fair value (FC)</td>
<td>96,370</td>
<td>87,114</td>
</tr>
<tr>
<td>Fair value (LC)</td>
<td>134,918</td>
<td>108,893</td>
</tr>
<tr>
<td>Amortised cost (FC)</td>
<td>98,800</td>
<td>90,300</td>
</tr>
<tr>
<td>Amortised cost (LC)</td>
<td>138,320</td>
<td>112,875</td>
</tr>
<tr>
<td><strong>Interest rate swap</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate swap (FC)</td>
<td>1,837</td>
<td>2,092</td>
</tr>
<tr>
<td>Interest rate swap (LC)</td>
<td>2,572</td>
<td>2,615</td>
</tr>
<tr>
<td><strong>Impairment – loss allowance</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss allowance (FC)</td>
<td>1,200</td>
<td>9,700</td>
</tr>
<tr>
<td>Loss allowance (LC)</td>
<td>1,680</td>
<td>12,125</td>
</tr>
<tr>
<td>FX rate (FC:LC)</td>
<td>1:1.4</td>
<td>1:1.25</td>
</tr>
</tbody>
</table>

As shown in the table, as at 31 December 20X1 the fair value of the bond is LC108,893 (FC87,114 × 1.25) and its amortised cost is LC112,875 (FC100,000 – 9,700) × 1.25).

The lifetime expected credit losses on the bond are measured as FC9,700 as of 31 December 20X1. Thus the impairment loss recognised in profit or loss in LC is LC10,625 (FC(9,700 – 1,200) x 1.25).

The loss recognised in profit or loss because of the changes in foreign exchange rates is LC14,820 (LC112,875 – LC138,320 + LC10,625), which is the change in the gross carrying amount of the bond on the basis of amortised cost during 20X1 in LC, adjusted for the impairment loss. The difference between the fair value of the bond and its amortised cost in the functional currency of the entity on 31 December 20X1 is LC3,982 (LC108,893 – LC112,875). However, the change in the cumulative gain or loss recognised in other comprehensive income during 20X1 as a reduction in other comprehensive income is LC11,205 (LC3,982 – LC3,402 + LC10,625).

A gain of LC43 (LC2,615 – LC2,572) on the swap is recognised in profit or loss and, because it is assumed that there is no hedge ineffectiveness, an equivalent amount is recycled from other comprehensive income in the same period.
The entity makes the following journal entries on 31 December 20X1:

<table>
<thead>
<tr>
<th>Debit LC</th>
<th>Credit LC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset—FVOCI</td>
<td>26,025</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>11,205</td>
</tr>
<tr>
<td>Profit or loss</td>
<td>14,820</td>
</tr>
<tr>
<td>(To recognise the foreign exchange gain on the bond, the adjustment to its carrying amount measured at fair value in LC and the movement in the accumulated impairment amount due to changes in foreign exchange rates)</td>
<td></td>
</tr>
<tr>
<td>Swap</td>
<td>43</td>
</tr>
<tr>
<td>Profit or loss</td>
<td>43</td>
</tr>
<tr>
<td>(To recycle the change in fair value of the swap)</td>
<td></td>
</tr>
<tr>
<td>Profit or loss</td>
<td>43</td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>43</td>
</tr>
<tr>
<td>(To recycle the change in fair value of the swap)</td>
<td></td>
</tr>
<tr>
<td>Profit or loss (impairment loss)</td>
<td>10,625</td>
</tr>
<tr>
<td>Other comprehensive income (accumulated impairment amount)</td>
<td>10,625</td>
</tr>
<tr>
<td>(To recognise lifetime expected credit losses)</td>
<td></td>
</tr>
</tbody>
</table>

On 1 January 20X2, the entity decides to sell the bond for FC87,114, which is its fair value at that date and also closes out the swap at fair value. The foreign exchange rate is the same as at 31 December 20X1. The journal entries to derecognise the bond and reclassify the gains and losses that have accumulated in other comprehensive income would be as follows:
### 9.4.11. Write off

The write off is defined by IFRS 9.5.4.4 as a derecognition event that consists in reducing the gross carrying amount of the financial asset. It happens when an entity has “no reasonable expectations” of recovering the contractual cash flows in its entirety or a portion thereof.

Estimated the moment when there are no reasonable expectations any longer is a judgemental area. Diversity may arise in practice, especially taking into account the specificities of the legal environment of transactions.

IFRS 9 explicitly permits partial write off. IFRS 9.B5.4.9 describes a situation where an entity expects to recover only 30% of the asset by selling its collateral, but has no reasonable prospects of recovering any further cash flows from the financial asset. In that situation, IFRS 9 requires writing off the remaining 70% of the financial asset.