Chapter 15

Leases (IFRS 16)

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Leases (IFRS 16)

Objective and scope

15.1 The objective of IFRS 16 is to set out the principles for the recognition, measurement, presentation and disclosure of leases.

[IFRS 16 para 1].

15.2 A lease is defined as a *"contract, or a part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration"*.

[IFRS 16 App A].

15.3 The standard excludes from its scope:

- leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources;
- leases of biological assets within the scope of IAS 41, 'Agriculture', held by lessees;
- service concession arrangements within the scope of IFRIC 12, 'Service concession arrangements';
- licences of intellectual property granted by a lessor within the scope of IFRS 15, 'Revenue from contracts with customers'; and
- rights held by lessees under licensing agreements within the scope of IAS 38, 'Intangible assets', for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.

[IFRS 16 para 3].

15.4 A lessee can choose to apply IFRS 16 to leases of intangible assets other than those mentioned above.

[IFRS 16 para 4].

Identifying a lease

15.5 A contract is, or contains, a lease if there is an identified asset and the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration.

[IFRS 16 para 9].

FAQ 15.5.1 – How is the term 'consideration' interpreted?

FAQ 15.5.2 – How is the term 'period of time' interpreted?

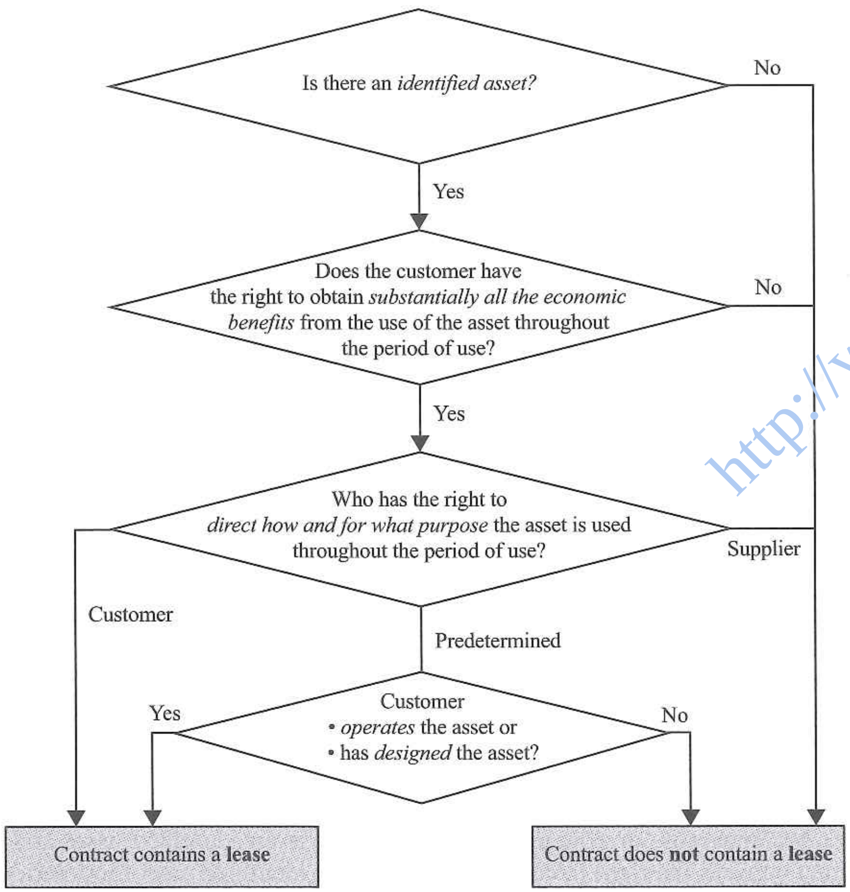
15.6 An entity assesses whether a contract is, or contains, a lease at the inception date. The inception date is the earlier of the date of a lease agreement and the date of commitment by the parties to the principal terms and conditions of the lease.

[IFRS 16 para 9].

15.7 An entity does not re-assess whether a contract contains a lease unless the terms and conditions of the contract are changed.

[IFRS 16 para 11].

15.8 The flow chart below summarises the analysis to be made to evaluate whether a contract contains a lease:



[IFRS 16 App B para B31].

15.9 An asset can be identified either explicitly or implicitly. If explicit, the asset is specified in the contract (for example, by a serial number or a similar identification marking); if implicit, the asset is not mentioned in the contract but is implicitly specified when the supplier makes it available to the customer. Both cases could result in an identified asset.

[IFRS 16 App B para B13].

FAQ 15.9.1 – Evaluation of whether the fulfilment of an arrangement is dependent on the use of an identified asset

15.10 There is no identified asset if the supplier has a substantive right to substitute the asset throughout the period of use. Substitution rights are substantive if the supplier has the practical ability to substitute an alternative asset and would benefit economically from substituting the asset.

[IFRS 16 App B para B14].

FAQ 15.10.1 – What has to be considered to assess whether a lessor benefits economically from substituting the asset?

15.11 The cost of substitution is generally higher where an asset is located at the customer's premises. The cost of substitution in these circumstances could outweigh its benefits.

[IFRS 16 App B para B17].

15.12 The assessment of whether a substitution right is substantive depends on the facts and circumstances at inception of the contract. It does not take into account circumstances that are not considered likely to occur.

[IFRS 16 App B para B16].

15.13 A right to substitute an asset if it is not operating properly, or if there is a technical update required, does not prevent the contract from being dependent on an identified asset.

[IFRS 16 App B para B18].

15.14 A supplier's right or obligation to substitute an underlying asset, for any reason, on or after a particular date or on the occurrence of a specified event does not prevent the contract from being dependent on an identified asset. The supplier does not have the practical ability to substitute alternative assets throughout the period of use.

[IFRS 16 App B para B15].

FAQ 15.14.1 – Substitution rights at a particular point in time or on the occurrence of a particular event

15.15 A substitution right is presumed to not be substantive if the customer cannot readily determine whether the supplier has a substantive substitution right.

[IFRS 16 App B para B19].

15.16 An identified asset can be a physically distinct portion of a larger asset, such as one floor of a multi-level building, or physically distinct dark fibres within a cable. A capacity portion (that is, a portion of a larger asset that is not physically distinct) is not an identified asset unless it represents substantially all of the capacity of the entire asset. A capacity portion of a fibre-optic cable that does not represent substantially all of the capacity of the cable would not qualify as an identified asset, because it is not physically distinct.

[IFRS 16 App B para B20].

15.17 A contract conveys the right to control the use of an identified asset if the customer has both the right to obtain substantially all of the economic benefits from use of the identified asset and the right to direct the use of the identified asset throughout the period of use.

[IFRS 16 App B para B9].

15.18 An entity can obtain economic benefits directly or indirectly (for example, by using, holding or subleasing the asset). Benefits include the primary output and any by-products (including potential cash flows derived from these items), as well as payments from third parties that relate to the use of the identified asset, within the defined scope of the entity's right to use the asset. Economic benefits relating to the ownership of the asset are ignored.

[IFRS 16 App B para B21]. [IFRS 16 App B para B22].

FAQ 15.18.1 – What are economic benefits relating to the ownership of an asset?

15.19 The entity must determine which party (that is, the customer or the supplier) has the right to direct how and for what purpose the identified asset is used throughout the period of use.

[IFRS 16 App B para B24].

15.20 The standard gives several examples of relevant decision-making rights:

- Right to change what type of output is produced.
- Right to change when the output is produced.
- Right to change where the output is produced.
- Right to change how much of the output is produced.

[IFRS 16 App B para B26].

FAQ 15.20.1 – Which decisions should be considered when assessing which party has the right to direct the use of an asset?

15.21 The relevance of each of the decision-making rights depends on the underlying asset being considered and on the terms and conditions of the contract. If both parties have decision-making rights, an entity considers the rights that are most relevant to changing how and for what purpose the asset is used. Decision-making rights are relevant where they affect the economic benefits to be derived from the use of the asset.

[IFRS 16 App B para B25].

15.22 An entity does not take into account protective rights in its assessment. A supplier might limit the use of an asset by a customer, in order to protect its personnel or to ensure compliance with relevant laws and regulations. For example, a customer who has hired a ship is prevented from sailing the ship into waters with a high risk of piracy or transporting hazardous materials. These protective rights do not affect the assessment of which party to the contract has the right to direct the use of the identified asset.

[IFRS 16 App B para B30].

15.23 Decisions about maintaining and operating an asset do not grant the right to direct the use of the asset. An entity only takes them into account if the decisions about how and for what purpose the asset is used are predetermined.

[IFRS 16 App B para B27].

15.24 The decisions about how and for what purpose the underlying asset is used could be predetermined before the inception of the lease. The customer in this case has the right to direct the use of an asset if either:

- it has the right to operate the identified asset throughout the period of use, without the supplier having the right to change those operating instructions; or
- it has designed the identified asset (or specific aspects of the asset) in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

[IFRS 16 App B para B24].

FAQ 15.24.1 – What has to be considered when analysing decisions that are made before the inception of the lease?

15.25 Decisions made before the period of use are ignored, unless they are made in the context of the design of the asset by a customer that predetermines its use.

[IFRS 16 App B para B29].

15.26 The analysis of whether a contract contains a lease can be complex. For various industries, examples are included below.

FAQ 15.26.1 – Applying the lease definition to a retail unit

FAQ 15.26.2 – Applying the lease definition to a rail car

Leases (IFRS 16)

FAQ 15.26.3 – Applying the lease definition to a fibre-optic cable

FAQ 15.26.4 – Applying the lease definition to a ship

FAQ 15.26.5 – Applying the lease definition to a solar farm/power plant

FAQ 15.26.6 – What are the main differences between IAS 17/IFRIC 4 and IFRS 16 with respect to the definition of a lease?

15.27 A joint arrangement, as defined by IFRS 11, 'Joint arrangements', or someone on behalf of the joint arrangement, could be the customer in a contract to receive goods or services. An assessment must be made as to whether the joint arrangement has the right to control the use of the identified asset.

[IFRS 16 App B para B11].

FAQ 15.27.1 – How does an entity assess whether a joint arrangement has the right to control the use of an identified asset?

Separating components of a contract

15.28 Contracts often combine different kinds of obligations of the supplier, which might be a combination of lease components or a combination of lease and non-lease components. For example, the lease of an industrial area might contain the lease of land, buildings and equipment, or a contract for a car lease might be combined with maintenance. In a multi-element arrangement, an entity has to identify each separate lease component (based on the guidance on the definition of a lease) and account for it separately.

[IFRS 16 para 12].

15.29 An arrangement contains more than one lease component if both of the following criteria are met:

- the lessee can benefit from use of the asset, either on its own or together with other resources that are readily available to the lessee; and
- the underlying asset is neither highly dependent on, nor highly interrelated with, the other underlying assets in the contract.

[IFRS 16 App B para B32].

15.30 When identifying non-lease components, an entity must consider whether a good or service is transferred to the lessee. For example, if a lessee pays for the right to use an asset and also for administrative tasks, which do not transfer a good or service to the lessee, the administrative tasks are not a separate non-lease component.

[IFRS 16 App B para B33].

FAQ 15.29.1 – How does a lessor separate components of a contract under IFRS 16 and IFRS 15?

15.31 The consideration must be allocated between the components if the analysis concludes that there are separate components (unless the practical expedient in para 15.34 is applied).

[IFRS 16 para 12].

15.32 The lessee allocates the consideration on the basis of relative stand-alone prices. The lessee estimates prices if observable stand-alone prices are not readily available, and it should maximise the use of observable information.

[IFRS 16 para 13]. [IFRS 16 para 14].

15.33 The lessor allocates the consideration on the basis of relative stand-alone selling prices in accordance with IFRS 15.

[IFRS 16 para 17].

FAQ 15.33.1 – How is the consideration allocated if the lessor sells disposables to the lessee?

15.34 As a practical expedient, lessees do not need to separate lease and non-lease components. A lessee can account for each lease component and any associated non-lease components as a single lease component. For example, a lessee that leases several machines (each of which meets the definition of a separate lease component) and also receives maintenance services from the lessor has two alternatives: the lessee can account for each lease component and each service component separately; or it can decide to combine the lease of a machine and the maintenance service related to that lease, and account for it as a single lease component. The practical expedient is an accounting policy choice by class of underlying asset.

[IFRS 16 para 15].

Combination of contracts

15.35 Several contracts with the same counterparty might be entered into, at or near the same time and in contemplation of each other. An entity combines contracts entered into at or near the same time with the same counterparty (or related parties of the counterparty) if one or more of the following conditions are met:

- the contracts are negotiated as a package with an overall commercial objective;
- the consideration in one contract depends on the price/performance of the other contract; or
- the assets involved are a single lease component.

The combination affects both the assessment of whether there is a lease and the accounting for the potential lease.

[IFRS 16 App B para B2].

FAQ 15.35.1 – Accounting for temporary building solutions provided based on separate contracts

Lease term

15.36 The lease term begins on the date on which the lessor makes the underlying asset available for use by a lessee (commencement date).

[IFRS 16 App B para B36].

15.37 The lease term includes the non-cancellable period for which the lessee has the right to use an underlying asset. Periods covered by an option to extend the lease term are included in the lease term if the lessee is reasonably certain to exercise that option. The same rationale applies to termination options. The term covered by a termination option is included in the lease term if the lessee is reasonably certain not to exercise the option. Otherwise, the lease term ends at the point in time when the lessee can exercise the termination option.

[IFRS 16 para 18].

FAQ 15.37.1 – How do termination options affect the length of the lease term?

FAQ 15.37.2 – How are perpetual lease contracts with bilateral termination options accounted for?

15.38 An entity should consider all facts and circumstances that create an economic incentive for the lessee to exercise an extension option (or not to exercise a termination option) in order to assess whether the exercise (or the non-exercise) is reasonably certain.

[IFRS 16 para 19].

15.39 Examples of factors that an entity takes into account are:

- Contractual terms and conditions for optional periods compared with market rates: it is more likely that a lessee will not exercise an extension option if lease payments exceed market rates. Other examples of terms that an entity takes into account are termination penalties or residual value guarantees.
- Significant leasehold improvements undertaken (or expected to be undertaken): it is more likely that a lessee will exercise an extension option if a lessee makes significant investments to improve the leased asset or to tailor it for its special needs.

- Costs relating to the termination of the lease/signing of a replacement lease: it is more likely that a lessee will exercise an extension option if doing so avoids costs such as negotiation costs, relocation costs, costs of identifying another suitable asset, costs of integrating a new asset, and costs of returning the original asset in a contractually specified condition or to a contractually specified location.
- The importance of the underlying asset to the lessee's operations: it is more likely that a lessee will exercise an extension option if the underlying asset is specialised or if suitable alternatives are not available.
- Conditionality associated with exercising the option, and the likelihood that those conditions will exist.

[IFRS 16 App B para B37].

FAQ 15.39.1 – How is the lease term impacted by break clauses?

FAQ 15.39.2 – How is the lease term impacted by extension options?

FAQ 15.39.3 – How should the different indicators of reasonable certainty be weighted?

15.40 There could be contracts that combine options with other features so that the lessor receives a guaranteed payment, whether or not the lessee exercises the option. An example is a combination of an extension option and a residual value guarantee. An entity should, in this case, assume that the lessee is reasonably certain to exercise the option to extend the lease.

[IFRS 16 App B para B38].

15.41 A lessee's past practice regarding the period over which it has typically used particular types of asset, and its economic reasons for doing so, might also provide helpful information.

[IFRS 16 App B para B40].

15.42 The assessment of the lease term is made at the commencement date (see para 15.36 for the definition of commencement date).

[IFRS 16 App B para B41].

15.43 A lessee re-assesses extension options and termination options only when a significant event or change in circumstances occurs that is within the control of the lessee and affects whether it is reasonably certain to exercise an option. A lessor does not re-assess whether or not an option is reasonably certain to be exercised.

[IFRS 16 para 20].

FAQ 15.43.1 – What are significant events or changes in circumstances within the control of the lessee that affect whether it is reasonably certain to exercise an option?

15.44 A change in the non-cancellable lease period results in a change in the lease term for both lessee and lessor. Examples of a change in the non-cancellable lease period include:

- the lessee exercises an option in a different way than the entity had previously determined was reasonably certain; or
- an event occurs that contractually obliges the lessee to exercise an option (/ prohibits the lessee from exercising an option) not previously included in the determination of the lease term (/previously included in the determination of the lease term). For example, a lessee of a retail store might be contractually obliged to extend the lease term if revenues from that store exceed a certain amount for the first time.

[IFRS 16 para 21].

Recognition and measurement exemptions

15.45 IFRS 16 contains two recognition and measurement exemptions: short-term leases; and leases for which the underlying asset is of low value. Both exemptions are optional, and they apply only to lessees.

[IFRS 16 para 5].

15.46 A lessee that applies either or both of the exemptions recognises the lease payments as expenses on a straight-line basis or another systematic basis that is more representative of the pattern of the lessee's benefit.

[IFRS 16 para 6].

Short-term leases

15.47 Short-term leases are leases with a lease term of 12 months or less. The lease term also includes periods covered by an option to extend, or an option to terminate, if the lessee is reasonably certain to exercise the extension option, or not to exercise the termination option. A lease that contains a purchase option is not a short-term lease.

[IFRS 16 App A].

FAQ 15.47.1 – Can perpetual lease contracts that contain termination options qualify as short-term leases?

15.48 The exemption for short-term leases must be applied by class of underlying asset.

[IFRS 16 para 8].

15.49 If a lease for which the short-term lease exemption has been taken is subsequently modified or the lease term is changed, it is accounted for as a new lease.

[IFRS 16 para 7].

Leases of low-value assets

15.50 A lessee makes the assessment of whether the underlying asset is of low value based on the value of the asset when it is new, regardless of the age of the asset.

[IFRS 16 App B para B3].

FAQ 15.50.1 – How does IFRS 16 define the term 'low value'?

15.51 The low-value exemption can be applied on a lease-by-lease basis.

[IFRS 16 para 8].

15.52 The analysis of low-value leases does not require the lessee to determine whether low-value assets in aggregate are material. The exemption is still available, even if the aggregate value of low-value leases is material to the lessee.

[IFRS 16 App B para B4].

15.53 An underlying asset only qualifies for the low-value exemption if two additional criteria are met. First, the lessee must be able to benefit from the asset on its own or together with other resources that are readily available. Secondly, the underlying asset must not be dependent on, or highly interrelated with, other assets.

[IFRS 16 App B para B5].

FAQ 15.53.1 – How does a lessee assess whether a leased asset meets the low-value asset criteria?

15.54 A lease does not qualify as a lease of a low-value asset if a lessee sub-leases, or expects to sub-lease, the leased asset.

[IFRS 16 App B para B7].

Portfolio exemption

15.55 Both a lessee and a lessor can apply IFRS 16 to a portfolio of leases with similar characteristics if they reasonably expect that the resulting effect is not materially different from applying the standard on a lease-by-lease basis.

[IFRS 16 App B para B1].

Accounting by lessees

Recognition

15.56 Lessees recognise a right-of-use asset and a corresponding lease liability for almost all lease contracts. A lease contract is the acquisition of a right to use an underlying asset, with the purchase price paid in instalments. The lessee recognises the right-of-use asset and the lease liability initially at the commencement date.

[IFRS 16 para 22].

Initial measurement – lease liability

15.57 At the commencement date, the lessee measures the lease liability at an amount equal to the present value of the lease payments during the lease term that are not paid at that date.

[IFRS 16 para 26].

15.58 The discount rate that the lessee uses is the interest rate implicit in the lease, if that rate can be readily determined. This is the rate of interest that causes the present value of (a) lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

[IFRS 16 para 26].

15.59 The lessee uses its incremental borrowing rate if the interest rate implicit in the lease cannot be readily determined.

[IFRS 16 para 26].

FAQ 15.59.1 – Which discount rate should a lessee use if the interest rate implicit in the lease is negative?

15.60 The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow, over a similar term and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment.

[IFRS 16 App A].

FAQ 15.60.1 – What factors should a lessee consider when determining an incremental borrowing rate?

15.61 Lease payments consist of the following components:

- fixed payments (including in-substance fixed payments), less any lease incentives receivable;

- variable lease payments that depend on an index or a rate;
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase option (if the lessee is reasonably certain to exercise that option); and
- payments of penalties for terminating the lease (if the lease term reflects the lessee exercising the option to terminate the lease).

[IFRS 16 para 27].

FAQ 15.61.1 – How should a lessee account for reimbursements from the lessor for leasehold improvements?

15.62 Payments for the right to use the underlying asset qualify as lease payments, regardless of the timing of the payments.

[IFRS 16 App B para B44].

Variable lease payments

15.63 There are three kinds of contingent payment, depending on the underlying variable:

- payments based on an index or a rate;
- payments not based on an index or a rate; and
- in-substance fixed payments.

[IFRS 16 para 27].

15.64 Variable lease payments based on an index or a rate are part of the lease liability. Examples include payments linked to a consumer price index, a benchmark interest rate or a market rental rate. These payments are unavoidable from the perspective of the lessee, because any uncertainty relates only to the measurement of the liability, but not to its existence.

[IFRS 16 para 28].

15.65 Variable lease payments based on an index or a rate are initially measured using the index or the rate at the commencement date. An entity does not forecast future changes of the index/rate; these changes are taken into account when the lease payments change.

[IFRS 16 para 27].

FAQ 15.65.1 – How are variable lease payments that depend on an index or a rate initially measured?

Chapter 42

Classification and measurement (IFRS 9)

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Introduction

42.1 The publication of IFRS 9 in July 2014 was the culmination of the IASB's efforts to replace IAS 39. IFRS 9 was released in phases from 2009 to 2014. In July 2014, limited modifications to the requirements for classifying and measuring financial assets were finalised, including the introduction of a fair value through other comprehensive income (FVOCI) category for debt instruments. IFRS 9 is mandatory for periods beginning on or after 1 January 2018, with early adoption permitted.

42.2 This chapter only covers the classification and measurement requirements of IFRS 9 for financial assets and financial liabilities. The other requirements of IFRS 9 are addressed in separate chapters.

Scope

42.3 IFRS 9 must be applied by all entities preparing their financial statements according to IFRS and to all types of financial assets and financial liabilities within its scope (refer to chapter 40 para 43 for a detailed overview of the scope of IFRS 9).

42.4 Financial assets and financial liabilities that are designated as hedged items are subject to measurement under IFRS 9's hedge accounting requirements (or IAS 39, if applicable). These special accounting rules generally override the normal accounting rules for financial assets. Hedge accounting is covered in chapter 46 (or chapter 6.8A if applying IAS 39).

[IFRS 9 para 5.2.3].

Classification of financial assets

42.5 An entity recognises a financial asset when it first becomes a party to the contractual rights and obligations in the contract. It is, therefore, necessary to measure those contractual rights and obligations on initial recognition.

[IFRS 9 para 3.1.1].

42.6 All financial assets under IFRS 9 are to be initially recognised at fair value, plus or minus (in the case of a financial asset not at FVTPL) transaction costs that are directly attributable to the acquisition of the financial instrument. See chapter 44 para 17 for detailed guidance on trade date versus settlement date accounting for financial asset recognition and de-recognition, and paragraph 42.94 for further guidance on initial measurement considerations.

[IFRS 9 para 5.1.1]. [IFRS 9 para 3.1.2].

42.7 IFRS 9 has two measurement categories: amortised cost and fair value. Movements in fair value are presented in either profit or loss or other comprehensive income (OCI), subject to certain criteria being met, as described below.

[IFRS 9 para 4.1.1].

42.8 To determine which measurement category a financial asset falls into, management should first consider whether the financial asset is an investment in an equity instrument, as defined in IAS 32, by considering the perspective of the issuer or a debt instrument (see chapter 43 para 3 to determine how the instrument would be categorised from the issuer). If the financial asset is an investment in an equity instrument, management should consider the guidance for 'equity instruments' (see para 42.62). If the financial asset is not an investment in an equity instrument, management should consider the guidance for 'debt investments'.

[IAS 32 para 15].

FAQ 42.62.1 – Classification of an investment in a puttable share

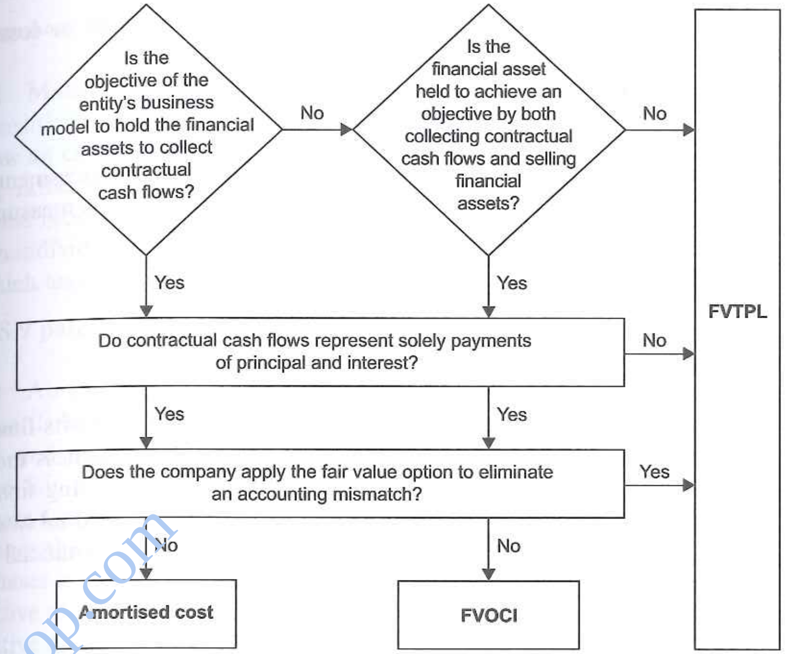
Classification of debt investments

42.9 If the financial asset is a debt instrument (or does not meet the definition of an equity instrument in its entirety), management should consider the following assessments in determining its classification:

- The entity's business model for managing the financial asset.
- The contractual cash flows characteristics of the financial asset.

[IFRS 9 para 4.1.1].

42.10 These considerations are represented in the following flow chart:



42.11 A financial asset should be subsequently measured at amortised cost if both of the following conditions are met:

- the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows; and
- the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding; 'principal' and 'interest' are defined in paragraph 42.34.

[IFRS 9 para 4.1.2].

42.12 A financial asset should be subsequently measured at FVOCI if both of the following conditions are met:

- the financial asset is held within a business model whose objective is achieved by both holding financial assets in order to collect contractual cash flows and selling financial assets; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are SPPI.

[IFRS 9 para 4.1.2A].

42.13 If the financial asset is measured at FVOCI, all movements in the fair value should be taken through OCI, except for the recognition of impairment gains or losses, interest revenue in line with the effective interest method and foreign exchange gains and losses, which are recognised in profit or loss. See paragraph 42.127.

[IFRS 9 para 5.7.10].

42.14 If the financial asset does not pass the business model assessment and SPPI criteria, or the fair value option is applied (see para 42.56), it is measured at FVTPL. This is the residual measurement category.

[IFRS 9 para 4.1.4].

Business model

42.15 An entity's business model refers to how an entity manages its financial assets in order to generate cash flows. IFRS 9 prescribes two business models: holding financial assets to collect contractual cash flows; and holding financial assets to collect contractual cash flows and selling. FVTPL is the residual category which is used for financial assets that are held for trading or if a financial asset does not fall into one of the two prescribed business models.

[IFRS 9 para B4.1.2A].

FAQ 42.15.1 – Business model assessment: stress case scenarios

Determining the business model

42.16 An entity's business model is determined by the entity's key management personnel (as defined in IAS 24).

[IFRS 9 para B4.1.1].

42.17 The business model is typically observable through the activities that the entity undertakes to achieve the objective of the business model. The business model for managing financial assets is not determined by a single factor or activity. Instead, management has to consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

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

[IFRS 9 para B4.1.2B].

Determining the level at which the business model condition should be applied

42.18 Management will need to apply judgement to determine the level at which the business model condition is applied. That determination is made on the basis of how an entity manages its business; it is not made at the level of an individual asset, rather it is performed at a higher level of aggregation. So the entity's business model is not a choice and does not depend on management's intentions for an individual instrument; it is a matter of fact that can be observed by the way in which an entity is managed and information is provided to its management.

[IFRS 9 para B4.1.2].

42.19 An entity can have multiple business models. For example, it might hold one portfolio of investments that it manages in order to collect contractual cash flows, and another portfolio of investments that it manages in order to sell to realise fair value changes. In some circumstances, it might be appropriate to separate a portfolio of financial assets into sub-portfolios, to reflect how an entity manages those financial assets. This might be the case if an entity originates or purchases a portfolio of mortgage loans, and manages some of the loans with an objective of collecting contractual cash flows and manages the other loans with an objective of selling them. This will be a highly judgemental area, because it might be difficult to distinguish, within a portfolio, which financial assets are held to collect, to collect and sell, or to trade.

[IFRS 9 para B4.1.2].

FAQ 42.19.1 – Business model assessment: useful indicators

'Hold to collect' business model

42.20 If the entity's objective is to hold the asset (or portfolio of assets) to collect the contractual cash flows, the asset (or the portfolio) should be classified under the 'hold to collect' business model. If the entity's objective is to hold to collect and sell the asset, see the guidance at paragraph 42.28 onwards below.

[IFRS 9 para B4.1.2C].

42.21 Although the objective of an entity's business model might be to hold financial assets in order to collect contractual cash flows, the entity does not need to hold all of those instruments until maturity. Thus, an entity's business model can be to hold financial assets to collect contractual cash flows, even where sales of financial assets occur or are expected to occur in the future.

[IFRS 9 para B4.1.3].

42.22 IFRS 9 provides guidance on the particular considerations that should be taken into account when assessing sales within the 'hold to collect' business model:

- The historical frequency, timing and value of sales.

- The reason for the sales (such as credit deterioration).
- Expectations about future sales activity.

[IFRS 9 para B4.1.2C].

42.23 Sales themselves do not determine the business model, and so they cannot be considered in isolation. Rather, information about past sales, and expectations about future sales, provide evidence related to the entity's objective for managing the financial assets and, specifically, how cash flows are realised and value is created.

[IFRS 9 para B4.1.2C].

42.24 Credit risk management activities aimed at minimising potential losses due to credit deterioration are not inconsistent with the 'hold to collect' business model. Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity could demonstrate in other ways that the sale occurred due to an increase in credit risk.

[IFRS 9 para B4.1.3A].

> FAQ 42.24.1 – Is alignment required between 'increase in credit risk' for business model purposes and 'significant increase in credit risk' for ECL purposes?

42.25 Some sales or transfers of financial instruments before maturity that are not related to credit risk management activities might be consistent with such a business model if they are infrequent (even if significant in value) or insignificant in value, either individually or in aggregate (even if frequent).

[IFRS 9 para B4.1.3B].

> FAQ 42.25.1 – Sales that are insignificant in value
>
> FAQ 42.25.2 – The impact of sales to a fellow group entity due to regulatory capital constraints

42.26 There is no bright line for how many sales constitute 'infrequent' or 'significant'; an entity will need to use judgement, based on the facts and circumstances. An increase in the frequency or value of sales in a particular period is not necessarily inconsistent with an objective to hold financial assets in order to collect contractual cash flows, if an entity can explain the reasons for those sales and demonstrate why those sales do not reflect a change in the business model. In addition, sales might be consistent with the objective of holding financial assets in order to collect contractual cash flows if the sales are made close to the maturity of the financial assets, and the proceeds from the sales approximate to the collection of the remaining contractual cash flows. IFRS 9 includes a number of examples of how to perform the business model assessment.

[IFRS 9 para B4.1.3B].

42.27 If more than an infrequent number of sales are made out of a portfolio, management should assess whether (and how) such sales are consistent with an objective of collecting contractual cash flows. However, management should be clear about the reason for determining if sales would prevent a group of financial assets from being classified within the 'hold to collect' business model. Entities might consider setting up a process to track this information.

[IFRS 9 para B4.1.3B].

> FAQ 42.27.1 – What examples of sales before maturity would not be inconsistent with a business model of holding financial assets to collect contractual cash flows?
>
> FAQ 42.27.2 – What is the impact of changes in cash flows that are no longer in line with the initial business model assessment?
>
> FAQ 42.27.3 – Business model assessment: portfolio of sub-prime loans
>
> FAQ 42.27.4 – Business model assessment: securitised loans
>
> FAQ 42.27.5 – Business model assessment for inter-company loans

'Hold to collect and sell' business model

42.28 If the entity's objective is to hold a group of financial assets to collect the contractual cash flows and then to sell those financial assets, the portfolio of assets should be classified under the 'hold to collect and sell' business model. The objective of this business model is unlike the 'hold to collect' business model, in which the objective was only to collect contractual cash flows. See paragraph 42.16 onwards above for guidance on how to perform the business model assessment.

[IFRS 9 para B4.1.4A].

42.29 Examples of business model objectives that could be consistent with the 'hold to collect and sell' business model are:

- managing everyday liquidity needs;
- maintaining a particular interest yield profile; and
- matching the duration of the financial assets to the duration of the liabilities that are funding those assets.

[IFRS 9 para B4.1.4A].

42.30 Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and value of sales. This is because selling financial assets is integral to achieving the business model's objective, instead of being only incidental to it.

However, there is no threshold for the frequency or value of sales that must occur in this business model, because both collecting contractual cash flows and selling financial assets are integral to achieving its objective.

[IFRS 9 para B4.1.4B].

42.31 The following are examples of when the objective of the entity's business model can be achieved by both collecting contractual cash flows and selling financial assets.

[IFRS 9 para B4.1.4C].

FAQ 42.31.1 – Business model assessment: financial assets used to fund future capital expenditure

FAQ 42.31.2 – Business model assessment: financial assets held to manage liquidity needs

FAQ 42.31.3 – Business model assessment: financial assets held by an insurer to fund financial liabilities

FAQ 42.31.4 – Business model assessment: banks that sell down loans to manage single counterparty credit risk limits

FAQ 42.31.5 – Impact of internal transfers on the business model

FAQ 42.31.6 – Impact of factoring on business model assessment

Fair value through profit or loss category

42.32 If a financial asset or group of financial assets is not held within the 'hold to collect' or the 'hold to collect and sell' business model, it should be measured at FVTPL. FVTPL is the residual category under IFRS 9. Additionally, a business model in which an entity manages financial assets, with the objective of realising cash flows through solely the sale of the assets, would result in an FVTPL business model. Even though the entity might collect contractual cash flows while it holds the financial assets, the objective of such a business model is not achieved by both collecting contractual cash flows and selling financial assets. This is because the collection of contractual cash flows is not integral to achieving the business model's objective; instead, it is incidental to it.

[IFRS 9 para B4.1.5].

FAQ 42.27.4 – Business model assessment: securitised loans

FAQ 42.32.1 – Business model assessment: different components of syndicated loans

FAQ 42.32.2 – Impact of fair value information on business model classification for repo transactions

Solely payments of principal and interest criteria

42.33 Once the business model assessment has been performed, management should assess whether the contractual cash flows of the financial asset represent solely payments of principal and interest (SPPI). Instruments that do not meet the 'hold to collect' or 'hold to collect and sell' business models are measured at FVTPL. For these instruments, the SPPI criterion is not relevant. Therefore, assessing the SPPI criterion is only necessary for the financial asset, or group of financial assets, to determine whether it should be classified at amortised cost or FVOCI.

[IFRS 9 para B4.1.7].

42.34 IFRS 9 provides definitions of 'principal' and 'interest' that will help management to make a preliminary assessment of whether contractual cash flows represent SPPI:

- 'Principal' is defined as the fair value of the financial asset at initial recognition.
- 'Interest' consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding, and for other basic lending risks (for example, liquidity risk) and costs (for example, servicing or administrative costs) associated with holding a financial asset for a period of time, as well as a profit margin. These are consistent with features of a basic lending arrangement. In extreme economic circumstances, interest can be negative if, for example, the holder of a financial asset, either explicitly or implicitly, pays for the deposit of its money, and that fee exceeds the consideration that the holder receives for the time value of money, credit risk and other basic lending risks and costs.

[IFRS 9 para 4.1.3]. [IFRS 9 para B4.1.7A].

FAQ 42.34.1 – Assessing SPPI for floating-rate instruments acquired at a discount

42.35 Contractual features that introduce exposure to risks or volatility in the contractual cash flows unrelated to a basic lending arrangement, such as exposure to changes in equity or commodity prices, do not give rise to contractual cash flows that are SPPI. For example, convertible bonds and profit participating loans will not meet the SPPI criterion.

[IFRS 9 para B4.1.7A].

FAQ 42.35.1 – Interplay between SPPI test and de-recognition

Modified solely payments of principal and interest

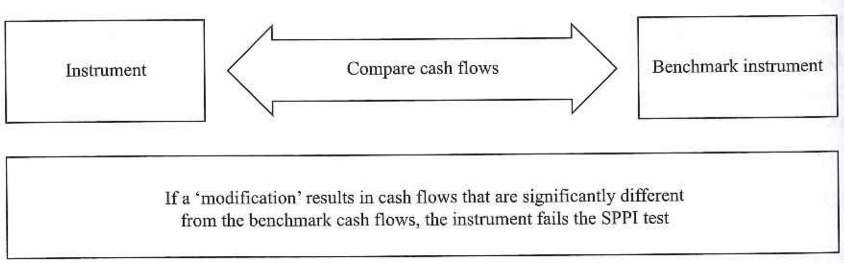
42.36 When assessing the SPPI condition, interest is, amongst others, consideration for the time value of money or, put simply, the passage of time (as noted in para 42.34 above). The time value of money element does not provide consideration for other risks or costs associated with holding the financial asset. In order to assess whether the time value of money element provides consideration for only the passage of time, an entity applies judgement and considers relevant factors, such as the currency in which the financial asset is denominated and the period for which the interest rate is set.

[IFRS 9 para B4.1.9A].

42.37 In some cases, however, the time value of money element can be modified. This might be the case, for example, if a financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates, or if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate). IFRS 9 provides guidance on how to assess whether contractual cash flows represent SPPI where the time value of money element of interest has been modified (the 'modified time value of money' element). Both qualitative and quantitative approaches can be used to determine whether the time value of money element of the interest rate provides consideration for just the passage of time.

[IFRS 9 para B4.1.9B].

42.38 When assessing a financial asset with a modified time value of money element, the IFRS 9 proposes that an entity should compare the contractual cash flows of the financial asset under assessment to the cash flows of a 'perfect' ('benchmark') instrument (that is, the cash flows that would arise if the time value of money element was not modified). For example, if the financial asset under assessment contains a variable interest rate that is reset every month to a one-year interest rate, the entity would compare that financial asset to a financial instrument with identical contractual terms and the identical credit risk, except that the variable interest rate is reset monthly to a one-month interest rate. If the difference between the cash flows of the benchmark instrument and the cash flows of the instrument under assessment are significantly different, its contractual cash flows are not considered SPPI, and the instrument must be measured at FVTPL.



[IFRS 9 para B4.1.9C].

42.39 It is not necessary to perform a detailed quantitative assessment if it is clear, with little or no analysis, that the cash flows of the instrument with a modified time value of money element are, or are not, significantly different from

the benchmark cash flows (that is, 'qualitative assessment' only). In performing a quantitative assessment for the instruments within the scope of this test, several factors need to be considered:

- An entity compares contractual un-discounted cash flows of the instrument with the contractual un-discounted cash flows that would arise if the time value of money element was not modified (that is, the 'benchmark' cash flows).
- The appropriate comparable 'benchmark' instrument is one with the same credit quality and the same contractual terms (for example, the same reset terms), except for the modification being evaluated.
- An entity must consider the effect of the modified time value of money element in each reporting period and cumulatively over the life of the instrument.
- An entity considers only reasonably possible scenarios rather than every possible scenario. However, identification of a range of scenarios is required, which means that more than one scenario needs to be evaluated.

[IFRS 9 para B4.1.9D].

FAQ 42.39.1 – Interpreting 'significantly different' when performing the modified time value of money test

FAQ 42.39.2 – Determining when a qualitative assessment of the SPPI criterion is required if the time value of money element is modified under a range of different scenarios

FAQ 42.39.3 – Applying the modified time value test to a 10-year bond whose interest rate resets annually to a 10-year rate

FAQ 42.39.4 – How should the 'benchmark test' be applied when assessing SPPI?

Regulated interest rates

42.40 In some jurisdictions, the government or a regulatory authority establishes interest rates. In some of these cases, the objective of the time value of money element in the interest rate is not to provide consideration for only the passage of time. However, a regulated interest rate is a proxy for the time value of money element, for the purpose of assessing the SPPI criterion, if that regulated interest rate provides consideration that is broadly consistent with the passage of time, and it does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement. In this case, a qualitative assessment would be sufficient to assess that the financial asset meets the SPPI criterion.

[IFRS 9 para B4.1.9E].

FAQ 42.40.1 – Determining SPPI for loans in highly regulated countries

FAQ 42.40.2 – Assessing SPPI for a five-year constant maturity interest rate loan

Contractual terms that change the timing or amount of contractual cash flows

42.41 If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows, the entity must determine whether the contractual cash flows that could arise over the life of the instrument, due to that contractual term, are SPPI. To make this determination, the entity must assess the contractual cash flows that could arise both before and after the change in contractual cash flows.

[IFRS 9 para B4.1.10].

Contingent events affecting cash flows

42.42 The entity might also need to assess the nature of any contingent event (that is, the trigger) that would change the timing or amount of the contractual cash flows. While the nature of the contingent event in itself is not a determinative factor in assessing whether the contractual cash flows are SPPI, it might be an indicator.

[IFRS 9 para B4.1.10].

FAQ 42.42.1 – [*Not used*]

FAQ 42.42.2 – Assessing SPPI where the issuer can pre-pay when the FTSE 100 index reaches a specific level

FAQ 42.42.3 – Assessing SPPI for loans with embedded cross-selling clauses

FAQ 42.42.4 – Impact of change of control provisions on the SPPI criterion

Pre-payment and extension options

42.43 If a financial asset contains a contractual term that could change the timing or amount of contractual cash flows, and the cash flows before and after the change in contractual cash flows are significantly different, the asset generally does not meet the SPPI criterion. Despite that, a financial asset meets the SPPI criterion if it contains a contractual term that permits (or requires) the issuer to pre-pay a debt instrument, or permits (or requires) the holder to put a debt instrument back to the issuer before maturity, if the entity acquires or originates the financial asset at a premium or discount to the contractual par amount, and:

- the pre-payment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest, which might include reasonable additional compensation for the early termination of the contract; and

- when the entity initially recognises the financial asset, the fair value of the pre-payment feature is insignificant.

[IFRS 9 para 4.1.12].

42.44 Similarly, a financial asset meets the SPPI criterion if it contains a contractual term that permits the issuer or the holder to extend the contractual term of a debt instrument, and the terms of the extension option result in contractual cash flows during the extension period that are SPPI on the principal amount outstanding, which might include reasonable additional compensation for the extension of the contract. If these conditions are met, the financial asset could still be measured at amortised cost or FVOCI, subject to satisfying the business model assessment.

[IFRS 9 para B4.1.11].

FAQ 42.44.1 – Assessing SPPI on a loan when the bank has an extension option

Examples of contractual terms

42.45 The standard provides the following examples of contractual cash flows that meet the SPPI criterion:

- An instrument such as a bond where the payments of principal and interest are linked to an un-leveraged inflation index of the currency in which the instrument is issued.
- An instrument that allows the borrower to choose the market interest rate on an ongoing basis, provided that the interest is reset with a frequency that matches the tenor of the interest rate, and the interest paid over the life of the instrument reflects consideration for the time value of money, for the credit risk associated with the instrument, and for other basic lending risks and costs, as well as a profit margin.
- An instrument such as a bond with a stated maturity date that pays a variable market interest rate that is subject to a cap, provided that the interest reflects consideration for the time value of money, for the credit risk associated with the instrument during the term of the instrument, and for other basic lending risks and costs, as well as a profit margin. The same principle applies to a bond that pays a variable market interest rate that is subject to a floor.
- An instrument such as a full recourse loan that is secured by collateral.
- An instrument that is issued by a regulated bank and has a stated maturity date. The instrument pays a fixed interest rate, and all contractual cash flows are non-discretionary. However, the issuer is subject to legislation that permits or requires a national resolving authority to impose losses on holders of the instrument in particular circumstances. For example, the national resolving authority has the power to write down the par amount of

the instrument, or to convert it into a fixed number of shares ('bail-in clause').

[IFRS 9 para B4.1.13].

FAQ 42.45.1 – Assessing SPPI for a euro bond linked to inflation in a Eurozone country

FAQ 42.45.2 – Assessing SPPI for changing credit spreads in loans with price-ratcheting clauses

FAQ 42.45.3 – Interaction of contractual and legal terms in loan contracts when assessing the SPPI criterion

FAQ 42.45.4 – Assessing SPPI when banks can adjust interest rates

FAQ 42.45.5 – Assessing SPPI for a multi-currency bond

FAQ 42.45.6 – Assessing SPPI for step-up notes

FAQ 42.45.7 – Assessing SPPI for shareholder loans that bear no interest

FAQ 42.45.8 – Assessing SPPI for dual currency bonds

42.46 The following are examples of contractual cash flows that do not meet the SPPI criterion:

- An instrument that is linked to an equity index, borrower's net income or other non-financial variables.
- An instrument such as a bond that is convertible into a fixed number of equity instruments of the issuer.
- Bonds where the amount of interest varies inversely to a market rate of interest (inverse floaters).
- Deferrals of interest payments where additional interest does not accrue on those deferred amounts.

[IFRS 9 para B4.1.13]. [IFRS 9 para B4.1.14].

FAQ 42.46.1 – Will a loan asset with an entity-specific non-financial underlying variable, such as a profit participating loan, fail SPPI?

Cash flows that are not genuinely SPPI, despite being described as such

42.47 In some cases, a financial asset might have contractual cash flows that are described as principal and interest, but those cash flows do not actually represent the payment of principal and interest on the principal amount outstanding, as defined in IFRS 9. For example, if the contractual terms of an instrument stipulate that the financial asset's cash flows provide interest, but this interest is based on the volume of vehicles that use a particular toll road, those contractual

cash flows are inconsistent with a basic lending arrangement. As a result, the instrument would not satisfy the SPPI criterion.

[IFRS 9 para B4.1.16].

Non-recourse

42.48 A non-recourse provision is an agreement that, if the debtor defaults on a secured obligation, the creditor can look only to the securing assets (whether financial or non-financial) to recover its claim. If the debtor fails to pay and the specific assets fail to satisfy the full claim, the creditor has no legal recourse against the debtor's other assets. The fact that a financial asset is non-recourse does not necessarily preclude the financial asset from meeting the SPPI criterion.

[IFRS 9 para B4.1.17].

42.49 If a non-recourse provision exists, the creditor is required to assess (that is, to 'look through to') the particular underlying assets or cash flows to determine whether the financial asset's contractual cash flows are SPPI. If the instrument's terms give rise to any other cash flows, or if they limit the cash flows in a manner inconsistent with the SPPI criterion, the instrument will be measured in its entirety at FVTPL.

[IFRS 9 para B4.1.17].

FAQ 42.49.1 – Non-recourse loans which might be inconsistent with SPPI

FAQ 42.49.2 – Non-recourse real estate financing

FAQ 42.49.3 – Non-recourse to portfolio of equity instruments

'De minimis' features

42.50 An entity does not need to take into consideration any contractual cash flow characteristics that do not represent SPPI if they could only have a 'de minimis' effect on the contractual cash flows of the financial asset.

[IFRS 9 para B4.1.18].

42.51 In considering whether the effect is 'de minimis', an entity must consider the possible effect of the contractual cash flow characteristic in each reporting period and cumulatively over the life of the financial instrument. Additionally, if a contractual cash flow characteristic could have an effect on the cash flows that is more than de minimis, but that characteristic is non-genuine, it does not affect the classification of a financial asset. A feature is non-genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur. In practice, judgement will be required to assess whether a contractual feature could be considered non-genuine, and therefore be disregarded when assessing whether cash flows are SPPI.

principal payments, or by selling the positions if a good price can be obtained in the market.

Can the entity classify the portfolio in 'run-off' as hold to collect?

Solution:

No. Opportunistic sales might be made to liquidate the portfolio in a quicker fashion if advantageous pricing is available. Assuming that these sales are not justified on the basis of credit deterioration, this is not consistent with a held to collect, amortised cost business model. Such a portfolio is likely to be measured at FVOCI.

Chapter 45

Impairment (IFRS 9)

Chapter 45

Impairment (IFRS 9)

Introduction

45.1 IFRS 9 outlines a 'three-stage' model ('general model') for impairment based on changes in credit quality since initial recognition:

Change in credit quality since initial recognition

Recognition of expected credit losses		
12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest revenue		
Effective interest on gross carrying amount	Effective interest on gross carrying amount	Effective interest on amortised cost carrying amount (that is, net of credit allowance)
Stage 1 *Performing* (Initial recognition*)	**Stage 2** *Underperforming* (Assets with significant increase in credit risk since initial recognition*)	**Stage 3** *Non-performing* (Credit-impaired assets)

*There is specific guidance on purchased or originated credit-impaired financial assets (see para 45.16 onwards below).

45.2 Stage 1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or that (at the option of the entity) have low credit risk at the reporting date. For these assets, 12-month expected credit losses ('ECL') are recognised and interest revenue is calculated on the gross carrying amount of the asset (that is, without deduction for credit allowance). 12-month ECL are the ECL that result from default events that are possible within 12 months after the reporting date. It is not the expected cash shortfalls over the 12-month period but the entire credit loss on an asset, weighted by the probability that the loss will occur in the next 12 months.

45.3 Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date and this option is taken by the entity) but that do not have objective evidence of impairment. For these assets, lifetime ECL are recognised, but interest revenue is still calculated on the gross carrying amount of the asset. Lifetime ECL are the ECL that result from all possible default events over the maximum contractual period during which the entity is exposed to credit risk.

ECL are the weighted average credit losses, with the respective risks of a default occurring as the weights.

45.4 Stage 3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime ECL are recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance).

FAQ 45.4.1 – Presentation of interest income and the unwinding of the ECL discount for stage 3 credit-impaired financial assets

45.5 The entity, when determining whether the credit risk on a financial instrument has increased significantly, considers reasonable and supportable information available, in order to compare the risk of a default occurring at the reporting date with the risk of a default occurring at initial recognition of the financial instrument.

45.6 Applying these requirements in practice can be complex. This chapter provides guidance on how to apply the model.

45.7 The IASB has set up the IFRS Transition Resource Group for Impairment of Financial Instruments ('ITG'), which is a discussion forum which will provide support for stakeholders on implementation issues arising from the new impairment requirements. Overall, the purpose of the ITG is to: solicit, analyse and discuss stakeholder issues arising from implementation of the new impairment requirements; inform the IASB about those implementation issues, which will help the IASB determine what, if any, action will be needed to address those issues; and provide a public forum for stakeholders to learn about the new impairment requirements from others involved with implementation. During the meetings, the ITG members share their views on the issues. The ITG will not issue guidance. The IASB will determine what action, if any, will be taken on each issue. Entities should follow the discussions of this group in order to be up to date on the latest implementation issues.

45.8 Additionally, the Basel Committee on Banking Supervision has issued guidance on credit risk and the implementation and application of expected credit loss models for banks. This chapter does not deal with that guidance and focuses only on IFRS 9, as issued by the IASB. Entities should refer to any relevant additional guidance provided by Basel or other regulators that affects them.

Scope

45.9 The model should be applied to:

- investments in debt instruments measured at amortised cost;
- investments in debt instruments measured at fair value through other comprehensive income (FVOCI);
- all loan commitments not measured at fair value through profit or loss;

- financial guarantee contracts to which IFRS 9 is applied and that are not accounted for at fair value through profit or loss; and
- lease receivables that are within the scope of IAS 17, 'Leases', trade receivables and contract assets within the scope of IFRS 15 that give rise to a conditional right to consideration.

The model does not apply to investments in equity instruments.

[IFRS 9 para 5.5.1].

45.10 An issuer of loan commitments should apply the impairment requirements of IFRS 9 to all loan commitments including those not otherwise within the scope of the standard.

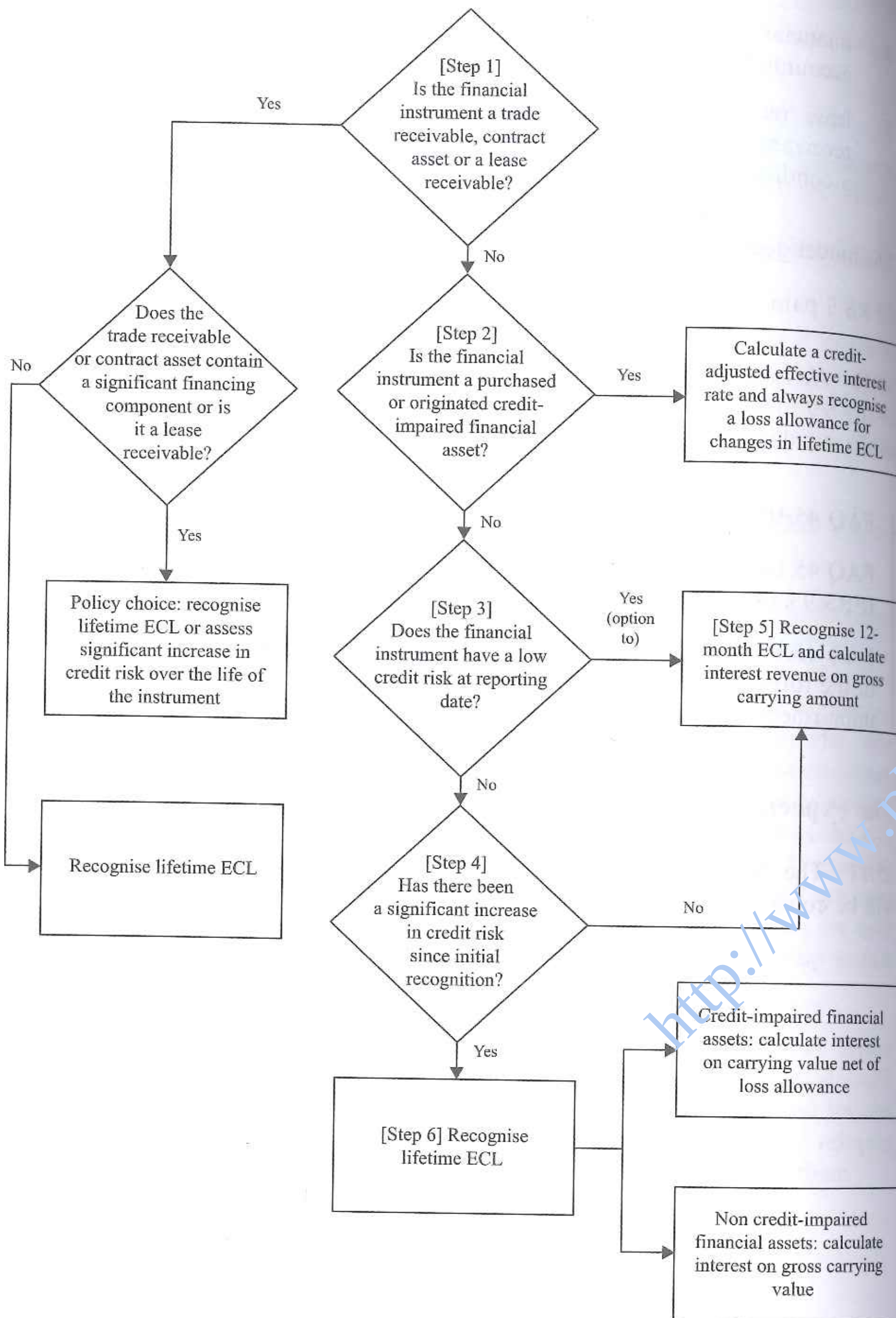
FAQ 45.10.1 – Loan commitments – scope

FAQ 45.10.2 – What is a loan commitment for the purposes of applying IFRS 9's impairment requirements?

FAQ 45.10.3 – Do legally binding arrangements to deliver non-financial items in the future on credit meet the definition of a loan commitment to which the impairment provisions in IFRS 9 apply?

The expected credit losses model

45.11 The illustration below shows the overall ECL model; each decision box will be considered over the following pages:



[Implementation guidance].

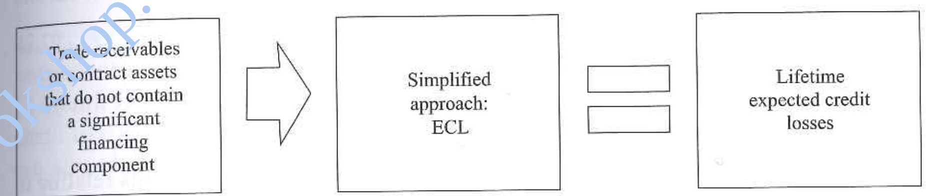
Step 1 – Scope exception from the general model: simplified approach for trade and lease receivables

45.12 The model includes some operational simplifications for trade receivables, contract assets and lease receivables, because they are often held by entities that do not have sophisticated credit risk management systems. These simplifications eliminate the need to calculate 12-month ECL and to assess when a significant increase in credit risk has occurred.

FAQ 45.12.1 – Implications of deferred consideration in contracts with customers on profit recognition

45.13 For trade receivables or contract assets that do not contain a significant financing component, the loss allowance should be measured at initial recognition and throughout its life at an amount equal to lifetime ECL. As a practical expedient, a provision matrix can be used to estimate ECL for these financial instruments.

[IFRS 9 para 5.5.15].



FAQ 45.13.1 – Use of a provision matrix

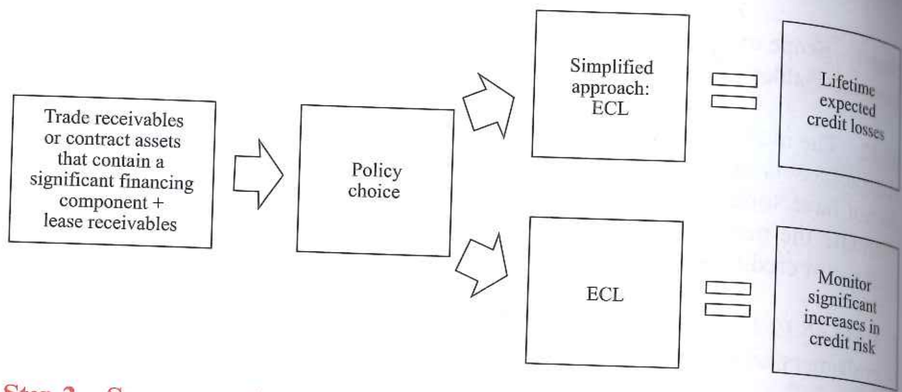
FAQ 45.13.2 – Example of a provision matrix for corporates

45.14 An entity has an accounting policy choice for lease receivables, and trade receivables and contract assets which contain a significant financing component, in accordance with IFRS 15. It can either apply the simplified approach (that is, to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout its life) or it can apply the general model.

[IFRS 9 para 5.5.15].

45.15 An entity can apply the policy election for trade receivables, contract assets and lease receivables independently of each other, but it must apply the policy choice consistently.

[IFRS 9 para 5.5.16].



Step 2 – Scope exception from the general model: purchased or originated credit-impaired assets

45.16 The general impairment model does not apply to purchased or originated credit-impaired assets. A financial asset is considered credit-impaired on purchase or origination if there is evidence of impairment at the point of initial recognition (for instance, if it is acquired at a deep discount). IFRS 9 includes a list of factors that would provide evidence that a financial asset is credit-impaired:

a. significant financial difficulty of the issuer or the borrower;

b. a breach of contract, such as a default or past due event;

c. 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;

d. it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

e. the disappearance of an active market for that financial asset because of financial difficulties; or

f. the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses.

The standard clarifies that it might not be possible to identify a single discrete event, so the combined effect of several events should be analysed.

[IFRS 9 App A].

FAQ 45.16.1 – Purchased or originated credit-impaired loans

FAQ 45.16.2 – New loans granted to defaulted debtors

FAQ 45.16.3 – Can purchased loan commitments be purchased or originated credit-impaired?

45.17 Impairment is determined based on full lifetime ECL on initial recognition for purchased or originated credit-impaired financial assets. Lifetime ECL

are included in the estimated cash flows when calculating the effective interest rate on initial recognition. The effective interest rate for interest recognition throughout the life of the asset is a credit-adjusted effective interest rate. As a result, no loss allowance is recognised on initial recognition.

[IFRS 9 para 5.5.13]. [IFRS 9 para 5.4.1]. [IFRS 9 para B5.5.44].

45.18 Any subsequent changes in lifetime ECL, both positive and negative, will be recognised immediately in the income statement, even if the lifetime ECL are less than the amount of ECL that were included in the estimated cash flows on initial recognition.

[IFRS 9 para 5.5.14].

FAQ 45.18.1 – Accounting for favourable changes in expected lifetime credit losses on purchased or originated credit-impaired financial assets

Step 3 – Practical expedient for financial assets with low credit risk

45.19 As an exception to the general model, if the credit risk of a financial instrument is low at the reporting date, the entity can measure impairment using 12-month ECL, and so it does not have to assess whether a significant increase in credit risk has occurred. The use of this practical expedient is optional; the entity can also choose to apply the general model for those assets.

[IFRS 9 para 5.5.10].

45.20 The financial instrument has to meet the following requirements, in order for this practical expedient to apply:

- it has a low risk of default;
- the borrower is considered, in the short term, to have a strong capacity to meet its obligations in the near term; and
- the lender expects, in the longer term, that adverse changes in economic and business conditions might, but will not necessarily, reduce the ability of the borrower to fulfil its obligations.

[IFRS 9 para B5.5.22].

45.21 The credit risk of the instrument needs to be evaluated without consideration of collateral. Financial instruments are not considered to have low credit risk because that risk is mitigated by collateral. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction within which the entity operates.

[IFRS 9 para B5.5.22].

45.22 Financial instruments are not required to be externally rated. An entity can use internal credit ratings that are consistent with a global credit rating definition of 'investment grade'.

[IFRS 9 para B5.5.23].

45.23 The low credit risk simplification is not meant to be a bright-line trigger for the recognition of lifetime ECL. Instead, when credit risk is no longer low, the entity should assess whether there has been a significant increase in credit risk to determine whether lifetime ECL should be recognised. This means that, if an instrument's credit risk has increased such that it no longer qualifies as low credit risk, it is not automatically included in stage 2. The entity needs to assess if a significant increase in credit risk has occurred before calculating lifetime ECL for the instrument.

[IFRS 9 para B5.5.24].

Step 4 – Exploring the general model: assessing a significant increase in credit risk

45.24 The entity looks at the change in the risk of a default occurring over the expected life of the financial instrument, rather than the change in the ECL, when assessing whether the credit risk on a financial instrument has increased significantly since initial recognition. An entity should compare the risk of a default at the reporting date with the risk of a default at the date of initial recognition.

[IFRS 9 para 5.5.9].

FAQ 45.24.1 – How should the IFRS 9 impairment model be applied when interest rate is re-set in response to a deterioration in the borrower's credit risk (ratchet loans)?

FAQ 45.24.2 – When can a significant increase in credit risk be assessed on an absolute, rather than relative, basis?

FAQ 45.24.3 – Counterparty assessment of significant increase in credit risk

FAQ 45.24.4 – Assessing significant increase in credit risk for financial assets with a maturity of less than 12 months

FAQ 45.24.5 – On transition to IFRS 9 do the historical measures of credit risk at the date initial recognition need to be adjusted?

45.25 For loan commitments, an entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates. For financial guarantee contracts, an entity considers the changes in the risk that the specified debtor will default on the contract. The date that the entity becomes a party to the irrevocable commitment is considered to be the date of initial recognition for the purposes of applying the impairment requirements to both loan commitments and financial guarantee contracts.

[IFRS 9 para B5.5.8]. [IFRS 9 para 5.5.6].

FAQ 45.25.1 – Can the date of initial recognition for determining a significant increase in credit risk be 'reset' to the date of a substantial increase in a loan commitment or credit facility?

Definition of 'default'

45.26 An entity applies a definition of 'default' that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and can consider qualitative indicators (for example, financial covenants) where appropriate. However, there is a rebuttable presumption that default does not occur later than when a financial asset is 90 days past due, unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate. The definition of default used for these purposes should be applied consistently to all financial instruments, unless information becomes available that demonstrates that another definition of default is more appropriate for a particular financial instrument.

[IFRS 9 para B5.5.37].

Using probability of default ('PD') information

45.27 If the entity chooses to make the assessment by using PD, generally a lifetime PD (over the remaining life of the instrument) should be used. However, as a practical expedient, a 12-month PD can be used if it is a reasonable approximation to lifetime PD.

[IFRS 9 para B5.5.13].

FAQ 45.27.1 – Assessing and re-assessing if changes in 12-month risk of default occurring can be used as a reasonable approximation to changes in lifetime risk of default occurring

45.28 A 12-month PD is not always a reasonable approximation to using lifetime PD. Exceptions include:

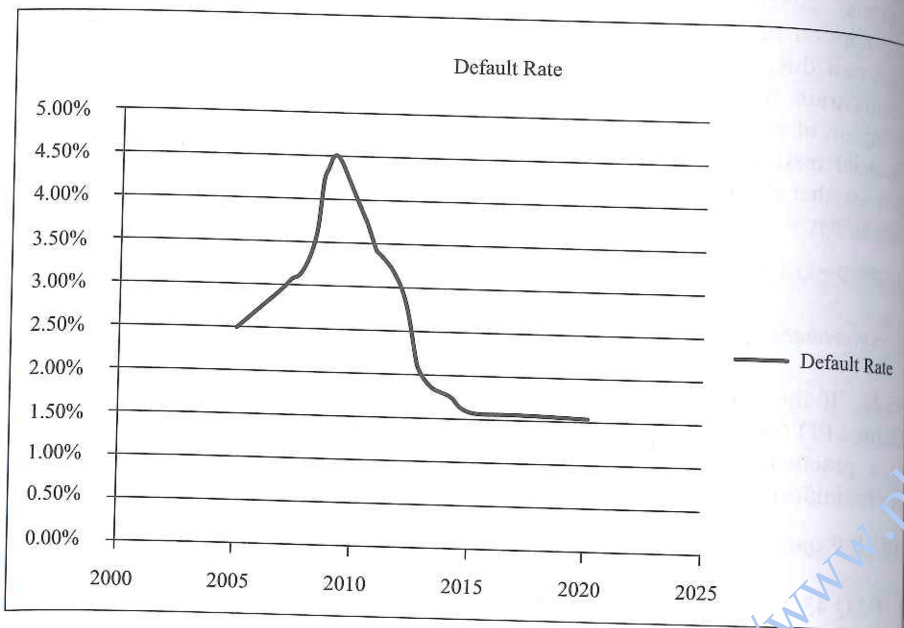
- bullet repayment loans, where the payment obligations of the debtor are not significant during the first 12 months of the loan facility;
- loans where changes in credit-related factors only have an impact on the credit risk of the financial instrument beyond 12 months; and
- where changes in relevant macroeconomic or other credit-related factors occur that are not adequately reflected in the risk of a default occurring in the next 12 months.

[IFRS 9 para B5.5.14].

FAQ 45.28.1 – Twelve month versus lifetime PDs

[The next paragraph is 45.30.]

45.30 A simple or absolute comparison of PDs at initial recognition and at the reporting date is not appropriate. The PD of a financial instrument should reduce with the passage of time. So, the entity needs to consider the relative maturities of a financial instrument at inception and at the reporting date when comparing PDs. This means that the PD for the remaining life of a financial asset at the reporting date (for example, two years if three years have already passed on a five-year instrument) should be compared to the PD expected at initial recognition for the last two years of its maturity (that is, for years 4 and 5). The entity might find this requirement operationally challenging.



[IFRS 9 para B5.5.11].

FAQ 45.30.1 – Regulatory versus IFRS 9 PDs

FAQ 45.30.2 – How to reconcile regulatory PDs to IFRS 9 PDs

Information to take into account to perform the assessment

45.31 All information available without undue cost or effort should be taken into account to perform the assessment of changes in credit risk.

[IFRS 9 para B5.5.15].

FAQ 45.31.1 – Can an entity use only behavioural indicators of credit risk when assessing significant increases in credit risk since initial recognition?

FAQ 45.31.2 – Factors to take into account in determining a significant increase in credit risk

45.32 The standard provides a non-exhaustive list of information that might be relevant in assessing changes in credit risk:

a. Significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date.

b. Other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition.

c. Significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same expected life. Changes in market indicators of credit risk include, but are not limited to:

   i. the credit spread;

   ii. the credit default swap prices for the borrower;

   iii. the length of time for which, or the extent to which, the fair value of a financial asset has been less than its amortised cost; and

   iv. other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.

d. An actual or expected significant change in the financial instrument's external credit rating.

e. An actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies.

f. Existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.

g. An actual or expected significant change in the operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that result in a significant change in the borrower's ability to meet its debt obligations.

h. Significant increases in credit risk on other financial instruments of the same borrower.

45.37 If there have been significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply.

[IFRS 9 para 5.5.11].

45.38 Generally, a significant increase in credit risk happens gradually over time and before the financial asset becomes credit-impaired or is in default. The lifetime ECL should be recognised before a financial asset is regarded as credit-impaired or in default.

[IFRS 9 para B5.5.7].

45.39 The qualitative and non-statistical quantitative information available might be sufficient to determine that a financial instrument has met the criterion for the recognition of a loss allowance at an amount equal to lifetime ECL. That is, the information does not need to flow through a statistical model or credit ratings process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. However, in other cases, an entity might need to consider qualitative information, including information from its statistical models or credit ratings processes. Alternatively, the entity might base the assessment on both types of information (that is, qualitative factors that are not captured through the internal ratings process and the credit risk characteristics at the reporting date) if both types of information are relevant.

[IFRS 9 para B5.5.18].

Level at which the increase in credit risk assessment should be performed

45.40 An entity might not be able to identify significant changes in credit risk for individual financial instruments before the financial instrument becomes past due. This might be the case for retail loans for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument until a customer breaches the contractual terms. If changes in the credit risk for individual financial instruments are not captured before they become past due, a loss allowance based only on credit information at an individual financial instrument level would not faithfully represent the changes in credit risk since initial recognition. The entity should look at information at the portfolio level to perform the assessment. The entity cannot avoid calculating lifetime ECL by considering the assessment at an individual asset level only, if information available at portfolio level indicates that there has been an increase in credit risk for the instruments included in the portfolio.

[IFRS 9 para B5.5.3].

45.41 An entity can group financial instruments on the basis of shared credit risk characteristics, with the objective of facilitating an analysis to identify significant increases in credit risk and recognition of loss allowance on a timely basis. The entity should not obscure this information by grouping financial instruments with different risk characteristics. Examples of shared credit risk characteristics might include, but are not limited to, the:

a. instrument type;

b. credit risk ratings;

c. collateral type;

d. date of initial recognition;

e. remaining term to maturity;

f. industry;

g. geographical location of the borrower; and

h. value of collateral relative to the financial asset if it has an impact on the probability of a default occurring (for example, non-recourse loans in some jurisdictions or loan-to-value ratios).

[IFRS 9 para B5.5.5].

FAQ 45.41.1 – Assessment of significant increase in credit risk for guaranteed debt instruments

45.42 IFRS 9 provides some examples of how to perform the portfolio analysis. It establishes that individual exposures could be grouped into sub-portfolios on the basis of common borrower-specific characteristics, such as geographical location or postcodes, headroom/access affordability at origination or behavioural scoring (that is, 'bottom up' approach). Alternatively, the entity could estimate the proportion of the portfolio that has experienced a significant increase in credit risk using general information and calculate ECL on that basis (that is, 'top down' approach).

[IFRS 9 para B5.5.6].

FAQ 45.42.1 – 'Top down' versus 'bottom up' approach

45.43 The entity must also consider forward-looking information at a portfolio level in order to determine whether there has been a significant increase in credit risk ('top down' approach), if it uses a bottom up approach.

[IFRS 9 para B5.5.16].

Step 5 – Exploring the general model: recognising 12-month ECL

45.44 If the entity determines that there has not been a significant increase in credit risk, it measures the loss allowance for the particular asset or group of assets at an amount equal to 12-month ECL.

[IFRS 9 para 5.5.5].