Yes, there is now a brand new all-singing, all-dancing IFRS on financial instruments (IFRS 9). The standard was issued last year and becomes examinable as of today. The IFRS is a monster, so it is certainly not possible to cover the whole standard in one article. I am going to focus on financial asset impairment (also known as ‘bad debts’) as this component of the IFRS is the newest. In fact, it might be worth looking at the issue dates of the components of the standard to put financial asset (FA) impairment in context.

<table>
<thead>
<tr>
<th>Content</th>
<th>Issue date</th>
</tr>
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<tbody>
<tr>
<td>Financial assets (FA)</td>
<td>2009</td>
</tr>
<tr>
<td>Financial liabilities (FL)</td>
<td>2010</td>
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<tr>
<td>Hedging</td>
<td>2013</td>
</tr>
<tr>
<td>FA impairment</td>
<td>2014</td>
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There is a good reason the FA impairment project took so long to complete. The story explains the craziness of the detail involved in FA impairment. Before there was IFRS 9 guidance on FA impairment there was IAS 39 guidance and before that in the 1990s there was nothing. While there was no guidance there was a culture of writing off sickly receivables using specific bad debt allowances and writing off a small proportion of healthy receivables using a general bad debt allowance. It was felt that this was prudent; but shareholders got fed up with corporate abuse of the general bad debts. This was easy to manipulate and investors felt that the general bad debts was being used to ‘profit smooth’ – make big allowances in good years to release credits in the bad years. So general bad debts was forbidden in 1998 with the issue of IAS 39.

Martin Jones explains the whys and wherefores of the new IFRS 9

**Incurred losses v expected losses**

Now IAS 39 has a horrible reputation, however, the recognition of FA impairment was widely accepted because of its simplicity. The concept became known as the ‘incurred loss model’ because you were allowed to recognise losses you had incurred but not allowed to make up possible losses that you might incur in the future. This worked well for 10 years, but when the financial crisis hit in 2009 the previously admired incurred loss model was blamed at least in part for the crash. The IASB did not agree, but the crash stoked up such powerful emotions that the IASB accepted they had to do something. Look at the picture below of the Lehman Bros employee holding his possessions on the day he was kicked out of his collapsing employer. He looks like American Psycho to me – but I find it impossible not to feel something for the fella. And think of all the countless less glamorous others that have been pushed out and held back by the recession.

So the IASB accepted that they had to rediscover some of the prudence of the old general provision for bad debts without letting in the wildly abusive profit smoothing that haunted us prior to IAS 39. The result adopted in IFRS 9 is a ferocious wall of complexity summed up by the term the ‘expected loss model’ and I shall try to give you a feel for some of the complexity now.

**Application**

Financial asset impairment only applies to FA carried at amortised cost (essentially). This means in particular lending to customers; either because you are a trader and give your customers trade credit or you are a bank and lend to your customers.

Amortised cost is mathematical and if your customer ends up in trouble then the mathematical carrying value of your receivable might be way above the recoverable value and so an impairment may be required.

**Expected credit losses (ECLs)**

The machinery to shave off some of the receivable is called an ‘expected credit loss’ (ECL) and represents the expected shortfall of expected cash flows against contractual cash flows. And like any ‘expectation’ this ECL requires guesswork.

I have the IFRS open here in front of me and it says “an entity shall measure expected credit losses in a way that reflects a probability weighted amount and the time value of money and forecasts of future economic conditions”. That sounds like a general allowance to me.

For simple trade receivables a ‘simplified lifetime ECL’ is required, meaning the entity is required to look into a crystal ball and predict trouble for current receivables until they are all received.

However, banks are required to follow a ‘general approach’. This only allows the above described lifetime ECLs “if the credit risk on that financial instrument has increased significantly”. Otherwise, a 12-month ECL is required. This 12-month ECL is likely to be tiny on healthy receivables and it is hoped by the IASB that this will mean that banks have limited scope to manipulate their ECL to get the profit they want. I am not so sure.

• Martin Jones lectures at LSBF

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