IFRS 9 Financial Instruments – the long wait is over!

Robert Kirk guides us through the new classification rules for financial instruments in IFRS 9 which is effective for annual periods beginning on or after 1 January 2018.

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Introduction

The topic of financial instruments has brought fear into the hearts of many practicing accountants as they often feel they do not understand the various complicated financial instruments devised by the financial 'wizards' working for financial institutions. The accounting treatment of financial instruments was also largely responsible for the disaster of the banking meltdown n in 2008. Even the politicians have been critical about the professions handling of the subject and the G20 group, in particular, requested the International Accounting Standards Board (IASB) to completely rethink their accounting rules that were contained in IAS 39. That process started eight years ago and it was only in July 2014 that a new standard, IFRS 9, was issued to replace IAS 39. However, its adoption date is only for financial statements commencing on or after the 1st January 2018 so we still have one more year to go with IAS 39. The reason for the long lead in period is to enable financial institutions to get their accounting systems sorted out so that they can deal

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with the required changes particularly on the introduction of a new impairment model based on expected rather than incurred losses.

The standard is broken down into a number of clearly defined sub headings as follows:

- The classification and measurement of financial assets and liabilities
- The recognition and derecognition of financial assets and liabilities
- The impairment of financial assets
- The rules to enable hedging to apply

The classification and measurement of financial assets and liabilities

Under IAS 39 financial assets were analysed into four different categories – loans and receivables, held for trading, held to maturity and available for sale. Loans and receivables and held to maturity assets were measured on an amortised cost basis whereas the other two were fair valued but the gain/loss went into profit for held for trading and into reserves and OCI for available for sale assets respectively. The latter would then be recycled back through profit on disposal of the investments. In addition the held to maturity category rarely worked as there were tainting rules which basically meant that if an asset was sold within that category before maturity it tainted the whole category and would have to be reclassified.

The new rules in IFRS 9 no longer have these categories but instead classify according to whether or not a financial asset passes the business model test and if its inflows are solely principal and interest. If that is the case they are measured at amortised cost but, if they fail the test, they are measured at fair value. Normally that would require reporting gains and losses in profit. However, there are two exceptions to that rule – if it would result in an accounting mismatch the gain/loss may be reported in reserves and OCI and if there are mixed objectives in holding the asset in that an entity might sell the asset or keep it then gains and losses must be reported in reserves and OCI.

There were not the same problems in financial liabilities so the rules are very much the same between IAS 39 and IFRS 9 with the vast majority being reported using the amortised cost approach. It would only be really negative derivative financial liabilities that would be reported in profit and loss.

However, one issue that did emerge was that of 'own credit risk'. When an entity's creditworthiness deteriorates, the fair value of its issued debt will decrease. For financial liabilities measured using the fair value method this causes a gain to be recognised in profit. Many investors found this result counter-intuitive and confusing. IFRS 9 has therefore introduced a two-step approach which should reduce the volatility created in the profit and loss as follows:

Step 1 the fair value change of liabilities under the fair value method would be recognised in profit and loss;

Step 2 the portion of the fair value change due to own credit would be reversed out of profit and loss and recognised in other comprehensive income.

The recognition and derecognition of financial assets and liabilities

The principles for recognising financial assets and liabilities have not changed from IAS 39 to IFRS 9. These cannot be recognised until one party clearly has a financial asset and another a financial liability and this is evidenced by a contractual relationship between the two parties.

Similarly there are few changes in the process of derecognising a financial asset. That will occur when the other party settles the amounts due or the originator has cancelled the debt or it has been time barred from collection.

Financial liabilities are derecognised when the lender has repaid the loan, or the lender has cancelled it or again it has been time barred. However, IFRS 9 does cover the situation where a loan has been renegotiated. In most cases, if the changes are substantial, the old loan is removed from the balance sheet and a new loan created. Usually the lender has offered more generous terms and this can result in a gain being recorded in profit by the borrower on the derecognition of the original loan.

The impairment of financial assets

Probably the most important change from IAS 39 is the replacement of an incurred loss model for the impairment of financial assets to an expected loss model. It was the most criticised part of IAS 39 and many commentators argued that the incurred loss model resulted in too much of a delay in reporting impairment as there had to be objective evidence that a genuine incurred loss had occurred. In common parlance, it really required evidence of specific bad debts but general bad debts provisions would not be acceptable.

The new standard has introduced the expected credit loss model. It requires companies to account for losses using a three stage approach as follows:

Stage 1 *Provide for 12 month expected credit losses*

As soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognised in profit or loss and a loss allowance is established. This is supposed to act as a proxy for the initial expectations of credit losses. The idea is that entities will know that a certain number of their customers/clients will not be able to pay back their loans and this loss has been incorporated in increasing the price that an entity charges its customers/clients and the entity is merely recognising a loss to match against that additional income. For financial assets, interest revenue is, however, calculated on the gross carrying amount without adjustment for any expected credit losses.

There will still be considerable subjectivity in calculating the 12 month provision but IFRS 9 requires the expected credit losses to be calculated as the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. However, it must be emphasised that they are not the expected cash shortfalls over the next twelve months. They are the effect of the entire credit loss on an asset weighted by the probability that this loss will occur in the next 12 months.

Undoubtedly this will create an enormous amount of extra work and changes in accounting systems so that reporting entities can report the 'correct' amount of that loss allowance.

Stage 2 Significant increase in credit risk

If the credit risk subsequently increases significantly **and** the resulting credit quality is not considered to be low credit risk, then full lifetime expected credit losses are recognised. It must be emphasised that Lifetime expected credit losses are only recognised if the credit risk increases **significantly** from when the entity originates or purchases the financial instrument. Lifetime expected credit losses are calculated as an expected present value measure of the losses that arise if a borrower defaults on their obligation throughout the life of the financial instrument. They represent the weighted average credit losses with the probability of default as the weight.

Again the issue will be how do you identify a significant increase in credit risk. IFRS 9 suggests that an entity should use the best information available without undue cost and effort but the Information that it should consider includes:

- Borrower specific data
- Macro-economic factors
- Internal default rates and probabilities of default
- External pricing
- Credit ratings; and
- Delinquencies

However there is a rebuttable presumption that assets a month overdue have deteriorated.

The calculation of interest revenue on financial assets, however, is still based on the gross carrying amount as there is no evidence of actual defaults.

Stage 3 Financial asset is credit impaired

If the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount adjusted for the loss allowance) and, at that stage, financial assets will be individually assessed.

As these Lifetime expected credit losses are already recognised on these assets there will be no further impairment recognised.

In summary, using common parlance, it appears that a general provision or loss allowance is required for all 12 month expected losses, then a more specific allowance is created for those assets where there is more evidence of probability of default due to a significant deterioration in credit risk and then finally specific bad debts are effectively written off.

There are exceptions to this general three stage model. The most significant is that for trade receivables with no significant financing component the entity will provide only on the full lifetime loss approach. There is an option for lease receivable to adopt the general approach or recognise full lifetime losses.

The rules to enable hedge accounting to apply

A major criticism of IAS 39 was that the rules to enable hedge accounting to apply were too restrictive and did not permitted genuine economic hedges from being accounted for as effective hedges. It seemed that the accounting rules were driving whether or not hedge accounting would be acceptable. There was also a very precise hedge effectiveness test (the 80-125% rule) which restricted the ability for hedges to be effective.

The solution in IFRS 9 was to change the approach. The principle now to be implemented merely requires the company to identify its risks, have a clear strategic plan to manage those risks and then whatever tools are adopted these should permit hedge accounting to be adopted. It will mean that hedge accounting will reflect the entity's actual risk management activities and non financial institutions will be able to apply it to non financial risk exposures.

The new approach will also enable entities to use internally developed information produced for risk management purposes as a basis for hedge accounting.

There are also improved disclosures provided with the new hedge accounting model which will explain both the effect that hedge accounting has had on the financial statements and an entity's risk management strategy, as well as providing details about derivatives that have been entered into and their effect on the entity's future cash flows.

Implementation

IFRS 9 is effective for annual periods beginning on or after 1 January 2018. However, reporting entities can choose to apply it before then. As an exception to this, prior to January 2018, the own credit changes can be applied at any time in isolation without the need to otherwise change any other changes.

Summary

Financial instruments are complex and very difficult for the IASB to police properly. There does not seem to be an easy solution to ensure that reporting entities report a true and fair view and undoubtedly it will cause financial institutions, in particular, to expend considerable monies to implement the standard but hopefully we will not see another 2008 debacle as a result of these changes.