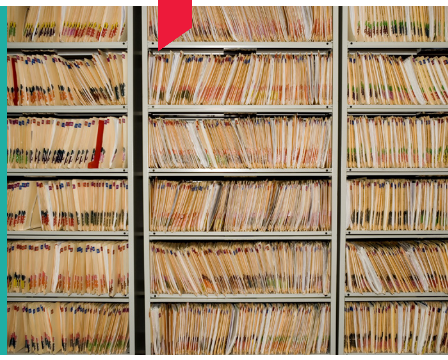
IFRS 9 *FINANCIAL INSTRUMENTS* (2014)
INTERNATIONAL FINANCIAL REPORTING BULLETIN 2014/12



Summary

On 24 July 2014, the International Accounting Standards Board (IASB) completed its project on financial instruments by publishing IFRS 9 *Financial Instruments* (2014). IFRS 9 (2014) incorporates the final requirements on all three phases of the financial instruments projects – classification and measurement, impairment, and hedge accounting.

IFRS 9 (2014) adds to the existing IFRS 9:

– New impairment requirements for all financial assets that are not measured at fair value through profit or loss

– Amendments to the previously finalised classification and measurement requirements.

In a major change, which will affect all entities, a new 'expected loss' impairment model in IFRS 9 (2014) replaces the 'incurred loss' model in IAS 39 *Financial Instruments: Recognition and Measurement*. Under IFRS 9 (2014), the impairment model is a more 'forward looking' model in that a credit event (or impairment 'trigger') no longer has to occur before credit losses are recognised. For financial assets at amortised cost or fair value through other comprehensive income (FVTOCI), an entity will now always recognise (at a minimum) 12 months of expected losses in profit or loss. Lifetime expected losses will be recognised on these assets when there is a significant increase in credit risk after initial recognition.

For trade receivables there is a practical expedient to calculate expected credit losses using a provision matrix based on historical loss patterns or customer bases. However, those historical provision rates would require adjustments to take into account current and forward looking information.

The new impairment requirements are likely to bring significant changes. Although provisions for trade receivables may be relatively straightforward to calculate, new systems and approaches may be needed. However, for financial institutions the changes are likely to be very significant and require significant changes to internal systems and processes in order to capture the required information.

In other changes, IFRS 9 (2014) also introduces additional application guidance to clarify the requirements for contractual cash flows of a financial asset to give rise to payments that are Solely Payments of Principal and Interest (SPPI), one of the two criteria that need to be met for an asset to be measured at amortised cost. Previously, the SPPI test was restrictive, and the changes in the application of the SPPI test will result in additional financial assets being measured at amortised cost. For example, instruments with regulated interest rates may now qualify for amortised cost measurement, as might some instruments which only marginally fail the strict SPPI test.

A third measurement category has also been added for debt instruments – FVTOCI. This new measurement category applies to debt instruments that meet the SPPI contractual cash flow characteristics test and where the entity is holding the debt instrument to both collect the contractual cash flows and to sell the financial assets.

In comparison with previous versions of IFRS 9, the introduction of the FVTOCI category may result in less profit or loss volatility, in particular for entities such as insurance companies which hold large portfolios with periodic buying and selling activities. The amendments could lead to significant reclassification of debt instruments across the different measurement categories: amortised cost, FVTOCI, and FVTPL. This may lead to less volatility in profit or loss for debt investment portfolios, but greater equity volatility if assets are reclassified from amortised cost to FVOTCI (which could affect regulatory capital).

STATUS
Final

EFFECTIVE DATE
Annual periods beginning on or after 1 January 2018.

Early application permitted.

Choice of which version of IFRS 9 to adopt (2009, 2010, 2013 or 2014) if the date of initial application is before 1 February 2015.

Option to early adopt the 'own credit' provisions for financial liabilities held at fair value through profit or loss (FVTPL) under the fair value option.

ACCOUNTING IMPACT
Major changes to impairment provisions for entities in the financial sector and for entities with large portfolios of loans. Significant effect likely for entities that hold significant portfolios of investments in debt instruments.

Will affect impairment provisions for all entities with financial assets not measured at fair value through profit or loss (including trade receivables, lease receivables, and loans).

In comparison with IAS 39, as with previous versions of IFRS 9, the measurement of financial assets (in particular debt – or loan – instruments) may change. Where embedded derivatives were previously separated and accounted for at FVTPL with the host contract being measured at amortised cost, the entire instrument may be accounted for on that basis. For others, features which gave rise to separable embedded derivatives will no longer do so, and the entire instrument will be measured at amortised cost. Other instruments previously measured at FVTPL may now be required to be accounted for at amortised cost or FVTOCI.

The effective date of the fully completed version of IFRS 9 is for periods beginning on or after 1 January 2018 with retrospective application. Early application is permitted. If an entity's date of initial application (the start of the period in which IFRS 9 is adopted) is before 1 February 2015, there is a choice of which version of IFRS 9 to adopt (2009, 2010, 2013 or 2014). The 2009 version covered financial assets only, the 2010 version added financial liabilities and derecognition, and the 2013 version added hedge accounting.

In addition, there is an option to early adopt the 'own credit' provisions for financial liabilities measured at fair value through profit or loss (FVTPL) under the fair value option without any of the other requirements of IFRS 9. This option will remain available until 1 January 2018.

Related US GAAP developments

The IASB and the US Financial Accounting Standards Board (FASB) were previously working together on a joint project for financial instruments. However, the FASB decided not to pursue major revisions to its existing requirements on classification and measurement of financial instruments but decided instead to work on minor changes to its existing requirements. For impairment, the FASB is currently working on refining their current expected credit loss (CECL) model, which is different from the IASB's IFRS 9 model. Under the CECL model, the credit impairment allowance always reflects the current estimate of lifetime expected credit losses at each reporting date. This results in a 'day 1' loss recognised for full lifetime credit losses. The FASB is expected to issue a final standard in the second half of 2014. It is unlikely that any final financial instruments standard issued by the FASB on financial instruments will converge with IFRS 9.

Background

IAS 39, the existing IFRS that covers the recognition and measurement of financial instruments, has been criticised as being difficult to understand, apply, and interpret. To address these observations, and in response to the global financial crisis of 2008/2009, the IASB embarked on a comprehensive project to replace IAS 39 with a new financial instruments standard, IFRS 9. The project was divided into three phases:

– Phase I: Classification and measurement

– Phase II: Impairment of financial assets

– Phase III: Hedge accounting.

Phase I: Classification and measurement

In November 2009, the IASB published its first version of IFRS 9 containing the requirements for classification and measurement of financial assets. This was supplemented in October 2010 by the accounting requirements for financial liabilities. The October 2010 version of IFRS 9 also carried over the scope and recognition and derecognition requirements from IAS 39. For more information about the previous finalised version of IFRS 9 (2010), please refer to BDO's publication *Need to Know* – IFRS 9 (2010) Financial Instruments – Classification and Measurement, available from the IFRS section of our website (www.bdointernational.com) at the link below:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/NTK_IFRS9_print.pdf

Following the publication of IFRS 9, the IASB received questions on the application of IFRS 9 to certain types of financial instruments and, in particular, how to apply the 'solely payments of principal and interest' notion to particular types of financial instruments. The IASB was also asked to consider the interaction of IFRS 9 for financial assets with the insurance project which deals with the accounting for insurance liabilities. In light of the feedback that the IASB received, the IASB decided to reconsider limited aspects of accounting for financial assets and issued Exposure Draft ED 2012/4 *Limited Improvements to IFRS 9* in November 2012. The proposals in ED 2012/4 on have now been finalised with the issue of IFRS 9 (2014).

Phase II: Impairment

Under the existing requirements for the impairment of financial assets that are set out in IAS 39, a loss provision is recognised when there is objective evidence of impairment. The incurred loss model was subject to criticism during and after the onset of the Global Financial Crisis for recognising losses on a 'too little, too late' basis. In addition, although (from a commercial perspective) an element of the interest rate is set by a lender to compensate it for expected losses, interest income was recognised in full. The combination of these two features had the effect, in particular for higher risk lending (for which the 'expected loss credit spread' is higher), of entities recognising interest income at the full contractual rate for an initial period (arguably overstating profits), followed by the recognition of impairment losses only at a later date as the expected (and other) losses emerged. The IASB also found that the incurred loss model resulted in inconsistent accounting for similar assets because different entities have used different trigger events to identify objective evidence of impairment, or have assessed the same trigger events differently.

In March 2013, the IASB released an ED on impairment, Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* proposing a three-stage credit deterioration model for impairment. This followed two previous EDs; the need for additional exposure drafts arose from modifications which were found necessary to make the IASB's original expected credit loss proposals operational, together with a desire to reach a converged solution with the FASB (prior to the FASB withdrawing from the project and developing a US specific proposal). The proposals in ED/2013/3 have now being finalised with the issue of IFRS 9 (2014).

Phase III: Hedge Accounting

The hedge accounting model in IAS 39 has been criticised as being complex, rules based, and failing to reflect risk management activities of organisations. In November 2013, the IASB published IFRS 9 (2013) which added a new hedge accounting model to IFRS 9. The new hedge accounting model is easier to implement and links better to the risk management activities of organisations.

For more information about the hedge accounting chapter of IFRS 9 (2013), please refer to BDO's publication *Need to Know* – Hedge Accounting (IFRS 9 Financial Instruments), available from the IFRS section of our website (www.bdointernational.com) at the link below:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/Need%20to%20Know%20-%20Hedge%20Accounting%20%28IFRS%209%29%20%28print%29.pdf

New application guidance for the contractual cash flow characteristics test

Under IFRS 9 (2009), to qualify for amortised cost measurement a financial instrument must meet both of the following tests:

– The business model test, and

– The cash flow characteristics test.

The business model test is whether the objective is to hold assets in order to collect contractual cash flows, rather than selling them. This test is not applied on an instrument by instrument basis, and is instead at a higher level. In contrast, the cash flow characteristics test is applied to each individual financial asset. An entity is required to assess whether the contractual terms of the instrument provide for cash flows that are solely payments of principal and interest (the SPPI test). IFRS 9 (2009) considers 'interest' to be the consideration for time value of money and credit risk.

Following the publication of IFRS 9, the IASB received questions about how to apply the SPPI test to particular instruments in the market. For example:

– Instruments with variable interest rates where the frequency of interest rate reset does not match the tenor (or maturity) of the instrument (for example, where interest is reset monthly to a quarterly rate. Certain Japanese government bonds have a semi-annual interest rate reset but the rate is always reset to a 10-year rate regardless of maturity (known as Japanese 10 year constant maturity bonds)

– Instruments with a variable interest rate but the variable interest is reset before the start of the interest period (for example, two months before so that the rate at the date of reset is not the current floating rate, but is instead the floating rate 2 months before).

Under IFRS 9 (2014) where the time value component of the interest rate has been modified (such as for the instruments set out above), a further assessment is required to determine whether the time value component is significantly different from a benchmark instrument. 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 quality except the variable interest rate is reset monthly to a one-month interest rate. The term 'significantly different' is not defined and no quantitative threshold is provided, but in practice only a small variation would be permitted.

In some jurisdictions, the government or a regulatory authority establishes interest rates. For example, such government regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. Under IFRS 9, a regulated interest rate may be used as a proxy for the time value of money element for the purpose of applying the SPPI test if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement. This exception would apply to interest rates in China, where the government determines interest rates.

IFRS 9 (2014) also clarifies that although the most significant elements of interest under the SPPI test are time value of money and credit risk, interest can also contain other elements such as liquidity risk, profit margin, and service or administrative costs.

In addition, IFRS 9 (2014) clarifies that other contractual provisions that changes the timing or amount of cash flow can still meet the SPPI test if it is consistent with the return of a basic lending arrangement. For example, an instrument with interest rate that is reset to a higher rate if the debtor misses a particular number of payments can still meet the SPPI test as the resulting change in the contractual terms is likely to represent consideration for the increase in credit risk of the instrument. Similarly, instruments where the interest payment is linked to net debt/earnings before interest tax, depreciation and amortisation (EBITDA) ratio (where the ratio is intended be a proxy reflecting the borrower's credit risk) are also likely to meet the SPPI test.

New measurement category for debt instruments – fair value through other comprehensive income (FVTOCI)

IFRS 9 (2014) introduces a new measurement category to IFRS 9 for debt investments. The new measurement category applies to debt instruments that meet the contractual cash flow characteristics test and the entity's business model objective is both to hold and collect the contractual cash flows and to sell the financial assets.

Criteria for FVTOCI for debt instruments

– *Contractual cash flow characteristics test* ☑

– *Business model objective:*

  – *Hold to collect* ☑

  – *Sell the financial assets* ☑

Illustration 1: Criteria for debt instruments at FVTOCI

The accounting mechanics for this new measurement category are as follows:

– Recognise interest revenue in profit or loss using the effective interest method (as for financial assets measured at amortised cost)

– Recognise credit impairment losses/reversals in profit or loss using the same credit impairment methodology as for financial assets measured at amortised cost

– Recognise the cumulative fair value gain or loss in OCI and recycle the gain or loss to profit or loss when the debt instrument is derecognised.

Impairment of financial assets

Scope

The new impairment model applies to:

– Financial assets at amortised cost (including trade receivables)

– Financial assets at FVTOCI

– Loan commitments and financial guarantee contracts where losses are currently provided or accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

– Lease receivables.

The 3 stage expected credit loss model

The new impairment model establishes a three stage approach, based on changes in expected credit losses of a financial instrument. This determines the recognition of impairment (as well as the recognition of interest revenue).

At initial recognition of a financial asset, an entity recognises a loss allowance equal to 12 months expected credit losses. These are the credit losses that are expected to result from default events that are possible within 12 months from the entity's reporting date. This means that the actual loss does not need to take place within the 12 month period; the focus is on the occurrence of the event that ultimately results in that loss.

After initial recognition the 3 stage expected credit loss model applies as follow:

– Stage 1: credit risk has not increased significantly since initial recognition – entities continue to recognise 12 month expected losses, updated at each reporting date

– Stage 2: credit risk has increased significantly since initial recognition – entities recognise life time expected losses and interest is presented on a gross basis

– Stage 3: the financial asset is credit impaired (using the criteria currently included in IAS 39) – entities recognise lifetime expected losses but present interest on a net basis (based on the gross carrying amount less credit allowance).

The recognition of impairment provisions (and interest revenue) is summarised in the table below:

Because the new model is forward looking, expected credit losses would be recognised from the point at which the financial assets are originated or purchased. This means that an entity will (at a minimum) be required to recognise 12-month expected credit losses that exist as at initial recognition. This means that there will be a day 1 loss for the 12 month expected credit losses recognised.

The rationale for this approach links to a component of the interest rate charged by a lender relating to a margin to cover expected losses. For example, if an interest rate is 8% per annum, 2% might relate to expected losses. The IASB's original model had proposed an approach under which entities would identify the expected losses element of the interest rate. Subsequently, using the example to illustrate, the entity would recognise interest revenue at 6% and use the 2% margin to build up a provision for expected losses. However, although technically an appropriate approach, feedback received by the IASB indicated that it would be very difficult to make this operational on large portfolios of loans. Consequently, the requirement to recognise a 12 month expected credit loss on initial recognition is intended to approximate the original model while at the same time making it operational in practice.

To simplify the application of the new impairment model, the IASB has included the following practical expedients:

– 30 days past due rebuttable presumption: There is a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due. This means that when payments are 30 days past due, a financial asset is considered to be in stage 2 and lifetime expected credit losses would be recognised. An entity can rebut this presumption when it has reasonable and supportable information available that demonstrates that even if payments are 30 days or more past due, it does not represent a significant increase in the credit risk of a financial instrument.

– Low credit risk instruments: Low credit risk instruments are considered to be those instruments that have a low risk of default and the counterparties have a strong capacity to repay. For example, for financial instruments that are of investment grade or equivalent, entities can assume that credit risk has not increased significantly. Consequently these instruments would remain in stage 1, and only 12 month expected credit losses would be provided.

<table>
<tr><th>Stage</th><th>1</th><th>2</th><th>3</th></tr>
<tr><td>Recognition of impairment</td><td>12 month expected credit loss</td><td colspan="2">Lifetime expected credit loss</td></tr>
<tr><td>Recognition of interest</td><td colspan="2">Effective interest on the gross carrying amount (before deducting expected losses)</td><td>Effective interest on the net (carrying) amount</td></tr>
</table>

Illustration 2: Recognition of impairment and interest under the 3 stage expected credit loss model

Short term trade receivables

For trade receivables with a maturity of 12 months or less, the standard sets out a simplified approach. Under the 'simplified approach' only 'lifetime expected credit losses' would be recognised i.e. stage 2.

The new impairment model allows entities to calculate expected credit losses on trade receivables using provision matrix. In practice today, many entities estimate credit losses using a provision matrix where trade receivables are grouped based on different customer bases and different historical loss patterns (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer). Under the new model, entities will need to adjust the historical provision rates (which are an average of historical outcomes) to reflect relevant information about current conditions and reasonable and supportable forecasts about future expectations.

Long term trade receivables and lease receivables

For other long term trade receivables and lease receivables, entities have a choice to either apply the general 3 stage expected credit loss model or the 'simplified approach' where only lifetime expected credit losses are recognised.

Loan commitments and financial guarantees

Provisions for financial commitments not recorded on balance sheet such as loan commitments and financial guarantees are currently accounted for in accordance with IAS 37. Under IFRS 9, the 3 stage expected credit loss model also applies to these off balance sheet financial commitments.

An entity considers the expected portion of a loan commitment that will be drawn down within the next 12 months when estimating 12-month expected credit losses (for those loan commitments that are in stage 1), and the expected portion of the loan commitment that will be drawn down over the remaining life the loan commitment when estimating lifetime expected credit losses (for those loan commitments that are in stage 2). The maximum period to consider when estimating credit losses is the maximum contractual period of where the entity is exposed to credit risk and not a longer period, even if that would be consistent with business practice.

However, loan commitments that are managed on a collective basis (e.g. revolving credit facilities such as credit cards and overdraft facilities) an entity estimates expected credit losses over the period until the entity has the practical ability to withdraw the loan commitment (for example until the next review of the loan commitment).

Disclosures

Extensive new disclosure requirements for the new impairment model have been added to IFRS 7 *Financial Instruments: Disclosures*.

Entities are required to disclose how an entity determines whether credit risk has increased significantly including the following information:

- Entity's definition of default
- How an entity determines when a financial asset is credit impaired
- Entity's write-off policy
- How the modification requirements have been applied
- Explanations of the inputs, assumptions and estimation techniques used to estimate expected credit losses.

In addition, entities are also required to disclose amounts arising from expected credit losses and the following information:

- Qualitative information about changes in the estimate of expected credit losses and reasons for the changes
- Reconciliation of the loss allowance
- Explanation of changes in gross carrying amounts
- Quantitative and qualitative information about modified financial assets
- Information about collateral.

Effective date and transition

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In addition, there is an option to early adopt the 'own credit' provisions for financial liabilities measured at fair value through profit or loss (FVTPL) under the fair value option without any of the other requirements of IFRS 9. This option will remain available until 1 January 2018.

Those entities that have already early adopted a previous version of IFRS 9, are permitted to continue applying that version and adopt IFRS 9 (2014) on its mandatory effective date.

On transition, if it is impracticable to apply the modified contractual cash flows characteristics test without the use of hindsight, then entities would apply the SPPI test in IFRS 9 (2010). For impairment, if initial credit risk information cannot be gathered without undue cost or effort, then an entity assesses whether the credit risk of its financial assets is low at the date of initial application. If credit risk is low at date of initial application, then 12-month expected credit losses will be recognised.

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