## Big changes ahead: accounting for financial instruments

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Financial instruments come in all shapes and forms. Many such instruments are very simple, such as a loan provided by a bank. But they can also be hugely complex. This means that accounting for financial instruments can be a challenge. And even when the financial instrument is a simple loan, providing information about loan loss expectations in a useful way can be a difficult task.

Encouraged by the G20, the Financial Stability Board and others, the International Accounting Standards Board (IASB) last year completed a project to improve the

way in which financial instruments are accounted for. This entailed improving the information that is provided about financial instruments to those who read financial statements and make investment decisions.

The new Standard, called IFRS 9 *Financial Instruments*, replaces the old Standard, IAS 39 *Financial Instruments: Recognition and Measurement*, which was seen as difficult to understand, apply and interpret both by those preparing financial statements and those reading them. IFRS 9 brings together all aspects of the accounting for financial instruments: classification and measurement, impairment and hedge accounting. Improved disclosures are also provided. The biggest difference under the new Standard will be in the accounting for impairment or loan loss provisions, because we are moving from an incurred loss model to an expected loss model.

## The new loan loss accounting model

Currently most standards on accounting for loan losses, including those published by the IASB, only require (and in fact only allow) provisions for these losses to be recognised when there is evidence that a loss event has occurred. In practice this has often meant that loan losses are only accounted for once borrowers default. And even then, the amount of losses that can be booked is restricted to reflecting the current situation. Even if a bank expects events to occur that will cause the borrower further problems, they cannot recognise that additional loss until those events happen. During the financial crisis this resulted in criticism that loan loss provisions were recognised 'too little, too late'.

IFRS 9 seeks to address this by requiring financial institutions and other companies to estimate and account for expected credit losses from when they first lend money or invest in a financial instrument, such as a bond. When measuring expected credit losses, companies will also be required to use all relevant information that is available to them. This is important, because it includes not only historical loss information and current information, but reasonable and supportable forward-looking information as well. Consequently, if a financial institution expects credit conditions to decline over the life of a loan, they must reflect that in their loan loss calculations immediately.

In addition to improving the timeliness of loan loss recognition, the new impairment model provides important information to assist users of financial statements to understand changes in the credit risk performance of financial instruments.

This is done by looking at loan losses separately for financial assets that are performing as, or better than, expected and those that are performing worse than expected. For example, suppose that a bank lends money and grades the loan as a 'C' on the bank's credit rating scale. Simply put, as long as the loan is graded 'C' or better, a loan loss provision will be recognised that reflects a portion of the total losses expected on such a loan over its life. However, if that loan is subsequently downgraded and is considered by the bank to have 'significantly increased in credit risk', in other words to be underperforming, the bank would need to increase the loan loss provision to reflect the full lifetime loss expected to occur over the life of the loan, because of its new lower credit quality. An economic loss is suffered so this is reflected in the financial statements.

The US Financial Accounting Standards Board (FASB) is also proposing a move to a forward-looking expected credit loss model for companies using US Generally Accepted Accounting Principles (GAAP). However, while the direction of travel for both the IASB and the FASB is towards a more forward-looking model, the two standard-setters have a slightly different approach despite efforts to agree on the same solution. The FASB's model will require that all expected credit losses (as for the underperforming loan in the example above) are always recognised. That recognition will start from the day a loan is made or a financial instrument is acquired. The IASB does not believe that recognising full lifetime losses on day one faithfully represent the economic situation (a bank does not suffer such a loss when it lends on market terms). The IASB is also concerned that requiring banks to recognise all expected losses whenever money is lent would allow a bank to improve its profits by curtailing lending and thus decreasing its loan loss provisions. This could have unintended economic consequences, especially in an economic downturn.

## Implementation

The change from an incurred to an expected loss model for loan loss provisions is a fundamental change in accounting. It will require considerable changes by many financial institutions and other companies. Banks that have already applied advanced approaches—as specified by the Basel Committee—to calculate expected losses for regulatory purposes should be able to use their existing systems and information as a basis for building the necessary models. Nevertheless, a number of systems changes and new data needs are expected as a result of this change. Because of this, these new requirements only become mandatory for annual reporting periods from 1 January 2018, to allow sufficient time for a robust implementation.

The original article appeared in Hebrew and is available <u>HERE.</u>