IFRS 9: A Complete Package for Investors

Sue Lloyd, a member of the IASB, discusses the new accounting standard for financial instruments.

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This month the IASB finalised its project to improve the accounting for financial instruments with the publication of IFRS 9 *Financial Instruments* (2014) (IFRS 9 or the Standard). IFRS 9 completes our main response to the global financial crisis and brings together all aspects of the accounting for financial instruments—classification and measurement, impairment and hedge accounting. Together with these changes, information about financial instruments is enhanced by an accompanying package of improved disclosures.

What are the main differences for investors?

Impairment

The biggest difference under the new Standard will be in the accounting for impairment. IFRS 9 will require entities to estimate and account for expected credit losses for all relevant financial assets, starting from when they first lend money or invest in a financial instrument. In addition, when measuring expected credit losses, entities will be required to use all relevant information that is available to them (without undue cost or effort). This is important in that it includes not only historical loss and current information, but also reasonable and supportable forward-looking information. These changes, in the timing of recognition and the consideration of reasonable and supportable forward-looking information, are important changes from existing IFRS, which only allowed impairment losses to be recognised when a loss had been 'incurred'. Even then, only the effect of events that had already occurred could be considered in measuring those impairment losses. The new requirements should help to address concerns by many investors about the recognition of impairment being 'too little, too late'.

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In addition, under current IFRS, impairment is measured differently depending on how a financial instrument is classified. This was a major criticism of accounting for financial assets in the financial crisis. For example, we were told that it was confusing that the same credit-impaired bond could have an impairment amount recognised based on either market prices, or on contractual cash flows, simply because it was classified as available for sale or held to maturity, respectively. Under the new model, measurement of impairment will be the same regardless of the type of instrument held and how it is classified.

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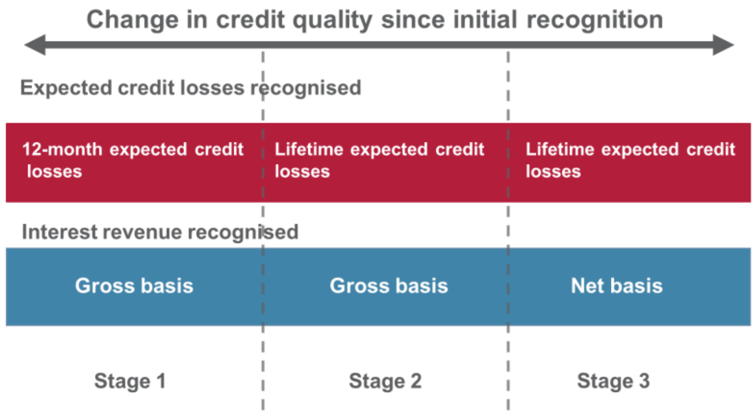
We were also told by investors and analysts that an impairment model that differentiates financial instruments based on whether they are performing as expected provides useful information. In this regard, the new impairment model provides two important pieces of information to assist users of financial statements in understanding changes in the credit risk performance of financial instruments.

Firstly, a portion of expected credit losses (a 12-month measure) is recognised for all relevant financial instruments from when they are first originated or acquired. In subsequent reporting periods, if there has been a significant increase in the credit risk of a financial instrument since it was first entered into or acquired, full lifetime expected credit losses would then be recognised.

Secondly, the way in which interest revenue is calculated depends on whether an asset is considered to be actually credit-impaired. Initially interest is calculated by applying the effective interest rate to the *gross* amount of an asset. However, if an asset is considered to be credit-impaired, the calculation changes to applying the effective interest rate to the amortised cost amount (ie *net* of the impairment allowance) of the asset. We felt that this better reflected the economic situation.

I have provided a diagram of the general model, including the interest revenue calculations, below.



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Classification and measurement of financial instruments

In contrast to the fundamental change in the accounting for impairment, at first glance the new classification and measurement requirements may not seem very different to what we have today. In particular, similarly to what happens today, financial assets will either be measured at amortised cost, fair value through other comprehensive income (OCI) or fair value through profit or loss. However, the new requirements will in fact result in differences that matter for those reading the financial statements.

For example, under the new requirements debt instruments can only be measured at fair value through OCI if they are held in a particular business model. That is different to the

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available-for-sale category today, which is generally an unrestricted option. Under IFRS 9, in order to be classified at fair value through OCI, a debt instrument needs to both have simple principal and interest cash flows and be held in a business model in which both holding and selling financial assets are integral to meeting management's objectives. This change provides more structure around the classification of these types of assets, which results in better information in the primary financial statements because it directly reflects both the nature of the instrument's contractual cash flows and the business model in which that instrument is held.

In addition, as mentioned above, because the same impairment model is applied to this category and to financial assets measured at amortised cost, investors will get a true amortised cost picture in profit or loss, while fair value measurement for these instruments will be provided on the balance sheet.

Accounting for changes in 'own credit'

Accounting for financial liabilities was not considered to need a fundamental overhaul, so IFRS 9 essentially does not change this accounting. Consequently, the vast majority of financial liabilities will continue to be measured at amortised cost. However, the main criticism we did hear about today's accounting for financial liabilities was about the accounting treatment of changes in 'own credit'. IFRS 9 will still require liabilities that an entity elects to measure at fair value to be recognised on the balance sheet at (full) fair value, because investors and analysts told us that changes in fair value provide useful early warning signals of changes in an entity's own credit risk. However, to address the concerns about accounting for 'own credit', IFRS 9 will require the portion of fair value changes caused by changes in the entity's own credit risk to be recognised in OCI rather than in profit or loss. This will remove the counterintuitive effects (especially apparent during the financial crisis) that result from accounting for changes in 'own credit' through profit or loss.

To make this improvement more readily accessible, an entity that applies IFRS 9 before 1 January 2018 can choose to apply this change to its accounting for financial instruments in isolation (that is, prior to applying any other parts of IFRS 9). We expect early application to be likely for banks, because they often choose to measure their structured debt financing at fair value and are often asked by those reading their financial statements to provide 'non-GAAP' adjustments to remove the 'own credit' effect from profit or loss.

More information about these changes can be found in the related Investor Perspective: *One fewer non-GAAP adjustment to worry about: improvements to the accounting for changes in own credit*.

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Hedge accounting

The final version of IFRS 9 includes the new hedge accounting requirements that were first published in November last year. These new requirements were not a result of the financial crisis. However, these improvements to hedge accounting address concerns and criticisms about shortcomings in the prior model and the information provided about risk management. As a result, the new hedge accounting model more closely aligns risk management and accounting. Information is also required to be provided about the effect of hedge accounting on the financial statements, which will assist in shedding light on a notoriously complex area of accounting. We expect this will significantly improve the information about risk management that will be available to investors and analysts.

A more detailed analysis of these requirements can be found in the Investor Perspective: *New Hedge Accounting Model Will Improve Investor Understanding of Risk Management*.

Disclosures

Expected credit losses reflect management's expectations of shortfalls in the collection of contractual cash flows. Clearly that gives rise to significant judgements, including in the choice both of the information used to measure expected credit losses and the information used to assess how credit risk has changed over the life of a financial instrument. Accordingly, we have introduced disclosures to assist investors and analysts to understand the amount of expected credit losses, the basis for their measurement and the reasons for changes in expected credit losses over time. In particular, entities will be required to provide information about key assumptions used in the measurement of expected credit losses, and how an entity determines whether there has been a significant increase in credit risk.

In addition, entities will be required to provide a reconciliation of the opening and closing expected credit loss amounts and associated opening and closing financial instrument carrying amounts. Information about the changes in the financial instruments' carrying amounts will have to be provided in a way that enables investors and analysts to understand the main drivers of changes in the amount of expected credit losses. (For example, is it caused by changes in credit risk or an increased amount of lending?)

These disclosures are required to be provided separately for different categories (such as 12-month and lifetime loss amounts) and by class of financial instrument. By requiring information about expected credit losses for different categories of financial instruments, a richer set of information is provided to investors and analysts about credit risk.

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At the request of investors and analysts, specific disclosures are also required about financial assets that have had their contractual cash flows modified (which may arise, for example, when there has been forbearance activity).

The following table illustrates how an entity might provide this information in its note disclosures.

Mortgage loans– loss allowance	**12-month expected credit losses**	**Lifetime expected credit losses**		
		Collectively assessed	**Individually assessed**	**Credit-impaired**
Loss allowance as at 1 January	**X**	**X**	**X**	**X**
Changes due to financial instruments recognised as at 1 January:				
Transfer to lifetime expected credit losses	(X)	X	X	–
Transfer to credit-impaired financial assets	(X)	–	(X)	X
Transfer to 12-month expected credit losses	X	(X)	(X)	–
Financial assets that have been derecognised during the period	(X)	(X)	(X)	(X)
New financial assets originated or purchased	X	–	–	–
Write-offs	–	–	(X)	(X)
Changes in models/risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31 December	**X**	**X**	**X**	**X**

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Next steps

The publication of IFRS 9 (2014) draws to a close the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. Even though IFRS 9 is mandatory from 1 January 2018, the effects could be apparent earlier than that. Entities can choose to apply it earlier, although the reality for many, particularly financial institutions, is that a significant amount of time will be needed to prepare for IFRS 9, not least because of

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the improvements to accounting for impairment, which is based on expected credit losses.

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In addition, we have a separate active project on accounting for dynamic risk management. Further information about this project can be found by reading the Investor Perspective: Dynamic risk management-accounting in an age of complexity. We would also be happy to hear your views on those proposals, which are currently out for public comment.

Respond to the author

Sue Lloyd is a member of the IASB. The views expressed in this article are those of the author and do not necessarily reflect the views of the IASB or the IFRS Foundation. The IASB/IFRS Foundation encourages its members and staff to express their individual views. This article has been developed by the author as an individual. It is has not been subjected to any due process of the IASB/IFRS Foundation. Official positions of the IASB/IFRS Foundation are determined only after extensive due process.

If you would like to discuss this topic or other areas of accounting, please contact Sue Lloyd at slloyd@ifrs.org or Barbara Davidson, IASB Investor Liaison, at bdavidson@ifrs.org