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IASB finalises IFRS 9 which changes the classification and measurement of financial assets and introduces an expected loss impairment model

Background and effective date

The IASB's project to replace IAS 39 Financial Instruments: Recognition and Measurement started in 2008 and has been completed in phases. The IASB first issued IFRS 9 in 2009 with a new classification and measurement model for financial assets followed by requirements for financial liabilities and derecognition added in 2010. Subsequently, IFRS 9 was amended in 2013 to add new general hedge accounting requirements.

he amendments discussed in this publication are the final requirements to be added which now completes IFRS 9. The Standard has a mandatory effective date for annual periods beginning on or after 1 January 2018, with earlier application permitted. The Standard is applied retrospectively with some exceptions (e.g. most of the hedge accounting requirements apply prospectively) but entities need not restate prior periods in relation to classification and measurement (including impairment).

Since IFRS 9 is now complete, the IASB decided to issue the full version of IFRS 9 (rather than just publishing the amendments) which will supersede all previous versions of the Standard. However, for annual periods beginning before 1 January 2018, an entity may elect to apply those earlier versions of IFRS 9 if the entity's relevant date of initial application is before 1 February 2015.

Amendments to the classification and measurement model for financial assets FVTOCI measurement category

IFRS 9 requires that certain financial assets held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets should be measured at FVTOCI (unless designated at fair value through profit and loss (FVTPL) to eliminate or significantly reduce a measurement mismatch). This applies to assets passing the contractual cash flow characteristics assessment (which is the same test used to determine whether financial assets are measured at amortised cost). Interest revenue, foreign exchange gains and losses and impairment gains and losses shall be recognised in profit or loss with all other gains or losses (i.e., the difference between those items and the total change in fair value) being recognised in other comprehensive income (OCI).

Any cumulative gain or loss recorded in OCI would be reclassified to profit and loss on derecognition, or potentially earlier if the asset is reclassified because of a change in business model. Interest income and impairment gains and losses would be recognised and measured in the same manner as for assets measured at amortised cost such that the amounts in OCI represents the difference between the amortised cost value and fair value. This results in the same information in profit or loss as if the asset was measured at amortised cost, yet the statement of financial position would reflect the instrument's fair value.

Observation

‘The FVTOCI category for debt instruments is not the same as the available-for-sale category under IAS 39. Under IAS 39 impairment gains and losses are based on fair value, whereas under IFRS 9 they are not. Instead, impairment is based on expected losses and is measured consistently with amortised cost assets (see below). Also, the criteria for measuring at FVTOCI is based on the entity's business model, which is not the case for the available-for-sale category.

Business model assessment

IFRS 9 provides guidance on how to determine whether a business model is to manage assets both to collect contractual cash flows and for sale. This is new guidance that follows from the introduction of the FVTOCI category for debt instruments.

The IASB has taken the opportunity to clarify the existing guidance in IFRS 9 on business models where the objective is to hold assets to collect contractual cash flows, (i.e., part of the amortised cost criteria). Where sales of financial assets, other than in response to credit deterioration, are more than infrequent and more than insignificant in value (either individually or in aggregate) then an assessment is needed as to whether and how such sales are consistent with an objective of collecting contractual cash flows. Further, sales of financial assets may be consistent with the objective of collecting contractual cash flows if they are made close to the maturity of the financial assets and the proceeds from the sales approximate the collection of the remaining contractual cash flows.

The IASB also amended the current application guidance with examples of when the business model may be to hold financial assets to collect contractual cash flows. Under the amendments some of the examples were modified and one further example (involving a financial institution) was added.

Observation

Entities will need to assess their business models for holding financial assets. For some entities, such as non-financial corporates, the assessment may be relatively simple as their financial assets may be limited to trade receivables and bank deposits where amortised cost measurement is likely. Entities that have a broader range of activities involving financial assets, e.g. lenders, investors in debt securities held for treasury activities, insurance entities, traders will require a greater amount of effort to understand the business model and consider the motivations that would lead to disposals of financial assets.

Reclassifications

Before these amendments, IFRS 9 required reclassification between classification categories if the business model for managing the financial assets changed. This was limited to debt instruments held at amortised cost and at FVTPL. As a FVTOCI category has been introduced for debt instruments this concept has been extended to cater for reclassifications out of, or into, FVTOCI.

If an entity reclassifies a financial asset out of the amortised cost category to the FVTOCI category, its fair value is determined at the reclassification date with any difference between this and its previous carrying amount recognised in OCI and no adjustment to the effective interest rate. If an entity reclassifies a financial asset out of the FVTOCI category to the amortised cost category, the asset is reclassified at its fair value with a concurrent removal of any previously accumulated gain or loss from OCI with this amount adjusting the fair value at the reclassification date. This has the effect of stating the carrying value of the asset to what it would have been had it always been measured at amortised cost. Also, the effective interest rate is not adjusted in this case. If an entity reclassifies a financial asset out of FVTPL to FVTOCI, it continues to be measured at fair value. This is also the case if an entity reclassifies a financial asset out of FVTOCI to FVTPL.

Contractual cash flow characteristics assessment

The amendments introduce new guidance on how the contractual cash flow characteristics assessment applies in certain cases.

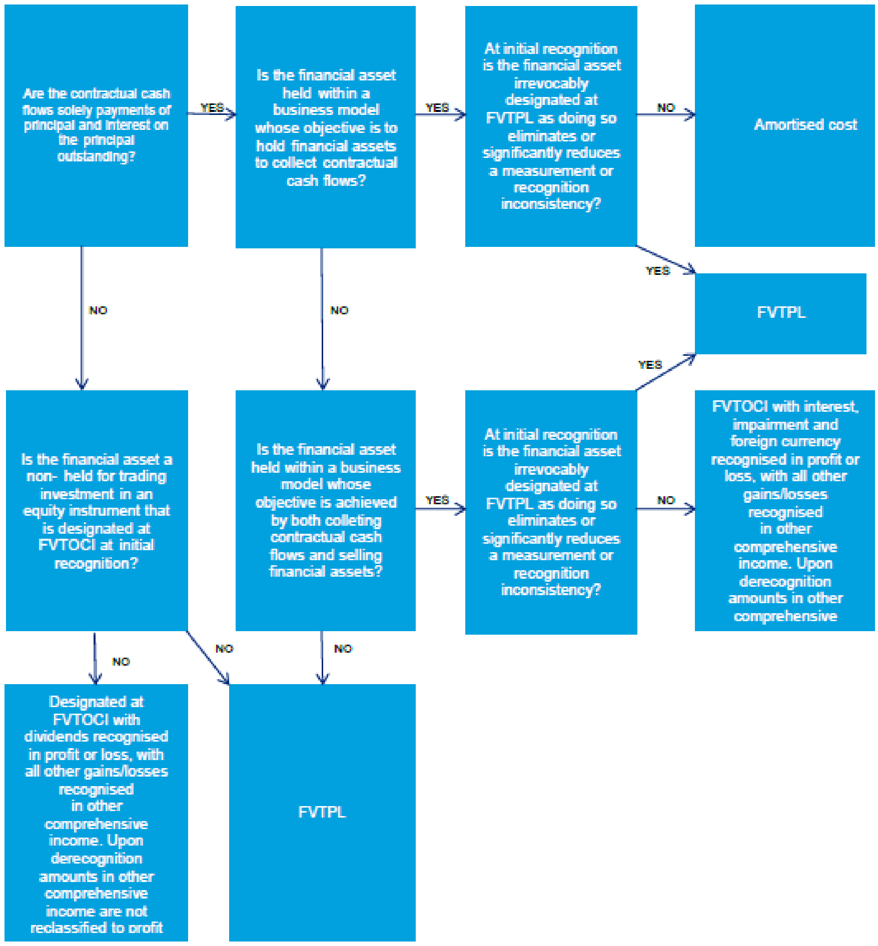
Modified time value element

In a basic lending arrangement the most significant elements of interest are consideration for the time value of money and credit risk. The amended application guidance acknowledges that consideration for other basic lending risks (e.g., liquidity risk) and costs (e.g., administrative costs) as well as a profit margin may also be part of interest.

The Standard defines time value of money as the element of interest that provides consideration for just the passage of time. IFRS 9 recognises that this element may be modified in certain cases and so requires an entity to assess the modified time value of money element in detail unless the result of this assessment is clear with little or no analysis. The objective of the assessment is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (i.e. a comparison to the benchmark cash flows). The example given is a variable interest rate that is resettable monthly to a one-year interest rate and the comparable benchmark instrument would be an instrument with identical contractual terms and identical credit quality except for the fact that the variable interest rate is resettable monthly to a one-month interest rate. If the contractual (undiscounted) cash flows could be significantly different from the (undiscounted) benchmark cash flows, given reasonably possible scenarios, then the contractual cash flow characteristics test is failed and the debt instrument must be measured at FVTPL.

Prepayment features

The finalised IFRS 9 takes a different approach to the impact of prepayment features on classifying debt instruments held. Under the previous version of IFRS 9 certain prepayment features resulted in failing the contractual cash flow characteristics test. The IASB felt that this was not always appropriate and as a result the new guidance requires an assessment of the prepayable amount to determine whether it substantially represents unpaid amounts of principal and interest on the principal outstanding (which may include additional compensation for the early termination of the contract) as well as an assessment of the events that need to occur for the prepayment option to be exercised (when exercise is subject to a contingent event). IFRS 9 provides an exception that where the financial asset is acquired or originated at a premium or discount to the contractual par amount and at initial recognition the fair value of the prepayment feature is insignificant the asset will pass the contractual cash flow characteristics test if the prepayment amount substantially represents the contractual par amount and accrued (but unpaid) contractual interest (which may include reasonable additional compensation).



Transition for the amendments to classification and measurement

The amendments apply retrospectively, in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, except for the following provisions:

• If it is impracticable to assess a modified time value of money element on the basis of the facts and circumstances at initial recognition of the financial asset, the contractual cash flow characteristics test is applied without taking into account that requirement.

If it is impracticable to assess whether the fair value of a prepayment feature was insignificant on the basis of the facts and circumstances at initial recognition of the financial asset, an entity applies the contractual cash flow characteristics test without taking into account the exception for prepayment features.

Summary of classification and measurement model for financial assets

The diagram below summarises the application of the classification and measurement model for financial assets following the amendments discussed above.

Expected loss impairment model

IFRS 9 introduces a new impairment model based on expected losses, rather than incurred loss as applied in IAS 39. The measurement basis differs compared with IAS 39 as does the scope to which the impairment applies.

Scope

The new impairment model applies to all of the following:

Financial assets measured at amortised cost;

Financial assets mandatorily measured at FVTOCI;

Loan commitments when there is a present obligation to extend credit (except where these are measured at FVTPL);

Financial guarantee contracts to which IFRS 9 is applied (except those measured at FVTPL);

Lease receivables within the scope of IAS 17 Leases; and Contract assets within the scope of IFRS 15 Revenue from Contracts with Customers (i.e. rights to consideration following transfer of goods or services).

Observation

IFRS 9 requires the same measurement basis for impairment for all items in the scope of the impairment requirements. This differs to IAS 39 where impairment was calculated differently for amortised cost assets and those available-for-sale assets measured at FVTOCI. Further, IFRS 9 applies the same measurement approach to certain loan commitments and financial guarantee contracts where previously these were measured differently in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

General Approach

With the exception of purchased or originated credit-impaired financial assets (see below), expected credit losses are required to be measured through a loss allowance at an amount equal to:

the 12-month expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or

full lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

A loss allowance for full lifetime expected credit losses is required for a financial instrument if the credit risk of that financial instrument has increased significantly since initial recognition, as well as to contract assets or trade receivables that do not constitute a financing transaction in accordance with IFRS 15. If the credit risk has not increased significantly expected credit losses are measured at an amount equal to the 12-month expected credit losses.

Additionally, entities can elect an accounting policy recognising full lifetime expected losses for all contract assets and/or all trade receivables that do constitute a financing transaction in accordance with IFRS 15. The same election is also separately permitted for lease receivables.

Significant increase in credit risk

With the exception of purchased or originated credit-impaired financial assets (see below), the loss allowance for financial instruments is measured at an amount equal to lifetime expected losses if the credit risk of a financial instrument has increased significantly since initial recognition, unless the credit risk of the financial instrument is low at the reporting date.

The Standard considers credit risk low if there is a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. The Standard suggests that 'investment grade' rating might be an indicator for a low credit risk.

The assessment of whether there has been a significant increase in credit risk is based on an increase in the probability of a default occurring since initial recognition. The Standard permits various approaches to assess whether credit risk has increased significantly. An approach does not need to include as an input an explicit probability of default. The Standard recognises that whilst in principle the assessment of whether there has been a significant increase in credit risk is made at the individual instrument level, some factors or indicators might not be available at an instrument level. In this case, the entity should perform the assessment on appropriate groups or portions of a portfolio of financial instruments.

The requirements also contain a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due. IFRS 9 also requires that (other than for purchased or originated credit-impaired financial instruments) if a significant increase in credit risk that had taken place since initial recognition and has reversed by a subsequent reporting period (i.e., cumulatively credit risk is not significantly higher than at initial recognition) then the expected credit losses on the financial instrument revert to being measured based on an amount equal to the 12-month expected credit losses.

Purchased or originated credit-impaired financial assets

Purchased or originated credit-impaired financial assets, e.g. distressed debt, are treated differently because the asset is credit-impaired at initial recognition. For these assets, an entity would recognise changes in lifetime expected losses since initial recognition as a loss allowance with any changes recognised in profit or loss. Under the requirements, any favourable changes for such assets are an impairment gain even if the resulting expected cash flows of a financial asset exceed the estimated cash flows on initial recognition.

Basis for estimating expected credit losses

The measurement of expected credit losses shall reflect an unbiased and probability-weighted amount that is determined by evaluating the range of possible outcomes as well as incorporating the time value of money. Also, the entity should consider reasonable and supportable information about past events, current conditions and reasonable and supportable forecasts of future economic conditions when measuring expected credit losses.

The Standard defines expected credit losses as the weighted average of credit losses with the weightings being respective risks of a default occurring. Not every possible scenario must be considered but, at a minimum, the risk or probability that a credit loss occurs and does not occur must be considered, even if the probability of a credit loss occurring is low.

An entity is required to incorporate reasonable and supportable information (i.e., that which is reasonably available at the reporting date). Information is reasonably available if obtaining it does not involve undue cost or effort (with information available for financial reporting purposes qualifying as such).

For applying the model to a loan commitment an entity will consider the risk of a default occurring under the loan to be advanced, whilst application of the model for financial guarantee contracts an entity considers the risk of a default occurring of the specified debtor.

An entity may use practical expedients when estimating expected credit losses if they are consistent with the principles in the Standard (e.g., expected credit losses on trade receivables may be calculated using a provision matrix where a fixed provision rate applies depending on the number of days that a trade receivable is outstanding).

To reflect time value, expected losses should be discounted to the reporting date using the effective interest rate of the asset (or an approximation thereof) that was determined at initial recognition. A "credit-adjusted effective interest rate" should be used for expected credit losses of purchased or originated credit-impaired financial assets.

In contrast to the "effective interest rate" (calculated using expected cash flows that ignore expected credit losses), the credit-adjusted effective interest rate reflects expected credit losses of the financial asset.

Expected credit losses of undrawn loan commitments should be discounted by using the effective interest rate (or an approximation thereof) that will be applied when recognising the financial asset resulting from the commitment. If the effective interest rate of a loan commitment cannot be determined, the discount rate should reflect the current market assessment of time value of money and the risks that are specific to the cash flows but only if, and to the extent that, such risks are not taken into account by adjusting the discount rate. This approach shall also be used to discount expected credit losses of financial guarantee contracts.

Observation

The amendments are clear that even for an individual financial asset, the measurement of expected credit losses must include the probability weighting of credit losses even if these are unlikely and the most probable outcome is the collection of the full contractual cash flows and zero credit losses. The requirements in effect prohibit an entity from estimating expected credit losses solely on the basis of the most likely outcome.

The discount rate applied in measuring the loan loss allowance for a financial asset differs from the proposals in the preceding exposure draft. The exposure draft permitted any discount rate between the risk free rate and the effective interest rate could be used in discounting the loan loss allowance for assets not credit impaired, whilst the final Standard requires the use of the effective interest rate or an approximation of it in all cases.

Modifications and write-offs

If a renegotiation or other modification of the contractual cash flows of a financial asset results in derecognition under IFRS 9, the revised instrument is treated as a new instrument.

If a renegotiation or other modification of the contractual cash flows of a financial asset does not result in derecognition, the entity shall recalculate the gross carrying amount of the financial asset (i.e., amortised cost amount before adjusting for any loss allowance). This is done by discounting the new expected contractual cash flows (post modification) at the original effective interest rate and recognising any resulting modification gain or loss in profit or loss. From this date, the entity assesses whether the credit risk of a financial instrument has increased significantly since initial recognition by comparing the risk of a default occurring at the reporting date (under modified terms) and the risk of a default occurring at initial recognition (under original, unmodified terms).

The Standard requires an entity to directly reduce the gross carrying amount of a financial asset when the entity has no reasonable expectations of recovery.

IFRS 9 states that a write-off constitutes a derecognition event and may relate to either the asset in its entirety or a portion of it.

Presentation

Whilst interest revenue is always required to be presented as a separate line item, it is calculated differently according to whether the asset is deemed to be credit-impaired. An asset is credit-impaired when one or more events have occurred and have a significant impact on the expected future cash flows of the financial asset.

> ***Observation***
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> IFRS 9 includes a list of indicators of when an asset is credit-impaired that are broadly the same as the incurred loss trigger events in IAS 39.

For a financial asset that is not a purchased or originated credit-impaired financial asset, or has not become credit- impaired since initial recognition, interest revenue is calculated by applying the effective interest rate method to the gross carrying amount ("gross method" for the purposes of this publication).

For a financial asset that is not a purchased or originated credit-impaired financial asset but subsequently has become credit-impaired, interest revenue is calculated by applying the effective interest rate to the amortised cost balance, which comprises the gross carrying amount adjusted for any loss allowance ("net method" for the purposes of this publication).

If following a period of using the net method, if the credit risk of the financial instrument improves so that the financial asset is no longer credit-impaired and the improvement can be related objectively to an event since the net method was applied, the calculation of interest revenue reverts to the gross method.

Finally, in the case of purchased or originated credit-impaired financial assets, interest revenue is always recognised by applying the credit-adjusted effective interest rate to the amortised cost carrying amount. The credit-adjusted effective interest rate is the rate that discounts the cash flows expected on initial recognition (explicitly taking account of expected credit losses as well as contractual terms of the instrument) back to the amortised cost at initial recognition.

Consequential amendments of IFRS 9 to IAS 1 Presentation of Financial Statements require that impairment losses, including reversals of impairment losses and impairment gains (in the case of purchased or originated credit-impaired financial assets), are presented in a separate line item in the statement of profit or loss and other comprehensive income.

> ***Observation***
>
> The trigger point for the change in presentation of interest income on financial assets from the gross method to the net method is based on them becoming credit impaired. This is different from the criteria used to move from 12-month expected credit losses to lifetime expected credit losses which is based on a significant deterioration in the credit risk of the financial asset.

Disclosures

The new expected loss impairment model is accompanied by extensive disclosure requirements that are added to IFRS 7 Financial Instruments: Disclosures. They are designed to enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. To achieve this objective, IFRS 7 requires credit risk disclosures that provide:

- information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses;
- quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for those changes; and
- information about an entity's credit risk exposure (i.e. the credit risk inherent in an entity's financial assets and commitments to extend credit), including significant credit risk concentrations.

IFRS 7 expands on each of the three key components of the credit risk disclosures noted above with more specific detailed requirements.

Transition for the expected loss impairment model

The amendments shall be applied retrospectively, in accordance with IAS 8 except for the following provisions:

At the date of initial application, an entity shall use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that financial instruments were initially recognised (or for loan commitments and financial guarantee contracts the date that the entity became a party to the irrevocable commitment) and compare that to the credit risk at the date of initial application of IFRS 9.

If it would require undue cost or effort at the date of initial application to determine whether there has been a significant increase in credit risk since initial recognition, an entity shall recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised. However, if the financial instrument is low credit risk at a reporting date, the entity may assume that the credit risk has not increased significantly since initial recognition.

Further information

Video interviews and podcasts that discuss these new requirements are available at www.iasplus.com.

Furthermore, publications on the other parts of IFRS 9 previously issued are also available as follows:

IFRS 9 (2009) - classification and measurement for financial assets

http://www.iasplus.com/en/publications/global/ifrs-in-focus/2009/ias-plus-newsletter-2014-ifrs-9-financial-instruments

IFRS 9 (2010) - classification and measurement for financial liabilities

http://www.iasplus.com/en/publications/global/ifrs-in-focus/2010/ifrs-9-revisions

IFRS 9 (2013) - general hedge accounting

http://www.iasplus.com/en/publications/global/ifrs-in-focus/2013/hedging