

IFRS industry insights: Non-financial corporates New financial instrument standard changes financial asset classification and bad debt provisioning

Headlines

- IFRS 9 has a new classification category, fair value through other comprehensive income (FVTOCI), for debt instruments
- An expected loss impairment model is added to IFRS 9
- Impairment losses and bad debt provisions will be recognised sooner than under IAS 39
- In many cases provisions will be recognised on initial recognition of loan assets and other receivables leading to a “day-one” provision

What’s happened?

The International Accounting Standards Board (IASB) has issued the final version of IFRS 9 *Financial Instruments* incorporating amendments to the classification and measurement model for financial assets and a new expected loss impairment model. IFRS 9 is the replacement to IAS 39 *Financial Instruments: Recognition and Measurement* and is effective for reporting periods beginning on or after 1 January 2018, with earlier application permitted (subject to local endorsement requirements).

The project to replace IAS 39 has been undertaken in stages. 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 the new general hedge accounting requirements. The final version of IFRS 9 issued in July 2014 supersedes all those previous versions although they remain available for early adoption for a limited time¹.

Implications for non-financial corporates

The most significant impacts from the amendments to the classification and measurement model and the new expected loss impairment model for non-financial corporates are included below. More detailed guidance on the accounting requirements and further resources are also noted.

Amendment to classification and measurement of financial assets

The new FVTOCI classification is a mandatory classification that is applied to assets that pass the contractual cash flow characteristics test but are held within a business model whose objective is achieved by both holding to collect contractual cash flows *and* selling the assets. A fair value option is available on initial recognition as an alternative to FVTOCI if measuring the asset at fair value through profit or loss (FVTPL) would eliminate or reduce an accounting mismatch.

¹ The previous versions of IFRS 9 may be early adopted if the entity’s relevant date of initial application is before 1 February 2015

The contractual cash flow characteristics test is passed if the financial asset solely consists of a return of principal and interest on the principal outstanding. If the financial asset passes this test it will be measured at amortised cost if it is held in a business model that collects contractual cash flows or FVTOCI if the business objective is to both collect the contractual cash flows and sell the asset. If neither business model applies, or the fair value option is invoked, the asset is measured at FVTPL.

Less profit or loss volatility

Compared to the original requirements in IFRS 9, the introduction of the FVTOCI category can result in some of those assets that would have been measured at FVTPL (due to failing the business model test for amortised cost measurement) to be at FVTOCI. This could result in less profit or loss volatility for corporates that invest in long-term debt instruments and manage the overall return generated by collecting the contractual cash flows and selling assets to reinvest to get a higher return. For example, such a strategy may be employed to fund capital expenditure in the short to medium term. These assets would not have met the requirements for amortised cost measurement due to frequent and significant sales but could be eligible for the FVTOCI classification.

FVTOCI vs AFS

The FVTOCI classification differs from the available-for-sale (AFS) classification under IAS 39 as FVTOCI is not the residual category (instead FVTPL is) and most importantly, expected losses are applied in measuring impairment (see below).

The AFS classification is often used by corporates holding quoted debt securities, since these assets are not eligible for amortised cost treatment unless they are specifically held to maturity. Hence the impact of such assets being measured at FVTOCI (or indeed amortised cost when eligible) will need to be considered.

New expected loss impairment model

IFRS 9 introduces a new expected loss impairment model which replaces IAS 39's incurred loss model which corporates will be required to apply to:

- debt instruments held measured at amortised cost or FVTOCI;
- trade receivables;
- 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 that the entity has transferred to a customer when that right is conditioned on something other than the passage of time, for example, the entity's future performance).

In addition, any corporates that have issued loan commitments or financial guarantees would also be required to apply the expected loss model (except in limited cases).

Day-one provision

The loan loss allowance is recognised on initial recognition and measured in one of two ways²:

- 12-month expected loss allowance; or
- Lifetime expected loss allowance

Therefore, when an entity recognises a trade receivable, lease receivable or contract asset, a day-one provision with a debit to profit or loss will be recognised. This also applies to debt securities measured at amortised cost or FVTOCI.

For both trade receivables and contract assets that do not contain a significant financing component (in accordance with IFRS 15), the loss allowance is always measured equal to lifetime expected losses.

For other trade receivables, other contract assets and lease receivables there is an accounting policy choice available (for each of these) to always measure the loan loss allowance equal to lifetime expected losses. Otherwise 12-month loss allowances are recognised on initial recognition.

Monitoring credit risk migration

When there is a significant increase in credit risk the loss allowance moves from a 12-month expected loss allowance to an allowance for lifetime expected losses. This new, earlier, trigger for recognising impairment losses will mean entities will have to establish appropriate systems and processes for identifying when there has been a significant increase in credit risk. The approach for different types of assets is likely to differ. For example, external ratings might be used for investments in debt securities, and 'past due' data might be used for trade receivables.

IFRS 9 includes a rebuttable presumption that once a receivable becomes 30-days past due there has been a significant increase in credit risk. Corporates will need to consider this threshold against their typical receivables noting that sufficient support will be required to rebut this presumption.

² With the exception of purchased credit-impaired assets where expected losses are incorporated into the expected cash flows from which the (credit-adjusted) effective interest rate is derived which is the same treatment as under IAS 39

Measuring expected losses

Loss allowances will be measured on a probability-weighted basis, discounted by the effective interest rate (or an approximation thereof), based on information regarding past events, current conditions and a reasonable and supportable forecast of future economic conditions that is reasonably available without undue cost and effort. This measure of the loan loss allowance will demand the use of data and information not previously used under IAS 39. The Standard allows the use of provision matrices, for example, to calculate the level of the provision based on days past due (e.g. measure lifetime expected losses at 1% of amounts outstanding for trade receivables 30 days past due; 3% for 60 days past due; 5% for 90 days past due; etc). The use of such an approach would require careful analysis of available information to support its application.

Transparency

Given the number of judgments and assumptions required to apply the model, IFRS 7 *Financial Instruments: Disclosures* requires extensive disclosures to accompany the accounting. These disclosures will provide transparency on the application of the model and is likely to be used to compare an entity's provisioning amongst peers and track changes in provisions from year to year. Therefore the messaging of these enhanced disclosures is likely to require some advance consideration.

Transition

When IFRS 9 is first applied, both the classification and measurement, and impairment requirements are to be applied retrospectively, with an option not to restate prior periods.

In addition to the exception from restating comparatives, if at the date of initial application, determining whether there has been a significant increase in credit risk since initial recognition would require undue cost or effort, a lifetime expected loss allowance is recognised until the financial instrument is derecognised (unless the credit risk is low at the reporting date). The effect of this is that an absolute measure of credit risk at the reporting date dictates the recognition of lifetime expected losses rather than a relative measure comparing to initial recognition. The practical benefit of this approach would have to be weighed against the consequence of recognising a higher provision on transition and the burden of having two impairment approaches running parallel for future periods.

Further information

More detailed information on the requirements of IFRS 9 can be found in Deloitte's IFRS in Focus publication, along with video interviews discussing the impact on banks, at www.iasplus.com

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as “Deloitte Global”) does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte’s more than 200,000 professionals are committed to becoming the standard of excellence.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the “Deloitte Network”) is, by means of this communication, rendering professional advice or services. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2014. For information, contact Deloitte Touche Tohmatsu Limited.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 37235A