



IFRS 9: Financial Instruments

• **Adoptions and Implications**
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Impact of IFRS 9, Financial Instruments

IFRS 9 takes effect on January 1, 2018. After the financial crisis of 2007-8, it became glaringly obvious that amendments were necessary to the existing accounting rules for financial instruments. The International Accounting Standards Board (IASB) issued IFRS 9, Financial Instruments on July 24, 2014.

The following is a summary of the new impairment rules.

Overview of expected credit loss model

The following financial instruments fall within the scope of the expected credit loss (ECL) model:

- a. Financial assets measured at amortized cost;
- b. Financial assets mandatorily measured at fair value through other comprehensive income (FVOCI);
- c. Loan commitments that are not measured at fair value through profit and loss (FVPL) when there is a present obligation to extend credit;
- d. Financial guarantee contracts that are within the scope of IFRS 9 and that are not measured at FVPL; and
- e. Lease and trade receivables.

The current loss model under IAS 39 only allows impairment provisions for losses occurring at the reporting date. The new impairment rules are forward-looking, which will have major implications for preparers of financial statements.

A 12-month ECL allowance is recognized at each reporting period for financial instruments that have not seen a significant increase in credit risk. The 12-month ECL is a portion of the lifetime ECL and represents the amount of expected credit losses resulting from a default in the 12 months following the reporting date.

For all financial instruments undergoing a significant increase in credit risk, a lifetime ECL is recognized. If afterwards, the credit risks decreases, so that the criteria for recognizing a lifetime ECL is no longer met, then the entity measures the loss allowance as the 12-month ECL.

The ECL is the present value of the expected cash shortfalls over the life of the financial instrument. Measurement should take into account an unbiased and probability weighted estimate of cash flows under a range of possible outcomes. The degree to which judgment is exercised will depend on the availability of information.

In assessing credit risk, only the risk of default over the remaining term of the financial instrument is considered. The exercise can be performed for a portfolio of instruments with shared credit risk. Although the standard does not prescribe the method to use, the objective is to use all reasonable and supportable information including forward-looking information, which is available without undue cost or effort.

Interest revenue is calculated using the effective interest method applied to the gross carrying amount of the financial instrument. When there is objective evidence of impairment, interest is calculated based on the net carrying amount (the gross carrying amount net of the ECL).

To decrease the burden of applying the new standard, entities are allowed to recognize a 12-month ECL allowance for any financial instruments considered low risk (for which criteria must be met) at the reporting date. Therefore, a credit risk assessment is not required. An example of a low risk instrument is one meeting the definition of 'investment grade' at the reporting date.

A rebuttable presumption is included: that there has been a significant increase in credit risk when contractual payments are more than 30 days past due. However, in assessing whether there has been a significant increase in credit risk for such instruments, information that is more forward-looking should also be considered.

The default definition that is applied must be consistent with the credit risk management practices applied. It must also take into account qualitative indicators of default (such as instruments that have financial covenants attached). There is a second rebuttable presumption: default does not occur later than after 90 days past due, unless the entity can support a longer timeframe using reasonable and supportable information.

An ECL is recognized for loan commitments and financial guarantee contracts for the period over which the entity is exposed to credit risk and future drawdowns cannot be avoided.

A simplified approach is allowed for trade receivables and lease receivables, which eliminates the need to calculate the 12-month ECL. An entity can opt to measure the loss allowance at an amount equal to the lifetime ECL throughout the life of these assets.

The How !!! The Accounting Effect

IFRS 9, the new standard on financial instruments will be applicable for financial years beginning on or after 1 January 2018. The standard was revised following the financial crisis and the criticism that IAS 39 was difficult to understand, apply and interpret. IFRS 9 rethinks the accounting for financial instruments and most entities applying IFRS should expect some change as a result of the new standard.

Key change	Implication for companies
Impairment of trade receivables will move from an incurred loss model to an expected loss model.	Bad debt provisions are likely to increase as provisions are made against expected losses and not just when there is evidence of impairment.
Existing four categories of financial assets replaced by three.	Accounting should be aligned with the underlying business model.
Relaxed and simplified hedge accounting rules compared to IAS 39.	Hedge accounting is easier to apply and hence a more attractive accounting option.

Recognition and measurement – financial assets

IFRS 9 follows a principles approach based on assessing the entity's business model for managing financial assets and the contractual cash flow characteristics of the financial asset. Financial assets are then recognised in one of the following three categories:

Category	Characteristics	Treatment
Amortised cost	The business model is to hold the asset in order to collect the contractual cashflows, those cashflows are solely payments of principal and interest and the cashflows arise on specified dates.	Recognised at amortised cost in the balance sheet with no recognition of fair value changes.
Fair value through other comprehensive income	The business model is achieved by both holding the asset to collect the contractual cash flows and by selling financial assets. In addition the cashflows are solely payments of principal and interest and the cashflows arise on specified dates.	Recognised at fair value in the balance sheet with fair value changes recognised in other comprehensive income and then reclassified to profit or loss on derecognition.
Fair value through profit or loss	Residual category that may also be used to reduce or eliminate an accounting mismatch.	Recognised at fair value in the balance sheet with fair value changes recognised in profit or loss.

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An entity may have more than one business model in some cases; for example, it may have one portfolio which is held to collect contractual cash flows and one which is held to be sold.

Reclassification between categories is only permitted when an entity changes its business model for managing financial assets. Reclassification is expected to occur only very rarely.

Recognition and measurement – financial liabilities

The recognition and measurement requirements for financial liabilities are largely unchanged from IAS 39 with most financial liabilities being measured at amortised cost. For those liabilities that are held for trading or where the option is taken to measure at fair value through profit or loss changes in the fair value attributable to changes in own credit risk will be recognised in other comprehensive income and not subsequently reclassified to profit or loss.

Impairment

IFRS 9 replaces the incurred loss model used in IAS 39, where impairments were only recognised when they occurred, with an expected loss model where expected losses are provided for. To measure impairment IFRS 9 introduces a three stage approach to measuring impairments as follows:

Stage One Initial recognition (unless credit impaired)	Recognise 12 month expected credit losses	Interest revenue on gross carrying amount
Stage two Significant increase in credit risk	Lifetime expected credit losses	Interest revenue on gross carrying amount
Stage three Non-performing (credit impaired)	Lifetime expected credit losses	Interest revenue on net carrying amount

The standard does introduce a simplified approach for trade receivables and contract assets that arise from transactions within the scope of IFRS 15 and for lease receivables. Under the simplified approach provision should be made for the estimated lifetime equivalent credit losses. In practice this will mean that provisions will be made earlier, probably based on historic experience, as opposed to waiting for evidence of impairment (such as a customer entering administration). As an example of the difference:

Receivables aging	Receivables \$'000	Historic loss estimate %	IFRS 9 provision \$'000	IAS 39 provision \$'000
1-30 days	600	0.5	3	-
31-90 days	400	0.75	3	-
90 days +	150	4	6	-
Customers in administration	10	100	10	10
Total provision			22	10

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Hedge accounting

As with IAS 39 hedge accounting remains an accounting policy choice under IFRS 9 though the ability to voluntarily revoke a hedging designation, available under IAS 39, has been removed. In general the requirements for hedge accounting have been relaxed, principally by relaxing the requirements around hedge effectiveness (including the requirement for this to be within 80%–125%). Whilst IFRS 9 makes it easier to qualify to use hedge accounting the underlying accounting for hedged transactions is very similar.

Jamaican Banking Sector

Under IFRS 9 a financial asset is credit-impaired when one or more events have occurred that have a Detrimental impact on the expected future cash flows of the financial asset. It includes observable data that has come to the attention of the holder of a financial asset about the following events:

- significant financial difficulty of the issuer or borrower;
- a breach of contract, such as a default or past-due event;
- the lenders for economic or contractual reasons relating to the borrower's financial difficulty granting the borrower a concession that would not otherwise be considered;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for the financial asset because of financial difficulties; or
- the purchase or origination of a financial asset at a deep discount that reflects incurred credit losses.

Why will impairment rise for many Jamaican banks?

There are three (3) main reasons, we can anticipate higher impairment Cost for Banks:

- Banks will provide for the lifetime expected credit loss of exposures that have declined in creditworthiness but not yet incurred a loss.
- IFRS 9 requires banks to recognize future losses immediately and hence Banks will need to develop Effective Credit Management skills and be able to manage problem accounts.
- Banks are expected to develop probability-weighted loss estimates against a range of macroeconomic scenarios. This is likely to result in a more conservative view of impairment in many cases. The ability to fully understand Micro economic indicators will be vital

What is the regulatory capital impact?

Regulatory capital resources are driven by shareholder distributions and profits, the latter of which incorporates credit impairment charges. So impairment acts as a drag on capital adequacy.

A rise in impairment inevitably depletes the capital adequacy of banks and affect Profitability

Making the CECL Transition



Governance and Oversight

Understanding risk management practices surrounding the development, execution, and maintenance of the CECL model. This includes established roles and responsibilities of the board and senior management, as well as policies and procedures in place to articulate the expectations of the CECL model and ongoing execution of the model.

Enabling Technology

Understanding the existing systems, including the capabilities and limitations of those systems that may support the execution of the CECL model. This includes source systems, data warehouses, modeling systems, financial statement spreading software, and vendor technology specially designed for CECL.

Risk Identification

Understanding portfolio characteristics and drivers of portfolio performance, including lending attributes, loan structures, prepayment risks, and changes in the macroeconomic environment. This component will enable the organization to appropriately segment and model the portfolios based on common drivers of risk.

Data Inventory

Understanding the availability and limitations of data required to develop and maintain an effective CECL model. This includes the reliability and accuracy of data elements in addition to the historical time horizon of data availability.

Resource Capabilities

Understanding the capabilities and limitations of the human resources identified to develop and execute on the CECL model.



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