

Financial instruments – the complete standard

Fundamental changes call
for careful planning

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IN THE HEADLINES

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“The new standard is going to have a massive impact on the way banks account for credit losses on their loan portfolios. Provisions for bad debts will be bigger and are likely to be more volatile.”

– Chris Spall,
KPMG’s global IFRS financial instruments leader

Overhaul of financial instruments accounting substantially complete

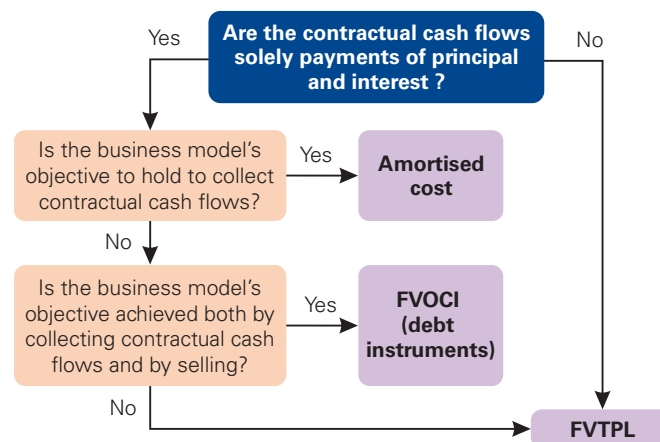
Implementation efforts for IFRS 9 *Financial Instruments* can finally begin in earnest now that the IASB has issued its completed standard. After long debate about this complex area, the standard’s release substantially completes a project launched in 2008 in response to the financial crisis.

The new standard includes revised guidance on the classification and measurement of financial assets, including a new expected credit loss model for calculating impairment, and supplements the new general hedge accounting requirements published in 2013.¹

¹ The new general hedge accounting requirements were discussed in our publication: [In the Headlines: Hedge accounting moves closer to risk management](#), issued in November 2013.

Classification and measurement

Although the permissible measurement bases for financial assets – amortised cost, fair value through other comprehensive income (FVOCI) and fair value through profit and loss (FVTPL) – are similar to IAS 39 *Financial Instruments: Recognition and Measurement*, the criteria for classification into the appropriate measurement category are significantly different. Embedded derivatives are no longer separated from financial asset hosts; instead, the entire hybrid instrument is assessed for classification as per the diagram below.



In addition, for a non-trading equity instrument, a company may elect to irrevocably present subsequent changes in fair value (including foreign exchange gains and losses) in OCI. These are not reclassified to profit or loss under any circumstances.

If classifying a financial asset at amortised cost or at FVOCI would create an accounting mismatch, a company can make an irrevocable choice to classify it at FVTPL if that would reduce the mismatch.

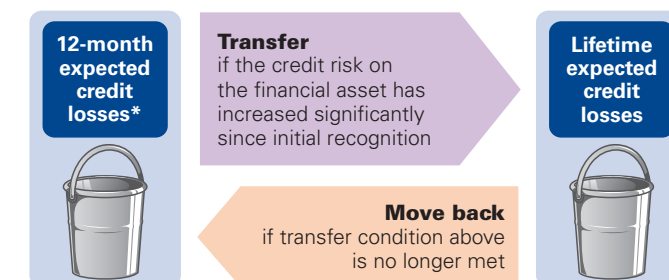
For debt instruments measured at FVOCI, interest revenue, expected credit losses and foreign exchange gains and losses are recognised in profit or loss in the same manner as for amortised cost assets. Other gains and losses are recognised in OCI and are reclassified to profit or loss on derecognition.

For the classification and measurement of financial liabilities, IFRS 9 retains almost all of the existing requirements from IAS 39. However, the gain or loss on a financial liability designated at FVTPL that is attributable to changes in its credit risk is usually presented in OCI; the remaining amount of change in fair value is presented in profit or loss.

Impairment

The new impairment model is similar to the model proposed in 2013.² IFRS 9 replaces the ‘incurred loss’ model in IAS 39 with an ‘expected credit loss’ model, which means that a loss event will no longer need to occur before an impairment allowance is recognised. The standard aims to address concerns about ‘too little, too late’ provisioning for loan losses, and will accelerate recognition of losses.

In general, the expected credit loss model uses a dual measurement approach, as follows.



* 12-month expected credit losses are defined as the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date.

If the credit risk of a financial asset has not increased significantly since its initial recognition, the financial asset will attract a loss allowance equal to 12-month expected credit losses. If its credit risk has increased significantly, it will attract an allowance equal to lifetime expected credit losses, thereby increasing the amount of impairment recognised. However, the standard does not define what is meant by ‘significant’ – so judgement will be needed to determine whether an asset should be transferred between these categories.

The new model will apply to financial assets that are:

- debt instruments recognised on-balance sheet, such as loans or bonds; and
- classified as measured at amortised cost or at FVOCI.

It will also apply to certain loan commitments and financial guarantees.

A simplified approach will be available for certain trade and lease receivables and for contract assets. Special rules will apply for assets that are credit-impaired on initial recognition.

² *Financial Instruments: Expected Credit Losses*, issued in March 2013.

	Judgements – new complexities and wider scope	New systems and processes	Equity, regulatory capital and covenants may be affected	Impact on KPIs and volatility
Classification and measurement of financial assets	<p>The implementation of a business model approach and the solely principal and interest criterion may require judgement to ensure that financial assets are classified into the appropriate category. Deciding whether the solely principal and interest criterion is met will require assessment of contractual provisions that do or may change the timing or amount of contractual cash flows.</p>	<p>New processes will be needed to allocate financial assets to the appropriate measurement category.</p> <p>In addition, companies that have already applied, or are planning to early apply, IFRS 9 (2009) or IFRS 9 (2010) may have to re-engineer the conversion process to take into account the new requirements of the standard on the classification and measurement of financial assets.</p>	<p>The way in which a company classifies financial assets could affect the way its capital resources and capital requirements are calculated. This may affect banks and other financial services companies that have to comply with the Basel capital requirements or other national capital adequacy requirements.</p>	<p>The standard may have a significant impact on the way financial assets are classified and measured, resulting in changes in volatility within profit or loss and equity, which in turn is likely to impact key performance indicators (KPIs).</p> <p>However, the own credit requirements for financial liabilities will help to reduce profit or loss volatility, which may be an incentive to early adopt these requirements.</p>
Impairment	<p>Estimating impairment is an art rather than a science. It involves difficult judgements about whether loans will be paid as due – and, if not, how much will be recovered and when. The new model – which widens the scope of these judgements – relies on companies being able to make robust estimates of:</p> <ul style="list-style-type: none"> • expected credit losses; and • the point at which there is a significant increase in credit risk. <p>For this purpose, companies will need to decide how key terms such as ‘significant increase’ and ‘default’ will be defined in the context of their instruments.</p> <p>The measurement of expected credit losses should reflect reasonable and supportable information that is available without undue cost or effort and that includes historical, current and forecast information.</p>	<p>The new model is likely to have a significant impact on the systems and processes of banks, insurers and other financial services companies, due to its extensive new requirements for data and calculations. In addition, all companies with trade receivables will be affected, but the impact is likely to be smaller and certain simplifications are available.</p> <p>Expanded data and calculation requirements may include:</p> <ul style="list-style-type: none"> • estimates of 12-month and lifetime expected credit losses; • information and data to determine whether a significant increase in credit risk has occurred or reversed; and • data for extensive new disclosure requirements. 	<p>The initial application of the new model may result in a large negative impact on equity for banks and, potentially, insurance and other financial services companies. It may also affect covenants. In addition, the regulatory capital of banks may be impacted. This is because equity will reflect not only incurred credit losses but also expected credit losses.</p> <p>The impact on a company may be substantially influenced by:</p> <ul style="list-style-type: none"> • the size and nature of its financial instrument holdings and their classification; and • the judgements it makes in applying the IAS 39 requirements and will make under the new model. 	<p>Credit risk is at the heart of a bank’s business, and is an important element of an insurer’s business. Accordingly, the standard is likely to have a significant impact on the KPIs of banks, insurers and similar companies.</p> <p>The new model is likely to introduce new volatility because:</p> <ul style="list-style-type: none"> • credit losses will be recognised for all financial assets in the scope of the model – rather than only for those assets for which losses have been incurred; • external data used as inputs may be volatile – e.g. ratings, credit spreads and predictions about future conditions; and • any move from a 12-month to a lifetime expected credit loss measurement may result in a big change in the corresponding allowance.
Next steps	<p>Companies will need to develop appropriate methodologies and controls to ensure that judgement is exercised properly and consistently throughout the organisation, and supported by appropriate evidence.</p>	<p>Companies may have to design and implement new systems and databases and related internal controls. Banks that plan to use data already captured for capital requirements under the Basel framework for expected credit loss calculations will need to identify differences between the two sets of requirements.</p>	<p>Companies should assess the impact and develop a plan to mitigate any negative consequences. The implementation plan should involve discussions with analysts, shareholders, regulators and providers of finance.</p>	<p>As well as understanding these impacts and communicating them to key stakeholders, banks should factor the new requirements into their stress testing, to ensure that potential impacts under adverse scenarios can be properly understood and addressed.</p>

No convergence with US GAAP

The project to revise accounting for financial instruments started as a joint project of the IASB and FASB, but the FASB decided to continue in a different direction to the IASB. As a result, companies applying both US GAAP and IFRS in their financial reporting will be required to implement different guidance – which could increase the costs of implementation and will result in lack of comparability.

Effective date

The standard will be effective for annual periods beginning on or after 1 January 2018, and will be applied retrospectively with some exemptions. Early adoption is permitted. The restatement of prior periods is not required, and is permitted only if information is available without the use of hindsight.

Next steps

Preparing for the far-reaching impacts of these changes may take considerable effort. Companies – especially in the financial sector – need to start assessing the possible impacts now, and begin planning for transition, to understand the time, resources and changes to systems and processes that are needed.

Find out more

For more information on the standard, please go to the [IASB press release](#), or speak to your usual KPMG contact.

Timeline³



24 July 2014:
Standard published



1 January 2018:
Effective date (early adoption permitted)



31 December 2018:
First annual financial statements in which the standard applies

³ Assumes a 31 December year end.