CASEWARE

UNDERSTANDING AND DEALING WITH IFRS 9

A CaseWare eBook

CONTENTS

INTRODUCTION

For entities reporting under IFRS or FRS 101, December 31, 2018 marked the end of the first year in which the new IFRS 15 standard applied.

Although work towards IFRS 9 Financial Instruments was underway before the financial crisis, it was accelerated after the crisis in response to concerns that financial institutions were too slow to recognise loan losses.

As the standard governs financial assets, it will undoubtedly be financial institutions that see the largest impact from the changes.

However, the new standard will also have an impact across many other sectors, particularly due to the changes surrounding bad debt provisioning.

Most parts of IFRS 9 became mandatory for all companies with accounting periods beginning on or after January 1, 2018.

Some companies with shorter accounting periods may already be incorporating the changes into their financial statements, while other entities can choose to early adopt the new standard.

In this eBook we examine the changes introduced under IFRS 9, outline the challenges and explain how accounting software can help those reporting under the new standard.

IFRS 9 – THE MAIN CHANGES

IFRS 9 replaces IAS 39 Financial Instruments: recognition and measurement and sets out the accounting requirements for financial instruments, including classification and measurement, impairment and hedge accounting.

Of these, it is the change in the requirements for impairments that is the most fundamental and also that is most likely to apply to companies outside the financial services sector. IFRS 9 introduces a new expected credit loss (ECL) model, which replaces the incurred loan loss model of IAS 39.

Previously, companies only needed to account for impairments that had already been incurred. Under IFRS 9 they will need to account for future impairments.

The effect of the new model will be to increase the need for loan loss provisions across all sectors, particularly as trade receivables can be considered financial instruments.

There are two different approaches to the ECL model. The full model involves three stages to determine the amount of ECL to recognise. The first stage is where there is no change in the credit risk of a financial asset. In this scenario, companies must make provisions for any potential shortfalls that could occur in the first 12 months.

IFRS 9 – THE MAIN CHANGES (CONTINUED)

The second stage is when there is a 'significant' increase in the credit risk and companies must then recognise lifetime ECL, however, interest continues to be recognised on a gross basis.

The third stage is when an asset is credit impaired. In this scenario, companies must recognise lifetime ECL and recognise interest only on a net basis.

There is a simplified approach for trade receivables, however it is still forward-looking and because it means calculating lifetime ECL from the start, it may involve provisioning for greater expected losses and therefore be unattractive to many firms.

The standard also applies to inter-company receivables, but these are subject to the full three-stage model and cannot use the simplified approach.

OTHER CHANGES

IFRS 9 also alters the way companies are required to classify and measure financial assets. There are three categories of measurement: amortised cost, fair value through other comprehensive income (FVTOCI) and fair value through profit or loss (FVTPL).

Initially, companies should value financial assets at fair value, similar to IAS 39. However, IFRS 9 changes the way entities measure financial assets after that initial recognition.

To determine which classification to give debt instruments, companies need to consider both their business model and the SPPI (solely payments of principal and interest) test. The latter means the debt instrument is made up solely of principal and interest, with no other components.

If a company's business model is 'hold to collect', meaning the primary purpose of the financial asset is to generate cash flows, and if a financial asset also meets the SPPI test, then it should be recognised as an amortised cost. One example would be trade receivables.

Where a company's business model is 'hold to collect and sell', for example, bonds that may be held to earn interest and also realise cash upon sale, if the asset meets the SPPI test it should be recognised at FVTOCI.

OTHER CHANGES (CONTINUED)

Any other business models, or instruments that fail the SPPI test, for example, contracts with embedded derivatives, should be recognised at FVTPL.

All equity instruments should be valued using fair value – usually through profit or loss, though with some exceptions. Companies can choose to recognise an equity instrument using FVTOCI if the instrument is not held for trading purposes. However, they cannot later recycle this via profit or loss when the instrument is sold.

When it comes to financial liabilities, IFRS 9 is broadly the same as IAS 39, apart from the recognition of a company's own credit risk. Under IFRS 9 changes in an entity's own credit risk must be recognised as FVTOCI rather than FVTPL.

IFRS 9 also provides changes to hedge accounting rules, with most corporates seeing the changes as positive as they allow more flexibility than the old standard. For this reason, more entities may begin to use hedge accounting going forward.

THE CHALLENGES

Particularly when it comes to impairments, the changes brought about by IFRS 9 mean companies will have to start assessing creditors in ways they have not had to before. This means compiling data that may not be easily accessible.

While financial institutions may have been the intended targets of the new standard, in some ways they will find it easier to adapt than corporate firms reporting under IFRS. There's an entire industry set up to help banks assess credit risk – there's less need for them to go into granular detail on clients when Moody's or Standard and Poor's has already done so and given them a credit rating.

But corporate firms are likely to find it more difficult to accurately assess the credit risk of firms they are supplying goods to. Indeed, following the collapse of unrated construction company Carillion in 2018, Moody's put out a report entitled, 'Non-financial companies — EMEA: Carillion's collapse highlights shortcomings in the accounting for reverse factoring'. The rating agency said it had "exposed shortcomings in the accounting for reverse factoring arrangements, a form of supply-chain finance".

Although IFRS 9 aims to increase transparency and comparability across sectors, there is still a large element of management judgement involved in assessing credit risk. There is no set definition of "significant increase in credit risk", and the standard requires firms to use "reasonable and supportable information that is available without undue cost or effort".

There are, however, a set of qualitative factors set out under IFRS 9 to guide firms. These include factors specific to the borrower, such as operating performance and credit rating, as well as general factors such as market and macroeconomic conditions. Companies should also take into account the past performance of borrowers in making their assessments.

TRANSITION OPTIONS

In the year of transition, the general requirement under IFRS 9 is that it must be applied retrospectively at the date of initial application.

IFRS 9 does not require restatement of previous periods, though entities can choose to do so if the restatements reflect all of the requirements of IFRS 9 and if it is possible without the use of hindsight.

If an entity does not restate, it must recognise the difference between the previous carrying amount and the new carrying amount at the time of initial application.

As the International Accounting Standards Board's macro hedge accounting project is not yet finalised, companies can choose to continue applying IAS 39's hedge accounting requirements until the project is complete. However, if a company wishes to apply the new standard to its hedge accounting it must apply it to all hedging relationships.

There is also an exception for firms where activities are predominantly related to insurance – these entities can choose to delay IFRS 9 adoption until 2021.

Firms are allowed to early adopt IFRS 9 so long as they adopt all requirements of the standard at the same time.

There is, however, an option for firms to choose to early adopt just the change to the recognition of own credit risk by recognising it as FVTOCI rather than FVTPL without adopting the rest of IFRS 9.

REPORTING

Because there's an element of judgement involved in measuring credit risk, IFRS 9 introduces new disclosures that provide information to help investors understand the key assumptions management has made in assessing credit risk.

There are also other new disclosures introduced by IFRS 9 in relation to financial instrument carrying values, credit losses and cash flow modifications.

At CaseWare we updated our AccountsAdvanced template with a host of new mapping codes to automate the disclosures within the financial statements so they are compliant with IFRS 9.

The new mapping codes will also populate multiple additional rows within existing notes and disclosures within accounting policies, with new help text located throughout the template to assist users in understanding how to cater for the reporting changes.

One of the reasons our IFRS template is popular with our clients is that we have invested a lot of time in developing a very flexible financial instruments note, one which is capable of coping with the huge variety of potential scenarios a client may have.

Our update is already live, so if you're working on a period start date from 2017 and want to early adopt, you'll be able to do so.

However, the new disclosures will only automate for periods commencing on or after 1 January 2018, so if you don't want to early adopt and are still finalising your financial statements for periods commencing prior to this date, you'll be able to do so without unwanted disclosures appearing.

Safeguards are also built in to restrict FRS 102 reporters from erroneously using the new mappings and disclosures within their financial statements.

CONCLUSION

We've invested a huge amount of time in developing and keeping our IFRS template up to date so that it's compliant with IFRS 9 and also IFRS 15, which came into force at the same time.

But IFRS 9 and IFRS 15 are simply the latest changes in standards that companies need to be aware of. Financial reporting standards are constantly changing – IFRS 16 is less than a year away and after that there will most certainly be something else to contend with.

We'll be integrating IFRS 16 later this year so that clients that wish to early adopt can do so. At CaseWare we maintain our software so it is not only up to date, but also ahead of any reporting changes.

As regulations continue to evolve, reporting using systems such as Word and Excel, which were never designed for such complex uses, is likely to become more and more burdensome.

Our IFRS template takes all the hassle out of reporting. CaseWare provides a very simple process for you to get the report that you want directly from your general ledger system, and is flexible enough that you can then change that report as you like.

If you haven't already, now is the perfect time to consider a more professional reporting solution.

Interested in streamlining and simplifying your financial reporting process?

CASEWARE

Sales & Enquiries
UK: **01622 355 200**
IE: **0818 333 981**

contact@caseware.co.uk

Technical Support
UK: **01622 355 250**
IE: **0818 333 980**

www.caseware.co.uk

CaseWare UK Ltd | County Gate 2,
Staceys Street, Maidstone, Kent, ME14 1ST