IFRS 9 Transition: Challenges and Way Forward

Abstract

The International Financial Reporting Standard 9 (IFRS 9) has a material impact on banks and financial institutions, not just from an IT system or process perspective, but also due to its effect on the profitability of the entity. In most jurisdictions, the standard will be applicable from January 1, 2018[1]. This paper gives an overview of the major areas of impact when an entity transitions from International Accounting Standard (IAS) 39 to IFRS 9. It also takes a closer look at the major challenges around classification, measurement, and impairment requirements specific to transition, and recommends best practices to address them.

Transition to IFRS 9: Background

The final version of 'IFRS 9: Financial Instruments' was issued by the International Accounting Standards Board (IASB) in July 2014. The standard provides detailed guidelines for accounting and reporting of financial instruments. IASB had taken up the project for replacing current accounting standard IAS 39, in response to demands from various stakeholders for a new standard that would be less complex and easier to apply, the global financial crisis of 2008, and recommendations of G20. IASB divided the project into three main phases:

- Classification and measurement of financial assets and financial liabilities
- Impairment methodology
- Hedge accounting

The IFRS 9 Transition Approach

IFRS 9 offers two transition approaches:

- Restate the relevant corresponding figures for the comparative period to reflect IFRS 9 requirements and recognize the resulting impact of transition in the opening retained earnings of the earliest period for which comparative figures are reported. This method facilitates easy comparison, but could mean more costs and effort.
- Do not restate comparative figures but adjust the opening retained earnings of the first IFRS 9 reporting year to reflect the cumulative effect of transition. This is less cumbersome as the entity can report the comparative period figures per the previous GAAP but significantly hampers comparability between the periods and entails additional disclosure requirements..

Under both methods, an entity is required to carry out detailed analysis and calculations for complying with IFRS 9 requirements with retrospective effect, that is, from the date of inception of financial instruments that are on the balance sheet of the entity on the transition date.

Challenges and Best Practices for Banks and Financial Institutions

Financial instruments account for the major part of total assets and liabilities of banks and financial institutions. The transition to IFRS 9 is likely to adversely impact the value of these

financial assets and liabilities appearing in the statement of financial position. The major areas where banks and financial institutions are likely to face challenges include:

- **Classification and measurement of financial assets:** Financial assets need to be reclassified on transition as amortized cost, fair value through profit or loss (FVTPL), or fair value through other comprehensive income (FVOCI) , based on an assessment of the business model and cash flow characteristics of each. For BFS entities that have a large number of non-standardized products, assessing the cash flow characteristics to determine whether the cash flows are 'solely payments of principle and interest' (SPPI) can be an area of concern as it may necessitate 'SPPI' testing at an instrument level. It also requires fresh assessment to determine whether a financial asset is to be designated at FVTPL or FVOCI on transition and takes away the option to measure at cost, unquoted equity instruments having no active market for an identical instrument. These requirements increase the volume of assets that need to be assessed or fair valued on transition. , thereby increasing the volume of assets that need to be fair valued. making fair valuation mandatory for these instruments.
  - **Systemic challenges:** Lack of standardization in documentation and multiple source systems or applications make it difficult to perform a standardized assessment. New fair valuation models would be required for unquoted equity shares and other unquoted instruments. Also, as a result of transition, more instruments might move into the fair value category (FVTPL/FVOCI), necessitating the enhancement of the fair valuation systems and processes.
  - **Best practices**
    - Artificial intelligence and robotics can be effectively used to handle the huge volume of instruments that would need to be subjected to the SPPI test.
    - Having centralized data for all financial instruments helps in running standardized assessment for SPPI test.
    - Analytical tools and models would help banks meet the requirements for fair valuation of additional asset classes.

- **Impairment Provisioning:** IFRS 9 moves the impairment requirements to an expected credit loss (ECL) model from the incurred credit loss model under IAS 39. This requires identification of the initial credit quality and continuous monitoring at every reporting date throughout the life of the asset, to determine whether the credit quality has deteriorated. This model places a huge burden on banks and financial institutions, because of the size of its impact. On transition, entities are required to assess all the assets for signs of significant deterioration in credit quality, unless they are already flagged as credit impaired. This is a massive exercise on transition, and is probably the most complex one and requires expert judgment. The assessment may be based on quantitative information, qualitative information, or a mix of both. ECL calculation also requires identification of the different macroeconomic factors which have a bearing on the expected credit losses, and their correlation to ECL.
  - **Systemic challenges:** Inadequate data, as well as lack of uniformity in the data makes it difficult to monitor significant deterioration in credit quality. Differences between Basel and IFRS 9 requirements with respect to ECL calculations, and non-availability of past data and models for determining forward looking estimates limit the usefulness of risk systems.
  - **Best Practices**
    - Aligning IFRS 9 impairment systems with the existing credit risk systems by building a common data dictionary, extending the risk systems to address IFRS 9 requirements and identifying and eliminating redundancy and duplication of processes between risk and finance would help in achieving efficiency in operations and savings in transition costs.
    - Creating models for different kinds of scenarios and asset classes considering the asset profile of the bank, data availability, and past experience would help build a transparent process for assessing significant deterioration in credit quality.
    - Banks that are implementing systems for Basel internal ratings based approach for capital adequacy can factor in the IFRS 9 requirements as well.

Conclusion

IFRS 9 has expanded the scope for digital technologies like analytics and artificial intelligence in financial reporting compliance. It also furthers the case for aligning risk and finance functions and leveraging the existing risk analytics, and related systems and processes, for IFRS 9 compliance. Such measures will help financial entities cut down the time and effort required for transition and post-transition business activities.

References

[1] IASB press release, IASB Completes Reform of Financial Instruments Accounting, July 24, 2014 http://www.ifrs.org/Alerts/PressRelease/Pages/IASB-completes-reform-of-financialinstruments-accounting-July-2014.aspx (24 July 2014), accessed August 2016

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