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IFRS 9 Financial instruments

Taking a closer look

Capital Markets and Accounting Advisory Services

September 2016

pwc

Taking a closer look

The IASB's new financial-instrument standard, IFRS 9, applies for years beginning on or after 1 January 2018 and introduces significant changes to classification and measurement, impairment and hedge accounting. Its impact is sure to reach far beyond finance to areas such as credit risk, systems, data, tax, internal audit and others. The time to act is now.

Some of the key changes are featured below:

Classification & measurement

IFRS 9 introduces a new model for classifying and measuring financial assets and liabilities and, in many cases, the required treatment will differ from IAS 39. For example, if you have complex financial instruments, externally regulated capital requirements or are sensitive to the potential impact that remeasurement could have on your income statement, careful analysis and planning can help to prevent headaches later on.
Key aspects of the new model include:

- Three categories for financial assets: fair value through profit or loss (FVPL), fair value through other comprehensive income (FVOCI) and amortised cost
- A two-part test for classifying debt instruments depending on the related business model and cash-flow characteristics
- FVPL is a residual category
- The option to use FVPL if it eliminates or substantially reduces a measurement inconsistency (i.e. accounting mismatch)
- Changes in own-credit risk are recognised under OCI for financial liabilities designated at FVPL

Impairment

IFRS 9's new impairment model is a move away from IAS 39's incurred-credit-loss approach towards an expected-credit-loss model. Consequently, impairment losses are likely to be recognised earlier and, for entities with significant lending activities, an overhaul of related systems and processes will be needed. Key aspects of the new model include:

- A three-stage general impairment model for financial assets that are performing, underperforming or non-performing
- A stage assessment is based on relative (rather than absolute) credit risk compared to credit risk at initial recognition
- Impairment is based on expected (rather than incurred) losses calculated using potential credit loss and probability of default
- Practical expedient to use lifetime expected losses for trade receivables, contract assets and lease receivables held by non-financial institutions

Hedging

Less stringent quantitative testing requirements and a broader scope mean that IFRS 9's new hedging guidance will be a welcome change for most. While all entities applying hedge accounting will require updates to their documentation and processes, those that previously didn't qualify for hedge accounting may find that they now do under IFRS 9. Key aspects of the new model include:

- Simplified requirements for quantitative analysis and closer alignment to the entity's risk-management activities
- The ability to hedge risk components of non-financial items (e.g. greater ability to hedge commodity or other risk exposures)
- Flexibility in hedging groups of items (i.e. net positions)
- A separate (ongoing) project to address open portfolio (macro) hedging

With less than two years remaining, what should audit committees and boards of directors be asking about the transition to IFRS 9?

1. What is our current state of implementation? In particular,

- Do we have a steering committee, which functions are represented on it, who is leading the initiative (e.g. accounting policy, credit or other) and why?
- How do budget and plans compare to those of our competitors, and do we understand any differences between what we need and what our peers are expected to spend?

2. What's our transition timeline, what are the key milestones, and are we on track?

3. What is our plan to win the "War on Talent"? Our competitors and service organisations will all be seeking to secure specialist skills and knowledge; what will we do?

4. What is our process for managing the IFRS 9 story? The market will be comparing how we are doing against to our competitors, so what are we doing to be prepared and proactive in this space?

5. How will we validate the appropriateness of new models and inputs in time for transition and thereafter; and what governance process will we put in place?

6. What key new data elements are being introduced to the financial reporting process and how will they be vetted?

7. What are our plans for parallel testing and disclosures during the transition period, and how will we approach the subjective areas of the forward-looking data and management overlays?

8. Have we considered whether we can use this change to enhance our existing credit risk, systems, or data management?

9. How have we assessed the following:

- the impact to our regulatory-capital position;
- what our regulators and supervisors will expect;
- the consequences for our financial performance;
- the potential impacts on our compensation programmes;
- budgeting/planning processes; and
- other unintended consequences as a result of the financial and regulatory impacts

10. What are our top three risks for the implementation and how are we addressing them?

What are the next steps?

2016 ▸ ▸ ▸ ▸ 2016 ▸ ▸ ▸ ▸ 2016/2017 ▸ ▸ 2017 ▸ ▸ ▸ ▸ 2018

Impact Assessment

- Programme governance
- Financial impact assessment
- Gap analysis and impact on downstream systems
- Implementation roadmap

Design and build

- Target operating model
- Roles and responsibilities
- Build the methodology
- Build or integrate data, systems, and controls
- Consider other impacts on the business

Implementation

- Implement target operating model
- Model testing
- Data, systems, and controls testing
- Systems integration
- Reporting and disclosure

Deployment (Parallel Run)

- Parallel run
- Impact analysis
- Reporting
- Deployment into full production starting 2018

GO Live

Training

Stakeholder Management/Develop a communication Plan

Program Management

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