

Event report

Accounting Standards for Financial Instruments: Is IFRS 9 designed to confuse?

30 May 2018 | 13:00 to 14:30 | Place du Congrès 1, Brussels 1000

International Financial Reporting Standards (IFRS) 9, issued by the International Accounting Standards Board (IASB) on 24 July 2014 and came into effect on 3 January 2018, addresses multiple aspects of accounting for financial instruments, namely classification and measurement, impairment of financial assets and general hedge accounting. The objective is to establish common and harmonised principles for the reporting of financial assets and financial liabilities. The new standard requires companies to apply a forward-looking approach (based on the expected credit loss model), enhances the risk management judgement and introduces additional disclosure requirements. While IFRS 9 creates opportunities to corporations and investors, it also poses challenges. For example, it has been difficult to achieve the international comparability that the standards attempt to establish, as each country follows its own set of rules. Synchronising accounting standards across the globe is an ongoing and challenging process.

- Are firms building on existing models and infrastructure, or are they redeveloping new models and segmentation?
- Are limitations on data availability and quality causing implementation challenges?
- How does IFRS 9 affect banks and non-bank financial intermediaries, in particular their investment strategies and lending mix (lower appetite for volatile sectors, higher risk assets and long maturities)?
- What are the implication of Brexit for UK financial reporting? Can the UK expect to continue to exercise a level of influence on international standard-setting?

Speakers:

Zsuzsanna Schiff, Manager, Auditing and Reporting, Financial Services Faculty, ICAEW

Jannis Bischof, Professor of Accounting, University of Mannheim & Member of EFRAG Financial Instruments Working Group

Pantelis Pavlou, IFRS Expert - Impairments, KBC Group

Emmanuel Dooseman, Partner, Global Head of Banking, Mazars

Moderator: **Karel Lannoo**, CEO, CEPS and General Manager, ECMI

Summary: The International Financial Reporting Standards (IFRS) 9 date back to the 2008 financial crisis and, in particular, the ensuing criticism about fair value accounting. After the International Accounting Standards Board (IASB) changed the rules in October 2008, political pressure – coming mainly from EU institutions – grew to further reduce the use of fair values on bank balance sheets. In response, IFRS 9 is introducing a new system for the classification and measurement of financial assets (based on the cash flow characteristics of the instrument and the firm’s business model behind the investment).

Yet it is unclear whether the new approach will actually reduce the use of fair values, in the view of **Jannis Bischof**. Early evidence shows that the impact of the new classification scheme is likely to vary substantially across firms. For example, for banks with a business model that is more geared to capital market transactions and investments in structured securities, the new rules tend to require even more fair value accounting than former International Accounting Standards (IAS) 39 did.

At the same time, IFRS 9 is also a response to regulatory concerns about the ‘too-little-too-late’ issues with the former incurred-loss model required by IAS 39. Evidence from the financial crisis suggests that the greatest portion of loan losses had to be recognised in 2009; rather late into the crisis because bank capital was also dampened by other losses and much too late for any meaningful corrective action.

Building on that, IFRS 9 replaces this model with a modified Expected Credit Loss (ECL) approach that allows for the earlier recognition of greater amounts of loan losses. While theory predicts significant economic benefits of the new approach (e.g. less procyclicality and more market discipline), the new accounting model comes at the cost of significantly greater reliance on data and on management judgement in setting up the loan loss forecasts. It will be left for future research to assess the costs and benefits of the new rules.

Concerning the implementation of the new standard, which is one of the biggest issues for **Emmanuel Doseman**, this started well in advance of its formal endorsement in the EU, as banks realised the challenges it would bring. This is mainly because the ECL model has some common features with prudential requirements; banks thus started by building on existing processes and models. Having said that, IFRS 9 ECL is different, and a number of changes and adaptations are needed. Its forward-looking approach, combined with its data-centric nature, pose considerable challenges for the industry.

For **Pantelis Pavlou**, IFRS 9 comes with a number of conceptual challenges, in addition to the technical implementation ones, because it has many areas that require individual judgement. For example, the assessment of a significant increase in credit risk (SICR); the use of forward-looking information; and the period over which life-time ECL are calculated for specific financial assets all need careful consideration. These areas make the analysis of results and benchmarking across the industry difficult as analysts have to read through a lot of granular disclosures to understand the numbers.

Regarding Brexit and its policy implications for financial reporting, the future endorsement of IFRS is a critical matter, as **Zsuzsanna Schiff** underlined. Trust in the financial reports of listed companies underpins investor confidence in capital markets, as well as economic growth and stability. The UK should therefore continue to adhere to internationally accepted standards, as the IFRS provides a high quality universal reporting language with multiple benefits.

There is, nevertheless, some ambiguity about what will happen during an expected transition period following the UK's departure from the EU. One possible option would be to introduce some form of UK endorsement mechanism and endorsement criteria. In this case, the design of such a mechanism should not only draw on the experience of Europe, but also that of Australia and Canada, for example, where the process is generally seen as 'light touch' or uncomplicated, with a strong emphasis on the ongoing assessment of IASB due process.

Generally speaking, it still remains unclear whether the new standard will bring more transparency to markets and address the drawbacks of its predecessor, or whether it will lead to fragmentation, divergence and inconsistency. One way or another, it is widely acknowledged that there is much room for improvement with respect to its implementation. The panel concluded that more time is needed to fully understand its impact on financial reporting and on the real economy.