Implementing IFRS 9: a guide for lessors

Patrick O'Driscoll

IFRS 9 brings together the classification and measurement, impairment and hedge accounting sections of the IASB's project replacing IAS 39 Financial Instruments: Recognition and Measurement and all previous versions of IFRS 9. IFRS 9 is effective for annual periods beginning on or after 1 January 2018 and will have a significant impact on lessors, specifically in relation to the following areas:

1. *Classification and measurement*
2. *Impairment of financial assets*
3. *Hedge accounting*
4. *Debt modification clarification*

Classification and measurement

IFRS 9 introduces a new model for classifying financial assets. In respect of financial liabilities, all IAS 39 requirements have been carried forward to IFRS 9.
The standard introduces principle-based requirements for the classification of financial assets, using the following four measurement categories:

i. Debt instruments at amortised cost
ii. Debt instruments at fair value through OCI (FVOCI) with cumulative gains and losses reclassified to profit or loss upon derecognition
iii. Debt instruments, derivatives and equity instruments at FVPL
iv. Equity instruments designated at FVOCI with no recycling of gains and losses upon derecognition

The classification of financial assets is summarised in the illustration below

Classification of financial assets

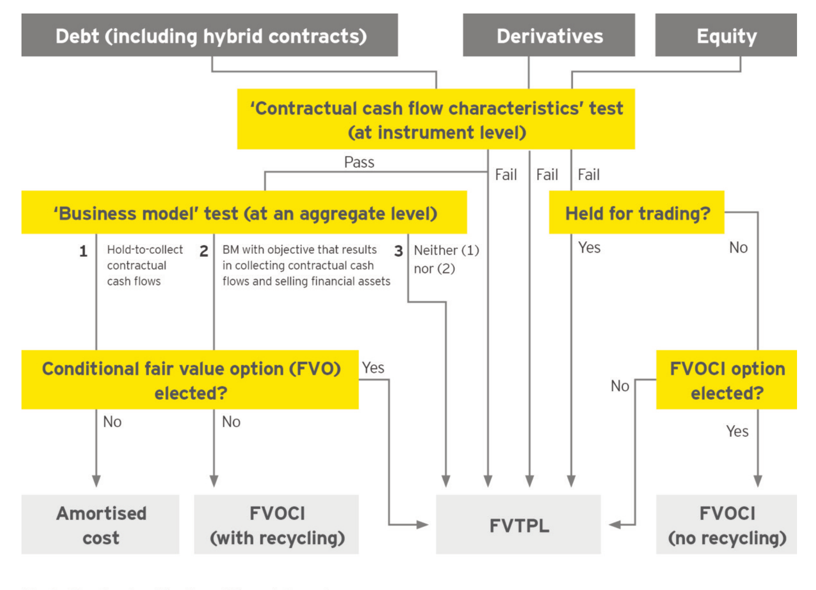


Illustration 1 - classification of financial assets

The typical financial assets held on the balance sheet of lessors impacted by IFRS 9 include the following;

Name	IAS 39 classification	IFRS 9 classification
Unrestricted and restricted cash	Amortised cost	Amortised cost
PPN assets	Amortised cost	FVTPL
Derivative financial assets	FVTPL	FVTPL
AFS assets/Investments at FVOCI	Available for Sale	FV through OCI
Amounts due from related parties	Amortised cost	Amortised cost
Trade receivables	Amortised cost	Amortised cost
Loans/Notes receivable*	Amortised cost	Amortised cost

**Assuming collecting principal and interest only.*

The above assets held at amortised cost under IAS 39 should, based on the typical fact pattern of these assets, meet the business model test, in that they are held to collect contractual cashflows and these cashflows are solely payments of principal and interest ('SPPI'). Hence, lessors will continue to account for these assets at amortised cost, with the exception of PPN assets.

PPN assets typically entitle the holder to the residual returns in a structure in exchange for the most subordinate class of debt in a structure and as such are akin to equity returns. As a result, PPN assets will be measured at FVTPL as the above conditions (SPPI) of the business model test are not met. Many groups will include these assets as part of their structure. In the majority of instances, given the structuring of PPN assets by most lessors through the group but not externally, the impact of this change in measurement will disappear on consolidation. This will still need to be considered in the standalone financial statements of the entity holding the PPN assets, or indeed in the company balance sheet of the parent if the parent company balance sheet requires inclusion in the financial statements.

The assets accounted for as "AFS" under IAS 39 will typically be categorised as FV through OCI under the business model test. This new category has similar objectives to the IAS 39 category, the objective being collecting contractual cash flows and selling financial assets with those contractual cashflows meeting the SPPI test. Those assets which were previously classified as FV remain being classified as FV.

Impairment of financial assets

The new impairment model in IFRS 9 addresses the IASB's key concern that the "incurred loss" model in IAS 39 contributed to the delayed recognition of credit losses which arose as a result of the financial crisis. Therefore, the new impairment requirements are based on a forward-looking expected credit loss (ECL) model.

IFRS 9 defines credit loss as the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e., all cash shortfalls), discounted at the original EIR. It goes on to define ECLs as 'the weighted average of credit losses with the respective risks of a default occurring as the weights'. The expected cash flows will include cash flows from the sale of collateral held or other credit enhancements that are integral to the contractual terms.

In applying the IFRS 9 impairment requirements, an entity needs to apply one of the following approaches:

1. The general approach
2. The simplified approach
3. The credit adjusted approach

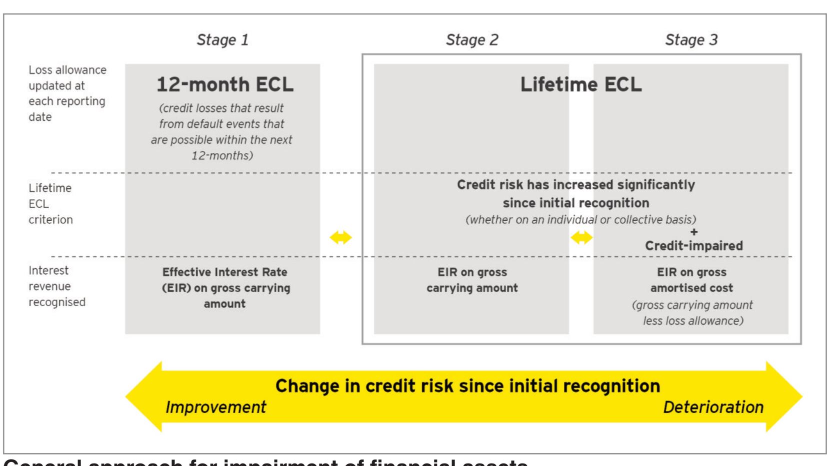
The credit adjusted approach will most likely not apply to lessors and has not been discussed in this paper. The application and impact of the remaining two approaches for lessors have been discussed below.

General Approach

The general approach will be applied to all loans and receivables not covered by another approach. In practice for lessors, it is not expected that cash will be considered for impairment. Therefore, lessors will apply this approach to the following financial assets:

- Investment at FVOCI
- Amounts due from related parties
- Loans/ Notes receivable

Under the general approach, entities must recognise ECLs in two steps as illustrated below:



General approach for impairment of financial assets

For credit exposures where there has not been a significant increase in credit risk since initial recognition (i.e., 'good' exposures), entities are required to provide for credit losses that result from default events 'that are possible' within the next 12-months (a 12-month ECL – stage one in the illustration above). For credit exposures where there has been a significant increase in credit risk since initial recognition, a loss allowance is required for credit losses expected over the remaining life of the exposure, irrespective of the timing of the default (a lifetime ECL – stages two and three in the illustration above). The loss allowance reduces the carrying amount of the financial asset in all three stages described above.

So what does this mean for lessors in practice and how can a lessor identify the impairment whether a 12 month of lifetime ECL should be applied?
The first consideration is to assess what in practice would evidence a significant change in credit risk. Firstly any arrears greater than 30 days past indicate a movement to stage two. For a lessor holding assets with counterparties who have credit ratings (or where a counterparties liabilities themselves have a rating), a deterioration of the credit rating of the counterparty would indicate a movement to stage two.
Other indicators include:

- Existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations.
- An actual or expected significant change in the operating results of the borrower.
- An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower.
- Significant changes, such as reductions, in financial support from a parent entity.
- Significant changes in internal price indicators of credit risk as a result of a change in credit risk since inception.

In many instances there may be limited information available for a counterparty. The standard is clear that in certain circumstances, qualitative and non-statistical quantitative information may be sufficient to determine that a financial asset has met the criteria for the recognition of lifetime ECLs.

Once a lessor has assessed whether 12 month or lifetime ECL is appropriate how is the impairment charge calculated?
Many large financial institutions already have sophisticated expected loss models and systems in place for capital adequacy purposes, capturing data such as the probability of default (PD), loss given default LGD) and exposure at default (EAD).

We do not expect many lessors to have models and systems in place that capture such information. For financial instruments that are rated, for example, listed bonds, an entity may be able to use historical default rates implied by the external credit ratings. Another possibility is the use of credit default swap (CDS) spreads and bond spreads. In addition, an LGD of 60% is commonly assumed for listed corporate bonds.

Measurement of ECLs is even more difficult and judgmental if the financial asset is not rated and no market observable information is available. In that case, the entity would be required to estimate the reasonably possible loss scenarios and the respective probabilities, to arrive at an unbiased and probability-weighted amount that reflects the time value of money. This estimation should be based on reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

The ECLs in respect of financial assets held at amortised cost are recognised as a loss allowance against the gross carrying amount of the asset, with the resulting loss being recognised in profit or loss.

For debt instruments measured at FVOCI, the ECLs do not reduce the carrying amount in the statement of financial position, which remains at fair value. Instead, an amount equal to the allowance that would arise if the asset was measured at amortised cost is recognised in OCI as the 'accumulated impairment amount'. This means that impairment losses (or reversals) are charged to profit or loss with a corresponding entry in OCI.

Collateral is not considered when assessing whether a financial asset is classified as stage one, two or three; however, collateral can be considered when considering what impairment provision should be applied.

Simplified Approach

The simplified approach is required for certain qualifying trade receivables, IFRS 15 contract assets and lease receivables. IFRS 9 allows the use of a provision matrix as a practical expedient for determining ECLs on trade receivables. Many corporates may already use a provision matrix to calculate their current impairment allowance, but they will now be required to consider how they can incorporate forward-looking information into their historical customer default rates. Entities would also need to group receivables into various customer segments that have similar loss patterns (e.g. by geography, product type, customer rating or type of collateral).

For lessors, their financial assets under this approach will have significant collateral in the form of security deposits and maintenance reserves (for trade/lease receivables).

The impairment disclosures have been expanded significantly in comparison to the existing disclosures required under IFRS 7. The objective of the new disclosures is to enable users to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

The disclosures should provide:
- Information about the entity's credit risk management practices and how they relate to the recognition and measurement of ECLs.
- Quantitative and qualitative information that allows users of financial statements to evaluate the amounts in the financial statements arising from ECLs.
- Information about the entity's credit risk exposure, i.e., the credit risk inherent in its financial assets and commitments to extend credit, including significant credit risk concentrations.

Hedge Accounting

The objective of IFRS 9 for hedge accounting is to reflect the effect of an entity's risk management activities in the financial statements. This includes replacing some of the arbitrary rules with more principles-based requirements and allowing more hedging instruments and hedged items to qualify for hedge accounting.

In general, for lessors, hedge accounting is non-complex and highly effective. We would not expect lessors to apply hedge accounting to relationships where hedge accounting was previously not allowed.

The following are the key changes to hedge accounting under IFRS 9:

- Hedge effectiveness testing is prospective only and can be qualitative depending on the complexity of the hedge. The 80-125% range is replaced by an objectives-based test that focuses on the economic relationship between the hedged item and the hedging instrument, and the effect of credit risk on that economic relationship.
- IFRS 9 allows risk components of non-financial items to be designated as the hedged item, provided the risk component is separately identifiable and reliably measureable. Under IAS 39, this was only possible for financial items or when hedging foreign exchange risk.
- IFRS 9 introduces the concept of costs of hedging. The time value of an option, the forward element of a forward contract and any foreign currency basis spread can be excluded from the designation of a financial instrument as the hedging instrument and accounted for as costs of hedging. This means that, instead of the fair value changes of these elements affecting profit or loss like a trading instrument, these amounts are allocated to profit or loss similar to transaction costs (which can include basis adjustments), while fair value changes are temporarily recognised in OCI.
- More designations of groups of items as the hedged item are possible, including layer designations and some net positions.

Debt modification

IFRS 9 provided a clarification on the treatment of modified debt. IAS 39 and IFRS 9 regard the terms of exchanged or modified debt as 'substantially different' if the net present value of the cash flows under the new terms (including any fees paid net of any fees received) discounted at the original effective interest rate is at least 10% different from the discounted present value of the remaining cash flows of the original debt instrument. This comparison is commonly referred to as 'the 10% test'.

Whilst IAS 39 and IFRS 9 do not say so explicitly, it seems clear that the discounted present value of the remaining cash flows of the original debt instrument used in the 10% test must also be determined using the original effective interest rate, so that there is a 'like for like' comparison. This amount should also represent the amortised cost of the liability prior to modification.

For entities applying IFRS 9, which is effective from 1 January 2018, the treatment of changes to the contractual cash flows of a financial liability that is not derecognised has been considered by both the Interpretations Committee and the IASB. Of particular relevance to them is the fact that IFRS 9 requires modification gains or losses to be recognised in profit or loss when the contractual terms of a financial liability measured at amortised cost are changed and those changes do not result in derecognition of the liability.

Historically, many lessors did not recognise this gain/loss on modified debt which under IFRS 9 has been clarified as required. As a result, any previous modification of a liability existing on the transition date of 1 January 2018 will have to be assessed to calculate the transitional impact as IFRS 9 is required to be applied retrospectively. This will be adjusted through opening retained earnings. Following transition, any gains/losses arising from debt modifications will be taken through the income statement.

Although the effect of IFRS 9 is not as great on non-financial entities, the impact of adopting IFRS 9 should not be underestimated. Should you have a question in relation to any of the points above please reach out to Pat O'Driscoll.

Patrick O'Driscoll is Aviation Finance Director, EY Financial Services.

Building a better working world