IFRS 9 *Financial Instruments* to take effect from 1 January 2018 (2/43/17)

IFRS 9 *Financial Instruments* is taking effect in a couple of months to replace the requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. The new standard will be mandatory for Latvian entities that prepare their financial statements to IFRS or whose parents require that financial information be prepared to IFRS for group reporting purposes. This article explores a number of areas where the new standard brings significant new features.

New features

The new standard not only changes the names of the financial asset categories but also modifies the approach to their classification. This will now depend on whether the asset is an equity instrument (e.g. shares in another company) or a debt instrument (e.g. a trade receivable, a finance-lease receivable, or a loan to a related party), on the company’s business model for holding those assets, and on the asset’s cash flows.

Instead of the current four categories, the new standard provides for three:

1) Financial assets at amortised cost:

- debt instruments held to collect all expected cash flows comprising the principal amount and interest charges only;

2) Financial assets at fair value with revaluation through other income (equity):

- debt instruments held to collect cash flows and sell these assets, with cash flows comprising the principal amount and interest charges only;
- equity instruments the company has elected to designate as such on initial recognition;

3) Financial assets at fair value with revaluation through profit and loss:

- debt and equity instruments held for trading;
- debt and equity instruments that fall into neither category above.

It is important to note that there are no significant changes to how financial liabilities are classified and measured.

Another area facing significant changes is the recognition of impairment losses. So far a loss was not recognised until after a loss event occurred, but the new model provides for recognising future expected losses. This means that the likelihood of a loss occurring and its size will have to be measured and an impairment loss recognised. Also, an impairment loss will have to be recognised on the initial recognition of an asset, meaning also earlier recognition of provisions.

The new approach to measuring impairment losses provides for regularly assessing each customer’s credit risk. The general impairment loss recognition principles are as follows:

- Losses expected in the next 12 months should be recognised on the initial recognition of financial assets;
- If a customer’s credit risk deteriorates significantly, then losses expected over the entire remaining life of the asset should be recognised for that customer;

- If credit risk continues to deteriorate and the customer becomes insolvent, the recognition of losses expected over the entire life of the asset should continue, and any interest revenue should be calculated on the asset's net value (i.e. initial value less total recognised impairment loss).

A number of reliefs are also available, most notably the option to recognise losses expected over the entire life of the asset for trade receivables and finance-lease receivables without conducting a credit risk assessment for each customer individually.

The new standard also brings changes to hedge accounting by significantly facilitating the measurement of effectiveness, expanding the range of instruments used, and providing more guidance on instruments and accounting methods.