Basics about Accounting

Supplement Material for Accounting

CASE STUDIES

IFRS 9

July 2014, the International Accounting Standards Board (IASB) published IFRS 9 *Financial Instruments* (2014). IFRS 9 was effective for annual periods beginning on or after 1 January 2018, subject to endorsement in certain fields.

Now we consider the new IMPAIRMENT model.

This standard introduces an expected credit loss (ECL) impairment model that applies to all financial instruments that are subject to impairment accounting, including trade and lease receivables.
The main reason for amending the previous model was to require major banks to recognise losses in advance of a credit event occurring.
The new impairment model is intended to result in earlier recognition of credit losses.

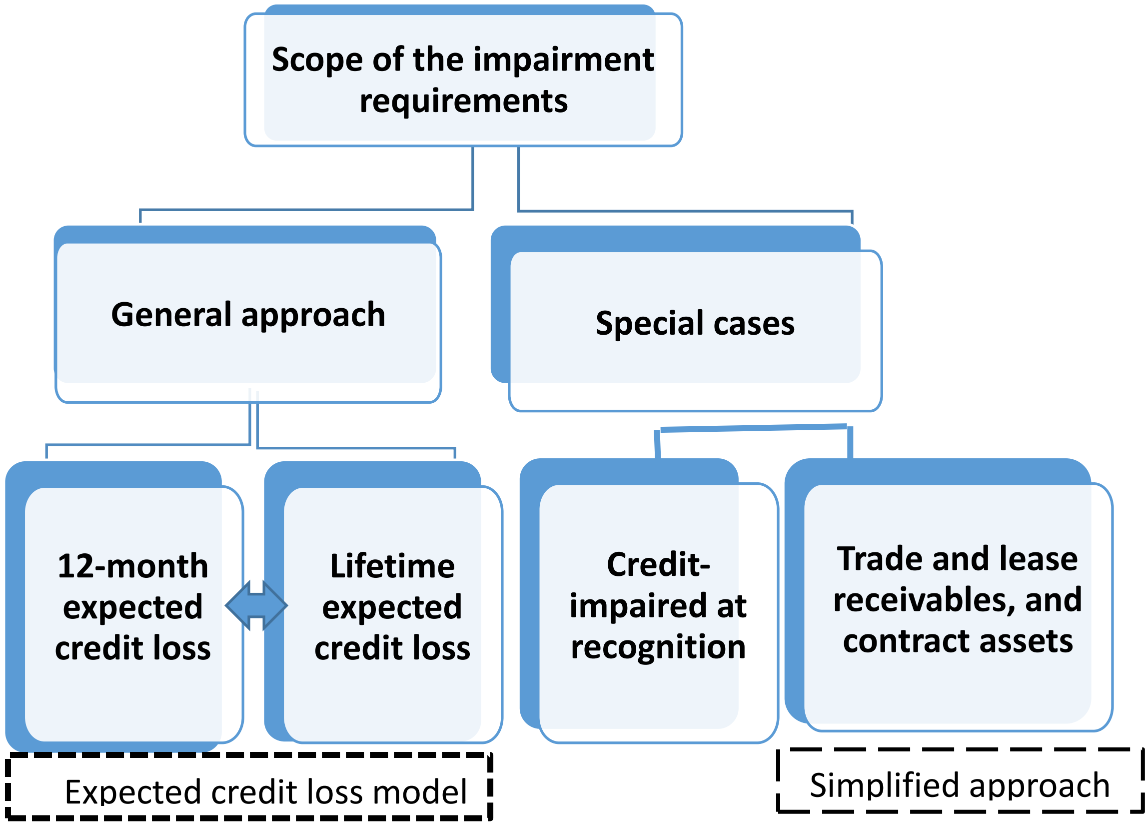
SCOPE OF THE STANDARD

IFRS 9 uses an "expected credit loss model" for all financial instruments that are subject to impairment accounting. It requires that an entity shall recognise a loss allowance for *expected credit losses* on

- a debt instrument measured at amortised cost,
- a debt instrument measured at fair value through other comprehensive income,
- a lease receivable,
- a contract asset (in accordance with IFRS 15 *Revenue from Contracts with Customers*)
- a loan commitment and
- a financial guarantee contract to which the impairment requirements of the Standard apply (IFRS 9. 2.1).

Under this model, expected credit losses would be recognised from the point at which financial instruments are originated or purchased. With limited exceptions, a *12-month expected credit losses* must be recognised initially for all assets subject to impairment. For example, an entity recognises a loss allowance at the initial recognition of a purchased debt instrument rather than when an event of default by the issuer occurs.
Investments in equity instruments are measured either at fair value through profit or loss (FVTPL) or at fair value through other comprehensive income (FVOCI). Equity investments in the scope of IFRS 9 are not tested for impairment.

APPROACHES TO IMPAIRMENT



GENERAL APPROACH

IFRS 9's general approach to recognising impairment is based on a three-stage process which is intended to reflect the deterioration in credit quality of a financial instrument.

• *Stage 1* covers instruments that have not deteriorated significantly in credit quality since initial recognition or (where the optional low credit risk simplification is applied) that have low credit risk. In this stage 12-month expected credit losses are recognised and interest is presented on a gross basis.

• *Stage 2* covers financial instruments that have deteriorated significantly in credit quality since initial recognition (unless the low credit risk simplification has been applied and is relevant) but that do not have objective evidence of a credit loss event. Lifetime expected credit losses are recognised and interest is presented on a gross basis.

• *Stage 3* covers financial assets that have objective evidence of impairment at the reporting date. It is considered credit-impaired financial asset. Recognise lifetime ECL but present interest on a net basis (i.e., gross carrying amount less credit allowance).

1. Scope exception from the general model: simplified approach for trade and lease receivables

The model includes some operational simplifications for trade receivables, contract assets and lease receivables because they are often held by entities that do not have sophisticated credit risk management systems. These simplifications eliminate the need to calculate 12-month ECL and to assess when a significant increase in credit risk has occurred.

For trade receivables or contract assets (in accordance with IFRS 15) that do not contain a significant financing component, the loss allowance should be measured at initial recognition and throughout the life of the receivable at an amount equal to lifetime ECL.

For lease receivables that result from transactions that are within the scope of IFRS 16, if the entity chooses as its accounting policy to measure the loss allowance at an amount equal to lifetime expected credit losses (IFRS 9.5.5.15).

As a practical expedient, a provision matrix may be used to estimate ECL for these financial instruments.

2. Scope exception from the general model: purchased or originated credit impaired assets (POCI assets)

The general impairment model does not apply to purchased or originated credit impaired assets. A financial asset is considered credit-impaired on purchase or origination if there is evidence of impairment (**as defined in IFRS 9 Appendix A**) at the point of initial recognition (for instance, if it is acquired at a deep discount).

For such assets, impairment is determined based on full lifetime ECL on initial recognition.

However, lifetime ECL are included in the estimated cash flows when calculating the effective interest rate on initial recognition.
The effective interest rate for interest recognition throughout the life of the asset is a credit-adjusted effective interest rate. As a result, no loss allowance is recognised on initial recognition (IFRS 9. 5.5.13, 5.5.14).

Any subsequent changes in lifetime ECL, both positive and negative, will be recognised immediately in profit or loss.

Examples in IFRS 9 of evidence that an asset is credit-impaired at origination

- It is becoming probable that the borrower will enter bankruptcy or other financial reorganization,
- the disappearance of an active market for that financial asset because of financial difficulties,
- the purchase or origination of a financial asset at a deep discount that reflects.

DEFINITIONS (IFRS 9 Appendix A)

Credit losses are defined as the difference between all the contractual cash flows that are due to an entity and the cash flows that it expects to receive ('cash shortfalls'). This difference is discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets).

12-month expected credit losses are defined as: "the portion of lifetime expected credit losses that represents the expected credit losses that results from default events on the financial instrument that are possible within the 12 months after the reporting data.

Lifetime expected credit losses are defined as "the expected credit losses that results from all possible default events over the expected life of the financial instruments.

The term *"default"* is not defined by the IASB, but instead requires each entity to do so. The definition has to be consistent with that used for internal credit risk policy, and has to consider qualitative factors (e.g., breaches of covenants) when appropriate.

There is a reputable presumption that default does not occur later than when a financial asset is *90 days* past due unless an entity has reasonable and supportable information to corroborate a more lagging default criterion (IFRS 9. B5.5. 37).

Determining significant increases in credit risk

The transition from recognising 12-month expected credit losses (i.e., Stage 1) to lifetime expected credit losses (i.e., Stage 2) in IFRS 9 is based on the notion of a significant increase in credit risk over the remaining life of the instrument in comparison with the credit risk on initial recognition. The focus is on the changes in the risk of a default, and not the changes in the amount of expected credit losses (IFRS 9.5.5.9).

For example, for highly collateralised financial assets such as real estate backed loans, when a borrower is expected to be affected by the downturn in its local economy with a consequent increase in credit risk, that loan would move to Stage 2, even though the actual loss suffered may be small because the lender can recover most of the amount due by selling the collateral.

This is the trigger which causes the entity to change the basis of its calculation of the loss allowance from 12- month ECLs to Lifetime ECLs.

Certain key presumptions apply in performing this test:

• An entity may assume that credit risk has not increased significantly if a loan or receivable is determined to have *"low credit risk"* at the reporting date, e.g., the risk of default is low, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations (IFRS 9.5.5.10, BC5.183-184), IFRS 9.B5.5.22-B5.5.24).

An example of a loan that has a low credit risk is one that has an external "investment grade" rating. An entity may use internal credit ratings or other methodologies to identify whether an instrument has a low credit risk, subject to certain criteria.

• If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information.

• There is a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than *30* days past due (IFRS 9.5.5.11, B5.52).
IFRS 9 clarifies that this presumption is not an absolute indicator but is presumed to be the latest point at which lifetime expected credit losses should be recognised, even when using forward-looking information (IFRS 9. B5.5.19).

A significant increase in credit risk (moving from Stage 1 to Stage 2) can include:

- Changes in general economic and/or market conditions (e.g., expected increase in unemployment rates, interest rates),
- Significant changes in the operating results or financial position of the borrower,
- Changes in the amount of financial support available to an entity (e.g., from its parent)
- Expected or potential breaches of covenants,
- Expected delay in payment (Note: Actual payment delay may not arise until after there has been a significant increase in credit risk).

To assess whether there has been a significant increase in credit risk, IFRS 9 sets out many examples of different sources of information and indicators that could be used **(IFRS 9. B5.5 16; B5. 5.17; B5.5.18).**

Credit-impaired financial assets are those for which one or more events that have a detrimental effect on the estimated future cash flows have already occurred. This is equivalent to the point at which an incurred loss would have been recognised under IAS 39. These financial assets would be in Stage 3 and lifetime expected losses would be recognised. Indicators that an asset is credit-impaired would include observable data about the following events:

(a) significant financial difficulty of the issuer or the borrower;

(b) a breach of contract, such as a default or past due event;

(c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;

(d) it is becoming probable that the borrower will enter bankruptcy or other financial reorganisation;

(e) the disappearance of an active market for that financial asset because of financial difficulties; or

(f) the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses **(IFRS 9 Appendix A).**

MEASUREMENT ISSUES OF THE EXPECTED CREDIT LOSSES

IFRS 9 defines expected *credit losses* as "the weighted average of credit losses with the respective risks of a default occurring as the weights".

In other words, expected credit losses are a probability-weighted estimate of credit losses (i.e., the present value of all cash shortfalls) over the expected life of the financial instrument.

General principles

IFRS 9 does not prescribe a particular method of measuring expected credit losses. The Standard instead acknowledges that measurement might vary based on the type of instrument in concern and the information that is available. It does however require that any method that an entity uses to measure credit losses should consider three key elements (IFRS 9.B5.5.12)

Measurement reflects three key elements

- an unbiased and probability weighted amount that is determined by evaluating a range of possible outcomes,
- the time value of money,
- reasonable and supportable information about past events, current conditions, and forecasts of future economic conditions without undue cost or effort. (IFRS 9. 5.5.17)

Other consideration

- *Collateral,*
- *Individual or collective basis*

Definitions, terms using in the measurement process

Cash shortfall is the difference between the cash flows due to the entity with the contract, and the cash flows the entity expects to receive (IFRS 9. B5.5.28).

The estimated period: the maximum period over which the entity is exposed to credit risk, and the credit losses are measured is the contractual period or a shorter period – (e.g., because of prepayments) (IFRS 9. 5.519, B5.5.38).

Discount rate: depends on the type of the financial instrument. The discount rate is generally the original EIR. Expected credit losses are discounted to the reporting date, not to the expected default date or another date.

Probability-weighted outcome: The estimate of ECL reflects an unbiased and probability-weighted amount, determined by evaluating a range of possible outcomes rather than based on a best -or wort-case scenario. The estimate should always reflect at least two scenarios:

- the probability that a credit loss occurs, even if this probability is very low; and
- the probability that no credit loss occurs (IFRS 9. 5.5. 17(a), 5.5.18, B5.5.41).

Collateral: the estimation of expected cash flows on a collateralised asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, irrespective of whether foreclosure is probable. The collateral is part of the contractual terms of the financial instrument and is not recognised by the entity separately from the financial instrument being assessed for impairment. (IFRS 9. B5.5.55).

Individual or collective basis:
Some factors or indicators may not be identifiable at an individual financial instrument level but can and should be assessed for portfolios (or groups or potions of portfolios).
In cases when an assessment of whether there has been a significant increase in credit risk on an individual basis would not faithfully represent changes in credit risk since initial recognition, the entity makes the assessment on a collective basis. (e.g., grouping the instruments: instrument type, credit risk ratings, industry, collateral) (IFRS 9. 5.5.4, B5. 5.3).

Reasonable and supportable information

The information used should include:
- factors that are specific to the borrower, and
- general economic conditions, including assessment of both the current conditions and the forecast direction of the change of conditions (IFRS 9.5.5.17(c), IFRS 9. B5.5.51).

Examples of the potential data sources: internal historical credit loss experience, internal and external rating, external reports and statistics, the credit loss experience of other entities (IFRS 9. B5. 5. 51).

Historical information: this base is adjusted on the basis of current observable data to reflect current conditions and a future forecast.
Observable data are the following: unemployment rate, property prices, commodity prices payment status and other relevant factors.

Factors which are used to calculate the ECL

ECL = PD x LGD x EAD

PD: Probability of default
LGD: Loss given default: Percentage of expected loss caused by the default
EAD: Exposure at default is the predicted amount of loss a bank may be exposed to when a debtor defaults on a loan.

Depending on the asset, the PD is measured either for the next 12 months or for the remaining life of the financial instrument. PD estimates are 'point-in-time' (PIT) measures based on an entity's assessment at the reporting date of current and expected future conditions. IFRS 9 contains no specific requirements about the observation period for the collection of historical data that is used for calculation of LGD and EAD.
Banks use internal models to estimate the PDs, and the regulator prescribes LGD and EADs. Banks may be able to use the data and systems applied for the regulatory PD estimates in their accounting calculations, subject to certain adjustment to ensure that the calculations comply with IFRS 9. (IRB approach is the internal ratings-based approach under the Basel regulatory framework.)

If the bank has no PD models, can choose between the direct estimation of lifetime PD and indirect estimation from 12 months PDs. The second is based on the cumulative marginal PDs.

PRESENTATION OF ECL IN THE FINANCIAL STATEMENTS

An entity recognises expected credit losses as a loss allowance in the Statement of financial position (Balance Sheet, B/S) if they relate to a financial asset measured at amortised cost, a lease receivable, or a contract asset.
However, it is not required to present the loss allowance as a separate line item in the Statement of financial position.
The carrying amount of the assets in the Statement of financial position is stated net of the loss allowance.

DISCLOSURE

Extensive quantitative and qualitative disclosures (in IFRS 7) are required to identify and explain the amounts in the financial statements that arise from ECL and the effect of deterioration and improvement in credit risk. *Example* of key disclosure requirements are presented below:

Qualitative disclosures
• inputs, assumptions, and techniques used to:
− estimate expected credit losses (and changes in techniques or assumptions)
− determine ‘significant increase in credit risk’ and the reporting entity’s definition of ‘default’
− determine ‘credit-impaired’ assets
• write-off policies
• policies regarding the modification of contractual cash flows of financial assets
• a narrative description of collateral held as security and other credit enhancements.

Quantitative disclosures
• reconciliation of loss allowance accounts showing key drivers for change
• explanation of gross carrying amounts showing key drivers for change
• gross carrying amount per credit risk grade or delinquency
• write-offs, recoveries, and modifications
• quantitative information about the collateral held as security and other credit enhancements for credit-impaired assets.

REFERENCES

- BDO, IFRS in practice 2016, IFRS 9 Financial instruments
- Grant and Thornton, Get ready for IFRS 9, The impairment requirements 2016
- IFRS 9 Financial Instrument, IASB 2020/2021
- KPMG, First impressions: IFRS 9 Financial Instruments 2014
- KPMG, Insight into IFRS, KPMG International Standards Group 2018/19