IFRS 9 (2014): A CRITICAL ANALYSIS OF EXPECTED CREDIT LOSSES IMPAIRMENT MODEL

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ABSTRACT

This paper aims to discuss the current revision made to IFRS 9, what was the cause for such a change and its usefulness to financial statement users. IFRS 9 extends the use of fair value accounting and it has been under deep scrutiny because of its alleged role in the financial crisis. Therefore, the usefulness of fair value accounting is a key issue for standard setting purpose. An expected loss impairment model is added to IFRS 9 which will demand the use of different information and data to measure loan loss allowances compared to IAS 39. The project to replace IAS 39 has been taken in stages. This paper delineates the background for expected loss model in IFRS 9, how to estimate the expected credit impairment loss, the disclosure requirements and the views of some leading professionals on the issue.

The new standard is likely to provide better transparency on a company's credit risk and provisioning process though it could be a challenge for auditors, banks and regulators.

Key words: IFRS (International financial reporting standards), IASB (International Accounting standards Board), Fair value accounting, FVTPL (Fair value through profit or loss), FVTOCI (Fair value through other comprehensive income), ECL (Expected credit losses)

INTRODUCTION

IAS 39 has been considered very complex and difficult to apply in countries, thus various accounting bodies urged the International Accounting Standards Board (IASB) to come out with reduced complexity of the accounting standards for financial instrument and provide a single set of high quality standard, therefore IASB in 2010 had come up with IFRS 9 as a replacement to International Accounting Standard (IAS) 39.

The IASB first issued IFRS 9 in 2009 with a new classification and measurement model for financial assets followed by requirements for financial liabilities and derecognition added in 2010. Subsequently IFRS 9 was amended in 2013 to add the new general hedge accounting requirements. The final version of IFRS 9 issued in July 2014 supersedes all those previous versions although they remain available for early adoption for a limited time. IFRS 9 (2014) incorporates the final requirements on all three phases of the financial instruments projects- classification and, measurement, impairment and hedge accounting.

Almost five years after the publication of the first phase of the replacement of IAS 39, the IASB completed its project to improve accounting for financial instruments by adding a **new expected credit loss model** for the recognition of impairment.

IFRS 9 (2014) adds to the existing IFRS 9:

- New impairment requirements or all financial assets that are not measured at fair value through profit or loss.
- Amendments to the previously finalized classification and measurement requirements.

IFRS 9, Financial Instruments is the final part of IASB's response to the financial crisis, which includes a forward-looking 'expected loss' impairment model and a substantially-reformed approach to hedge accounting as key elements in a single, integrated standard. It is designed to address concerns which emerged following the global financial crisis when banks were unable to account for losses until they were incurred, even when it was apparent to them that they were going to experience those losses.

IASB says IFRS 9 provides a logical, single classification and measurement approach for financial assets that reflect the business model in which they are managed and their cash flow characteristics. It includes a forward-looking expected credit loss model which IASB says will result in more timely recognition of loan losses and is a single model that is applicable to all financial instruments subject to impairment accounting, thus reducing complexity. The IASB has already announced its intention to create a transition resource group to support stakeholders in the transition to the new impairment requirements. In addition, IFRS 9 addresses the so-called 'own credit' issue, whereby banks and others book gains through profit or loss as a result of the value of their own debt falling due to a decrease in credit worthiness when they have elected to measure that debt at fair value.

Limitation of Incurred Loss Impairment Model

Accounting standards around the world are currently based upon incurred loss model. Under Incurred loss model, Impairment was only recognized just before a loan defaulted and it was designed to limit management's ability to create hidden reserves during the good times that could be used to flatter earnings during the bad times which was misleading to investors.

However, during this most recent crisis the model has been accused of resulting in impairment being 'too little, too late'. During the recent crisis the existing model was, in many cases, applied so that impairment was only recognized just before a loan defaulted. This meant that the loan losses were often recognized too late because of which many investors lost trust in Bank's balance sheet.

IFRS 9: New 'Expected loss' Impairment Model

IFRS 9 (2014) is applied to:

- Debt instruments held measured at amortized cost or FVTOCI
- Written loan commitments and written financial guarantee contracts
- Lease receivables within the scope of IAS 17 Leases, and
- Contract assets within the scope of IFRS 15 Revenue from contracts with customers.

The new forward looking model contains three stages:

Stage 1: Expected losses arising from an event occurring within the next 12 months are provided.
It includes financial instruments that have not had a significant increase in credit risk since initial recognition or which have low credit risk at the reporting date. For these items, 12-month ECL are recognized and interest revenue is calculated on the gross carrying amount of the asset (i.e., without deduction for credit allowance). The 12-months ECL are the expected credit losses that result from default events that are possible within 12 months after the reporting date. It is not the expected cash shortfalls over the 12 month period but the entire credit loss on an asset weighted by the probability that the loss will occur in the next 12 months.

Stage 2: Life time expected losses are recognized, with interest revenue being recognized on the gross carrying amount.
It includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of impairment. For these items, lifetime expected credit losses are recognized, but interest revenue is still calculated on the gross carrying amount of the asset. Lifetime ECL is an expected present value measure of losses that arise on default throughout the life of the instrument. It is the weighted average credit losses with the probability of default as the weight.

Stage 3: Life time expected losses are recognized, with the object of impairment.
It includes financial assets that have objective evidence of impairment at the reporting date. For these items, lifetime expected credit losses are recognized and interest revenue is calculated on the net carrying amount (i.e. net of credit allowance).

The new standard moves from an incurred loss model to an expected loss model, marking a big change for banks, insurance companies and the users of financial statements. For the first time, banks will have to recognize not only credit losses that have already occurred but also losses that are expected in the future. This is designed to help ensure that they are appropriately capitalized for the loans that they have written.

Concerns about impairment came under the spotlight during the financial crisis because banks were unable to book accounting losses until they were incurred, even though they could see the losses coming. At times the incurred loss rule meant banks overstated profits upfront and did not make prudent provisions against expected losses, particularly in areas such as the loans they secured against real estate.
The ECL model relies on a relative assessment of credit risk; this means that a loan with the same characteristics could be included in Stage 1 for one entity and in Stage 2 for another depending on credit risk at initial recognition for each entity. Moreover, an entity could have different loans with the same counterparty that could be included in different stages depending on the credit risk that each one had at origination.

Possible impact on the following sectors

The changes are likely to have a significant impact on the following entities:

- Banks (Expected for credit systems and processes)
- Insurance companies
- Leasing Companies
- Corporates (Trade Receivables)

Exploring the general model: assessing a significant increase in credit risk

1. When assessing whether the credit risk on a financial instrument has increased significantly since initial recognition, management looks at the change in the risk of a default occurring over the expected life of the financial instrument rather than the change in the ECL. An entity should compare the risk of a default as at the reporting date with the risk of a default occurring on the financial instrument as at the date of initial recognition. If management chooses to make the assessment by using PD, generally a lifetime PD (over the remaining life of the instrument) should be used. However, as a practical expedient, a 12-month PD can be used if it is not expected to give a different result to using lifetime PDs.
2. When determining whether the credit risk on an instrument has increased significantly, management should consider reasonable and supportable best information available without undue cost or effort. This information should include actual and expected changes in external market indicators, internal factors and borrower-specific information.

Examples of ways in which the assessment of significant increases in credit risk could be implemented more simply include:

- Establishing the initial maximum credit risk for a particular portfolio by product type and/or region (the 'origination credit risk') and comparing that to the credit risk at the reporting date. This would only be possible for portfolios of financial instruments with similar credit risk on initial recognition;

- Assessing increases in credit risk through a counterparty assessment, as long as such assessment achieves the objectives of the proposed model; and
- An actual or expected significant change in the financial instrument's external credit rating.

3. Generally a financial instrument would have a significant increase in credit risk before there is objective evidence of impairment or before a default occurs. The standard requires both forward-looking and historical information to be used in order to determine whether a significant increase in credit risk has occurred.
4. Lifetime ECL are expected to be recognized before a financial asset becomes delinquent. If forward-looking information is reasonably available, an entity cannot rely solely on delinquency information when determining whether credit risk has increased significantly since initial recognition; it also needs to consider the forward-looking information. However, if information that is more forward-looking than past due status is not available, there is a rebuttable presumption that credit risk has increased significantly since initial recognition no later than when contractual payments are more than 30 days past due.
5. This presumption can be rebutted if there is reasonable and supportable evidence that, regardless of the past-due status, there has been no significant increase in the credit risk: For example, where non-payment is an administrative oversight, instead of resulting from financial difficulty of the borrower. Another example is where management has access to historical evidence that demonstrates that there is no correlation between significant increases in the risk of a default occurring and financial assets on which payments are more than 30 days past due, but that evidence does identify such a correlation when payments are more than 60 days past due.
6. Generally, a significant increase in credit risk happens gradually over time and before the financial asset becomes credit-impaired or is in default. As a result, the lifetime ECL should not be delayed and is recognized before a financial asset is regarded as credit-impaired or in default.

Estimating expected credit losses

A credit loss is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive discounted at the original effective interest rate.

This calculation of lifetime ECL could be challenging, as IFRS 9 requires entities to take into account all information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions when performing the assessment. Therefore, the calculation of the impairment provision will require a significant amount of judgment especially with regards to how to incorporate forward looking information in the measurement.

IFRS 9 establishes that for periods beyond 'reasonable and supportable forecasts' an entity should consider how best to reflect its expectations by considering information at the reporting date about the current conditions, as well as forecasts of future events and economic conditions. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgment to estimate ECL increases.

The estimate of ECL does not require a detailed estimate for periods that are far in the future – for such periods, an entity may extrapolate projections from available, detailed information. The standard is not specific on how to extrapolate projections from available information. Different ways of extrapolating may be used; an entity could apply the average expected credit losses over the remaining period or use a steady rate of expected credit losses based on the last available forecast. These are only examples and other methods might apply. This is a highly judgmental area which may have a big impact on the allowance for impairment.

As a result, the value of the allowance for impairment will vary depending on the movements in the projections and on the relative credit quality of the financial instruments. It is therefore expected that this will generate more volatility in the P&L than the current IAS 39 incurred loss model. Nevertheless this volatility should be more aligned to the information contained in credit risk management systems of financial institutions.

In short, while calculating ECL following information needs to be considered:

- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
- The time value of money; and
- Reasonable and supportable information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date.

MEASUREMENT AND PRESENTATION OF ECL

The following action needs to be considered while measuring ECL:

- Perform comprehensive review of financial assets to ensure that they are appropriately classified and measured.
- Decide how to apply the expected credit loss model to different Financial Assets.
- Develop impairment methodologies and controls to ensure judgment is exercised consistently and supported by appropriate evidence.

The calculation for the lifetime ECL and 12 months ECL is as follows:

Lifetime ECL = Present value of all cash shortfalls expected over the remaining life of financial instrument.

- [PD(year1) x LGD + PD(year 2) x LGD + … + PD(last year) x LGD]

12-month ECL= the portion of lifetime ECL associated with probability of a default occurring in next 12 months after reporting date.

- PD(year1) x LGD(year1)

Where PD = Probability of default and LGD = Loss governing default.
Presentation in Financial Statement

- Management should present **interest revenue** in the statement of comprehensive income as a separate line item. Impairment losses (including reversals of impairment losses or impairment gains) should also be presented as a separate line item.
- An entity should recognize ECL in the statement of financial position as:
- A **loss allowance** for financial assets measured at amortized cost and lease receivables; and
- A **provision** (that is, a liability) for loan commitments and financial guarantee contracts.
- For financial assets that are mandatorily measured at fair value through other comprehensive income, the accumulated impairment amount is not separately presented in the statement of financial position. However, an entity should disclose the loss allowance in the notes to the financial statements.

New Disclosure Requirements

Sufficient information should be provided to allow users to reconcile line items that are presented in the statement of financial position. For disclosure purposes, financial instruments should be grouped into classes that facilitate the understanding for users. The information should also be provided on the same level of aggregation or disaggregation as the reconciliation of the related loss allowance and shall include relevant qualitative and quantitative information.
It is expected that in order to comply with the new disclosure requirements entities will need to modify their current information systems in order to gather and track the data required (i.e., credit risk of the financial asset at inception).Example of key disclosure requirements are presented below:

QUANTITATIVE	QUALITATIVE
Reconciliation of opening to closing amounts of loss allowance showing key drivers of change	Inputs, assumptions and estimation techniques for estimating ECL.
Reconciliation of opening to closing amounts of gross carrying amounts showing key drivers of change	Inputs, assumptions and estimation techniques to determine significant increases in credit risk and default.
Gross carrying amounts by credit risk grade	Inputs, assumptions and techniques to determine credit-impaired assets
Write offs, recoveries and modifications	Write off policies, modi. policies, collateral

Views of some Leading Professionals

- Andrew Spooner, lead financial instruments partner at Deloitte, said: 'The new standard on financial instruments will affect all sectors though the introduction of an expected loss model for loan loss provisioning, but will impact banks most. 'Banks have told us they expect provisions will increase, on average, by 50% on adoption. IFRS 9 should give investors better insight into the credit quality of all financial assets, not just those that are considered "bad".' The changes will reduce profits in the first year of implementation, but this is likely to have only a short-term impact on income statements. However, IFRS 9 will increase running costs for banks and financial institutions.
- Chris Spall, KPMG's global IFRS financial instruments leader, said: "The new standard is going to have a massive impact on how banks account for credit losses on their loan portfolios. Provisions for bad debts will be bigger and are likely to be more volatile. And after long debate about this complex area, it is good that we finally have a complete standard and that the implementation effort can begin in earnest,"
- Colin Martin, head of KPMG UK assurance services, banking, said: "Adopting the new rules is going to mean a lot of time, effort and money for banks and a major issue for banks and investors in banks will be how adoption of the new standard will affect regulatory capital ratios. Banks will need to factor this into their capital planning and we expect that users will be looking for information on the expected capital impacts."
- Hans Hoogervorst, IASB chairman, said: "The reforms introduced by IFRS 9 are much needed improvements to the reporting of financial instruments and are consistent with requests from the G20, the Financial Stability Board and others for a forward-looking approach to loan-loss provisioning."
- Joachim Kölschbach, KPMG's global IFRS insurance leader, said: "Insurers have to plan for adopting new standards on both financial instruments and insurance contracts over the next few years. The overall effect cannot be assessed until the insurance standard is finalised over the next 12 months, but we can expect a sea-change in financial reporting for most insurers."
- Jessica Taurae, Global Accounting Consulting Services Partner, said: "The new classification requirements are not likely to have a big impact but the new impairment provisions could require some work. IFRS 9 requires entities to calculate the impairment allowance on trade receivables based on the losses they expect to have during the life of the instrument. That means that an entity needs to compare the present value of the cash flows based on the contract to the present value of the cash flows that the entity expects to receive. So if the entity expects to be paid later than when the cash is contractually due, an impairment loss is recognized, even if the entity expects to be paid in full."

- Lain Coke, head of ICAEW's financial services faculty, said: 'It is important to remember that this accounting change will not change the cash flows of underlying loans. 'However, when combined with tougher regulatory capital requirements, it may force banks to hold more capital for the same risks. This may make banks safer but may also make them more costly to run.'
- Nigel Sleigh-Johnson, head of the financial reporting faculty at ICAEW, the UK accountancy body, said: "While, importantly, both boards have moved from an incurred loss model to an expected loss one, it's not an ideal outcome for such a significant sector in such a significant area of accounting. Investors will have to understand sets of accounts prepared under both regimes, and it will be harder for investors to benchmark."
- Spooner said: "When you have more judgment, there is potential for greater variability and there is a potential lack of comparability as the prospects for the future are assessed differently by different institutions."
- Tony Clifford, partner at EY, said: 'The impairment requirements in the new standard are going to be based on an expected credit loss model and replace the IAS 39 incurred loss model. This has the potential to impact the capital requirements of banks and may also make it harder to compare the reported results of different entities.

CASE STUDY

A bank makes a five-year loan of Rs 1,000,000 to Company A in the last quarter of 2018. The bank makes an initial credit assessment consistent with the economics of the lending decision.

As long as a loan is performing as expected when money was first lent, no credit loss is suffered economically, so IFRS 9 requires a portion of lifetime expected credit losses to be recognised (12-month expected credit losses).

In this instance, the bank assesses that there has been no change in the credit risk – ie the risk of a default occurring – since initial recognition. The bank estimates the loan loss allowance based on 12-month expected credit losses to be Rs 1,250.

A year later, at December 31 2019, the bank assesses the credit risk over the life of the loan based on currency conditions and relevant forecast conditions over the remaining life of the loan. While the loan is currently performing, the bank determines that the credit risk on the loan – the likelihood of it defaulting – has increased significantly.

When a loan's credit risk increases significantly from the initial expectations the lender is no longer being compensated for the losses to which it is exposed and so IFRS 9 requires lifetime expected credit losses to be recognised. The bank estimates that at December 31 2019 the lifetime expected credit losses for the loan are Rs 9,000.

Previous IFRS (IAS 39)

- Impairment of financial assets is recognized on an incurred loss basis, which requires objective evidence of likely impairment before a provision can be made.
- At December 31 2018, there is no objective evidence of impairment, hence no provision is made.
- At December 31 2019, the bank continues to recognize the loan at Rs 1,000,000 because there is still no objective evidence of impairment that has an impact on the estimated future cash flows of the financial asset, even though the risk of impairment has increased significantly.

New requirements (IFRS 9 – 2014)

- Impairment of financial assets is recognized on an expected credit loss basis, which requires historic, current and forecast information to be considered in determining the loss allowance.
- At December 31 2018, the bank recognizes a loss allowance at an amount equal to 12-month expected credit losses of Rs 1,250. The bank recognizes an impairment loss of Rs 1,250 in profit or loss.
- At December 31 2019, the bank has assessed that the credit risk of the loan has increased significantly since initial recognition and therefore recognizes a loss allowance of an amount equal to lifetime expected credit losses. The bank recognizes an additional impairment loss of Rs 7,750 (or Rs 9,000-Rs 1,250) in profit or loss accordingly.

CONCLUSION

By this change the banks and insurance companies that hold large portfolios of loans on their books are most affected. Banks will face the cost of updating their systems and processes to move from calculating incurred loss to expected loss.

The new standard is likely to provide better transparency on a company's credit risk and provisioning process but it introduces a greater degree of subjectivity because it is more forward looking. One challenge for auditors, banks and regulators is that banks could have different valuations of collateral and different treatments of trigger events that resulted in an expected loss.

Advantages of this Model

- Realistic recognition of impairments.
- Good for investors as they can have a true picture.
- Good for Economy as credit will stop flowing to Zombie Companies and the resources are freed up for companies that do have a future.

Implementation Challenges

- Very challenging, in particular for financial institutions as most entities do not collect the amount of credit information required by the standard.
- Management will need to build new models to determine both 12-month and lifetime ECL. This will require complex judgments (for example, definition of default, definition of low credit risk and behavioral life of revolving credit facilities).

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