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IFRS Developments

IASB issues IFRS 9 *Financial Instruments* – expected credit losses

What you need to know

- The impairment requirements in the new standard are based on an expected credit loss model and replace the IAS 39 incurred loss model.
- The expected credit loss model applies to debt instruments recorded at amortised cost or at fair value through other comprehensive income (such as loans, debt securities and trade receivables), lease receivables and most loan commitments and financial guarantee contracts.
- Entities are required to recognise either 12-month or lifetime expected credit losses, depending on whether there has been a significant increase in credit risk since initial recognition.
- The measurement of expected credit losses would reflect a probability-weighted outcome, the time value of money and reasonable and supportable information.
- The expected credit losses requirements must be adopted with the other IFRS 9 requirements from 1 January 2018, with early application permitted.

Adopting the expected credit losses requirements will require many entities to make significant changes to their current systems and processes.

Introduction

On 24 July 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9 *Financial Instruments*, bringing together the classification and measurement, impairment and hedge accounting phases of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and all previous versions of IFRS 9[1].

The IASB has addressed the key concern that arose as a result of the financial crisis that the incurred loss model in IAS 39 contributed to the delayed recognition of credit losses, by issuing the new impairment requirements that are based on a more forward-looking expected credit loss model. The expected credit losses (ECL) requirements and application guidance are accompanied by 14 illustrative examples in IFRS 9.

How we see it

As the ECL model is more forward looking than the IAS 39 impairment model, the new requirements are expected to increase the credit loss allowances of many entities, particularly financial institutions. However, the increase in the loss allowance will vary by entity, depending on past practice; entities with shorter term and higher quality financial assets are likely to be less significantly affected. The quantitative effect for short-term trade receivables is likely to be relatively small.

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[1] See our recent publications, *IFRS Developments Issue 86: IASB issues IFRS 9 Financial Instruments – classification and measurement*, *IFRS Developments Issue 68: The IASB issues IFRS 9 (2013) - hedge accounting is now complete* and *Applying IFRS – Hedge accounting under IFRS 9*.

The new requirements will affect both financial and non-financial institutions and are designed to result in earlier recognition of credit losses by necessitating an allowance for either 12-month or lifetime ECL.

Scope

The ECL requirements would apply to:

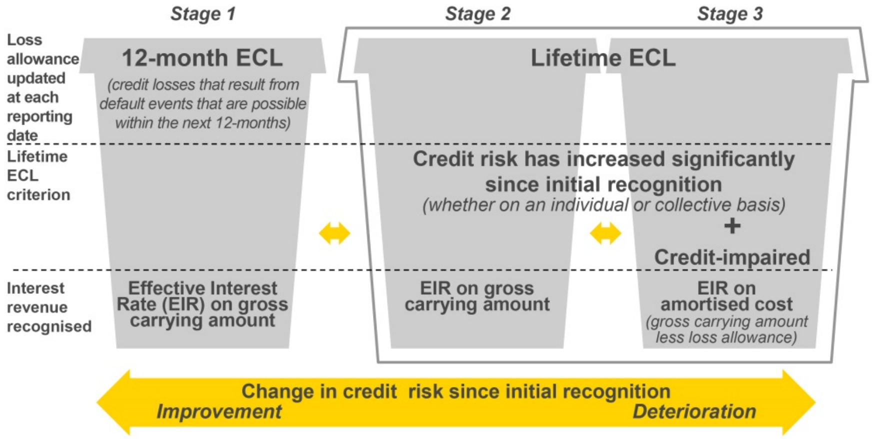
- Financial assets measured at amortised cost or at fair value through other comprehensive income under IFRS 9 (which include debt instruments such as loans, debt securities and trade receivables)
- Loan commitments and financial guarantee contracts that are not accounted for at fair value through profit or loss under IFRS 9
- Contracts assets under IFRS 15 *Revenue from Contracts with Customers*[2]
- Lease receivables under IAS 17 Leases

General approach

Under the general approach, entities must recognise ECL in two stages. 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 1 in the illustration below). For those 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 2 and 3 in the illustration below).

If the financial assets become credit-impaired (Stage 3 in the illustration below), interest revenue would be calculated by applying the effective interest rate (EIR) to the amortised cost (net of loss allowance) rather than the gross carrying amount.

Financial assets are assessed as credit-impaired using the same criteria as for the individual asset assessment of impairment under IAS 39[3].



Assessing significant increases in credit risk

When applying the general approach, a number of operational simplifications and presumptions are available to help entities assess significant increases in credit risk since initial recognition. These include:

- If a financial instrument has low credit risk (equivalent to investment grade quality), then an entity may assume no significant increases in credit risk have occurred.
- If forward-looking information (either on an individual or collective basis) is not available, there is a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due (DPD).
- The change in risk of a default occurring in the next 12 months may often be used as an approximation for the change in risk of a default occurring over the remaining life.

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[2] Contract assets are defined in Appendix A of IFRS 15.
[3] The examples of events to assess whether a financial asset is credit-impaired are provided in paragraph 59 of IAS 39 and Appendix A of IFRS 9.

Operational simplifications are available, including the simplified approach for trade and lease receivables, the 'low credit risk' and more than 30 DPD presumptions.

- The assessment may be made on a collective basis or, as indicated by illustrative example 7 in IFRS 9, at the level of the counterparty.
- Also, as indicated by illustrative example 6 in IFRS 9, an entity may also determine the maximum initial credit risk accepted for a portfolio with similar credit risks on initial recognition and thereby establish a threshold for recognising lifetime ECL.

Illustrative example 5 in IFRS 9 demonstrate how to determine whether there has been a significant increase in credit risk when the assessment is made on a collective basis. These examples indicate that the portion of the portfolio for which a lifetime ECL needs to be provided can be restricted to a portion of the exposures. This can be achieved by either segmenting the portfolio into sub-portfolios that are most affected by specific macroeconomic factors (a bottom-up approach), or by selecting a portion of the portfolio that is representative of the marginal increase in lifetime ECL due to specific macroeconomic factors, based on historical loss experience (a top down approach).

Purchased or originated credit-impaired financial assets

For financial assets that are credit-impaired on purchase or origination, the initial lifetime ECL would be reflected in a credit-adjusted EIR, rather than recording a 12-month ECL. Subsequently, entities would recognise in profit or loss, the amount of any change in lifetime ECL as an impairment gain or loss.

Simplified approach

The simplified approach does not require the tracking of changes in credit risk, but instead requires the recognition of lifetime ECL at all times.

For trade receivables or contract assets that do not contain a significant financing component[4], entities are required to apply the simplified approach. For trade receivables or contract assets that do contain a significant financing component, and lease receivables, entities have a policy choice to apply the simplified approach.

Measurement of expected credit losses

Lifetime ECL would be estimated based on the present value of all cash shortfalls over the remaining life of the financial instrument. The 12-month ECL is a portion of the lifetime ECL that is associated with the probability of default events occurring within the 12 months after the reporting date.

'Default' is not defined and the standard is clear that default is broader than failure to pay and entities would need to consider other qualitative indicators of default (e.g., covenant breaches). There is also a rebuttable presumption that default does not occur later than 90 DPD.

In measuring ECL, entities would need to take into account:

- **The period over which to estimate ECL:** Entities would consider the maximum contractual period (including extension options). However, for revolving credit facilities (e.g., credit cards and overdrafts), this period extends beyond the contractual period over which the entities are exposed to credit risk and the ECL would not be mitigated by credit risk management actions. This is to be calculated based on historical experience.
- **Probability-weighted outcomes:** Although entities do not need to identify every possible scenario, they will need to take into account the possibility that a credit loss occurs, no matter how low that possibility is. This is not the same as the most likely outcome or a single best estimate.

[4] Paragraphs 60-65 of IFRS 15 provide the requirements for determining the existence of a significant financing component in the contract.

- **The time value of money:** For financial assets, the ECL is discounted to the reporting date using the EIR that is determined at initial recognition and may be approximated. For loan commitments and financial guarantee contracts, the EIR of the resulting asset will be applied and if this is not determinable, then the current rate representing the risk of the cash flows is used.
- **Reasonable and supportable information**: Entities need to consider information that is reasonably available at the reporting date about past events, current conditions and forecasts of future economic conditions.

How we see it

The need to incorporate forward-looking information means that application of the standard will require considerable judgement as to how changes in macroeconomic factors will affect ECL.

Moreover, the focus on expected losses is likely to result in higher volatility in the amounts charged to profit or loss, especially for financial institutions, while the increased level of judgement required in making the calculation may mean that it will be more difficult to compare the reported results of different entities. However, the more detailed disclosure requirements, compared with IAS 39, should provide greater transparency over an entity's credit risk and provisioning processes.

Disclosures

The new credit risk disclosures required by IFRS 7 *Financial Instruments: Disclosures* will enable readers of financial statements to understand better an entity's credit risk management practices and credit risk profile, the ECL estimates and changes in credit risks. These disclosures include:

- Reconciliation of the loss allowance
- Explanation of how significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the loss allowance
- Inputs, assumptions and techniques in estimating ECL
- Separate disaggregation by credit risk rating grades of the gross carrying amount
- Information about collateral, modified financial assets and write offs still subject to enforcement activity

Effective date and transition

The standard is effective for annual periods beginning on or after 1 January 2018, with early application permitted. Retrospective application will be required, however, transition reliefs are provided (including no restatement of comparative period information).

How we see it

Although the mandatory application date of IFRS 9 is not until 1 January 2018, this is intended to provide sufficient time for entities to develop systems and processes and to gather historical data in order to make the calculations. It is likely that systems and processes will be based on those used for credit risk management and so application of the standard will require a much closer alignment of credit risk management and financial reporting functions than may currently be the case.

Adopting the IFRS 9 ECL requirements will require significant effort and investment for many entities, in particular, banks and insurers. Financial and non-financial institutions alike need to start planning an initial assessment of the likely impact of the new IFRS 9 ECL requirements to manage a successful transition and implementation.

In addition, financial institutions will need to fully understand the complex interactions between the IFRS 9 and regulatory capital requirements in relation to credit losses. In many cases, it is expected that the new IFRS 9 ECL requirements will result in a reduction in the regulatory capital of financial institutions.