FINANCIAL INSTRUMENTS WORKSHOP

Impairment under IFRS 9

Presentation by:

CPA Asif Chaudhry
Member ICPAK PSC and Partner PKF Kenya

Uphold public interest

Introduction

- Not all assets classified as FVTPL and therefore impairment remains a key consideration
- Impairment has probably been one of the most challenging aspects in developing the final IFRS 9, with multiple EDs
- Impairment address the credit risk that is inherent within financial assets
- A key difference between IFRS 9 and IAS 39 is the requirement to recognise expected credit losses even before an impairment event has taken place

What we will cover

- Impairment of financial assets – scope
- When to recognise an impairment
- Measurement of impairment

Terms you will need to know

EXPECTED CREDIT LOSS

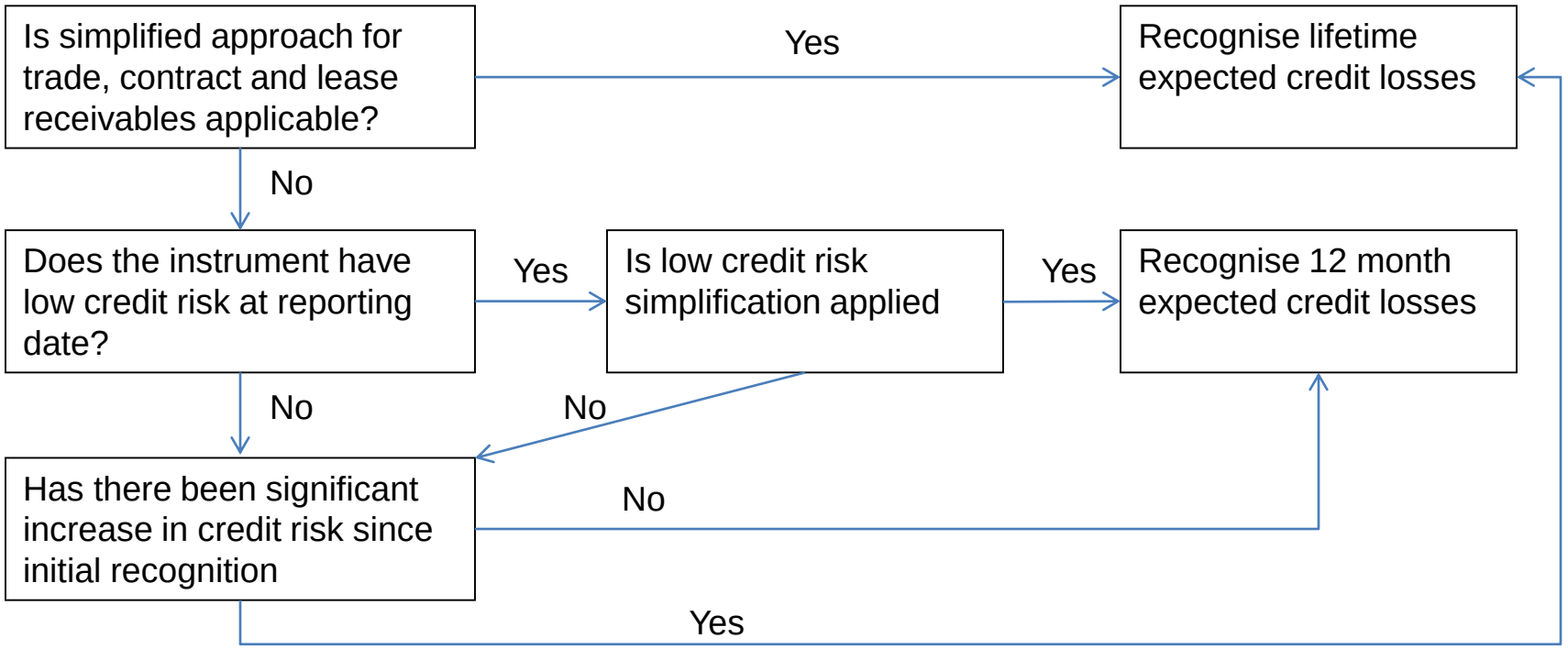
12 MONTH EXPECTED CREDIT LOSS

LIFETIME EXPECTED CREDIT LOSS

SIGNIFICANT INCREASE IN CREDIT RISK

PROBABILITY WEIGHTED OUTCOMES

The decision tree



Scope of impairment assessment

- financial assets that are measured at amortised cost or debt instruments assets measured at FVTOCI;
- lease receivables under IFRS 16 Leases;
- contract assets recognised under IFRS 15 Revenue from Contracts with Customers;
- written loan commitments that are not measured at FVTPL; and
- written financial guarantee contracts that are not measured at FVTPL that are in the scope of IFRS 9.

Note that not included in this list are all financial assets designated as FVTPL
Also not included are Equity Instruments that are designated at FVTOCI as these re-measurements are always recognised in OCI

Loan commitments and guarantees – impairment???

- Under a loan commitment the issuer is committed to providing credit and there is a risk that borrower may not fully repay the loan

- Under IFRS 9, the risk of expected credit loss is the same for a commitment as is for an actual loan that has been disbursed

- Such commitments can include:
  - Finance lease commitments including sale and leaseback
  - Commitments to offer credit through store and other credit cards

- Guarantees follow very similar thinking as the above

What is expected credit loss?

- Under IFRS 9 it is not necessary for an impairment event to have taken place before credit losses are recognised

- Therefore a loss provision is recognised from the very inception of the credit instrument

- IFRS 9 however provides for a general approach for purposes of expected credit loss provisions:
  - 12 month expected credit losses
  - Lifetime expected credit losses

- It also provides for some exceptions to applying the above general approach

- The provision of these approaches follows the prolonged debate about the impairment model under IFRS 9 and the objective to make it easier to implement

The general approach

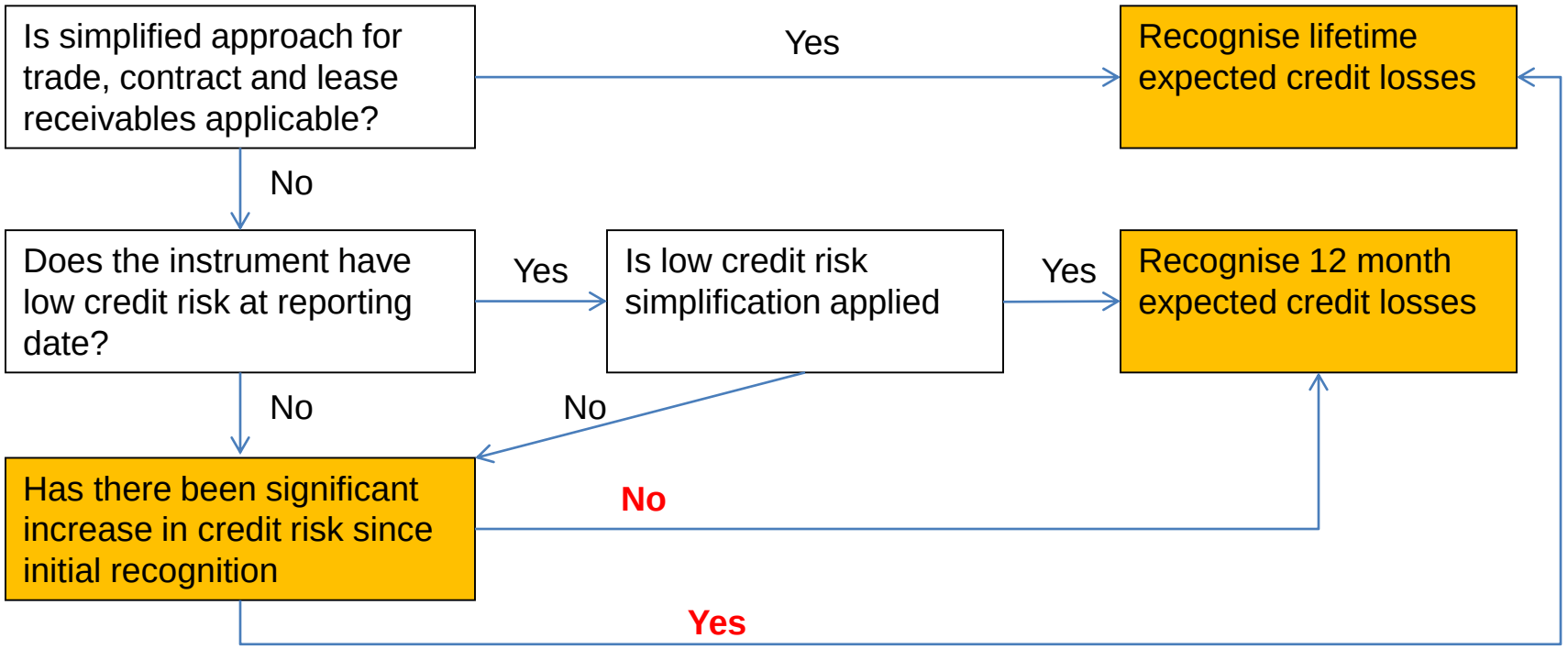
- Case 1 – if there has been no significant increase in credit risk since the date of the issue – recognise 12 month expected credit losses

- Case 2 – if there has been significant increase in credit risk – recognise lifetime credit losses

lifetime expected credit losses are the expected credit losses that result from all possible default events over the expected life of a financial instrument; and

12-month expected credit losses are the portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

The decision tree



12 month credit loss - caution

- IFRS 9:B5.5.43 states that the 12-month expected credit losses are a portion of the lifetime expected credit losses and represent the **lifetime cash shortfalls** that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighted by the probability of that default occurring.

- Therefore, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months nor the cash shortfalls that are predicted over the next 12 months.

12 month credit loss - illustration

- Bank A issues a loan of Shs. 1 million on 1 January 2017 repayable over 3 years. It has determined the following probabilities with respect to this loan based on past history:
  - The probability of the loan being in default over the 3 year term is 3 per cent and the present value of the contractual cash flow over the life of the loan that will not be recovered given the default is Shs. 500,000.
  - The probability of the loan being in default over the next 12 months is 1 per cent and the present value of the contractual cash flows due in the next 12 months that will not be recovered given the default is Shs 100,000.
  - The probability of the loan being in default over the next 12 months is 1 per cent and the present value of the contractual cash flows over the life of the loan that will not be recovered given the default is Shs. 300,000.
- What will Bank A use to determine impairment under the lifetime expected credit loss model and 12 month expected credit loss model respectively?

Significant change in credit risk - critical

- Remember that the use of the lifetime vs. 12 month model is based on significant increase of credit risk
- Therefore it's the change in credit risk that is relevant and not the risk itself
- Its judgemental and based on market and other observations
- Also note that for financial assets that mature is 12 or less months, the 12 month model will equate to the lifetime model. However for purposes of disclosure, it is still necessary to segregate these
- Also note that credit risk is the risk of default and not the risk of credit loss. A loan could have very high default risk but because of collateral, may be very low on actual credit loss – but this is a measurement issue.

Relativity of change in credit risk

- As at 31 December 2017, Bank B has two loans issued that both have a probability of default of 7 per cent. At initial recognition financial instrument on 1 January 2017, loan 1 had a probability of default of 6 per cent whereas loan 2 had a probability of default of 2 per cent. Even though both loans have the same absolute probability of default at 31 December 2017, Bank B considers that for loan 2 the credit risk has increased significantly since initial recognition whereas for loan 1 it has not.

- Loan 2 will therefore be measured for impairment purposes using the lifetime model whereas loan 1 will continue to be measured using the 12 month model.

Collateral vs. credit risk vs. impairment allowances

- The guidance in IFRS 9:B5.5.12 and IFRS 9:B5.5.22 explains that collateral is not taken into account when ***assessing*** credit risk.
- Instead recoveries from collateral are taken into account when ***measuring*** expected credit losses.
- The ability to reduce cash shortfalls through the enforcement of collateral does not reduce the risk of default occurring on the financial instrument.
- This same guidance equally applies to other credit enhancements such as financial guarantees integral to a financial asset. The recoveries from such guarantees are taken into account in the *measurement* of expected credit losses.
- It should be noted, however, that *changes* in the value of collateral and the quality of financial guarantees (and other credit enhancements) can affect the risk of default.

Further guidance....

- As noted above, assessing whether a change in credit risk is 'significant' is judgemental
- For instance, in assessing a change in credit risk, one does not look at changes in the likelihood of recovery from collateral or indeed changes in value of such collateral
- IFRS 9 requires that an entity use reasonable and supportable information that is available without undue cost of effort
- Remember that for a bank or similar institution, the undue cost of effort threshold will be high
- To make life easier, IFRS 9 presumes (rebuttable) that payments more than 30 days past due are indicators of significant increase in credit risk

Impairment on a collective basis

- IFRS 9 permits the grouping of a portfolio of financial assets into ‘buckets where they share similar characteristics
- These characteristics can include industry type, geography, credit risk rating etc as appropriate
- Measurement of significant changes in credit risk can then be performed for the grouped instruments
- However care needs to be taken to review the groupings regularly and particularly calling out subgroups where circumstances change for a small group of instruments within a group

Indicators of changes in credit risk

- Significant changes in terms of an instrument were it to be re-issued
- Changes in external market conditions
- Credit rating scores
- Changes in value of collateral (however note comments above)

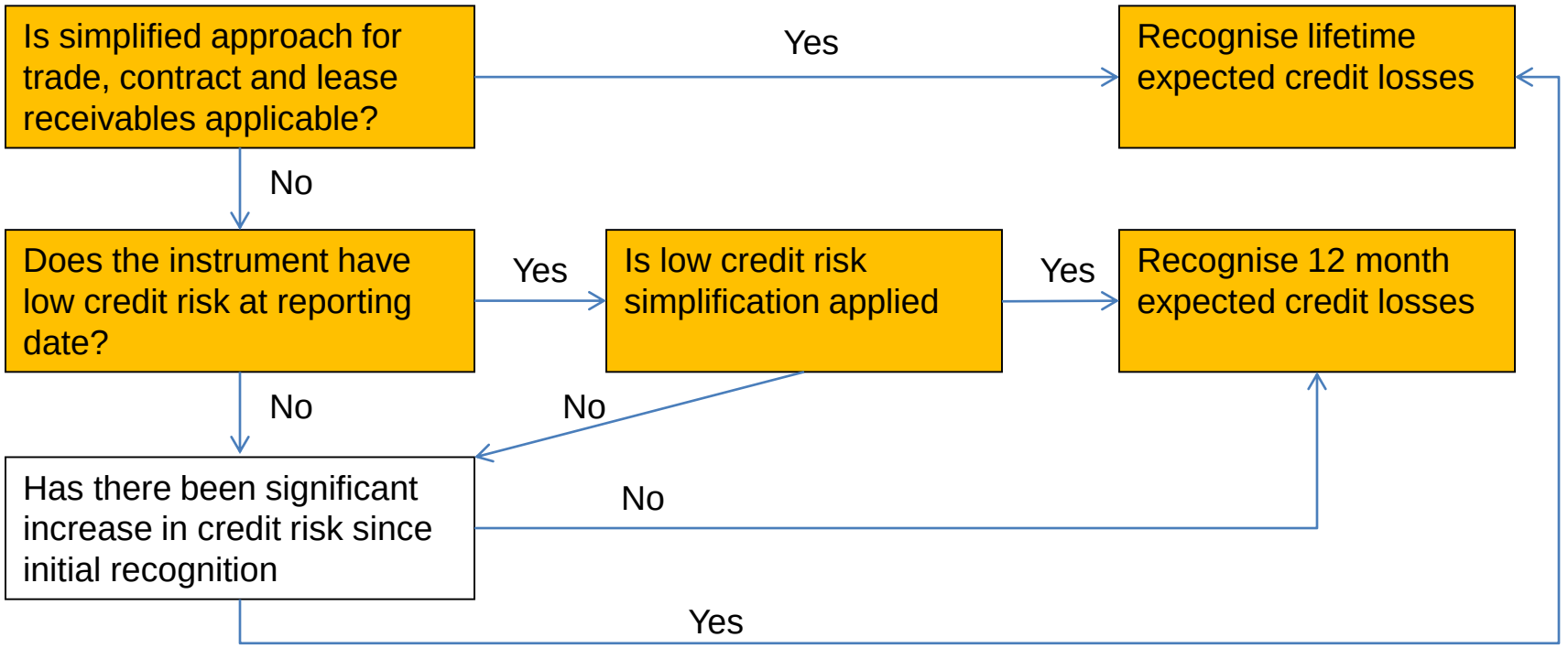
Assessing credit risk when the terms of an instrument are modified

- Substantial modifications which under IFRS 9 result in the de-recognition of the old instrument and the recognition of a new instrument – modification date to be taken as date of initial recognition
- Modifications not deemed to be substantial – Should assess for change in credit risk by comparing risk of default at modification date vs. risk of default at inception

Simplifications and exceptions to the general approach

- On low credit risk instruments (read government debt?) an entity can assume no significant change in credit risk
- Trade receivables, contract assets and lease receivables – an entity can opt to always recognise lifetime expected losses to such instruments – this avoids the need to re-assess changes in credit risk but means that higher loss allowances will be recognised
- Note that for trade and contract receivables without financing components, this is a required policy. For others, it's an accounting policy choice. For trade receivables, a provision matrix can be used.
- Purchase or origination of credit impaired assets – effective interest rate method updated for this and post this only changes in lifetime credit risk allowances recognised – no day one provision

The decision tree



Trade receivables – practical approach

- IFRS 9 does not preclude the use of % allowances for credit risk based on ageing of trade receivables, through a provision matrix provided it is based on relevant information and experience
- Recall that these will be lifetime credit risk provisions as trade receivables do not typically comprise a financing element

Example – provision matrix

To determine the expected credit losses for the portfolio of trade receivables, Company M uses a provision matrix. The provision matrix is based on its historical observed default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates. At every reporting date the historical observed default rates are updated and changes in the forward-looking estimates are analysed. In this case it is forecast that economic conditions will deteriorate over the next year.

On that basis, Company M estimates the following provision matrix:

	Current	1–30dayspast due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

Provision matrix (continued)

The trade receivables from the large number of small customers amount to CU30 million and are measured using the provision matrix.

	Gross carrying amount	Lifetime expected credit loss allowance(Gross carrying amount x lifetime expected credit loss rate)
Current	CU15,000,000	CU45,000
1–30 days past due	CU7,500,000	CU120,000
31–60 days past due	CU4,000,000	CU144,000
61–90 days past due	CU2,500,000	CU165,000
More than 90 days past due	CU1,000,000	CU106,000
	CU30,000,000	CU580,000

Measurement of expected credit loss

- Probability weighted estimate of credit loss
- i.e. present value of estimated cash shortfalls
- Cash shortfall = cashflows that are due less expected cashflows including cash flows from collateral
- Therefore in considering collateral, allowance is made for costs of realising such collateral
- For loan commitments, the expected credit loss is the difference between the amount of commitment due to the borrower that is expected to be drawn down and the amount of cashflows expected post draw down

Principals of measuring expected credit loss

An entity should measure expected credit losses of a financial instrument in a way that reflects:

- 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 that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Applying probability

- Objective – the most likely outcome and not the best case nor the worst case – i.e. prudence is not a fundamental override!
- Does not need to be overly complex
- History of credit losses a good basis for this – however note that IFRS 9 states that where future information is available without undue cost or effort, it must be considered
- However it may also be important to consider forward looking information where circumstances are expected to change from historical experience

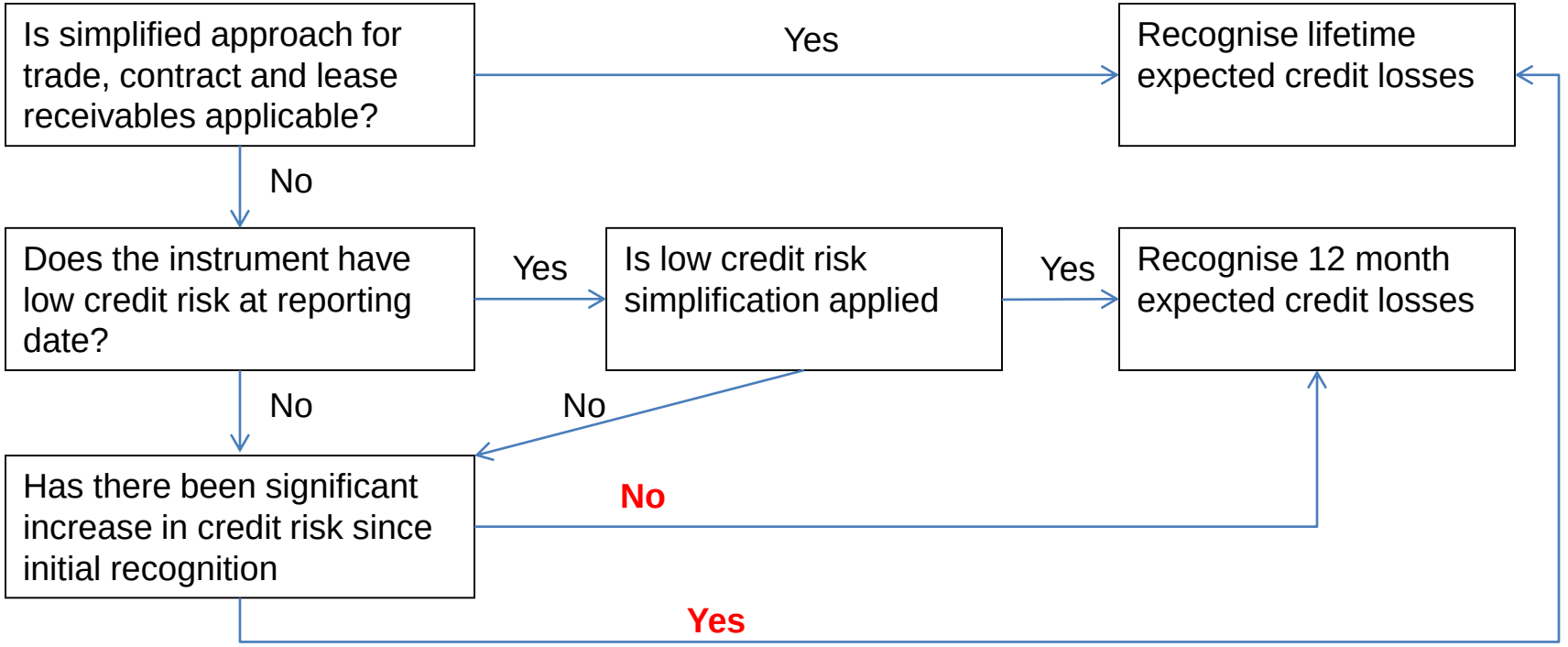
Probability - example

- Bank C disburses a loan of Shs. 10 million to a manufacturing concern involved in FMCG
- Based on available information including historic records for similar loans to this industry and players of similar size and the available future expectations information, the 12 month likelihood of credit loss is 1%. This implicitly means that there is a 99% probability that there will be no credit loss
- At reporting date there is no significant change in this credit risk
- From information and history, if the credit loss does materialise, Bank C will lose 25% of the loan (ignore discounting)
- The loss allowance will be Shs. 10 million x 1% x 25% = Shs. 15,000

Transitional requirements

- Impairment requirements need to be applied retrospectively
- Therefore initial credit risk needs to be assessed on date of initial recognition of the instrument which may be several years ago
- If on date of application the determination of credit risk on initial recognition involves undue cost or effort, the entity would be required to apply the lifetime expected credit loss model
- Remember that the mandatory effective date of the standard is 1 January 2018 (i.e. 31 December 2018 year-ends) and therefore the transition balance sheet will be 31 December 2016.

The decision tree - revisited



Remember that what is not on the above decision tree is the factors relevant to purchased or originated credit impaired assets (where EIR factors in impairment) and lifetime impairment is always recognised.

Interactive Session