Understanding the measurement of expected credit losses in accordance with IFRS 9 *Financial Instruments*

Date: 2 June 2023

Addis Ababa

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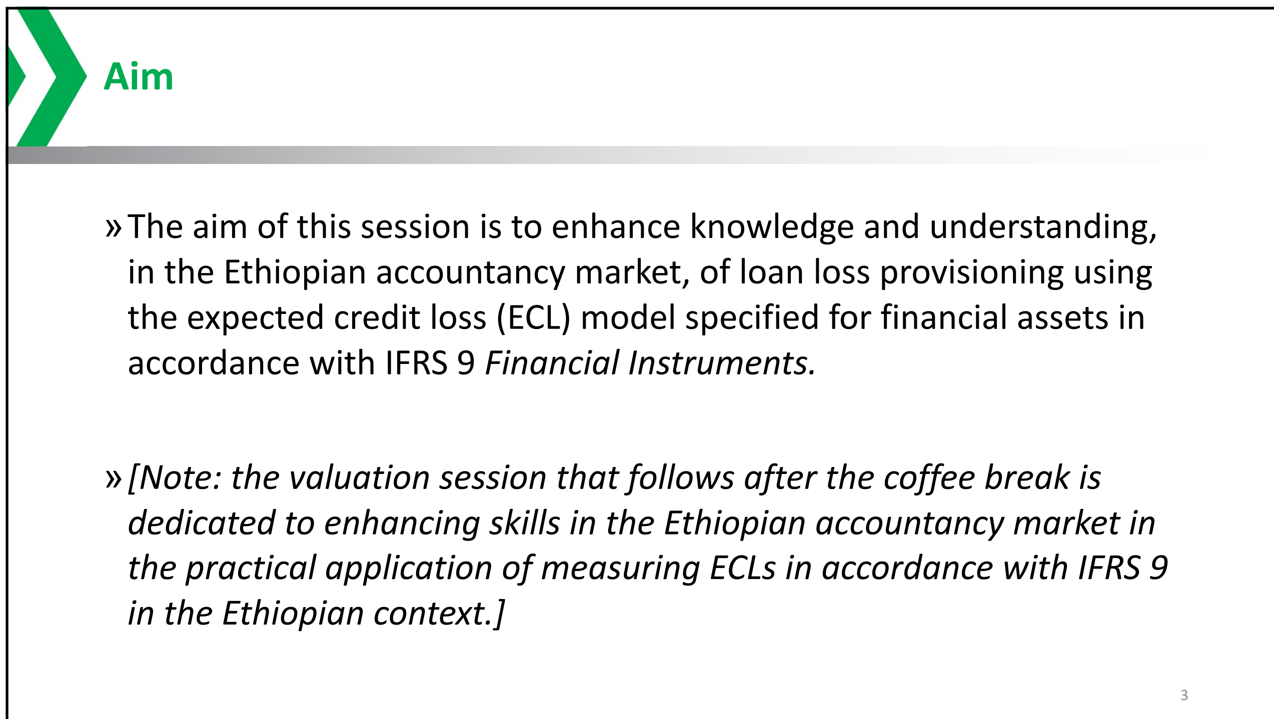

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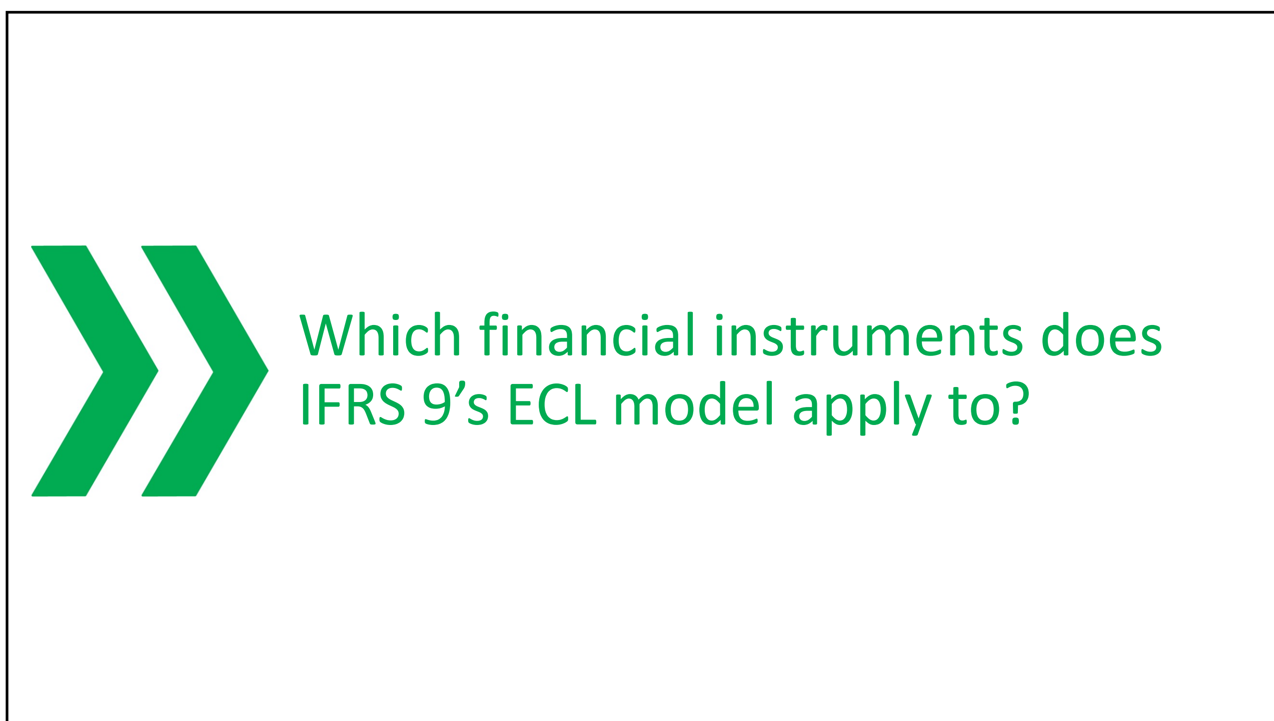

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Which financial instruments does IFRS 9's ECL model apply to?
Summary of class discussion

IFRS Accounting Standard	Item / measurement model
IFRS 9 *Financial Instruments*	• Amortised cost • FVOCI 'debt instrument' • Qualifying financial guarantee contracts • Otherwise unrecognised commitments to lend
IFRS 15 *Revenue From Contracts with Customers*	Contract assets and contract receivables
IFRS 16 *Leases*	Lessor's net investment in the lease (amortised cost)

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IFRS 9: asset classification and measurement
ECL model?

	Business model = hold to collect	Business model = hold to collect and sell	Other business models (eg held for trading)	**FVPL option** available to avoid an **accounting mismatch**	**FVOCI option** available for **equity** not held for trading
Cash flows: solely payments of principal and interest (SPPI)	Amortised cost (AC)	FV through other comprehensive income (OCI) (but with AC in PL)	FVPL	FVPL	
Other types of cash flows	Fair value (FV) through profit or loss (PL)	FVPL	FVPL		FVOCI

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Financial statement compliance review issues identified by JSE omissions from IFRS 9 ECL impairment testing

- Several issuers focussed **all their attention** on trade receivables and neglected their other **material** financial assets, leading to an **incomplete application of IFRS 9** and the disclosure provisions of IFRS 7.
  - Problem areas were in the context of loans receivable, loans to joint ventures / associates, contract assets and 'other receivables'.
  - This matter was compounded by the (inappropriate) aggregation of 'other receivables' into one total figure. (p14)

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019

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Financial statement compliance review issues identified by JSE omissions from IFRS 9 ECL impairment testing

- The fact that a receivable is owing by a subsidiary (or related) company does **not negate** the need to both perform a credit risk assessment and provide disclosure thereof. (**omission**)

Source: JSE, Reporting back on proactive monitoring of financial statements in 2021, p5

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Ethiopian context

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Ethiopian context: Which assets subject to IFRS 9's ECL model do Ethiopian companies have?

Summary of class discussion

1. IFRS 9 financial assets measured using:
   » Amortised cost (pass SPPI test and held to collect)
   » Fair value OCI debt instrument (pass SPPI test and held to collect and sell)
2. Aspect of the subsequent measurement **financial guarantee contracts** that are in the scope of IFRS 9 (ie IFRS 17 is not applied and **ECL** > the amount initially recognised less the cumulative amount of income recognised with IFRS 15 *Revenue From Contracts with Customers*.)
3. Unrecognised (otherwise 'off-balance sheet') **commitments to lend**, when **ECL** > the amount initially recognised less the cumulative amount of income recognised with IFRS 15 *Revenue From Contracts with Customers*.)

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Ethiopian context:
Example 1 Commercial Bank of Ethiopia

COMMERCIAL BANK OF ETHIOPIA
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE 2021
(IN ETHIOPIAN BIRR)

	Note	30 June 2021	30 June 2020
Assets			
Cash and cash equivalents	9	117,165,815,748	97,524,063,189
Debt and equity securities	10	552,453,627,251	445,140,387,326
Loans and advances to customers, net	11	279,001,679,067	232,510,755,443
Loans to micro-finance institutions, net	12	207,442,852	576,608,467
Receivables	13	7,799,402,955	8,904,265,586
Investments in associates	14	277,125,422	211,041,876
Non-current assets held for sale	15	935,486,774	1,030,518,314
Total assets		**991,319,048,071**	**819,278,822,786**

Note 4 Significant Accounting Policies… (c) Financial Assets and Financial Liabilities… (viii) Impairment The Group recognises loss allowances for ECL on the following financial instruments that are not measured at FVTPL: • Financial assets that are debt instruments; • Lease receivables; • Financial guarantee contracts issued; and • Loan commitments issued.

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Ethiopian context
Example 1 Commercial Bank of Ethiopia: Extract from Notes to the Consolidated Financial Statements 30 June 2021

(22) PROVISIONS

	Bonuses	Cash Prize Award	Legal	Unutilized O/D,LC and Guarantee	Total
Balances at 30 June 2019	548,285,021	-	64,916,278	48,828,844	662,030,144
Increases (decrease) recorded in income	525,035,191	116,563,214	80,950,417	5,380,191	727,929,013
Balances at 30 June 2020	**1,073,320,212**	**116,563,214**	**145,866,695**	**54,209,036**	**1,389,959,157**
Increases (decrease) recorded in income	1,141,551,353	122,891,273	(10,002,174)	67,894,171	1,322,334,624
Provisions used during the year	(1,065,203,434)	(116,563,214)	(2,516,643)	-	(1,184,283,291)
Balances at 30 June 2021	**1,149,668,131**	**122,891,273**	**133,347,878**	**122,103,206**	**1,528,010,488**

Note 4 Significant Accounting Policies… (c) Financial Assets and Financial Liabilities… (viii) Impairment The Group recognises loss allowances for ECL on the following financial instruments that are not measured at FVTPL: • Financial assets that are debt instruments; • Lease receivables; • Financial guarantee contracts issued; and • Loan commitments issued.

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Ethiopian context:
Example 2 Ethiopian Airlines Group

ETHIOPIAN AIRLINES GROUP
STATEMENT OF FINANCIAL POSITION
AS of 30 JUNE 2021

	Notes	Birr	2020 Birr
ASSETS			
NON-CURRENT ASSETS			
Property, plant and equipment	2(f),(g),9	255,882,476,143	208,039,709,357
Intangible Assets	2(h),(g),10	250,195,036	208,274,212
Right of use assets	2(c)(d),29A	123,234,070,922	101,660,545,066
Investment in associates	2(q),11	282,667,596	679,621,685
Standing deposits	13	16,086,242,811	14,440,967,183
Other loan receivables	2(j),14	524,158,491	485,326,884
		396,259,810,999	**325,514,444,387**
CURRENT ASSETS			
Stock	2(p),15	7,769,012,608	6,514,499,341
Trade and other receiveables	2(k),16	30,954,905,930	19,128,121,173
Short term investments	17	1,144,878	1,679,810,839
Cash and cash equivalents	2(r),18	35,101,311,627	17,129,005,132
		73,826,375,043	**44,451,436,485**
TOTAL ASSETS		**470,086,186,042**	**369,965,880,872**

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Overview of IFRS 9’s ECLs model

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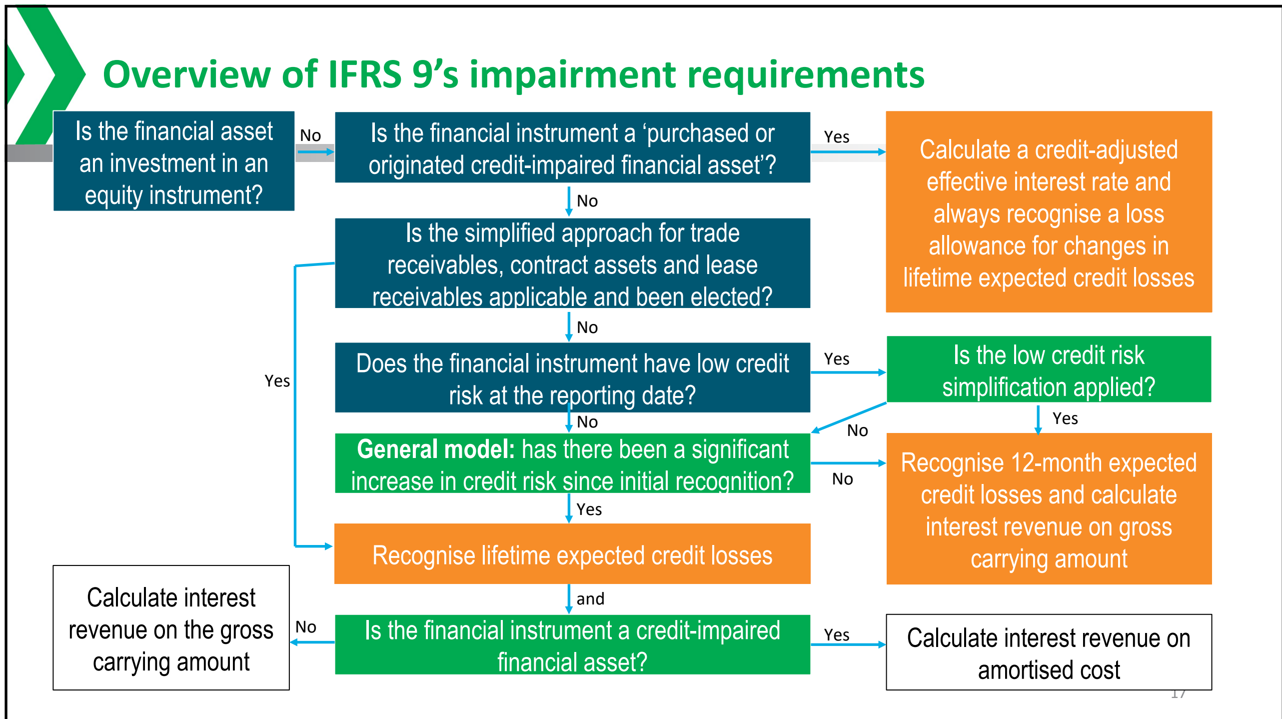

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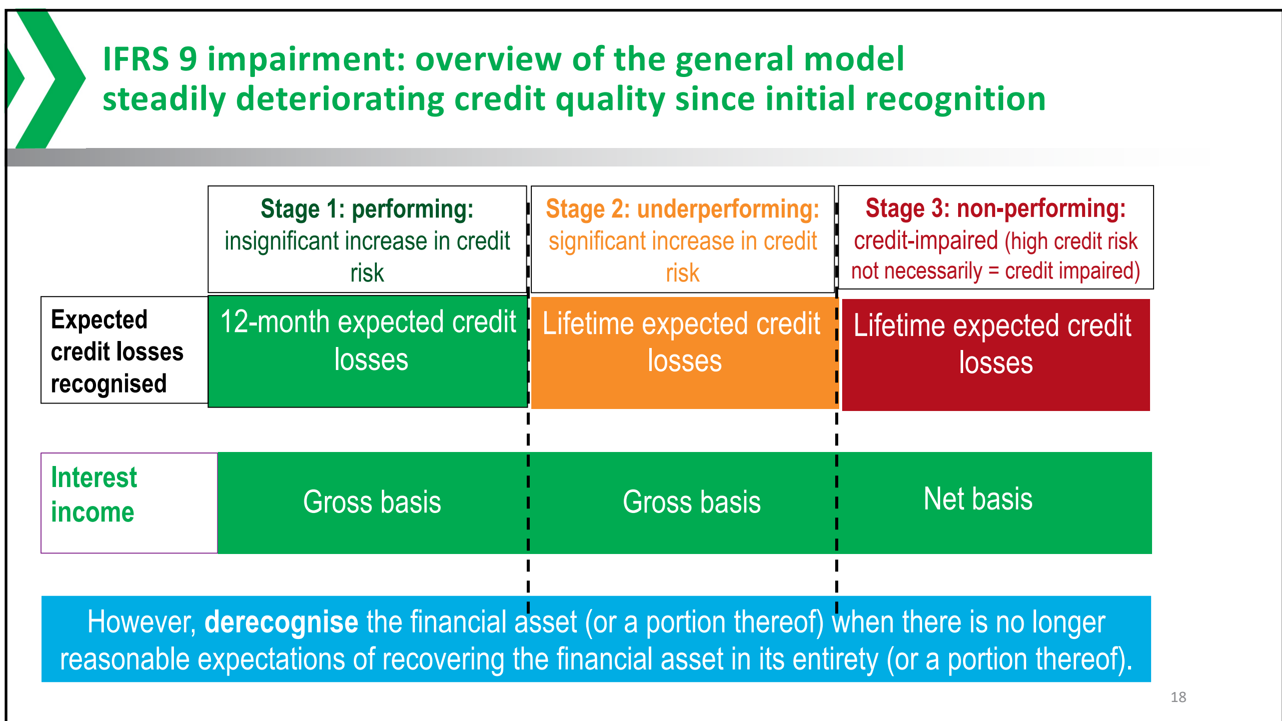

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IFRS 9 impairment: the general model classifications: performing, underperforming and non-performing
Summary of class discussion

Could a bank have different loans to the same counterparty included in different stages for impairment testing purposes (for example, 'Stage 1: performing' and 'Stage 2: underperforming')?

Choose one of: 1) Yes (if the loans were granted at different time, their credit risk at origination could be different); 2) No.

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IFRS 9: impairment some defined terms

» **Credit loss:** the difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets).

- » An entity shall **estimate cash flows** by **considering all contractual terms** of the financial instrument (for example, prepayment, extension, call and similar options) through the expected life of that financial instrument. The cash flows that are considered shall include cash flows from the **sale of collateral held** or other credit enhancements that are integral to the contractual terms.
- » There is a **presumption** that the expected life of a financial instrument can be estimated reliably. However, in those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument.

Source: Appendix A to IFRS 9

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IFRS 9: impairment
some defined terms (continued)

» **Expected credit losses:** the weighted average of credit losses with the respective risks of a default occurring as the weights.

» **12-month expected credit losses:** the portion of 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.

» **Lifetime expected credit losses:** the expected credit losses that result from all possible default events over the expected life of a financial instrument.

  » Note: **default events** are not defined in IFRS 9. An entity must define default for itself consistently with its internal credit risk management taking account of qualitative indicators and a rebuttable 90-day past due quantitative limit.

Source: Appendix A to IFRS 9

IFRS 9: impairment
some defined terms (continued)

Credit-impaired financial asset: when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred, including observable data about the following events in isolation or in combination:

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**.

Source: Appendix A to IFRS 9

IFRS 9's General ECL Model: Step 1 assessing whether a significant increase in credit risk has occurred

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Impairment: the general model examples of factors to consider when assessing for a significant increase in risk

- Significant change in what would charge for credit risk now because of changes in credit risk since initial recognition
- Changes in external market indicators of credit risk eg CDS levels for obligor
- Actual or expected change in internal or external credit rating
- Actual or expected increase in the risk of default on another facility with the same obligor
- An actual or expected significant change in the operating results of a borrower
- Changes in how the bank manages the credit risk on the instrument
- Past due information, including the 30 days past due rebuttable presumption

Source: paragraph B5.5.17 of IFRS 9

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Regulatory case studies: significant increase in credit risk

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Financial statement compliance review issues identified by FRC (UK) Banks – Impairment: staging and credit risk profile

Summary of class discussion

Is each bank's disclosure below about the factors considered in its assessment of whether there has been a significant increase in credit risk (a key judgement): 1) inadequate; or 2) adequate?

A. **Bank A** states that loans are in default if 90 days past due but does not elaborate if there were other factors which result in an asset being classified as in default. 1) inadequate! Boilerplate!

B. **Bank B** refers to both qualitative and quantitative indicators of whether there has been a significant increase in credit risk but did not provide details of what these indicators are. 1) inadequate! Boilerplate!

C. **Bank C** refers to the low credit risk exception but does not make it clear if it has applied that practical expedient. 1) inadequate! Boilerplate!

Source: FRC (UK), IFRS 9 Thematic Review: Review of Disclosures in the First Year of Application (2019), p13

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IFRS 9's General ECL Model: Step 2: measuring expected credit losses

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IFRS 9 impairment: the general model measuring expected credit losses (ECLs)

- ECLs are defined (Appendix A of IFRS 9) as the weighted average of credit losses with the respective risks of a default occurring as the weights.
- A credit loss is the present value of the **expected cash shortfalls**, ie the difference between:
  - the contractual cash flows that are due to an entity under the contract; and
  - the cash flows that the entity expects to receive.
- In other words, ECLs are a probability-weighted estimate of credit losses (ie the present value of all cash shortfalls) over the expected life of the financial instrument.
- However, **cash shortfalls are identified differently** for Stage 1 loans (ie performing loans) and loans at other stages (ie Stage 2 underperforming and Stage 3 non-performing loans)

Source: paragraphs 5.5.17, 5.5.19, B5.5.12 and B5.5.29 to B5.5.55 of IFRS 9

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IFRS 9 impairment: the general model measuring expected credit losses (ECLs) (continued)

- In particular:
  - For 'Stage 1 performing loans' that use **12-month ECLs,** cash shortfalls are identified as the proportion of lifetime cash shortfalls resulting only from default events that are possible in the ensuing 12 months;
  - For **lifetime ECLs**, cash shortfalls are identified as resulting from default events that are possible over the expected lifetime of the financial instrument.

Note: default events are not defined in IFRS 9. An entity must define default for itself consistently with its internal credit risk management taking account of qualitative indicators and a rebuttable 90-day past due quantitative limit.

Source: paragraphs 5.5.17, 5.5.19, B5.5.12 and B5.5.29 to B5.5.55 of IFRS 9

IFRS 9 impairment: the general model measuring expected credit losses (ECLs) (continued)

- The maximum period to consider when measuring ECLs is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.
  - For example, take account of **expected prepayments on mortgages**
  - However, note that there are different rules for revolving credit facilities (for example, **bank overdrafts**) that provide for consideration of a longer position (but judgements needed to determine: (i) when to start assessing for significant increases in credit risk; and (ii) what is the appropriate period of future period of exposure to credit risk). Three factors specified in IFRS 9. Note: in making the judgement, take account of credit risk management actions only to the extent that they are expected to reduce or remove an undrawn facility.

Source: paragraphs 5.5.17, 5.5.19, B5.5.12 and B5.5.29 to B5.5.55 of IFRS 9

IFRS 9 impairment: the general model measuring expected credit losses (ECLs) (continued)

- The estimate of expected cash **shortfalls reflects the cash flows expected from collateral** and other credit enhancements that are part of the contractual terms and are not recognised separately.
  - expected cash shortfalls on a collateralised financial instrument reflects the probability of a foreclosure and the cash flows that would result from it (including any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract).

Source: paragraphs 5.5.17, 5.5.19, B5.5.12 and B5.5.29 to B5.5.55 of IFRS 9

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Financial statement compliance review issues identified by FRC (UK) *Summary of class discussion*

'Application of lifetime

Expected credit loss is estimated based on the shorter of the expected life and the maximum contractual period for which the Group is exposed to credit risk. For Retail Banking credit cards and Corporate & Institutional Banking overdraft facilities, however, the Group does not typically enforce the contractual period. As a result, for these instruments, the lifetime of the exposure is based on the period the Group is exposed to credit risk. This period has been determined by reference to expected behavioural life of the exposure and the extent to which credit risk management actions curtail the period of exposure. For credit cards, this has resulted in an average life of between 3 and 10 years across our footprint markets. Overdraft facilities have a 22-month lifetime.' Standard Chartered plc, p137

Is the company's explanation of how the lifetime of revolving credit facilities is determined: 1) inadequate; or 2) adequate?

Source: FRC (UK), IFRS 9 Thematic Review: Review of Disclosures in the First Year of Application (2019), p13

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IFRS 9 impairment: the general model
measuring expected credit losses (ECLs)

» IFRS 9 does **not prescribe a single method** for measuring ECLs.

» However, must measure ECLs in a way that reflects:

- » an **unbiased** and **probability-weighted** amount that is determined by evaluating a range of possible outcomes (for example, see next slides);
- » the **time value of money** (for example, see slides after next); and
- » **reasonable and supportable information** available without undue cost or effort at the reporting date about **past events, current conditions and forecasts** of future economic conditions. For example: borrower-specific factors (like changes in operating results of borrower, technological advances that affect future operations, changes in collateral supporting obligation) and macroeconomic factors (like unemployment rates, house price indexes, GDP, household debt ratios).

Source: paragraphs 5.5.17, 5.5.19, B5.5.12 and B5.5.29 to B5.5.55 and BC5.266 of IFRS 9

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IFRS 9 impairment: the general model
example: using multiple scenarios to measure ECLs

On 31/12/2023 Bank pays ETB1 billion for a portfolio of performing loans. Bank develops three scenarios for the effect of the unemployment rate on the ECLs for its portfolio of loans:

» **Scenario 1 bullish:** 30% probability of 2% unemployment

- » 12-month probability of default (PD) = 5%; loss given default (LGD) = 40%

» **Scenario 2 most likely outcome:** 50% probability of 3% unemployment

- » 12-month PD = 10%; LGD = 50%

» **Scenario 3 bearish:** 20% probability of 4% unemployment

- » 12-month PD = 20%; LGD = 70%

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IFRS 9 impairment: the general model example: using multiple scenarios to measure ECLs (continued)

Summary of class discussion

At 31/12/2023 Bank must measure the loss allowance at? Choose one of:

1) **Scenario 1 bullish:** ETB20 million (ie ETB1 billion EAD x 5% 12-month PD x 40% LGD)
2) **Scenario 2 most likely outcome:** ETB50 million (ie ETB1 billion EAD x 10% 12-month PD x 50% LGD)
3) **Scenario 3 bearish:** ETB140 million (ie ETB1 billion EAD x 20% 12-month PD x 70% LGD)
4) **Weighted average:** ETB59 million (ie 30% x ETB20 million Scenario 1 + 50% x ETB50 million Scenario 2 + 20% x ETB140 million)

Reference: paragraphs 5.5.17 to 5.5.19, B5.5.28, B5.5.29 and B5.5.43 of IFRS 9

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Good disclosure example: FRC (UK) identified Banks – Impairment: alternative economic scenarios

Examples of good disclosure…

Metro Bank plc presented the economic variable assumptions for the initial four year projection period as at 31 December 2018 and 1 January 2018:

Economic variable assumptions

The period-end assumptions used for the ECL estimate as at 31 December 2018 are as follows:

	2019	2020	2021	2022
Interest rates (%)	Base: 2.2% Upside: 2.1% Downside: 0.9% Brexit:0.5%	Base: 2.6% Upside: 3.1% Downside: 1.2% Brexit: 0.8%	Base: 2.8% Upside: 3.1% Downside: 1.4% Brexit: 0.9%	Base: 3.2% Upside: 3.5% Downside: 1.6% Brexit: 1.3%
UK unemployment (%)	Base: 4.6% Upside: 3.3% Downside: 6.2% Brexit: 6.7%	Base: 4.8% Upside: 3.4% Downside: 7.2% Brexit: 8.4%	Base: 5.0% Upside: 3.6% Downside: 7.3% Brexit: 8.5%	Base: 5.0% Upside: 3.0% Downside: 6.9% Brexit: 8.1%
UK house price index – % change year-on-year	Base: 1.9% Upside: 7.6% Downside: (5.3)% Brexit: (8.5)%	Base: 0.5% Upside: 4.5% Downside: (6.4)% Brexit: (11.1)%	Base: 1.2% Upside: 1.9% Downside: 0.0% Brexit: (1.7)%	Base: 1.9% Upside: 0.9% Downside: 3.7% Brexit: (4.3)%
UK GDP – % change year-on-year	Base: 1.6% Upside: 4.0% Downside: (1.9)% Brexit: (3.6)%	Base: 1.4% Upside: 2.1% Downside: 0.8% Brexit: (0.2)%	Base: 1.9% Upside: 1.9% Downside: 2.6% Brexit: 2.6%	Base: 1.8% Upside: 1.6% Downside: 2.0% Brexit: 2.3%

Source: FRC (UK), IFRS 9 Thematic Review: Review of Disclosures in the First Year of Application (2019), p19

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IFRS 9 impairment: the general model example: collateral and write-off portion of a loan

» On 01/01/2022 Bank advances a five-year loan to Borrower.

» Borrower's only business is a single coffee farm.

» Contractual terms of the loan:

- » 01/01/2022 bank pays ETB100 million to Borrower
- » 31/12/2026 Borrower pays ETB161.051 million to Bank
- » **Collateral:** in the event that Borrower defaults, ETB100 million of Bank's claim is secured by an exclusive and most senior claim against Borrower's head office building; the collateral does not extend to the accreted interest.

» In late 2022 the coffee price halves, significantly impacting Borrower's cash flows.

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IFRS 9 impairment: the general model example: collateral and write-off portion of a loan (continued)

Summary of class discussion

» At 31/12/2022 the gross carrying amount of the loan is ETB110 million and Bank assesses:

- » there to have been a significant increase in Borrower's credit risk
- » the lifetime probability of default (**PD**): to be 50%
- » loss given default (**LGD**):
  - » nil on the secured portion of the loan (because the gross carrying amount of the secured loan is covered more than two times by the fair value of the collateral); and
  - » 50% on the unsecured accreted interest.

At 31/12/2022 Bank must measure the loss allowance at? Choose one of:

1) ETB2.5 million (ie ETB10 million x 50% PD x 50% LGD)
2) ETB25 million (ie ETB100 million x 50% PD x 50% LGD)
3) ETB27.5 million (ie ETB110 million x 50% PD x 50% LGD)
4) another amount

Reference: paragraphs 5.5.17 to 5.5.19, B5.5.28, B5.5.29 and B5.5.43 of IFRS 9

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IFRS 9 impairment: the general model example: collateral and write-off portion of a loan (continued)
Summary of class discussion

» In 2023 Borrower's coffee plants suffer catastrophic drought and die. Consequently, in late 2023 Borrower files for bankruptcy.

» At 31/12/2023:

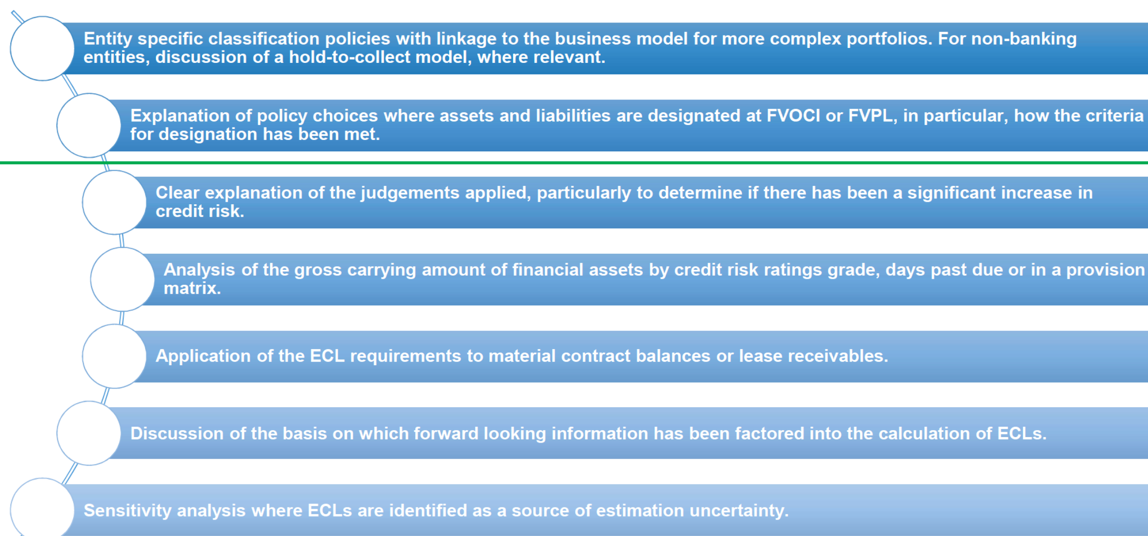
- » Borrower's unsecured creditors are expected to receive nothing in settlement of their claims.
- » The fair value of Borrower's head office building is reliably measured at ETB200 million.

At 31/12/2023 Bank must? Choose one of:

1) write-off (ie derecognise) the entire loan (ie GCA = nil; loss allowance = nil)
2) continue to recognise both the secured and the unsecured portions of the loan (ie GCA = ETB121 million; loss allowance = ETB21 million)
3) write-off (ie derecognise) the unsecured portion of the loan and continue to recognise the secured portion of the loan (ie GCA = ETB100 million; loss allowance = expected time value of money effect)

Reference: paragraphs 5.4.4 and B5.4.9 of IFRS 9

Financial statement compliance review areas of ongoing focus FRC (UK)



Source: FRC (UK) IFRS 9 Thematic Review: Review of Disclosures in the First Year of Application, p24

Financial statement compliance review issues identified by JSE financial instruments

- The **biggest area of** weak disclosure related to expected credit loss (ECL) calculations in terms of the **omission of** (p10):
  - ECL assessments being carried out on 'other receivables';
  - disclosing *entity specific* inputs and assumptions;
  - details that demonstrated how forward looking information had been incorporated into calculations; and
  - information that explained how changes in the gross carrying amount of receivables contributed to changes in the ECL.

Source: JSE, Reporting back on proactive monitoring of financial statements in 2021

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Financial statement compliance review issues identified by JSE impairment testing of related party financial assets

- Amounts due from related parties (or inter-group receivables) was a common asset class for which ECL disclosures were found lacking in sufficient detail (or boilerplate).
- For receivables that are payable on demand, the disclosure in the company AFS should include an assessment of the liquid assets (including restrictions thereon) of the underlying subsidiary's (IFRS 7: 35G).
- The fact that a receivable is owing by a subsidiary (or **related) company** does not negate the need to both perform a credit risk assessment and provide disclosure thereof. (**omission**)

Source: JSE, Reporting back on proactive monitoring of financial statements in 2021, p5

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Financial statement compliance review issues identified by JSE

» Must **explain the inputs, assumptions and estimation techniques** used in recognising the ECL allowance, including how **forward-looking information** has been incorporated into the determination and how macroeconomic information was used (paragraph 35G of IFRS 7).

» JSE found many examples of **generic disclosure**. For example:

"future economic conditions and the impact on our client base are one of the inputs used to determine the probability of default used in our ECL calculation." (example 5, p17, 2019)

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019 75

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Financial statement compliance review issues identified JSE identified **good practice example**: entity specific forward-looking information (IFRS 7.35G read in the context of IFRS 7.35B) **(1)**

Economic variable assumptions

The most significant period-end assumptions used for the ECL estimate as at 31 December 2018 are set out below. The scenarios "base", "bear" and "bull" were assigned weightings of 60%, 25% and 15% respectively, and used for all categories within the company's mortgage portfolio.

2018	Base	Bear	Bull
Interest Rates	0.25%-0.50% increase over the next 12 months, followed by a further increase of between 0.25%-0.50% over the period 2019-2020	0.75%-1.00% increase over the next 12 months, followed by a stabilisation thereafter	No increase in rates over the 12-month period following the reporting date, with an increase of 0.50%-0.75% over the period 2019-2020
Consumer Price Inflation	Averaging 5% in 2018 increasing to around 5.5% in 2019 and 2020	Breaches upper end of target band (6%) in 2019 and falling back below thereafter	Averaging 5% in 2018 increasing to around 5.5% in 2019 and 2020
Domestic GDP	1% in 2018 increasing to close to 2% thereafter	0.5% in 2018 increasing slowly thereafter	1.2% in 2018 and on an increasing path towards 3% thereafter
Mortgage Extension levels	Inflationary growth through forecast period	Nominal contraction in mortgage extension levels	Growth exceeding inflation through forecast period
House Price Index	Below CPI in 2018 followed by an improvement thereafter	Negative nominal house price growth in 2019	House price inflation above CPI from 2019 onwards

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019 (p16)

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Financial statement compliance review issues identified JSE identified **good practice example**: entity specific forward-looking information (IFRS 7.35G read in the context of IFRS 7.35B) **(2)**

The AFS then included further scenarios (i.e. illustrating estimation uncertainty) as to how changes in these weightings could impact their calculation.

Set out below are the changes to the ECL as at 31 December 2018 that would result from reasonably possible changes in these scenario weightings from the actual weightings used by the company in measuring ECL at the reporting date:

	Base	Bear	Bull
Upward Stress	0%	100%	0%
Actual weightings	60%	25%	15%
Downward Stress	0%	0%	100%

The impact of the "stress" adjustments on the ECL allowance is reported in the table below:

	2018	2017
	R'000s	R'000s
Upward Stress	4,387	N/A
ECL based on actual weightings	4,240	N/A
Downward Stress	4,118	N/A

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019 (p17)

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IFRS 9's General ECL Model: **practical expedients**

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IFRS 9: impairment
simplifications and exceptions to the general model

» Low credit risk
  » choice to assume no significant increase in credit risk (remain in stage 1)

» 30 days past due backstop
  » **rebuttable presumption** => significant increase in credit risk (move to stage 2)

» 90 days past due backstop
  » **rebuttable presumption** => default has occurred (move to stage 3)

Source: paragraphs 5.5.10, 5.5.11 and B5.5.37 of IFRS 9

» Lifetime ECL must be recognised for trade receivables and contract assets that do not contain a significant financing component

» Accounting policy choice to always recognise lifetime ECL for:
  » trade receivables assets that contain a significant financing component
  » contract assets that contain a significant financing component
  » lease receivables

Source: paragraphs 5.5.15 and 5.5.16 of IFRS 9

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Impairment: the general model
default
Summary of class discussion

The purpose of the '90 days past due' rebuttable presumption is?
Choose one of:

1) To ensure uniformity in defining default
2) To delay the default event until the financial asset becomes 90 days past due
3) A back-stop: to ensure that default is not defined as later than 90 days past due without reasonable and supportable information to the contrary

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IFRS 9 impairment: simplifications and exceptions low credit risk (**investment grade**) exception

- If a financial asset is objectively determined from the perspective of market participant to be low credit risk (ie a low risk of default because the investment is, for example, investment grade) and entity can **assume that the instrument's credit risk has not increased** significantly since initial recognition.
  - can choose to apply this simplification on an instrument-by-instrument basis
- When an instrument no longer has a low credit risk, the exception no longer applies, and the entity entity reverts to the general requirements for assessing whether there has been a significant increase in credit risk since initial recognition.

Source: paragraphs 5.5.10 and B5.5.22 to B5.5.24 of IFRS 9

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IFRS 9 impairment: simplifications and exceptions purchased or originated credit-impaired financial assets

- from initial recognition, apply the credit-adjusted effective interest rate to the amortised cost of the financial asset
  - (credit-adjusted effective interest rate is the rate that exactly discounts the estimated future cash payments or receipts through the expected life of the financial asset (ie the estimated contractual cash flows reduced by lifetime expected losses) to the amortised cost of a financial asset that is a purchased or originated credit-impaired financial asset)
- at the reporting date:
  - recognise cumulative changes in lifetime expected credit losses since initial recognition as a loss allowance
  - recognise in profit or loss the amount of the change in lifetime expected credit losses as an impairment (recognise favourable changes in lifetime expected credit losses as an impairment gain, even if the lifetime expected credit losses are less than the amount of expected credit losses that were included in the estimated cash flows on initial recognition).

Source: paragraphs 5.4.1(a), 5.5.13, 5.5.14 and Appendix A to IFRS 9

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IFRS 9 impairment: a non-financial institution practical expedient example: provision matrix (all ETB amounts in millions)
What's the amount of Manufacturer's ECL at 31/12/2022?

- Manufacturer sells goods on 30 days interest free credit to a large number of small clients in the same geographic location. Categorising trade receivables by common risk characteristics manufacturer appropriately uses a provision matrix to determine the expected credit losses for the portfolio.
- At 31/12/2022, on the basis of its **historical observed default rates** **adjusted for relevant forward-looking information**, Manufacturer estimates the following default rates for each of its two portfolios of trade receivables by aging category.

At 31/12/2022	Current	1–30 days past due	31–60 days past due	61–90 days past due	>90 days past due
Default rate Group A	0.5%	2%	5%	8%	10%
Receivables Group A	ETB80,000,000	ETB9,000,000	ETB6,000,000	ETB4,000,000	ETB1,000,000
Default rate Group B	0.1%	0.25%	1%	3%	5%
Receivables Group B	ETB19,000,000	ETB500,000	ETB250,000	ETB150,000	ETB100,000

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IFRS 9 impairment: a non-financial institution practical expedient example: provision matrix (all ETB amounts in millions)
Summary of class discussion

	Receivables Group A			Receivables Group B		
	Gross carrying amount	Default rate	Lifetime expected credit loss allowance	Gross carrying amount	Default rate	Lifetime expected credit loss allowance
Current	80,000,000	0.5%	400,000	19,000,000	0.1%	19,000
1–30 days past due	9,000,000	2%	180,000	500,000	0.25%	1,250
31–60 days past due	6,000,000	5%	300,000	250,000	1%	2,500
61–90 days past due	4,000,000	8%	320,000	150,000	3%	4,500
>90 days past due	1,000,000	10%	100,000	100,000	5%	5,000
	100,000,000		**1,300,000**	**20,000,000**		**32,250**

Source: paragraphs 5.5.15, **B5.5.35**, B5.5.51 and B5.5.52 of IFRS 9

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Financial statement compliance review issues identified by JSE
Summary of class discussion

1 JANUARY 2018
Application of provision matrix

	Total R	Current R	30 R	60 R	90 R	120 R	150 R	180 R
	Aging bucket per age analyses (days)							
Gross receivables (excluding VAT)	106 412 011	39 121 651	37 300 112	10 931 459	3 727 581	2 069 486	1 576 454	11 685 267
Adjusted loss ratio (%)		1.3	3.1	9.2	15.4	28.8	48.7	93.8
	15 591 060	524 134	1 161 794	1 006 044	575 472	596 318	768 016	10 959 282

Adjusted historical loss ratio

	Current %	30 %	60 %	90 %	120 %	150 %	180 %
	Aging bucket per age analyses (days)						
Historical loss ratio*	1.0	2.2	6.6	11.0	20.6	34.8	67.0
Forward-looking adjustment**	0.4	0.9	2.6	4.4	8.2	13.9	26.8
Adjusted historical loss ratio	1.3	3.1	9.2	15.4	28.8	48.7	93.8

Historical loss ratios were adjusted for forward-looking information by increasing these ratios by a factor of 40%. This factor was determined through consideration of the business confidence index and other macroeconomic indicators and calculating a probability-weighted range of possible outcomes. The historical loss ratios and the forward-looking adjustment of these ratios used at the date of initial application of IFRS 9 were unchanged at year-end. The Group does not consider that any significant change in credit conditions occurred.

Questions:

1. What's good?
   Disclosure of the effect of forward-looking information (p17)
2. What needs improving?
   Reference to 'other macroeconomic indicators' is too generic.

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019, Example 6 (p18)

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Financial statement compliance review issues identified by JSE

» Must provide both **quantitative and qualitative** information to explain how **significant changes in the gross carrying amount** of financial instruments during the period contributed to changes in the ECL allowance (paragraph 35I of IFRS 7).

» JSE found many examples where **only one aspect** of this information (i.e. either quantitative or qualitative information) was considered. (p19)

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019

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Financial statement compliance review issues identified by JSE
What do you think (regarding paragraph 35I of IFRS 7)?

2018

Groups	Current	30 days	60 days	90 days	120+ days	Total
Gross trade receivables	9 650 659	1 475 850	518 394	354 062	2 259 796	14 258 761
Allowance for credit loss	(546 324)	-	-	-	(294 553)	(840 877)
	9 104 335	**1 475 850**	**518 394**	**354 062**	**1 965 243**	**13 417 884**

2017

Groups	Current	30 days	60 days	90 days	120+ days	Total
Gross trade receivables	6 132 264	1 359 834	148 478	69 224	891 558	8 601 358
Allowance for bad debts	-	-	-	-	(68 798)	(68 798)
	6 132 264	**1 359 834**	**148 478**	**69 224**	**822 760**	**8 532 560**

Question: what needs improving?

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019, Example 7 (p19)

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Financial statement compliance review issues identified by JSE
Summary of class discussion

» **Question: what needs improving?** Qualitative explanations must be provided explaining how the significant changes in the gross carrying amount of financial instruments during the period contributed to changes in the ECL allowance. In particular those disclosures should address:

- » why is the ECL allowance at 5.6% for the current receivables compared to zero in 2017
- » why is there no ECL allowance for the 30-days; 60-days; and 90 days brackets yet there is an ECL allowance for the current bracket;
- » why has the percentage ECL allowance for the oldest bracket jumped to 13% (2017-7.7%);
- » why is the older bracket of gross trade receivables at 15.8% of the total trade receivables (2017-10.3%); and
- » how material are the trade receivables in the oldest bracket that are say 6 months or older.

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019, Example 7 (p19 & 20)

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y FRC (UK)

Case Study[8]

Impairment of financial assets

The Group measures the loss allowance at an amount equal to lifetime expected credit losses for all trade receivables.

Intercompany receivables

Included in loans to subsidiary undertakings is an £85 million unsecured subordinated loan to TradeCo Limited. The loan was advanced on 27 September 2012, at a fixed rate of 9.5%, with a repayment date of 27 September 2032.

TradeCo Limited has cash and cash equivalents of £614.7 million and borrowings of £240.0 million. Based on its liquidity and expected cash generation, there has been no significant increase in credit risk and the expected 12 months credit loss for TradeCo Limited trade and other receivables is not considered to be significant. As a result, no impairment has been recorded for amounts owed by Group companies on the grounds of materiality.

Receivables excluding trade receivables

The Group's credit risk is primarily attributable to its trade receivables and the risk of customer default. Credit risk also arises on accrued income, which primarily arises where services have been provided but the amount has yet to be invoiced on to the client. The accrued income balance is short term in nature, with an average ageing of 21 days, and relates to clients with a strong credit history. Therefore, the expected credit losses on receivables, other than trade receivables, were negligible.

Concentrations of credit risk

The Group has no significant concentrations of credit risk. The trade receivables balance is spread across a large number of different customers with no single debtor representing more than 5% of the total balance due (last year: 6%).

However, the Group's debtors include counterparties in sectors that have increased exposure to Government-imposed Covid-19 lockdown restrictions, which may increase the risk of non-payment. The proportions of the trade receivables balance relating to these sectors are: Retail 12%, Leisure 5%, and Office Space 18%.

Question: what do you believe to be good about this disclosure?

Source: FRC (UK), Annual Review of Corporate Reporting 2020/21, p19

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Financial statement compliance review issues identified by FRC (UK)

Summary of class discussion

- The disclosures explain that the simplification available under paragraph 5.5.15 of IFRS 9 has been applied to all trade receivables.
- Disclosure explains how ECLs have been assessed for intercompany receivables.
- The company confirmed that it considered impairment of receivables other than trade receivables, and provided specific detail in respect of the accrued income balance.
- The company provided a helpful indication that there is no significant concentration of credit risk to individual customers.
- The company highlights its credit exposure to certain sectors which may result in increased credit risk as a result of the economic impact of Covid-19.

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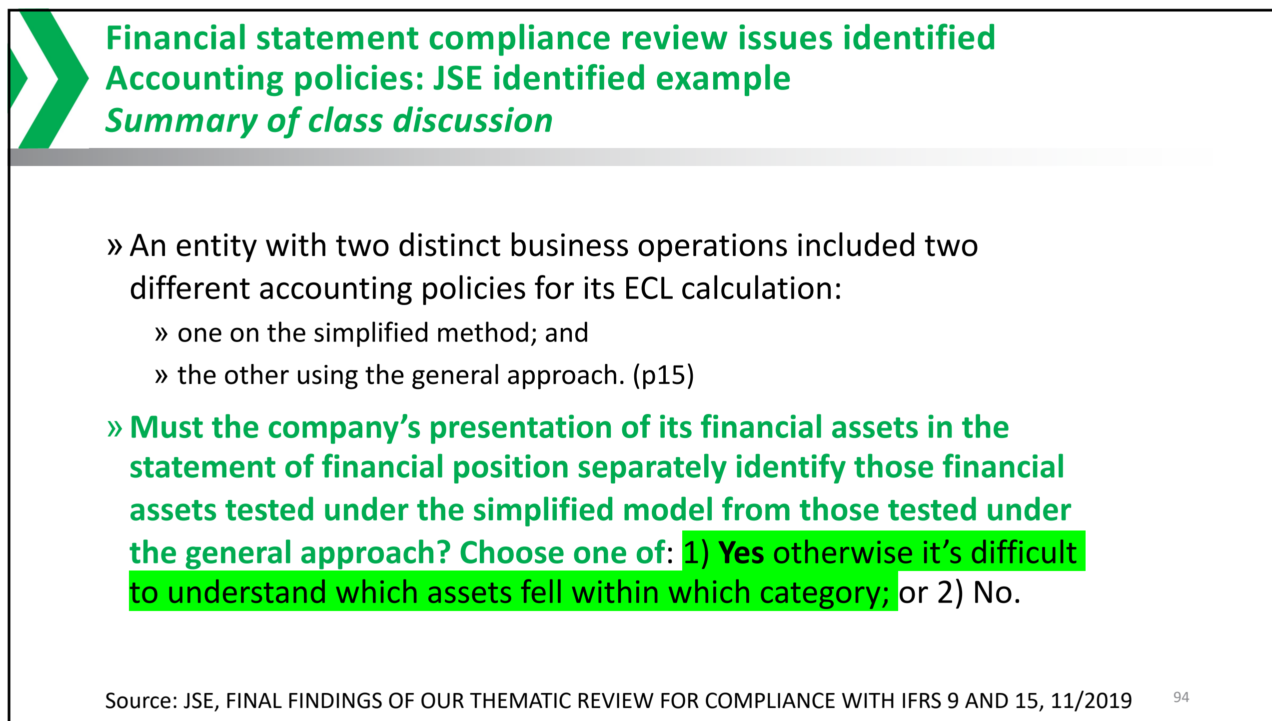

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Financial statement compliance review issues identified
IFRS 9 most significant judgements and estimates

- **Generic disclosures** about **most significant judgements** (paragraphs 122-124 of IAS 1) and estimation uncertainty (paragraphs 125-129 of IAS 1) are **inadequate,** also in terms of the various requirements of IFRS 7—**especially regarding disclosures of the assumptions relating to ECLs**. (p15)

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019

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Financial statement compliance review issues identified
IFRS 9 most significant judgements and estimates

- A **useful test** to assess whether something is generic or entity specific is as follows (p16):
  - copy those disclosures into the AFS of any other issuer operating in that sector;
  - determine how they 'read' within the context of those AFS;
  - is there is any relevant differentiating characteristics between the way that it reads in the context of your AFS compared to when it is read in the context of the other issuer's AFS;
  - if the answer is no, then the disclosures are likely to be generic.

Source: JSE, FINAL FINDINGS OF OUR THEMATIC REVIEW FOR COMPLIANCE WITH IFRS 9 AND 15, 11/2019

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Financial statement compliance review issues identified FRC (UK) identified good practice example 1: ECL key source of estimation uncertainty (paragraphs 125-129 of IAS 1)

1. Basis of preparation and significant accounting policies continued

The weightings applied to each scenario are considered to represent a significant accounting estimate. We have performed an assessment of the impact on the ECL if each of the Baseline, Upside, Downside and Hard Brexit scenarios were applied to the ECL calculation using a 100% weighting (that is, ignoring all other scenarios in each case):

Scenario	ECL (£million)	Variance to reported weighted ECL at 31 December 2018
Weighted	33.8	–
Baseline	31.6	(7%)
Upside	26.5	(22%)
Downside	40.4	19%
Hard Brexit	49.4	46%

We note that the sensitivities disclosed above represent example scenarios and may not represent actual scenarios which occur in the future. If one of these scenarios did arise then at that time the ECL would not equal the amount disclosed above, as the amounts disclosed do not take account of the alternative possible scenarios which would be considered at that time. We also note that the sensitivities disclosed above do not take into account movements in impairment stage allocations that would result under the different scenarios

Source: Metro Bank plc, p117; cited by FRC (UK) IFRS 9 Thematic Review: Review of Disclosures in the First Year of Application, p21 98

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Financial statement compliance review issues identified FRC (UK) identified good practice example 2: ECL key source of estimation uncertainty (paragraphs 125-129 of IAS 1)

To give an indication of the sensitivity of ECLs to different economic scenarios, the table below shows the ECL if 100% weighting is applied to the upside, central and downside scenarios.

Sensitivity analysis impact of multiple economic scenarios

	Upside scenario ECL	Central scenario ECL	Downside scenario ECL
4 April 2019	**£m**	**£m**	**£m**
Residential mortgages	**99**	**112**	**242**
Consumer banking	**381**	**383**	**400**
Commercial and other lending	**37**	**37**	**37**
Total	**517**	**532**	**679**
5 April 2018	£m	£m	£m
Residential mortgages	128	143	279
Consumer banking	350	352	374
Commercial and other lending	24	24	24
Total	502	519	677

The ECL for each scenario multiplied by the scenario probability will not reconcile to the final probability weighted ECL, since the stage allocation of loans varies in each scenario. In the probability weighted ECL, each loan is allocated to a discrete stage based on the weighted average PD under the economic scenarios. The impact of the severe downside scenario on impairment provisions is explained above.

Source: Nationwide Building Society, p202;
cited by FRC (UK) IFRS 9 Thematic Review: Review of Disclosures in the First Year of Application, p21 99

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