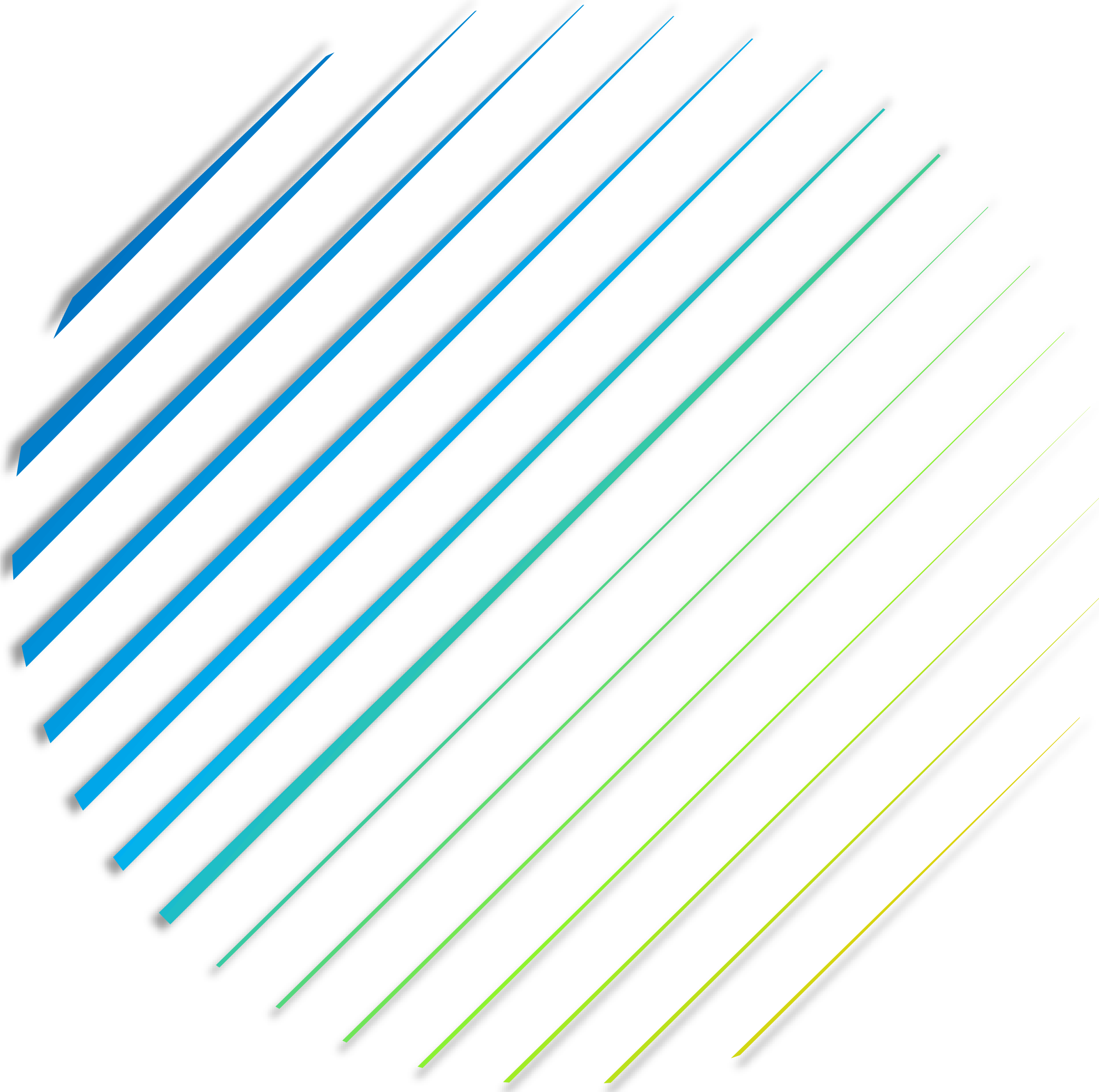
EXPECTED CREDIT LOSSES – IFRS 9

POCKET GUIDE



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INTRODUCTION

IFRS 9, Financial Instruments was introduced to improve the reporting and accounting of financial assets and liabilities. It replaced IAS 39 and rule-based approach to deal with financial instruments. It became effective for annual periods beginning on or after 1 January 2018 with earlier application permitted.

DIFFERENCE IN IFRS 9 AND IAS 39

Under IAS 39, credit loss of financial assets was recognized on a "incurred loss" basis which did not consider future risk and uncertainty. Resultantly, it delayed the recognition of credit losses until there is objective evidence of impairment. Only past events and current conditions were considered when determining the amount of impairment and different impairment models were used for different financial instruments that were subject to impairment testing.

However, IFRS 9 requires recognition of impairment losses on a forward-looking basis and uses an expected loss approach to the impairment of financial assets, which means that impairment loss is recognized before the occurrence of any credit event. These impairment losses are referred to as expected credit losses ('ECL').

Credit loss

Credit loss is 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, discounted at the original effective interest rate (EIR) or credit adjusted EIR.

It requires the entities to recognise impairment loss on:

- assets measured at amortized cost,
- assets measured at FVOCI,
- loan commitments (not at FVTPL),
- financial guarantee contracts (not at FVTPL),
- lease receivables (IFRS 16),
- contract assets (IFRS 15).

There are three approaches to impairment recognition as indicated below:

GENERAL APPROACH

This approach follows a three-stage model for recognizing impairment:

	Stage 1	Stage 2	Stage 3
Trigger	Initial recognition	Significant increase in credit risk	Credit-impaired
ECL	12-month ECL	Lifetime ECL	Lifetime ECL
Effective Interest rate (EIR)	EIR on gross carrying amount (w/o ECL)	EIR on gross carrying amount (w/o ECL)	EIR on amortised cost (with ECL)

Stage 1: 12-month ECL, expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date, is recorded on initial recognition using effective interest rate on gross carrying amount (without ECL).

Stage 2: Lifetime ECL, expected credit losses that result from all possible default events over the life of the financial instrument, is recorded when there is a significant increase in credit risk using effective interest rate on gross carrying amount (without ECL).

Stage 3: When the asset is credit impaired, then lifetime ECL is recorded using effective interest rate on amortized cost (with ECL).

An entity moves from 12-month to lifetime ECL when there is significant increase in credit risk in a financial instrument, contract asset or trade receivable without financing transaction as per IFRS 15.

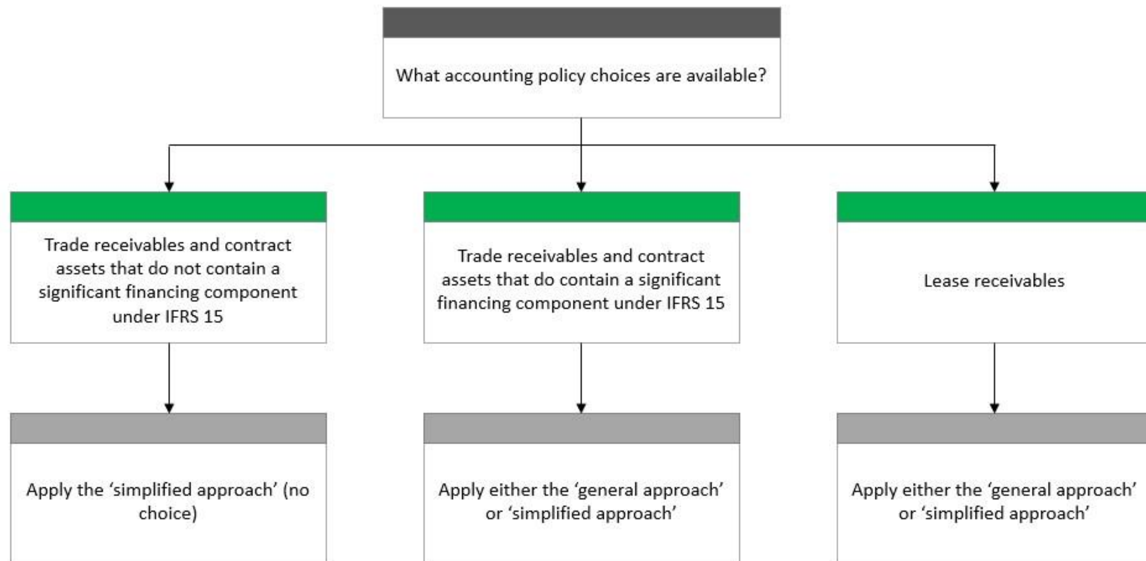
Credit risk is significantly increased when there is high risk of default. To achieve this, an entity compares the risk of a default occurring on the financial instrument at the reporting date with the risk of a default occurring on the financial instrument at the date of initial recognition. A rebuttable presumption is that credit risk has increased significantly when contractual payments are more than 30 days past due.

All the changes in the loss allowance are recorded in profit or loss account as impairment gain or loss.

SIMPLIFIED APPROACH

IFRS 9 allows the entities to use simplified approach and record lifetime credit loss from the date of initial recognition of a financial asset.

The table on the next page summarizes the available accounting policies:



IFRS 9 allows an entity to use a simplified "provision matrix" for calculating expected losses as a practical expedient (e.g., for trade receivables), if consistent with the general principles for measuring expected losses. The provision matrix is based on an entity's historical default rates over the expected life of the trade receivables and is adjusted for forward-looking estimates.

SPECIFIC APPROACH FOR PURCHASED OR CREDIT-IMPAIRED ASSETS

For financial assets that are purchased or originated credit-impaired because it has high credit risk, IFRS 9 requires entities to record lifetime expected credit since initial recognition and all subsequent changes to be recognised in profit or loss.

A financial asset is credit impaired when the occurrence of the events has significant impact on the expected future cash flows. It includes the observable data that has come to the attention of the holder of a financial asset about the following events:

- Significant financial difficulty of the issuer or borrower;
- A breach of contract, such as a default or past-due event;
- The lenders for economic or contractual reasons relating to the borrower's financial difficulty granted the borrower a concession that would not otherwise be considered;
- It is becoming probable that the borrower will enter bankruptcy or other financial reorganization;
- The disappearance of an active market for the financial asset because of financial difficulties; or
- The purchase or origination of a financial asset at a deep discount that reflects incurred credit losses.

Furthermore, IFRS 9 identifies that the measurement of ECL should reflect:

- Marginal Probability of Default (MPD)
- Loss given default (LGD)
- Exposure at default (EAD)
- Discount Factor (D)

Loss Given Default: LGD is an estimate of the loss from a transaction/share of losses given that default occurs.

Exposure at Default (EAD) - is the predicted amount of loss an issuer may face in the event of, and at the time of, the borrower's default.

Probability of Default: PD is probability of whether the borrower will default on their obligations in future. PD is determined based on the historical loss experience of an entity.

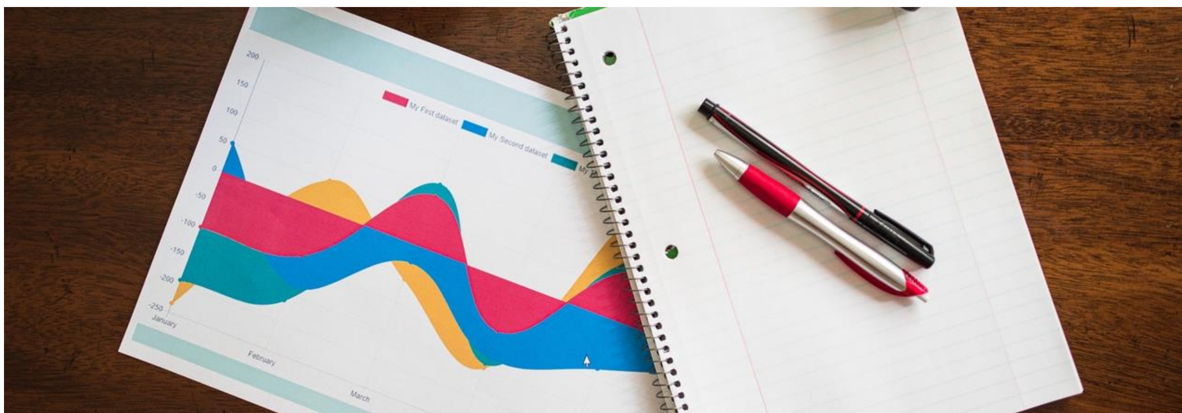
The typical formula used in practice for ECL is:

ECL = EAD x PD x LGD

DISCLOSURE

IFRS 9 does not introduce new disclosure requirements, although the IASB made a number of amendments to other standards when it finalised IFRS 9, including amendments to IFRS 7 Financial Instruments: Disclosures (IFRS 7), which introduce new disclosure requirements in connection with the introduction of IFRS 9.

Disclosure requirements relating to impairment and credit risk in general are contained in paragraphs IFRS 7: 35A-38.



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