Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.

Why corporates should take note of IFRS 9 Impairment implementation issues

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May 2016

Shortly after the release of IFRS 9 *Financial Instruments* (2014) (AASB 9/NZ IFRS 9 (2014)), the International Accounting Standards Board (IASB) set up a Transition Resource Group for Impairment of Financial Instruments (ITG) to discuss implementation issues related to the new impairment model for financial assets. The ITG consists of preparers and auditors with expertise in this area. Whilst most of the ITG discussions have been from a banking context, some issues will pose practical challenges for corporates. The discussions are not authoritative, however corporates should be aware of the discussions to ensure that IFRS 9 implementation is consistent with what the standard requires as they do provide useful guidance to application of the new model. Noting that in many cases the ITG discussions amounted to confirming that the wording in IFRS 9 was clear and that current practices under IAS 39 (AASB 139/NZ IAS 39) simply would not be appropriate for the new forward-looking impairment model.

IFRS 9 introduces an expected credit loss (ECL) impairment model which should recognise losses well in advance of the current "incurred "loss model in IAS 39. It applies to annual periods beginning on or after 1 January 2018. While the main reason for amending the current model was to require banks to recognise losses in advance of a credit event occurring, this new model also applies to all receivables, including trade receivables, lease receivables, intercompany receivables, related party receivables etc. For more information on the model, please refer to the July 2015 Perspective article *Practical challenges of applying the IFRS 9 impairment model to trade and lease receivables*.

The ITG held three meetings in 2015 and discussed 22 agenda papers. There are no further ITG meetings planned by the IASB at this stage, but further meetings could be convened if required. Full meeting summaries prepared by the IASB staff are available on the IASB website.

Below we look at ITG discussions that are relevant to corporates.

Impact of future uncertain events

The ITG concluded that there was no right answer when it came to predicting future credit losses or when identifying whether there had been a significant increase in credit risk in relation to the impact of future uncertain events. Rather a corporate should apply the correct process to consider forward looking estimates and properly disclose those events or conditions it had included or excluded in its predicted losses. Whilst the ITG concluded that the new model would require entities to factor in the effects of future one-time uncertain events that have not been included in an entity's budgets and forecasts, it accepted that some events including the possibility of a Greek exit or Scottish independence would not be included due to insufficient reasonable and supportable information.

This issue is relevant to corporates because corporates will be required to forecast and calculate ECLs for all its receivables (regardless of whether it applies the simplified model or the full 3-stage model applies). In calculating ECLs, corporates would need to consider all available, reasonable and supportable information that could have an impact on credit losses (either directly or indirectly) regardless of whether it has been included in internal budgets and management forecasts and regardless of how uncertain or remote that event might be.

For corporates, this is likely to mean that consideration would need to be given as to how macroeconomic information (e.g. a collapse in stock market, iron ore price, oil price etc) and other events could impact your trade receivables. For example:

- If your customers are in the mining services or mining industry, how might commodity prices impact your trade receivables?
- If your customers are in the property development industry, how might a collapse in property prices impact your trade receivables?
- If your customers are in the plastics industry, how might a fall in oil price impact your trade receivables?
- If your customers are impacted by the strengthening/weakening of the Australian dollar, how might a move in the AUD/USD exchange rate impact your trade receivables?
- If your customers are in the UK how will a potential "Briexit" from the EU impact the collectability of your trade receivables?

Forecast of future economic conditions

The ITG discussed the challenges of whether and how to incorporate new information and events that occur after the reporting date but before the signing date of financial statements. This issue is a challenge for corporates as the following scenario illustrates.

Scenario

- Entity A has a June year end
- Entity A's trade receivables consists of customers that are iron ore miners
- At 30 June 20X6, the spot iron ore price is $80/tonne. The consensus forecast price for iron ore is also $80/tonne
- On 31 July 20X6 the iron ore price collapses to $30/tonne. The collapse of the iron ore price is a result of oversupply with too much iron ore in storage in China and too little demand from Chinese steel mills. It is likely that these conditions (i.e. oversupply) already existed at 30 June 20X6.

Should Entity A, for its 30 June 20X6 financial statements factor in the effect of the iron ore price collapse in to the calculation of ECL and assessment of significant increase in credit risk?

The ITG noted that IAS 10 *Events after Reporting Date* (AASB 110/NZ IAS 10) states that bankruptcy of a customer that occurs after the reporting period usually confirms that the customer was credit impaired at the end of the reporting period and is therefore an adjusting event.

The ITG concluded that determining whether such information is an adjusting event or a non-adjusting event requires judgement. The ITG noted that a change in interest rates or the outcome of a public vote after the reporting date are non-adjusting events but the expected movements in interest rates and expected outcomes of a future public vote at reporting date should be taken into account.

For corporates, this is likely to mean consideration would be required to determine whether any subsequent events that arise after the reporting date indicate conditions that existed at reporting date and whether expectations of those events at reporting date have been sufficiently factored in to the ECL calculation e.g. :

- Subsequent significant increase/decrease in commodity prices after reporting date
- Subsequent significant increase/decrease in exchange rate after reporting date
- Subsequent significant changes in stock market after reporting date
- Subsequent changes in government and government policy after reporting date.

In the case of the iron ore example above it is unlikely that the subsequent fall in the iron ore price should be factored into Entity A's bad debt provisioning as at 30 June 20X6. This is because the market did not forecast the collapse in the iron ore price at reporting date, it is therefore effectively a non-adjusting post balance sheet event, with hindsight not being allowed to adjust the entity's forecasts.

Incorporating forward-looking information

The ITG concluded that depending on the characteristics of a portfolio of receivables, forecasts of future economic conditions and scenarios (e.g. unemployed rates, interest rates etc.) might have different relevance to individual receivables or sub-portfolios of receivables. This issue is relevant to corporates with receivables and/or subsidiaries with customers from different geographical regions and/or industries. Macroeconomic information may affect customers in different industries or geographic location differently e.g.:

- Possibility of Greece exiting the Eurozone more likely to impact trade receivables from customers in Europe
- Chinese GDP growth would have greater impact on trade receivables from customers operating in China.

Therefore corporates will have to consider generating loss provisions based on the characteristics of sub-portfolios of their receivables, rather than treat all receivables the same when predicting ECLs.

Non-linear relationships

The ITG concluded that it is necessary to consider multiple future scenarios in cases where the relationship between the different future scenarios and credit losses are non-linear. This issue is relevant to corporates because the effects of macroeconomic factors (e.g. GDP growth, commodity prices, exchange rates etc.) on bad debt credit losses are typically non-linear.

Examples of possible non-linear relationships include:

- Commodity prices and bad debt on receivables from customers from in the mining industry
- Exchange rates and bad debt on receivables from customers in the tourism industry.

The ITG discussed the following two examples:

Example 1

Unemployment	Probability	Credit loss
4%	20%	CU30
5%	50%	CU70
6%	30%	CU170

In this example, there is a non-linear relationship between the different possible future scenarios (unemployment rates) and credit losses. ECLs is a probability-weighted amount and is therefore CU92 ((CU30 × 0.2) + (CU70 × 0.5) + (CU170 × 0.3)). It would not be acceptable under IFRS 9 to use the most likely outcome of 5% unemployment and therefore ECLs of CU 70.

Example 2

- An entity has a mortgage portfolio where there is a non-linear relationship between changes in interest rates and credit losses
- An entity obtains 10 independent forecasts of forward-looking interest rates:

	25bps increase	100 bps increase
# of economists	7	3

It is not correct to assume a 25bps increase because this is the most likely scenario. Two possible approaches would be consistent with IFRS 9 are:

- Run two calculations with the first using 25 base points (bps) increase and the second using 100bps increase as the inputs and then weigh the outcomes based on their probabilities of 70% and 30%.
- Perform a single calculation assuming a 25bps increase, because this is the most likely outcome but add on an 'overlay' adjustment to take into account the credible minority view of a 100 bps increase.

For corporates, consideration would need to consider the different credit loss outcomes on receivables based on multiple scenarios and not just the most likely scenarios e.g.:

- For entities with customers in the mining industry, consider the impact on credit losses for different possible future iron ore price movements
- For entities with customers that are importers/exporters, consider the impact on credit losses for different possible future exchange rate movements.

Assets with a maturity of less than 12 months

The ITG concluded that entities would still be required to assess significant increase in credit risk for assets with maturity of less than 12 months. For corporates, this means the need to establish criteria (including systems and processes) for assessing significant increase in credit risk for those short-term receivables where the full 3 stage model applies (e.g. related party or intercompany loan receivables), even though the provision account for stage 1 (12mth ECL) and stage 2 (lifetime ECL) is the same. The ITG notes that IFRS 7 *Financial Instruments: Disclosures* (AASB 7/NZ IFRS 7) requires separate disclosures of provision account for those receivables that are in stage 1 and stage 2.

Sale of a defaulted loan

The ITG agreed that cash flows from selling bad debt (e.g. to a specialist buyer of bad debt) can be included the calculation of ECLs (subject to certain conditions). This may mean a lower impairment amount being recorded when sales proceeds are more than the amount that can be expected to be recovered from the debtor directly.

Collateral and other credit enhancements

For receivables that are guaranteed by a third party, the ITG concluded that entities should not include recoveries from the guarantor in assessing significant increases in credit risk.

Scenario

- On 1 January 20X8, Company B loans CU1,000 to Company C, a sister subsidiary for 3 years
- The loan is guaranteed by Parent A
- On 31 December 20X9 Company C is expected to have cash flow problems due to deterioration in economic conditions and decreasing profit
- Company C owns four of the five major well-known consumer brands of the Group
- Parent A is in a strong financial position and is expected to inject cash into Company C to cover Company C's cash outflows over the next couple of years.

Discussion

Whether the loan to should remain in stage 1 or should move to stage 2 depends on the nature of the guarantee. The loan is likely to remain in stage 1 in this scenario because the parent is in a strong financial position and has an incentive and the financial ability to prevent Company C from default by capital injection (IFRS 9.B5.5.17(k)).

However, if the nature of the guarantee is such that Company C is likely to default and Company B recovers the cash shortfall from Parent A directly, the loan is likely to be in stage 2. This is because the ITG concluded that, the ability to reduce credit losses through third party guarantees does not reduce the borrower's risk of default.

Note: The cash flows from the guarantee is included in the calculation of ECLs (IFRS 9.B5.5.55).

Conclusion

Whilst the discussions at the ITG are very much banking focused, corporates should not underestimate the implication of these discussions to trade receivables and more significantly other long-term receivables (e.g. intercompany loans). Corporates need to consider the ITG discussions and how it impacts their trade receivables and other receivables when considering implementation of the expected credit loss model.