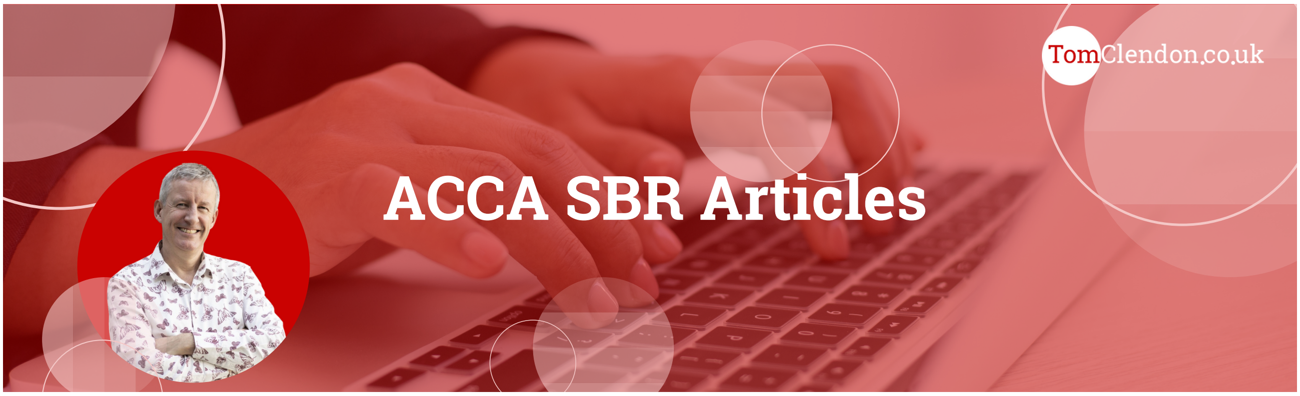

Impairment of financial assets

Although IFRS 9® *Financial Instruments* was first issued in November 2009, it has been updated on a frequent basis. A completed version of the IFRS standard was finally issued in July 2014. Whilst IFRS 9 replaced IAS 39® *Financial Instruments: Recognition and Measurement*, IAS 32 *Financial Instruments: Presentation* is still applicable. The objective of IFRS 9 is to '...establish principles for the financial reporting of financial assets and financial liabilities that will present relevant and useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of an entity's future cash flows.' (para 1.1).

If a financial asset is deemed to be impaired, then this will impact its carrying amount and future cash flows and so this article considers the principles on which the impairment of financial assets is considered.

The impairment of financial assets – the expected credit loss (ECL) approach

IFRS 9 requires that credit losses on financial assets are measured and recognised using the 'expected credit loss (ECL) approach. Credit losses are the difference between the present value (PV) of all contractual cashflows and the PV of expected future cash flows. This is often referred to as the 'cash shortfall'. The present values are discounted at the original effective interest rate. ECLs are then calculated using the weighted average of credit losses with the respective risks of a default occurring as the weights.

The ECL approach results in the early recognition of credit losses because it includes, not only losses that have already been incurred, but also expected future credit losses – it is a forward looking model. Arguably, this method is prudent as both financial assets and profits will be reduced. It is however open to the criticism that, by requiring the estimation of future credit losses, which will necessarily involve judgment, it will allow some companies to engage in profit smoothing. Consequently, IFRS 9 has included definitions to provide clarity as to what (and what is not) permitted. The ECL approach also impacts on the calculation of interest revenue recognised from the financial asset (see below).

Before we look in detail at the ECL process required by IFRS 9, consideration of two further definitions will be helpful. ECLs are further classified into (i) lifetime ECLs and (ii)

12-month ECL. The former are those that result from all possible default events over the expected life of a financial instrument. The latter are those that result from default events that are possible within 12 months after the reporting date.

Under the approach required by IFRS 9, it is no longer necessary for a loss event to have occurred but instead an entity is required to account for ECLs on initial recognition of the financial asset (the ECL could be nil) and then separately account for changes in the ECL at each reporting date. Therefore, the impairment of financial assets is recognised in stages:

- **Stage 1**—as soon as a financial instrument is originated or purchased, a 12-month ECL is recognised in profit or loss and a loss allowance is established (may be nil). For financial assets, interest revenue is calculated on the gross carrying amount (ie without deduction for ECLs).
- **Stage 2** at each reporting date, the ECL is remeasured:
  - (i) if the credit risk has not increased significantly, continue to recognise a 12 month ECL. The calculation of interest revenue is the same as for Stage 1.
  - (ii) if the credit risk increases significantly and is not considered low, full lifetime ECLs are recognised in profit or loss. The calculation of interest revenue is the same as for Stage 1.
  - (iii) if the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount less the loss allowance). Financial assets in this stage will generally be assessed individually. Lifetime ECLs are recognised on these financial assets.

Example of the expected credit loss approach

Bale Co has a portfolio of $50,000 financial assets (debt instruments) that have two years to maturity and are correctly accounted for at amortised cost. Each asset has a coupon rate of 10% as well as an effective rate of 10%.

No previous loss allowance has been recognised as the 12 month ECL was assessed to be nil and there had been no significant change in the credit risk since the portfolio had been acquired (this is Stage 1).

At the year-end (this is Stage 2), information has emerged that the sector in which the borrowers operate is experiencing tough economic conditions. It is now felt that a proportion of loans will default over the remaining loan period and therefore the credit risk has increased significantly. After considering a range of possible outcomes, the overall rate of return from the portfolio is expected to be approximately 6% per annum for each of the next two years. The debt instruments are not, however, considered credit impaired.

Required:
Calculate the lifetime expected credit losses and the loss allowance required.

Answer
The lender was expecting an annual return of $5,000 a year ($50,000 × 10%) but is now only expecting an annual return of $3,000 a year ($50,000 × 6%). There is therefore a cash

shortfall – ie an ECL of $2,000 per year. A loss allowance should be calculated at the present value of the shortfalls over the remaining life of the asset.

The discount rate used should be the effective discount rate ie 10%.

	Contractual cash flow shortfall $	Discount rate $	Present value $
Year 1	2,000	0.9091	1,818
Year 2	2,000	0.8264	1,653
			3,471

Thus, the ECL is $3,471. This is recognised as a loss allowance creating an expense to be charged to profit or loss and offset against the carrying amount of the financial asset on the statement of financial position. You should note IFRS 9 is not prescriptive about the presentation in the statement of financial position and the loss allowance may be presented as a liability instead of offset against the asset.

Financial assets subject to impairment

If deemed necessary, a loss allowance for ECLs should be recognised for the following financial assets:

- those measured at amortised cost and at fair value through other comprehensive income (OCI)
- lease receivables
- contract assets
- irrevocable loan commitments, and
- financial guarantee contracts that are not accounted for at fair value through profit or loss under IFRS 9.

Therefore, this includes debt instruments such as loans, debt securities and trade receivables (but see later for a simplified approach).

The recognition of ECLs is required for these financial assets by creating a loss allowance/provision based on either 12-month or lifetime ECLs. Some entities would recognise a loss allowance whilst others may choose to present ECLs as a liability.

Financial assets with a low credit risk would not meet the lifetime ECL criterion. An entity does not recognise lifetime ECL for financial assets that are equivalent to 'investment grade', which means that the asset has a low risk of default. There is a rebuttable presumption that lifetime expected losses should be provided for if contractual cash flows are more than 30 days overdue ('backstop indicator'). If the credit quality subsequently improves and the lifetime ECL criterion is no longer met, the credit loss reverts back to a 12-month ECL basis. Therefore a financial asset can move from 12 month ECL to a lifetime

ECL and back again if there is evidence that there is no longer a significant increase in credit risk and there should not be an assumption that a financial asset with a lifetime ECL will default. The assessment of significant increases in credit risk can be performed on a collective basis, rather than on an individual basis if the financial instruments share the same risk characteristics. However, if any assets are deemed credit impaired they will generally be assessed on an individual basis.

Summary of the two-stage approach:

Stage 1 - on initial recognition

An entity would recognise a loss allowance based on the 12-months' ECL. This may be assessed as nil.

Stage 2 - each reporting date

Where there is no evidence that the credit quality of a financial asset has deteriorated significantly since initial recognition, then the loss allowance continues to be based on the 12 months' ECL (which could continue to be nil).

Where there is evidence that the credit quality of a financial asset has deteriorated significantly since initial recognition, then the impairment loss is based on the lifetime ECL. If the asset is considered credit impaired then there is a further impact as the interest revenue is calculated on the carrying amount net of the loss allowance.

Simplified approach

For trade receivables there is a simplified approach in that no credit loss allowance is recognised on initial recognition. Any loss allowance will be the present value of the expected cash flow shortfalls over the remaining life of the receivables. This approach uses the conventional matrix method (aged receivables list) of considering historically observed default rates and adjusted for forward-looking estimates.

Conclusion

The ECL model will require judgment carrying amount of financial assets and assessment of impairment is dependent on forward-looking information which can be subjective. IFRS 9 has attempted to limit this subjectivity by providing detailed definitions. IFRS 9 addressed the criticism that losses were recognised too late, only after a credit event, and by requiring a considered forward looking approach to impairment assessment it will make the financial reporting of financial assets more relevant and useful to users of financial statements.

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