# Implementing HKFRS 9's new impairment model

With less than two years to implement the new HKFRS 9 *Financial Instrument*, the Hong Kong Institute of CPA's Standard Setting Department highlights a key aspect of the new impairment model under the standard, which applies to any entity with receivables (regardless of whether it is trade receivables from debtors or loan receivables from borrowers). HKFRS 9 is the equivalent of IFRS 9 (of the same title) issued by the International Accounting Standards Board. An overview of implementation challenges faced by banks and other corporate entities was reported in the May 2015 issue of *A Plus*.

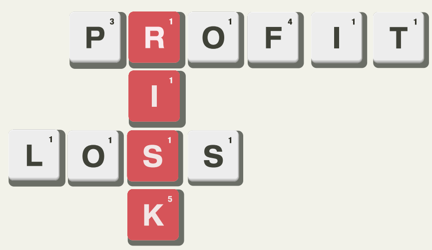
## Why we need a new impairment model

IFRS 9 is the IASB's comprehensive response to the global financial crisis of the yesteryears, where accounting for loan losses was deemed as "too little, too late." IASB Chairman Hans Hoogervorst commented that "the reforms introduced by IFRS 9 are much needed improvements to the reporting of financial instruments and are consistent with requests from the G20, the Financial Stability Board and others for a forward-looking approach to loan-loss provisioning. The new standard will enhance investor confidence in banks' balance sheets and the financial system as a whole."

The final version of HKFRS 9 was issued in September 2014 and is effective for annual periods beginning on or after 1 January 2018. HKFRS 9 supersedes HKAS 39 *Financial Instruments: Recognition and Measurement* on its effective date.

## An outline of HKFRS 9's new impairment model

HKAS 39 contained many different impairment models associated with the classification categories. HKFRS 9




applies only one impairment model which is forward-looking and takes into account all reasonable and supportable information available with respect to expected credit losses. It also provides a richer set of information to users of the financial statements, by requiring specific quantitative and qualitative disclosures.

The diagrams on the next page illustrate, at a high level, the three stages and the requirements of the new impairment model.

## Assessing significant increases in credit risk: implementation considerations

The IASB has established a transition resource group for the impairment of financial instruments. This group is a discussion forum aimed at providing support to stakeholders on issues arising from the implementation of the new expected credit loss impairment model.

In this article, we summarize the group's implementation considerations pertaining to the assessment of significant increases in credit risk, which is a key part of the new impairment model. Details of all implementation issues raised by stakeholders and discussed to date are available on the IASB website.

Entities are reminded that the assessment of changes in credit risk should always be based on a wide range of both internal and external indicators.

Internal indicators can include:
(i) internal credit grading systems;
(ii) contractual terms and pricing of receivables and loans issued; and
(iii) actual and expected performance of debtors and borrowers; and
(iv) behavioural indicators.

External indicators can include:
(i) credit ratings from independent credit rating agencies; and (ii) reasonable and supportable forecasts of future market conditions pertaining to your debtor or borrower.

**How should internal credit grading systems identify significant increases in credit risk?**

Entities with an internal credit grading system should assess the appropriateness of its current systems as a means of identifying significant increases in credit risk. This will depend on an entity's specific facts and circumstances, the range of factors in determining individual credit grades, how the internal credit grading system operates and how it is related to the risk of a default occurring.

For example, an entity should review its credit grades frequently, ensure that reasonable and supportable information including forward-looking information is incorporated in the credit risk assessment of its receivables, and ensure that its credit risk assessment reflects the risk of default over the life of the receivables.

Entities with internal credit grading systems should assess and determine which movement within a range of internal credit grades represent a significant increase in credit risk. For example, an entity may assess and determine that movements within internal credit grade 1 to grade 5 may not represent a significant increase in credit risk but movements from credit grades 1 through 5 to credit grades 6 or more represent a significant increase in credit risk.

## Overview of the impairment requirements

**What are the stages?**

### Stage 1

As soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognized in profit or loss and a loss allowance is established.

This serves as a proxy for the initial expectations of credit losses.

For financial assets, interest revenue is calculated on the gross carrying amount (i.e. without adjustment for expected credit losses).

### Stage 2

If the credit risk increases significantly and the resulting credit quality is not considered to be low credit risk, full lifetime expected credit losses are recognized.

Lifetime expected credit losses are only recognized if the credit risk increases significantly from when the entity originates or purchases the financial instrument.

The calculation of interest revenue on financial assets remains the same as for stage 1.

### Stage 3

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 amortized cost (i.e. the gross carrying amount adjusted for the loss allowance). Financial assets in this stage will generally be individually assessed.

Lifetime expected credit losses are still recognized on these financial assets.

### What are 12-month expected credit losses?

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

It is not the expected cash shortfalls over the next 12 months – instead, it is the effect of the entire credit loss on an asset weighted by the probability that this loss will occur in the next 12 months.

It is also not the credit losses on assets that are forecast to actually default in the next 12 months. If an entity can identify such assets or a portfolio of such assets that are expected to have increased significantly in credit risk, lifetime expected credit losses are recognized.

**Increase in credit risk since initial recognition**

| | Stage 1 | Stage 2 | Stage 3 |
|---|---|---|---|
| **Impairment recognition** | 12-month expected credit losses | Lifetime expected credit losses | Lifetime expected credit losses |
| **Interest revenue** | Effective interest on gross carrying amount | Effective interest on gross carrying amount | Effective interest on amortized cost |

### What are lifetime expected credit losses?

Lifetime expected credit losses are an expected present value measure of losses that arise if a borrower defaults on their obligation throughout the life of the financial instrument. They are the weighted average credit losses with the probability of default as the weight.

12-month expected credit losses are the portion of the lifetime expected credit losses associated with the possibility of a default in the next 12 months.

Because expected credit losses consider the amount and timing of payments, a credit loss (i.e. cash shortfall) arises even if the entity expects to be paid in full but later than when contractually due.

Source: IASB's project summary of IFRS 9 issued in July 2014

**How can behavioural indicators be incorporated in an assessment of significant increases in credit risk?**
Behavioural indicators, such as when a customer has failed to make a payment, are often lagging indicators of increases in credit risk and consequently, they should be considered in conjunction with other, more forward-looking information.

When considering the use of behavioural indicators, an entity should: (a) focus on identifying pre-delinquency behavioural indicators of increases in credit risk, for example increased utilization rates or increased cash drawings on specific products; (b) only use indicators that are relevant to the risk of default occurring; (c) establish a link between the behavioural indicators of credit risk and changes in the risk of default occurring since initial recognition; (d) be mindful that while behavioural indicators are often predictive of defaults in the short term, they are often less predictive of defaults in the longer term; and (e) consider whether the use of behavioural indicators is appropriate for the type of product being assessed. For example, if a loan has only back-ended payments, behavioural indicators based on timeliness of payment will not be appropriate.

Entities with multiple debtors and borrowers should be aware that information available at an individual financial instrument level may not incorporate forward-looking information as required by IFRS 9. Portfolio segmentation is important and entities should ensure that sub-portfolios are not defined too widely.

**How should an ongoing review of significant increases in credit risk be performed?**
When an entity assesses whether a significant increase in credit risk has occurred, it may conclude upfront that changes in the risk of a default occurring over the next 12 months is a reasonable approximation of changes in the lifetime risk of a default occurring. In these cases, entities are reminded that they should complete a robust analysis to support their conclusion.

Entities also need to be satisfied on an ongoing basis that their initial upfront conclusion continues to be reasonable. This requires an appropriate level of ongoing review.

One way of approaching an ongoing review would be as follows: (a) identify the key factors that would affect the appropriateness of using changes in the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of default occurring; (b) monitor these factors on an ongoing basis as part of a qualitative review of circumstances; and (c) consider whether any changes in those factors indicate that changes in the 12-month risk of a default occurring are no longer an appropriate proxy for changes in a lifetime risk of default occurring.

Entities are reminded that they are required to disclose how they make their assessment of significant increases in credit risk, in accordance with IFRS 7 *Financial Instruments: Disclosures*.

**Does the ability to recover cash flows from a financial guarantee contract impact the assessment of significant increases in credit risk?**
Cash flow recoveries from financial guarantee contracts should be excluded from the assessment of significant increases in credit risk. The assessment should be focused on the risk of the borrower defaulting.

However, information about the financial guarantee may be relevant to assessing changes in credit risk, to the extent that it affects the likelihood of the borrower defaulting on the instrument.

**Is there a requirement to assess significant increases in credit risk for financial assets with a maturity of less than 12 months?**
An entity is required to assess whether there has been a significant increase in credit risk for all financial instruments, including those with a maturity of 12 months or less.

Entities are reminded that (a) the assessment of significant increases in credit risk is distinct from the measurement of expected credit losses. For example, a collateralized financial asset may have suffered a significant increase in credit risk, but owing to the value of the collateral there may not be an increase in the amount of expected credit losses even if measured on a lifetime rather than a 12-month basis; (b) assessing changes in credit risk would be consistent with normal credit risk management practices; and (c) the expected life of a financial instrument may change if it has suffered a significant increase in credit risk.

Entities are reminded that there are some operational simplifications to the impairment model for trade and lease receivables. Entities are encouraged to explore whether these simplifications could be applicable to their company.

## Have you started implementing the new impairment model?
Get in touch with the Institute's Standard Setting Department (*outreachhk@hkicpa.org.hk*) if you have any questions or issues with implementing the new impairment model. Also, look out for more Institute seminars on implementing HKFRS 9, which will be released soon.

This article is contributed by the Institute's Standard Setting Department