STAFF PAPER

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ITG meeting

Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	Forecasts of future economic conditions

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Introduction

1. We have received a submission about incorporating information about forecasts of future economic conditions when assessing significant increases in credit risk and measuring expected credit losses. The issue is how to deal with events arising:
   (a) after economic forecasts have been made but before the reporting date; and
   (b) between the reporting date and the date of signing the financial statements (ie the interaction with IAS 10 *Events after the Reporting Period*).
2. This paper:
   (a) provides some background information, including the relevant requirements in IFRS 9 *Financial Instruments* (2014) and IAS 10;
   (b) summarises the potential implementation issues; and
   (c) asks the members of the Transition Resource Group for Impairment of Financial Instruments ('ITG') for their views for their views on the issue identified..

Background and accounting requirements

3. In this section, we set out the relevant requirements of:

    (a) IFRS 9 about taking into account forward looking forecasts of future economic conditions;

    (b) IAS 10 about whether events after the balance sheet date should be reflected in the financial statements at the reporting period end; and

    (c) IAS 8 *Accounting policies, Changes in Accounting Estimates and Errors*, about the use of estimates in financial reporting.

IFRS 9

4. IFRS 9 requires an entity to take into account forward looking forecasts of future economic conditions when:

    (a) determining significant increases in credit risk; and

    (b) measuring expected credit losses.

Determining significant increases in credit risk

5. Paragraph 5.5.9 of IFRS 9 requires an entity to assess, *at each reporting date*, whether the credit risk on a financial instrument has increased significantly since initial recognition. This assessment determines whether loan loss allowances are measured at an amount equal to 12-month expected credit losses (if there is no significant increase in credit risk) or lifetime expected credit losses (if there is a significant increase in credit risk since initial recognition).

6. In making this assessment, paragraph 5.5.9 of IFRS 9 requires an entity to consider reasonable and supportable information that is available without undue cost or effort, and that is indicative of significant increases in credit risk since initial recognition. Paragraph 5.5.11 of IFRS 9 further requires that if reasonable and supportable forward-looking information is available without undue cost or effort, the entity cannot rely solely on past due information.

7. Paragraph 5.5.17(c) of IFRS 9 requires that an entity shall measure expected credit losses in a way that reflects reasonable and supportable information that is

available without undue cost or effort *at the reporting date* about past events, current conditions and forecasts of future economic conditions. Paragraph B5.5.15 of IFRS 9 further emphasises that when determining whether the recognition of lifetime expected credit losses is required, an entity shall consider reasonable and supportable information that is available without undue cost or effort and that may affect credit risk on a financial instrument in accordance with paragraph 5.5.17(c).

8. Paragraph B5.5.17 of IFRS 9 lists examples of information that may be relevant in assessing changes in credit risk. This includes references to forecast or expected changes, as follows:

> (f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in the borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates.
>
> (i) an actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology.

Measuring expected credit losses

9. As noted above, paragraph 5.5.17 of IFRS 9 requires that an entity shall measure expected credit losses of a financial instrument in a way that reflects reasonable and supportable information that is available without undue cost or effort *at the reporting date* about past events, current conditions and forecasts of future economic events.

10. Paragraph 5.5.17 of IFRS 9 requires that expected credit losses are measured in a way that reflects an unbiased and probability-weighted amount that is determined

by evaluating a range of outcomes. However as noted in paragraph 5.5.8 of IFRS 9, an entity need not necessarily identify every possible scenario.

11. Further requirements on reasonable and supportable information is given in paragraphs B5.5.49-B5.5.54 of IFRS 9. For ease of reference these paragraphs are reproduced in Appendix A. In particular paragraph B5.5.51 states that:

> The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. An entity may use various sources of data, that may be both internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics.

12. Furthermore paragraph B5.5.52 of IFRS 9 includes the following requirements:

> Estimates of changes in expected credit losses should reflect, and be directionally consistent with, changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). An entity shall regularly review the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience.

IAS 10

13. IAS 10 distinguishes between events after the balance sheet date that:

    (a) provide evidence of conditions that existed at the end of the reporting period (adjusting events after the reporting period); and

    (b) are indicative of conditions that arose after the reporting period (non-adjusting events after the reporting period).

14. Paragraph 9 of IAS 10 includes the following example of an adjusting post-balance sheet event:

> the receipt of information after the reporting period indicating that an asset was impaired at the end of the reporting period, or that the amount of a previously recognised impairment loss for that asset needs to be adjusted. For example: (i) the 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; …[1]

15. In contrast, paragraph 11 of IAS 10 has the following example of a non-adjusting post-balance sheet event:

> An example of a non-adjusting event after the reporting period is a decline in fair value of investments between the end of the reporting period and the date when the financial statements are authorised for issue. The decline in fair value does not normally relate to the condition of the investments at the end of the reporting period, but reflects circumstances that have arisen subsequently. Therefore, an entity does not adjust the amounts recognised in its financial statements for the investments.

IAS 8

16. Paragraphs 32-34 of IAS 8 acknowledge that as a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Loan loss allowances in respect of financial instruments are one of these items. IAS 8 confirms that the use of reasonable estimates is an essential part of the preparation of financial

[1] IFRS 9 defines a financial asset as credit-impaired when one or more events that have a detrimental impact on the estimated cash flows of that financial asset have occurred. Evidence that a financial asset is credit-impaired includes observable data about it becoming probable that the borrower will enter bankruptcy or other financial reorganisation.

statements and does not undermine their reliability. Furthermore, paragraph 34 of IAS 8 notes that:

> An estimate may need revision if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.

The issue

17. The question is about whether and how to incorporate events and forecasts that occur after the date at which the measurement of expected credit losses is modelled, which could have an effect both on the assessment of significant increases in credit risk and the measurement of expected credit losses. The events and new information may become known either:

    (a) before the reporting period end (Issue 1); or

    (b) between the reporting period end and the date of signing the accounts (Issue 2).

18. As noted in paragraphs 4-12, the Standard requires that the assessment of significant changes in credit risk and the measurement of expected credit losses should use ‘reasonable and supportable information that is available without undue cost or effort *at the reporting date* about past events, current conditions and forecasts of future economic conditions’.

19. However, as well as considering the interaction with IAS 10 for events arising after the reporting period end, the issue is largely one of operational practicality. This is because in practice there will be a potentially large number of factors and events that could cause expectations to change. The submitter notes that there will be a need to take a practical and structured approach to ensure that entities are able to complete and publish their financial statements in a timely and well controlled manner.

20. The submitter provides a scenario of a bank that has a December year end and meets the requirements of paragraph 5.5.17 of IFRS 9 by adjusting risk components (probability of default ('PD'), loss given default ('LGD') and exposure at default ('EAD')) to incorporate the effect of forecasts of future economic conditions. An additional process may be used, where necessary, to include judgemental overlays incorporating the impact of events that cannot be modelled or that are not (currently) incorporated in the model process. The bank incorporates the effects of forecasts of future economic conditions by developing a single, coherent and internally consistent economic forecast through a committee of economic, business and risk experts who exercise their expert judgement by reference to externally developed consensus forecasts. The adjustments to the risk components are based on correlations that are accepted as being valid through the model governance process. As a result, the process uses inputs and assumptions that are developed in, say, November in order to meet the financial reporting deadlines as at end December.

21. Events that occur after the date of measurement may be:

(a) completely unexpected (eg a natural disaster) and hence not factored into the original forecasts; or

(b) changes in the expectations of future economic conditions as a result of new information (eg new unemployment figures that reverse previous trends), if the original expectations were taken into account in the original forecasts.

22. The submitter gives the following examples of events that could occur after the date of measurement of expected credit losses:

(a) A central bank in a country with its currency pegged to the US dollar has consistently provided policy statements that it will continue to support the currency and confirms this position in public meeting minutes in November. In the middle of December, it in fact ceases to support the currency, which immediately falls in relation to the US dollar. This may either be an event that is completely unexpected, or the possibility of the currency falling in relation to the US dollar may have been considered in developing the economic forecast in November, despite the central bank's stated policy.

(b) The outcome of an election or referendum that beforehand may have been unpredictable, so that the link between the results and the economic outlook was highly uncertain and the predicted consequences of such a link were subject to differing expert views.

Issue 1: events arising after economic forecasts have been made but before the reporting date

23. The submitter asks the following questions:

(a) If the possibility was considered in developing the economic forecast, would it be reasonable to consider that it was sufficiently taken into account, even though the event has in fact occurred?

(b) Alternatively, must the occurrence of an event that affects the economic forecast in a way that will have a material impact on the measurement of expected credit losses be reflected in the loan loss allowance at the reporting period end (eg 31 December)?

(c) Does this view change depending on whether or not it was considered possible when an economic forecast was determined? For example, if the event were a natural disaster rather than something that could be included in economic forecasting?

24. IFRS 9 requires the use of reasonable and supportable information that is available without undue cost or effort *at the reporting date* about past events, current conditions and forecasts of future economic conditions. Consequently, subject to materiality considerations, reasonable and supportable information of events and current conditions and forecasts of future economic conditions that becomes available between the measurement date in November, say, and the reporting period end (of say 31 December) are required to be reflected in the assessment of significant increases in credit risk and the measurement of expected credit losses at the reporting date. This is the case regardless of whether new information about events, current conditions and forecasts of future economic

conditions available before the reporting period end were taken into account in earlier assessments of the loan loss allowance (subject to materiality considerations).

Issue 2: Events arising between the reporting date and the date of signing the financial statements

25. The submitter asks the following questions:

    (a) If the event occurs after the reporting period end (say 31 December), but before the date of signing the accounts, will the impact on the loan loss allowance at the reporting period end be different, depending upon whether the event was completely unexpected or was considered to be a possibility?

    (b) If, for example, the change in central bank policy in the example given in paragraph 22(a) was not considered a possibility at the reporting period end, does its subsequent occurrence indicate the existence of conditions that arose after the reporting period end and therefore it is a non-adjusting event?

    (c) Alternatively, regardless of whether the change in central bank policy was considered to be a possibility at 31 December, is the occurrence after the reporting period end evidence of conditions that existed at the end of the reporting period (because pressures on the currency would not arise overnight) and therefore it is an adjusting event (assuming that the impact is material)?

26. IFRS 9 does not specifically require events and new information that might affect forecasts that occurs after the reporting date to be reflected in the measurement of expected credit losses at the reporting date.

27. As noted in paragraphs 13-15, IAS 10 requires entities to consider whether events after the reporting period end should be adjusted in the financial statements for the period. For example information about an event that happened before the reporting date might become available after the reporting date, that may need to be reflected in the measurement of expected credit losses at the reporting date.

An example of an event given in IAS 10 that may be an adjusting event after the reporting period is the bankruptcy of a customer, which usually confirms that the customer's balance was credit-impaired at the end of the reporting period. A credit-impaired financial asset is one for which one or more events that have a detrimental impact on the estimated future cash flows of the financial asset have occurred.

28. Determining *expected credit losses* at the reporting period end is inherently dependent upon reasonable and supportable estimates and forecasts at that date, regardless of whether subsequent events confirm or rebut those estimates and forecasts.[2] Indeed, it is to be expected that events, new information after the reporting period will result in changes in the estimates and forecasts that were used at the reporting period date. However this does not automatically mean that those changes should always be reflected in the measurement of expected credit losses as at the reporting period end. Paragraph 34 of IAS 8 (see paragraph 16) confirms that revisions of estimates due to changes in circumstances or as a result of new information does not relate to prior periods.

29. Consequently, it needs to be assessed whether such events and new information after the reporting period end are adjusting or non-adjusting events and it is envisaged that some judgement will be required. The staff would like to note that there has been no change to the requirements in IAS 10 on adjusting and non-adjusting events.

Question for the members of the ITG
What are your views on the issues presented above?

[2] However, the discovery of errors in the estimation process that show that the financial statements are incorrect at the reporting period end are adjusting events after the reporting period.

APPENDIX A

Paragraphs B5.5.49-B5.5.54 of IFRS 9

Reasonable and supportable information

B5.5.49 For the purpose of this Standard, reasonable and supportable information is that which is reasonably available at the reporting date without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions. Information that is available for financial reporting purposes is considered to be available without undue cost or effort.

B5.5.50 An entity is not required to incorporate forecasts of future conditions over the entire expected life of a financial instrument. The degree of judgement that is required to estimate expected credit losses depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement required to estimate expected credit losses increases. The estimate of expected credit losses does not require a detailed estimate for periods that are far in the future—for such periods, an entity may extrapolate projections from available, detailed information.

B5.5.51 An entity need not undertake an exhaustive search for information but shall consider all reasonable and supportable information that is available without undue cost or effort and that is relevant to the estimate of expected credit losses, including the effect of expected prepayments. The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current as well as the forecast direction of conditions at the reporting date. An entity may use various sources of data, that may be both internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics. Entities that have no, or insufficient, sources of entity-specific data may use peer group experience for the comparable financial instrument (or groups of financial instruments).

B5.5.52 Historical information is an important anchor or base from which to measure expected credit losses. However, an entity shall adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based, and to remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows. In some cases, the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of the historical information and when it was calculated, compared to circumstances at the reporting date and the characteristics of the financial instrument being considered. Estimates of changes in expected credit losses should reflect, and be directionally consistent with, changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). An entity shall regularly review the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience.

B5.5.53 When using historical credit loss experience in estimating expected credit losses, it is important that information about historical credit loss rates is applied to groups that are defined in a manner that is consistent with the groups for which the historical credit loss rates were observed. Consequently, the method used shall enable each group of financial assets to be associated with information about past credit loss experience in groups of financial assets with similar risk characteristics and with relevant observable data that reflects current conditions.

B5.5.54 Expected credit losses reflect an entity's own expectations of credit losses. However, when considering all reasonable and supportable information that is available without undue cost or effort in estimating expected credit losses, an entity should also consider observable market information about the credit risk of the particular financial instrument or similar financial instruments.