SAICA DIFFERENCE MAKERS™

27 September 2023

International Accounting Standards Board
7 West ferry Circus
Canary Wharf
London E14 4HD
United Kingdom
Email: commentletters@ifrs.org

Dear Sir/Madam

SAICA SUBMISSION ON RFI/2023/1 – REQUEST FOR INFORMATION – POST IMPLEMENTATION REVIEW OF IFRS 9: *FINANCIAL INSTRUMENTS – IMPAIRMENT*

In response to your request for comments on the RFI/2023/1– Request for Information – Post Implementation Review of IFRS 9: *Financial Instruments – Impairment,* attached is the comment letter prepared by the South African Institute of Chartered Accountants (SAICA). This comment letter results from deliberations of SAICA's Accounting Practices Committee (APC). The APC comprises members from reporting organisations, regulators, auditors, IFRS specialists, investment analysts and academics.

We thank you for the opportunity to provide comments on this RFI.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Prof Ahmed Mohammadali-Haji
Chairperson: APC

Mulala Sadiki
Project Director: Financial Reporting

Cc: Bongeka Nodada
Executive: Corporate Reporting

SPECIFIC COMMENTS

Question 1—Impairment

Do the impairment requirements in IFRS 9 result in:

(a) more timely recognition of credit losses compared to IAS 39 and address the complexity caused by having multiple impairment models for financial instruments? Why or why not?

(b) an entity providing useful information to users of financial statements about the effect of credit risk on the amount, timing, and uncertainty of future cash flows? Why or why not?

We are generally in support of the impairment requirements of IFRS 9 and we believe that IFRS 9 does result in timely recognition of credit losses. This was specifically observed through the Covid-19 pandemic. However, multiple impairment models for financial instruments between the different portfolios within financial services entities still exist and are still complex requiring judgement and estimates. Current models are specific to, and depend on, the type of product the expected loss is being calculated for. In terms of IAS 39 – *Financial Instruments: Recognition and Measurement*, a bottom-up approach was followed, where it determined categorisation of various instruments, both debt and equity, and then applied different types of approaches for calculating impairment losses. At the outset, it might appear as if there is one approach for impairment under IFRS 9, however, there are various considerations and complexities taken into consideration when applying the models, but with the understanding that this is unavoidable.

From a disclosure perspective, as preparers from the analysts' and investors' sessions and decisions, there is no evidence/ need for additional disclosure as information provided is useful to these users of financial statements about the effect of credit risk on the amount, timing and uncertainty of future cash flows. The current disclosure that is being provided is very well received by investors and analysts and preparers have not been asked for any additional detail.

Whilst we agree with the impairment requirements and that it results in more timely recognition of credit losses compared to IAS 39, we have noted some challenges in applying the impairment requirements. We have particularly noted the following points that we suggest the International Accounting Standards Board (IASB) take into consideration:

- The smaller industries, mainly non-banks, have the added complexity of not having enough and/or reliable historic data which also results in added costs.

- Although we are of the view that generally the IFRS expected credit losses (ECL) requirements work, there are certain instances such as in the accounting for intercompany loans that might give outcomes which do not align with impairment conclusions reached on non-financial assets as an example. In this regard, some constituents noted that, whilst not specific to any limitations within IFRS 9, the impairment requirements in IFRS 9 do not result in more timely recognition of expected loss and does not provide useful information on intercompany loans advanced to subsidiaries in the separate financial statements. The issue highlights a general disconnect within accounting standards when evaluating financial instruments that exist between parents and investees (including joint ventures and associates) based on contractual terms that establish a legal relationship and the true nature of such instruments which are impacted by the complex practical relationship that exists between the participants to the contract. It was noted that at a separate financial statement level there is often no difference between an intercompany loan advanced to a subsidiary and shares in the subsidiary as both can be repaid and redeemed with no fixed or determinable payments and

the subsidiary's credit risk applied in both instances is the same. It is therefore recommended that the Board provide clarity on an example where tension exists between the expected losses in terms of IFRS 9 in an entity's separate financial statements and the asset impairment model applied to the underlying assets in the consolidated financial statements. If no impairment loss is recognised on underlying assets, but credit losses are recognised in the entity providing the intercompany loan's separate financial statements and reversed again on consolidation, such instance brings doubt on whether useful information is provided to users of both these sets of financial statements.

- Some constituents have also noted that although IFRS 9 results in more timely recognition of credit losses, the risk experienced relating to incorporating forward looking information is recording losses that don't materialise (refer to question 4 for more detail).

- Constituents have also noted that some preparers provide disclosure pertaining to expected credit losses using both IFRS 7 – *Financial Instruments: Disclosures* before the amendments due to IFRS 9 (i.e., following IAS 39 principles) and IFRS 7 post the amendments due to IFRS 9 which results in an increase in volume of disclosures and clutters the financial statements.

Question 2—The general approach to recognising expected credit losses

(a) Are there fundamental questions (fatal flaws) about the general approach? If yes, what are those fundamental questions?

(b) Are the costs of applying the general approach and auditing and enforcing its application significantly greater than expected? Are the benefits to users significantly lower than expected?

Constituents raised a fundamental question around whether all cash shortfalls should be included in the definition of ECL. The question is raised on the back of the IFRIC agenda decision finalised in September 2022 on lessor forgiveness of lease payments, where the Committee concluded that the lessor should include considerations of its expectations to forgive lease payments in measuring expected credit losses, i.e., all cash shortfalls, whether related to credit events or not. We believe that this could potentially result in including cash shortfalls that don't relate to credit risk, which would not result in relevant information being disclosed within the financial statements. This is particularly relevant in the South African context as we move into a downward interest rate cycle which could result in modifications due to cash flow forgiveness which per the IFRIC agenda decision should then be included in the measurement of ECL and we do not believe this is fit for purpose, as per IFRS 9 paragraph B5.4.5, re-estimation of future cash flows as a result of movements in the market rates of interest should not have a significant effect on the carrying amount of the impacted financial asset or liability. Further examples include changes in a legal framework and litigation risk that may impact future cash flows of a debt instrument. Therefore, we suggest that the Board reconsider the definition of ECL and whether the current definition which refers to all cash shortfalls should be limited to only those due to credit events.

In addition, certain countries within Africa may not be able to pay outstanding debt on time due to a shortage in currency (i.e. United States Dollar (USD)) and not due to credit risk. It is unclear whether such delays in payments, not due to credit risk, should be incorporated into the ECL measurement, as shortage is not severe in order to qualify as 'non-exchangeability of a currency'. Additional application guidance in this regard would be useful.

There also appears to be a discrepancy between the above mentioned IFRIC agenda decision and IFRS 15 – *Revenue from Contract with Customers* where specific guidance is provided on a post-sale reduction (i.e. contract modification resulting in a reduction of the transaction price). IFRS 15 requires this to be recognised as an adjustment to revenue at the date of the contract modification and the adjustment to revenue is made on a cumulative catch-up basis. We therefore request the IASB to provide further guidance on the conclusion reached as part of the IFRIC agenda decision in September 2022, as further decisions that could potentially result in an amendment to IFRS 9 were taken during its March 2023 Update.

Question 3—Determining significant increases in credit risk

(a) Are there fundamental questions (fatal flaws) about the assessment of significant increases in credit risk? If yes, what are those fundamental questions?

(b) Can the assessment of significant increases in credit risk be applied consistently? Why or why not?

Generally, we agree that the principle-based approach of assessing significant increase in credit risk (SICR) achieves the IASB's objective of recognising lifetime ECL on all financial instruments for which there has been a SICR event, however, constituents have different views on whether the assessment of SICR can be applied consistently and whether SICR should be assessed since initial recognition at each reporting period.

We would welcome additional application guidance on the determination of significant increase in credit risk and how it should be applied. There is currently diversity in practice in how this is applied, mostly in the financial services industry.

Certain constituents raised a fundamental question on the assessment relative to origination, as this implies that a lender should know the lifetime risk of a customer at origination. Different entities and different segments (business units) within these entities apply different score cards. The application of these score cards show that the expectations significantly change once a financial instrument has been on book for a period of time, sometimes as short as six months. These constituents' view is that if one keeps referencing the expectation at origination, suboptimal decisions for the business or decisions that are not relevant are reached, because expectations change and doesn't hold after an account has been on book.

Another challenge that is experienced by certain constituents is how to apply the relative approach when the level of risk and expectations keep on changing. For example, a customer that changes from a 1% expectation of a SICR event occurring to a 2% expectation is deemed as significant, due to it representing a 100% change. However, a customer that changes from a 5% expectation of a SICR event occurring to a 5.5% expectation would not necessarily be deemed as significant due to the relatively small percentage change, even though the absolute level of risk is much higher than for the customer that started at a 1% expectation of a SICR event occurring. We recommend that the Board reconsider whether SICR should be assessed at each reporting period relative to the expectation at initial recognition and also request additional application guidance in how this relative approach should be applied.

We also recommend that the Board provide clarity on instances whereby an existing customer is issued with a new loan that would naturally be in stage one, however the customer's existing

products are in stage 2 or stage 3 due to SICR since its initial recognition. The new loan is originated in stage 1, however the lender is not convinced that it reflects the correct credit view of the customer, based on information on existing products. We find that users of financial statements will form a different view of loans and advances that are in good quality versus poor quality to that of the preparer, due to the disclosure that is provided in the financial statements being based on staging.

Question 4—Measuring expected credit losses

(a) Are there fundamental questions (fatal flaws) about requirements for measuring expected credit losses? If yes, what are those fundamental questions?

(b) Can the measurement requirements be applied consistently? Why or why not?

Generally, we agree that the requirements for measuring ECL achieve the IASB's objective of providing users of financial statements with useful information, however there are differing views on whether the measurement requirements can be applied consistently, due to the level of judgement involved.

We would welcome additional application guidance on the measurement of ECL, and specifically in the following instances:

Constituents would welcome additional guidance on rehabilitation. IFRS 9 is not very specific about how to apply the measurement of ECL requirements in instances where a loan cures from stage 3 into either stage 2 or stage 1 and from stage 2 to stage 1. We recommend that the IASB provide guidance on how to specifically build the probability of rehabilitation into the model for measuring expected credit losses.

We recommend that the IASB consider providing additional guidance on the off-balance sheet items, how to include this in the measurement of ECL and how to present it in the financial statements. IFRS 9 is not clear on whether the ECL on these items should be calculated at a portfolio or specific account level. We suggest that the Board provide clarity on this as well as guidance on its presentation.

We propose the IASB to consider incorporating additional guidance on the measurement of post model adjustments and overlays, including clarification on the requirements and principles to incorporate in estimating ECL and whether the current requirements would equally apply to post model adjustments and overlays. We also recommend the IASB to clarify whether the current IFRS 7 disclosure requirements apply equally to post model adjustments and overlays.

Constituents have noted that a lot of judgement and subjectivity are involved in measuring ECL and entity specific adjustments are used extensively to compensate for limitation in the models themselves. Judgement and subjectivity are specifically used with regards to forward looking information, both on the inputs and disclosure of these inputs. We therefore advise the Board to consider providing clarity or a definition on what would constitute entity specific adjustments, due to a lack of understanding when reading this information provided in financial statements, as well as the existence of different types of post model adjustments and overlays.

Some constituents also noted that IFRS 9 is a procyclical standard that causes a significant increase in the ECL provision raised in difficult economic conditions. We would like to

understand whether the IASB would consider reopening the discussion to incorporate some countercyclical elements, similar to the capital methodology.

We would like to propose to the Board to consider guidance regarding the type of forward-looking information that needs to be considered when measuring ECL for loans that are repayable on demand.

We note that IFRS 9, paragraph B5.5.55 gives clear guidance on how to account for costs of foreclosing collateral when loans are collateralised. "*The estimate of expected cash shortfalls on a collateralised financial instrument reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable*.". However, it is less clear how to deal with the costs of collection on uncollateralized loans and accordingly we have noted diversity in practice on how these costs are incorporated into the ECL calculation. This diversity could result in material differences in ECL recognised as well as presentation of the related costs in the statement of comprehensive income. We suggest that the IASB clarify how these costs should be considered when measuring ECL and in this regard, perhaps consider extending the TRG's guidance for collateralised exposures to uncollateralised exposures. The Transition Resource Group (TRG), in their December 2015 meeting, provided guidance in respect of the treatment of selling costs incurred when it expects that on default one of the mechanisms to realise proceeds would be to sell the defaulted loan. In this case the sales proceeds from the realisation of the defaulted loan are done net of selling costs. We suggest incorporating this guidance into IFRS 9.

Some constituents also believe that the guidance provided by the Transition Resource Group in their December 2015 meeting relating to instruments in the scope of IFRS 9 paragraph 5.5.20 should be included in IFRS 9. Specifically, these constituents believe that the guidance in respect of the period over which to estimate ECL for these instruments should be included in IFRS 9, including how credit risk mitigation actions should be considered in this assessment.

Question 5—Simplified approach for trade receivables, contract assets and lease receivables

(a) Are there fundamental questions (fatal flaws) about the simplified approach? If yes, what are those fundamental questions?
(b) Are the costs of applying the simplified approach and auditing and enforcing its application significantly greater than expected? Are the benefits to users significantly lower than expected?

We do agree with the simplified approach for trade receivables, contract assets and lease receivables and do not have any fundamental questions about the simplified approach.

However, we would like to understand whether the Board will consider allowing an accounting policy choice to applying the simplified approach for financial instruments with a lifetime of 12 months or less, but that do not fall under the trade receivables, contract assets or lease receivables. This is due to the triggering of a SICR event not necessarily resulting in an increase in ECL when moving through the stages, as they are already recognised at lifetime losses, but the only impact where this is seen, is the disclosure in the financial statements as these instruments move between the different stages. This may also assist in addressing some of the complexity involved in determining SICR on intergroup receivables that are repayable on demand or have contractual maturities of less than 12 months.

Question 6—Purchased or originated credit-impaired financial assets

Can the requirements in IFRS 9 for purchased or originated credit-impaired financial assets be applied consistently? Why or why not?

We do not believe the requirements in IFRS 9 for purchased or originated credit-impaired financial assets can be applied consistently to these types of financial assets and leads to accounting outcomes that do not faithfully reflect the underlying economic substance of these transactions. There are different instances that would result in a financial asset being recognised in this category, which doesn't come through in the requirements of IFRS 9. We therefore recommend the Board to provide clarity or distinction between financial assets that are purchased credit-impaired and financial assets that would fall within this category due to a restructure i.e. originated credit-impaired due to a significant modification resulting in the recognition of a new instrument. Some indicators of a significant modification, focuses on the financial difficulty of an obligor, whilst other indicators focus on an incurred loss. These are concepts that, even though an obligor may be in default, the loss associated with such exposure could be minimal, due to collateral and other financial guarantees in place. Further guidance on the application of exposures originated or purchased in these instances would be helpful. We also propose that the Board, as part of this, reconsider which types of instruments would remain in this category for its entire lifetime and provide an option for certain types of instruments to cure subsequent to initial recognition. Often restructures that result in a significant modification were granted to customers with the purpose of improving their credit risk subsequent to the restructure occurring. We would therefore expect to see these financial assets being able to cure from originated in stage 3 subsequently back into stage 2 or stage 1.

Specific examples include revolving facilities where customers start paying as a performing customer in stage 1, but due to the current IFRS 9 requirements, the lender is locked into a credit adjusted effective interest rate, as the financial asset was recognised as originated credit-impaired due to a substantial modification. Current systems don't allow and can't calculate a credit adjusted effective interest rate which adds another complexity in accounting for a financial instrument at this rate indefinitely.

Another example in the Africa context, is where country sovereigns are being restructured and due to these being deemed substantial modifications, they also are being recognised in this category with the same challenges being experienced. If a lender has two different instruments in isolation where one is recognised into this category due to a substantial modification, but another instrument is completely new and originated into stage 1, users of financial statements obtain two completely different views for financial instruments in the same context.

We therefore propose that the Board considers the above examples in considering whether to change the requirements for the category of purchased or originated credit-impaired financial assets.

There is confusion regarding the application of the requirements pertaining to the loss allowances and impairment gains and losses recognised in profit or loss for credit-impaired financial assets. We propose that the Board provide additional practical application examples and guidance to assist with the initial allowance on credit-impaired assets and subsequent gains and losses on impairment and ECL.

Question 7—Application of the impairment requirements in IFRS 9 with other requirements

Is it clear how to apply the impairment requirements in IFRS 9 with other requirements in IFRS 9 or with the requirements in other IFRS Accounting Standards? If not, why not?

We agree that it is clear how to apply the impairment requirements in IFRS 9 with other requirements in the same and other IFRS Accounting Standards. We have noted that there is a lack of guidance in IFRS 9 on rehabilitation and therefore suggest that the Board provide more application guidance specifically related to curing (refer to question 4 for more detail).

With regards to modifications to financial assets, we propose that the Board considers providing clarification regarding how to account for modification from an ECL perspective as we have noted that some constituents are not certain how to account for modifications especially as financial models and systems do not accommodate for the complexities regarding the modification.

Question 8—Transition

Were the costs of applying the transition requirements and auditing and enforcing their application significantly greater than expected? Were the benefits to users significantly lower than expected?

We have noted that the costs of applying the transition requirements and auditing and enforcing their application significantly were significantly greater than expected.

Question 9—Credit risk disclosures

(a) Are there fundamental questions (fatal flaws) about the disclosure requirements in IFRS 7 for credit risk? If yes, what are those fundamental questions?

(b) Are the costs of applying these disclosure requirements and auditing and enforcing their application significantly greater than expected? Are the benefits to users significantly lower than expected?

The current disclosure, based on feedback from the preparers (including their analysts and investors sessions), provides useful and relevant information and a good blueprint, regardless of the element of some diversity in the application thereof observed across the market.

However, the following concerns were raised by a minority of constituents within the committee:

- It would be useful to require entities to disclose key estimates and judgements involved regarding when other SICR criteria is used vs the 30-day rebuttable presumptions and to clarify that IFRS 7 should be read in conjunction with the requirements of IAS 1 – *Presentation of Financial Statements* to disclose significant judgements and estimation uncertainty.
- The standard requires disclosure of the maximum exposure to credit risk by credit rating grades of the gross carrying amount. The idea of staging as seen by users as the absolute exposure to risk whereas it's designed to be a relative exposure. If those disclosure

requirements around credit risk rating grades were given alongside an ECL, users would be able to better understand this relative versus absolute issue. It is important to note that not all constituents share this view.

- Benchmarking internationally depends on regulators' preferences, which results in different write off points being applied across different jurisdictions which limits comparability of stage 3 proportions and ratios. We therefore recommend enhanced disclosure around the write-off point.
- We propose that the Board indicate whether it is intentional for all disclosures to be given by class. We note that some of the disclosures, such as IFRS 7.35H explicitly requires the disclosures to be provided by class. However, other paragraphs, for example IFRS 7.35I, are not as explicit which leads to diversity in application.
- The diversity around the level of aggregation within the disclosures, for example how entities identify classes or provide the reconciling items required by IFRS 7.35H and IFRS 7.35I, make comparability difficult.
- We note that the measurement of ECL often involves the use of significant judgements and estimates, particularly relating to when SICR is deemed to have occurred and forward-looking information. IAS 1 sets out disclosure requirements in respect of such significant judgements and estimates. However, there are different interpretations of the requirements of IAS 1 in the context of ECL, with some believing that the impact of changing these assumptions should be disclosed in a similar manner as required by IAS 1 and others believing that the requirements of IAS 1 are not applicable to the assumptions made for the purposes of determining ECL. We suggest including in IFRS 7 a specific requirement to disclose a sensitivity analysis of the most significant inputs into the ECL measurement.
- We further note, as indicated above, that users perceive 12-month and lifetime ECL as credit quality distinction, resulting in a single counterparty with multiple origination dates distorting the credit risk disclosure and creating a disconnect between credit quality staging and ECL staging. A similar disconnect arises where credit enhancements (such as high-quality credit insurance) on a specific instrument for a defaulting party result in no material provision being raised, but the exposure is disclosed in stage 3 (i.e. poor credit quality and credit impaired). Credit analysts consulted believe that the focus on the counterparty credit assessment disclosure, rather than on the credit enhancement disclosure which effectively replaces the counterparty as the primary risk counter, does not faithfully present the credit risk of the exposure to users of financial statements.

The cost of auditing these disclosure and underlying models has increased compared to IAS 39. This is as a result of credit and valuation specialists that need to be incorporated into audit teams.

Question 10—Other matters

(a) Are there any further matters that you think the IASB should examine as part of the post-implementation review of the impairment requirements in IFRS 9? If yes, what are those matters and why should they be examined?

(b) *Do you have any feedback on the understandability and accessibility of the impairment requirements in IFRS 9 that the IASB could consider in developing its future IFRS Accounting Standards?*

No further matters were raised that were not addressed in the previous questions.