NEW EXPECTED LOSS IMPAIRMENT MODEL – A CHALLENGE FOR THE BANKS IN BULGARIA

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Abstract. This article introduces some of the leading works on loan impairment published by supervisory authorities, auditing companies and researchers. It makes analysis of the impairment model on the basis of the expected credit losses introduced with the requirements of International Financial Reporting Standard (IFRS) 9 Financial Instruments effective for periods beginning on or after 1 January 2018. There are a number of research works which show that the senior bankers may in some ways manage the financial result through the impairment, where it is assumed that the new impairment model will bring higher recognized losses. It also makes a comparative analysis of the announced information on the loan impairment and the preparation for the introduction of the IFRS 9 Financial Instruments requirements into the annual financial statements of the public banks in Bulgaria for the period 2013 – 2016.

Key words: financial statements, banks, impairment model.

1. Introduction

Following the financial crisis in the period 2007-2009, the activity of financial and credit institutions, being enterprises of public interest, has been subject to analysis, intensive supervision and regulation. There are numerous publications of supervisory authorities, auditing companies, professional organizations and researchers. In result of the above, the International Accounting Standards Board (IASB) updates the rules regards financial instruments. Banks are among the enterprises affected by the changes at the most, primarily regards any loans extended by them.

IFRS 9 Financial instruments was published on 24 July 2014 by IASB effective for periods commencing on or after 1 January 2018 and adopted by the European Commission Regulation No.2016/2067 of 22 November 2016 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 9. The standard introduces new requirements for the financial instrument classification and measurement, impairment and hedging. The issue related to the classification of the financial assets as subsequently measured at amortised cost, at fair value through other comprehensive income or fair value through profit or loss, is essential to banks. In the case two criteria exist for this distinction: the business model of the financial asset management, and the parameters of the cash flows agreed. Several business models could exist within one bank institution. The financial assets subsequently measured at amortised cost, as well as those measured at fair value through other comprehensive income, are subject to impairment. The impairment sum will reduce the carrying amount of the financial assets measured at amortised cost and that will be presented in the statement of financial position. Respectively, the impairment will not affect the carrying amount, and it will be recognized in other comprehensive income with financial assets measured at fair value through other comprehensive income. The new approach requires the recognition of any expected credit loss throughout the term of the financial instrument if the credit risk for this instrument has significantly increased after the initial recognition, and all reasonable and evidenced information will be taken into account for the said purpose, incl. such for future periods as well. In case the credit risk has not increased considerably as of the respective reporting date, an adjustment for losses should be recognized for the respective financial instrument in the amount of the expected credit losses for a 12-months' period. The following should be considered during the measurement of any expected credit losses, and namely: possible result probability; cash value with time; reliable information obtained without any special costs for past events, ongoing conditions, as well as estimated economic information.

All these put a number of difficulties and challenges to the financial and accounting departments and the credit risk management departments of any banks, both worldwide and in Bulgaria.

2. Literature review

In the accounting theory and practice the term "provision" is related to two basic concepts: 1/ accounting for asset impairment, and 2/ accounting for liabilities uncertain timing or amount. Any enterprises applying the international accounting regulations use the term in its second meaning. Nevertheless, since 01.01.2003 credit institutions in Bulgaria have applied the International Accounting Standards (IAS) as a base to prepare their statements, the long-term bank practice is the reason for the term "provisioning" to be used in relation to the impairment of any loans in the disclosures to the financial statements of some banks yet. Similarly, this term can be still found in its first meaning in many foreign publications as well.

Recently, particularly after the 2007-2009 financial crisis, the issue regards the interaction between the supervision rules and the financial accounting is of major interest and significance. The tendency is the two types of regulation: supervisory and accounting, to be synchronized and it is evidenced by the changes in the accounting standards proposed by International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB), as well as the supervisory institutions' instructions, guidebooks and letters.

The Basel Committee of Banking Supervision publishes regularly its studies and instructions, thus encouraging the application of common approaches and common standards in bank practice. As a result of the discussions on significant revision of the IAS 39 Financial Instruments: Recognition and Measurement and setting up a new standard, in August 2009 the Basel Committee of Banking Supervision published the following document: "Guiding principles for the replacement of IAS 39" (BCBS, 2009). The publication describes any principles related to provisioning, such as:

1/ the provisions for covering the risk of losses on loans should be reasonable and based on appropriate methods related to any expected credit losses in the existing bank loan portfolio throughout the portfolio life cycle;

2/ the accounting model of provisioning should allow early loss identification and recognition;

3/ the provisioning approach should allow professional judgment to be made;

4/ if possible, approaches taken from the bank departments of risk management and capital adequacy to be used;

5/ the provisioning approach should be oriented to any credit losses related to the whole range of various categories of loan portfolios.

We can summarize that the Basel Committee of Banking Supervision encourages the application of an impairment accounting model based on expected credit losses.

In December 2015 the Basel Committee published "Guidance on credit risk and accounting for expected credit losses" (BCBS, 2015). The objective is some supervisory guidelines to be given for accounting for expected credit losses, not contradicting with the applicable accounting standards, including with the impairment requirements of IFRS 9 Financial Instruments. The following principles essential for the banks were introduced, and namely:

1/ the management of a certain bank is responsible for the use of appropriate practices for credit risk, the internal control system efficiency and the determination of adequate provisions;

2/ the bank should adopt reasonable methods oriented to the credit risk assessment and measurement for all credit expositions, and any expected credit losses to be recognized appropriately and timely in compliance with the applicable accounting framework;

3/ the bank should have a rating process for credit risk suitable for group credit expositions based on shared credit risk parameters;

4/ the total of the bank provisions should be adequate and complying with the purpose of the applicable accounting framework;

5/ the bank should have procedures for appropriate validation models used for assessment and measurement of any expected credit losses;

6/ based on expertise judgments on loans to be used, when estimated information is presented in particular, including where macroeconomic factors are used;

7/ the bank should have adopted a process of assessment and measurement of reasonable credit risk being the base of accounting for any expected credit losses;

8/ transparent and comparable information should be disclosed in the financial statements.

Since its setting up, the European Banking Authority has always been active in monitoring the development of regulations in accounting and auditing, because they ensure the base of stability of the banks and the overall financial system. A report on the assessment of the results from the effect of IFRS 9 Financial Instruments was published (EBA, 2016), and the findings were based on a survey among approximately 50 institutions of European Economic Area. It is interesting to mention that 75% of the banks included in the survey foresee that the new requirements of the accounting standard are going to influence the profit or loss fluctuations. 16% of the banks affirm that the expected loss model is not going to affect the profit changeability because it may cause the more gradual recognition of losses in comparison with IAS 39 Financial Instruments: Recognition and Measurement providing for the incurred loss model to apply. The remaining 9% of the banks have not assessed the effect of the future application of the expected loss model. European Banking Authority, just like Basel Committee of Banking Supervision support the application of an impairment accounting model based on expected credit losses.

Large auditing companies also make surveys on the upcoming introduction of the new IFRS 9 Financial Instruments rules. For example, Deloitte has recently made annual survey in the banking sector (Deloitte, 2011; Deloitte, 2012; Deloitte, 2013; Deloitte, 2014; Deloitte, 2015; Deloitte, 2016), where the latest one (Deloitte, 2016) was primarily focused on the introduction of the expected credit loss model. 91 banks of various countries (from Europe, the Middle East & Africa, Asia Pacific and the Americas) took part in the survey. It is interesting to list the three most difficult tasks for technical implementation according to the participants questioned:

1/ the requirements to the information to be used in the impairment model, as well as the determination method of the so called “significant increase in the credit risk”;

2/ the elaboration of statistical expected loss models;

3/ the structure of the systems of calculation and reporting of the impairment model data.

Moreover, the survey found that the bank institutions predominantly had not calculated the effects of the transition to the new IFRS 9 Financial Instruments rules yet.

Ernst & Young also make regular surveys among the banks (Ernst & Young, 2011; Ernst & Young, 2012; Ernst & Young, 2014; Ernst & Young, 2016) and one of the latest studies concerned the topic of the adoption of IFRS 9 Financial Instruments (Ernst & Young, 2016). 36 banks of various countries (United Kingdom, Australia, Austria, Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Singapore, Sweden, Switzerland), being in the stage of elaborating a policy of the IFRS 9 Financial Instruments application and the business model assessment, took part in the survey. Its objective was to assess the stage of readiness of the banks for introducing the international standard’s requirements and the impairment rules in particular. One of the main findings was that the banks had advanced considerably in the implementation of their impairment programme, and the focus was falling on the identification of data and system requirements. Most credit institutions intended to disclose quantitative information of the new rules impact in 2017.

Interesting studies carried out by economic and mathematical models have been published in the area of loan impairment in recent years. One of the directions is related to the consequences of the European banks’ transition to International Accounting Standards. In this regard the researches analyze how changed recognition and measurement of a certain basic item of the operational activity and the loan loss provision would influence the income smoothing behavior and the timely loss recognition (Gebhardt and Novotny-Farkas, 2011). It is established that the restriction of recognizing any incurred losses only pursuant to IAS 39 Financial Instruments: Recognition and Measurement reduces the income smoothing to a great extent. Moreover, the application of the incurred loss approach reflects on less timely recognized losses. The conclusions of Adzisa, Tripeb and Dunmorec (2010) are similar. It is reasonable to ask the question if this trend is continuing after the introduction of the new impairment model (expected loss model). The fact that impairment would allow the management of a bank to manage its income underlines the necessity of transparency of any information in the financial statements even more clearly.

Another interesting direction in the surveys lately has been related to the interaction between the financial and supervision accounting. One of the latest researches of Novotny-Farkas (2016) studied the interaction between the “expected credit loss model” provided for by IFRS 9 Financial Instruments and the supervision rules, and discussed the potential impact on the European Union financial stability. The said researcher believed that the IFRS 9 Financial Instruments impairment model was closer to the supervision requirements compared to the impairment model applied pursuant to IAS 39 Financial Instruments: Recognition and Measurement. A forecast was made that compulsory disclosures would contribute to a more efficient market discipline and thus to financial stability. And not least, bank supervision would have an important role in introducing the IFRS 9 Financial Instruments rules, but excessive influence may also have a negative effect on the financial reporting.

3. Methodology

22 licensed banks function in Bulgaria, and they are arranged by the Bulgarian National Bank in two groups (first group – 5; second group – 17) depending on the amount of their total assets (BNB, 2016). Currently 4 banks are registered as public issuers, where one bank belongs to the first group, i.e. it is one of the five largest banks in the country, and the rest fall in the second group. Taking into consideration that surveys focus predominantly on public banks worldwide, in this article we are going to pay attention to the analyses of the disclosures to the annual financial statements of any banks licensed by Bulgarian National Bank and being public issuers of securities. All banks in Bulgaria have applied International Accounting Standards since 01.01.2003, and following the country’s joining the European Union, since 01.01.2007, International Accounting Standards have been applied in their revised version adopted by the European Commission. Here are some additional reasons for studying public banks in this country: a wider range of users of information contained in their financial statements (predominantly investors); their obligation to publish both annual and interim financial statements on the Bulgarian Stock Exchange website; the public companies’ strive for high quality disclosures and achievement of transparency of the financial reporting, etc.

The disclosures in the 2013, 2014, 2015 and 2016 annual financial statements of the public banks in Bulgaria have been studied in two main directions:

1/ disclosure of information related to loans and their impairment;

2/ disclosure of information on the preparation for applying the new IFRS 9 Financial Instruments rules.

It should be noted that banks are audited by large auditing companies having the necessary reputation in the professional circles. 16 annual financial statements have been analyzed. Common research methods, such as comparison, deduction, induction, etc., are applied.

4. Results

The following common findings, relevant to all public banks, were established on the issues studied, and namely:

1/ The disclosure structuring of each bank is of the same type for the four years studied (despite of the change of the Auditor at some banks) which is a prerequisite for information comparability. In addition, most of the order numbers of separate notes in the disclosures regards the different years were kept the same;

2/ There are no sudden fluctuations in the volume of the information disclosed at the banks for the four periods;

3/ IFRS 9 Financial Instruments with a short presentation of the main changes, is stated as a standard pending to be introduced;

4/ In the disclosed basic components of the accounting policy:

- Loans are defined as non-derivative financial assets with fixed or determinable payments not quoted on an active market;
- It is stated that loans are accounted for at amortised cost through applying the effective interest rate method;
- The measurement of any losses from impairment is shown as an area of uncertainty;
- The loss from impairment of loans and prepayments is calculated as a difference between the asset carrying amount and the present value of the expected future cash flows discounted by the original effective interest rate, where short-term receivables are not discounted (similarly some statements show that the carrying amount is reduced by the recoverable value);
- Loans are recorded net and the carrying amount is reduced by the accrued individual or portfolio impairment;
- The banks regularly revise their loan portfolio to determine the value of impairment. It is assessed if there is data of a measurable decrease available in the estimated future cash flows. The management makes judgments based on their historical experience;

5/ In the risk management disclosures regarding credit risk, there is information for two consecutive years on collectively impaired and individually impaired loans, also there is information on the credit risk concentration by branches;

6/ In the individual note on the loans extended, there is information for two consecutive years on the types of loans and the changes in impairment.

7/ In the individual note on the impairment, there is information for two consecutive years on the impairment increase (currently accrued impairment), the impairment decrease (reintegrations) and the net impairment as a result.

The following differences on the issues studied were established:

1/ The basic components of the accounting policy are of the same type at the banks but presented in a different sequence. For example, the credit management risk in some statements is in the beginning of the disclosures, and in others, it is in the end, which may influence the perception of information psychologically;

2/ Some banks continue using the term “provision” along with the term “impairment”;

3/ The level of information disclosure related to the application of IFRS 9 Financial Instruments is different. Some banks just note (briefly or in details) the main changes to be introduced, while others describe the level of their preparation and the actions performed in 2016, as well as any upcoming activities in 2017.

5. Conclusion

As a result of the study one can draw the conclusion that the banks, being public issuers, comply strictly with the requirements of the applicable accounting base, International Accounting Standards, in relation to the disclosures on loans and impairment, which is actually stated in the auditing reports too. Yet no conclusion may be drawn on the stage of readiness of the banks to apply the IFRS 9 Financial Instruments requirements and the expectations are that the effect of the new standard is going to be disclosed in the 2017 statements. Procedures of assessment of the business models, the parameters of the agreed cash flows from the financial instruments, the introduction of appropriate methods of impairment based on any expected losses, synchronization of the risk management departments and the financial and accounting departments, staff training, etc. The impact of the new rules application is yet to be studied. Although the findings established refer to the public banks in Bulgaria, to a great extent they can be referred to any other non-public banks as well for two reasons: the International Accounting Standards application and the bank auditing by large auditing companies.

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