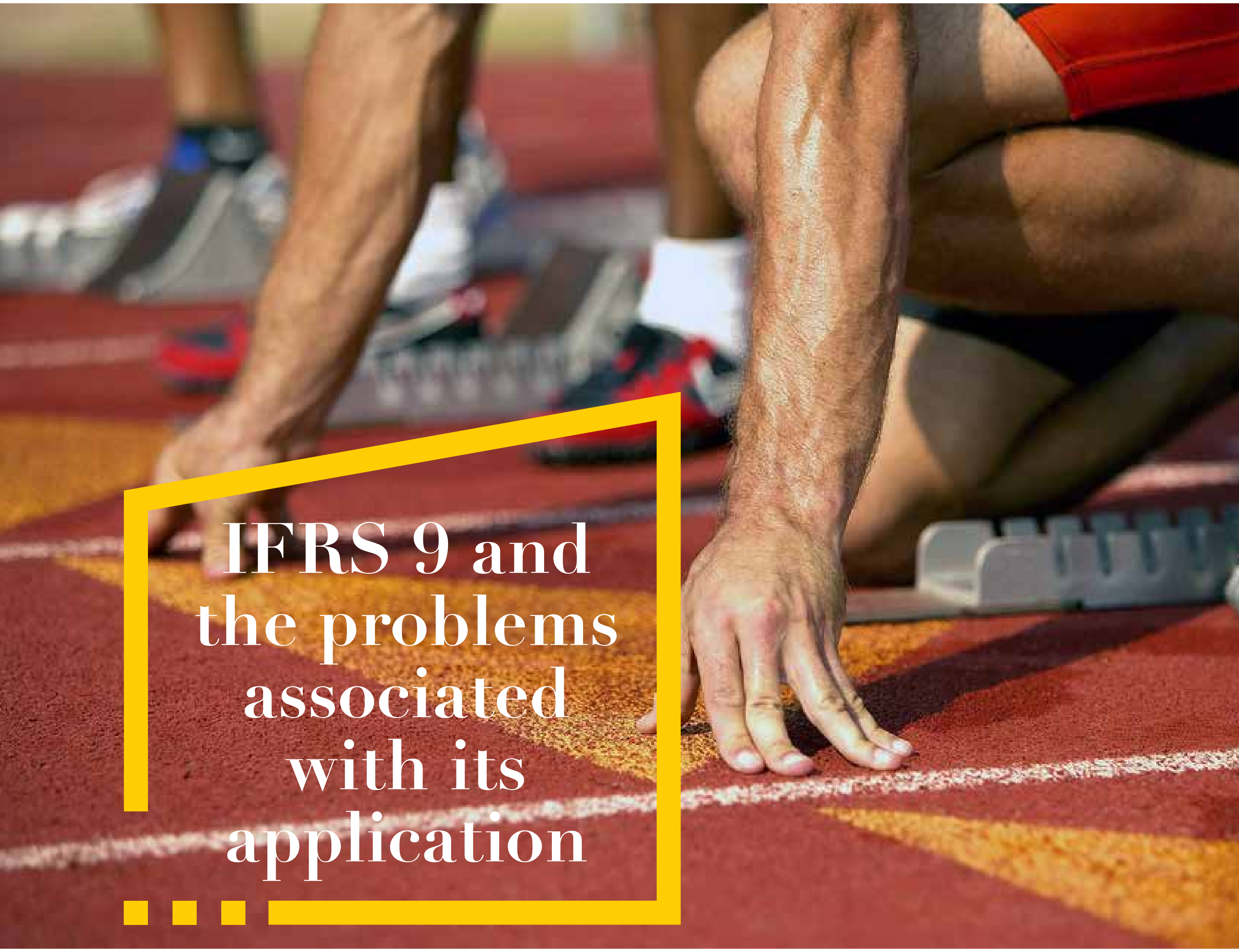

IFRS 9 and the problems associated with its application

What are the requirements and reasons for applying IFRS 9? How would you briefly explain the essence of IFRS 9 (IFRS9)?

During the financial crisis, the delayed recognition of credit losses that are associated with loans and other financial instruments was identified as a weakness in existing accounting standards. This is primarily due to the fact that current impairment requirements under IAS 39 are based on an 'incurred loss model', i.e., credit losses are not recognised until loss event occurs.

The new impairment requirements in IFRS 9 are based on an expected credit loss (ECL) model and replace IAS 39 approach. The guiding principle of the ECL is to reflect the general pattern of deterioration or improvement in the credit quality of financial instruments. The amount of ECL recognised depends on the extent of credit deterioration since initial recognition. Under the general approach, there are two measurement bases:

- 12-month ECL (Stage 1), which applies to all items (from initial recognition) as long as there is no significant deterioration in credit quality
- Lifetime ECL (Stages 2 and 3), which applies when a significant increase in credit risk has occurred on an individual or collective basis

When measuring ECLs, an entity needs to take into account:

- The probability-weighted outcome;
- The time value of money so that ECLs are discounted to the reporting date;
- Reasonable and supportable information that is available without undue cost or effort represented by past

events, current conditions and forecasts of future economic conditions.

It is expected that the application of IFRS 9 will be as complex and interesting as the application of IFRS for companies for the first time. What do you think these difficulties are related to? Why can the application of this standard create certain problems for financial institutions?

IFRS 9 is effective for annual periods beginning on or after 1 January 2018 and requires retrospective application (however, restatement of prior periods is not necessary). There is a lot of work to be done and very little time left. As described above, IFRS 9 introduced new forward-looking model that is the main challenge. In addition to analysis of quality of borrowers, the new approach will involve macro-economic factors. This will require the banks to develop / attract new skills and knowledge to the sector. Moreover, there is a new classification approach for financial instruments as well as changes to hedge accounting.

In addition, there is a general expectation that the new standard will increase provisions and therefore would affect IFRS capital (no impact on prudential capital as it is not linked to IFRS) and potentially could even impact covenants in external financing agreements. However, this needs to be carefully analysed in each case, and results depend on each country, bank and its clients.

As already noted, at present the level of awareness of the application of the standard in our country, especially in financial institutions, is low. What steps should be taken to improve this situation? What would you recommend to the companies?

We have had numerous seminars for our clients and the whole banking sector on the upcoming changes. The first seminar was held more than five year ago together with the Central Bank of Azerbaijan and the most recent one was delivered this summer together with Azerbaijan Banks Association. We have also been addressing these changes on our annual IFRS update trainings. Therefore, we believe that all banks have had sufficient opportunities to prepare for the transition. However, due to recent developments in the local banking sector, this might have not been at the top of priority list for the banks. As a result, we are falling behind when comparing to other CIS countries, where all major banks have already made significant progress on this matter. We would strongly recommend all banks to immediately prioritize this matter and establish working groups to begin transition. Most of the banks will require assistance from external consultants so their involvement should be timely planned and budgeted. Note, that it is not right to rely on external auditors to deliver this transition due to strict independence limitations. There are situations when external auditor can provide certain assistance, however management should lead the process, have the knowledge and take the responsibility.

As you know, the volume of problem loans in the country over the past 3 years has sharply increased as a result of devaluation. Do you think that the growth of problem loans increases the risk of obtaining unreliable results when applying the current standard? Do we need a special approach to these loans? Your advice on this matter will be of interest to our readers.

As discussed above delayed recognition of credit losses under IAS 39 was preeminently the key reason of transition to IFRS 9. Deterioration of loan portfolio increases risk related with underestimation of credit losses under current IAS 39. The new IFRS 9 impairment requirements eliminate the IAS 39 threshold for recognition of credit losses, i.e., it is no longer necessary for a credit event to have occurred before credit losses are recognised. Instead, an entity always accounts for ECLs and updates the loss allowance for changes in these ECLs at each reporting date to reflect changes in credit risk since initial recognition. Therefore, the main difference between current and the new standards are in provisioning for loans, which have not yet been impaired. The requirements for impaired loans are similar (but not the same) to those deemed by IAS 39 and the impact for such loans is not expected to be significant. In other words, if IFRS 9 would be implemented two years earlier, we would have seen dramatic increase in provisioning by the banks. However, by the time we get to 2018, majority of problems that occurred due to devaluations will already be known and therefore provided even under the current standard. Having said that, there will always be new challenges and therefore it is difficult to estimate the overall impact. For example, if oil price significantly drops again, this could have a negative impact on the borrowers and therefore provisions. Conversely, an increase in oil prices and strong GDP growth could have positive effect.

As a professional audit and consulting service, you serve many financial institutions and have certain information about the level of maturity of their information systems. Do you think that existing credit information systems, credit bypass systems in banks are ready to apply this standard or should some steps be taken to improve it?

We believe that finance and credit risk management systems and processes will have to be better connected than today because of the necessary alignment between risk and accounting in the new model. Risk models and data will have to be more extensively used to make the assessments and calculations required for accounting purposes, which represent both a major difference from IAS 39 and a key challenge. It is likely that systems and processes will be based on those used for credit risk management and so application of the standard will require a much closer alignment of credit risk management and financial reporting functions than may currently be the case.

Banks will, where feasible, seek to make use of existing credit risk management and regulatory reporting systems. But most banks will need, at least in part, to build new processes in order to comply with the standard.

Turgay Teymurov
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Turgay Teymurov is an Assurance Partner and Talent leader for EY Azerbaijan. He has 17 years of experience in providing assurance services to various multinational and local clients in Azerbaijan, Kazakhstan and Georgia, with focus on International IFRS, US GAAP, UK GAAP and PSA audits. Turgay is also a member of American Institute of CPAs and Associate of the Institute of Chartered Accountants in England and Wales.

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