

WILL THE INTERNATIONAL ACCOUNTING STANDARDS BOARD'S DECISION TO INTRODUCE 'THE EXPECTED LOSS MODEL' UNDER IFRS 9 CONTRIBUTE TO GREATER TRANSPARENCY OF FINANCIAL STATEMENTS INFORMATION? IS IT TRUE OR IS IT TOO EARLY TO ADDRESS THE QUESTION?

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Abstract: *The most recent global crisis of 2007 to 2009 exposed considerable vulnerability and numerous weaknesses of the financial system worldwide. More specifically the crisis highlighted the costs incurring because of delays in recognition of credit losses on loans and receivables not only on the part of banks, but also on the part of other financial institutions and lenders. All this proved out to be inconsistent with the philosophy of prudence, for long considered an overriding accounting principal especially in Continental Europe and an essential theoretical concept in the Anglo-Saxon world. Subsequently the debates on the matter have extremely intensified, and it has become more than obvious that the strategic far-reaching goal of making efforts to globally improve not only the resilience of the financial system, but the lending practices as a whole should be regarded as being of highest priority.*

Logically the considerable part of the discussions has focused extremely on the essence of various shortcomings in accounting standards that embody or are based on a prudential philosophy, the relevant requirements, and, on the everlasting societal and social necessity of neutral and well-balanced compliance with the guiding principles of prudential policy as well as on the key importance of regulatory oversight process as emphasized by the G20.

Consequently a major area of focus for a long time up to now has been the development of coherent approaches, and attempts have been globally made to search for and propose well-grounded models of accounting recognition of objects, whose valuation needs estimation, so as to resolve the most crucial problems as the issue of provisioning for loan losses. All this has not occurred unexpectedly. The recognition of loan losses and the provisioning for loan losses consistent with the previous International Accounting Standards approaches have also been criticized as not being designed on a prudential basis even to the point of being unsound. As a result the new IFRS 9 Financial Instruments was intended to respond to attacks on the part of large number of academicians, professionals and other stakeholders. The major motive was that IAS 39 Financial Instruments: Recognition and Measurement was perceived as too complex, inconsistent in the approaches to recognizing losses experiencing because of impairment of financial assets of various categories, and inconsistent with the manner entities manage their business activities and inherent risks. There was criticism and disapproval because some of the rules under IAS 39 give rise to significant delays in the recognition of credit losses on loans and loan receivables until it is too late in the credit cycle.

The key question of whether the International Accounting Standards Board's decision to introduce the model of expected credit losses will contribute to achieve greater transparency of the information produced for and provided by financial statements, and whether it will improve its quality, still stands. It is too early probably to give an objective and unambiguous answer, and any attempt to generalize would most probably be not unmistakable. At present the most realistic answer perhaps is that this will largely depend on the specific circumstances,

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since too much subjective judgements regarding the possible impact of various external and internal factors and indicators, including ones related to the forward-looking macroeconomic conditions, will influence the reliability (consistency) of the estimates of the expected credit losses; the reliability of these judgments will depend first and foremost on the competencies, professionalism, expertise, integrity and the independence and professional responsibilities of people at the highest levels of corporate governance and management.

The underlying argument, central to the present article, supporting the author's view, is that too much discretionary power in modelling expected credit losses is retained, that is, set aside for entities' officials, executives, high-ranking managers and other superiors. The discussions on the possible implications of the expected credit loss model under IFRS 9 often emphasize that such circumstance may potentially inhibit the long-standing efforts targeted at achieving greater transparency of information, which is inherent in IFRS 9 main objectives.

Managerial shifts towards more prudential policies can be expected, and that in turn can possibly improve the transparency not only in theory. However, in practice that may not be the case at all times. The implementation of the new expected credit loss model poses challenges for many undertakings concerned. Actions are needed on the part of policy makers to ensure consistency in its development and implementation, in order to constrain the emergence of potential dissimilarities in respect of the reported results even if created under the burden of similar set of risky circumstances. As regards disclosure of information related to the inputs, assumptions and techniques used to duly identify significant increases in credit risk and to estimate expected credit losses (ECLs), they will continue to be crucial, and its quality not just quantity will be of great importance for improving transparency and taking advantage of the forecasted (predicted) reduced procyclicality.

A complete understanding of the importance of auditors' key role would be also critical. This could be constructive in promoting an improvement of auditing practices worldwide, and, as a result of this, in achieving the long-desired higher degree of quality of financial statements information, and globally restoring trust in its credibility.

Key words: Prudence, incurred loss model, expected loss model, transparency, managerial discretion, financial accounting and financial reporting;

“Landmark Lifts Reserve, Takes \$28 Million Loss”

“PNC to Boost Loss Reserves by As Much As \$450 Million”

“Big loan-loss provisions, reflecting gloomy economic prospects, continued to color the earnings reports of regional banks ...”

“UJB Raises Loan Reserves and Posts \$17 Million Loss”...

“Bank of Boston reported Thursday that it lost \$187 million in the fourth quarter, after taking a \$280 million provision for credit losses. The company also announced plans to cut 1000 jobs ...”

(J. R. Walter, Economic Review, 1991, p. 20)

(American Banker various 1991 issues)

“Achieving a true and fair view is subject to the compliance, by good faith, of the accounting principles (Horomnea, 2012), and those which have refined the concept of financial reporting were the conceptual accounting frameworks (Gorgan, 2013).”

1. INTRODUCTION

The most recent global crisis (of 2007 to 2009), arisen as a financial one in the US, evolved into an economic one on an unprecedented scale, exposed considerable vulnerability and numerous weaknesses of the financial system worldwide. Specifically, the crisis highlighted the systemic (attributable to the system as a whole) costs incurring because of delays in recognition of loan losses not only on the part of banks but also on the part of other financial institutions and lenders. Subsequently, the debates on the matter have extremely intensified, and it has become more than obvious that the strategic goal of making efforts to globally improve the resilience of the financial system as a whole should be regarded as being of highest priority. Logically, a substantial part of the discussions has been focused on the essence of various shortcomings of the prudential requirements under IFRS, the everlasting societal and social necessity of compliance with the guiding principles of prudential strategies, as well as on the key importance of supervisory oversight process as emphasized by the G20. The leaders of G20, many investors, regulatory institutions and other authorities on guidelines of prudential policies emphasized the necessity of decisive action on the part of the most influential accounting standards setters as to improve the approaches and the specific rules inherent in the guiding principles of prudential policies, and, therefore, the practices of provisioning for loan losses both in the financial and non-financial sectors. Key aspects of the Basel Committee on Banking Supervision supervisory guidance, 2015¹¹⁰.

Consequently, for a long time up to now a major area of focus has been the development

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¹¹⁰ Discussing the supervisory guidance principles, the Basel Committee on Banking Supervision highlighted that banks must maintain sound corporate governance over their credit risk management and ECL estimation processes. Sound methodologies for assessing credit risk and estimating ECL should cover all lending exposures, including for restructured and credit impaired loans, should be subject to independent reviews, and must go beyond historical and current data to consider relevant forward-looking information [‘Key aspects of the Basel Committee on Banking Supervision supervisory guidance’, 2015].

of coherent approaches to assessment of objects, respectively items, whose financial statement presentation, including valuation is essentially complex, and subsequently, attempts have been internationally made to search for and to propose well-founded models of recognition of such items. That is because of the fact that the evaluation in practice imposes even often requires subjective judgements in the estimation process (procedure); however, it is supposed that such judgements should be competently made; however, that is not always the case in practice. As a consequence, robust efforts have been globally made to resolve some of the most crucial problems such as the issue of provisioning for loan losses, and all that has not become a fact unexpectedly. The recognition of allowances for loan losses arising out of impairment of financial assets as well as the provisioning for loan losses in compliance with the approaches of IAS 39 have been considerably and deservedly criticised as not being designed and executed on a prudential basis even to the point of being unsound.

What was in fact the main reason for that common observation? Under the previous approach of the incurred loss consistent with IAS 39, the recognition of credit losses focused just on past events that had actually occurred already instead of focusing primarily on possible unfavorable events (at present or in future). However, it must be considered that such events potentially exist during the full time of the credit cycle; thus such events may possibly occur even in case the probability of their occurrence is judged as insignificant (immaterial). Under the IAS 39 Financial Instruments: Recognition and Measurement, accrual of provisions for loan losses has been mainly based upon an objective evidence of an incurred loss, caused by a specific “triggering event”. A non-exhaustive list of “triggering events” that are indicators of impairment is provided by IAS 39. Reporting entities are not allowed to incorporate the effects of future events that will occur after the balance sheet date, even if such events are reasonably expected. More specifically, the model of recognising loan losses under both previous standards of the IASB and the US FASB is commonly discussed that way since it requires recognition of credit losses that have actually incurred as of the balance sheet date but not (of) losses that can be expected by the reason of unfavorable forthcoming events in the future, i.e., even if it is highly probable that such events will inevitably occur. Potentially unfavorable events that might cause losses always exist. Previously the identification of loss was mostly based on the occurrence of “a causing event”, supported by observable evidence of significant deterioration in the credit quality of the financial asset (for example, a debtor’s loss of employment, a decrease in the value of the property serving as collateral, a status of overdue credit etc.) usually combined with an expert subjective judgment. That practice led in fact to the emergence of incurred losses that were recognized far too late, and, moreover, to the overestimation of the recognized interest revenues until the moment of failure to pay. All this is consistent with the concept of the incurred loss, and that theory underlies the relevant incurred loss model (ILM).

The incurred loss model (ILM) of accounting for losses on loans and loan receivables is designed and applied across the world through the standards, including the IFRS, US GAAP and UK GAAP¹¹¹, to counteract admissible managerial inclinations of creating hidden reserves during periods of economic upsurge that can be reversely used, that is opportunistically, depending particularly on the specific conditions, in order to flatten, enhance or reinforce earnings during periods of downturn. As it has been discussed in my previous research, focused on the problem, the deliberate creation of hidden reserve when/where there is in fact no surrounding uncertainty is neither cautious nor prudential response to something even nonexistent, but merely concealment of facts; and, in my view, it is not compatible with the

¹¹¹ Generally Accepted Accounting Practice in the UK (UK GAAP) is the body of accounting standards and other guidance published by the UK’s Financial Reporting Council (FRC). A new financial reporting framework in the UK is effective on 1st January, 2015.

essence of the traditional prudence in accounting, and moreover, with the guiding principles of prudential policy. Therefore, the main considerations were to ultimately constrain excessively conservative managerial attitudes, inclined to unreasonably trust most pessimistic prognoses or unfavorable scenarios, and further, to prevent possible consequences of such unprofessional behaviour on financial statement performance. Any attempts of conducting such destructive policies would lead to complete distortion of data as well as of accounting information, and would bring about all the negative implications. All that, was contrary to the essence of a number of core accounting principles or concepts as they are referred to in the UK, e.g., as the one of prudence or independence of the separate reporting periods, the matching concept, and others. The approach under IAS 39, commonly discussed as backward in nature, lead to loan losses being recognized that have been broadly regarded as “too little, too late”. Essentially, this means that loan losses are only considered when the probability of default (PD) is near to 100%. It is argued by authoritative authors like Zoltán Novotny-Farkas¹¹² that: “A fundamental problem with the incurred loss model is that impairment allowances for credit losses tend to be at their lowest level before an economic cycle trends downward and actual losses begin to emerge”. With regard to that common observation appreciating the significance of the important improvements introduced along with IFRS 9, concerning problems of classification and measurement of financial assets, the expected credit loss model for calculating and accounting for losses of impairment of financial assets and provisioning for loan losses, the general hedge accounting requirements and others, Hans Hoogervorst admitted (2014) that accounting standards around the world, including the IFRS, US GAAP and UK GAAP, are based (Hoogervorst has in mind the relevant approaches as implemented at that time in 2014) upon the incurred loss impairment model, designed that way to limit management’s ability to create hidden reserves during good times that could be used to flatten earnings during bad times^{113 114}.

It was more than obvious that the IASB’s members were confronted by the complex task to develop rules, designed for well-thought-out, well-organized and disciplined management of earnings and risks, and that responsibility has probably been considered to be the main concern. As a result, in July 2014, the International Accounting Standards Board (IASB) issued IFRS 9 *Financial Instruments*¹¹⁵, and in 2016 the Financial Accounting Standards Board (US FASB) in the US published its final standard that is based on ‘the current expected credit losses’ (CECL) approach.¹¹⁶

The author’s main goal is to highlight problems that as potentially existent give rise to concerns even though the newly introduced improvements will most probably imply more prudential

¹¹² Novotny-Farkas, Z. (2015) “The Significance of IFRS 9 for Financial Stability and Supervisory Rules”, 2015, pp.1-54, European Parliament”, Brussels: European Union, 2015.

¹¹³ Hoogervorst, H. (2014) “Charting progress towards global accounting standards”, *Conference Singapore*, pp.1-9

¹¹⁴ Further the IASB Chairman points out that “during this most recent crisis the model has been accused of resulting in impairment being ‘too little, too late’. In practice ... impairment was only recognised just before a loan defaulted. ...loan losses were often recognised far too late. As a result, many investors lost trust in the quality of banks’ balance sheets... For this reason we decided to move from an incurred loss model to an expected loss model.” [H. Hoogervorst, 2014, pp.1-9]

¹¹⁵ In July 2014 the IASB issued IFRS 9 *Financial Instruments* with mandatory implementation from January 1st, 2018. The IFRS 9 supersedes all previous versions and is mandatorily effective for periods beginning on or after January 1st, 2018 with early adoption permitted (subject to local endorsement requirements). For a limited period, previous versions of IFRS 9 may be adopted early, provided the relevant date of initial application is before February 1st, 2015 (subject to local endorsement).

¹¹⁶ It is expected that both of the new standards will come into effect in the period between 2018 and 2021.

policies on the part of the entities mostly impacted by the changes, and as well as to support the relevant considerations with comprehensive arguments.

2. WHY SHOULD MODELS OF PROVISIONING FOR LOAN LOSSES BE BASED ON ESTIMATES OF EXPECTED LOSSES?

Critical questions have been raised in the debates on the matter, and many of these questions have been encouraged by the long-standing implications of the recent global crisis on the financial status and performance of thousands of entities both in financial and non-financial sectors as well as on the social status of millions of people. Researchers like Cohen and Edwards Jr ¹¹⁷ brought up the issue of “*whether models of provisioning, including the effect of provisioning on regulatory capital levels, contributed to procyclicality by spurring excessive lending during the boom and forcing a sharp reduction in the subsequent bust*” (*Emphasis added*). Furthermore, Cohen and Edwards Jr thoroughly discussed the crucial question of *why entities should provision for expected credit losses*¹¹⁸, focusing on interesting insights of many other researchers. For example, Cohen and Edwards Jr discussed the views of Borio and Lowe (2001), who argue that, “conceptually, if lending rates accurately reflected credit risks, banks would have no reason to set aside additional provisions at the initiation of a loan to cover *expected losses*”. In Borio and Lowe’s view, the core reasoning in the case is that: “The higher margin of interest on a risky loan would reflect the increased risk of non-payment, while a higher rate of discount, which reflects greater risk relating to the loan’s cash flows, would counterbalance the higher interest margin in guiding the decision of lending.” Regarding this Borio and Lowe deliberated that “capital would still be needed to cover unexpected losses.” As specified by these authors “Provisions would then be appropriate, if the riskiness of the loan increases after initiation, to recognize the higher discount rate and the reduced likelihood of repayment, or, equivalently, the value of the loan would be marked down as part of a fair value accounting approach”. Similarly, in Cohen and Edwards’s view, “a bank might even take negative provisions” (an increase in asset values), if riskiness were to recede”¹¹⁹

The critical question that should be raised at this point as it distinctly stands, is namely why then provisions should be based on estimates of expected losses since the moment a loan is initiated. It is pointed out in the quoted article, that one answer is that loan pricing may not completely reflect the risks for the reason of transitory (temporary, passing) market conditions that will soon recede, and that explanation can be accepted as an objective and reasonable one. “If past experience and sound modelling suggest that credit risks are not fully reflected in loan pricing decisions, prudential risk management would presuppose supplementing market signals with additional evidence.”¹²⁰ More explanations related to capital are also further discussed since the issue of capital adequacy is no less important. In their analysis, Cohen and Edwards Jr referred to Peek and Rosengren (1995), for example, as well as to Dugan (2009), who noted that the need to maintain adequate capital (or rebuild deficient capital) is less likely to bind banks’ decisions in good times than in bad times, creating a bias to lend freely during economic upsurges. “Forward-looking provisioning essentially brings the capital cost of a lending

¹¹⁷ Cohen, B. H., and G. A. Edwards Jr. (2017) “The new era of expected credit loss provisioning”, BIS Quarterly Review, March, pp.39-56 (40-42 and following ones).

¹¹⁸ Cohen, B. H., and G. A. Edwards Jr. (2017) “The new era of expected credit loss provisioning”, BIS Quarterly Review, March, pp.39-56 (40-42 and following ones).

¹¹⁹ Cohen, B. H., and Gerald A. Edwards Jr. (2017) “The new era of expected credit loss provisioning”, BIS Quarterly Review, March, pp.39-56 (40-42).

¹²⁰ Ibid, pp. 40.

decision forward in time, restoring to some extent the incentive value of capital for marginal lending decisions, even in times when the capital buffer itself is not a binding constraint.”¹²¹

The essential explanation underlying most incompatible arguments advocated by opponents is that allowing too much judgment in setting provisions could enable banks and not only banks but other financial institutions and corporate entities to deliberately use those opportunities of exercising provisioning practices, to smooth earnings, and as a consequence, to significantly impair the transparency of financial statement information, therefore, to significantly reduce its usefulness to investors and other counterparties. It should be emphasized that, *in order to avoid such possible consequences or scenario, provisioning needs to be based on clear rules of when and how provisions are recognized and adjusted over time, alongside transparency of the methodologies and assumptions.*¹²²

Vast majority of scientific research support the widely maintained conclusion that delayed provisioning or backward-looking provisioning practices lead to the procyclicality of lending, while forward-looking provisioning reduces procyclicality. It is comprehensively discussed by Cohen and Edwards Jr (2017), that Laeven and Majnoni (2003), for example, looking at 1,419 banks in 45 countries in the period between 1988 to 1999, find a positive relationship between provisions and pre-provision earnings, suggesting that banks use provisions to smooth income, and that a negative relationship holds between provisions and growth in lending and GDP, implying that provisions are procyclical. Some findings of other authors also discussed by Cohen and Edwards Jr (2017) are those Beatty and Liao (2011), who looking at quarterly data on 1,370 US banks in the period of 1993 to 2009, find out that a longer delay in banks' loan loss recognition increases the negative impact of recessions on bank lending. These scientists find out this result for several measures of delayed loss recognition at bank level: a flow measure (the responsiveness of provisions to past non-performing loans), a stock measure (the ratio of loan loss allowances to contemporaneous non-performing loans) and a market measure (the link between a bank's current reported income and future equity returns). Cohen and Edwards Jr referred to the findings of more researchers like Bushman and Williams (2012), who apply a similar approach to banks in 27 countries, and investigate the relationship between banks' loan-loss provisions and their past and future non-performing loans. They find out that banks' risk-taking discipline (the tendency to reduce leverage when asset volatility rises) is greater for banks that take provisions well ahead of actual loan losses.¹²³

In general, loan loss reserves designed to absorb current losses, are represented on the balance sheet via a contra-asset line item; such reserves differ in essence from capital and its comprising components, represented on the balance sheet through an equity line items, usually intended to absorb future unexpected losses. Loan loss reserves are developed, i.e., accumulated over time through accrual of provisions for loan losses along with recognition of an impairment expense item on the income statement, in order current losses on loans to be recognized. Under IAS 39 *Financial Instruments: Recognition and Measurement*, loan loss provisions have been largely reported on an ex-post basis. More specifically, the accrual of provisions subsequently, after the “loss event” has in fact occurred, is constructed upon the techniques of the incurred loss models. In complete unanimity with Gebhardt and Novotny-Farkas (2011) Nicolas Stefano reasonably deliberated¹²⁴ that since the incurred loss models focus on objective evidence of

¹²¹ Ibid, pp. 40-41.

¹²² Cohen, B. H., and Gerald A. Edwards Jr. (2017) “The new era of expected credit loss provisioning”, BIS Quarterly Review, March, pp.39-56 (40-42).

¹²³ Ibid, pp. 41-42.

¹²⁴ Stefano, N. (2017) Norges Bank Economic Commentary, no. 8, 2017, IFRS 9, Implementation, pp. 1-10, p.3.

loss, that can limit the potential for earnings management through discretionary loan losses provisioning as it is also noted by Gebhardt and Novotny-Farkas (2011), to whom the author refers. Stefano respected the extensive research focused on the problem – the possibility for capital and earnings management through discretionary, optional or flexible loan loss provisioning, and discussed opinions of authoritative authors like Moyer (1990), Beatty et al. (1995), Collins et al. (1995), Liu and Ryan (2006), and Norden and Stoian (2013)¹²⁵. Stefano soundly suggested that market participants often searching for transparency of financial statements information may have appreciated such methodical approaches even before the crisis. Those assumptions are supported through a reference to Dugan (2009), who also noted that provisioning based upon incurred loss models, in practice reinforced the procyclicality effects, observed during the financial crisis. More than a few analyses have supported the opinion that delays in provisioning for loan losses under incurred loss models have contributed to procyclicality [18.N. Stefano, 2017]¹²⁶. Moreover, it is argued that the employment of such models can lead to incomparable results due to the potential for varying underlying assumptions and inconsistency in application that can inhibit transparency¹²⁷.

Under IFRS 9 provisioning for loan losses will largely rest on an ex-ante basis. Specifically, provisions will be recognized before the “loss event” has actually occurred even though such loss event may not occur; this in itself supposes that provisioning will (*should*) be based upon forward-looking trustworthy and provable information and that the loan losses will be calculated through the techniques of expected credit loss models. Therefore, the new IFRS 9 embodies philosophy imposing a shift in focus towards more prudential considerations in future provisioning practices for loan losses. Under the new approach, provisioning will no longer be focused on past one-off events, but rather on reasonable expectations that should be based on reliable, i.e., verifiable and supportable information, and methodically weighed probability of what could possibly happen over the full lifetime of the financial asset. It is argued that against the backdrop of a financial cycle, such an approach may reduce procyclicality¹²⁸. However, it is actually admitted that the results have not yet been observed in practice¹²⁹.

The purpose of estimating expected credit losses is neither to estimate the worst-case scenario nor to estimate the best-case scenario. Instead, an estimate of expected credit losses shall always reflect the possibility (probability) that a credit loss occurs and the possibility that no credit loss occurs even if the most likely outcome is no credit loss¹³⁰.

It is emphasized in IFRS 9, Paragraph 5.5.17(a), that the estimate of the expected credit losses should reflect an unbiased and probability-weighted amount, which is determined by evaluating a range of possible outcomes. It is explicitly highlighted in IFRS 9 that in practice estimating expected credit losses may not necessarily need to be a complex process of analysis, and that an entity does not need to identify every possible scenario. In some cases, relatively simple modelling may prove to be sufficient, without the need for a large number of detailed

125 See also Moyer (1990), Beatty et al. (1995), Collins et al. (1995), Liu and Ryan (2006), and Norden and Stoian (2013).

126 Nicolas Stefano refers (2017) to many authoritative authors like Laeven and Majnoni (2003), Beatty and Liao (2011) and Bushman and Williams (2015).

127 Ibid, pp. 1-10, p.3.

128 The IASB and the US FASB issued their standards since they believe the ECL approaches would provide more useful information for investors. The Boards did not seek to address procyclicality issues. Nevertheless, the Financial Stability Forum noted, the earlier recognition of ECL should nonetheless help to mitigate procyclicality.

129 Stefano, N. (2017) Norges Bank Economic Commentary, no. 8, 2017, IFRS 9, Implementation, pp. 1-10, p.3.

130 IFRS 9 Financial Instruments as issued by the IASB.

simulations of scenarios. In other cases, entities will need to determine how many more scenarios are required. IFRS 9 also permits the use of models for estimating expected losses that do not require explicit scenario and probability analysis. For example, it is stated that the average credit losses for a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount. In other situations, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of those outcomes will probably be needed. In those situations, the expected credit losses shall reflect at least two outcomes in accordance with Paragraph 5.5.18¹³¹. As a general rule, the maximum period to consider in measuring expected credit losses is the maximum contractual period (including extension options). For lifetime expected credit losses, an entity shall estimate the risk of default occurring on the financial instrument during its expected lifetime. 12-month expected credit losses are a portion of the lifetime expected credit losses, and represent the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date (or a shorter period if the expected life of a financial instrument is less than 12 months), weighed by the probability of that default occurring. *Therefore, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months nor the cash shortfalls that are predicted over the next 12 months*¹³².

It is required by IFRS 9 the estimates of the expected credit losses to reflect the amount, reliably determined (measured) and weighed on the basis of probability by evaluating the scope of possible outcomes (results), however passing through the professional judgement.

The new IFRS 9 *Financial Instruments* impairment model was proposed to respond to robust attacks on the part of great number of academicians, professionals, and stakeholders that IAS 39 *Financial Instruments: Recognition and Measurement* is too complex, besides inconsistent with the manner entities manage their business activities and inherent risks. Another criticism was that some of the IAS 39 rules defer the recognition of credit losses on loans and loan receivables until too late in the credit cycle. It should be admitted that some members of the International Accounting Standards Board (IASB) have realized the necessity of reconsidering the models of IAS 39 *Financial Instruments: Recognition and Measurement*, and have intended to introduce requirements as to presuppose more prudential accounting policies.

3. THE PROSPECTS WITH REGARD TO THE POSSIBLE CONSEQUENCES OF IFRS 9 FINANCIAL INSTRUMENTS EXPECTED LOSS MODEL

The stakeholders' forecasts mostly discussed with regard to the possible implications of IFRS 9 *Financial Instruments* alongside its new expected credit loss (ECL) model include:

- The appropriate application of the expected credit loss model under IFRS 9 imposes much more relevant information (historical, current and forecast) to be collected, accumulated and incorporated in the process of identifying, recognizing and estimating expected future credit losses, a circumstance that may be considered a prerequisite the credit quality of financial assets to be better reflected. Therefore, it addresses the appeal of G20 and other globally interested groups for strengthening the accounting recognition of loan losses by including a broader range of information. It was specified that the purpose of estimating expected credit losses is neither to estimate the worst-case (pessimistic) scenario nor to estimate the best-case scenario. Instead, an estimate of an expected credit loss shall (should) always reflect the possibility (probability) that a credit loss occurs (may occur)

¹³¹ IFRS 9 *Financial Instruments* as issued by the IASB.

¹³² IFRS 9 *Financial Instruments* as issued by the IASB.

and the possibility (probability) that no credit loss occurs (may occur) even if the most likely outcome is no credit loss.

- It is supposed that some of the changes ever since the standard is effective will contribute to more volatility with regard to the income statement/statement of profit or loss and other comprehensive income as IFRS 9 potentially raises the likelihood (probability) of that more financial assets to be measured after initial recognition at fair value through profit or loss (FVTPL), and, therefore, it can be expected that possible significant changes in fair values will be recognized in profit or loss as soon as they arise.
- As highlighted previously, earlier identification and recognition of probable future losses due to impairment of financial assets on loans and receivables including trade receivables, is expected, since entities will have to start providing for possible future credit losses in the very first reporting period a loan is recognized in the accounts – even if it is highly probable that the asset will be completely and timely collectible as provided for under the lend arrangement of repayment. The earlier and probably higher impairment allowances can limit the possibilities of distributing overstated profits in the form of dividends and premiums, and also to constrain high-ranking managers’ excessively optimistic expectations. With regard to the broadly discoursed assumptions for earlier recognition of loan losses, the European Financial Reporting Advisory Group (EFRAG) as an active group who has always contributed to the IASB’s due process has confirmed their standpoint. EFRAG conducted a test in the field with the National Standard Setters of leading states as France, Germany, Italy and the UK. The objective was to assess whether the proposals set out in the Exposure Draft (‘ED’) would address the weaknesses of the incurred loss model consistent with IAS 39, whether the proposals were operational, and the likely costs of expected loss model implementation (EFRAG’s Comment Letter - Financial Instruments: Expected Credit Losses). EFRAG also agreed with the analysis in Paragraph BC170 of the ED that the proposed model would ensure more responsiveness to the changes in the credit quality compared to IAS 39, and, therefore, would result in an earlier recognition of expected credit losses.
- An increased accrual of provisions is expected from the moment IFRS 9 comes into force. “Since this convergence (between the Basel regulatory framework and IFRS) comes with some challenges with regard to the pressure on the capital ratios due to an increased accrual of provisions, the credit institutions must estimate the degree of impact on their capital, and be active in designing a plan for the execution of developed models as early as 2017, before IFRS 9 comes into effect as of January 1st, 2018.”¹³³
- In that way, IFRS 9 can mitigate the amplifying effect of the incurred loss approach on procyclicality and can enhance financial stability. [Zoltán Novotny-Farkas, The Significance of IFRS 9 for Financial Stability and Supervisory Rules, 2015, pp.1-54]
- It can also be suggested that those entities that are more significantly impacted by the introduced considerable quantitative and qualitative disclosure requirements may need new systems and processes to collect, accumulate and provide the essential data and information. Disclosure practices will need to fortify prudential assessment and management of risk through market discipline. Results of many surveys indicate a need for that central banks and other prudential authorities to be more active in encouraging banks to devote more resources to implementing expected credit loss provisioning requirements in a more robust, consistent and transparent manner.
- It is reasonably argued that a great degree of discretionary power in modelling expected credit losses on loans and long-term trade receivables is reserved for entities’ officials,

¹³³ Milanova, E. (2017) “Compatibility between IFRS 9 Financial Instruments and the Basel framework for capital requirements”, Yearbook 2016: IDES/ICPA in Bulgaria, 2017, pp. 31-78.

executives, high-ranking managers and other superiors at corporate governance level. A great margin of discretion – freedom of choice, i.e. leeway to maneuver, is retained for the representatives of corporate governance; the major concern is that potential exists of turning that circumstance into a prerequisite for reducing the long desired and looked-for effect of all efforts targeted at achieving a higher degree of transparency, inherent in the main objectives of IFRS 9. The discussed changes signify potential shifts towards more prudential approaches that may hypothetically improve or might not improve the transparency of information. The implementation of the new accounting standards poses challenges that should be thoroughly comprehended by policy makers, and, therefore, skillfully managed by them. Actions that ensure consistency in the development and implementation of models in such way as to minimise potential differences in financial statements information provided will remain crucial to enhancing disclosure in practice. That issue is of key importance to achieve better transparency and to realize the benefits of the anticipated decrease in procyclicality.

- Entities will need to assess their business models of holding financial assets. For some entities, such as non-financial corporates, the assessment may be relatively simple as their financial assets may be limited to trade receivables and bank deposits that are obviously held to collect contractual cash flows. Entities that have a broader range of activities involving financial assets, for example lenders, investors in debt securities held for treasury activities and insurance entities, will need to perform more thorough analysis to understand the relevant business model and consider the motivations that would lead to disposals of financial assets.¹³⁴

4. FURTHER INFERENCES

It can be argued as discussed by specialists that IFRS 9 *Financial Instruments* along with the new impairment model, which it proposes, if applied consistently, will (may) lead to the recognition of provisions for loan losses in a more timely fashion manner than that kind of practice was performed (executed) under IAS 39 *Financial Instruments: Recognition and Measurement*. The possible improvements primarily due to the requirement or opportunity for earlier recognition of 12-month ECL for all the exposures allocated (positioned) in Stage 1, of earlier recognition of lifetime losses as soon as it is noticed that credit risk significantly increases in Stage 2, and of the usage of a considerably broader range of data and information, including information pertaining to macroeconomic conditions and forward-looking one, can be actually realized only if the requirements are properly implemented. In particular, the ECL model under IFRS 9 imposes changes in the probability of default be taken into account earlier in comparison with the relevant model under IAS 39. With regard to rapidly expanding loan portfolios, when that process is logically combined with rising expectations probability of default to increase over time, under IFRS 9 ECL model it is required earlier and higher loan loss allowances to be recognized. It can be suggested that the new extended requirements of disclosure (qualitative and quantitative) may contribute to raise the level of transparency of loan loss provisioning and credit risk profile, and to improve management of credit risk.

However, there are preconceptions giving rise to concerns regarding the effects of IFRS 9 ECL model implementation. The scheme of ‘the three stage classification’ is based on a relative

¹³⁴ Entities will also need to reassess their business models each reporting period, to determine whether the business model has changed since the preceding period. Increasing levels of sales of financial assets held within a business model that previously had met the pressure on the capital ratios due to an increased accrual of provisions, will enforce institutions to estimate the degree of impact of these changes on their capital, and be responsible in designing a plan for the execution of previously thought-out actions, adequate to the new circumstances.

credit risk model. It means that all assets are initially allocated to the first stage (Stage 1), and furthermore, that subsequent reallocations from one stage to another will occur only when initial credit risk expectations substantially change, that is, when the credit quality of a financial asset significantly deteriorates. Under the absolute credit risk model, financial assets on loans would be initially allocated to one (any) of the three possible stages on the basis of the assessments of their absolute risk; that means that loans bearing higher risk would be directly classified either into the second stage (Stage 2) or the third one (Stage 3). As a main disadvantage of the credit risk absolute model is highlighted that it would require immediate recognition of lifetime losses, which conceptually would be questionable (can be questioned) since initially expected credit losses can be assumed to be incorporated in the pricing on the loan. The relative credit risk model mitigates this possible initial ‘mismeasurement’ only to some extent by recognising the 12-month expected credit losses (ECL). As a potential drawback of this model is pointed out by Novotny-Farkas [Novotny-Farkas, 2017, pp.15-16] that one and the same asset could be classified as to be included in Stage 1 by one bank and by another one in Stage 2, and that might impair comparability of information provided by financial statement of different financial institutions. Those concerns are partly mitigated by the presumption that riskier assets positioned in Stage 1 will probably have a higher 12-month ECL and also larger periodic adjustments of 12-month ECL^{135 136}.

It is believed that “the IFRS 9 expected loss approach represents a reasonable compromise between providing relevant information and catering for the needs of supervisors to enhance financial stability.”[29.Novotny-Farkas, 2015, p. 8-9, pp. 41-42]¹³⁷ However, it is emphasized that the alignment of accounting and supervisory rules in combination with the increased minimum capital requirements under the Capital Requirements Regulation (CRR)¹³⁸ will probably reinforce incentives or motivations of bank superiors to opportunistically manipulate loan loss amounts in order to avoid breaches of regulatory thresholds, which, in turn, trigger limitations of dividend payments.¹³⁹

It is argued by specialists that the expected credit loss (ECL) model under IFRS 9 stands much closer to the regulatory and supervisory framework requirements. The new impairment approach is based on prudential considerations predominantly; in addition, it is designed that way, in order to presuppose earlier and probably higher or at least more realistic impairment allowances, if applied consistently. For that reason, there is likelihood the application of IFRS 9 expected credit loss model to mitigate the tendencies of procyclicality considered an emblematic drawback of IAS 39 incurred loss model (ILM). The expectations about more reliable provisioning practices under IFRS 9 ECL model along with the anticipated improved

¹³⁵ Zoltán Novotny-Farkas (2015) “The Significance of IFRS 9 for Financial Stability and Supervisory Rules”, pp.1-54, European Parliament, Brussels: European Union, 2015.

¹³⁶ Novotny-Farkas reasonably argues that the initial recognition of 12-month ECL is somewhat arbitrary and lacks conceptual justification. Moreover, the author highlights potentially existent problems due to the stepwise recognition of loan losses in Stage 1 and Stage 2 that will often lead to an over- or understatement of loan loss allowances, and the magnitude of these deviations will depend on that how timely entities incorporate relevant information and update loan loss allowances, particularly an issue – in his view, with regard to financial assets moving from Stage 1 and Stage 2 and the switch from 12-month ECL to the recognition of lifetime ECL. Novotny-Farkas reveals the most critical question – if management is not able or is not willing to identify ‘significant increases’ in credit risk on a timely basis, the switch from Stage 1 to Stage 2 would result in significant ‘cliff effects’ creating the same problems as IAS 39. [Zoltán Novotny-Farkas, 2015]

¹³⁷ Ibid.

¹³⁸ Regulation (EU) 2017/2401 of The European Parliament and of The Council of 12 December 2017 amending Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

¹³⁹ Zoltán Novotny-Farkas (2015) “The Significance of IFRS 9 for Financial Stability and Supervisory Rules”, pp.1-54, European Parliament, Brussels: European Union, 2015.

transparency of financial statement information, may (might) contribute to enhancing financial stability.

The IFRS 9 model provides a considerably larger scope for managerial discretion than IAS 39 model. The expected loss model under IFRS 9 introduces a significant increase of managerial discretionary power with regard to the timing of recognition of expected credit losses and the assessment. There is a substantial scope for subjective judgment in determining whether significant increases in credit risk has incurred, and, if it is so, that will trigger (cause) the switch from the 12-month ECL to the recognition of lifetime losses. Management might be inclined to delay the movement of assets from Stage 1 to Stage 2, in order to avoid such ‘cliff effects’, and in such case impairments that would be recognised, would also be ‘too little, too late’. In a downturn, when problems develop quickly, the initial delay of recognition of losses in Stage 2 can exacerbate the ‘cliff effect’ with a sudden and substantial increase in loan loss allowances and a hit to regulatory capital causing the same problems as observed with IAS 39 incurred loss model. In addition, “the longer the forecast horizon that has to be considered in the measurement of expected losses the greater the valuation uncertainty and subjectivity.”¹⁴⁰ With respect to this concern it is broadly admitted in the accounting literature that “discretion is a double edged sword”¹⁴¹. Therefore, whether the looked-for potential benefits of IFRS 9 will be realised will ultimately depend on the specific manner in which the approaches are applied – and the right way is the approaches to be applied properly and consistently, in any case, not depending on the conjuncture. This, in turn, requires systematic and joint efforts to be made on the part of professional accountants as prepares as well as on the part of auditors¹⁴², supervisors and policymaking bodies.

It is reasonable to argue, therefore, that clear roles and responsibilities for validation of the IFRS 9 ECL model are needed along with adequate independence and competence, sound documentation and independent process review¹⁴³. In conclusion, the key question of whether the International Accounting Standards Board’s decision to introduce the model of the expected credit loss will contribute to greater transparency of the information provided by financial statements of general purpose, and whether it will improve the quality of financial reporting, still stands. Probably it is too early to give an objective and unambiguous answer, and any attempt to generalize would most probably be not unmistakable. At present, the most realistic answer perhaps is that this will largely depend on the specific circumstances, since subjective judgements regarding the possible impact of various external and internal factors as well as indicators, including the forward-looking macroeconomic conditions, will influence the estimates of the expected credit losses and their reliability; the reliability (consistency) of these

¹⁴⁰ See Zoltán Novotny-Farkas (2015), p.33.

¹⁴¹ See Bushman and Landsman (2010); See also Bushman (2015), p. 11.

¹⁴² Cohen and Edwards Jr emphasized that authorities can encourage auditors to achieve a greater understanding of IFRS 9 as well as related implementation efforts and supervisory guidance. Supervisors should gain a better understanding of auditor roles, in their view. These authors consider that could be helpful in encouraging an improvement in the quality of auditor practices. Furthermore, the authors argued that: “Models will need to be validated and regularly reviewed... Disclosure practices will need to reinforce prudent risk measurement and management through market discipline. Survey results indicate a need for central banks and other prudential authorities to become more active in encouraging banks to devote more resources to implement ECL provisioning requirements in a more robust, consistent and transparent manner. New, forward-looking thinking will be needed for a new era.” [B. H Cohen and G. A. Edwards Jr, The new era of expected credit loss provisioning: BIS Quarterly Review, 2017]

¹⁴³ See ‘Key aspects of the Basel Committee on Banking Supervision supervisory guidance, 2015’. <http://laviecco.com/news/economie/la-norme-ifrs-9-va-bouleverser-le-mode-de-comptabilisation-des-provisions-bancaires.html>, <https://www.bankingsupervision.europa.eu/press/speeches/date/2015/html/se150421.en.html>

judgments will depend first and foremost on the competencies, professionalism, expertise, integrity and the independence and professional responsibilities of people at the highest levels of corporate governance, policymaking and supervisory or controlling.

5. THE PERSPECTIVE OF CONVERGENCE BETWEEN THE IFRS 9 *FINANCIAL INSTRUMENTS* ECL MODEL AND THE US GAAP RELEVANT MODEL

The project of IFRS 9 *Financial Instruments* was a substantial part of an initiative of the two Boards – the International Accounting Standards Board (IASB) located as known in London, and the US Financial Accounting Standards Board (US FASB) in the US. Unfortunately, the Boards are not working any more on this project except for issues focused on impairment of financial instruments as loans and loan receivables as the Boards’ members were unable to reach an agreement on key problems though great efforts had been made over the years to develop a converged, mutually acceptable approach. As a result priorities have been given to other projects; however, it should be admitted that the two regulatory environments differ, which in turn poses challenges, and may make the alignment of the two accounting models impracticable. The alignment both in principle and application would be meaningful to compare the financial performance of those reporting entities that prepare financial statements under the approaches and rules of the two different regimes. Ultimately, the Boards’ members do agree on principles for measuring impairments of loans and loan receivables, but they do not agree on the critical question of the timing of recognition.

The new similar US FASB’s standard alongside its relevant model of impairment, which it proposes, will be effective for Securities and Exchange Commission (SEC) filers for years beginning on or after December 15th, 2019. The adoption is allowed one year earlier and one year later for other entities. Under the analogous US FASB’s standard on the subject of provisioning for expected credit loss, all expected credit losses are considered over the lifetime of the loan from the time the asset is recorded on the balance sheet. Probably that will result in higher overall provisioning levels. It is reasonable to argue that the approach under the US FASB’s comparable standard may prove to be more conservative in principle, in comparison with IFRS 9 expected credit loss (ECL) model.

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