The Institute of
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of Pakistan

CA
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Accounting Guidance

Application of IFRS 9 by Non-Banking Finance Companies

The Accounting Standards Board

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Section 1 - Preamble

In 2014, the International Accounting Standards Board (IASB) issued the IFRS 9, *Financial Instruments*.

The Securities and Exchange Commission of Pakistan (SECP), through S.R.O. 229 (1)/ 2019 (dated February 14, 2019) has adopted IFRS 9, effective from June 30, 2019. However, for Non-Banking Finance Companies (NBFCs), SECP deferred the application of IFRS 9 and made it applicable from June 30, 2021.

The financial statements and results of operations of NBFCs would be affected once IFRS 9 is applicable. In particular, the application of new impairment requirement i.e. Expected Credit Loss (ECL) requires all NBFCs to establish provisions for expected future credit losses. Under the IFRS 9 ECL approach, NBFCs need to consider current conditions and reasonable and supportable forward-looking information that is available without undue cost or effort when estimating expected credit losses.

The Accounting Standard Board (ASB), with the objective to facilitate NBFCs in the implementation and transition to IFRS 9, has developed the Accounting Guidance *'Application of IFRS 9 by Non-Banking Finance Companies'* (the Accounting Guidance). The ASB, for the development of this Accounting Guidance formed the Working Group which included representation of SECP.

This Accounting Guidance aims to assist the NBFCs in developing understanding and effective implementation of IFRS 9, and discusses key areas of IFRS 9, including:

- Classification and measurement of financial assets and financial liabilities;
- Application of ECL and its interaction with the time-based classification and provisioning requirements provided in the Non-Banking Finance Companies and Notified Entities Regulations 2008 (NBFC Regulations); and
- Disclosure requirements.

The Accounting Guidance does not intend to prescribe specific methodologies, action plans, systems and models for the application of IFRS 9 by NBFCs.

The Accounting Guidance has been developed with objective to facilitate implementation of IFRS 9. It is not a substitute or over-ride the requirements of IFRS 9, Companies Act 2017 (including directives of SECP), Non-Banking Finance Companies (Establishment and Regulation) Rules 2003 and NBFC Regulations. The Accounting Guidance should not be considered as all-inclusive, and could be updated with time in consideration of the new facts and developments.

With regards to IFRS 9 application by NBFCs, ASB would welcome the opportunity to respond to the emerging accounting application issues raised by the stakeholders.

Section 2 - Classification and measurement requirements for financial assets and liabilities

A. Classification and measurement requirements for debt securities

1. *Initial Measurement:* The financial instruments will be initially measured at fair value plus or minus, transaction costs that are directly attributable to the acquisition or issue of the financial instruments.

2. *Initial Classification:* Financial assets under IFRS 9 will be classified into one of three main classification categories i.e.:

   - Amortized Cost
   - Fair Value through Other Comprehensive Income (FVTOCI)
   - Fair Value through Profit and Loss (FVTPL)

   The financial assets have to meet the following tests in order to be subsequently measured at either amortized cost or fair value based on the following:

   - The business model used in managing the asset
   - The contractual cash flow characteristics of the asset

3. *Business Model Assessment:* In order to classify the financial asset, the NBFCs will have to analyze the nature of its key operating units. This will be accomplished by reviewing how groups of financial assets are managed together in order to achieve a particular business objective. The NBFCs will apply the business model test at a level that is consistent with the practices used to manage its assets. Eventually, the financial assets will fall under either of the following three business models:

   - Hold to Collect business model (Holding assets in order to collect contractual cash flows, "HTC Business Model");

   - Hold to Collect and Sell business model (Collecting contractual cash flows and selling financial assets, "HTC&S Business Model"); and

   - Other business models (resulting in fair value through profit or loss classification, "FVTPL Business Model").

4. *Hold to Collect (HTC) Business Model:* The 'hold to collect' business model does not require that financial assets are always held until their maturity. An NBFC's business model can still be "to hold financial assets to collect contractual cash flows" even when sales of financial assets occur. However, if more than an infrequent number of sales or sale(s) of significant value are/is made out of a portfolio, the NBFC will assess whether and how the sales are consistent with the 'hold to collect' objective. This assessment should include the reason(s) for the sales, the expected frequency of sales, and whether the assets that are sold are held for an extended period of time relative to their contractual maturities. Examples of sales that would not contradict holding financial assets to collect contractual cash flows include:

   - Selling the financial asset to realise cash to deal with an unforeseen need for liquidity;

   - Selling the financial asset due to significant internal restructuring/business combinations;

   - Selling the financial asset close to its maturity and the proceeds from the sales approximate the collection of the remaining contractual cash flows;

- Sale of the financial asset when there is an increase in credit risk or to manage credit concentration risk. The NBFC will sell a financial asset if it no longer meets the credit criteria specified in their documented investment policy. (Sale due to an increase in credit risk);

- Sales in 'stress case' scenario (e.g., a run on the NBFC's deposits).

5. It is expected that sales of financial assets held under HTC business model will be rare and will happen in exceptional circumstances.

6. *Hold to Collect and Sell Business Model:* Under this model, the intention of NBFC is to hold the asset to collect its contractual cash flows and to sell the financial asset. The NBFC will need to exercise judgement in determining whether they have a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets as it involves greater frequency of sales. This is because selling financial assets is integral to achieving the business model's objective instead of being only incidental to it as in the case of HTC business model. There are various objectives that may be consistent with this type of business model e.g. the objective of the business model may be to manage everyday liquidity needs, to maintain a particular interest yield profile or to match the duration of the financial assets to the duration of the liabilities that those assets are funding.

7. *Other Business Models:* Financial assets are measured at fair value through profit or loss if they are not held within a business model whose objective is to hold assets to collect contractual cash flows or within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. IFRS 9 gives a number of examples of such models, including one where:

   - NBFC manages the financial assets with the objective of realising cash flows through the sale of the assets (Held-for-Trading);

   - NBFC manages and evaluates a portfolio of financial assets on a fair value basis;

   - A portfolio of financial assets that does not fall under the HTC and HTC&S Business Models.

8. The financial assets will be classified on the basis of their business models used in managing the financial asset. The NBFC's business model for managing financial assets is a matter of fact and not merely an assertion. It is typically observable through the activities that the NBFC undertakes to achieve the objective of the business model. The NBFCs will need to use judgement when it assesses its business model for managing financial assets and that assessment is not determined by a single factor or activity. The NBFCs must consider all relevant evidence that is available at the date of the assessment. Such relevant evidence includes, but is not limited to:

   - how the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;

   - the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed;

   - how managers of the business are compensated (e.g., whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

The NBFC may hold the same type of instrument, such as government bonds, in all three classification categories (Amortized Cost, FVTOCI and FVTPL) depending on its intention and model for managing the assets.

9. *Contractual Cash Flow Characteristics Test*: This test is to be done at the asset level and seeks to establish whether the contractual cash flows of an asset are based “solely on payments of principal and interest” (SPPI). Only assets that meet this criterion can qualify for Amortised Cost and FVTOCI classification treatment. The minimum standard for meeting the SPPI determination is that the contractual cash flows compensate the holder for (a) the time value of money plus (b) credit risk plus (c) other allowable components such as liquidity risk. As such, for the contractual cash flows of an asset to qualify as SPPI, they must be consistent with a basic lending arrangement. Contractual features that introduce exposure to risks or volatility into the contractual cash flows that are unrelated to a basic lending arrangement, such as exposure to changes in equity or commodity prices via a structured note security, would not pass the SPPI assessment. The SPPI determination should only be performed once for each individual type of asset. This should not be a recurring, periodic test. However, the NBFCs will need to establish procedures to ensure that newly purchased or originated assets are tested.

10. *Investments and Other Assets:* Investments and other assets may include:

    Other Unquoted Securities: Participation Term Certificates (PTCs) and Term Finance Certificates (TFCs) and Sukuk shall be classified in accordance with criteria prescribed under paragraph 2 and ECL shall be calculated as required for debt instruments. For Non-performing, i.e. stage 3 assets the level of provision shall any way be higher of IFRS 9 or regulatory provisions.

    Quoted Securities: Government Securities will be valued at PKRV (Reuter Page). TFCs, PTCs, Sukuk and shares will be valued at their market value.

    Other Assets: The financial assets falling within “Other Assets” shall also be classified in accordance with the criteria described in paragraph 2.

11. *Use of Fair Value Option:* It is to be noted that IFRS 9 contains an option to designate, at initial recognition, a financial asset as measured at FVTPL if doing so eliminates or significantly reduces an ‘accounting mismatch’ that would otherwise arise from measuring assets or liabilities on different bases. Financial assets designated at FVTPL are not subject to the reclassification requirements of IFRS 9. This option should not be used for credit exposure of lending NBFCs.

    The NBFCs may apply the fair value option under this criterion if: (a) consistent with a documented risk management strategy, it eliminates or significantly reduces the measurement or recognition inconsistency of measuring financial assets or liabilities together on a different basis, and (b) the fair values are reliable at inception and throughout the life of the instrument. Nonetheless, this option should be avoided, where the fair value option is applied for financial instruments that are categorized as Level 3 in terms of the IFRS 13 hierarchy.

12. *Financial Liabilities:* Financial liabilities will be measured at amortised cost except for those liabilities which are held for trading and those where the NBFC opts to measure them at fair value. The NBFCs will apply the fair value option only if: (a) the NBFC has a documented risk management strategy to manage the group of financial instruments together on a fair value basis and can demonstrate that significant financial risks are eliminated or significantly reduced, and (b) the fair values are reliable at inception and throughout the life of the instrument. The NBFCs are required to disclose the liabilities that would result in their measurement at fair value.

B. Classification and measurement requirements for equity securities

13. *Classification of Equity Investments:* Investments in equity securities will be measured at fair value and will not be subject to impairment testing. The equity securities that are traded in an active market can be categorized by NBFCs as held for trading purposes and will be classified as FVTPL. The equity securities that are not categorized as held for trading may be classified as FVTOCI (irrevocable option). The decision can be made on instrument by instrument basis at the time of purchase and documented. The NBFCs may hold the equity instrument of the same company in both categories (FVTOCI and FVTPL) depending on its business model for managing the assets.

14. *Unquoted Equity Securities:* IFRS 9 does not allow for the recognition of unquoted equity investments at cost, though it acknowledges that in rare circumstances cost of an instrument may be an appropriate estimate of fair value. The NBFCs are advised to be prudent in carrying out the valuation of unquoted equity investments based on relevant information and meticulously adhere to the valuation disclosure requirements of IFRS 13 for such cases.

15. *Investments in Subsidiaries and Associates:* The investments in subsidiaries and associates shall be accounted for under the applicable approved accounting and reporting standards, i.e. IFRS 10 *Consolidated Financial Statements* and IAS 28 *Investments in Associates and Joint Ventures*.

C. Re-classification

16. NBFCs are allowed to reclassify financial assets in accordance with the requirements of IFRS 9. IFRS 9 only allows reclassification of debt instruments when an entity changes its business model for managing these financial assets. Re-classification of financial assets will only be made in exceptional cases as they will only occur when an entity significantly changes the way it does business. Such changes must be demonstrable to external parties. The following changes in circumstances will not be considered as change in business model for the purposes of reclassification:

    - a change in intention related to particular financial assets
    - a temporary disappearance of a particular market for financial assets
    - transfer of financial assets within different business models

    Changes to the classification should be clearly disclosed in the financial statements in line with the requirements of IFRS 9.

Section 3 - Expected Credit Loss

A. Application of proportionality, materiality and symmetry:

1. NBFCs are advised to comply with the application of expected credit loss (ECL) model in a manner that is appropriate to their size and nature, scope and complexity of their activities and portfolios. The use of properly designed proportionate approaches should not jeopardise the high-quality implementation of the IFRS 9 - ECL accounting framework; rather their use should enable NBFCs to adopt sound provision methodologies commensurate with the size, complexity, structure, economic significance, risk profile and, all other relevant facts and circumstances of the NBFC and the group (if any) to which it belongs.

2. NBFCs should also give due consideration to the application of the principle of materiality. However, this should not result in individual exposures or portfolios being considered immaterial if, cumulatively, these represent a material exposure to the NBFC. In addition, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date. For instance, large portfolio(s) of high-quality credit exposures should be considered material even if they are highly collateralised. In considering how to take proportionality or materiality into account in the design of an ECL methodology or in its implementation, it is important to ensure that bias is not being introduced. It means that a NBFC will choose to adopt an approach to ECL estimation that would generally be regarded as an approximation to "ideal" measures. It is important that such approximation methods are designed and implemented so as to avoid bias. However, the corporate exposure will be assessed by the NBFCs individually rather than collective assessment i.e. on portfolio basis.

   The objective of ECL application is the timely recognition of provisions, so that the recognition of credit deterioration is not delayed. Nevertheless, it is recognized that the IFRS 9 ECL accounting framework is symmetrical in the way that subsequent changes (both deteriorations and reversals of those deteriorations) in the credit risk profile of an obligor should be considered in the measurement of the provisions.

B. Reasonable and supportable information

3. NBFCs are required to consider a wide range of information when applying ECL accounting models. Information considered should be relevant to the assessment and measurement of credit risk to the particular credit exposure being assessed and should include information about past events, current conditions and forecasts of future economic conditions. Information which is ultimately included in the assessment of credit risk and measurement of ECL should also be reasonable and supportable. NBFCs should use their experienced credit judgment in determining the range of relevant information that should be considered and in determining whether information is considered to be reasonable and supportable. The information will be considered as reasonable and supportable, if it is based on relevant facts and sound judgment.

C. Consideration of forward-looking information

4. It is a distinctive feature of the ECL accounting framework to consider forward-looking information, including macroeconomic factors, for timely recognition of ECL. NBFCs will have to employ sound judgment consistent with generally accepted methods for economic analysis and forecasting.

   NBFCs should be able to demonstrate how they have considered relevant, reasonable and supportable information in the ECL assessment and measurement process. NBFCs should apply experienced credit judgement in the consideration of future scenarios and take into

account the potential consequence of events occurring or not occurring, and the resulting impact on the measurement of ECL. Information should not be excluded from that process simply because an event has a low likelihood of occurring or the effect of that event on the credit risk or the amount of expected credit losses is uncertain. In certain circumstances, information relevant to the assessment and measurement of credit risk may not be reasonable and supportable and should therefore be excluded from the ECL assessment and measurement process. Given that these circumstances would be exceptional in nature, NBFCs should provide a clearly documented, robust justification for such circumstances. The information used shall include an unbiased consideration of relevant factors and their impact on creditworthiness and cash shortfalls. Relevant factors include those intrinsic to the NBFC and its business or derived from external conditions.

D. Data requirements

5. To enable the calculation of ECL, NBFCs will have to gather historic data as well as develop forward-looking capabilities in their credit risk management systems and techniques e.g. in order to judge significant deterioration in credit quality, NBFCs are required to use life time Probability of Default (PD) as the relevant measure (See H “Significant Increase in Credit Risk”). In practice this means that life time PD information is required on a year by year basis at origination and at IFRS 9 implementation date (and on an ongoing basis at each assessment date thereafter). This requires NBFCs to develop capability to determine forward-looking PDs for each year of the life of a credit exposure. In addition, to calculate forward-looking ECL, PDs are required to be adjusted keeping in view the impact of macroeconomic factors that have an impact on PDs. This means that NBFCs shall need to collect data on macroeconomic factors that affect particular exposures and calculate the sensitivity of PDs in respect of those factors, requiring advanced modelling techniques and relevant data. The NBFCs are advised to ensure data used for ECL is cleansed and is of high quality.

6. In addition, NBFCs will be required to develop or enhance their existing loss given default (“LGD”) and exposure at default (“EAD”) models based on forward-looking assumptions. All of this effort is based on availability and collection of data. The NBFCs are advised to prioritize data collection in their overall IFRS 9 implementation plans during the parallel run period in order to avoid issues at its implementation date.

   ECL estimation is complex and inherently judgmental and is dependent on a wide range of data, which may not be immediately available, including forward-looking estimates of key macro and micro-economic factors and management’s assumptions about the relationship between these forecasts and the amounts and timing of recoveries from borrowers.

E. Classification and provision determination

7. The requirements outlined in the NBFC Regulations, on the portfolios of specific credit facility classification, provision determinations, collateral/security benefits, rescheduling/restructuring instructions shall be applied in conjunction with the requirements of IFRS 9. Annexure-I describes the mechanism to applied for mapping of time based criteria outlined in the NBFC Regulations and the staging requirements outlined in IFRS 9.

F. Low credit risk assets

8. NBFCs are required to develop policies to determine assets that can be considered as ‘low credit risk’. The financial assets classified as having ‘low credit risk’ will be required to book 12- month expected credit losses provisions. The financial instruments are not considered to have low credit risk simply because of the value of collateral or simply because they have a lower risk of default than the entity’s other financial instruments.

Simplifying low credit risk is not intended to be considered as a standard practice to recognise a 12-month ECL. Rather, if credit risk is no longer low, NBFCs should assess whether there has been a significant increase in credit risk to determine whether they should recognize the lifetime expected credit losses.

G. Definition of default

9. NBFCs have to establish their own policies for what they consider as default and apply that definition consistently with that used for internal credit risk management purposes. They should also consider qualitative factors (e.g. financial covenants) when appropriate. The definition of default used should be aligned and consistent with the default criteria used for regulatory purposes. Regulatory requirements will be considered as minimum, while the NBFCs can consider more stringent default criteria.

H. Significant increase in credit risk

10. The NBFCs are advised to devise their own assessment criteria for the significant increase in credit risk (SICR) in line with the IFRS 9 Standard. IFRS 9 does not specify what constitutes a SICR but it provides guidance as to what events can be construed as SICR. NBFCs are required to sufficiently document and consider all other relevant information that indicate a significant increase in credit risk. They are expected to have a clear view of the relationship between macroeconomic factors and obligor/facility attributes, and the level of credit risk in a portfolio. The reasonable and supportable information (as required by IFRS 9) for SICR consists of information about past events, current conditions and forecast of future economic conditions (i.e. forward looking macroeconomic information).

11. Additionally, NBFCs are advised to also use other expedients like ‘days past due’ to identify transition from one stage to the other (i.e. From Stage 1 to Stage 2, Stage 2 to 3, or vice versa). In using quantitative elements, NBFCs should consider the change in PD by comparing the PD at the reporting date with the PD at initial recognition.

12. In addition to above, the NBFCs, should consider qualitative criteria which are relevant to their portfolio including the factors given in IFRS 9 B5.5.17 and the following factors for assessing changes in credit risk:

    - Classification of the borrower by other financial institutions on the overdue exposure reported by NBFCs as per the Credit Information Bureau (CIB) Report;
    - All instructions on the restructured/rescheduled credit exposure in the relevant NBFC regulations will be complied with, by NBFCs. The status change of classification of restructured/rescheduled credit exposure of non-performing assets will also be made after meeting the conditions of relevant NBFC regulations.
    - The following may be considering factors where applicable:
        - Restructuring/Rescheduling due to credit reasons;
        - Unavailable/inadequate financial information/financial statements;
        - Expectation of forbearance (restructuring/rescheduling) occurring;
        - Qualified report by external auditors;
        - Significant contingent liabilities;
        - Pending litigation resulting in a detrimental impact;

- Loss of key staff to the organization;
- Increase in operational risk and higher occurrence of fraudulent activities; and
- Continued delay and non-cooperation by the borrower in providing key relevant documentation.

13. Where NBFC sets its transfer threshold for groups of financial assets, it is important that all financial instruments in that portfolio must have similar credit risk characteristics at initial recognition. NBFCs should consider both counterparty and individual exposures of the obligor(s) (including syndicate loans) for corporate/commercial loans, in determining SICR. Further, the impact of multiple exposures to the same obligor originated at different periods needs to be considered in compliance with IFRS 9.

14. Where there is evidence that there is significant reduction in credit risk, NBFCs would continue to monitor such financial instruments/credit exposures for a minimum probationary period defined under a policy approved by the board of directors or its sub-committee, to confirm if the risk of default has decreased sufficiently before upgrading such exposure from Lifetime ECL (Stage 2) to 12-months ECL (Stage 1).

    An exposure cannot be upgraded from Stage 3 to 1 directly and should be upgraded to Stage 2 initially and thereafter follow the same probation period as mentioned in above paragraph before upgrading to Stage 1.

I. Rebuttable Presumptions

15. The transfers between stages under IFRS 9 are based on relative movement in credit risk since origination rather than based on absolute level of risk. Moreover, IFRS 9 includes a rebuttable presumption that a default does not occur later than when a credit exposure is 90 days past due and it also presumes that there is a significant increase in credit risk since initial recognition if credit exposure is more than 30 days past due. In order to bring consistency, the backstop to the rebuttable presumption of days past due of credit portfolio against the specific credit facility and their stage allocation under IFRS 9 is mentioned in Annexure-I.

    The NBFCs are advised not to rely solely on the days past due presumption, but to incorporate reasonable and supportable forward-looking information. The days past due presumption can only be applied if the forward-looking information is not available without undue cost or effort.

Section 4 - Disclosures

NBFCs should ensure compliance with the disclosure requirements laid down by IFRS 9 along with IFRS 7 *Financial Instruments Disclosures* and IFRS 13 *Fair Value Measurement*. In addition, NBFCs should also ensure compliance with the disclosure requirements outlined in the NBFC Regulations.

Section 5 - Oversight by the board of directors

In order to ensure smooth and effective implementation of IFRS 9 by NBFCs, it is highly recommended that the board of directors (the Board) of an NBFC should be sufficiently involved in the process with an oversight role. It is recommended that the Board should consider the following:

- Constitution of an IFRS 9 'Project Steering Committee' to administer the project;
- Review and approval of IFRS 9 transition plan and a periodic review of the progress against the plan;
- Approval and documentation of the business models i.e. decisions about managing the financial assets and their classification under IFRS 9. Further, the reclassification of financial assets should also be approved by the Board along with the rationale for the change in the business model and resultant classification;
- Approved policy for the sales under HTC business model;
- Approved criteria for relative quantitative increases in PD that is indicative of a significant increase in credit risk;
- Consideration of sound methodologies for computation of ECL based on lending exposure, size, complexity and risk profile of the NBFC etc.;
- Consideration of underlying assumptions and parameters (including any subsequent changes) used in the computation of ECL and their sensitivity.

Annexure-I

Particulars of Financing Facilities	Days Past Due	Classification under NBFC Regulations	Minimum provision required under NBFC Regulations		Stage allocation under IFRS 9	Provision to be made
			Specific	***General***		
Financing facilities other than microfinance	1-30	N/A	Nil	1 % of net outstanding unsecured finance portfolio	Stage 1	Higher of (a) IFRS 9 ECL; or (b) As per NBFC Regulation 25A
	30-89	N/A	Nil		Stage 2	
	90-179	Other Assets Especially Mentioned (OAEM)	Nil	Nil	Stage 3	Higher of (a) IFRS 9 ECL; or (b) As per NBFC Regulation 25
	180 or more	Substandard	25 % of outstanding balance less Forced Sales Value (FSV) of collateral	Nil		
	One year or more	Doubtful	50 % of outstanding balance less Forced Sales Value (FSV) of collateral	Nil		
	One and a half year or more 180 days or more (Discounted financial instrument)	Loss	100 % of outstanding balance less Forced Sales Value (FSV) of collateral	Nil		

Particulars of Financing Facilities	Days Past Due	Classification under NBFC Regulations	Minimum provision required under NBFC Regulations		Stage allocation under IFRS 9	Provision to be made
			Specific	***General***		
Microfinance facilities	1-30	N/A	Nil	0.5 % of net outstanding microfinance portfolio and 1 % of net outstanding unsecured finance portfolio	Stage 1	Higher of (a) IFRS 9 ECL; or (b) As per NBFC Regulation 25A
	30-59	OAEM	Nil		Stage 2	
	60-89	Substandard	25 % of outstanding balance less Forced Sales Value (FSV) of collateral	Nil	Stage 3	Higher of (a) IFRS 9 ECL; or (b) As per NBFC Regulation 25
	90-179	Doubtful	50 % of outstanding balance less Forced Sales Value (FSV) of collateral	Nil		
	180 days or more	Loss	100 % of outstanding balance less Forced Sales Value (FSV) of collateral	Nil		