

The Impact of International Financial Reporting Standards (IFRS) 9 on the Financial Statement of Nigerian Deposit Money Banks

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Abstract

The International Financial Reporting Standard (IFRS) 9 was introduced in order to address the problems inherent in International Accounting Standard (IAS) 39, which was believed to have caused the 2008 financial crises. This paper examines the impact of IFRS 9 on the Financial Statement of Nigerian Deposit Money Banks (DMBs). The implementation of IFRS 9 started in 2018. Nigerian DMBs complied with the date. The new standard introduced strange issues such as computation of impairment, which is unfamiliar to operators in the banking sector and the new system seems to have negative impact on the financial statements of banks implementing it. This study aimed at assessing if the implementation of IFRS 9 has any impact on banks' financial statements in Nigeria. In order to carry out the study, an exploratory research strategy was adopted. Related literature was reviewed academic and industry experts' views were critically studied. The work revealed that Nigerian DMBs in the first day of implementation lost over N1 billion due to reclassification of financial instruments and that cost of implementation was high. In addition to the transition plan of the Central Bank of Nigeria, which aimed at reducing the impact of the loss, the study recommends that the operators should develop a pool of experts within Nigerian economy to address the knowledge gap caused by the new standard.

Keywords: *IAS 39, IFRS 9, Financial Instruments, Deposit Money Banks, Impairment, Central Bank of Nigeria*

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Background to the Study

The global financial crises of 2008 prompted the need for the improvements in the accounting for financial instruments world-wide (Bischof, Brüggemann, & Daske, 2010, Jones & Slack, 2013). Experts and institutions called for improvement of IAS 39 or outright change in the standard. A study by Huian, (2012) revealed that the 2008 financial crises was caused by managers taking advantage of the weaknesses in the standard. Bahgat, (2002) agreed with other studies and specifically pointed out that banks encountered various challenges while implementing IAS 39. For example, the research shows that preparers of financial statements were left with recognize impairment only when loss occurred. International Accounting Standard Board (IASB) in an attempt to avert the re-occurrence of the crises embarked upon the project of IFRS 9 in 2009. The Board (IASB) published IFRS 9 in three different phases with the final publication of IFRS 9 (Financial instruments) in July 2014 (Gornjak, 2017). The new Standard replaced the international accounting standard (IAS) 39. IFRS 9 – Financial instruments became operational on 1st January 2018. The new standard requires all firms with financial instruments in the statement of financial position to replace the existing IAS 39 with IFRS 9 (PWC, 2017).

IFRS 9 implementation was not accepted immediately by the European Union due to the change introduced in the new model (Armstrong, Barth, Jagolinzer, & Riedl, 2019). The replacement has a significant impact on accounting itself, processes, activities, decision-making and ultimately on financial statements. Some scholars argued that the demand for migration to the new standard were not for developing nations (Sekibo, 2019).

Nigeria adopted IFRS in 2010 and required compliance by public interest entities like banks, etc on 1st January 2012. The time Nigeria adopted IFRS, the IFRS 9 project had started. Deposit Money Banks (DMBs) in Nigeria are in the forefront of the implementation to avoid sanctions and promote international competition. Accounting for financial instrument in Nigeria started with IAS 39 despite the publication of some phases of the IFRS 9 project (Jibril, 2019). Nigerian DMBs were not permitted by the Financial Regulatory Council of Nigeria (FRCN) to implement it (Okwuosa, 2019). Perhaps due to inadequate knowledge of IFRS and the intrigue in it.

In 2014, IASB completed the project (IFRS 9) and was published with an effective date of implementation on 1st January 2018 (with earlier adoption allowed). DMBs were required to comply with the implementation. But many banks seem not to have understood the new standard or had difficulty in the implementation. Okwuosa, (2019) and Sekibo, (2019) in their interviews revealed that Nigerian DMBs were facing enormous implementation challenges. It is against this background that this article, “the impact of IFRS 9 on the Financial Statement of Deposit Money Banks (DBMs) in Nigeria.

In this paper, IAS 39 and IFRS 9 were reviewed. CBN guidance notes were also reviewed and finally, the paper ends by identifying the various challenges affecting the Nigerian DMBs.

An Overview of the International Accounting Standard 39

IAS 39 was first issued in 1999 and later revised in 2003 (Bahgat 2002, Spector, 2003). The scope of the standard covers all entities with financial instruments, except when it is clearly in conflict with another accounting standard or an item is classified with a different accounting treatment. All derivatives are also covered by IAS 39 (Bahgat, 2002).

IAS 36 classified Financial assets into four classes namely; held for trading, available for sale financial assets, loans and receivables, and held to maturity investment. The standard uses incurred loss model to make provision for losses. This model was widely criticised by experts and institutions for lack of prudence because it allows greater lending and credit expansion, unrealized profits and unwarranted bonuses and dividends. Above all, the IASB Chairman revealed that the model used in IAS 39 for recognition of losses by banks has a huge setback. The model according to researchers allows managers to conceal losses that should be recognized (Huian, 2012). Despite the weaknesses in the standard, IAS 39 brings visibility in the use of derivative instruments for investors and other financial statements users (Fiechter 2011, Huian 2012, Ryzhenkova 2013).

An Overview of IFRS 9

In July 2014 the International Accounting Standards Board (the IASB) issued the final version of IFRS 9 Financial Instruments (IFRS 9). IFRS 9 replaces IAS 39: Financial Instruments and Measurement (IAS 39). Gornjak, (2017) contributed that IFRS 9 will have a direct, quantifiable impact on loans loss allowances thus affecting the operating margin, but also an indirect but material impact on existing operating models – most notably modelling, infrastructure and data requirements.

The New Reporting Requirements

The key areas of IFRS 9 accounting include:

1. The classification and measurement of financial assets.
2. The new impairment model, and
3. The hedge accounting

IFRS 9 Classification and measurement

Armstrong, Barth, Jagolinzer, & Riedl, (2019) argued that the classification and measurement of financial assets are dependent on the contractual cash flows of the asset and the business model within which the asset is held; this is an area where changes have been introduced by IFRS 9. Whilst there is a fair value option to fair value through profit or loss (FVTPL) that can be elected, for entities to classify and measure at amortised cost they will need to pass the following tests (PWC, 2017):

- I. Business model test: The financial asset is held within a business model whose objective is to hold financial assets to collect their contractual cash flows (rather than to sell the assets prior to their contractual maturity to realise changes in fair value); The business model assessment is highly judgmental and will depend on the facts, circumstances and the intentions of the entity as to how it manages its financial assets in order to generate cash flows.

- ii. Contractual Cash Flow Characteristics (CCC) test: Armstrong, Barth, Jagolinzer, & Riedl, (2019) and Limani & Meta, (2017) added that the contractual terms of the financial asset give rise, on specified dates, to cash flows that are Solely Payments of Principal and Interest (SPPI) on the principal amount outstanding. The CCC test is more prescriptive and depend on the specific contractual terms of financial assets. Judgement is needed to assess whether a payment (or non-payment) of a contractual cash flow that only arises as a result of the occurrence (or non-occurrence) of a contingent event leads to the instrument failing the contractual cash flows characteristics test (Gea-Carrasco, 2015).

The above test suggests that financial assets classifications under IFRS 9 is far different from the classifications given by IAS 39.

IFRS 9 Impairment

The new impairment requirements in IFRS 9 are based on an **Expected Credit Loss (ECL)** model and replaced the IAS 39 “Incurred Loss” model. The ECL model applies to debt instruments (such as bank deposits, loans, debt securities and trade receivables) recorded at amortised cost or at fair value through other comprehensive income, plus lease receivables, contract assets and loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss (Armstrong, Barth, Jagolinzer, & Riedl, 2019, Gornjak, 2017).

According to Limani & Meta, (2017), the guiding principle of the ECL model is to reflect the general pattern of deterioration or improvement in the credit quality of financial instruments. The amount of ECLs recognised as a loss allowance or provision depends on the extent of credit deterioration since initial recognition. PWC (2017) and Gea-Carrasco (2015) summarised that under the general approach, there are two measurement bases:

- i. 12-month ECLs (Stage 1), which applies to all items (from initial recognition) as long as there is no significant deterioration in credit quality.
- ii. Lifetime ECLs (Stages 2 and 3), which applies when a Significant Increases in Credit Risk (SICR) has occurred on an individual or collective basis. When assessing Significant Increases in Credit Risk (SICR), there are a number of operational simplifications available, such as the low credit risk simplification. Stages 2 and 3 differ in how interest revenue is recognised. Under Stage 2 (as under Stage 1), there is a full decoupling between interest recognition and impairment and interest revenue is calculated on the gross carrying amount. Under Stage 3 (where a credit event has occurred, defined similarly to an incurred credit loss under IAS 39), interest revenue is calculated on the amortised cost (i.e., the gross carrying amount after deducting the impairment allowance), which is also called, the net carrying amount.

Hence, the approach has been commonly referred to as the 'three-bucket' approach, although IFRS 9 does not use this term.

However, Fiechter, (2011) and Sekibo, (2019) argued that adopting the ECL model would lead to earlier recognition of impairment losses and would also alter the measurement of interest revenue. Impairment losses would be recognized in profit or loss and would still be reversible.

Roles and Responsibilities for Assessing Impairment

Gornjak (2017) and Masadah, Al-Omush and Shiyyab (2016) contributed that the monitoring, measuring and reporting requirements for impairment under IFRS 9 are more extensive when compared to IAS 39. Key areas that should be considered for assessing assets for impairment include the responsibilities for:

- i. Defining and monitoring the stage allocation of assets for determining the loss allowance;
- ii. Defining default for determining the comparison in the Probability of Default (PD) at initial recognition of the asset and at the reporting date;
- iii. The assessment of significant credit deterioration;
- iv. Obtaining and maintaining data, at both origination and over the life of the financial asset, for monitoring, measurement and reporting; and the calculation of expected loss (probability- weighted, forward-looking and inclusive of macro- and micro-economic factors).

Implementation Benefits and Challenges of IFRS 9 Impairment Model

Gea-Carrasco, (2015) in the research findings discovered that the transition from the current "Incurred Loss" approach to the Expected Credit Loss approach requires banks to make a significant investment in new models. Similarly, Limani and Meta, (2017) also discovered that banks faces IT infrastructures, data collection and human resources challenges in the implementation of the standard. Attributing ECLs to all SPPI instruments subject to measurement at amortised cost or fair value through other comprehensive income will involve a considerable effort. Banks familiar with the internal-ratings based (IRB) approach to regulatory capital requirements (which already involves using an expected loss approach to regulatory provisions) face several challenges when implementing IFRS 9 (Armstrong, Barth, Jagolinzer & Riedl, 2019).

All banks must therefore make a significant effort in terms of modelling, IT infrastructure, data gathering and dedicated human resources before the first application of IFRS 9. On the other hand, Sekibo, (2019) note that most banks using internal models for the purposes of regulatory capital are building on such models, adapting them to the requirements of the new expected credit loss approach. Study also revealed that only some of the larger banks plan to create entirely new models for the purposes of IFRS 9 (Armstrong, Barth, Jagolinzer, & Riedl, 2019).

Central Bank of Nigeria Guidance Note on the Implementation of IFRS 9

The Central Bank of Nigeria (CBN) issued a guidance note to banks and discount houses on the implementation of IFRS 9 on 20th December 2016. A further guidance was issued on October 18, 2018 (Transitional arrangements treatment of IFRS 9 expected credit loss for

regulatory purposes by banks in Nigeria). Another guidance note was issued on 5th March 2019 on the implementation by other financial institutions. The latter is not covered by the scope of this study.

The main purpose of the guidance note is to communicate supervisory expectations for the implementation of the new standard, especially in areas where banks are expected to exercise considerable judgment and/or elect to use simplifications and other practical expedients permitted under the standard. The Note also specifies information to be submitted to CBN not later than April 30, 2017 on IFRS 9 Implementation Projects while requiring banks to submit monthly status updates on the implementation projects starting May 2017. The earlier date was later reviewed by subsequent circulars.

The December 20, 2016 and October 18, 2018 Guidance Notes focuses on Deposit money banks and discount houses. Some of the issues addressed include:

- a) **Assessment of Significant Increase in Credit Risk:** The CBN expects banks to put in place policies and systems as well as governance arrangements and controls to identify instances where their exposures have suffered significant increase in credit risk (SICR). In assessing significant increase in credit risk, banks are to consider quantitative, qualitative and 'backstop' (30 days past due presumption) indicators. These are factored into the Probability of Default (PD) model.
- b) **Staging and Transfer Criteria:** At transition, banks are expected to place financial instruments without significant increase in credit risk in the 12-months ECL bucket irrespective of the obligor's credit risk rating at origination. However, where significant increase in credit risk has been observed, such credits are moved to Lifetime ECL. Consequently, CBN requires Banks to adopt a definition of "default" consistent with the provisions of the paragraph 12.1(b) (2) of the Prudential Guidelines 2010.
- c) **Impairment of Financial Instruments:** CBN requires Banks to choose to adopt simpler approaches in the computation of ECL. The apex bank permits banks to implement sound ECL methodologies commensurate with their size, complexity, structure and risk profile. ECL should reflect the probability-weighted outcome, time value of money and best available forward-looking information.
- d) **Model Validation:** The CBN would periodically evaluate the effectiveness of banks' credit risk management practices to ensure among others, that the methods used for determining accounting allowances lead to appropriate measurement of ECLs in line with the Standard.
- e) **Low Credit Risk Simplification:** IFRS 9 permits that a financial instrument, which is considered to have low credit risk on the reporting date, needs not be assessed for significant increase in credit risk since its initial recognition. CBN expect banks to exercise this simplification in limited circumstances. Accordingly, banks are required to use this simplification for only risk free and gilt edged securities.
- f) **Reasonable and Supportable Information without Undue Cost and Effort:** CBN requires banks to monitor whether their approaches to analysing forward-

looking information continues to be appropriate in the light of changing circumstances. For the avoidance of doubt, the forward looking information integrated into banks' ECL models must be related to the credit risk drivers for particular exposures of portfolios.

- g) **Write-off of Non-Performing Facilities:** Where there is no reasonable expectation of recovering a non-performing financial asset or any part thereof, banks are required to abide by relevant extant regulations guiding write off of non-performing financial assets.
- h) **Modified Financial Assets:** Banks are required to fully disclose all modified financial assets that result in de-recognition in its financial statements in line with the requirements of IFRS. Furthermore, banks are required to submit quarterly returns to the CBN, to be received within 10 days of the end of the quarter effective 1st quarter of 2018, on all financial assets derecognized during the affected quarter as a result of modification.
- i) **Transitional Arrangement:** The CBN IFRS 9 impact assessment for the banking industry also noted that the transition will result to higher provisions for credit losses. These losses could have impact on retained earnings and capital adequacy. Therefore, based on the Basel Committee on Banking Supervision (BCBS) standard, the CBN recommends a window period of four-years transitional arrangement to mitigate the effects on Nigerian DMBs. In doing this, CBN prescribed how the effect could be cushioned thus:
 - i. Utilisation of regulatory risk reserve to cushion the impact of IFRS 9 ECL provisions on transition date.
 - ii. Transitional arrangement of the ECL accounting provisions for regulatory capital purpose.
 - iii. Categorization of ECL provisions as general provision and specific provision for regulatory purposes.
 - iv. Regulatory reporting and disclosure requirements.

Challenges of IFRS 9 Implementation in Nigeria

Challenges of implementing IFRS 9 in Nigeria are enormous. Research shows that over N1 trillion was lost from capital reserves of all the Nigerian banks because huge amount of provision recognised on 1st January 2018. Experts and bank managers revealed their challenges in the first implementation exercise.

Okwuosa (2019) opined that the implementation of IFRS 9 will change the balance sheet of banks in Nigeria due to the reclassification of financial instrument and the methodology of assessing the loan provisions. It was reported that the Day one loss on 1st January, 2018 wiped about N1 trillion off the capital base of DMBs in Nigeria (John, Olufikayo & Olakoyenikan 2019). In addition, finding expertise is difficult in Nigeria. Expertise in this case include; financial reporting skills for classifications and measurement, risk specialist for modelling, economist for forecasting and IT specialist for programming (CBN, 2019). However, a pool of IFRS expertise knowledge in Nigeria will reduce the impact on banks.

Another challenge is the IT infrastructure because software generating such report has to change. This means more cost will be incurred in acquiring, changing from existing reporting software and training the software users for smooth implementation. In calculating ECL, multiple scenarios are used thereby taking longer time to prepare.

Knowledge gap in the part of the regulators, that is Central Bank of Nigeria, Nigerian Deposit Insurance Company, Nigerian Stock Exchange, etc. was seen as a threat to the implementation of the standard. Regulators ought to be ahead of the industry to guide and assist where banks are facing challenges (Adeniyi, 2019).

Furthermore, IFRS 9 impairment computation requires portfolio segmentation in order to allocate data relevant to each portfolio. Accessing the required historical data to support model building may be difficult in Nigeria (Olakinsan, 2019).

However, the CBN transitional arrangements for banks was released to reduce the effect of the migration on the balance sheet (CBN, 2018). Sekibo (2019) expressed confidence that banks will bounce back after few years of implementation.

Conclusion

IFRS 9 implementation in Nigeria is still new, and the process of replacing IAS 39 and its application is currently limited. The implementation of the new standard has stimulated much interest from experts and scholars. The old standard, IAS 39 was examined to have some inherent problem in it apart from being a rule-based standard.

The new standard has a major strength of being a principle-based standard. IFRS 9 has improved the quality of reporting by being prudent in loss recognition. In addition, the simplified rules dealing with measurement of hybrid contracts containing embedded derivatives is particularly praised. Some commentators underline the opportunity given by IFRS 9 to reclassify, on initial adoption, some financial assets previously measured at fair value to the amortised cost accounting and vice-versa (Grant Thornton, 2009). Nigerian DMBs are learning the implementation of the standard because the entire system is still in the development stage, however, the capital base impact has been absolved by the transitional arrangement. Others have to borne by the banks.

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