

MEDIA RELEASE

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New bad debt accounting proposals could have a significant impact on current reported numbers

Banks, financial service companies and some retailers that offer payment terms will be most affected by the proposals

Johannesburg, Monday, 27 May 2013 – Bad debts and impairments on loans to clients or debtors are critical figures in analysing companies in the financial sector as well as those extending credit to customers. A new proposed accounting standard for the recognition of bad debt losses and impairment is necessary to address the criticisms of *'too little, too late'* that arose during the financial crisis.

The recent proposals issued by the International Accounting Standards Board (IASB) indicate that companies will need to re-examine how they currently provide for bad debts in their financial statements. Unpopular consequences of the proposed new standard include companies having to revise their performance metrics, the integration of forward looking data into their provisioning and the collection of additional future looking data as a basis for determining provisions.

Sue Ludolph, project director of financial reporting at the South African Institute of Chartered Accounts (SAICA) says that the model proposed for bad debts or credit losses is a more forward-looking impairment model than at present that will not only potentially result in the

recognition of larger credit impairment losses, but would also recognise such impairment losses earlier.

“For trade receivables with a significant financing element an entity may elect to recognise lifetime expected losses at initial recognition and throughout the life of the receivable,” she states, adding that for trade receivables without a significant financing component, lifetime expected losses have to be applied on initial recognition and throughout the life of the asset. This fundamentally changes the thought process for providing for bad debt losses as the current standard allows one to provide for a bad debt loss when an impairment/loss event has occurred. The new approach is more subjective.

In today’s era of fierce competition, more and more companies are offering “free” goods or services as incentives to customers in order to boost sales. These contracts inevitably have a degree of financing associated with them – and therefore will be included in the scope of the proposals. Banks, financial service companies and some retailers that offer payment terms will be most affected by the proposals whilst companies in other industries will be affected to a lesser extent.

According to Raisibe Morathi, Nedbank’s Chief Financial Officer, the requirement to integrate future looking economic forecasting into provision models could prove to be difficult. The difference between the outlooks and the policies adopted by the various industry role-players could lead to vastly different results. The transitioning between the various categories of performance of the loans could drastically affect the financial performance reported by a company. Banks and financial service companies who already report under the Basel II Advanced Internal Ratings Based approach will be less affected – although the education of all investors and users of the financial statements will be considerable.

“Bank and financial services companies who have large data warehouses will find the implementation of the proposals complex. The proposals require the integration of future looking assumptions into the provisioning for bad debts. The proposals are closely linked to the provisioning requirements of Basel for the performing book. A key decision for these companies is the transition between a performing loan and that which appears on a watchlist,” says Morathi.

She explained that a performing loan requires a 12 month expected loss to be provided whereas a loan on the watchlist requires a full lifetime loss to be provided. The results of banks and financial service companies could therefore vary greatly depending on their outlooks on the economic cycle. If company's view of the future economic outlook is positive this may lead to a significant reduction in expected losses due to the migration of large portions of the book from lifetime losses to 12 month losses without a commensurate reduction in risk and vice versa during a negative outlook.

Ludolph adds that the forecasting of a lifetime loss could prove difficult when companies have to forecast what the future economic conditions will be and the likelihood during that period that a debtor may default. Many companies currently do not have the systems to obtain the data required to produce such future looking forecasts.

She strongly advises companies to review the proposed standard and conduct their own field testing to understand the resources needed to implement the proposals relating to bad debt provisions for debtors and other financial assets.

The proposals on expected credit losses are intended to replace the guidance on impairment of financial assets in IAS 39 Financial Instruments: Recognition and Measurement with new requirements that will form part of IFRS 9 Financial Instruments. Users, preparers and auditors are further encouraged to provide comments on the proposals to the International Accounting Standards Board until 5 July 2013 or email suel@saica.co.za. It is anticipated that the proposals will become effective for annual financial periods beginning on or after 1 January 2015.

Ends

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