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## IASB<sup>®</sup> meeting

Date	<b>April 2024</b>
Project	<b>Post-implementation Review of IFRS 9—Impairment</b>
Topic	<b>Purchased or originated credit-impaired financial assets</b>
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## Introduction

1. The purpose of this paper is to analyse the feedback on the application of the impairment requirements in IFRS 9 *Financial Instruments* to purchased or originated credit-impaired (POCI) financial assets, in response to the [Request for Information Post-implementation Review of IFRS 9—Impairment](#) (the RFI).
2. This paper provides:
  - (a) a summary of [staff recommendation](#) and [question for the IASB](#);
  - (b) a reminder of the [IFRS 9 requirements for POCI financial assets](#);
  - (c) a summary of [feedback](#) and [staff analysis](#) of that feedback, including the [application questions](#) identified by respondents; and
  - (d) [staff assessment of whether to take action in response to the feedback on POCI financial assets](#).

## Summary of staff recommendation

3. Based on the analysis in this paper, we recommend the IASB take no further action on matters identified in regard to the requirements in IFRS 9 for POCI financial assets.

## Question for the IASB

### Question for the IASB

Do IASB members agree with the staff recommendation summarised in paragraph 3 of this paper?

## IFRS 9 requirements for POCI financial assets

4. IFRS 9 has specific requirements for the recognition of interest revenue and ECL for POCI financial assets:
  - (a) paragraph 5.4.1(a) of IFRS 9 requires an entity to apply a *credit-adjusted* effective interest rate (EIR) to the *amortised cost* of POCI financial assets from initial recognition.
  - (b) an entity is required to include the initial ECL in the estimated cash flows when calculating the credit-adjusted EIR for these assets. Neither a loss allowance nor credit losses are recognised on initial recognition of POCI financial assets.
5. Subsequently, only the cumulative changes in lifetime ECL since initial recognition are recognised as a loss allowance.

## Feedback

6. Most respondents to the RFI said that the requirements in IFRS 9 for POCI financial assets can be applied consistently to these types of financial assets and lead to accounting outcomes that faithfully reflect the underlying economic substance of these transactions.
7. However, a few respondents suggested that the IASB instead requires the application of the general approach for recognising ECL on POCI assets because:

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- (a) *it is burdensome to apply the POCI requirements for entities that do not manage these assets as part of their main business activity.* Some respondents (mostly preparers) said that applying the POCI requirements is operationally burdensome for financial institutions that do not originate or purchase credit-impaired financial assets as part of their main business activity. Such entities, generally, have small portfolios of POCI assets and therefore, in their view, maintaining a separate ECL approach for these assets is not cost effective. They would therefore prefer to instead just apply the general approach to POCI assets.
- (b) *accounting for POCI assets applying the general approach provides more faithful representation.* Some respondents, including those who shared the view in (a), said that, in their view, the general approach would more faithfully represent the change in credit risk on these assets after initial recognition. In essence, these respondents disagree with the requirement in IFRS 9 for POCI assets to always remain POCI. Instead, they would prefer to account for POCI financial assets at initial recognition as credit-impaired (ie stage 3) assets and reflect subsequent improvements in their credit risk in a similar way to other financial assets for which the general approach applies.
8. Some respondents also identified two application questions about POCI financial assets. We provide the feedback and staff analysis on those questions in paragraphs 16–43 of this paper.

## Staff analysis

9. As explained in paragraphs BC5.214–BC5.220 of the Basis for Conclusions on IFRS 9, the requirements for POCI financial assets were substantially carried forward from IAS 39 *Financial Instruments: Recognition and Measurement*. Particularly, paragraph BC5.218 of the Basis for Conclusions on IFRS 9 explains that respondents to the 2013 Impairment Exposure Draft almost unanimously supported the proposals for POCI financial assets. These respondents had noted that the proposals were the

conceptually correct outcome and appropriately reflect the economics of the transaction and management's objective when acquiring or originating such assets. Respondents additionally noted that the proposals were operable because they are consistent with the accounting treatment in accordance with IAS 39.

10. In developing IFRS 9, the IASB considered but rejected applying the general approach to POCI financial assets. As explained in paragraph BC5.215 of the Basis for Conclusions on IFRS 9, at that time, some users of financial statements expressed a preference for a single impairment model for all financial assets to ensure comparability. However, in the IASB's view, the POCI requirements represent the underlying economics for these financial assets more faithfully than the general approach, and the benefits of this better representation outweigh the costs for these financial assets.
11. We considered respondents' feedback described in paragraph 7(a) of this paper. However, in our view, introducing the threshold of 'main business activity' as suggested by respondents would be arbitrary and give rise to additional operational costs, complexity, and challenges of its own. Entities would be required to determine if they manage POCI financial assets as one of their main business activities. Furthermore, for economically similar assets the accounting outcome would be different depending on the entity that holds those assets. Such an outcome would reduce the usefulness of information to users of financial statements.
12. We also considered feedback described in paragraph 7(b) of this paper whereby some respondents said that the IASB should require the general approach to recognise ECL for POCI assets to achieve a more faithful representation. We note that this feedback is at strong contrast with views from other respondents to the RFI who had suggested the IASB requires the POCI approach for all financial assets to achieve a more faithful representation (see [Agenda Paper 27A of the February 2024 meeting](#)).
13. This PIR evidence confirms that a few stakeholders hold contrasting views (ie views at different ends of a spectrum) about whether the general approach or the POCI requirements would achieve a more faithful representation of economic substance of a

financial asset. Such views are inconsistent with majority of respondents to the RFI who said that the general approach and POCI requirements provide an adequate basis to account for the relevant financial assets.

14. We also think that the nature of the credit risk exposure of a purchased or originated credit-impaired asset is significantly different to warrant a different outcome to a financial asset that is not credit-impaired at initial recognition.
15. In the light of the PIR feedback that majority of respondents support the requirements for POCI financial assets and their view that such requirements faithfully reflect the underlying economic substance of these transactions, we think no further action is warranted by the IASB.

## Application questions

16. In this section we describe two application questions identified by some respondents to the RFI. For each application question, we summarise feedback describing the question and staff analysis of that feedback.

### ***1. How to account for subsequent improvements in credit risk?***

#### *Feedback*

17. Some respondents (mainly standard-setters and accounting firms) said that, in practice, there is diversity in how entities recognise the effect of subsequent improvements in credit risk in the statement of financial position for POCI financial assets. Some recognise it as a negative entry (ie reduction) to the ECL allowance, others recognise it as an adjustment to the gross carrying amount of a POCI financial asset.
18. They suggested the IASB clarify this issue to support consistency in presentation and hence, facilitate comparability of financial information. Although the different presentation practices do not ultimately affect the amortised cost of a financial asset, it

affects metrics such as ECL coverage ratios. An accounting firm, however, said this issue does not materially affect entities' financial statements.

19. We sought further input on this matter from the members of IFRS Interpretations Committee (Committee) and the members of the Accounting Standards Advisory Forum (ASAF) in March 2024 to supplement feedback to the RFI on whether the matter is pervasive, has substantial consequences and its root cause.
20. Some Committee members acknowledged the diversity in application but reported no substantial consequences in practice. One member added that, in practice, if the favourable change in lifetime ECL is material, entities generally disclose it separately in the notes to the financial statements which facilitates investors' analyses.
21. Two ASAF members reported that, in their jurisdictions, for some entities purchasing credit-impaired financial assets represents their main business activity. For such entities this matter is important, to ensure consistent reporting of key ratios such as ECL coverage ratio.

#### *Staff analysis*

22. Paragraph 5.5.13 of IFRS 9 states that an entity shall recognise the **cumulative changes in lifetime ECL since initial recognition as a loss allowance** for POCI financial assets. [Emphasis added.]
23. Paragraph 5.5.14 of IFRS 9 then sets out requirements for the amounts an entity recognises in the statement of profit or loss for POCI financial assets—it requires an entity to recognise in profit or loss the amount of the change in lifetime ECL as an impairment gain or loss. Specifically, an entity recognises favourable changes in lifetime ECL as an **impairment gain, even if the lifetime ECL is less than the amount of ECL that was included in the estimated cash flows on initial recognition**. [Emphasis added.]
24. Paragraph BC5.210 of the Basis for Conclusions on IFRS 9 further reinforces these requirements in IFRS 9, explaining that the IASB's view is that an entity should

recognise favourable changes in credit risk consistently with unfavourable changes in credit risk to the extent that those favourable changes represent a reversal of risk that was previously recognised as unfavourable changes. Doing so would reflect the fact that the expectations of credit losses have moved back towards the initial expectations. It further explains that for POCI financial assets, an entity would recognise a gain if credit risk improved after initial recognition, reflecting an increase in the expected cash flows.

25. We note that the term 'cumulative' used in paragraph 5.5.13 of IFRS 9 makes it explicit that all the changes in ECL (ie favourable or unfavourable) since initial recognition of a POCI financial asset are recognised as loss allowance in the statement of financial position. This is also consistent / symmetrical with the requirement for recognition as impairment gain in profit or loss. Specifically, paragraph 5.5.14 of IFRS 9 is explicit that an entity shall recognise in profit or loss the amount of the change in lifetime ECL as an impairment gain or loss, even if the lifetime expected credit losses are less than the amount of expected credit losses that were included in the estimated cash flows on initial recognition.
26. We, therefore, think there is no ambiguity about the accounting for subsequent improvements in credit risk of a POCI asset or the related presentation in the statement of financial position or the statement of profit or loss.
27. Accordingly, we do not think a clarification by the IASB is warranted.

## ***2. How to assess if a modified financial asset is originated credit-impaired?***

### *Feedback*

28. Some respondents said that due to insufficient application guidance or specific requirements there is diversity in how entities assess whether:

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- (a) modification of a restructured asset results in derecognition of the original asset and recognition of a ‘new asset’; and
  - (b) that ‘new asset’ represents an originated credit-impaired asset.
29. They reported that different conclusions reached in this assessment result in some entities concluding that modifications to restructure those assets are substantial and hence derecognise the restructured assets and recognise ‘new assets’ as POCL. Other entities conclude such modifications are not substantial, ie do not result in derecognition, and hence continue to recognise them as stage 3 (credit-impaired) financial assets. This diversity could have a material effect on the related ECL amount and the ECL stage for that financial asset.
30. In this context, a few respondents also said it is challenging to determine the fair value at initial recognition for originated credit-impaired assets that arise from a substantial modification due to the lack of observable purchase prices.

#### *Staff analysis*

31. Paragraph B5.5.26 of IFRS 9 mentions that in some unusual circumstances, following a modification that results in derecognition of the original financial asset, there may be evidence that the modified financial asset is credit-impaired at initial recognition, and thus, the financial asset would be recognised as an originated credit-impaired financial asset.
32. Paragraph B5.5.26 of IFRS 9 further explains that this might occur, for example, in a situation in which there was a substantial modification of a distressed asset that resulted in the derecognition of the original financial asset. In such a case, it may be possible for the modification to result in a new financial asset which is credit-impaired at initial recognition.



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***Whether modification of a restructured asset results in derecognition?***

33. We acknowledge that diversity in how entities determine whether modification of a restructured financial asset results in derecognition of that asset might reduce the usefulness of information to users of financial statements.
34. We note that the IASB decided in July 2022 that the [Amortised Cost Measurement](#) project would consider the interaction of the impairment requirements in IFRS 9 with the application questions on modification of financial assets (including whether a modification results in derecognition and how to assess whether a modification is ‘substantial’).<sup>1</sup>
35. The matter of assessing whether modification of a restructured financial asset results in derecognition of that asset and recognition of a ‘new asset’ is therefore part of that project.

***Whether the ‘new asset’ represents an originated credit-impaired asset?***

36. Appendix A of IFRS 9 defines purchased or originated credit-impaired financial assets as those that are purchased or originated credit-impaired at initial recognition.
37. The definition of a credit-impaired financial asset states that a financial asset is credit-impaired when one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred.
38. This definition also provides examples of events that provide evidence that a financial asset is credit-impaired. For example, the purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses; or the lender having granted the borrower a concession that it would not otherwise consider due to the borrower’s financial difficulty.

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<sup>1</sup> See the table C6 of the [Project Report and Feedback Statement](#) published at the end of the PIR of IFRS 9—Classification and Measurement.

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39. An entity is ultimately required to apply judgement to determine whether the ‘new asset’ originated subsequent to a restructuring of the original financial asset is credit-impaired. We think that the definition in Appendix A of IFRS 9 provides a helpful basis to apply such judgement. The PIR feedback has not provided evidence that such guidance is insufficient or inappropriate, therefore, we do not think that further action by the IASB is warranted for this matter.

***How to determine the fair value of an originated credit-impaired asset?***

40. We acknowledge that determining the fair value of a modified financial asset which is recognised as a ‘new asset’ might require significant judgement to be applied. The fair value of a financial instrument at initial recognition is normally the fair value of the consideration given or received (see paragraphs B5.1.1–B5.1.2A of IFRS 9).
41. However, for financial assets that are originated as credit-impaired there is no consideration given or received and there might be no observable price. Nonetheless, we note that IFRS 13 *Fair Value Measurement* does not require use of observable inputs. Specifically, paragraph 87 of IFRS 13 requires that unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Furthermore, IFRS 13 provides detailed requirements and application guidance for determining fair value in the absence of observable inputs.
42. Accordingly, in our view, an entity will be required to apply judgement to specific facts and circumstances in selecting the unobservable inputs to use in determining fair value of an originated credit-impaired financial asset applying IFRS 13.
43. In conclusion, based in the PIR evidence and our analysis, we do not think that further action by the IASB is warranted for this matter.

## Staff assessment—Is further action needed?

44. The staff assessed the above topics against the PIR framework to determine whether any further action needs to be taken:

PIR evaluation requirements	Staff assessment
Are there fundamental questions (ie 'fatal flaws') about the clarity and suitability of the core objectives or principles in the new requirements?	<b>No.</b> PIR feedback and the staff analysis in this paper on the matters identified indicated that the POCI requirements are working as intended and that there are no fundamental questions about their clarity and suitability.
Are the benefits to users of financial statements of the information arising from applying the new requirements significantly lower than expected?	<b>No.</b> Although a few respondents suggested the IASB require an alternative approach to recognise ECL for POCI assets so that changes in credit risk are better represented, majority of respondents said the POCI requirements faithfully reflect the economics of POCI assets and can be applied consistently. Therefore, PIR feedback did not provide evidence that the benefits to users of financial statements of information arising from applying the POCI requirements are significantly lower than expected.
Are the costs of applying the new requirements and auditing and enforcing their application significantly greater than expected?	<b>No.</b> A few respondents raised concerns that applying the POCI requirements can be burdensome for entities for which managing POCI assets is not their main business activity. This is because such entities are also required to apply other ECL approaches (eg the general approach) to financial assets that are not POCI. Nonetheless, majority of respondents acknowledged that these requirements were carried forward from IAS 39 and said that the requirements can be applied consistently. Notwithstanding the two application questions identified by respondents, the PIR feedback did not provide evidence that the costs of applying the new requirements and auditing and enforcing their application are significantly greater than expected.