

Project	<b>Financial Instruments: Replacement of IAS 39 Amortised Cost and Impairment</b>
Topic	<b>Scope: short-term trade receivables</b>

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## Introduction

### **Background**

1. The Board in its redeliberations to date has focused its discussions in the context of open portfolios. The feedback from the Expert Advisory Panel (EAP) and feedback on the exposure draft *Financial Instruments: Amortised cost and Impairment* (the Impairment ED) indicated that it is operationally challenging to apply the model proposed in the Impairment ED to open portfolios.
2. Another prominent issue that was raised by many constituents (particularly non-financial institutions) during the public consultation period is the scope of the Impairment ED. More specifically the application of the impairment proposals to short-term trade receivables.

### **Purpose**

3. The purpose of this paper is to ask for direction from the Board, to be confirmed formally at a later date, on whether short-term trade receivables (that are without a stated interest rate and are so short-term that the effect of discounting for the time value of money is immaterial) should be treated as follows:
  - (a) exclude from forthcoming ED on impairment until requirements in revenue recognition are finalised ; and

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This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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- (b) once the Board has finalised the requirements for revenue recognition, then consider (under this phase of the project to replace IAS 39) which of the following impairment approaches should apply to short-term trade receivables:
  - (i) the time-proportionate approach that the Board is currently developing for open portfolios; or
  - (ii) the proposals in the Impairment ED; or
  - (iii) the IAS 39 impairment approach; or
  - (iv) any other approach that the Board subsequently develops (including any joint approach with the Financial Accounting Standards Board (FASB)).

**Structure**

- 4. The rest of the paper is structured as follows:
  - (a) overview of the Board's proposals in relation to short-term trade receivables;
  - (b) staff analysis of comments received from constituents;
  - (c) alternatives for how the Board could proceed;
  - (d) the staff recommendation; and
  - (e) the question to the Board.

**Overview of the Board's proposals**

- 5. This section of the paper sets out:
  - (a) an overview of proposals in the Impairment ED for short-term trade receivables;
  - (b) the interaction with the exposure draft *Revenue from Contracts with Customers* (the Revenue ED); and
  - (c) the requirements under IFRSs today.

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**Overview of the proposals in the Impairment ED**

6. The Impairment ED proposes for those trade receivables that are without a stated interest rate and are so short-term that the effect of discounting (for the effect of time value of money) is immaterial, the entity would measure the trade receivables on initial recognition at their invoice amount less the initial estimate of undiscounted expected credit losses. This becomes the starting point for the amortised cost measurement.<sup>1</sup> The initial estimate of undiscounted expected credit losses would be treated as a reduction of the invoice amount in determining the revenue to which the trade receivables relates (eg from the sale of goods).<sup>2</sup>

**Interaction with the proposals in the Revenue ED**

7. The proposals set out in the Impairment ED for short-term trade receivables are consistent with the proposals set out in the Revenue ED. That proposes that one of the factors that the entity should consider when determining the transaction price is collectibility.<sup>3</sup>
8. Collectibility refers to the customer's credit risk—the customer's ability to pay the amount of promised consideration. In determining the transaction price, the Revenue ED proposes that an entity shall reduce the amount of promised consideration to reflect the customer's credit risk (consistent with paragraph 6 above).<sup>4</sup>

**Current requirements under IFRSs**

9. The proposals in the Impairment ED and the Revenue ED are in the staff's view consistent with the current requirements under IAS 18 *Revenue*. That standard requires revenue to be measured at the fair value of the consideration received or

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<sup>1</sup> For these 'short-term' trade receivables the entity would neither determine an effective interest rate nor recognise any interest revenue.

<sup>2</sup> Paragraph B16 of the ED.

<sup>3</sup> The other factors are time value of money, non-cash consideration and consideration payable to the customer (paragraph 42 of the Revenue ED).

<sup>4</sup> Paragraph 43 of the Revenue ED.

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receivable (eg when an entity provides interest free credit to the buyer).<sup>5</sup>

Paragraph 11 of IAS 18 states:

In most cases, the consideration is in the form of cash or cash equivalents and the amount of revenue is the amount of cash or cash equivalents received or receivable. However, when the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash received or receivable.

10. The requirement in IAS 18 is also consistent with the initial measurement of the trade receivable at fair value (plus transaction costs, if any) under IFRS 9 *Financial Instruments*.<sup>6</sup>

## Staff analysis of comments received from constituents

### *Feedback from constituents (comment letters and outreach activities)*

11. A large majority of the respondents that commented on the treatment of short-term trade receivables stated that such instruments should **not** fall within the scope of the model proposed in the Impairment ED. Many of these respondents suggested that the current impairment model under IAS 39 should continue to apply to trade receivables.

#### *Interaction and (in)consistency with revenue recognition*

12. Some respondents disagree that the Impairment ED is consistent with IAS 18 *Revenue* and the *Framework*. They believe the current requirement is to recognise revenue at the full nominal amount.
13. Other constituents agree that the proposals in the Impairment ED are consistent with the requirements in IAS 18, but acknowledge that widespread practice today is to recognise revenue and the related trade receivable at the invoice amount. This may be because the first part of paragraph 11 of IAS 18 states that in most cases, the amount of revenue is the amount of cash received or receivable. Due to the short-term nature of the receivables (and corresponding

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<sup>5</sup> IAS 18.9.

<sup>6</sup> IFRS 9.5.1.1. IAS 39 contains the same requirements (IAS 39.43).

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short lag between expected losses and actual losses), many entities might not consider the recoverability of cash flows (ie, credit losses) when determining the fair value of the consideration receivable. See the staff analysis section below describing the requirements of IAS 18 (ie that revenue be measured at the fair value of the consideration received or receivable).

14. Some respondents also comment that it is essential that the any final requirements on impairment and revenue recognition for short-term trade receivables be fully consistent, and that the two issues need to be considered together.

*Short-term trade receivables vs 'interest earning' financial assets*

15. Many respondents commented that most short-term trade receivables are not held for interest gains and hence the nature of such receivables is different from other financial assets that arise as a result of a lending transaction. They argue that any credit component is incidental to the revenue generating transaction of the sale of goods and services. For example, a respondent stated the following:

While it is certainly true that a trade receivable does involve the provision of some form of credit to a third party, it is first and foremost the reflection of a sale transaction... It is not of itself a revenue-earning asset....Credit losses are regarded as a cost in the same way as selling expenses or production costs, not an element of revenue. (CL 15)

16. A few respondents who commented on this issue (including the above quoted respondent) also noted that that credit losses would be relevant if the sales transaction does involve significant credit terms.

*Timing of credit loss recognition*

17. Some respondents also commented that due to the short-term nature of most trade receivables (usually 90 days), the time lag between expected losses and actual losses is quite short and these respondents do not believe the costs of moving to an expected loss approach would outweigh any benefits.
18. Some also commented that the recent financial crisis was not caused by the application of the incurred loss impairment approach to short-term trade receivables.

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*Disclosures*

19. Many respondents who commented on this issue (including some users) think that the proposed disclosures in the Impairment ED are overly burdensome for non-financial institutions and do not provide any additional useful information on these entities.

**Staff analysis**

*Interaction and (in)consistency with revenue recognition*

20. As described in paragraph 12 above, some respondents commented that the proposal in the Impairment ED is inconsistent with the requirements under IFRSs today. More specifically a few constituents refer to paragraph 85 of the *Framework* which states:

For example, when it is probable that a receivable to an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognised.

21. The staff note that the above paragraph does not specify whether the recognition of an expense is for the initial or subsequent assessment of non-payment of the receivable.
22. IAS 18 states that revenue shall be measured at the fair value of the consideration received or receivable.<sup>7</sup> The staff are of the view that recoverability of cash flows (credit losses) is one of the factors to consider when determining the fair value of the consideration receivable. When recoverability of cash flows is considered, the fair value of the consideration may be less than the nominal amount. When cash payment is deferred (eg when an entity provides interest free credit) and hence constitutes a financing arrangement, IAS 18 requires entities to take into account the effect of credit losses by

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<sup>7</sup> IAS 18.9.

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discounting all future receipts using an imputed rate of interest with a similar credit rating<sup>8</sup> (and not just the risk free rate).

23. An expense is recognised for subsequent assessment of non payment as paragraph 18 of IAS 18 states:

However, when an uncertainty arises about the collectibility of an amount **already** included in revenue, the uncollectible amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense, rather than as an adjustment of the amount of revenue originally recognised. (**Emphasis added**)

24. Hence, the staff is of the view that IAS 18 is consistent with the proposals set out in the Impairment ED. The initial estimate of undiscounted expected credit losses would be treated as a reduction of the invoice amount in determining revenue. Subsequent changes to the assessment of collectibility are recognised as an expense. The staff note that the *Framework* does not override any specific IFRSs. In cases where there is a conflict between the requirement of an IFRS and the *Framework*, the requirement in the specific IFRS prevails.<sup>9</sup>
25. The staff further note that the accounting in paragraph 24 above also applies under the time-proportionate approach. For short-term trade receivables there is no interest revenue recognised over the life of the instrument. Hence there is no time-proportionate allocation of expected credit losses.<sup>10</sup> Changes to the estimate of expected credit losses are also recognised immediately.
26. However, the staff also acknowledge that wide spread practice today is to recognise revenue and the related trade receivable at the invoice amounts (see paragraph 13).

*Short-term trade receivables vs 'interest-earning' financial assets*

27. The staff note that the Impairment ED sets out proposals relating to accounting for credit losses—inherent in both short-term trade receivables and other 'interest-earning' financial assets. The proposals allocate credit losses to the

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<sup>8</sup> IAS 18.11.

<sup>9</sup> IAS 8.11 and paragraphs 2 and 3 of the *Framework*

<sup>10</sup> The Impairment ED deals with amortised cost as a **subsequent** measurement. Under the time proportionate approach, the recognition of expected credit losses corresponds with that of the related interest revenue earned over the life of the financial instrument.

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related revenue of the financial assets. For ‘interest-earning’ financial assets, it is allocated against the related interest revenue, and for short-term trade receivables it is the consequence of initial measurement of revenue and trade receivables at fair value but with no discounting (ie the EIR is zero).

28. The IASB’s project on revenue recognition sets out new proposals for revenue recognition (see paragraphs 7 and 8). These proposals are subject to the Board’s redeliberations. The staff note that the initial measurement for short-term receivables (ie the starting point for amortised cost measurement) should align with the related measurement of revenue.

*Timing of credit loss recognition*

29. The staff agree with some respondents’ comments that for short-term trade receivables the time lag between expected losses and actual losses are quite short and moving from an incurred loss model to an expected loss approach as proposed in the ED may be less useful for short-term trade receivables than for other financial assets such as loans that arise from lending activities.

*Disclosures*

30. The staff agree that some of the proposed disclosures are more relevant for financial institutions than for non-financial institutions (eg loss triangle and vintage information). However the staff also note that other disclosures such as the reconciliation of changes in non-performing financial assets could be useful in assessing the credit risk management of non-financial institutions and the way they manage bad debts.

**Alternatives**

31. The staff think that the Board has at least the following alternatives for short-term trade receivables (that are without a stated interest rate and are so short-term for which the effect of discounting for the time value of money is immaterial):
  - (a) alternative 1: include in the forthcoming ED on impairment; and



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- (b) alternative 2: exclude from forthcoming ED on impairment until requirements in revenue recognition are finalised.

**Staff analysis of the alternatives**

***Alternative 1***

32. Alternative 1 is to include short-term trade receivables in the forthcoming ED on impairment. Alternative 1 allows the possibility of avoiding multiple impairment recognition models.<sup>11</sup> The staff note that any impairment approach that the Board further develops for short-term trade receivables at this stage faces the risk of inconsistency (see paragraph 35) with the final requirements in the revenue recognition project—which is still subject to Board redeliberations. Many respondents have noted that it is important that the requirements in the impairment phase and revenue recognition for trade receivables should be consistent.

***Alternative 2***

33. Alternative 2 is to exclude from the forthcoming ED on impairment for short-term trade receivables (that are without a stated interest and are so short-term which the effect of discounting for time value of money is immaterial) until the requirements on revenue recognition are finalised. Once the Board has finalised the requirements for revenue recognition, it could then consider (under the impairment phase of the project to replace IAS 39) which of the following impairment approaches should apply to trade receivables:

- (i) the time-proportionate approach; or
- (ii) the proposals in the Impairment ED; or
- (iii) the current IAS 39 impairment approach; or
- (iv) any other approach that the Board subsequently develops (including any joint approach with the Financial Accounting Standards Board (FASB)).

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<sup>11</sup> Depending on whether the time-proportionate approach will also apply to short-term trade receivables.

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34. The staff note that the proposals in the Impairment ED and the time-proportionate approach result in the same accounting for short-term trade receivables (see paragraphs 24 and 25).
35. If the Board decides to finalise the current proposals in the Revenue ED without any amendments, maintaining the current requirements in IAS 39 for short-term trade receivables would result in :
  - (a) multiple impairment models; and
  - (b) inconsistency with initial measurement of trade receivables (see paragraph 10).
36. If the Board decides not to consider collectibility in recognising revenue for short-term trade receivables, applying an expected loss approach as proposed in the Impairment ED will result in a day 1 loss.
37. Alternative 2 would temporarily scope out short-term trade receivables from the impairment phase of the IAS 39 replacement project until the proposals in the Revenue ED are finalised. This would ensure consistency between the two final IFRSs in relation to the treatment of initially expected credit losses for short-term trade receivables.
38. Given the same accounting outcome will result from the proposals in the Impairment ED and the time-proportionate approach (see paragraphs 24, 25 and 34), no re-exposure for short-term receivables would be required if the Board decides in the future to finalise the requirements for short-term receivables based on either of the two approaches.

**Direction for developing model**

39. Many respondents noted that the impairment project should not affect the measurement of related revenue for short-term trade receivables. The staff note that the impairment phase determines the subsequent measurement of financial assets at amortised cost. The staff further note that the starting point for amortised cost measurement for short-term trade receivables should be aligned with the related revenue. Whether revenue recognition should include the effect of initially expected credit losses in the staff's view is a question of revenue

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measurement. Hence the staff thinks that the impairment model to be used as the basis for the upcoming exposure draft should be developed based on short-term trade receivables being excluded from the scope as set out in alternative 2 in paragraph 33 above.

**Question –**

Does the Board agree with the staff's suggestion on the scope of the upcoming impairment exposure draft as set out in paragraph 39 above (to be used to further develop the impairment model)?

If not, what does the Board propose instead and why?