

# STAFF PAPER

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## REG FASB | IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Application of the 'three-bucket' model to trade receivables		
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## Introduction

### Tentative decisions

1. In February 2012 the boards first discussed the application of the three-bucket impairment model to trade receivables, including whether an expected loss model or an incurred loss model should be applied to trade receivables without a significant financing component.<sup>1</sup>
2. The boards asked the staff to evaluate whether an expected loss model would be operational for these trade receivables before making a tentative decision about whether an expected loss model should be applied.
3. Subject to the decision on whether an expected loss model should be applied, in February 2012 the boards separately discussed how an expected loss approach would be applied to trade receivables without a significant financing component. This discussion was not joint because of the different initial measurement requirements for financial instruments in accordance with IFRSs

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<sup>1</sup> As defined in the ED 2011/6 *Revenue from Contracts with Customers* (the Revenue ED). Agenda Papers 4B/Memo 137 and Agenda Paper 4C (IASB only) provide additional background on the February 2012 discussion of trade receivables.

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and those in accordance with U.S. GAAP—nevertheless, the boards’ decisions (as outlined below) were consistent and would simplify the application of the three-bucket model. To address the different initial measurement requirements, the IASB tentatively agreed that trade receivables would be measured at the transaction price as defined in the Revenue ED (ie the invoice amount in many cases) on initial recognition. In addition, both boards tentatively decided that trade receivables without a significant financing component would be included in Bucket 2 or 3 on initial recognition, thus recognising lifetime expected losses on initial recognition and throughout the life of the asset.

**Purpose and scope of this paper**

4. This paper provides the analysis requested by the boards of whether an expected loss model would be operational for trade receivables without a significant financing component. This analysis is important because one of the primary objectives of the impairment project is to reduce complexity in the financial reporting of financial instruments for users of financial statements. Applying an expected losses approach to these trade receivables would be less complex for users of financial statements than an incurred loss approach because the impairment of other financial assets also follows an expected loss approach.
5. This paper contains the following sections:
  - a. Feedback from outreach on current practice (paragraphs 7-11);
  - b. Proposals and feedback on original IASB ED (paragraph 12);
  - c. Alternatives (paragraph 13)
  - d. Staff analysis (paragraphs 14-16); and
  - e. Staff recommendation (paragraph 17). The staff recommend that an expected loss approach should be applied to trade receivables without a significant financing component, along with a practical expedient clarifying that a provision matrix can be used.
6. This paper does not summarise and analyse feedback on the conceptual merits of applying an expected loss model or incurred loss model, which was part of

Agenda Paper 4B/Memo 137 from the February 2012 meeting (included as Appendix A).

### **Feedback from outreach on current practice**

7. In order to evaluate whether it would be operational for an expected loss approach to be applied to trade receivables without a significant financing component, the staff performed outreach with both US and non-US entities to better understand current practices for recognising an impairment allowance for these receivables.
8. Some entities find it challenging to identify an incurred loss event for trade receivables other than simply on the basis of payment delinquencies. Consequently, many entities reporting in accordance with IFRSs and US GAAP today use a provision matrix to estimate their incurred credit losses on a portfolio of trade receivables, as follows:
  - a. grouping trade receivables based on different customer bases which show different loss patterns (eg geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer)
  - b. using historical loss experience on trade receivables to estimate the incurred credit losses, and
  - c. applying a fixed provision rate depending on the number of days that a receivable is past due.
9. The provision matrix approach described above is based on incurred loss triggers. Consequently, trade receivables do not have an identified incurred loss until they are past due. IFRSs require objective evidence of impairment as a result of one or more events that occurred after initial recognition, (ie past due status) for trade receivables to be impaired. In contrast, entities reporting under US GAAP may recognise a reserve associated with the 'current' portion of the trade receivables based on historical data that may indicate that a loss has been incurred but is not yet reported or specifically identified.
10. In addition to the provision matrix methodology described above for portfolios of receivables, many entities apply a different methodology when information indicates the loss rates based simply on a number of days past due may not

represent the incurred losses on those trade receivables specifically identified. This practice is because the reporting entity typically has more detailed information about the specific receivables—for example, about a major customer who is experiencing financial difficulty, or trade receivables in a jurisdiction that is experiencing increased economic difficulty. In making this assessment, entities monitor current and possibly forward-looking information and consider that information within the context of their historical experience.

11. In addition, despite the fact that entities use a provision matrix based on past due status to determine their impairment loss for portfolios of receivables, many entities have experience in considering cash shortfalls at the point of sale (before receivables become past due). For example, they may consider overall expectations of cash shortfalls for internal purposes, or for external purposes such as evaluating a general provision in accordance with some statutory national GAAPs, as part of applying an incurred loss methodology (as described in the preceding paragraphs).

### **Proposal and feedback on the original IASB ED**

12. The original IASB ED would have required credit losses on trade receivables to be recognised and measured on the basis of expected losses. Paragraph B16 provided a practical expedient which clarified that entities could determine the amortised cost of trade receivables using a provision matrix. Feedback on the original IASB ED specific to trade receivables did not indicate that the provision matrix would provide insufficient operational relief for an expected loss model.<sup>2</sup>

### **Alternatives**

13. In the following section, the staff have analysed two alternatives:
  - a. **Alternative A**— Use an expected loss credit impairment model for trade receivables without a significant financing component, including a practical expedient that a provision matrix can be used.

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<sup>2</sup> The feedback received focused on aspects of the impairment model that have since been changed by the boards' tentative decisions on the impairment and revenue recognition projects: the calculation of an integrated EIR, the requirement to assess the materiality of the time value of money on trade receivables, and the presentation of revenue net of estimated credit losses.

- b. **Alternative B**— Use an incurred loss credit impairment model for trade receivables without a significant financing component.

### Staff analysis

14. Outreach participants indicated that they would not have significant operational difficulty in applying an expected loss approach to their trade receivables without a significant financing component (Alternative A). While these participants acknowledge that an expected loss approach would require a change in practice, they believe that they can incorporate forward-looking information within their current methodologies. As described above, some outreach participants noted that they already use forward-looking information to a limited extent in their impairment assessments. In addition, the outreach participants noted that the application of an expected loss approach to current trade receivables (ie those that are not past due) could be made operational without undue cost or burden.
15. The staff think that a provision matrix can be an acceptable method to measure expected losses for these trade receivables. Under an expected loss approach, these methodologies would take into account an entity's historical loss experience on its trade receivables to estimate the lifetime expected losses. These historical provision rates, which are an average of historical outcomes, would be adjusted to reflect relevant information about current conditions and reasonable and supportable forecasts and their implications on expected credit losses. Such an approach would be consistent with the measurement objective of expected credit losses described in Agenda Paper 5B/Memo 143.
16. In contrast, Alternative B would require entities to apply an incurred loss approach when measuring its impairment allowance for trade receivables without a significant financing component. This alternative would not result in a change to current US GAAP and IFRSs. One outreach participant that applies IFRSs noted that the practical application of the current impairment requirements in IAS 39<sup>3</sup> often results in impairment losses not being

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<sup>3</sup> According to IAS 39.59, “[a] financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a ‘loss event’) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated.”

recognised until the receivables become past due (unless another incurred loss trigger for those receivables is identified). Along with other outreach participants, this constituent thinks that financial reporting would be improved if entities were required to recognise impairment before receivables become past due.

### Staff recommendation

17. The staff recommend Alternative A for the following reasons:
  - a. the application of an expected loss approach to all financial assets would result in less complexity for users of financial statements;
  - b. outreach participants noted that an expected loss approach could be operationalised without undue cost or burden because entities could leverage current practices (ie a provision matrix); and
  - c. entities would be required to recognise impairment for trade receivables before they become past due.

#### Question to the boards

Do the boards agree with the staff recommendation that an expected loss approach should be applied to trade receivables without a significant financing component, along with a practical expedient clarifying that a provision matrix can be used (Alternative A)? If not, what would the boards alternatively suggest?

### Appendix A: Excerpt from Agenda Paper 4B/Memo 137 from the February 2012 joint meeting

- A1. The staff have made a few minor edits in this appendix for clarity and consistency with this paper. All edits are in [square brackets].

#### Issue and alternatives

8. The basic question in this issue is whether the credit impairment guidance for trade receivables should be based on an ‘incurred loss’ model or an ‘expected loss’ model. [The two alternatives are as follows:
  - (a) **Alternative A**—Use an ‘expected loss’ credit impairment model for trade receivables.

- (b) **Alternative B**—Use the existing ‘incurred loss’ credit impairment model for trade receivables]
9. Alternative [B] would make no change to existing GAAP, but would instead merely exclude trade receivables from the scope of the general three-bucket impairment model that is currently being developed.<sup>4</sup>
10. Alternative [A] would include trade receivables within the scope of the expected loss model currently being developed. If this approach is favoured by the boards, it raises questions that are explored in Issue 2 and Issue 3 [of Agenda Paper 4B/Memo 137 from February 2012] regarding how expected losses for trade receivables should function in the impairment model (including whether a 12-month expected loss or lifetime expected loss should be recognised at initial recognition).

#### **Staff analysis**

11. [Appendix A to Agenda Paper 4B/Memo 137 from February 2012] contains the comment letter summary, which discusses the feedback received on impairment accounting for trade receivables (paragraphs 31-34 of Agenda Paper 9A from the July 2010 IASB meeting).
12. Proponents of Alternative [B] (the ‘incurred loss’ approach) suggest that the current model is not broken for trade receivables. They believe that the genesis of this project is related to impairment of other assets such as loans and debt securities, and see no reason to include trade receivables within its scope. Furthermore, these individuals believe that the benefits of moving from an ‘incurred’ approach to an ‘expected’ approach do not outweigh the cost of doing so.
13. In addition, as noted in the comment letter feedback in [Appendix A to Agenda Paper 4B/Memo 137 from February 2012], respondents to the original IASB ED believed that applying an expected loss model to non-interest-bearing (eg, short-term) trade receivables would not provide more

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<sup>4</sup> For purposes of this discussion, the staff have not considered potential modifications if the boards believe that an incurred loss model should be followed but improved or made to converge. If the boards want a converged (or modified) incurred loss approach for impairment, the staff would consider those types of approaches for discussion at a later time.

useful information than an incurred loss model would do, because of their short maturity. They also noted that there would be operational burdens for smaller financial institutions and/or non-financial institutions of applying an expected loss approach.

14. Opponents of Alternative [B] note that for at least some short-term trade receivables, the time lag between an expected and an incurred loss event may not be significant and so an operational simplification would not, in those cases, result in an improvement in the usefulness of the information reported. (Of course, the question would remain as to whether this effect would be significant and/or material.)
15. In addition, although some constituents do not see the cost/benefit attraction of an expected loss model for short-term receivables, because incurred losses would be recognised quickly anyway, there is no reason in economic terms why the impairment approach for trade receivables with no significant financing component should be different from other financial assets with the same maturity that are subject to impairment.
16. Proponents of Alternative [A] note that trade receivables meet the definition of ‘financial assets’ in IFRS and US GAAP, and as such should use an ‘expected loss’ approach. They see no reason to use a different conceptual model for trade receivables.
17. Proponents of Alternative [A] believe that an expected loss model is superior to an incurred loss model, because it takes future expectations into consideration. They also believe that it would reduce complexity by having all financial assets use a single impairment model.
18. Furthermore, proponents of Alternative [A] believe that the boards have the flexibility to mitigate the costs of applying an ‘expected loss’ approach (see Issues 2 and 3 [of Agenda Paper 4B/Memo 137 from February 2012] for some of the simplifications that could be permitted for trade receivables if using an expected loss model, thereby reducing the cost to preparers). Some also believe that many corporates have experience in considering forward-looking information in assessing anticipated losses—for example, many national GAAPs recognise a general loan loss provision even for the ‘not past due’



subset of the trade receivables and consideration is already given to future expectations in assessing whether losses are incurred today. This knowledge would help in a move to an expected loss approach.

***Staff recommendation***

19. The staff recommend Alternative [A] (ie, an ‘expected loss’ approach) for the reasons articulated above. However, the recommendation by some staff for an ‘expected loss’ approach instead would ultimately change if the modifications to the three-bucket model to simplify its application to trade receivables that are discussed in Issues 2 and 3 [of Agenda Paper 4B/Memo 137 from February 2012] were not made. If such modifications are not made, these staff believe the benefits of changing from the existing incurred loss model would not outweigh the costs of doing so.