

## STAFF PAPER

9–13 December 2013

## REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Cover note: Background information and progress report		
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

## Introduction

1. This cover note provides a summary of this month's Agenda Papers and the IASB's next steps.
2. In addition, Appendix A provides a brief overview of the proposals in the Exposure Draft (ED) *Financial Instruments: Expected Credit Losses* together with the tentative decisions to date.
3. This paper is for information purposes only and there are no questions for the IASB.

## Background to this meeting

4. At the November board meeting, the IASB deliberations focused on specific aspects of the proposals in the ED, namely:
  - (a) loan commitments and financial guarantee contracts;
  - (b) financial assets measured at fair value through other comprehensive income (FVOCI);
  - (c) purchased or originated credit-impaired financial assets;
  - (d) trade receivables and lease receivables; and

- (e) the calculation and presentation of interest revenue for instruments that have objective evidence of impairment (ie Stage 3).
5. Lastly, the IASB tentatively decided that the final version of IFRS 9 *Financial Instruments* will be no earlier than annual periods beginning on or after 1 January 2017. The IASB will make a decision on the mandatory effective date closer to finalisation of the impairment and classification and measurement projects.
6. The staff did not ask the IASB for a decision on whether it wanted to proceed with the redeliberations on the proposals in the ED with the aim of finalising it. Instead, the papers asked the IASB to make decisions about changes they would like to make to the proposals in the ED on the assumption that we were to proceed to finalise the ED. This is still the case at the December IASB meeting.

### Overview of Agenda Papers for this meeting

7. In December, the IASB staff will present the following papers for deliberations by the IASB:
- (a) Paper 5A—Loan commitments and financial guarantee contracts; and
  - (b) Paper 5B—Transition and Effect Analysis;
- Paper 5A—Loan Commitments and financial guarantee contracts*
8. This Agenda Paper is a follow-up to the deliberations at the November 2013 meeting on Agenda Paper 5A *Loan commitments and financial guarantee contracts*. On the basis of the tentative decisions that it had reached (refer to Appendix A), the IASB requested the staff to perform further analysis to determine whether these tentative decisions about revolving facilities should apply to a wider scope of loan commitments and financial guarantee contracts.
9. The Agenda Paper presents and analyses a number of examples to illustrate the application of the proposed requirements and the effect of the IASB's tentative decision for revolving credit facilities.

*Paper 5B—Transition and Effect Analysis*

10. This Agenda paper analyses the feedback received from respondents on the Transition proposals and the Effect Analysis. The paper considers whether additional relief should be provided on transition.

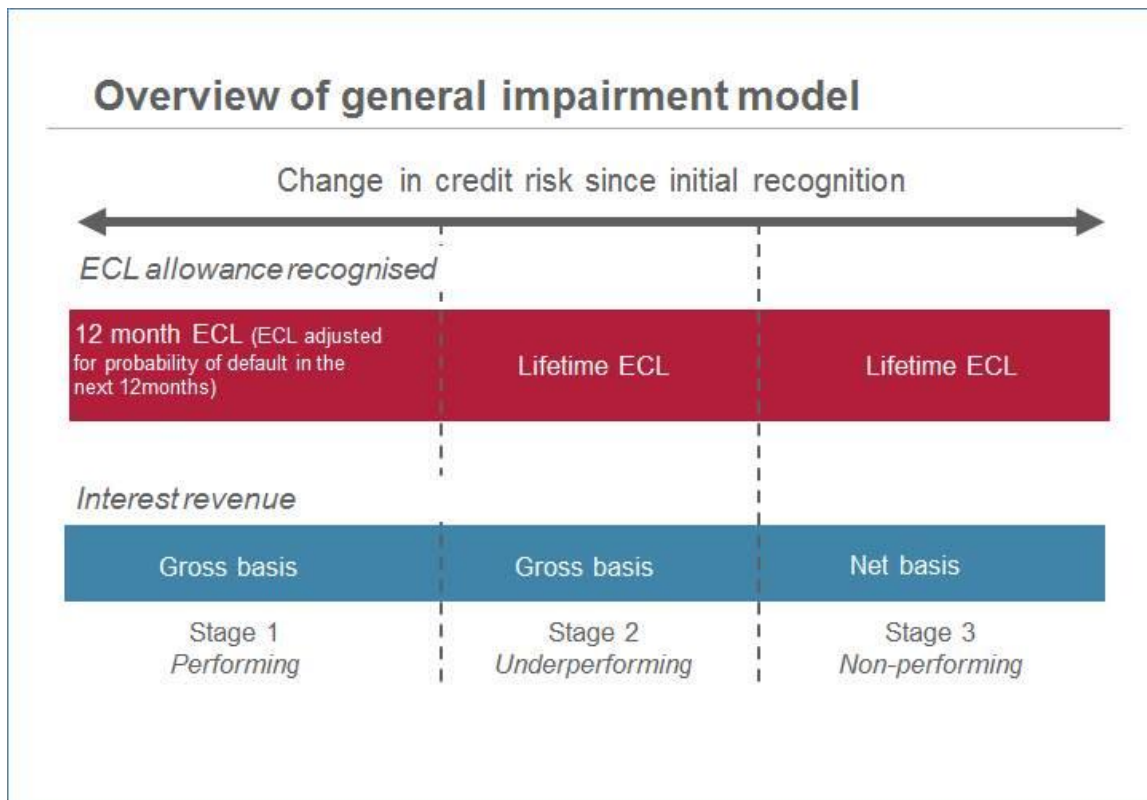
**Next steps**

11. The staff propose summarising the model for the IASB considering the tentative decisions made during redeliberations and to provide the IASB with an update on the FASB's discussions.
12. The staff intend to discuss with the IASB the following topics at forthcoming meetings:
  - (a) disclosures;
  - (b) IFRS 1 *First-time Adoption of International Financial Reporting Standards*; and
  - (c) any potential sweep issues.

## Appendix A: Exposure Draft (ED) *Financial Instruments: Expected Credit Losses*

### Overview of the general model

- A1. The ED proposed a single impairment model that aimed to provide users of financial statements with more useful information about an entity's expected credit losses.
- A2. We can summarise the general model graphically as follows:



- A3. The proposals require that an entity shall recognise, **at each reporting date**, for financial instruments (other than those that are credit-impaired on initial recognition):
- lifetime ECL (ECL resulting from default events over the life of the instrument) for financial instruments if there has been a significant increase in credit risk since initial recognition (Stages 2 and 3); and
  - 12-month ECL (ECL resulting from default events within the next 12 months) for all other financial instruments (Stage 1).

- A4. The ED proposed that an entity would generally present and calculate interest revenue using the effective interest method on the gross carrying amount. However, the way in which that interest revenue is calculated and presented changes if there is objective evidence of impairment (Stage 3). An entity would then present and calculate interest revenue using the effective interest method on the net carrying amount (ie the gross carrying amount less allowance for the ECL).
- A5. To estimate the ECL and the changes in credit risk, an entity shall consider information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions. The degree of judgement that is required for the estimates depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement to estimate ECL increases. The estimate of ECL does not require a detailed estimate for periods that are far in the future—for such periods, an entity may extrapolate projections from available, detailed information.

#### **Tentative decisions made by the IASB on default**

**September 2013:** The IASB tentatively decided to require a default definition to be applied that is consistent with credit risk management practices and to emphasise that qualitative indicators of default should be considered when appropriate (such as for financial instruments that contain covenants). The IASB also tentatively decided to include a rebuttable presumption that default does not occur later than 90 days past due unless an entity has reasonable and supportable information to support a more lagging default criterion.

#### *Recognition and measurement of the 12-month ECL and the lifetime ECL*

##### *Recognition of the 12-month ECL*

- A6. Most financial instruments would generally have a 12-month ECL allowance on origination or purchase. This stage would capture at the reporting date those instruments that have not significantly increased in credit risk since initial recognition.

- A7. The 12-month ECL is the amount of expected credit losses that would result from a default in the 12 months after the reporting date. The losses are therefore *not*:
- (a) the expected cash shortfalls in the next 12 months; or
  - (b) the losses on those assets that are expected to default in the next 12 months.
- A8. At each reporting period the entity would remeasure the 12-month ECL (ie update the 12-month expected loss allowance) for financial instruments that have not had a significant increase in credit risk since initial recognition, to reflect the entity's current expectations about expected credit losses.

#### **Tentative decisions made by the IASB on recognition of the 12-month ECL**

**September 2013:** The IASB tentatively decided to confirm that 12-month expected credit losses are the measurement objective for instruments in Stage 1.

**October 2013:** The IASB tentatively decided to clarify the measurement of 12-month expected credit losses by incorporating the discussion in paragraph BC63 of the Exposure Draft as part of the application guidance, namely that 12-month expected credit losses are a portion of the lifetime expected credit losses. Thus, 12-month expected credit losses are neither the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months, nor the cash shortfalls that are predicted over the next 12 months.

#### *Recognition of the lifetime ECL*

- A9. The ED proposed that an entity shall recognise lifetime ECL when credit risk has increased significantly since initial recognition.

#### *Assessing significant deterioration*

- A10. The ED proposed that an entity should assess whether there has been a significant increase in credit risk by comparing the:
- (a) credit risk at the reporting date; to
  - (b) the credit risk at initial recognition of the financial instrument.

- A11. In assessing credit risk, the entity considers the likelihood of not collecting some or all of the contractual cash flows over the *remaining maturity* of the financial instrument (ie the probability of a default occurring over the remaining life).

#### Tentative decisions made by the IASB on the recognition of lifetime ECL

**October 2013:** The IASB tentatively decided to confirm that lifetime expected credit losses shall be recognised when there is a significant increase in credit risk since initial recognition. The IASB also tentatively decided to clarify (potentially through examples) that:

- the assessment of significant increases in credit risk could be implemented more simply by establishing the initial maximum credit risk for a particular portfolio (by product type and/or region) (the 'origination' credit risk) and then comparing the credit risk of financial instruments in that portfolio at the reporting date with that origination credit risk. This would be possible for portfolios of financial instruments with similar credit risk on initial recognition;
- the assessment of significant increases in credit risk could be implemented through a counterparty assessment as long as such assessment achieves the objectives of the proposed model;
- the assessment of when to recognise lifetime expected credit losses should consider only changes in the risk of a default occurring, rather than changes in the amount of expected credit losses (or the credit loss given default (LGD));
- an assessment based on the change in the risk of a default occurring in the next 12 months is permitted unless circumstances indicate that a lifetime assessment is necessary. Examples will be provided of when a 12-month assessment would not be appropriate and a lifetime assessment would be necessary; and
- a loss allowance measured at an amount equal to 12-month expected credit losses shall be re-established for financial instruments for which the criteria for the recognition of lifetime expected credit losses are no longer met.

- A12. Generally, a financial instrument would have a significant increase in credit risk before there is objective evidence of impairment or before default occurs.
- A13. The ED included two operational simplifications to assist entities in assessing significant increases in credit risk:

- (a) for financial instruments with ‘low credit risk’ at the reporting date (for example, a loan that has an internal credit risk rating equivalent to the external credit rating of ‘investment grade’), the entity would continue to recognise the 12-month ECL. The IASB’s intention was to reduce the operational burden of assessing significant increases in credit risk for those high quality investments. The intention was not that the ‘low credit risk’ should be treated as an absolute threshold test for the recognition of lifetime ECL.

#### **Tentative decisions made by the IASB on assessing significant deterioration**

**October 2013:** The IASB tentatively decided that an entity can assume that a financial instrument has not significantly increased in credit risk if it is low credit risk at the reporting date. The IASB also tentatively decided to:

- modify the proposed description of low credit risk to better reflect the characteristics, namely that: the instrument has a low risk of default; the borrower is considered, in the near term, to have a strong capacity to meet its obligations; and the lender expects for the longer term that adverse changes in economic and business conditions may, but not necessarily, reduce the ability of the borrower to fulfil its obligations;
- clarify that the low credit risk notion is not meant to be a bright-line trigger for the recognition of lifetime expected credit losses. Instead, when an instrument is no longer low credit risk, an entity would assess whether there has been a significant increase in credit risk to determine whether lifetime expected credit losses should be recognised; and
- clarify that financial instruments are not required to be externally rated; but that low credit risk equates to a global credit rating definition of ‘investment grade’.

- (b) a rebuttable presumption that there is a significant increase in credit risk when contractual payments are more than 30 days past due. However, information that is more forward-looking than past due information will typically be available and shall be considered in determining whether there has been a significant increase in credit risk at the reporting date.



**Tentative decisions made by the IASB on assessing significant deterioration**

**October 2013:** The IASB tentatively confirmed the rebuttable presumption that there is a significant increase in credit risk when contractual payments are more than 30 days past due. In addition, the IASB tentatively decided to clarify that:

- the objective of the rebuttable presumption is to serve as a backstop or latest point at which to identify financial instruments that have experienced a significant increase in credit risk;
- the presumption is rebuttable; and
- the application of the rebuttable presumption is to identify significant increases in credit risk before default or objective evidence of impairment.

- A14. The ED did not prescribe a particular method to assess increases in credit risk. It proposed that an entity could perform the assessment for financial instruments that have shared credit risk characteristics.

**Tentative decisions made by the IASB on assessing significant deterioration**

**September 2013:** The IASB tentatively decided to clarify that the objective of the model is to recognise lifetime expected credit losses on *all* financial instruments for which there has been a significant increase in credit risk—whether on an individual or portfolio basis—and that all reasonable and supportable information, including forward-looking information that is available without undue cost or effort needs to be considered. In addition, the IASB tentatively decided to include Illustrative Examples to reflect the intention of the proposals.

*Measurement of the ECL*

- A15. The ECL is the *present value* of the expected cash shortfalls over the life of the financial instrument.
- A16. The ED did not prescribe a method to measure the ECL. However, it proposes that an entity's estimate of expected losses reflects:
- (a) the best available information;
  - (b) an unbiased and probability-weighted estimate of cash flows associated with a range of possible outcomes; and

(c) the time value of money.

A17. The ED proposed that an entity can use a discount rate between, and including, the risk-free rate and the effective interest rate when discounting expected credit losses. The choice of discount rate must be applied consistently in the accounting for the impairment allowance of a financial asset over its life.

#### **Tentative decisions made by the IASB on the measurement of ECL**

**October 2013:** The IASB tentatively decided to require that expected credit losses should be discounted at the effective interest rate or an approximation thereof. Furthermore, in measuring expected credit losses, the IASB tentatively confirmed that:

- the measurement of expected credit losses should incorporate the best available information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. For periods beyond 'reasonable and supportable forecasts' an entity should consider how best to reflect its expectations by considering information at the reporting date about the current conditions, as well as forecasts of future events and economic conditions; and
- regulatory expected credit loss models may form a basis for expected credit loss calculations, but the measurement may need to be adjusted to meet the objectives of the proposed model.

#### ***Loan commitments and financial guarantee contracts***

A18. An entity would apply the impairment proposals to:

- (a) loan commitments in which there is a present legal obligation to extend credit, except any loan commitments that are measured at fair value through profit or loss in accordance with IFRS 9 *Financial Instruments*; and
- (b) financial guarantee contracts to which IFRS 9 is applied and that are not measured at fair value through profit or loss.

A19. The ED proposed that an entity should recognise a liability for the ECL for those loan commitments and financial guarantee contracts. When estimating the ECL

of loan commitments, an entity considers the remaining contractual period, or shorter period, over which it is exposed to credit risk.

- A20. The proposals in the ED did not propose to change the accounting for revenue that arises from loan commitments or financial guarantee contracts.

#### **Tentative decisions made by the IASB on loan commitments and financial guarantee contracts**

**November 2013:** The IASB discussed whether expected credit losses for revolving credit facilities should consider the contractual ability to cancel the undrawn commitment or whether that contractual ability does not necessarily limit an entity's exposure to credit losses to the contractual notice period. The IASB tentatively decided that for revolving credit facilities:

(a) expected credit losses, including expected credit losses on the undrawn facility, should be estimated for the period over which an entity is exposed to credit risk and over which future drawdowns cannot be avoided.

(b) expected credit losses on the undrawn facility should be discounted using the same effective interest rate, or an approximation thereof, used to discount the expected credit losses on the drawn facility.

(c) the provision for the expected credit losses on the undrawn facility should be presented together with the loss allowance for expected credit losses on the drawn facility if an entity cannot separately identify the expected credit losses associated with the undrawn facility.

On the basis of this tentative decision, expected credit losses on other loan commitments and financial guarantee contracts will still be based on considering the contractual obligation to extend credit as proposed in the Exposure Draft. However, the IASB requested the staff to perform further analysis to determine whether these tentative decisions should apply to a wider scope of loan commitments and financial guarantee contracts.

### ***Financial assets measured at FVOCI***

- A21. The IASB proposed that the general model in the ED should apply to financial assets measured at FVOCI in order to address the weakness of having multiple impairment approaches.

#### **Tentative decisions made by the IASB on financial assets measured at FVOCI**

**November 2013:** The IASB tentatively confirmed the proposals in the Exposure Draft for the treatment of expected credit losses for financial assets measured at FVOCI and not to introduce any relief from recognising 12-month expected credit losses.

Furthermore, the IASB agreed to clarify in drafting that expected credit losses reflect management's expectations of credit losses. However, when considering the 'best available information' in estimating expected credit losses, management should consider observable market information about credit risk.

### ***Credit impaired financial assets on initial recognition***

- A22. When there is objective evidence of impairment as a result of one or more events that occurred on or before the initial recognition of an financial asset, the ED proposed that an entity should:
- (a) include lifetime expected credit losses in the estimated cash flows when computing the effective interest rate on initial recognition (ie a credit-adjusted effective interest rate); and
  - (b) recognise subsequent changes in lifetime expected credit losses in profit or loss.
- A23. This treatment is similar to the accounting treatment of purchased credit-impaired financial assets in paragraph AG5 of IAS 39 *Financial Instruments: Recognition and Measurement*.
- A24. The ED proposed that an entity should present and calculate interest revenue using the effective interest method on the amortised cost (ie net carrying amount, or gross carrying amount less allowance for the ECL) of those financial instruments.

**Tentative decisions made by the IASB on POCI assets**

**November 2013:** The IASB tentatively confirmed the proposals in the Exposure Draft for the treatment of purchased or originated credit-impaired financial assets. In addition, the IASB agreed to provide more guidance on originated credit-impaired financial assets.

***Simplified approach for trade and lease receivables***

- A25. The proposals relating to trade receivables and lease receivables interact with the Revenue Recognition and Leases projects.
- A26. The ED proposed operational simplifications for those financial instruments, because they are often held by entities that do not have sophisticated credit risk management systems. This would provide relief by eliminating the need to calculate 12-month ECL and to assess when a significant increase in credit risk has occurred.

*Trade receivables with a significant financing component*

- A27. The ED proposed that an entity could be allowed to make an accounting policy election to apply the simplified approach to measure the loss allowance at an amount equal to lifetime expected credit losses at initial recognition and throughout the trade receivables' life.

*Trade receivables without a significant financing component*

- A28. For trade receivables that do not have a significant financing component, the ED proposed a mandatory requirement that an entity should measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout the trade receivables' life. As a practical expedient, a provision matrix could be used to estimate expected credit losses for these trade receivables.
- A29. In addition, the ED proposed that the entity should measure trade receivables that do not have a significant financing component (in accordance with the Revenue ED) at the transaction price as defined in the Revenue ED on initial recognition. In many cases this would be the invoice amount.

*Lease receivables*

- A30. For lease receivables, an entity could make an accounting policy election to apply the simplified approach to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout the asset's life.
- A31. The simplified approach aims to reduce complexity in practice, because an entity would not need to identify increases in credit risk. The cash flows used in the measurement of the lease receivables would be used as the contractual cash flows when assessing the lease receivables' expected credit loss allowance. When selecting the discount rate to be used, the upper limit of the permissible range is the discount rate used in the measurement of the lease receivable.

**Tentative decisions made by the IASB on the simplified approach**

**November 2013:** The IASB tentatively confirmed the proposals in the Exposure Draft for the simplified approach for trade receivables and lease receivables. The IASB also noted that the applicability of accounting policy choice for lease receivables to different populations of those receivables would be further considered when the Leases project is finalised.

***Application of the model to modified financial assets***

- A32. The ED proposed that modified financial assets (that do not result in derecognition) should be considered in the same way as other (non-modified) assets within the model.
- A33. When an entity evaluates significant increases in credit risk, the entity should compare the credit risk at the reporting date (based on the modified contractual terms) to the credit risk at initial recognition (based on the original contractual terms).
- A34. The gross carrying amount should be recalculated on the basis of the modified contractual cash flows discounted at the original EIR and a modification gain or loss should be recognised in profit or loss.

**Tentative decisions made by the IASB on the measurement of ECL**

**October 2013:** The IASB tentatively decided to confirm the proposals that:

- the modification requirements apply to all modifications or renegotiations of contractual cash flows, regardless of the reason for the modification; and
- the modification gain or loss should be recognised in profit or loss;
- modified financial assets are subject to the same 'symmetrical' treatment (ie a modified asset can revert back to Stage 1, with a 12-month expected credit losses allowance) as other financial instruments.

***Uncollectability/Write-off***

- A35. The ED proposed that an entity considers a financial asset to be uncollectable if the entity has no reasonable expectation of recovery. Consequently, an entity would write off a financial asset, or part of a financial asset, in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset).
- A36. A write-off requires the entity to directly reduce the gross carrying amount of a financial asset resulting from uncollectability. A write-off constitutes a derecognition event.

***Presentation***

- A37. The ED proposed that an entity should present in the statement of profit or loss and other comprehensive income separate line items for the following amounts:
- (a) interest revenue, calculated using the effective interest method and applying the effective interest rate to the gross carrying amount unless paragraph A38 applies; and
  - (b) gains and losses resulting from changes in the ECL.
- A38. An entity calculates interest revenue using the effective interest method on the amortised cost (ie net carrying amount, or gross carrying amount less loss allowance) if:

- (a) as at the reporting date, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset; or
- (b) the asset was purchased or originated credit-impaired on initial recognition (and in this case a credit-adjusted EIR is used).

#### **Tentative decisions made by the IASB on presentation**

**November 2013:** The IASB tentatively confirmed the proposals in the Exposure Draft for the calculation and presentation of interest revenue.

### ***Disclosure***

A39. The ED proposed disclosures that would identify and explain:

- (a) the amount of the ECL that arises in the financial statements; and
- (b) the effect of changes in credit risk of financial instruments that are within the scope of the proposals.

A40. To meet this objective, the ED included proposed disclosure requirements such as:

- (c) reconciliation of gross carrying amounts and allowance balances;
- (d) disclosures on credit risk grading; and
- (e) disclosures on techniques, assumptions and policies (for example, write-off policy).

### ***Transition***

A41. The ED proposed that an entity should use the credit risk at initial recognition for existing financial assets when initially applying the new impairment model (ie to determine whether there has been a significant increase in credit risk), unless obtaining such credit quality information requires undue cost or effort.

A42. If the credit risk at initial recognition is not used at the date of initial application (as per the relief outlined above), the transition provisions proposed that those financial assets should be evaluated only on the basis of whether the credit risk



is low (as per the ‘investment grade’ exception) at each reporting date until those assets are derecognised.

- A43. The ED proposed to permit, but not require, a restatement of comparative periods if the information is available without the use of hindsight. In addition, the disclosures in paragraph 28(f) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would be permitted, but not required, for prior periods if the information is available without the use of hindsight.
- A44. The ED proposed that on the date of initial application of IFRS 9 the entity should disclose a reconciliation of the ending impairment allowances under IAS 39 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening impairment allowances under IFRS 9 by measurement category, showing separately the effect of reclassifications on the allowance balance at that date.

### ***Mandatory effective date***

- A45. As part of the ED the IASB noted that all phases of IFRS 9 Financial Instruments have the same effective date and asked for feedback on what lead time was required to implement the proposals on expected credit losses and also asked for views on what the resulting mandatory effective date for IFRS 9 should be.
- A46. At the July 2013 meeting, the IASB noted that it will only be able to determine the mandatory effective date after the redeliberations on the impairment and classification and measurement requirements have been completed, and the issue date of the final version of IFRS 9 is known. The IASB therefore agreed to defer the mandatory effective date of IFRS 9 without specifying a new mandatory effective date, pending the finalisation of both the impairment and classification and measurement requirements.

**Tentative decisions made by the IASB on the mandatory effective date****November 2013:**

The IASB noted that it will only be able to determine the mandatory effective date after redeliberations on the impairment and classification and measurement requirements have been completed and the issue date of the final version of IFRS 9 is known.

However, to assist entities in their planning, the IASB tentatively decided that the mandatory effective date of IFRS 9 will be no earlier than annual periods beginning on or after 1 January 2017.