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Introduction

Purpose of the paper

1. Since July 2013 the IASB has been discussing enhancements to its proposals in the Exposure Draft 2013/3 *Financial Instruments: Expected Credit Losses* ('the ED'). The majority of respondents supported the proposals in the ED as being an appropriate balance between faithful representation of credit losses on financial instruments, and the costs of producing that information¹.
2. The ED proposed that requirements should be applied retrospectively on initial application, except when it is not possible to determine (without undue cost and effort) whether the credit risk of a financial instrument has increased significantly since initial recognition. When it is not possible to make such a determination the amount of the allowance is based on the credit risk at each reporting date for the remaining life of the financial instrument. So a loss allowance (or provision) at an amount equal to lifetime expected credit losses should be recognised until the financial instrument is derecognised, unless the financial instruments have low credit risk at a reporting date. This does not apply for financial instruments whose past-due status is used to assess changes in credit risk, because it is assumed that the information will be available to make the assessment.

¹ Refer to Agenda Papers 5A, 5B and 5C discussed at the joint board meeting held in July 2013

3. In addition, the ED did not require comparative information to be restated. Entities are, however, permitted to provide restated comparative information if it is possible to do so without the use of hindsight.
4. This paper discusses:
 - (a) feedback received, staff analysis and recommendation on the proposed transition requirements; and
 - (b) feedback received on the Effect Analysis of the ED.

Background

5. The IASB preference in deliberations leading to the ED for transition was retrospective application. However, there are two main issues with retrospective application of the model, which the IASB discussed in the ED:

BC152... (a) Availability of initial credit quality data—the proposed model relies on entities assessing whether there has been an improvement in credit quality since the initial recognition of a financial instrument to decide whether they should establish a loss allowance balance at an amount equal to lifetime expected credit losses. Entities have told the IASB that they typically do not currently retain information about initial credit quality, so making this assessment on transition is likely to be difficult; and

... (b) Risk of hindsight—entities have not previously been required to recognise or disclose expected credit losses for accounting purposes. Accordingly, there is a risk that hindsight would be used to recognise and measure the amount of expected credit losses in prior periods.

6. To address the concern set out in paragraph 5, the ED proposed that when obtaining such credit quality information on transition requires undue cost or effort, the transition provisions proposed that those financial instruments should

be evaluated only on the basis of whether the credit risk is low² at each reporting date until those assets are derecognised.

7. In developing these proposals, the IASB noted that:

BC153 ... For financial instruments for which an entity has not used information about the initial credit quality on transition, the recognition of lifetime expected credit losses will be required for those financial instruments when their credit risk is not low (eg their credit risk is not equivalent to investment grade) at any reporting date until they are derecognised.

BC154 **Such an approach should be relatively simple to apply**, because it would not require any assessment of changes in credit quality for these financial instruments relative to the initial credit quality. In addition, it corresponds with credit risk management systems that assess credit quality as at the reporting date. **However, the IASB decided that this relief would not be applicable when an entity uses the past-due statuses of payments to apply the model, because it would have the necessary information to decide whether a financial instrument has deteriorated since initial recognition.**

BC155 The IASB acknowledges that, if an entity uses an approach that is based solely on credit quality at the reporting date, then, when the entity is deciding the amount of expected credit losses to recognise, that approach will not allow the entity to consider the credit deterioration that has occurred since initial recognition. Thus, entities will be required to recognise lifetime expected credit losses for a financial instrument with credit risk that is not low (eg its credit risk is not equivalent to investment grade at a reporting date), even if they had

² Refer to Agenda Paper 5B *Operational Simplifications: 30dpd and low credit risk* of the IASB October meeting 2013 and the IASB Update October 2013, which is available at <http://www.ifrs.org/Updates/IASB-Updates/Pages/IASB-Updates.aspx>

priced that instrument to reflect that risk and there has not been a significant deterioration in credit quality since initial recognition. It will also have a more negative impact for entities whose business model focuses on originating or purchasing financial instruments with credit risk that is not low (eg their credit risk is not equivalent to investment grade). **Requiring an assessment on the credit quality alone might encourage the use of information about the initial credit quality from transition to the proposed requirements, which will enhance comparability and the quality of the information provided.** However, under some circumstances such an approach may discourage the use of information about initial credit quality, particularly if an entity is able to absorb lifetime expected credit losses on those financial instruments on transition to the proposed requirements.

BC156 While acknowledging the inconsistency with the overall model, the IASB decided that such an approach was the best way to balance the provision of useful information with the associated cost of providing it. 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. [emphasis added]

8. The ED proposed that an entity should not be required to restate prior periods, and that it should adjust the opening balance of its retained earnings (or other component of equity, as appropriate) at the beginning of the annual reporting period that includes the date of initial application for the effect of applying the proposed requirements. 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 *Financial Instruments: Recognition and Measurement*

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.

Structure of paper

9. The paper is structured as follows:
 - (a) transition from the requirements in IAS 39 to the current proposal for expected credit losses (ECL):
 - (i) detailed feedback received (paragraphs 10-14);
 - (ii) staff analysis, recommendations and questions to the IASB (paragraphs 15-30); and
 - (b) feedback received on the Effect Analysis of the ED and questions to the IASB (paragraphs 31-34);

Transition requirements

Detailed feedback received

10. The majority of respondents support the transition requirements. They argued that the proposals achieve a balance between the cost to implement the proposals and presenting relevant information.
11. Some, however, asked the IASB to consider practical ways to assess increases in credit risk at transition, because the initial credit risk at initial recognition may not be available retrospectively. In addition, some respondents asked for clarification on how the requirements of the rebuttable presumption of ‘more than 30 days past due’ interacts with the transition proposals.
12. Furthermore, some respondents were concerned that the proposals in the ED could effectively result in all financial instruments that are not ‘low credit risk’ being measured at lifetime ECL because of the lack of data on transition, which they considered inappropriate. They argued that if the financial instruments were inappropriately measured at lifetime expected credit losses, it might result in large releases of loss allowance upon derecognition. These respondents asked the IASB

to clarify whether delinquency and other relevant information can be considered for the assessment of significant increases in credit risk at transition.

13. The vast majority of respondents agreed with the transition proposals not to require the restatement of comparative information. We do not intend to consider this aspect of the proposals again.
14. A number of respondents also asked for the same requirements to apply for first-time adopters of IFRS, because these entities would encounter the same concerns as entities that transition to the new requirements from IAS 39.

Transition

Staff analysis

15. In accordance with IAS 8, retrospective application of the proposed impairment model requires that an entity should apply the proposed model as if it had always been in place. In other words, an entity should measure the loss allowance (or provision) based on the extent to which credit risk has increased since initial recognition.
16. In order to do this, an entity would be required to identify, on transition:
 - (a) instruments that since initial recognition:
 - (i) have not experienced significant increases in credit risk, ie those in Stage 1;
 - (ii) have experienced significant increases in credit risk, ie those in Stage 2;
 - (b) instruments that have objective evidence of impairment³, ie those in Stage 3; and
 - (c) instruments that were purchased or originated credit-impaired on initial recognition.
17. For lease receivables and trade receivables with a significant finance component for which the entity elected as an accounting policy choice to apply the general

³ At its November 2013 the IASB requested that in drafting the staff should consider a different term to better describe assets transferred to Stage 3.

model⁴ the entity would need to undertake this analysis. For trade receivables without a significant finance component, or for trade receivables and lease receivables that the entity elected as an accounting policy choice to measure the allowance at lifetime expected credit losses, an entity would measure the loss allowance at the lifetime expected credit losses at the date of initial application.

18. The staff believe that identifying instruments that have objective evidence of impairment on initial application would not require the use hindsight and that the information should be available without undue cost or effort because the assessment is based on the current best available information on that date. Consequently, we do not think that any additional transition relief should be provided for these financial instruments.
19. The staff also believe that the information needed to determine whether financial instruments have low credit risk at the date of initial application should be available without undue cost or effort and that additional transition relief should not be provided for these financial instruments.
20. Furthermore, the proposals for financial assets that are purchased or originated credit-impaired are consistent with the current requirements of IAS 39⁵. Consequently, the information to apply the proposed requirements retrospectively should be available without undue cost and effort and no additional transition relief should be provided.
21. The staff are therefore of the view that the only additional transition relief that should be considered for the remaining financial instruments (ie those that are not low credit risk or credit-impaired on the date of initial application of the requirements, were not purchased or originated credit-impaired and are not trade or lease receivables for which lifetime ECL is always recognised). For these items the change in credit risk since initial recognition needs to be determined to effect retrospective application.

⁴ In applying the general model, an entity recognises (i) lifetime ECL for financial instruments whose credit risk has significantly increased; and (ii) 12-month expected credit losses for all other instruments.

⁵ Refer to Agenda Paper 5D *Purchased or originated credit-impaired financial assets* of the November 2013 IASB meeting.

22. Contrary to how some respondents interpreted the proposed transition requirements, the staff do not believe that it was the IASB's intention to penalise entities that do not have access to the exact credit risk at initial recognition without undue cost or effort. Instead, we believe that an entity should be permitted to use reasonable and supportable information (through analysis or statistical methods) to approximate the credit risk at initial recognition.
23. Throughout the development of the proposals the IASB has considered the various credit risk management practices and systems being applied. The IASB has made tentative enhancements to the proposed model to make the requirements more operable and to more align the assessment of significant increases in credit risk more closely with the way in which entities are managing credit risk.
24. The staff believe that these tentative proposals and enhancement could be applied on transition to identify financial instruments for which lifetime expected credit losses should be recognised.

Staff recommendation

25. At a high level the staff recommend to clarify the proposed transition requirements and make it more clear how the requirements would apply, including how recent decisions are also relevant.
26. The staff recommend that the IASB should confirm that:
- (a) The final requirements should be applied retrospectively in accordance with IAS 8.
 - (b) In order to assist entities to apply the proposals retrospective, entities may apply:
 - (i) the low credit risk exception to identify financial instruments for which the credit risks has not significantly increased;⁶ and
 - (ii) the rebuttable presumption for contractual payments that are more than 30 days past due if the entity identifies increases in credit risk according to days past due⁶.

⁶ Refer Agenda Paper 5B *Operational Simplifications: 30dpd and low credit risk* of the IASB October meeting 2013 and the IASB Update October 2013 available at <http://www.ifrs.org/Updates/IASB-Updates/Pages/IASB-Updates.aspx>

27. At its October 2013 meeting the IASB tentatively decided that entities could assess changes in credit risk using an approach that considers the credit risk of an asset at the reporting date compared with the credit criteria on origination for that financial asset type⁷. Consistent with this decision, the staff think that it would be helpful to acknowledge that entities could assess the change in credit risk on transition by considering the credit quality applicable for financial assets of the relevant type at the time that the financial asset was originated.
28. For the remainder of instruments not identified in paragraphs 26 and 27 the staff recommend that the transition requirements should be clarified to state that an entity should use the best available information that is available without undue cost or effort to obtain or approximate the credit risk on initial recognition.⁸ The best available information is information that is:
- (a) reasonably available and does not require the entity to undertake an exhaustive search for information; and
 - (b) relevant in determining or approximating the credit risk at initial recognition.
29. If the entity is not able to determine or approximate the credit risk on initial recognition in accordance with paragraph 28, the entity should measure the loss allowance at the lifetime expected credit losses until that financial instruments is derecognised.

Question 1 to the IASB

Does the IASB agree with the staff recommendation in paragraphs 25-29?

First-time adoption of IFRS

30. The staff will present at a future meeting their proposals for first-time adoption of IFRS—IFRS 9 *Financial Instruments* as a package. Accordingly we will not consider the proposals in this Agenda Paper.

⁷ Refer Agenda Paper 5A *Assessing when to recognise lifetime expected credit losses and* of the IASB October meeting 2013 and the IASB Update October 2013 available at [http://www.ifs.org/Updates/IASB-Updates.aspx](http://www.ifs.org/Updates/IASB-Updates/Pages/IASB-Updates.aspx)

⁸ Consistent with Application Guidance B5-B8 included in the ED

Feedback on the Effect analysis

31. This section provides the IASB with an overview of the feedback by respondents. We intend to address these comments during drafting.
32. Respondents generally supported the assessment in the Effect Analysis, in particular:
 - (a) the model would result in timelier recognition of expected credit losses;
 - (b) it better reflects economic reality than the current requirements in IAS 39; and
 - (c) it provides more useful and comparable information.
33. However, a number of respondents did not agree with the cost assessment. They argued that the analysis should place more emphasis on the substantial initial investment in systems and personnel outlay required. Furthermore, the cost assessment also needs to consider the continuous costs to manage the system and the costs associated with the disclosures.
34. In addition to the responses noted above, respondents recommended that the Effect Analysis should be expanded to include the following areas:
 - (a) information and results (including quantitative information) from the fieldwork undertaken;
 - (b) additional analysis specifically for non-financial entities, including addressing the fact that these entities often manage credit risk based on delinquency information;
 - (c) challenges with comparability because the model requires a number of estimates and judgements from management;
 - (d) limitations of the model because as with any model measuring ECL it will necessarily reflect only what is *expected*. In particular preparers are concerned that the expectation of the new model is that it will predict events similar to the 2008 crises. However, they note that events like the economic crises in 2008 would not be identified by any model, because the events are unusual and not predictable enough to build into statistical models;

- (e) an assessment of the proposed disclosures (we will discuss Disclosures at a future meeting); and
- (f) an acknowledgement of the increased cost to both users and preparers if the IASB and FASB does not issue a converged solution.

Question 2 to the IASB

Are there any additional points the IASB thinks should be addressed in the final Effects Analysis?