prepared in accordance with IAS 39 to the opening loss allowances in accordance with IFRS 9 by measurement category, showing separately the effects of changes in classification on the loss allowance balance at that date. This would provide the necessary information for users of financial statements to understand the effect of applying the proposed model. Consequently, when the new model is initially applied, disclosure of the line item amounts that an entity would have reported in accordance with the impairment model in IAS 39 in the current period should not be required.

First time adopters of IFRS

BC163 In publishing this Exposure Draft, the IASB noted that it will reconsider the transition to IFRS 9 for first-time adopters of IFRS in the redeliberations of this project. That reconsideration will include the proposed limited modifications to IFRS 9 that were published in November 2012 to make sure that first-time adopters of IFRS are given sufficient lead time for the adoption of IFRS 9 and are not disadvantaged when compared to existing preparers. Until that time, if a first-time adopter of IFRS chooses to early apply an available version of IFRS 9, it would follow the current requirements in IFRS 1 *First-time Adoption of International Financial Reporting Standards* that relate to IFRS 9.

Analysis of the effects of this Exposure Draft

Introduction

BC164 The IASB is committed to assessing and sharing knowledge about the likely costs of implementing proposed new requirements and the likely ongoing application costs and benefits associated with the new proposals—the costs and benefits are collectively referred to as 'effects'. The IASB notes that although the analysis of the effects of these proposals considers the directional impact of the proposed approach on the amortised cost of those financial instruments that will be subject to these proposals, it cannot quantify the magnitude of the impact. This is because the calculation of the overall magnitude will require entities to apply the proposals to their financial instruments to gather new information (such as credit quality on initial recognition) and to make system changes, all of which will require significant time, effort and cost. The impact on the loss allowance will also depend on the availability of, and access to, reliable information that can be used to apply the model and that, in turn, relies to an extent on the sophistication of an entity's credit risk management systems, which cannot be assessed until entities apply the proposals.

BC165 Furthermore, the IASB is aware that entities across different jurisdictions have applied the existing impairment requirements in IAS 39 differently, in part as a result of the interaction with local or jurisdictional regulatory definitions and requirements.

BC166 The magnitude of the proposals' impact on an entity's financial reporting will therefore depend on the financial instruments an entity holds, how the entity has applied the IAS 39 requirements, the sophistication of the entity's credit risk management systems, and the availability of information about, for example, the probabilities of a default occurring, past-due statuses and estimates of lifetime expected credit losses for all financial instruments (for example products, geographical areas and vintages).

BC167 Given that the proposed approach is more responsive to changing economic circumstances compared to the incurred loss model, the magnitude of the impact will also be dependent on the prevalent economic conditions at the time of implementation.

BC168 Based on the limited outreach performed to date, the IASB is aware that some financial institutions have modeled the preliminary application of the proposals and anticipate that it will result in an increase in loss allowance balances. The IASB plans to undertake fieldwork during the comment period for this Exposure Draft to obtain more information on the likely effect of the proposals in different jurisdictions.

Timely recognition of deterioration in credit quality

BC169 The IASB believes that measuring the expected credit losses at the present value of expected cash shortfalls over the remaining life of a financial instrument (see paragraph B27) would provide relevant information about the timing, amounts and uncertainty of an entity's future cash flows.

BC170 Furthermore, the IASB also believes that the proposed approach will overcome the weaknesses of the IAS 39 incurred loss model as described in paragraph BC4. The incurred loss model in IAS 39 only allows for the recognition of credit losses once there is objective evidence that a loss event has occurred. As a result, the effect of future events, even when expected, cannot be considered. The proposals in this Exposure Draft always require expected credit losses to be recognised using the best available information at the reporting date. Such information includes reasonable and supportable forecast information. The proposed model would therefore be more responsive to changing economic conditions than the existing IAS 39 incurred loss model and would result in an earlier recognition of expected credit losses.

Dual measurement objective

BC171 The measurement of a loss allowance (as set out in paragraphs 4–5) is based on a dual measurement approach that reflects the deterioration in the credit quality of financial instruments. This will result in the more timely recognition of lifetime expected credit losses than the current requirements in IAS 39 or the TPA that was proposed in the SD. It also results in the recognition of credit losses when expectations of credit losses have deteriorated in comparison with the expectations that were initially priced into the financial instrument.

BC172 The IASB is aware that some interested parties favour a lifetime expected credit loss approach, whereby an entity recognises a loss allowance at an amount equal to lifetime expected credit losses on initial recognition, regardless of the credit quality and relative credit pricing of the financial asset. Under such an approach, the recognition of initial lifetime expected credit losses is triggered by the initial recognition of a financial asset rather than by the deterioration in credit quality since initial recognition. The IASB does not believe that this is appropriate because it would result in financial assets being recognised at a carrying amount significantly below fair value on initial recognition and would therefore be inconsistent with the economics of the asset.

BC173 The IASB believes that the approach that is proposed in this Exposure Draft enables a clear distinction to be made between financial instruments where the credit risk has increased significantly since initial recognition and those financial instruments where this has not occurred. Users of financial statements, in particular, have indicated that this distinction provides useful information.

Better reflecting economic reality

Single impairment model

Mandatory FVOCI measurement category

BC174 The impairment of debt instruments that are classified as available-for-sale financial assets under IAS 39 is one of the requirements that is most heavily criticised by users of financial statements, as it is based on fair value fluctuations and not aligned with the impairment model applied to similar financial assets measured at amortised cost.

BC175 Similar to financial assets that are measured at amortised cost, the contractual cash flow characteristics of financial assets mandatorily measured at FVOCI would solely represent payments of principal and interest. The IASB therefore believes that an impairment approach that is based on expected future cash flows and changes in credit quality, rather than changes in fair value, more faithfully reflects the economic reality of expected credit losses that are associated with these financial assets. It is also consistent with both amortised cost and fair value information about these financial assets being provided to the users of financial statements.

Modified financial instruments

BC176 As noted in paragraph BC125, the IASB concluded that financial instruments with modified contractual cash flows should be permitted to change to a loss allowance at an amount equal to 12-month expected credit losses in the same way as unmodified financial instruments if there is no longer a significant deterioration in credit quality. The IASB believes that such a symmetrical approach faithfully represents the economics of the transaction and that faithful representation should not be sacrificed for anti-abuse purposes.

BC177 Some users of financial statements are concerned that these proposals will be more permissive than the current IAS 39 requirements because forbearance is currently regarded as objective evidence of impairment. However, because deterioration in credit quality is determined by reference to the initial credit risk (on the original contractual terms), financial instruments will not necessarily move to a loss allowance at an amount equal to 12-month expected credit losses as a result of a modification of contractual cash flows. Furthermore, while forbearance provides objective evidence for the recognition of an incurred loss in accordance with IAS 39, the effect of the modification of contractual cash flows is reflected in the measurement of the impairment loss.

Consequently, if a modified financial instrument is not considered to have deteriorated significantly, it is likely that only a small incurred loss would currently be recognised under IAS 39.

BC178 As a result, the IASB believes that even if, subsequent to a modification, a loss allowance at an amount equal to 12-month expected credit losses is recognised, it should not result in a smaller loss allowance than would be recognised under IAS 39. The IASB further proposes to require entities to disclose the gross carrying amount for modified financial assets that have moved back to a loss allowance measured at an amount equal to 12-month expected credit losses.

Loan commitments and financial guarantee contracts

BC179 The IASB noted that financial institutions that provide loan commitments and financial guarantee contracts often already determine the expected drawdowns for prudential regulatory and credit risk management purposes. However, the proposals in this Exposure Draft differ from those estimates in that the expected drawdown is determined over the period for which an entity has a contractual obligation to extend credit and not the period over which an entity expects to extend credit. Consequently, if an undrawn facility is immediately revocable, no provision for expected credit losses will be recognised in accordance with the proposals—even if, for credit risk management purposes, an entity assumes that the facility will not be revoked. Current credit risk analyses and systems can be used as the basis for applying the proposals but the IASB expects that adjustments to these estimates will be required.

BC180 As noted in paragraph BC131, some participants in the IASB's outreach noted that estimating future drawdowns over the life of the instrument will introduce additional complexities. However, the IASB believes that the calculation of expected drawdowns is necessary to remove the arbitrage between on balance sheet and off balance sheet exposures and achieve a consistent expected credit loss model.

Interest revenue

BC181 The IASB noted that for financial assets for which objective evidence of impairment exists, the calculation of interest revenue on the basis of the gross carrying amount reflecting the contractual return would no longer faithfully represent the effective return. The IASB believes that calculating and presenting interest revenue on the amortised cost of such financial assets (ie adjusted for any loss allowance (see paragraph 25(b))) better represents the economic return on such financial assets. IAS 39 already requires this calculation, and as financial assets to which this approach will apply are determined using criteria already in IAS 39, the implementation of this proposal should not be complex nor require system changes.

Comparability of financial information

BC182 The IASB acknowledges that the more judgement that is required in the application of an expected credit loss approach, the more subjective the estimates will be, and that this subjectivity will affect the comparability of reported amounts between different entities. Notwithstanding the concerns about the application of judgement, in the IASB's view, the proposed approach will improve the comparability of reported amounts. This is because under the incurred loss model in accordance with IAS 39, deterioration in credit quality would not have been reported in the absence of a loss event, which limited the comparability of the reported amounts and the effective return on the financial assets.

BC183 In the IASB's view, considering the term structure and initial credit risk when assessing whether lifetime expected credit losses should be recognised will better reflect credit risk management and improve the comparability of the requirements for financial instruments with different maturities and different initial credit risk.

BC184 Any approach that attempts to reflect expected credit losses will be subject to measurement uncertainty and will place greater emphasis on management's judgement and the quality of the information used. This will require both qualitative and quantitative disclosures to assist users of financial statements in understanding and comparing different measures of expected credit losses. The Exposure Draft proposes disclosure requirements that will enable users of the financial statements to identify and understand the inputs, assumptions and techniques applied, the amounts arising from expected credit losses and the effect of deterioration and improvements in credit risk. The IASB believes that this will lead to greater comparability between different reporting periods of the same entity.

BC185 Some interested parties have also indicated that it would be useful if the IASB could enhance the comparability between financial assets that are credit-impaired on initial recognition and those that are measured using the general expected credit loss approach as this would alleviate some of the accounting complexity in this area. Consequently, the IASB proposes that an entity should disclose the expected contractual cash shortfalls that are implicit in the price of such financial assets at initial recognition.

Usefulness of financial information

BC186 The IASB noted that the expected credit loss model proposed in this Exposure Draft would reflect how an entity approaches credit risk management for different classes of financial instruments and provides information on the effect of the deterioration and improvements in the credit quality of its financial instruments.

BC187 In assessing the usefulness of the information provided by the proposed approach, the IASB has compared it to the information provided by a general provisioning approach and a fair value approach. In the IASB's view, the general provisioning approach, whereby entities build up reserves to absorb both expected and unexpected credit losses (without any reference to the deterioration in credit quality) lacks any measurement objective and fails to provide a link between the loss allowance that is recognised and the deterioration in credit quality. Furthermore, explicit information on expected credit losses is not provided by a full fair value model. Changes in the fair value of a financial instrument include those arising from changes in risks other than credit risk, such as interest rate risk, liquidity risk and market risk. The IASB does not believe that such an approach provides useful information because measuring expected credit losses using fair value information is inconsistent with a cost-based measurement that focuses on contractual cash flows.

BC188 In the IASB's view, the proposed credit deterioration criterion, together with the related proposed disclosure requirements, achieves the best balance between the benefits of distinguishing financial instruments that have deteriorated in credit quality and the costs and complexity of making that assessment.

Relevant information for economic decision-making

BC189 The IASB believes that the proposed approach provides information that is more relevant for economic decision-making by depicting changes in the credit quality of financial instruments through the use of a broad range of information, including forward-looking information and the recognition of expected credit losses on a timelier basis. The IASB is of the view that loss allowances should reflect actual credit loss expectations for financial instruments accounted for as at the reporting date.

BC190 The IASB acknowledges that the proposed approach would result in an overstatement of expected credit losses for financial assets, and a resulting understatement of the value of the related assets, through the recognition of a loss allowance for 12-month expected credit losses. However, the IASB has sought to provide a proxy for the 2009 ED that is less operationally burdensome and more cost effective. The IASB determined that the proposals provide the best balance of the benefits of providing useful information and the costs of providing it. In addition the overstatement will not be of the same magnitude as if full lifetime expected credit losses were to be recognised on initial recognition. For long-term assets and those with a high probability of default occurring at initial recognition, the difference between a 12-month and lifetime expected credit loss measure can be significant.

BC191 Furthermore, relevant information is provided by updating expected credit loss estimates for changes in expectations, through the recognition of lifetime expected credit losses when there has been significant credit deterioration and also by requiring the calculation of interest revenue on the amortised cost amount of a financial asset when there is evidence that one or more credit loss events have occurred.

Regulatory concept of expected credit losses

BC192 Some users of financial statements have asked the IASB to ensure that the proposed expected credit loss approach is both aligned to the prudential capital frameworks and is counter-cyclical, resulting in a loss allowance that is sufficient to absorb all credit losses.

BC193 Certain prudential regulation and capital adequacy systems, such as the framework developed by the Basel Committee on Banking Supervision, already require financial institutions to calculate 12-month expected credit losses as part of their regulatory capital provisions. However, these estimates only use credit loss experience based on historical events to set out 'provisioning' levels over the entire economic cycle ('through-the-cycle'). Furthermore, through-the-cycle approaches consider a range of possible economic outcomes rather than those actually expected at the reporting date. This would result in a loss allowance that does not reflect the economic characteristics of the financial instruments at the reporting date.

BC194 The IASB notes that financial reporting, including estimates of expected credit losses, are based on information, circumstance and events at the reporting date. The IASB expects entities to be able to use these regulatory measures as a basis for the calculation of expected credit losses in accordance with the proposals in this Exposure Draft. However, these calculations would have to be adjusted to meet the measurement requirements of this Exposure Draft. Only information that is available and supportable at the reporting date should be considered. This may include information about current economic conditions as well as reasonable and supportable forecasts of future events and economic conditions, as long as the information is available (and supportable) when the estimates are made.

BC195 The IASB acknowledges that any transition adjustments arising on the initial application of these proposals will affect retained earnings, which could have a potential negative impact on regulatory capital. However, the IASB believes that the objective of financial reporting should be to provide transparent information that is useful to a broad range of users of financial statements and that prudential regulators are best placed to consider how to address the interaction between IFRS and the regulatory requirements.

BC196 Some are of the view that loss allowance balances should be used to provide a counter-cyclical effect by building up loss allowances in the good times to be used in the bad times. This would, however, mask the effect of changes in credit loss expectations. The expected credit loss approach that is proposed in this Exposure Draft is based on the information available at the reporting date and is designed to reflect economic reality, rather than adjusting the assumptions and inputs applied to achieve a counter-cyclical effect. For example, when credit quality increases the expected credit loss approach proposed will faithfully represent that change. This is consistent with the objective of general purpose financial statements.

BC197 The objective of the proposed model is to faithfully represent the economic reality of expected credit losses in relation to the carrying amount of a financial asset. The IASB has not included in this objective the recognition of a loss allowance that will be sufficient to cover unexpected credit losses because this is not the primary objective of financial reporting. Some users of financial statements would prefer a representation of credit losses with a conservative or prudential bias, arguing that such a representation would better meet the needs of regulators who are responsible for maintaining financial stability, and of investors.

The likely effect on compliance costs for preparers

BC198 The proposals seek to address the cost of identifying deteriorated financial instruments by using significant changes in credit risk as a basis for the distinction. This is intended to ensure that only meaningful changes in credit risk are captured that should align with changes that would be monitored by credit risk management.

BC199 The IASB acknowledges that the implementation and ongoing application of an expected credit loss approach is complex and costly. The costs resulting from the particular expected credit loss approach proposed include those caused by the complexities involved with:

(a) tracking financial instruments to assess the deterioration in credit quality and the difficulty of making that assessment; and

(b) calculating lifetime expected credit losses.

Cost of implementation

BC200 The IASB acknowledges that the approach proposed in this Exposure Draft is different from a credit risk management perspective because an entity needs to assess the change in credit quality since initial recognition, whereas credit risk managers assess credit risk at a particular date. In particular, entities have raised concerns that two loans to the same entity could have different loss allowances when they are originated at different times. Although such a difference in perspective is likely to add cost and complexity to the approach, the IASB believes it is justified because of the underlying concept that a loss only arises when an asset's credit loss expectations exceed those that are priced into the asset.

BC201 The implementation of the expected credit loss approach will require substantial system changes, time and resources resulting in significant costs for most entities including financial institutions that are already calculating expected credit losses for regulatory purposes.

BC202 Participants in recent outreach activities noted that the cost of implementing the proposed expected credit loss approach would depend on how entities segment their portfolios. An entity may, for example, segment its portfolios by credit quality at origination and assess deterioration by comparing the credit quality at the reporting date with the initial credit quality for only that segment of the portfolio that did not have low credit risk. Thus, the costs of applying the deterioration criteria would vary depending on the diversity of initial credit quality and the sophistication of credit risk management systems.

BC203 However, the IASB notes that significant implementation costs are not limited to the approach proposed in this Exposure Draft and that, regardless of which expected credit loss approach an entity implements, the cost and effort of implementation will be significant. The IASB believes that this Exposure Draft appropriately balances the complex requirements of an expected credit loss model, with simplifications designed to make the approach more operational, thereby reducing the cost of implementation.

Cost of ongoing application

Interest revenue recognition

BC204 The proposal to change interest revenue recognition from a gross basis to a net basis at a different level of deterioration in credit quality compared to when lifetime expected credit losses are recognised adds a further level of complexity. However, the IASB believes that the financial assets for which there is objective evidence of impairment will be a subset of the financial assets for which lifetime expected credit losses are recognised in accordance with this Exposure Draft. As the objective evidence of impairment listed in this Exposure Draft is similar to the existing criteria in IAS 39, the IASB believes that the application of these concepts should result in a minimal change in practice and will therefore have no significant cost implications.

Allowance for 12-month expected credit losses

BC205 The calculation of a loss allowance equal to 12-month expected credit losses would also add costs and complexity. These costs will be less for financial institutions that are already required to calculate 12-month expected credit losses for prudential purposes; however, that measure would have to be adjusted to meet the measurement requirements of the proposals. In some cases, entities can use information such as loss rates to calculate the loss allowance for 12-month expected credit losses, thus building on information they already use for risk management purposes. However, the cost of measuring a loss allowance at an amount equal to 12-month expected credit losses will be higher for non-Basel II financial institutions and entities that are not financial institutions because 12-month expected credit losses is a unique calculation that would not normally be required for other purposes. However, some relief is provided, for example because the calculation of 12-month expected credit losses is not required for trade or lease receivables.

Tracking of initial credit risk

BC206 Respondents to the 2009 ED highlighted that the proposals would have required entities to track the initial estimate of lifetime expected credit losses through the credit-adjusted effective interest rate and to measure subsequent changes in the lifetime expected credit losses. This would have led to significant operational challenges and substantial costs as the effective interest rate information is not contained in the same systems as the credit risk information.

BC207 Some preparers, particularly credit risk managers, indicated that the tracking of credit risk, in most circumstances, is simpler and more closely aligned to credit risk management practices than the tracking of expected credit losses. The proposals in this Exposure Draft require an assessment of the change in credit risk that has occurred since initial recognition separately from the determination of the effective interest rate. Entities will therefore be required to measure and track the initial credit risk to be able to determine whether there has been a significant increase in the credit risk at the reporting date.

BC208 In order to reduce the operational burden of tracking the probability of a default occurring for all financial instruments since initial recognition, this Exposure Draft does not require an entity to recognise lifetime expected credit losses on financial instruments with low credit risk at a reporting date (irrespective of their change in credit risk). Consequently, an entity will not need to assess the change in credit quality from initial recognition for financial instruments that have a low credit risk on a reporting date (eg financial instruments whose credit risk is equivalent to investment grade).

BC209 The IASB acknowledges that not all entities have advanced credit risk management systems that will enable them to track the changes in credit risk over time. To further reduce the operational burden on such entities, the IASB proposes that entities may use past-due information to determine whether credit risk has increased significantly if no other borrower-specific information is available without undue cost or effort, rather than requiring the implementation of more sophisticated credit risk management systems.

BC210 Some preparers are concerned that the loss allowance at an amount equal to lifetime expected credit losses will need to be determined for each individual financial instrument, which will add to the operational burden of tracking. However, the proposals in this Exposure Draft do not require individual financial instruments to be identified as significantly deteriorated in credit quality. Financial instruments with common risk characteristics can be assessed, and have a lifetime loss allowance recognised, on a collective basis.

Simplified approach for trade receivables and lease receivables

BC211 The IASB proposes to address the costs and complexities for non-financial institutions and other entities through the proposed simplified approach for trade receivables and lease receivables, by removing the need to both calculate 12-month expected credit losses and track the credit deterioration on these financial assets.

The likely effect on costs of analysis for users of financial statements

BC212 The IASB believes that users of financial statements will benefit from the more timely information provided by an entity's assessment of expected credit losses using its assessment of the credit deterioration since initial recognition. The approach proposed in this Exposure Draft is in strong contrast to the incurred loss model in IAS 39, where credit losses are only recognised once there is objective evidence that a loss event has occurred. In accordance with this Exposure Draft, a loss allowance at an amount equal to 12-month expected credit losses will be recognised for all financial instruments unless the credit risk has increased significantly, in which case a loss allowance at an amount equal to lifetime expected credit losses should be recognised. Lifetime expected credit losses are therefore recognised earlier than under the incurred loss model in IAS 39 because the credit risk will generally increase significantly before one or more credit loss events occur—particularly given the use of forward-looking information.

BC213 The IASB acknowledges that, from the perspective of users of financial statements, a disadvantage of the proposed approach is that, for poor credit-quality financial instruments that are not credit-impaired on initial recognition, only a loss allowance at an amount equal to 12-month expected credit losses will be recognised until there has been a significant increase in the credit risk. However, the IASB did not want to create a disincentive for entities to lend to customers with poor credit quality. Furthermore, the IASB believes that full lifetime expected credit losses should not arise on initial recognition if the financial instruments are priced correctly.

BC214 Under IAS 39, different impairment approaches were applied to the different measurement categories. To further reduce the cost of implementation and ongoing application, the IASB proposes that a single expected credit loss approach applies to all financial instruments within the scope of this Exposure Draft. This is more consistent with the way in which entities manage credit risk internally.

BC215 The IASB acknowledges that it would be preferable for users of financial statements if the accounting for expected credit losses was aligned between IFRS and US GAAP. The IASB notes that although it has not achieved complete convergence between the approach proposed in this Exposure Draft and the current expected credit loss model developed by the FASB, both approaches should result in the same loss allowance for financial assets that have deteriorated significantly in credit quality since initial recognition and that do not have low credit risk and for trade receivables and lease receivables where an entity measures the loss allowance using lifetime expected credit losses. Furthermore, as both models use the same data and information sets, the IASB believes that there would not be a significant difference in the loss allowance on short-term assets and financial assets with low credit risk (eg credit risk equivalent to investment grade) at any time.

BC216 The IASB acknowledges that the assessment of expected credit losses inherently involves a significant amount of subjectivity and therefore reduces the verifiability and comparability of reported amounts, which inevitably passes on the costs of analysis to users of financial statements. However, decisions about when credit losses are incurred and the measurement of impairment losses currently also involve subjectivity and there is a lack of comparability due to differences in the application of the incurred loss criteria. The proposals in this Exposure Draft would mitigate these issues to some extent by expanding the disclosure requirements to provide users of financial statements with information about the inputs, assumptions and techniques that the entity used when assessing the criteria for the recognition of lifetime expected credit losses and the measurement of expected credit losses. This Exposure Draft also proposes the disclosure of information on financial assets with a loss allowance at an amount equal to lifetime expected credit losses that have been modified, including the gross carrying amount of the financial assets, the gain or loss resulting from the modification and the re-default rate. Proposing information on modifications is responsive to requests for enhanced information in this area from users of financial statements.

