STAFF PAPER

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IASB Meeting

Project	**Financial Instruments: Impairment**
Paper topic	Simplified approach for trade receivables and lease receivables

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Introduction

Purpose of this paper

1. The Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* ('the ED') included proposals for a simplified approach for trade receivables and lease receivables ('the simplified approach'). In cases in which the simplified approach applies, lifetime expected credit losses ('ECL') are recognised in full throughout the financial instrument's life.

2. This paper analyses the responses received on the simplified approach. This paper does not consider the disclosure exemptions when an entity applies the simplified approach. The complete package of disclosure requirements will be discussed at a future meeting.

Paper structure

3. This paper is structured as follows:

   (a) what the ED proposed and why; (paragraphs 4 – 6)

   (b) detailed feedback received; (paragraphs 7 – 16)

(c) staff analysis; and (paragraphs 17 – 31)

(d) staff recommendations and question to the IASB. (paragraphs 32 – 33)

What the ED proposed and why

4. The ED proposed that an entity should have an *accounting policy choice* to always measure the loss allowance at an amount equal to lifetime ECL for trade receivables that constitute a financing transaction in accordance with IAS 18 *Revenue* (or have a significant financing component in accordance with the Revenue Recognition project). The same choice would apply to lease receivables. This accounting policy choice should be applied consistently to all such trade receivables and lease receivables, but the choice for either is independent of each other. For trade receivables that do not constitute a financing transaction (ie that do not have a significant financing component in accordance with the Revenue Recognition project), measurement of lifetime ECL is *required* throughout the asset's life.

5. The ED also proposed to amend IFRS 9 *Financial Instruments* to measure trade receivables that do not constitute a financing transaction at the transaction price on initial recognition, rather than at fair value as is required for all other financial instruments.

6. The ED asked the following question on this topic:

Question 10

(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?
(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

Detailed feedback received

Simplified approach

7. The vast majority of respondents agreed with the simplified approach for trade receivables (both those that constitute a financing transaction and those that do not) and for lease receivables. Many of those who agreed said that the simplified approach would provide operational relief by alleviating some of the concerns of tracking increases in credit risk on these instruments, particularly for entities with less sophisticated systems. Though some pointed out that the approach would affect comparability, they felt that this did not outweigh the operational concerns and that the proposals are a pragmatic solution that appropriately balances the costs and benefits.

8. Furthermore, many noted that trade receivables are usually short in duration, and that the majority of trade receivables without a significant financing component would have a maturity of less than one year. There would therefore not be a significant difference (if any) between 12-month and lifetime ECL for these financial assets. For this reason, many felt that the quality of the information provided would not be diminished to an extent that would outweigh the costs of applying the general model.

9. Several respondents disagreed with the accounting policy choice for trade receivables that constitute a financing transaction and for lease receivables, because it would result in reduced comparability. They instead preferred a single approach for these assets.

Trade receivables that do not constitute a financing transaction

10. The largest amount of support for the simplified approach was observed for trade receivables that do not constitute a financing transaction. Nearly all respondents who commented on the approach agreed with the proposals for these assets, and many stated there would be little or no difference between 12-month and lifetime ECL, because of their short duration.

11. Nearly all respondents who commented on this topic agreed with the proposal to measure trade receivables that do not constitute a financing transaction at the

transaction price on initial recognition when [draft] IFRS X *Revenue from Contracts with Customers* is published.

12. Many supported the proposal because it aligns the requirements in IFRS 9 with those of the Revenue Recognition project, which was seen as beneficial in terms of consistency across IFRS. Several also cited the benefit that the proposal would result in the amortised cost of these receivables at initial recognition being closer to fair value (this is further explained in paragraphs 24 – 25). It was also stated that recognition at transaction price is consistent with current practice for these receivables.

13. Several respondents stated a preference for retaining the incurred loss requirements in IAS 39 *Financial Instruments: Recognition and Measurement* for trade receivables that do not constitute a financing transaction. These respondents felt that these receivables were not part of the reasoning behind the development of an expected credit loss model, and that applying such a model to them would be too complex. The costs of implementing any expected credit loss model were therefore considered to outweigh any benefits. A couple of respondents stated that the difference between IAS 39 and the proposed model would be immaterial, because of the short contractual life.

14. Nevertheless, many of these respondents stated that if the model was adopted as proposed they would support the simplified approach for these assets.

Lease receivables

15. The vast majority of respondents agreed with the accounting policy choice to apply the simplified approach to lease receivables. Some however raised concerns, namely:

    (a) that leases receivables are similar to other financial assets (eg secured loans), and therefore should be accounted for under the general model; and

    (b) that entities should be allowed separate accounting policy choices for different types of lease receivables (such as finance versus operating leases, or Type A versus Type B leases).

16. Some other respondents noted that the Leases project is yet to be finalised, and either requested further clarification on the ED's interaction with the new requirements, or stated that they would reserve their comments for when that project is completed.

Staff analysis and recommendations

Simplified approach

17. The simplified approach was introduced to provide operational relief from the requirement to calculate 12-month ECL and determine *when* to recognise lifetime ECL (ie when there has been significant increases in credit risk) for particular financial assets. The rationale for providing this approach is stated in the Basis for Conclusions as follows:

> [BC143] Entities would have a choice of accounting policy both for trade receivables that have a significant financing component in accordance with the Revenue Recognition ED and, separately, for lease receivables in accordance with IAS 17 *Leases* or in accordance with the tentative decisions in the Leases project. Those accounting policy choices would allow entities to decide between fully applying the proposed model and recognising a loss allowance for lifetime expected credit losses from initial recognition until derecognition (the simplified approach). **The IASB noted that allowing this option for trade receivables and lease receivables would reduce comparability. However, it would alleviate some of the practical concerns of tracking credit deterioration for entities that do not have sophisticated credit risk management systems. In addition, not many trade receivables without a significant financing component would have a maturity that is longer than one year, so the lifetime expected credit losses and the 12-month expected credit losses would be the same, or very similar. In the IASB's view, the benefits of achieving**

> **comparability do not outweigh the costs to implement the full model in this case.** [emphasis added]

18. Though some respondents admitted that there were comparability considerations, many agreed that the operational relief was of greater weight, and therefore supported the proposals. The staff believe that the simplified approach remains a welcome element that contributes to the operability of the model for many entities, including corporates of which at least some have less sophisticated credit risk management systems.

19. The issue of comparability was considered during the development of the proposals, but the IASB determined that the benefits that would result from a more comparable treatment did not outweigh the costs to implement the general model. This reasoning is outlined in the Basis for Conclusions as mentioned above (BC143).

20. The staff still believe that the proposals should allow entities the choice of whether or not to apply the simplified approach for trade receivables that have a significant financing component, and also for lease receivables. Removing the accounting policy choice would result in *requiring* the application of either the simplified approach or the general model. To remove the option of applying the simplified approach would remove a well-received operational aspect of the model, a removal that the staff do not support. However, the staff also disagree with mandating the use of the simplified approach for these assets, because there are receivables for which entities may find it more appropriate to apply the general model (such as for entities providing long-term financing using leases).

Trade receivables that do not constitute a financing transaction

21. The ED proposed that trade receivables that do not constitute a financing transaction should:

    (a) always have a loss allowance measured at lifetime ECL; and

    (b) be measured at the transaction price at initial recognition.

22. During its deliberations, the IASB noted that for many of these receivables there will be no difference between 12-month and lifetime ECL, because of their short

duration[1]. The complexity of applying the general model to these receivables would therefore arguably be unjustifiable, because the allowance balance would most likely reflect lifetime ECL, regardless of the extent of increases in credit risk since initial recognition.

23. Recognising trade receivables that do not constitute a financing transaction at the transaction price on initial recognition aligns the impairment proposals with the Revenue Recognition project, and with what the IASB has been told is current practice for many entities.

24. A major benefit of recognising these receivables at the transaction price on initial recognition is that the resulting amortised cost will be much closer to fair value. IFRS 9 (consistently with IAS 39) requires that all financial assets must be measured at fair value on initial recognition. Because IFRS 9 requires recognition at fair value (which includes the expected credit losses), taking a further impairment loss allowance against that amount results in double-counting.

25. The recognition of receivables that do not constitute a financing transaction at transaction price, instead of at fair value, helps to avoid this double counting because the impairment allowance is then taken against an amount that has not already been discounted to include them. The IASB noted this in the February 2012 meeting, and the measurement can be illustrated as follows for a trade receivable with a transaction price of CU1000[2], initial expected credit losses of CU5, and a time value assumed to be immaterial for illustration purposes:

	Trade receivable without a significant financing component	Other financial asset
Financial asset	CU1000	CU995
Impairment allowance	CU(5)	CU(5)
Carrying amount	CU995	CU990
Amount recognised in profit or loss	CU5	CU5

[1] Agenda Paper 4C discussed in February 2012.

[2] In this paper, currency amounts are denominated in 'currency units' (CU).

26. The April 2012 IASB meeting considered whether to apply an incurred loss or expected credit loss model to trade receivables that do not constitute a financing transaction[3]. At that meeting the IASB noted that outreach participants indicated they did not have significant operational concerns about applying an expected credit loss model to these assets, and that they already use forward-looking information to some extent in their impairment assessments. Participants also noted that they could leverage current practice such as the use of a provision matrix.

27. The IASB tentatively decided that the application of an expected credit loss model to these types of receivables was appropriate, because applying a single impairment model to all financial assets within the scope of the proposals would result in more useful information, and less complexity, for users of financial statements. In addition, the proposed model would result in the recognition of an ECL allowance before the receivables become past due, which would improve financial reporting. This is reflected in the Basis for Conclusions to the ED (BC144).

28. The staff still believe that the proposed expected credit loss model should apply to all financial assets, including trade receivables that do not constitute a financing transaction. The staff furthermore do not consider there to be significant operational concerns for applying the proposed model to trade receivables that do not constitute a financing transaction, because the simplified approach removes the need to make an assessment of a significant increase in credit risk on those assets. The proposals also allow the use of practical expedients such as a provision matrix to measure ECL.

Lease receivables

29. The accounting policy choice to apply the simplified approach to lease receivables received wide support from respondents.

[3] April 2012 Agenda Paper 5B.

30. The staff note that during the May 2012[4] meeting the IASB considered whether lease receivables under the proposed Leases requirements should be accounted for under the general model without the option to apply the simplified approach. However, for operational reasons the IASB decided to allow the simplified approach to be applied as an accounting policy choice. This reasoning is reflected in the excerpt from the Basis for Conclusions above (BC143). Furthermore, because the simplified approach is an accounting policy choice, entities will have the option to apply the general model to assets for which they think it is more appropriate.

31. The staff acknowledge the feedback requesting the ability to apply a separate accounting policy choice to different types of lease receivables. However, the Leases project is ongoing and its current proposals are subject to change. The staff do not think it is appropriate to consider an accounting policy choice based on the type of lease as part of the impairment requirements until the requirements in the Leases project are finalised. Thus the staff recommend maintaining a choice for all leases at this time, which can be reconsidered as a potential consequential amendment on completion of the Leases project.

Staff recommendations and question to the IASB

32. On the basis of the feedback, analysis and recommendations provided in paragraphs 7-31 above, the staff are recommending to the IASB that it should confirm the following proposals:

    (a) the accounting policy choice to always measure the loss allowance for trade receivables that constitute a financing transaction in accordance with IAS 18 (or have a significant financing component in accordance with the Revenue Recognition project) at an amount equal to lifetime ECL, and to also make such a choice for lease receivables;

    (b) that for trade receivables that do not constitute a financing transaction (ie that do not have a significant financing component in accordance

[4] May 2012 Agenda Paper 5C.

with the Revenue Recognition project), the loss allowance shall always be measured at an amount equal to lifetime ECL; and

(c) that trade receivables that do not constitute a financing transaction (ie that do not have a significant financing component in accordance with the Revenue Recognition project) shall be measured at the transaction price on initial recognition.

33. Furthermore, the staff do not recommend that the IASB should reconsider the need to permit an accounting policy choice for different types of lease receivables until the Leases project has been finalised.

Question to the IASB
Does the IASB agree with the staff recommendation to confirm the proposals for the simplified approach for trade and lease receivables as outlined in paragraph 32(a)-(c)? If not, why not and what would the IASB prefer?