

STAFF PAPER

28 October – 1 November 2013

REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Cover note: Background information and progress report		
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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 Board.

Background to this meeting

4. At the September joint board meeting, the IASB and the FASB held joint discussions, however:
 - (a) agenda papers presented by the IASB staff were for IASB decision-making only; and
 - (b) agenda papers presented by the FASB staff were for FASB decision-making only.

The purpose of having the joint meeting was to allow each board the opportunity to understand how the other would enhance its proposed model to address the feedback received.

5. The staff did not ask the IASB for a decision on whether they 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 we were to proceed to finalise the ED. This is also the case at the October IASB meeting.

Overview of Agenda Papers for this meeting

7. In September, the IASB staff started to present papers on the proposed model to:
 - (a) Improve the responsiveness of the general model¹ to changes in credit risk;
 - (b) Confirm and clarify certain aspects of the general model.

This month the staff will continue with these discussions.

8. The staff will present the following papers this month for IASB decision making:
 - (a) Paper 5A—Assessing significant deterioration;
 - (b) Paper 5B—Operational simplifications – 30 days past due (30 dpd) and ‘low credit risk’;
 - (c) Paper 5C—Measurement of expected credit losses; and
 - (d) Paper 5D—Modifications

Paper 5A—Assessing significant deterioration

9. This paper analyses the feedback received and addresses:
 - (a) the timing of recognition of lifetime ECL (ie when to recognise lifetime ECL); and

¹ ie the model wherein financial instruments begin in Stage 1 with a 12 month measure of ECL and move to lifetime if there is a significant increase in credit risk.

(b) how to assess significant increases in credit risk (ie what entities should consider when assessing changes in credit risk).

10. This paper also includes a number of clarifications to enhance the application of the proposed model.

Paper 5B—Operational simplifications – 30dpd and ‘low credit risk’

11. The paper analysis the feedback received from respondents on the two operational simplifications proposed for the general model in the ED, namely:

(a) A rebuttable presumption that instruments where contractual payments are more than 30 days past due have experienced significant increases in credit risk; and

(b) That instruments that are regarded as *low credit risk* at the reporting date have not experienced significant increases in credit risk.

12. The paper also proposes a number of clarifications on these proposals to enhance application.

Paper 5C—Measurement of expected credit losses

13. The paper considers various aspects of the measurement of expected credit losses that arose from feedback we received on the proposals in the ED and from the FASB meeting held in September 2013. The paper analyses aspects such as

(a) clarification of what the measurement of the 12-month expected credit losses represent;

(b) the use of forward looking information; and

(c) the use of regulatory information.

14. In addition, the paper analyses the feedback received on the permissible range of discount rates in reflecting the time value of money when measuring expected credit losses.

Paper 5D—Modifications

15. This paper analyses the responses received on the application of the proposed impairment model to assets that have been modified but not derecognised. It also

addresses feedback received on how the general model applies to modified assets.

This feedback includes

- (a) The scope of the modification requirements;
- (b) How the model applies to modified assets (for example whether a 12 month ECL can be recognised post modification);
- (c) Operational concerns related to the tracking of modifications over the remaining life; and
- (d) The presentation of modification gains or losses.

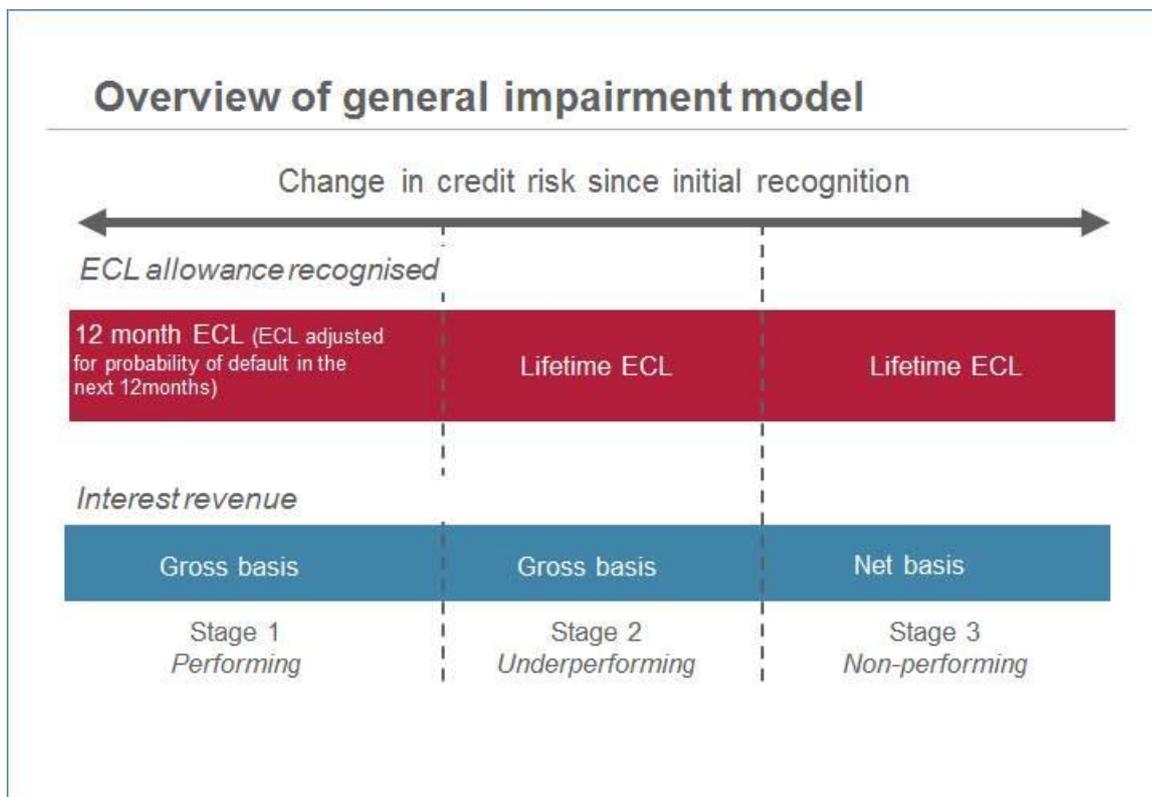
Next steps

- 16. The staff proposes that the IASB should further consider possibilities for convergence after considering any amendments to the proposals in the IASB's ED and any changes that have been made by the FASB to their own proposals.
- 17. The staff intend to discuss with the IASB the following topics at forthcoming meetings:
 - (a) Loan commitments and financial guarantee contracts;
 - (b) Purchased or originated credit impaired instruments;
 - (c) Expected credit losses for instruments measured at fair value through other comprehensive income;
 - (d) Measuring and presenting interest revenue;
 - (e) Application of the simplified approach for trade and lease receivables;

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 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.

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.

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 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 assesses 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).
- 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.

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

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.

Loan commitments and financial guarantee contracts

- A18. An entity would apply the impairment proposals to
- (a) loan commitments when 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.

Credit impaired financial assets on initial recognition

- A21. When there is objective evidence of impairment as a result of one or more events that occurred on or before the initial recognition of a 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.

- A22. This treatment is similar to the accounting treatment of purchased credit-impaired financial assets in paragraph AG5 of IAS 39 *Financial Instruments: Recognition and Measurements*.
- A23. 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.

Simplified approach for trade and lease receivables

- A24. The proposals relating to trade receivables and lease receivables interact with the Revenue Recognition and Leases projects.
- A25. The ED proposed operational simplifications for those financial instruments, as 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 assess when a significant increase in credit risk has occurred.

Trade receivables with a significant financing component

- A26. 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

- A27. 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.
- A28. In addition to the above, 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

- A29. 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.
- A30. 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

Application of the model to modified financial assets

- A31. 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.
- A32. When an entity evaluates significant increases in credit risk an 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).
- A33. 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.

Uncollectability/Write-off

- A34. 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).

A35. 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

A36. 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:

- (c) interest revenue, calculated using the effective interest method and applying the effective interest rate to the gross carrying amount unless paragraph A37 applies; and
- (d) gains and losses resulting from changes in the ECL.

A37. 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).

Disclosure

A38. 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.

A39. 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

- A40. 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.
- A41. 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.
- A42. 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.
- A43. 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.