# STAFF PAPER

**REG IASB Meeting**

| Project | **Financial Instruments: Impairment** |
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| Paper topic | Measurement of expected credit losses |

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## Introduction

### *Purpose of this paper*

1.  The Exposure Draft *Financial Instruments: Expected Credit Losses* (the ED) proposed that , in applying the general model[1], an entity recognises:

    (a)  lifetime expected credit losses for financial instruments whose credit risk has significantly increased (ie expected credit losses[2] that result from all possible default events over the life of the financial instrument, for financial instruments in Stage 2 and 3); and

    (b)  12-month expected credit losses for all other instruments (ie expected credit losses that result from default events within the 12 months after reporting date, weighted for the probability of that default event occurring in Stage 1).

2.  When estimating the expected credit losses (ECL) , the ED proposed that the estimates should incorporate the best available information that reflects:

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[1] The general model excluded purchased and originated credit impaired financial instruments, and also trade receivables and lease receivables for which the loss allowance is measured in accordance with the simplified approach .

[2] Appendix A of the ED defines *expected credit losses* as the weighted average of credit losses with the respective probabilities of default as the weights.

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(a)     an unbiased and probability-weighted amount of expected credit losses; and

(b)     the time value of money.

3.     In this paper we discuss the feedback we received and the potential clarifications to the guidance on measuring expected credit losses.

4.     This paper does not discuss

(a)     the measurement of ECL (including the discount rate) for loan commitments and financial guarantee contracts; or

(b)     the discount rate for purchased or originated credit-impaired financial assets.

These will be discussed at future meetings when we shall examine the application of the model to those instruments.

### Summary of staff analysis and recommendations

#### Discount rate to be used

5.     The ED did not specifically ask respondents to comment on these proposals, but a number of respondents provided feedback on them.  The majority of these respondents did not agree with our proposals (see paragraph 23).

6.     We have considered two alternatives, namely:

(a)     Alternative 1: confirming the proposals in the ED subject to clarification; or

(b)     Alternative 2: requiring the effective interest rate to be used (or an approximation thereof), but permitting the use of the risk-free rate if it is impractical to determine the effective interest rate (EIR).

7.     We are recommending **Alternative 1**, subject to providing application guidance to assist entities in determining what is meant by a 'reasonable rate'.

#### Clarification of measurement requirements

8.     The ED included guidance on the use of the best available information, including reasonable and supportable forecasts of future events.  The ED did 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.

9.   In general, respondents supported the proposals and thought that the ED proposed sufficient guidance on the measurement of lifetime expected credit losses. However, respondents have asked for clarification or additional guidance on particular aspects of the proposals, including the use of forward-looking information and the use of regulatory models (these are discussed in paragraphs 51-70).

10.   We recommend that the IASB should confirm the proposals in the ED, subject to the clarifications discussed in paragraphs 56-66.

*Clarifying the measurement of 12-month expected credit losses*

11.   During its September 2013 meeting, the IASB tentatively confirmed that the measurement objective for instruments in Stage 1 is the 12-month expected credit losses.

12.   In the feedback during our outreach and from a few comment letters, some respondents commented that the proposals in the ED were not clear about what the 12-month ECL represented.

13.   To clarify, we recommend that the explanation provided in paragraph BC63 of the ED should be included in the application guidance.


### *Structure of this paper*

14.   The detailed feedback received and the staff analysis are set out as follows:

(a)   Discount rate to be used

  (i)   background (paragraphs 15-17)

  (ii)   detailed feedback (paragraphs 19-30)

  (iii)   staff analysis and recommendation (paragraphs 31-50)

(b)   Clarification of measurement requirements

  (i)   use of forward-looking information (51-70);

    1.   interaction between historical, current and forward-looking information (paragraphs 56-60):

      2. use of regulatory models (paragraphs 61-66); and

(ii) clarifying the measurement of 12-month expected credit losses (paragraphs 67-70).

## Discount rate to be used

### *Background*

15. As mentioned in paragraph 2(b), the measurement of ECL should reflect the time value of money. The IASB has always viewed the discounting of ECL as an integral feature of amortised cost measurement. The proposals in the ED therefore required the measurement of ECL to reflect time value of money. We do not intend to discuss this aspect of the proposals again. Instead, we are only discussing the appropriate rate to be used when discounting ECL.

16. The IASB has at previous meetings[3] discussed what it considers to be the correct discount rate and has previously confirmed that the original EIR is the conceptually correct rate. This is because[4]:

(a) amortised cost is calculated using the effective interest method and determines the carrying amount (after deduction of the allowance) and revenue (interest) recognition pattern for a financial asset as part of an integrated calculation. In that sense, the carrying amount of a financial asset, the associated revenue recognition and impairment calculations are interrelated. Consequently, the same rate (EIR) that is used in recognising revenue should also be used in measuring an impairment loss.

(b) furthermore, using the original EIR reinforces the fact that amortised cost is a cost-based measurement.

17. Currently, IAS 39 *Financial Instruments: Recognition and Measurement* [5] requires the expected future cash flows to be discounted using the original

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[3] The IASB has previously discussed discounting at board meetings held in December 2010 (Agenda Paper 1B), April 2011 (Agenda Papers 4A, 4B, and 4C) and May 2012 (Agenda Paper 5A).

[4] Refer Agenda Paper 5A *Discount rate* discussed at the May 2012 IASB meeting.

effective interest rate (EIR). This applies whether or not there is an impairment allowance (ie the rate is also relevant to shortfalls in contractual cash flows for which there are incurred losses). However, in developing the 2011 Supplementary Document ('the SD') the IASB proposed to allow *any reasonable rate that is between (and including) the risk-free rate and the effective interest rate* to be used as the discount rate to discount ECL. This flexibility was intended to make discounting more operational. The IASB said that permitting an entity to use any reasonable rate between (and including) the risk-free rate and the effective interest rate as currently determined in accordance with IAS 39 would encourage the use of discounted amounts.

18.   Respondents broadly supported the proposed range of discount rates in the SD. As a result, in the recent ED the IASB confirmed the use of that range for the discount rate to help ease preparers' operational challenges in determining and maintaining the discount rate.

### Detailed feedback received

#### Comment letters

19.   The ED did not specifically ask respondents to comment on the proposals relating to the discount rate when calculating the expected credit losses, because they had been previously exposed in the SD. However, a number of respondents specifically commented on this point. These respondents included some that have undertaken detailed analysis of the effects of applying the proposals, and so are well informed.

20.   Of those respondents that commented on the discount rate:

(a)   a few supported the proposed range for operational reasons; and

(b)   most, including preparers, did not agree with our proposals (see paragraph 23) .

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[5] IAS 39 paragraph 63.

21. We believe that the change in views reflects the fact that respondents, including some fieldwork participants, have now focused more closely on the practical implications of the permitted range.

22. The respondents to the ED that supported the proposals on the discount rate argued that, although using the EIR is conceptually more sound, it is also more complex, particularly when applied on a portfolio level or to open portfolios. They consider that using the permitted range would make the proposals more operable.

23. The respondents that did not support the proposals made the following observations:

    (a)  using the EIR is consistent with other proposals in the ED, namely for originated or purchased credit-impaired instruments and instruments with objective evidence of impairment (ie Stage 3);

    (b)  discounting using a risk-free rate is inappropriate because it ignores the fact that there is credit risk associated with financial instruments;

    (c)  the permitted range of discount rates is 'too flexible' and, importantly, they noted that *differences in the amount of the loss allowance using different discount rates could be material*, in particular for high interest rate environments or high credit risk products. They were concerned that this could result in earnings management, and result in a lack of consistency and comparability among entities; and

    (d)  the rate used to recognise interest revenue should be the same as the rate used for discounting expected credit losses.

24. These respondents proposed that the final Standard should require one of the following alternatives for the discount rate:

    (a)  the effective interest rate (or an approximation thereof); or

    (b)  the effective interest, or, if the EIR is not practical to determine the risk-free rate.

25. These respondents observed that if the IASB decides to retain the current proposals, additional guidance should be provided on what the rate should reflect (eg should it reflect credit risk) and how to determine a 'reasonable rate'.

*Fieldwork*

26. During the fieldwork, participants generally supported a range of possible discount rates being permitted. They indicated that having a range improved the operability of the proposals, because they were able to use the discount rate implicit in their existing credit risk management systems to the extent that the rate was within the permitted range.

27. However, some of the participants raised the same concerns stated in paragraph 23(c), namely concern about earnings management and lack of comparability in high interest rate jurisdictions. Additionally, some observed that it may be appropriate to use a rate other than EIR, eg a weighted average cost of capital (WACC), to discount expected credit losses.

*FASB proposals and most recent decisions*

28. During its meeting in September 2013, the FASB discussed whether particular loss rate type approaches *implicitly* satisfy the time value of money principle[6].

29. The FASB tentatively decided at this meeting that:

> …in addition to using a discounted cash flow model to estimate expected credit losses, an entity would not be prohibited from developing an estimate of expected credit losses using loss-rate methods, probability-of-default methods, or a provision matrix using loss factors…

30. The IASB continues to explicitly require that time value of money be reflected in the measurement of ECL, whereas we understand the FASB would not require it. We believe that in most instances the outcomes would be the same. However, differences could arise for:

    (a)    discounted cash flow models: The FASB would require discounting using the EIR, whereas the IASB would permit a range of discount rates, including EIR (this is subject to confirmation in this Agenda Paper, see paragraphs 49-50);

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[6] Refer FASB Memo 239 *Clarification of Expected Credit Losses,* paragraph 18.

(b)     loss-rate models, probability-of-default methods and provision matrix
using loss factors: The IASB would require explicit discounting of ECL
using a discount rate within the permitted range, if it is not already
reflected in the model. We understand the FASB would not require it.

### *Staff analysis and recommendation*

31.     On the basis of the feedback received, the staff have identified the following two
alternatives for the IASB to consider:

(a)     **Alternative 1**: confirm the proposals in the ED, subject to clarification.

(b)     **Alternative 2**: require the EIR (or an approximation thereof), but
permit the use of the risk-free rate when it is impractical to determine
the EIR.

### Alternative 1: confirm the proposals in the ED subject to clarification

32.     This alternative would be consistent with the proposals in the SD and the ED.
Although the IASB regards the EIR as the conceptually correct rate, it has noted
that permitting a range of rates to be used would enhance the operability of the
proposals.  The IASB cited the following in paragraph BC94 of the ED:

> BC94  Most respondents to the SD supported flexibility in
> an entity choosing which discount rate it should apply.
> These respondents agreed that this flexibility was helpful
> for easing the operational challenges of determining and
> maintaining the discount rate. They also felt that it was
> appropriate to allow preparers to choose a rate that is
> suitable for the level of sophistication of their systems and
> their operational capability. Those who did not support
> permitting flexibility in determining the appropriate rate
> wanted to maintain comparability between entities.

33.     However, the disadvantages of permitting the range of discount rates are:

(a)     selecting any rate other than the EIR (or an approximation thereof) is
not consistent with amortised cost, because it is a cost-based
measurement; and

(b)     it reduces comparability amongst entities. The differences could be large for some products in some jurisdictions.

34.     During our outreach, respondents provided us with information to better understand the impact of the range of discount rates amongst different jurisdictions (refer paragraph 33(b)). Respondents noted that the difference between the risk free rate and the EIR could be as little as 0,5times and as much as 20times in some jurisdictions. For example, assume the risk-free rate is 1%, the EIR could be as little as 1,5% or as much as 20%.

35.     In order to mitigate the issue of comparability, the ED proposed disclosure of the relevant rate that was used (paragraph 39(d)(i) in the ED).

36.     Furthermore, using this approach, those who prefer using the EIR for conceptual or other reasons would be permitted to do so.

37.     Some also observe that market forces may encourage entities to use the EIR.  This is because in discounting the expected credit losses, the highest rate (namely, the EIR on initial recognition) would result in the lowest loss allowance.  However, opponents of this view believed that entities that want to inflate their loss allowances would use a lower rate, and subsequently change this rate, as a means of manipulating earnings.

*Reasonable rate*

38.     As noted in paragraph 25, some respondents requested that if the IASB confirms this proposal, the final Standard should provide guidance on what would be considered to be a 'reasonable rate'.

39.     Although IAS 39 requires the EIR to be used, we are aware that entities sometimes use an approximation thereof, which could include the contractual interest rate.

40.     When developing guidance on what would be considered a reasonable rate for the purpose of discounting ECL, we consider a reasonable rate to be a rate that approximates the EIR.

41. Furthermore, Agenda Paper 1B *Allocation of lifetime expected credit losses under decoupling in open portfolios*[7], discussed at the IASB meeting on 1 December 2010, listed the following factors that are reflected in the EIR:

    (a)    time value of money ('risk-free rate');

    (b)    compensation for initial expected credit losses;

    (c)    compensation for accepting risk (eg unexpected credit loss, liquidity risk etc);

    (d)    a profit margin; and

    (e)    adjustments for premiums or discounts, fees and points paid, and/or transaction costs.

42. A discount rate that reflects these factors could also be considered to be a reasonable rate.

**Alternative 2: require the use of the effective interest rate (or an approximation thereof), but permit the use of the risk-free rate when it is impractical to determine the effective interest rate**

43. As an alternative, the IASB could decide to require the use of the EIR (or an approximation thereof), but permit the use of the risk-free rate when it is determining the EIR is impracticable.  As noted in paragraph 39 above, IAS 39 requires the effective interest rate to be used, but for operational reasons entities sometimes use an approximation of the EIR.  An extract from Agenda Paper 5A *Discount rate* discussed at the May 2012 joint board meeting noted:

    > Par 8 Although the discount rate has to be kept constant over the life of the assets, the staff understands that in practice today, many entities do not calculate the original EIR. This is because in an open portfolio, entities have operational difficulty in maintaining historical EIR information.

    > Par 9 Instead, entities make approximations. They often use the contractual interest rate as well as allocate

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[7] Refer paragraph 16 of the Agenda Paper.

premiums/ discounts, fees etc on a straight-line basis over the life of the asset to recognise interest revenue. For impairment, some entities estimate what the original EIR would have been, knowing that any difference is likely to be immaterial. This approach results in a similar effect to using the original EIR.

44.     The advantages of this approach are that:

(a)     the EIR is the conceptually correct rate and is consistent with amortised cost measurement as a historical measure;

(b)     it limits the range of rates an entity can use in discounting shortfalls in cash flows, thereby limiting the potential for manipulation;

(c)     it enhances comparability between entities; and

(d)     it avoids the adjustment that arises when financial assets move to Stage 3, (ie when there is objective evidence of impairment) when a rate other than the EIR has been used to discount the expected credit losses up to that point[8].

45.     The introduction of the risk-free rate when it is impractical to determine the EIR would assist in creating consistency and comparability. The ED stated:

> BC93  In developing the proposals in the SD, the IASB noted that, conceptually, the discount rate for cash flows of an asset cannot be below the risk-free rate.

46.     However, the risk-free rate is the rate that is furthest away from the conceptually correct rate.  In addition, this rate disregards any compensation that the entity might receive to compensate it for credit risk, or any of the other factors discussed in paragraph 41.

47.     Unlike IAS 39, in which shortfalls on cash flows are only measured on a subset of financial instruments (those for which there is objective evidence of impairment), the proposed impairment model would result in expected credit losses being

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[8] At that point, because interest is calculated on the <u>net</u> carrying amount, cash flows must be discounted at the EIR. So, if ECL were previously discounted at a rate other than the EIR there is a catch up effect in profit or loss.

measured on all financial instruments[9]. This results in the major disadvantage of this approach, namely operability in implementing the requirements. Respondents have noted that they would have to integrate credit risk management and accounting systems and rely more on the interaction between them. For some this would require significant changes to their current systems. The extent of the system changes would depend on the sophistication of the credit risk and accounting systems. For example, some credit risk management systems are not configured to use the EIR, but may instead use weighted average cost of capital (WACC) or regulatory rates (which could be within the proposed permitted range). Although this alternative is conceptually sound, it may result in significant operational complexity for some entities.

48.    Furthermore, we are concerned that the views of those that *support* the proposals in the ED (ie permitting a range of discount rates) may not be representative, because the ED did not ask respondents to specifically comment on the discount rates to be used to discount ECL. It could be argued that the respondents who did not specifically comment on this aspect of the proposals, implicitly agreed and those who disagreed were more likely to comment.

### *Staff recommendation*

49.    The staff **recommend Alternative 1**, ie retain the proposals in the ED to use any reasonable rate that is between (and including) the risk-free rate and the EIR, subject to the clarifications below.

50.    We recommend that additional guidance should be provided on what would be considered a reasonable rate. Such guidance should clarify that the following could be considered a reasonable rate:

(a)     a rate that approximates the EIR; or

(b)     a rate that reflects the following factors:

     (i)     time value of money ('risk-free rate');

     (ii)    compensation for initial expected credit losses;

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[9] The allowance may however be calculated at nil for some financial instruments such as those that are fully or over-collateralised.

(iii)    compensation for accepting risk (eg unexpected credit loss, liquidity risk etc);

(iv)    a profit margin; and

(v)    adjustments for premiums or discounts, fees and points paid, and/or transaction costs.

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**Questions to the IASB**

1. Does the IASB agree with the staff recommendation to confirm the proposals in the ED to use of any *reasonable rate* that is between (and including) the risk-free rate and the effective interest rate as the discount rate for measuring expected credit losses?

2. If so, does the IASB agree with the staff recommendation to include guidance on what would be considered a reasonable rate as listed in paragraph 55*?*

If not, what guidance would the IASB prefer?

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**Clarification of the measurement requirements**

*Use of forward-looking information*

51.    The ED proposed that an entity include 'reasonable and supportable forecasts of future events and economic conditions' in estimating the expected credit losses (paragraph 17 of the ED). Appendix B to this paper includes a detailed extract from the application guidance.

52.    The proposed application guidance illustrates that an entity would start with historical information as the anchor and would adjust this, using reasonable and supportable information, to reflect:

(a)    current observable data; and

(b)      forecasts of future conditions, if such forecasts are different from past information.

53.    The proposed guidance does not require estimates to incorporate forecasts of future conditions over the entire remaining life of the financial instruments. In fact, the guidance acknowledges the difficulty that arises when estimating further into the future and the associated lower reliability of data. Instead, the guidance notes that an entity should only use information that is reasonably available and supportable to extrapolate information beyond this point.

54.    During the September 2013 joint board meeting, the FASB redeliberated the measurement of ECL and tentatively decided:

> …to clarify that an entity should revert to a historical average loss experience for the future periods beyond which the entity is able to make or obtain reasonable and supportable forecasts. In addition, the FASB decided that the final guidance on expected credit losses should include Implementation Guidance to describe the factors that an entity should consider when adjusting historical loss experience for current conditions and reasonable and supportable forecasts;

55.    We received very little feedback in our comment letters and during our outreach on the requirements in paragraph 51. In general, respondents supported the guidance and proposals in the ED on the measurement of lifetime expected credit losses and seemed to understand the proposals. However, to ensure that the IASB considers the points raised by the FASB as deliberations continue, and to address the concerns raised by a few respondents on measurement, we think the following two points are worth clarifying in estimating ECL:

(a)      interaction between historical, current and forward-looking information;

(b)      use of regulatory models.

*Interaction between historical, current and forward looking information*

56.     One respondent suggested that the IASB should include *as guidance* the alternatives included in the FASB FAQ[10] document which included reversion to *unadjusted historic averages* beyond the reasonable and supportable future.  We believe that it is *not* appropriate to *require* this, because:

(a)     it fails to consider how current and forecast period information affects those historic averages (ie consideration needs to be given to similarities and differences between the historic period and the outlook period); and

(b)     it could result in the allowance becoming less responsive to changes in economic conditions because it reverts back to historical averages that may not reflect current or forecast information.

57.     During its September 2013 meeting, the FASB considered including this as a *requirement*; however, the FASB rejected this view.

58.     We think that historical information is always an important anchor or base to measure ECL.  In fact, we note that in some cases the best reasonable and supportable information *could* be the unadjusted historical information, depending on the nature of the historical information and when it was calculated compared to the reporting date.  It may in some circumstances be an appropriate long-term measurement, but it should not be *assumed* to be appropriate in all circumstances. However, even if an unadjusted measure is not appropriate, the historical measurement could still be used as a starting point from which adjustments are made to estimate ECL on the basis of reasonable and supportable information that incorporates both current and forward-looking information.

59.     The majority of respondents supported the proposals and we are of the view that the proposals and guidance in the ED are still appropriate.  We believe that the historical information is important.  However, consideration must be given to adjustments to reflect current and supportable future estimates to ensure that the objectives of the ECL measurement are satisfied.

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[10] FASB Proposed Accounting Standards Update – *Financial Instruments* (Subtopic 825-15) available from www.fasb.org

60.     **Accordingly, we recommend that the current proposals should be confirmed**.

*Use of regulatory models*

61.     The ED did not require or propose any specific method for measuring ECL. However, the ED did propose objectives for the measurement which would be relevant in determining appropriate approaches for measuring ECL.

62.     Respondents acknowledged the efforts of the IASB to ease the operational concerns about measuring ECL, compared to previous models. However, a few respondents asked the IASB to consider permitting the use of prudential approaches to measurement, in particular the use of risk parameters covering the entire economic cycle ('through-the-cycle'). They believed that the difference between (i) the IASB proposals, which focus on a specific point in time and use expectations over the life of the financial instruments as at the reporting date would require significant system changes[11] compared to (ii) the regulatory measures, which focus on through-the-cycle information. They noted that both types measure expected credit losses and use similar inputs and assumptions, and that eliminating this difference by allowing the prudential approach to be used for accounting purposes, would alleviate a major area of difficulty in applying the new requirements.

63.     During its deliberations, the IASB considered whether it would permit the use of the through-the-cycle information as a way to measure ECL. Appendix C provides a relevant extract from the Basis for Conclusion.

64.     The IASB noted that regulatory measures are designed with different objectives than the ECL proposals. In particular the IASB noted:

(a)     that the objective of the model is to faithfully represent the economic reality of ECL in relation to the carrying amount, not to recognise an allowance sufficient to cover *unexpected losses*, which is not the primary objective of general purpose financial reporting; and

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[11] A point in time estimate (as proposed) means that an entity needs to estimate actual expected credit losses based on economic conditions in the relevant forecast period, eg in the next 2 years. In comparison, so-called through-the-cycle estimates reflect losses over an average 2-year period throughout a business cycle.

(b)    the estimation of ECL considers the information available as at the reporting date, rather than adjusting those assumptions to achieve a counter-cyclical effect.

65.    Apart from the request to reduce the number of systems changes required, we have not received any additional information that suggests that regulatory-based measurements would actually provide appropriate information for general purpose financial statements. We note, however, that an entity may use regulatory information as a basis for the measurement of ECL, but would need to make appropriate adjustments to this base to achieve the objectives of the proposals.

66.    **Accordingly, we recommend confirming the proposals in the ED for the use of the regulatory model as a *basis* for calculation of expected credit losses, however, it would still require adjustments to meet the objective of the standard.**

### Clarifying the measurement of 12-month expected credit losses

67.    At the September 2013 Board meeting, the IASB tentatively confirmed that the measurement objective of Stage 1 is the 12-month expected credit losses.

68.    In our outreach, and in a few comment letters, respondents commented that it was unclear what information the 12-month ECL captures. In particular, some asked whether the allowance (provision) captures:

(a)    the cash shortfalls expected in the next 12 months; or

(b)    the lifetime ECL of the instruments that the entity predicts will default in the next 12 months.

69.    We clarify that it captures neither of the points above. Instead, the IASB stated:

> BC63 …12-month expected credit losses is the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring. Thus, 12-month expected credit losses are a portion of the lifetime expected credit losses…12-month expected credit losses are **not** the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next

12 months…12-month expected credit losses are **not** the
cash shortfalls that are predicted over the next 12 months.
[emphasis added]

70.    **We recommend that this explanation should be included in the application
guidance**.

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**Questions to the IASB**

Does the IASB agree with the staff recommendation to confirm the proposals
that:

-    In estimating expected credit losses, the entity shall incorporate the best
available information that is reasonably available, including information
about past events, current conditions and reasonable and supportable
forecasts of future events and economic conditions at the reporting date.
For periods beyond 'reasonable and supportable forecasts' an entity
should consider how best to reflect its expectations by considering
information at reporting date about the current conditions, as well as
forecasts of future events and economic conditions;

-    While regulatory models may form a basis for ECL calculations,
regulatory measurement should not be accepted as the measure of ECL
(ie the objectives of the ECL measure must be met)?

Does the IASB agree to include the arguments in paragraph 69 (BC63 of the
ED) as part of the application guidance to clarify the measurement of
12-month expected credit losses?

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**Appendix A**

**Extract from the Basis for Conclusions on the Discount rate**

> **BC92  Consistent with the proposals in the SD, this Exposure Draft would allow an entity to discount expected credit losses using the risk-free rate, the effective interest rate on the related financial asset, or any rate in between these two rates.**
>
> BC93  In developing the proposals in the SD, the IASB noted that, conceptually, the discount rate for cash flows of an asset cannot be below the risk-free rate**. The IASB further noted that the discount rate used in the 2009 ED is conceptually appropriate for calculations of amortised cost.** However, if the IASB proposed the credit-adjusted effective interest rate from the 2009 ED as the upper limit, entities would need to calculate that rate to decide whether they could use a rate that is more readily determinable. That is, such a proposal would not avoid the operational complexity of determining that credit-adjusted effective interest rate, which would be counter-productive. Thus, the IASB proposes that an entity should use any rate between the risk-free rate and the effective interest rate, not adjusted for credit, as the discount rate.
>
> BC94  Most respondents to the SD supported flexibility in an entity choosing which discount rate it should apply. These respondents agreed that this flexibility was helpful for easing the operational challenges of determining and maintaining the discount rate. They also felt that it was appropriate to allow preparers to choose a rate that is suitable for the level of sophistication of their systems and their operational capability. Those who did not support permitting flexibility in determining the appropriate rate wanted to maintain comparability between entities.
>
> BC95 The IASB observed that some credit risk management systems discount expected cash flows to the

date of default. The proposals will require an entity to discount expected credit losses to the reporting date.

BC96  The IASB decided to confirm the proposals in the SD, but to require the entity to disclose the discount rate it used and any significant assumptions that it made in determining that rate. This choice of discount rates does not apply to purchased or originated credit-impaired financial assets on which the amortised cost measurement always uses the credit-adjusted effective interest rate.

[emphasis added]

## Appendix B

## Extract from the ED on application guidance for Best available information

B5    In accordance with paragraph 17(b), 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 to estimate expected credit losses 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 expected credit losses increases. The estimate of expected credit losses 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.**

B6    An entity need not undertake an exhaustive search for information but shall consider all available information that is relevant to the estimate of expected credit losses, **including the effect of expected prepayments.** The information used shall include factors that are specific to the borrower, general economic conditions and an assessment of both the current **as well as the forecast direction of conditions at the reporting date**. An entity may use various sources of data, which may be internal (entity-specific) and external. Possible data sources include internal historical credit loss experience, internal ratings, credit loss experience of other entities and external ratings, reports and statistics. Entities that have no entity-specific or insufficient sources of data may use peer group experience for the comparable financial instrument (or groups of financial instruments).

B7    An entity **shall adjust historical data**, such as credit loss experience, on the **basis of current**

**observable data to reflect the effects of the current conditions and its forecasts of future conditions that** did not affect the period on which the historical data is based and to remove the effects of the conditions in the historical period that do not exist currently. Estimates of changes in expected credit losses reflect, and are directionally consistent with, changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of credit losses on the financial instrument or in the group of financial instruments and in the magnitude of those changes). An entity shall regularly review the methodology and assumptions used for estimating expected credit losses to reduce any differences between estimates and actual credit loss experience.

B8     When using historical credit loss experience in estimating expected credit losses, it is important that information about historical credit loss rates is applied to groups that are defined in a manner that is consistent with the groups for which the historical credit loss rates were observed. Consequently, the method used shall enable each group to be associated with information about past credit loss experience in groups of assets with similar risk characteristics and with relevant observable data that reflects current conditions.

[emphasis added]

**Appendix C**

**Extract from Basis for Conclusions on 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.