STAFF PAPER

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ITG meeting

Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	Loan Commitments—Scope

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Introduction

1. We have received two submissions asking whether particular commitments to extend credit that are not in the context of traditional 'lending' should be treated as loan commitments within the scope of the impairment requirements in IFRS 9 *Financial Instruments* (2014). In particular, the submitters refer to the following two transactions:

   (a) on inception of a finance lease that has not yet commenced (ie for which a finance lease receivable has not yet been recognised); and

   (b) on issuing store accounts that enable customers to buy goods or services in the future from the issuer on credit.

2. This paper:

   (a) provides some background information, including the relevant requirements in IFRS 9;

   (b) summarises the potential implementation issues; and

(c) asks the members of the Transition Resource Group for Impairment of Financial Instruments ('ITG') for their views on the issues identified.

Background and accounting requirements

Scope of IFRS 9

3. Chapter 2 of IFRS 9 sets out the scope of the Standard. Paragraph 2.1 of IFRS 9 first and foremost states that the Standard applies to all types of financial instruments, except the specific exceptions that are listed.

4. Financial instruments are defined in IAS 32 *Financial Instruments: Presentation*. Paragraph 11 of IAS 32 defines a financial instrument as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. IAS 32 also defines financial asset, financial liability and equity instrument.

5. Paragraph 2.1(g) of IFRS 9 excludes from the requirements of the Standard loan commitments other than those that are set out in paragraph 2.3. However, paragraph 2.1(g) of IFRS 9 requires issuers of loan commitments to apply the impairment requirements of IFRS 9 to loan commitments that are not otherwise within the scope of the Standard. The relevant wording from IFRS 9 is set out below[1]:

> '2.1 This Standard shall be applied by all entities to all types of financial instruments except:
>
> ….
>
> (g) loan commitments other than those loan commitments described in paragraph 2.3. However, an issuer of loan commitments shall apply the impairment requirements of this Standard to loan commitments that are not otherwise within the scope of this Standard. Also, all loan

[1] Paragraph 2.3 is not reproduced in this paper because it is not directly relevant to the issues discussed.

commitments are subject to the derecogntion requirements of this Standard.'

6. 'Loan commitment' is not a defined term in IFRS. However, paragraph BCZ2.2 of IFRS 9 describes them as follows:

> Loan commitments are firm commitments to provide credit under pre-specified terms and conditions.

7. Chapter 2 of IFRS 9 also explicitly scopes into the Standard some items that are not financial instruments. These items are set out after paragraph 2.1. In particular, paragraph 2.2 scopes into IFRS 9 those contracts specified by IFRS 15 *Revenue from Contracts with Customers* and paragraphs 2.4-2.7 address contracts to buy or sell non-financial items.

Finance leases

8. Paragraph 4 of IAS 17 *Leases* defines a lease as 'an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time'. A finance lease is defined as a lease that transfers substantially all the risks and rewards incidental to ownership of an asset (title may or may not eventually be transferred).

9. Paragraph AG9 of IAS 32 notes that under IAS 17, a finance lease is regarded as primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. Paragraph AG9 of IAS 32 also states that 'accordingly, a finance lease is regarded as a financial instrument…'.

10. Paragraph 2.1(b) of IFRS 9 generally excludes from the scope of IFRS 9 rights and obligations under leases to which IAS 17 applies. However, in accordance with paragraph 2.1(b)(i), lease receivables recognised by a lessor are subject to the impairment (and derecognition) requirements of the Standard.

11. Paragraph 4 of IAS 17 makes a distinction between the inception of the lease and the commencement of the lease term.[2] The inception of the lease is the earlier of the date of the lease agreement and the date of commitment by the parties to the principal provisions of the lease. However, the commencement of the lease term is the date from which the lessee is entitled to exercise its right to use the leased asset. It is this (later) date that the lease is initially recognised in the financial statements. Hence, a finance lease receivable will be initially recognised only at the date of the *commencement of the lease term*.

Contracts with customers

12. Paragraph 2.1(j) of IFRS 9 excludes from the scope of IFRS 9 rights and obligations within the scope of IFRS 15 that are financial instruments, except for those that IFRS 15 specifies are accounted for in accordance with IFRS 9. Accordingly, enforceable executory contracts with customers to sell goods or services are not within the scope of IFRS 9.

13. However, paragraph 2.2 of IFRS 9 requires an entity to apply the impairment requirements of IFRS 9 to those rights that IFRS 15 specifies are accounted for in accordance with IFRS 9 for the purposes of recognising impairment gains or losses. Those rights specified in IFRS 15 are rights associated with contract assets and receivables.

The issue

14. Unless other specific requirements apply (see paragraph 5 of this paper), an issuer of a loan commitment is required to apply the impairment requirements of IFRS 9 to that loan commitment. However, the issue that is the subject of this paper is whether the impairment requirements in IFRS 9 must also be applied to other commitments to extend credit. Examples put forward by submitters are:

[2] Similarly, the Exposure Draft *Leases* published in 2013 proposed to keep a similar distinction between lease inception and lease commencement. This has been confirmed in redeliberations.

(a) a commitment (on inception of a finance lease) to commence a finance lease at a date in the future (ie a commitment to transfer the right to use an asset at the commencement date in return for a payment or series of payments in the future); and

(b) a commitment by a retailer through the issue of a store account to give a customer credit when the customer buys goods or services from the retailer in the future.

Finance lease commitment

15. At the inception of a finance lease, the lessor is committed to providing a right to use an asset by delivering that asset to the lessee in exchange for payment on credit terms (ie deferred payment terms after the delivery of the asset). The lessor fulfils that commitment at the commencement of the lease term, when it transfers the right to use an asset to the lessee, and recognises a finance lease receivable on its balance sheet.

16. The submitter asks whether, in the period from inception of the finance lease agreement until the commencement of that lease, the commitment to provide credit under the finance lease must be assessed for impairment in accordance with IFRS 9.

Store accounts

17. Some retailers issue store accounts under which customers are able to buy goods or services on credit in the future from the issuing retailer. The submitter notes that the typical features of such store accounts are as follows:

    (a) the store accounts cannot be used to withdraw cash or to buy from other retailers or suppliers;

    (b) at the time of issuing the store account, there is no specific sales agreement with the customer. The customer can use the account to purchase specific goods from the retailer, and the retailer agrees at that time (ie when the customer presents its card as form of payment) to sell those specific goods to the customer;

(c) the agreement between the retailer and the customer does not include an obligation of the issuer to supply goods or services to the customer;

(d) the retailer retains the credit risk and does its own credit checks before, and during, extending credit to the customer; and

(e) the retailer can revise or cancel the credit agreement at any time by providing the customer with the relevant notice.

18. The submitter asks whether commitments to extend credit under store accounts such as those described above must be assessed for impairment in accordance with IFRS 9.

Review of the requirements in the Standard

19. The issue raised is largely about how to apply the scope requirements of IFRS 9. To determine whether the impairment requirements in IFRS 9 apply to a commitment it is necessary to consider the following questions:

(a) Question 1: Is there a loan commitment?

and

(b) Question 2: Does it meet the definition of a financial instrument?

Question 1: Is there a loan commitment?

20. Paragraph 2.1(g) of IFRS 9 requires issuers of loan commitments to apply the impairment requirements of IFRS 9 to loan commitments. Hence, it is necessary to analyse each agreement to determine if it is a loan commitment. A loan commitment is described in paragraph BCZ2.2 of IFRS 9 as a 'firm commitment to provide credit under pre-specified terms and conditions'. It is thus necessary to determine if the agreement provides such a commitment.

21. Some contracts, such as irrevocable finance lease agreements, might clearly contain a firm commitment at inception to provide credit under pre-specified terms and conditions.

22. However, other cases might not be so clear cut, depending upon the specific terms of the agreement and other facts and circumstances; for example, if the issuer of a store account has the discretion to refuse to sell products or services to a customer with a store card and hence can avoid extending credit.

Question 2: Does it meet the definition of a financial instrument?

23. The scope of IFRS 9 as determined by paragraph 2.1 is all types of *financial instruments* with specific exceptions. Paragraph 2.1(g) of IFRS 9 scopes out most loan commitments that are financial instruments (issued and held) from the requirements of IFRS 9. However paragraph 2.1(g) then scopes back in loan commitments for issuers for the purposes of the impairment requirements.

24. However, for any of the requirements in IFRS 9 to apply to items listed in paragraph 2.1, that item must be first within the purview of IFRS 9; ie it has to meet the definition of a financial instrument (as defined in IAS 32). Hence, even if the commitment in question is a loan commitment, it is necessary to also determine if that loan commitment meets the definition of a financial instrument. If none of the specific exclusions from the scope of IFRS 9 apply and the answers to questions 1 and 2 are both 'yes', the impairment requirements of IFRS 9 apply by virtue of paragraph 2.1(g) in IFRS 9 (see paragraph 5 of this paper).

25. It is noted that even if the contract were determined to be both a loan commitment and a financial instrument, then in determining expected credit losses it would be important to consider the collateral provided by the underlying item (ie the goods or services or right of use asset) in calculating the expected credit losses.

Question for the members of the ITG
What are your views on the issues presented above?