STAFF PAPER

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Project	**Transition Resource Group for Impairment of Financial Instruments**
Paper topic	Assessing for significant increases in credit risk in respect of financial assets with a maturity of less than 12 months

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Introduction

1. This paper addresses an issue raised by a submitter regarding the application of the impairment requirements of IFRS 9 *Financial Instruments* (2014). The issue relates to whether an entity is required to assess for significant increases in credit risk in respect of financial instruments with a maturity of less than 12 months.

2. This paper:

   (a) sets out the relevant accounting requirements in IFRS 9 and IFRS 7 *Financial Instruments: Disclosures*;

   (b) summarises the potential implementation issue raised by the submitter; and

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

Accounting requirements

3. Paragraphs 5.5.3-5.5.5 of IFRS 9 set out the requirements pertaining to the measurement of expected credit losses for all financial instruments with some limited exceptions:

> **5.5.3** Subject to paragraphs 5.5.13–5.5.16, at each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition.
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> **5.5.4** The objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking.
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> **5.5.5** Subject to paragraphs 5.5.13–5.5.16, if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses.

4. One of the exceptions to the requirements of paragraph 5.5.3 and 5.5.5 of IFRS 9 relates to certain trade receivables and contract assets, specifically those that do not contain a significant financing component or when the entity applies the practical expedient for contracts that are for one year or less in accordance with IFRS 15 *Revenue from Contracts with Customers* [emphasis added]:

> **5.5.15** Despite paragraphs 5.5.3 and 5.5.5, an entity shall always measure the loss allowance at an amount equal to lifetime expected credit losses for:

> (a) trade receivables or contract assets that result from transactions that are within the scope of IFRS 15, and that:
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> (i) **do not contain a significant financing component (or when the entity applies the practical expedient for contracts that are one year or less) in accordance with IFRS 15**; or
>
> […..]

5. Paragraphs BC5.221-BC5.224 of IFRS 9 set out the IASB's deliberations relating to the exception outlined in paragraph 5.5.15(a)(i) of IFRS 9.[1]

6. Paragraph 5.5.9 of IFRS 9 requires an entity to assess, at each reporting date, whether the credit risk on a financial instrument has increased significantly since initial recognition and notes that an entity shall use the change in the risk of default occurring over the expected life of the financial instrument rather than changes in the amount of expected credit losses [emphasis added]:

> **5.5.9** At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making the assessment, **an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses**. […..]

7. As noted in paragraph BC5.155 of IFRS 9, many respondents agreed that the risk of a default occurring was the most relevant factor in assessing credit risk:

> **BC5.155** Many respondents to the proposals in the 2013 Impairment Exposure Draft agreed that an assessment of when to recognise lifetime expected credit losses should take into consideration only the changes in credit risk (ie the risk of a default occurring) instead of changes in the

[1] Paragraphs BC5.221-BC5.224 of IFRS 9 are reproduced in Appendix A.

> amount of expected credit losses. These respondents noted that the risk of a default occurring was considered the most relevant factor in assessing credit risk, and that tracking only the risk of a default occurring makes the model more operational, because that generally aligns with their credit risk management practices.

8. In accordance with IFRS 7, an entity is required to make disclosures that enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

9. More specifically, paragraph 35H of IFRS 7 requires an entity to disclose information pertaining to the changes in loss allowance, showing separately changes in loss allowances measured at 12-month and lifetime expected credit losses:

> **35H** To explain the changes in the loss allowance and the reasons for those changes, an entity shall provide, by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance, in a table, showing separately the changes during the period for:
>
> (a) the loss allowance measured at an amount equal to 12-month expected credit losses;
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> (b) the loss allowance measured at an amount equal to lifetime expected credit losses for:
>
>> (i) financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;
>>
>> (ii) financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and

(iii) trade receivables, contract assets or lease receivables for which the loss allowances are measured in accordance with paragraph 5.5.15 of IFRS 9.

(c) financial assets that are purchased or originated credit-impaired. In addition to the reconciliation, an entity shall disclose the total amount of undiscounted expected credit losses at initial recognition on financial assets initially recognised during the reporting period.

10. Paragraph 35M of IFRS 7 also requires disclosure pertaining to an entity's credit risk exposure and again distinguishes between financial instruments for which 12-month expected credit losses and lifetime expected credit losses are measured:

35M To enable users of financial statements to assess an entity's credit risk exposure and understand its significant credit risk concentrations, an entity shall disclose, by credit risk rating grades, the gross carrying amount of financial assets and the exposure to credit risk on loan commitments and financial guarantee contracts. This information shall be provided separately for financial instruments:

(a) for which the loss allowance is measured at an amount equal to 12-month expected credit losses;

(b) for which the loss allowance is measured at an amount equal to lifetime expected credit losses and that are:

(i) financial instruments for which credit risk has increased significantly since initial recognition but that are not credit-impaired financial assets;

(ii) financial assets that are credit-impaired at the reporting date (but that are not purchased or originated credit-impaired); and

(iii) trade receivables, contract assets or lease receivables for which the loss allowances are measured in accordance with paragraph 5.5.15 of IFRS 9.

(c) that are purchased or originated credit-impaired financial assets.

11. Paragraphs BC48CC-BC48FF of IFRS 7 set out the IASB's deliberations pertaining to the disclosure requirements in paragraph 35M of IFRS 9.[2] In paragraph BC48DD of IFRS7, the IASB noted the following:

> **BC48DD** [.....] The Board also noted that this disclosure [.....] provides relevant and useful information about credit risk migration and changes in overall credit risk over time.

12. As noted in paragraph BC5.135 of IFRS 9, one of the benefits of the impairment model in IFRS 9 is that financial statements will clearly distinguish between financial instruments for which credit risk has increased significantly since initial recognition and those for which it has not:

> **BC5.135** On the basis of the feedback received from respondents on the proposals in the 2013 Impairment Exposure Draft about the usefulness of the information and the responsiveness of the impairment model to changes in credit risk, the IASB decided to finalise the proposed approach. In doing so, the IASB considered that this expected credit loss approach will improve financial reporting because:
>
> (a) financial statements will clearly distinguish between financial instruments for which credit risk has increased significantly since initial recognition and those for which it has not;
>
> [.....]

[2] Paragraphs BC48CC- BC48FF of IFRS 7 are reproduced in Appendix B.

Potential implementation issue identified

13. The submitter notes that in accordance with paragraph 5.5.15(a)(i) of IFRS 9, an entity is required to always measure the loss allowance at an amount equal to lifetime expected credit losses for trade receivables or contract assets (within the scope of IFRS 15) that do not contain a significant financing component in accordance with IFRS 15. The submitter observes that IFRS 9 neither requires nor permits an entity to always measure the loss allowance at an amount equal to lifetime expected credit losses in respect of other financial assets originated with a term of 12 months or less.

14. In order to illustrate the issue, the submitter describes a scenario in which a lender (Entity A) originates short-term financial assets (that are not originated credit-impaired) with a maturity of nine months or less. For these financial assets, the submitter notes that the 12-month expected credit loss allowance will be the same as the lifetime credit expected loss allowance. Consequently, the submitter observes that monitoring whether there has been a significant increase in credit risk in respect of these financial assets will not be relevant for the purpose of measuring expected credit losses.

15. However, the submitter also notes that paragraphs 35H and 35M of IFRS 7 require disclosures that distinguish between financial instruments for which the loss allowance is equal to 12-month expected credit losses and financial instruments for which the loss allowance is equal to lifetime expected credit losses.

16. Within the context of the example presented in paragraph 14, the submitter asks whether Entity A would be required to assess for significant increases in credit risk the short-term financial assets that have a maturity of less than 12 months and for which 12-month expected credit losses equals lifetime expected credit losses. In the submitter's view, the costs associated with such an assessment could be significant.

17. The submitter presents two views together with supporting arguments:

(a) *View A*—Yes, it is necessary for Entity A to assess for significant increases in credit risk the short-term financial assets that have a maturity of less than 12 months and for which 12-month expected credit losses equal lifetime expected credit losses.

(b) *View B*—No, it is not necessary for Entity A to assess for significant increases in credit risk the short-term financial assets that have a maturity of less than 12 months and for which 12-month expected credit losses equal lifetime expected credit losses..

18. In support of View A, the submitter observes that the disclosures in paragraph 35M of IFRS 7 are required in order to provide users with information about the credit quality of financial instruments that are subject to the IFRS 9 impairment requirements. This information distinguishes between financial instruments that have not suffered a significant increase in credit risk and financial instruments that have suffered a significant increase in credit. In the example presented, despite there being no difference in the measurement of the loss allowance between 12-month and lifetime expected credit losses, the submitter observes that the separate disclosure is relevant, because it distinguishes between financial instruments that have suffered a significant increase in credit risk and those that have not. This is useful and relevant credit risk information for users to understand an entity's exposure to credit risk, regardless of the term to maturity of the financial asset. The submitter observes that this information could also be used to comply with the requirements of paragraph 35H of IFRS 7.

19. In support of View B, the submitter observes that the purpose of the disclosures in paragraph 35H of IFRS 7 is to provide users with information about changes in the loss allowance for financial instruments during the reporting period. In the example presented, the submitter notes that there is no difference between the 12-month and lifetime expected credit losses and consequently, an analysis of the change in the loss allowance is not relevant for the short-term financial assets in question. The submitter suggests that Entity A could show changes in the loss allowance for its short-term financial assets separately from all other financial

assets. The submitter also suggests that Entity A could add an explanation that 12-month expected credit losses are equal to lifetime expected credit losses for these assets and observes that a similar approach could be taken in order to comply with the disclosure requirements of paragraph 35M of IFRS 7. In the submitter's view, disclosing the risk rating grades for Entity A's short-term financial assets, without distinguishing between those with a 12-month loss allowance versus a lifetime loss allowance, provides the relevant information about credit risk exposure on those assets and also meets the underlying objective of paragraph 35M of IFRS 7. Lastly, the submitter observes that this would be consistent with the approach for short-term trade receivables and contract assets within the scope of paragraph 5.5.15(a)(i) of IFRS 9, because the associated disclosures in paragraphs 35H(b)(iii) and 35M(b)(iii) of IFRS 7 do not distinguish between financial assets that have suffered a significant increase in credit risk and those that have not.

Review of accounting requirements

20. We note that in accordance with paragraphs 5.5.3 and 5.5.5 of IFRS 9, unless a more specific exception applies, an entity is required to measure 12-month expected credit losses in respect of financial instruments that have not suffered a significant increase in credit risk since initial recognition and lifetime expected credit losses in respect of financial instruments that have suffered a significant increase in credit risk since initial recognition. We observe that IFRS 9 sets out a number of exceptions to these requirements in paragraphs 5.5.13-5.5.16 of IFRS 9 and we note that these exceptions do not relate to financial instruments with a maturity of less than 12 months (unless they otherwise fall within one of the exceptions set out in paragraphs 5.5.13-5.5.16 of IFRS 9).

21. We also note that in accordance with paragraph 5.5.9 of IFRS 9, an entity is required to assess significant increases in credit risk using the change in the risk of default occurring over the expected life of the financial instrument rather than

changes in the amount of expected credit losses. This requirement highlights that the IFRS 9 impairment model aims to distinguish between financial instruments that have, or have not, suffered a significant increase in credit risk since initial recognition regardless of whether or not there has been an increase in the expected credit losses associated with that financial instrument.

22. In this regard, we observe that there may be situations in which a financial instrument suffers a significant increase in credit risk and moves from a 12-month measure of expected credit losses to a lifetime measure, but there may not be a corresponding increase in loss allowance. One such example would be in the case of financial instruments with a maturity of less than 12 months, such as those described by the submitter in paragraph 14. Another example would be in the case of a highly collateralised financial asset, ie although the value of collateral would be excluded from the assessment of significant increases in credit risk, it would be taken into account in the measurement of expected credit losses.

23. Consistently with the principle set out in paragraph 5.5.9 of IFRS 9 regarding the need to distinguish between financial instruments that have suffered a significant increase in credit risk and those that have not, the disclosure requirements set out in paragraphs 35H and 35M of IFRS 7 require disclosures that distinguish between financial instruments for which the loss allowance is equal to 12-month expected credit losses and financial instruments for which the loss allowance is equal to lifetime expected credit losses. We observe that for financial instruments falling within the scope of paragraph 5.5.15(a)(i) of IFRS 9, IFRS 7 does not require the distinction between 12-month and lifetime expected credit losses, because in accordance with paragraph 5.5.15(a)(i) of IFRS 9, lifetime expected credit losses must always be recognised in respect of these financial instruments.

24. We also note that in accordance with paragraphs 5.5.15(a)(ii) and 5.5.15(b) of IFRS 9, an entity is permitted, as an accounting policy choice, to always recognise the loss allowance at an amount equal to lifetime expected credit losses for trade receivables and contract assets that contain a significant financing component and for lease receivables respectively. If an entity chooses to always recognise

lifetime expected credit losses in accordance with paragraphs 5.5.15(a)(i) or 5.5.15(b) of IFRS 9, IFRS 7 does not require the distinction between 12-month and lifetime expected credit losses because the entity has availed itself of a specific exception to always recognise lifetime expected credit losses.

25. On the basis of the analysis above, we observe that IFRS 9 does not include any specific exceptions regarding financial instruments with a maturity of 12 months or less. Consequently, an entity would be required to comply with the requirements of paragraph 5.5.3 and 5.5.5 of IFRS 9 together with the related disclosure requirements in paragraph 35H and 35M of IFRS 7. We note that it would not be appropriate to analogise to the specific exception set out in paragraph 5.5.15(a)(i) (or paragraphs 5.5.15(a)(ii) or 5.5.15(b)) of IFRS 9.

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

Appendix A

Extracts from the Basis for Conclusions of IFRS 9

Simplified approach for trade receivables, contract assets and lease receivables

BC5.221 The 2013 Impairment Exposure Draft proposed that trade receivables that do not have a significant financing component in accordance with IFRS 15 should be accounted for as follows:

(a) an entity would be required to measure the trade receivable at initial recognition at the transaction price as defined in IFRS 15 (ie the invoiced amount in many cases); and

(b) an entity would be required to recognise a loss allowance for lifetime expected credit losses on those trade receivables throughout their life.

BC5.222 Most respondents to the 2013 Impairment Exposure Draft supported the approach proposed for trade receivables without a significant financing component. Respondents noted that most trade receivables without a significant financing component would have a maturity that is less than one year, so the lifetime expected credit losses and the 12-month expected credit losses would be the same, or very similar. In addition, respondents supported the recognition of these trade receivables at transaction price, because it aligns the requirements in IFRS 9 with revenue recognition requirements and results in the amortised cost of these receivables at initial recognition being closer to fair value.

BC5.223 Respondents indicated that they would not have significant operational difficulty in applying an impairment model based on expected credit losses to their trade receivables without a significant financing component. While these participants acknowledge that such an impairment model would require a change in practice, they believe that they can incorporate forward-looking information within their current methodologies. In addition, the outreach participants noted that the IASB had made the application of the impairment model to current trade receivables (ie those that are not past due) more operational without the loss of useful information.

BC5.224 The IASB therefore decided to retain the proposed approach for trade receivables without a significant financing component.

Appendix B

Extracts from the Basis for Conclusions of IFRS 7

Credit risk exposure

BC48CC Because the recognition of lifetime expected credit losses is based on a significant increase in credit risk since initial recognition, there could be a wide range of initial credit risk for which 12-month expected credit losses is recognised (for example, loans that are originated with a high credit risk but have not increased in credit risk subsequently would have a loss allowance based on 12-month expected credit losses as would high quality loans that have not significantly increased in credit risk since initial recognition). To provide users of financial statements with information about the changes in the loss allowance and the entity's exposure to credit risk on financial instruments, the 2013 Impairment Exposure Draft proposed a disaggregation of the carrying amounts of financial instruments into credit risk categories, for both 12-month and lifetime expected credit losses.

BC48DD Disaggregating by credit risk shows the entity's exposure to credit risk and its credit risk profile at a given point in time (ie the reporting date). Users of financial statements indicated that they were concerned about the relative nature of the disclosure that is based on the range of credit risk relevant to the entity's portfolio and that it would lack comparability as a result (ie a high risk for one entity may only be a medium risk for another). Furthermore, without vintage information, a user would not be able to determine whether changes in the risk profile are a result of changes in the credit risk of existing financial instruments or a result of the credit risk of new instruments recognised during the period. However, they believed that risk disaggregation would still provide insight into an entity's exposure to credit risk and were therefore in favour of including it in the notes to the financial statements. The Board required the disclosure because changes in risk will affect the measurement of expected credit losses and it would therefore provide users of financial statements with information about the drivers of the change in the measurement. The Board also noted that this disclosure, particularly when considered together with the reconciliation of the gross carrying amount and loss allowance, provides relevant and useful information about credit risk migration and changes in overall credit risk over time.

BC48EE The Board considered adding language to the proposed disclosure that would have required an entity to reconcile this disclosure to internal credit rating grades. However, responses to the Supplementary Document considered this internal risk-rating information to be proprietary and therefore objected to this level of specificity. Consequently, the Board decided not to propose this reconciliation.

BC48FF Some respondents to the 2013 Impairment Exposure Draft also commented that the disclosure was incompatible with the credit risk management practices for some asset classes and for non-financial entities, and noted that the disclosure should be aligned with an entity's internal credit risk approach. In the light of this feedback the Board decided to remove the requirement to provide a disaggregation across a minimum of three credit risk rating grades, and instead require that the disaggregation to be aligned with how credit risk is managed internally. The

Board additionally decided to permit the use of an ageing analysis for financial assets for which delinquency information is the only borrower-specific information available to assess significant increases in credit risk.