STAFF PAPER

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IASB® meeting

Project	**Second Comprehensive Review of the *IFRS for SMEs*® Standard**
Paper topic	Towards an Exposure Draft—IFRS 9 *Financial Instruments* (Impairment of Financial Assets)
CONTACT(S)	Jan Carlo T Pereras cpereras@ifrs.org

Introduction

1. This paper seeks direction from the International Accounting Standards Board (IASB) on whether and, if so, how to align Section 11 *Basic Financial Instruments* of the *IFRS for SMEs* Standard with the impairment requirements in IFRS 9 *Financial Instruments*.

2. In this paper, the term SMEs refers to small and medium-sized entities that are eligible to apply the *IFRS for SMEs* Standard.

Purpose of the paper

3. The purpose of this paper is to ask the IASB to:

   (a) consider feedback on the Request for Information *Comprehensive Review of the* IFRS for SMEs *Standard*, published in January 2020, and the recommendations of the SME Implementation Group (SMEIG) on aligning the *IFRS for SMEs* Standard with the simplified approach to the impairment of financial assets in IFRS 9 (Question S3B of the Request for Information); and

   (b) provide direction on whether and, if so, how to amend the *IFRS for SMEs* Standard to align the impairment requirements with IFRS 9.

Structure of the paper

4. This paper is structured as follows:
   (a) background (paragraphs 6–7 of this paper);
   (b) question in the Request for Information (paragraph 8 of this paper);
   (c) feedback on the Request for Information (paragraphs 9–21 of this paper);
   (d) feedback from preparer interviews (paragraphs 22–23 of this paper);
   (e) SMEIG recommendations (paragraphs 24–27 of this paper);
   (f) additional work performed (paragraphs 28–35)
   (g) staff analysis (paragraphs 36–61 of this paper); and
   (h) question for the IASB (paragraph 62 of this paper).
5. Appendices to this paper include:
   (a) Appendix A—extract from the Request for Information on aligning the *IFRS for SMEs* Standard with IFRS 9; and
   (b) Appendix B—impairment requirements in the *IFRS for SMEs* Standard and IFRS 9.

Background—Differences between the *IFRS for SMEs* Standard and IFRS 9

6. Appendix B to this paper summarises the impairment requirements for financial assets in the *IFRS for SMEs* Standard and IFRS 9. Comparing the requirements for impairment of financial assets in the *IFRS for SMEs* Standard and IFRS 9, the main differences are:
   (a) scope of impairment. Applying the *IFRS for SMEs* Standard, all debt instruments and those equity instruments measured at cost (when fair value cannot be measured reliably without undue cost or effort) are subject to impairment. Applying IFRS 9, all financial assets except for debt instruments measured at fair value through profit or loss and equity instruments are subject to impairment.

(b) approach to impairment. The *IFRS for SMEs* Standard has an 'incurred loss' model whereas IFRS 9 has an 'expected credit loss' model. Under the incurred loss model, impairment loss is only recognised when there is objective evidence of impairment, a recognition threshold. Under the expected credit loss model, this threshold is eliminated and impairment loss is always accounted for.[1] An expected credit loss model requires the incorporation of forward-looking factors in its assessment in addition to historical and current information. The two impairment models also differ when it comes to individual and collective impairment assessments. The *IFRS for SMEs* Standard *prescribes* which financial assets should be assessed for impairment individually or collectively whereas in IFRS 9, individual and collective assessment is linked to assessing changes in credit risk and IFRS 9 *describes* circumstances when such an assessment is appropriate.

7. The key differences between the impairment requirements for financial assets of the *IFRS for SMEs* Standard and IFRS 9 are summarised in the following table.

<table>
<tr><th></th><th>Section 11
(incurred loss model)</th><th>IFRS 9
(expected loss model)</th></tr>
<tr><td>Trade receivables/contract assets:
- without significant financing component</td><td rowspan="3">Carrying value less present value of estimated cash flows, when there is objective evidence of impairment</td><td>Simplified approach</td></tr>
<tr><td>- with significant financing component
Lease receivables</td><td>General approach or simplified approach</td></tr>
<tr><td>Other debt instruments (loans, investments in bonds, bank placements)</td><td>General approach</td></tr>
</table>

[1] Paragraphs BCE.107–108, Basis for Conclusions on IFRS 9 *Financial Instruments*

Investment in equity instruments *	Carrying value less best estimate of the amount that entity would receive if the asset were to be sold	Not applicable
Individual and collective impairment assessment	Individually for all equity instruments regardless of significance and those financial assets that are individually significant.	Linked to assessment of changes in credit risk and depends on circumstances and nature of the financial asset

* For investments in equity instruments:

- applying IFRS 9, they are measured at fair value. In some cases, cost may be the appropriate estimate of fair value (see paragraph B5.2.3 of IFRS 9).
- applying the *IFRS for SMEs* Standard, if publicly traded or fair value can be measured reliably without undue cost or effort, they are measured at fair value. Otherwise, they are measured at cost less impairment.

Question in the Request for Information

8. Question S3B of the Request for Information asked for views on aligning the *IFRS for SMEs* Standard with the simplified approach to the impairment of financial assets in IFRS 9. Appendix A of this paper explains the IASB's reasons for asking this question.

Feedback on the Request for Information

Overall feedback

9. Overall, there were mixed views on aligning the impairment requirements in Section 11 of the *IFRS for SMEs* Standard with the simplified approach in IFRS 9. While there was support for alignment there were also calls for the simplified approach in IFRS 9 to be further simplified. For example, measure expected credit losses (ECL) as contractual cash flows less expected cash flows based on

management's 'best estimate' (best estimate approach) instead of considering a weighted probability of a range of possible outcomes. In addition, some respondents suggested including illustrative examples in the *IFRS for SMEs* Standard.

Feedback from comment letters

10. Fifty-one comment letters responded to Question S3B on the alignment of impairment requirements in the *IFRS for SMEs* Standard with the simplified approach in IFRS 9. Respondents who commented expressed mixed views. Although, many respondents supported the alignment, many also suggested further simplifications to the simplified approach in IFRS 9. Some respondents expressed concerns and disagreed with alignment.

11. Many respondents supported alignment with the simplified approach in IFRS 9 as this specifically addresses impairment of financial assets held by entities with less complex transactions and reduces costs by removing the need to monitor changes in credit risk.

12. A respondent noted that SMEs are already intuitively applying the principles of forward-looking ECL when extending credit to customers.

13. Some respondents noted that if the *IFRS for SMEs* Standard is aligned with the expected credit loss model in IFRS 9, users would be able to better predict future cash flows which is important to users of SMEs' financial statements. For example, one respondent said:

> … if Section 11 in the *IFRS for SMEs* were amended to include the simplified approach in IFRS 9 (that requires the loss allowance to be measured at an amount equal to lifetime expected credit losses), users would be better able to predict future cash flows than they could using the incurred loss model in Section 11.

14. However, some of these respondents expressed concerns that the simplified approach in IFRS 9 is still complex for SMEs. For example, an accounting firm said:

> … We anticipate significant challenges to preparers of the financial statements in terms of the *IFRS for SMEs* Standard to comply with the requirements to measure the impairment losses in this manner. Moreover, faithful representation—when analysed from the perspective of the user—is

> not significantly enhanced by the inclusion of the simplified model to justify the cost. Given the inherent complexities of the IFRS 9 model, and the potentially constrained resources of SME preparers, we consider retaining the impairment model in IAS 39 as sufficient to meet the information needs of users. We suggest retaining the IAS 39 incurred loss model due to the simplicity that it brings when compared to the complexities of IFRS 9 (such as the inclusion of forward-looking information). The incurred loss model had been in place for several years under full IFRS. Users of the financial statements prepared using *IFRS for SMEs* understand the concept of incurred loss, and they can draw appropriate conclusions based on the information currently presented under the incurred loss model…

15. Some respondents suggested that the IASB consider the following in aligning the *IFRS for SMEs* Standard with the simplified approach:

    (a) using a 'best estimate' approach rather than a weighted probability of a range of possible outcomes to estimate ECL. A respondent said that this would be appropriate for trade receivables.

    (b) require the 'provision matrix' approach in measuring ECL.[2]

    (c) including illustrative examples in the *IFRS for SMEs* Standard and issuing educational material that supports the implementation of ECL for SMEs.

16. Some respondents disagreed with aligning the *IFRS for SMEs* Standard with the expected credit loss model in IFRS 9, including the simplified approach. For example, some of these respondents noted that the impairment model in IFRS 9 is not relevant to SMEs. In their opinion, the model (including the simplified approach) is complicated therefore it would be difficult for SMEs to apply and would impose undue cost or effort on smaller SMEs. Nevertheless, a few of these respondents said that if the IASB should proceed with the alignment, the *IFRS for SMEs* Standard should be aligned with the simplified approach as proposed in the Request for Information, rather than fully aligned with the approach in IFRS 9.

17. Some of the respondents who disagreed with alignment suggested that the IASB should wait until the completion of the Post-implementation Review of IFRS 9 before

[2] An example of a provision matrix is described in paragraph B5.5.35 of IFRS 9, specifying fixed provision rates depending on the number of days that a trade receivable is past due (for example, 1% if not past due, 2% if less than 30 days past due, 3% if more than 30 days but less than 90 days past due, 20% if 90–180 days past due etc).

considering whether to align the *IFRS for SMEs* Standard with the simplified expected credit loss approach.

18. In responding to the Request for Information, some respondents noted the following:

    (a) if the IASB proceeds with alignment with the simplified approach, the IASB should consider whether the approach should be applied only to those financial assets to which it is applied in IFRS 9 (trade receivables, contract assets and lease receivables) or to all financial assets within the scope of the *IFRS for SMEs* Standard; and

    (b) whether the general approach in IFRS 9, which requires monitoring of changes in credit risk, should be applied in certain circumstances (for example, financial assets with a term of more than one year).

Feedback from the online survey and outreach events

19. Many respondents to the online survey supported the alignment of the *IFRS for SMEs* Standard with the simplified approach. Twelve of the 17 (71%) online survey respondents supported the alignment. They noted:

    (a) that the simplified approach in IFRS 9 is easy to apply and will not lead to undue cost or effort for SMEs; and

    (b) some suggestions about the use of a provision matrix under the simplified approach:

        (i) remove the requirements to use appropriate groupings of trade receivables if the historical credit loss experience shows significantly different loss patterns for different customer segments; and

        (ii) allow ECL to be calculated on the total balance of trade receivables rather than by category.

20. Five (29%) online survey respondents disagreed with alignment and noted that the expected credit loss model in IFRS 9 is complex for SMEs to apply.

21. Participants in outreach events raised specific concerns on applying the simplified approach. These concerns include:

    (a) complexity of the simplified approach and the need to further simplify it;

(b) request for additional guidance on incorporating forward-looking information;

(c) implementation costs could be high;

(d) some large companies find the approach challenging;

(e) application of the simplified approach to intercompany loans and advances could be challenging; and

(f) applying the provision matrix could be difficult.

Feedback from preparer interviews

22. The staff interviewed four global preparers[3] in their application of the expected credit loss model in IFRS 9 including the simplified approach. They noted:

(a) implementation of the expected credit loss model was challenging but ongoing application is straightforward. However, less sophisticated SMEs might find it difficult to incorporate forward-looking considerations into their existing impairment model.

(b) for financial assets, in particular trade receivables, they assess impairment both individually and collectively, and make use of a provision matrix.

(c) given the short-term nature of most trade receivables, the difference between the 12-month ECL and the lifetime ECL is often insignificant and requiring the loss allowance for all trade receivables to be measured at lifetime ECL at each reporting date could be a welcome relief.

23. One preparer suggested that in aligning the impairment requirements in Section 11 of the *IFRS for SMEs* Standard with IFRS 9 the IASB should include the description of cash shortfall in IFRS 9 to describe how expected credit loss is measured (being the difference between contractual cash flows and expected cash flows, see paragraph B5.5.28 of IFRS 9).[4]

[3] Preparers include finance officers and accountants preparing general purpose financial statements.

[4] Paragraph B5.5.28 of IFRS 9 describes a cash shortfall as the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive.

SMEIG recommendations[5]

24. The SMEIG met in February 2021 to discuss the feedback to the Request for Information and the staff preliminary thoughts.

25. Based on the feedback received on the Request for Information the staff's preliminary thoughts were that the IASB should undertake additional work to understand the practical challenges entities face in implementing or applying the simplified approach to decide on whether to propose amendments to the *IFRS for SMEs* Standard to align with IFRS 9. SMEIG members supported this suggestion.

26. One SMEIG member said the incurred loss model in the *IFRS for SMEs* Standard should be retained because the simplified approach would be difficult for SMEs to apply.

27. Some SMEIG members suggested considering further simplifications of the simplified approach (for example, using the 'best estimate' of lifetime ECL instead of using weighted probability of a range of possible outcomes).

Additional work performed

28. As noted in paragraph 25, the staff performed additional work by:

    (a) interviewing preparers (see paragraphs 22–23); and

    (b) developing proposals with a subgroup of SMEIG members (see paragraphs 29–35).

Developing proposals with a subgroup of SMEIG members

29. The staff consulted with a subgroup of SMEIG members in developing the proposals on how to align the impairment requirements in Section 11 of the *IFRS for SMEs* Standard with the simplified approach in IFRS 9. Given that this is a specialised area, the staff asked SMEIG members for volunteers with practical experience or expertise in application of IFRS 9's expected credit loss model and/or accounting for financial

[5] The Report on the SMEIG meeting, held via remote participation, on 4–5 February 2021 can be accessed here.

guarantees to help staff develop proposals. All SMEIG members were given the opportunity to comment on the staff proposals once developed.

30. In exploring how to align with the simplified approach for SMEs, the staff made the following assumptions which were discussed (and agreed) with the subgroup of SMEIG members:

    (a) for debt instruments:

        (i) SMEs' debt instruments consist principally of trade receivables.

        (ii) typically trade receivables are short-term and non-interest bearing. Given the short-term nature, SMEs include forward-looking information when applying impairment requirements in Section 11 (eg, they consider current and future economic conditions in performing their impairment assessment) and time value, if considered, is insignificant and can be ignored.

        (iii) for SMEs with voluminous trade receivable accounts, many are currently applying a collective impairment approach using a provision matrix.

        (iv) SMEs maintain relationships with their customers and partners albeit on a less formal/ structured basis compared to public accountable entities. SMEs likely understand the credit quality of their customers and partners on an individual or collective basis.

    (b) for equity instruments:

        (i) SMEs, if they invest in equity instruments, often hold shares traded in a public market (eg. stock exchange).

        (ii) when fair value is not available without undue cost or effort, equity instruments are measured at cost less impairment, measured applying paragraph 11.25(b) of the *IFRS for SMEs* Standard. This amount might be considered a prudent estimate of the fair value of the equity instruments, because if the asset is impaired it is measured at the amount that the SME would expect to receive if it sold the asset, otherwise it is measured at cost.

31. The staff discussed two alternative possible simplifications for measuring impairment loss based on an expected credit loss model for SME's debt instruments with the subgroup of SMEIG members:

    (a) *Alternative 1*—measure ECL at each reporting date as contractual cash flows less expected cash flows (akin to a 'cash shortfall' as described in paragraph B5.5.28 of IFRS 9) using the SME's best estimate of the expected cash flows instead of evaluating a range of possible outcomes, and allow the use of a provision matrix as a practical expedient.

    (b) *Alternative 2*—for trade receivables and contract assets arising from transactions within the scope of Section 23 *Revenue* of the *IFRS for SMEs* Standard[6], measure impairment loss at each reporting date as described in alternative 1; for other debt instruments, measure impairment loss at each reporting date applying the simplified approach in IFRS 9; and allow the use of a provision matrix as a practical expedient for all debt instruments.

32. Under both alternatives in paragraph 31, the other inputs to measuring ECL would remain the same (consideration of the time value of money, and reasonable and supportable information about past events, current conditions and forecasts of future economic conditions).

33. The subgroup of SMEIG members generally supported using a best estimate of ECL. In addition, some suggested that instead of using forward-looking information, an SME could use historical loss experience as the main basis to measure ECL.

34. One SMEIG member supported Alternative 2. Other SMEIG members of the sub-group supported Alternative 1.

35. Some participants in the SMEIG subgroup noted that SMEs also invest in shares that are not traded in a public market and where it might not be possible to measure fair value reliably without undue cost or effort. Nevertheless, they agree that the current measurement requirements in Section 11 for impairment of equity instruments measured at cost should be left unchanged.

[6] In its October 2021 meeting, the IASB tentatively decided to develop amendments to the *IFRS for SMEs* Standard to align it with IFRS 15 *Revenue from Contracts with Customers* by rewriting Section 23 *Revenue* of the *IFRS for SMEs* Standard to reflect the principles and language used in IFRS 15.

Staff analysis—applying the alignment principles

36. In considering whether and, if so, how to align the *IFRS for SMEs* Standard with new and amended IFRS Standards, the IASB agreed to apply the three 'alignment principles' on which the IASB consulted in the Request for Information (relevance to SMEs, simplicity and faithful representation—see Agenda Paper 30 *Cover paper*) including the assessment of costs and benefits. When analysing the feedback on the Request for Information, the SMEIG recommendations and the alternatives for simplification discussed in paragraph 31, the staff have applied these alignment principles.

Relevance to SMEs

37. Relevance to SMEs requires consideration of whether SMEs would be affected by the impairment requirement in IFRS 9 and, if they are, whether alignment with IFRS 9's impairment requirements (recognition and measurement of impairment) would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Standard.

38. SMEs have financial assets; different SMEs have exposure to different financial assets depending on the nature of their business operations. For financial assets measured on a historical cost basis (cost or amortised cost), timely recognition of impairment losses is fundamental. Therefore, the consideration becomes whether applying the impairment requirements in IFRS 9, rather than those in Section 11, would make a difference in the decisions of users of financial statements.

39. The main criticism with the incurred loss model is that it may delay an SME's recognition of credit losses because an impairment test is not required until there is objective evidence of impairment. The expected credit loss model removes this 'trigger event' and impairment loss is always accounted for. The expected credit loss model enables users to better predict future cash flows than they can based on information from the incurred loss model (as noted by respondents in paragraph 11 of the paper) as cash flows are based on an entity's expectation that considers past, current and forecast information. Aligning the impairment requirements in Section 11

of the *IFRS for SMEs* Standard with IFRS 9 would allow these improvements to be reflected in SME financial statements.

40. Some respondents said that due to the complexity of applying the expected credit loss model for SMEs with limited resources (for example, considering forward-looking information and probable outcomes), the *IFRS for SMEs* Standard should not be aligned with the impairment requirements of IFRS 9.

41. Other respondents suggested that IASB should wait until the completion of the Post-implementation Review of IFRS 9 before considering alignment. The staff also note that in September 2016, the UK Financial Reporting Council (UK FRC) considered amending FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* [7] to incorporate the expected credit loss model in IFRS 9 (as part of its triennial review of UK and Republic of Ireland Financial Reporting Standard). In June 2017, the FRC published its feedback on its triennial review[8]. The FRC said that further evidence-gathering and analysis needs to be undertaken before a decision is made on the most appropriate timetable and approach for reflecting the principles of the expected credit loss model from IFRS 9 in FRS 102, if at all. This includes further consideration of whether different approaches are appropriate for financial institutions (or a sub-set thereof) and other entities within the scope of FRS 102.

42. Although not aligning or waiting until the post implementation review is completed before considering alignment may reduce cost for SMEs, this needs to be balanced with the loss or delay of the improvement to information for users of financial statements prepared applying the *IFRS for SMEs* Standard.

43. The staff think that the *relevance* condition is met. Timely recognition of impairment is fundamental to financial assets measured on a historical basis. The issue addressed by IFRS 9's impairment requirements (recognition and measurement of impairment) would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Standard—it addresses the weakness of the incurred loss

[7] FRS 102 is based on the *IFRS for SMEs* Standard. However, the scope of FRS 102 is wider than that of the IFRS for SMEs Standard so that some entities that would otherwise be precluded from applying the Standard could apply FRS 102, including financial institutions.

[8] Feedback Statement: Consultation Document Triennial review of UK and Ireland accounting standards - Approach to changes in IFRS

model and provides better information to users because users would be able to better predict future cash flows.

44. As discussed in the Request for Information (see Appendix A) the general approach to impairment in IFRS 9 would not be relevant to many entities applying the *IFRS for SMEs* Standard. However, the simplified approach in IFRS 9 applies to trade receivables, contract assets and lease receivables, which are financial assets commonly held by many SMEs. Therefore, as noted in paragraph 8 of the paper, the IASB sought views specifically on aligning Section 11 with the simplified approach.

Simplicity

45. The feedback on the Request for Information provides evidence that applying the simplified approach in IFRS 9 is complicated for SMEs. Despite this, the staff think that moving to an expected credit loss model is relevant to SMEs and particularly beneficial to users of SME financial statements. However, to respond to concerns about complexity, the staff performed the additional work in paragraph 28 to analyse how the simplified approach in IFRS 9 could be further simplified for SMEs. Two alternatives for measuring impairment loss based on an expected credit loss model were explored by the staff as described in paragraph 31 (Alternative 1 and 2).

46. Alternative 1 and Alternative 2 are compared in paragraph 47 and the adaptations to the simplified approach made in developing these alternatives are discussed in paragraphs 48–51. The IASB could explore these two alternatives (or develop another alternative) in considering whether to replace the incurred loss model in Section 11 with an expected credit loss model. On the other hand, the IASB could decide to retain the impairment requirements in Section 11, considering the feedback that the simplified approach in IFRS 9 is complex for SMEs and the costs of applying it to the types of instruments principally held by SMEs may not justify the benefits to users of SME financial statements. The IASB might also decide to retain the impairment requirements in Section 11 if it considers that any simplifications made to the simplified approach would undermine the quality of information reported to users (discussion on *faithful representation* is in paragraphs 53–56).

Comparing Alternative 1 and Alternative 2 (see paragraph 31)

47. Alternative 1 is likely to be simpler for SMEs to apply than Alternative 2 as it requires a single simplified approach for all debt instruments, and considers the costs of developing estimates to measure ECL and the resources available to SMEs. Furthermore, a single approach would also enhance comparability of SMEs' financial statements and may be easier for users to understand. Alternative 1 is also supported by the assumption that SMEs' debt instruments typically consist of short-term receivables. There could be instances where an SME holds a different kind of financial asset and the simplified approach in IFRS 9 (and hence Alternative 2) might be suitable, for example, when a debt instrument constitutes a financing transaction, eg a long-term lease receivable, or when an SME has an investment in long-term bonds. However, the staff think that these types of instruments are not commonly held by SMEs, particularly those that might have a material impairment loss. Therefore, it could be argued that Alternative 2 would add complexity to the Standard for all SMEs to cater for the needs of few SMEs with less common instruments whose financial statement users might benefit from the information provided by Alternative 2.

Best estimate

48. Respondents said that measuring ECL based on a probability-weighted estimate considering a range of possible outcomes would be difficult for an SME to apply. Many comment letter respondents said that an SME could instead use its best estimate of ECL rather than a probability-weighted estimate. 'Best estimate' is a term already used in several sections of the *IFRS for SMEs* Standard and one that SMEs are familiar with (eg see paragraphs 11.24, 18.5, and 21.7). As such, using the best estimate could facilitate the application of the simplified approach.

(a) Section 11 of the *IFRS for SMEs* Standard requires that impairment loss for financial assets measured at cost less impairment to be measured as the difference between the asset's carrying amount and the best estimate of the amount that the entity would receive for the asset if it were to be sold at the reporting date.

(b) Section 18 *Intangible Assets* of the *IFRS for SMEs* Standard requires that an entity assess the probability of expected future economic benefits using reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the useful life of the asset.

(c) Section 21 *Provisions and Contingencies* describes best estimate as the amount an entity would rationally pay to settle an obligation at the end of the reporting period or to transfer it to a third party at that time.

Forward-looking considerations

49. An expected credit loss model would require an SME to consider forward-looking information in addition to past and current information.

50. In April 2012, when developing IFRS 9, the IASB considered whether to apply an incurred loss model or expected loss model to trade receivables (that do not constitute a financing transaction). At that meeting the IASB noted that outreach participants indicated they did not have significant operational concerns about applying an expected credit loss model to these assets, and that they already use forward-looking information to some extent in their impairment assessments.[9]

51. Financial assets typically held by SMEs are short-term trade receivables. Therefore, the staff think that although SMEs may have limited resources compared to many entities applying IFRS Standards, estimating lifetime ECL (albeit using the entity's 'best estimate') at each reporting date, considering current and forecast information, would not be difficult for most SMEs.

52. Feedback from the staff's additional work described in paragraph 28 provides support for an expected credit loss model based on Alternative 1 considering cost-benefits and the nature of debt instruments that SMEs typically hold. Nevertheless, as noted in paragraph 47, there could be instances where the simplified approach in IFRS 9 might be suitable, for example, if SMEs hold other kinds of financial assets eg investments in long-term bonds or other debt instruments. Consequently, the staff would like to seek the IASB's views on whether Alternative 1 and Alternative 2 meet the principle of faithful representation for SMEs.

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[9] Paragraph 26 of Agenda Paper 5E *Simplified approach for trade receivables and lease receivables* of the November 2013 IASB meeting.

Faithful representation

53. The principle of faithful representation is intended to help the IASB assess whether financial statements prepared applying the *IFRS for SMEs* Standard would faithfully represent the substance of economic phenomena in words and numbers. Simplifications that would result in financial statements that do not meet this criterion could damage the quality of information reported to users.

54. The staff think that the expected credit loss model described in Alternative 1 would faithfully represent the substance of economic phenomena (recognition and measurement of an impairment loss based on an expected credit loss model) for the types of financial assets typically held by SMEs and would not undermine the quality of information reported to users.

55. Using 'best estimate' instead of a 'probability-weighted estimate based on a range of possible outcomes' in estimating ECL would facilitate the application of an expected credit loss model in the *IFRS for SMEs* Standard. Typically, most financial instruments held by SMEs are short-term trade receivables, and so the 'future information' that an SME has to consider would be around one year or less. As such, the staff think that the difference between the 'best estimate' and a 'weighted probability based on a range of possible outcomes' in this instance would not be significant (since the variations between, and the number of, possible outcomes increases when the period an entity has to consider is longer). Therefore, the staff think that the best estimate of ECL would not result in an impairment model that gives a significantly different outcome from the expected credit loss model in IFRS 9 for the types of instruments typically held by SMEs.

56. Nevertheless, the staff would like to ask if IASB members are comfortable extending the best estimate approach to all financial assets held by SMEs (Alternative 1), noting that in some cases SMEs may have longer term receivables and debt instruments and Alternative 2 may provide a more faithful representation.

Assessment of costs and benefits

57. If the IASB consider replacing the incurred loss model in Section 11 of the *IFRS for SMEs* Standard with *an* expected credit loss model (eg Alternative 1), SMEs would incur initial implementation costs. These include, among others, potential changes in system and processes, and training costs. Aspects of an expected credit loss model that could be challenging to many SMEs include developing forecast information (see paragraph 58) and the subjectivity involved (see paragraph 59).

58. Nevertheless, for SMEs who mostly hold short-term debt instruments (eg. trade receivables), considering forecasts of future economic conditions would not be expected to cause significant difficulties as this would often be within 12 months from the reporting date—the same period that an SME should consider in assessing whether a going concern assumption is appropriate (see paragraph 3.8 of the *IFRS for SMEs* Standard).

59. Further, as discussed in paragraph 55, the outcome from using a best estimate approach would not be significantly different from the outcome from using a weighted probability estimate approach. Furthermore, the other inputs to measuring ECL would remain the same (considering time value of money, and reasonable and supportable information about past events, current conditions and forecast of future economic conditions). Therefore, SMEs could still utilise the knowledge and tools available in the market from the implementation of IFRS 9 in applying the expected credit loss model.

60. The staff think that the benefits of moving to an expected credit loss model (addressing the weakness of an incurred loss model and better information being provided to users) justifies the costs of applying it (potential changes in system and processes) if we consider the simplifications in Alternative 1. As noted in paragraph 47, the staff think that Alternative 2 would add complexity to the *IFRS for SMEs* Standard and could increase costs for all SMEs, to cater for the few SMEs that have less common financial assets and whose financial statement users might benefit from the information provided by Alternative 2.t To further facilitate the application of an expected credit loss model, some respondents said the IASB could include

illustrative examples into Section 11 of the *IFRS for SMEs* Standard or in educational materials.

Equity instruments

61. Section 11 requires equity instruments, whose fair value cannot be measured reliably without undue cost or effort to be measured at cost less impairment. However, IFRS 9 requires all equity instruments to be measured at fair value, and so the expected credit loss model does not apply to equity instruments. Consistent with the observation made in paragraph 30(b)(ii), the staff think that the requirements in Section 11 would result in measurement that could be considered as a prudent estimate of fair value of those equity instruments. This is because if the asset is impaired it is measured at the amount that the SME would expect to receive if it sold the asset at the reporting date, otherwise it is measured at its cost.

Question for the IASB

62. Based on the analysis in paragraphs 37–61, the staff would like to ask the IASB for its views on:

    (a) whether to propose amendments to the *IFRS for SMEs* Standard replacing the incurred loss model in Section 11 with either:

        (i) an expected credit loss model described in Alternative 1:

            1. for debt instruments, recognise and measure ECL at each reporting date as contractual cash flows less expected cash flows and use the SME's best estimate instead of evaluating range of possible outcomes in estimating ECL (other inputs to measuring ECL would still need to consider time value of money, and reasonable and supportable information about past events, current conditions and

forecast of future economic conditions), while allowing the use of a provision matrix as a practical expedient; and

2. for equity instruments, leave unchanged the requirements (including the requirements on measuring impairment) in the *IFRS for SMEs* Standard; or

(ii) an expected credit loss model described in Alternative 2:

1. for trade receivables and contract assets arising from transactions within the scope of Section 23 of the *IFRS for SMEs* Standard, measure impairment loss at each reporting date as described in Alternative 1;

2. for other debt instruments, measure impairment loss at each reporting date applying the simplified approach in IFRS 9; and allow the use of a provision matrix as a practical expedient for all debt instruments; and

3. for equity instruments, leave unchanged the requirements (including the requirements on measuring impairment) in the *IFRS for SMEs* Standard; or

(b) if the IASB disagrees with the two alternatives above, whether to retain the existing impairment requirements in Section 11 of the *IFRS for SMEs* Standard.

Question for the IASB
What are the IASB's views on paragraph 62?

Appendix A—Extract from the Request for Information on aligning the *IFRS for SMEs* Standard with IFRS 9

A1. In considering aligning the requirements for impairment of financial assets in Section 11 with IFRS 9, the Board noted that the scope of the *IFRS for SMEs* Standard excludes any entity that holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. Most banks, credit unions, insurance companies, securities brokers, securities dealers, mutual funds and investment banks satisfy this criterion. Therefore, the general approach to impairment in IFRS 9 would not be relevant to many entities applying the *IFRS for SMEs* Standard.

A2. IFRS 9 includes a simplified approach that applies to trade receivables, contract assets and lease receivables. It requires the loss allowance to be measured at an amount equal to lifetime expected credit losses. The simplified approach reduces the need to track separately increases in credit risk. Therefore, the simplified approach alleviates the practical concerns about using the general approach for tracking changes in credit risk to determine whether there has been a significant increase in credit risk.

A3. The Board decided to seek views on replacing the incurred loss model in Section 11 for the impairment of financial assets with the simplified approach in IFRS 9. It did so because the expected credit loss model is widely regarded as an improvement on the approach in IAS 39 *Financial Instruments: Recognition and Measurement*. Furthermore, if Section 11 were amended to include the simplified approach in IFRS 9, users would be better able to predict future cash flows than they can using the incurred loss model in Section 11.

Appendix B—Impairment requirements in the *IFRS for SMEs* Standard and IFRS 9

IFRS for SMEs *Standard—the incurred loss model*

B1. Section 11 of the *IFRS for SMEs* Standard sets out the impairment requirements for financial assets within the scope of its section. The impairment requirements in Section 11 are based on the principles in IAS 39 *Financial Instruments: Recognition and Measurement*. The *IFRS for SMEs* Standard uses an 'incurred loss' model in its impairment of financial assets—impairment loss is recognised only when there is objective evidence of impairment.

(a) for debt instruments, impairment loss is the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the asset's original effective interest rate.

(b) for equity instruments whose fair value cannot be measured reliably without undue cost or effort (see paragraph 11.14(c) of the *IFRS for SMEs* Standard) they are measured at cost less impairment. Impairment loss is measured as the difference between the equity instrument's carrying amount and the best estimate of the amount that the SME would receive for the asset if it were to be sold at the reporting date.

Collective and individual assessment

B2. Section 11 requires that an entity assess individually for impairment (i) all equity instruments regardless of significance and (ii) those financial assets that are individually significant. Other financial assets are assessed either individually or grouped on the basis of similar credit risk characteristics (see paragraph 11.24 of the *IFRS for SMEs* Standard).

IFRS 9—the expected credit loss model

B3. IFRS 9 uses an 'expected credit loss' model. This model is forward-looking and it eliminates the threshold for the recognition of an impairment loss on financial asset (ie impairment loss is accounted for every reporting date regardless whether objective evidence of impairment exists).

B4. ECL are a probability-weighted estimate of credit losses (ie present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the contractual cash flows and expected cash flows. When measuring ECL, IFRS 9 requires the entity to consider:

(c) the probability-weighted outcome. ECL should represent neither a best or worst-case scenario. Rather the estimate should reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs.

(d) time value of money. ECL should be discounted to the reporting date.

(e) reasonable and supportable information that is available without undue cost or effort that includes historical, current and forecast information.

B5. ECL is recognised as a loss allowance at each reporting date to reflect changes in credit risk of the debt instruments—if credit risk has increased significantly since initial recognition of the debt instruments, lifetime ECL is recognised on those financial assets; if not, 12-month ECL is recognised. This is referred to as the general approach (see paragraphs 5.5.1–5.5.8). The general approach is:

(a) *available* as an accounting policy choice for trade receivables or contract assets with significant financing component and lease receivables; and

(b) *required* for all other types of debt instruments.

B6. Despite this, an entity could measure the loss allowance equivalent to lifetime ECL at each reporting date without the need to monitor changes in credit risk of the debt instruments. This is referred to as the simplified approach (see paragraphs 5.5.15–5.15.16). The simplified approach is:

(a) *available* as an accounting policy choice for trade receivables or contracts assets with significant financing component and lease receivables; and

(b) *required* for trade receivables or contract assets without a significant financing component.

B7. Further, IFRS 9 requires all investments in equity instruments to be measured at fair value and as such they are not subject to its impairment requirements (see paragraphs B5.2.3–B5.2.6).

Collective and individual assessment

B8. Assessment of significant increases in credit risk may be done on a collective basis, for example on a group or sub-group of financial instruments. This is to ensure that lifetime ECL are recognised when there is a significant increase in credit risk even if evidence of that increase is not yet available on an individual level. Typically, credit risk increases significantly before a financial instrument becomes past-due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed.

B9. However, depending on the nature of the financial instrument and the credit risk information available, an entity may not be able to identify significant changes in credit risk for individual financial instruments before delinquency. It may be necessary to group financial instruments to capture significant increases in credit risk on a timely basis (such as by identifying particular geographical regions that have been most adversely affected by changing economic conditions).