IFRS® Accounting

Staff paper

Agenda reference: 2

Global Preparers Forum

Date	**11 November 2022**
Project	**Post-implementation Review (PIR) of IFRS 9—Impairment**
Topic	**Phase 1—identifying matters to be examined**
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Purpose of this session

Ask GPF members to share their views on the application of the impairment requirements in IFRS 9 *Financial Instruments* and the related credit risk disclosures in IFRS 7 *Financial Instruments*: *Disclosures*, as well as matters they think should be considered by the IASB in the post-implementation review (PIR) of these requirements

Information for GPF members

- Slide 3 sets out the questions for GPF members
- Slides 5–8 provide PIR objective and process
- Slides 9–12 provide background information related to IFRS 9
- Slides 13–28 include detailed information on eight topics of the impairment requirements

Questions for GPF members

A	**Are there fundamental questions (ie 'fatal flaws') on the clarity and suitability of the core objectives or principles in the impairment requirements?**	• Do the requirements achieve the objective of providing useful information about changes in credit risk and timely recognition of expected credit losses (ECLs)?
B	**Are the benefits to users of financial statements from applying the requirements significantly lower than expected?**	• Are the requirements and application guidance capable of being applied consistently? If diversity in practice exists, in your view, what is the cause and effect of that?
C	**Are the costs of applying some or all of the requirements and auditing and enforcing their application significantly greater than expected?**	• Have you identified any significant effects (positive or negative) of applying the ECL requirements?

Supporting material

PIR objective and process

PIR—what is the objective?

OBJECTIVE

To **assess** whether the effects of applying the new requirements on users of financial statements, preparers, auditors and regulators are as intended when the IASB developed those new requirements

Overall, are the requirements working as intended?	**Fundamental questions** (ie 'fatal flaws') about the core objectives or principles—their clarity and suitability—would indicate that the new requirements are not working as intended
Are there specific application questions?	**Specific application questions** would not necessarily prevent the IASB from concluding that the new requirements are operating as intended but may nonetheless need to be addressed, if they meet the criteria for whether the IASB would take further action

PIR—how does the IASB respond to findings?

1 Consider whether to take action, based on the extent to which:

the **objective** of the new requirements is not being met;

benefits to users are significantly lower than expected

costs of applications are significantly higher than expected

2 Determine the prioritisation of the findings based on the extent to which :

finding has **substantial consequences**

finding is **pervasive**

finding arises from an issue that **can be addressed** by the IASB or the Interpretations Committee

the benefits of any action would be expected to **outweigh** the costs

3 Determining the timing of taking action

High priority	to be addressed as soon as possible
Medium priority	to be added to the IASB or the IFRIC research pipeline
Low priority	to be considered in the next agenda consultation
No action	require no further action

PIR—what is the process and where we are?

Phase 1
Identify matters to be examined

Phase 2
Consider feedback

Start when sufficient information is available

Publish public consultation requesting information

Report findings and next steps

H2 2022	Q4 2022 – Q1 2023	H1 2023
IASB decided to start PIR of Impairment	Phase 1 outreach and information gathering	Request for Information to be published

Background

IFRS 9 and PIRs

IFRS 9 was issued in July 2014 and:

- became effective for annual reporting periods beginning on or after 1 January 2018
- improved and simplified accounting that replaced IAS 39, including addressing the delayed recognition of credit losses and the complexity of multiple impairment models

Classification and measurement	A single logical classification approach driven by contractual cash flow characteristics and how the instrument is managed	PIR started in 2020
Impairment	A much needed and strongly supported forward-looking expected credit loss model	**First stage of PIR started in H2 2022**
Hedge accounting	An improved and widely welcomed model that better aligns accounting with risk management	IASB will consider in H2 2022 when to begin this PIR

A forward-looking impairment model

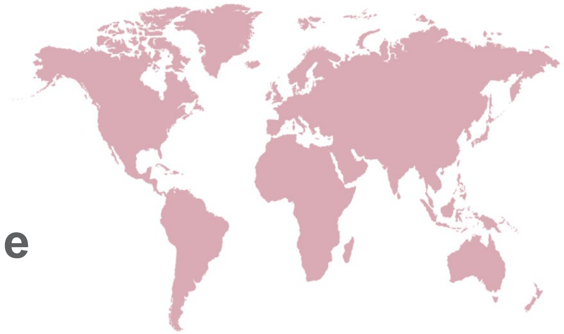
Addressing ‘too little, too late’

During the financial crisis, many stakeholders, including the G20, highlighted the delayed recognition of credit losses as weakness in the accounting standards at the time

In response, the IASB developed an expected credit losses impairment model that provides useful information to investors about expected credit losses to reflect changes in credit risk

Issues with IAS 39 impairment model	Solutions in IFRS 9
Delayed recognition of credit losses until evidence of a trigger event	Expected and updated credit losses recognised at all times. Eliminates the need for a trigger event
Credit losses reflective of past events and current conditions—future losses not considered	More timely recognition of expected credit losses based on historical, current and forecast information
Multiple impairment models for financial instruments	Same impairment model is applied to all financial instruments that are subject to impairment accounting
Limited relevant information about changes in credit risk	Improved disclosures explaining the basis of expected credit losses and of changes in credit risk

A solid foundation for the PIR



The IASB has put significant efforts into monitoring and supporting the implementation of the impairment requirements in IFRS 9

The information gathered through all our activities since IFRS 9 was issued provides a solid foundation on which to start the PIR

Some examples of activities that directly relate to supporting implementation of the impairment requirements:

Provided supporting materials such as articles and webcasts

Established a Transition Resource Group for Impairment (ITG)

Analysed application questions at the IFRS Interpretations Committee

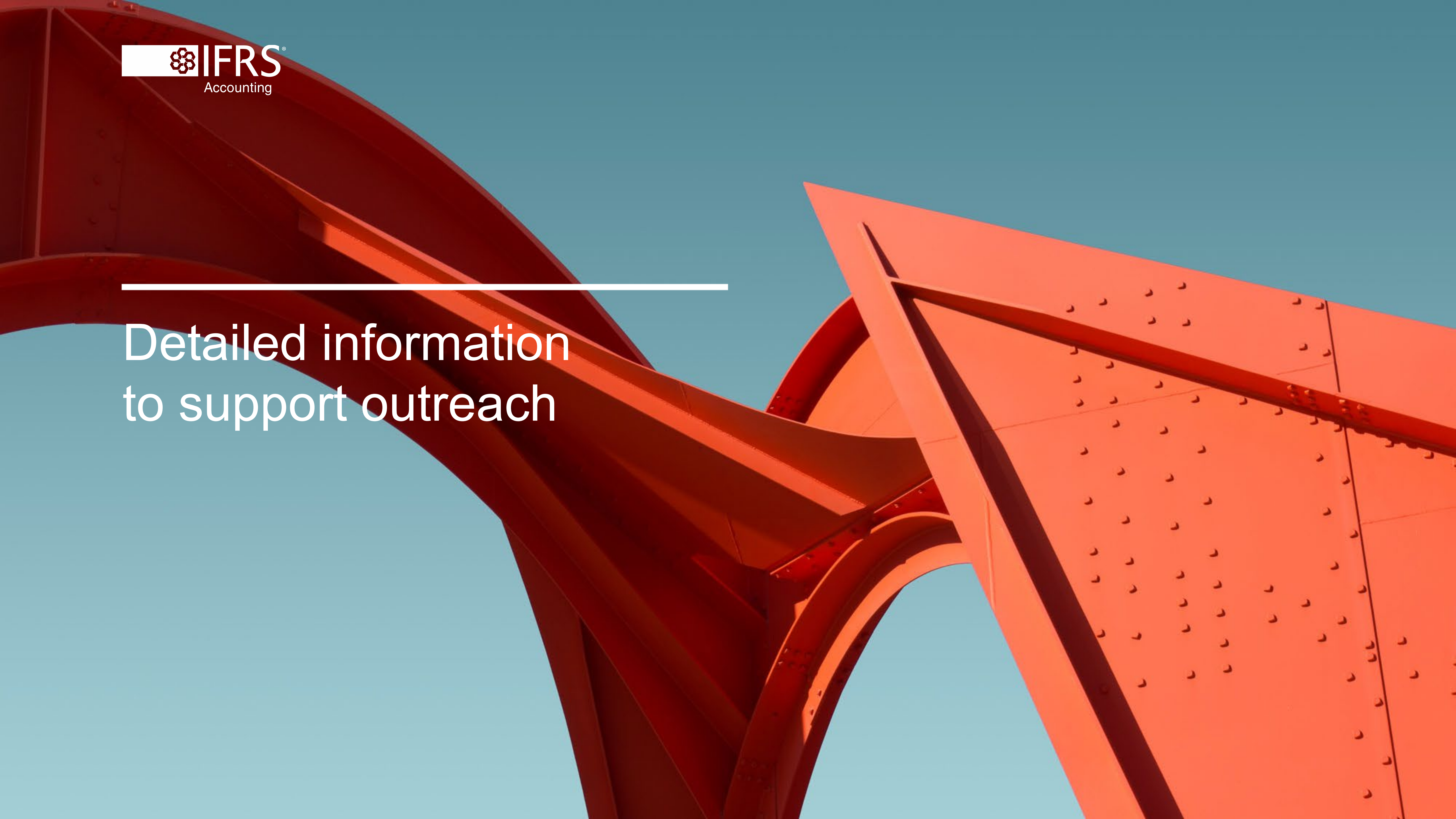
Provided educational material on applying IFRS 9 in the light of coronavirus uncertainty

32 Submissions discussed by the ITG

A wide variety of topics discussed, including: forward-looking information, loan commitments, revolving credit facilities

Agenda decisions finalised by the Committee include:

- Curing of a credit-impaired financial assets
- Credit enhancement in the measurement of expected credit losses



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Detailed information to support outreach

Impairment requirements—topic areas

1 General Approach

2 Determining significant increases in credit risk

3 Measurement of ECLs

4 Credit-impaired on initial recognition

5 Simplified approach for trade and lease receivables

6 Loan commitments and financial guarantees

7 Disclosures

8 Transition

Note

- Slides 15–28 provide an overview of the requirements for each of these areas

1. General approach—12-month or lifetime ECLs

BACKGROUND

- Users of financial statements supported an impairment model that distinguishes between financial instruments for which credit risk has increased significantly since initial recognition and those for which it has not, to provide useful information about changes in credit risk and the resulting economic losses
- The impairment model in IFRS 9 is therefore designed to be responsive to changes in credit risk and economic conditions. It achieves that by requiring:
  a. a loss allowance at an amount equal to at least 12-month ECLs is recognised throughout the life of financial assets, thereby:
     i. reducing the systematic overstatement of interest revenue in accordance with the requirements in IAS 39;
     ii. acting as a proxy for the recognition of initial expected credit losses over time; and
  b. lifetime ECLs are recognised when there are significant increases in credit risk since initial recognition, resulting in better reflection of true economic losses in the financial statements

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1. General approach—overview of the impairment model

12-month ECLs:

- are expected shortfalls in all contractual cash flows given probability of default occurring in next 12 months

not

- expected cash shortfalls in next 12 months
- credit losses on assets expected to default in next 12 months

Change in credit risk since initial recognition

	Stage 1 'Performing'	Stage 2 'Underperforming'	Stage 3 'Non-performing'/ Credit-impaired
Impairment	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest revenue	Gross basis	Gross basis	Net basis

Lifetime ECLs:

- result from all possible default events over the expected life of a financial instrument
- are weighted average credit losses with the probability of default as the weight
- are reflective of amount and timing—a loss arises even entity expects to be paid in full but later than contractually due

2. Determining significant increases in credit risk (SICR)

BACKGROUND

- The IASB's objective of the impairment requirements is to capture lifetime ECLs on all financial instruments that have SICR
- IFRS 9 has no bright lines and does not prescribe a specific or mechanistic approach to determine SICR. Nor does it mandate the use of an explicit probability of default to make this assessment. The appropriate approach will vary for different levels of sophistication of entities, the financial instrument and the availability of data

Why recognise lifetime expected credit losses only after SICR?

- When credit is first extended the initial creditworthiness of the borrower and initial expectations of credit losses are taken into account in determining acceptable pricing and other conditions
- A true economic loss arises when expected credit losses exceed initial expectations (ie when the lender is not receiving compensation for the level of credit risk to which it is now exposed). Recognising lifetime expected credit losses after a significant increase in credit risk better reflects that economic loss in the financial statements

2. Determining significant increases in credit risk

- Change in credit risk **over the life** of the instrument—risk of default occurring (not changes in ECLs)
  - – no definition of default, but rebuttable presumption that no later than 90 days past due
  - – maturity matters
- Compare to credit risk **at initial recognition**
  - – consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk
- Financial instruments that have **low credit risk** at the reporting date—ie a globally comparable notion of low credit risk, not based on entity-specific or jurisdictional factors
  - – may assume credit risk has not increased significantly
- More than 30 days past due
  - – rebuttable presumption that credit risk has increased significantly since initial consideration

3. Measurement of ECLs

BACKGROUND

- IFRS 9 was developed in response to requests by the G20 and others to provide more forward-looking information about credit losses and give transparent and timely information about changes in credit risk
- Entities are required to estimate ECLs based on the best available information about past events, current conditions and forecasts of economic conditions—that is, reasonable and supportable information available to an entity without undue cost or effort
- Entities are not required to use a ‘crystal ball’ to predict the future; what an entity uses depends on the availability of information. As the forecast horizon increases, it is expected that the specificity of information used to measure ECLs will decrease.
- The IASB noted that historical data is always considered to be an important anchor or base but should be adjusted on the basis of current observable data to reflect the effects of current conditions and forecasts of future conditions

3. Measurement of ECLs

ECLs need to reflect:

Probability-weighted outcome
Must consider at least possibility that default will/will not occur

Time value of money
Discount at effective interest rate or an approximation thereof

Reasonable and supportable information
Available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions

Particular measurement methods are not prescribed—designed to accommodate different information availability

An entity may use various sources of data that may be internal (entity-specific) and external

Information does not necessarily need to flow through a statistical model or credit-rating process in order to determine whether it is reasonable and supportable

Historical information can be used as a base but must be updated with current observable data to reflect the effects of current conditions and forecasts of future conditions

Information should not be excluded simply because:

- the event has a low or remote likelihood of occurring; or
- the effect of that event on the credit risk or the amount of expected credit losses is uncertain

4. Credit-impaired on initial recognition

- Applies to **purchased** and **originated** credit-impaired (POCI) financial assets
- Use **credit-adjusted effective interest rate**
  - No day 1 loss allowance balance
  - No day 1 impairment loss recognised
- Allowance balance always represents **cumulative changes** in lifetime ECLs

BACKGROUND

- The IASB considered but rejected a gross-up approach, whereby an allowance is recognised for initial expected credit losses and is used to gross-up the carrying amount of the POCI. This is because if assets are initially recognised at fair value and then grossed-up for the loss allowance balance, it would result in a carrying amount above fair value at initial recognition.
- Although the scope of requirements for credit-impaired assets usually relates to purchased financial assets, in unusual circumstances financial assets could be originated that would be within this scope (ie if a substantial modification of a distressed asset resulted in derecognition of the original financial asset)

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5. Simplified approach for trade receivables, contract assets and lease receivables

Trade receivables or contract assets that do **not** contain a significant financing component:	• Allowance is always lifetime ECLs • Provision matrix can be used
Trade receivables or contract assets that **do** contain a significant financing component and lease receivables:	Policy election: • general model or • always recognise lifetime ECLs

BACKGROUND

- When developing IFRS 9, the IASB considered the costs and complexities for non-financial institutions to calculate 12-month ECLs and track the SICR
- Feedback indicated that most trade receivables without a significant financing component would have a maturity less than one year, so the lifetime ECLs and the 12-month ECLs would be similar

6. Loan commitments and financial guarantee contracts

BACKGROUND

- Previously, IAS 37 applied to some loan commitments and financial guarantees. This was the case despite the exposure to credit risk on these instruments being similar to that on loans or other financial instruments and the credit risk is managed in the same way. The IASB therefore concluded that an entity shall apply the same impairment model to those loan commitments and financial guarantee contracts
- Aligning the impairment requirements for all credit exposures irrespective of their type reduces operational complexity because, in practice, loan commitments and financial guarantee contracts are often managed using the same credit risk management approach and information systems

6. Loan commitments and financial guarantee contracts

Issued loan commitments and financial guarantees
 	
(Issuers' perspective)
	• Commitments and financial guarantees not measured at FVTPL are in scope of ECL
	• General approach to ECL is applied:
	    – Credit risk managed in same way so same model
	    – Have a present legal obligation to extend credit
	    – Generally measure ECLs over contractual period exposed to credit risk
	    – Exception for some loan commitments such as revolvers (consider term beyond contractual period during which financial instrument is exposed to credit risk and would not be mitigated by credit risk management actions)

	Financial guarantees: • Initially recognised at fair value, typically equal to the premium received • Subsequently measured at the higher of: (1) the loss allowance applying the ECL model; and (2) the initial recognition amount less the cumulative income recognised in accordance with the principles of IFRS 15
Collateral and other credit enhancements *(Holders' perspective)*	• For the purposes of measuring ECLs, the estimate of expected cash shortfalls shall reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity

7. Disclosures—credit risk disclosures in IFRS 7

BACKGROUND

- Improved disclosure requirements were included in IFRS 7 for ECLs. The IASB identified three objectives for the disclosure requirements and required both qualitative and quantitative information to assist users of financial statements to understand and identify:
  - an entity's credit risk management practices;
  - the amounts in the financial statements that arise from ECLs; and
  - an entity's credit risk profile, including significant credit concentrations at the reporting date.
- Considering the differences in how entities approach credit risk management, the IASB decided to include objective-based disclosures which allow entities to decide how much detail to disclose and how much emphasis to place on different aspects of the disclosure requirements

7. Disclosures—credit risk disclosures in IFRS 7

Objective

Enable users to understand the **effect of credit risk** on the amount, timing and uncertainty of future cash flows

Entities' credit risk management practices and how they relate to recognition and measurement of ECLs

Quantitative and qualitative information to evaluate amounts in the financials arising from ECLs

Entities' credit risk exposure including significant credit risk concentrations

Amounts arising from ECLs	• Reconciliation of the loss allowance • Significant changes in the gross carrying amounts contributing to changes in the loss allowance • Inputs and assumptions used to measure 12-month and lifetime ECLs • Write-offs, modifications, collateral
Effect of deterioration, improvement in credit risk	• Carrying amount by credit risk rating grades • Inputs and assumptions used in determining whether SICR has occurred • Carrying amount of assets evaluated on individual basis

8. Transition to IFRS 9—impairment

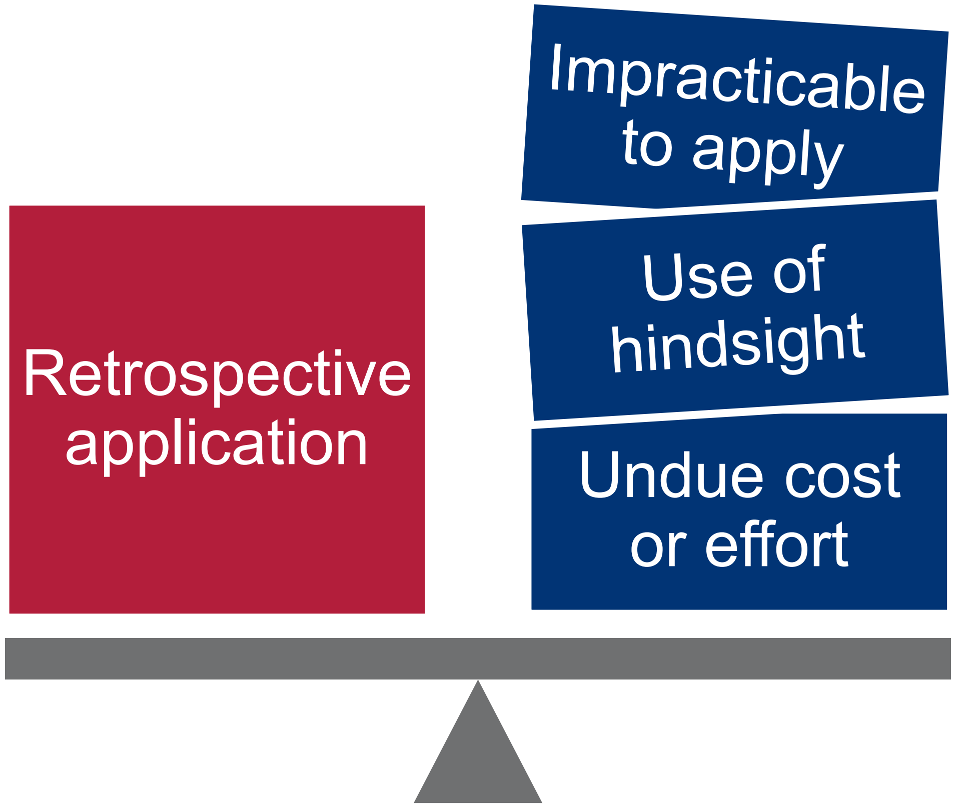
BACKGROUND

- When developing IFRS 9, the IASB considered the difficulties of retrospective application of the impairment requirements such as availability of initial credit risk data and risk of hindsight
- Whilst most stakeholders agreed that in principle retrospective application provides the best information, many questioned the practicability and noted a need for extensive reliefs
- The IASB considered requiring prospective application, but ultimately decided the best balance was achieved by requiring retrospective application with reliefs to address particular difficulties. The IASB also decided not to require restatement of comparative information, but to instead require extensive transition disclosures

8. Transition to IFRS 9—impairment

Retrospective application required, with some reliefs

- On transition determine if instruments are at stage 1, 2 or 3 unless not possible to determine initial credit quality without undue cost or effort
  - If initial credit quality not used, always evaluate based whether or not 'investment grade'
- Permit but not require restatement of comparatives
- Reconciliation of impairment allowances under IAS 39 and IFRS 9



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