IFRS Accounting

Staff paper

Agenda reference: 4

IFRS Interpretations Committee meeting

Date	**March 2024**
Project	**IASB PIR of IFRS 9 *Financial Instruments*—Impairment**
Topic	**Application matters in determining ECL**
Contacts	**Iliriana Feka** (ifeka@ifrs.org) **Riana Wiesner** (rwiesner@ifrs.org)

This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee (Committee). This paper does not represent the views of the International Accounting Standards Board (IASB), the Committee or any individual member of the IASB or the Committee. Any comments in the paper do not purport to set out what would be an acceptable or unacceptable application of IFRS® Accounting Standards. The IASB's technical decisions are made in public and are reported in the IASB® *Update*. The Committee's technical decisions are made in public and are reported in IFRIC® *Update*.

Purpose of this session

To obtain IFRS Interpretations Committee (Committee) members' input to the IASB's post-implementation review (PIR) of impairment requirements in IFRS 9—specifically, on application matters related to determining expected credit losses (ECL) for:

1. intragroup financial instruments;
2. loan commitments;
3. financial guarantee contracts; and
4. purchased or originated credit-impaired (POCI) financial assets.

Contents

Questions for Committee members

Questions for Committee members

- For the application matters identified in this paper (see slides 10–22), what is your overall assessment on:
  1. whether the matter is pervasive;
  2. whether the matter has substantial consequences; and
  3. what is the root cause for the matter.
- Additional input required, when applicable, is described in slides 14–22.

Background

PIR—objective and process

Assess whether the **effects** of applying the requirements on users of financial statements, preparers, auditors and regulators are those the IASB **intended** when it developed the requirements

PIR of **impairment requirements** in IFRS 9 and **credit risk disclosure requirements** in IFRS 7 *Financial Instruments: Disclosures*

Phase 1 of PIR	The RFI	Phase 2 of PIR	Project Summary
Q4 2022	**May 2023**	**Nov 2023 – Q2 2024**	**Q3 2024**
Outreach and identify matters to examine	Comment period ended in Sep 2023	Feedback analysis	

PIR—how does the IASB respond to findings?

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

objectives have **fundamental questions** (ie 'fatal flaws')

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 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 Committee research pipeline
Low priority	to be considered in the next agenda consultation
No action	require no further action

Overview of PIR feedback

Overall positive feedback

Almost all stakeholders said that the impairment requirements in IFRS 9:

- result in more timely recognition of credit losses compared to IAS 39; and
- work as intended with no fundamental questions ('fatal flaws').

Hot topics

- the interaction between the impairment requirements and other IFRS 9 requirements on modification and derecognition; and
- diversity in the quality and granularity of credit risk disclosures.

Other application matters, including:

- ECL for intragroup financial instruments and initial ECL for purchased financial assets; and
- measuring ECL for loan commitments and reflecting the effect of some financial guarantees in the measurement of ECL.

Topic 1—Intragroup financial instruments

IFRS Accounting

Background

- The IASB is discussing feedback on the PIR of impairment requirements in IFRS 9. Specifically, at its February 2024 meeting, the IASB discussed feedback on the application of the general approach to recognise ECL.
- Although PIR feedback suggested that there are no fundamental questions (‘fatal flaws’) with the general approach and the requirements generally work as intended, some stakeholders asked the IASB to reconsider the application of this approach to specific groups of financial instruments.
- Specifically, some stakeholders said that applying the general approach to recognise ECL for intragroup financial instruments, including instruments issued between entities under common control, results in undue costs.
- Agenda Paper 27A of the February 2024 IASB meeting provides PIR feedback and staff analysis on this matter. At its February 2024 meeting, the IASB tentatively decided to take no standard-setting action on the matters identified for the general approach, including the matter related to intragroup financial instruments.
- The IASB is evaluating matters identified in the PIR feedback against the criteria set out in the PIR framework (see slide 8), to assess what, if any actions should be taken in response to the feedback.

PIR feedback

- The costs of applying the general approach to intragroup financial instruments, such as loans and receivables or financial guarantee contracts, exceed the benefits of the resulting information.
- The costs of determining significant increases in credit risk (SICR) or measuring ECL are high because:
  - current statistical models lack appropriate information about credit losses for intragroup instruments and developing specific statistical models would be challenging and costly; and
  - generally, there is no historical experience or future expectations for credit losses, including peer group experience for comparable financial instruments. Doing exhaustive searches for alternative information is costly.
- A few stakeholders also said that applying the general approach might also lead to counterintuitive outcomes because it does not capture the subjective or qualitative factors inherent in intragroup instruments—the amount of credit losses expected usually depends on the financial support from the parent or group entities and their incentive to prevent default.
- Ultimately, stakeholders consider that there is low risk of credit losses from intragroup instruments and therefore, ECL does not necessarily provide useful information to users of financial statements.
- To reduce these operational costs, some stakeholders suggested the IASB consider:
  - extending the scope of the simplified approach in IFRS 9 to these instruments or add more application guidance;
  - removing intragroup instruments from the scope of IFRS 9, similar to the exemption in US GAAP.

Staff analysis

- Some assumptions and data sources informing the way ECL is implemented for financial instruments issued to third parties may not fully hold for intragroup instruments—entities might need to adjust the ECL approach to tailor it to the characteristics of intragroup instruments and availability of data. Adjusting the ECL approach is both required and allowed by the principle-based requirements of IFRS 9.
- IFRS 9 does not list acceptable techniques or methods for assessing SICR or measuring ECL:
  - information does not necessarily need to flow through a statistical model or credit ratings process—qualitative and non-statistical quantitative information available may be sufficient in some cases (see paragraph B5.5.12, B5.5.17 and B5.5.18 of IFRS 9); and
  - estimating a probability weighted ECL amount may not need to be a complex analysis—an entity may use practical expedients when measuring ECL if they are consistent with the principles in IFRS 9 (see paragraph B5.5.35 and B5.5.42 of IFRS 9).
- Both, the assessment of SICR and the measurement of ECL, are required to be based on reasonable and supportable information that is available to an entity without undue cost or effort—an entity may use internal data (see paragraphs B5.5.49-B5.5.54 of IFRS 9)
- Consistent with the IASB's educational material, mechanically applying an ECL methodology which fails to reflect the entity's actual expectations about credit losses would be inconsistent with the impairment requirements in IFRS 9.

Committee members' input

- The PIR feedback demonstrates that the costs of applying the general approach to intragroup financial instruments might be excessive in some cases, if requirements are applied mechanically.
- However, as explained in more detail in paragraphs 23–37 of Agenda Paper 27A of the February 2024 IASB meeting, IFRS 9 provides an adequate basis for determining ECL for these instruments and applying the requirements mechanically would be inconsistent with the principles in IFRS 9. A mechanical approach might also contribute to high application costs (eg costs of developing specific statistical models or doing extensive searches for information).

Additional input:

- If this matter is pervasive, is it limited to intragroup financial instruments only or is the matter part of a broader underlying question?
- In the light of the IASB's tentative decision to take **no standard-setting action** in response to the PIR feedback on this matter, do you have any views about other actions the IASB could take that might reduce the application challenges for intragroup instruments?

Topic 2—Loan commitments

1. Lack of definition for loan commitments

PIR feedback

- Suggest that the IASB defines what is a ‘loan commitment’.
- Entities refer to the definition of a financial instrument in IAS 32 *Financial Instruments: Presentation* and the description of a loan commitment in paragraph BCZ2.2 of the Basis for Conclusions on IFRS 9 which explains that ‘loan commitments are firm commitments to provide credit under pre-specified terms and conditions’.
- Lack of a definition gives rise to application questions eg whether a commitment to enter into a convertible bond is a loan commitment subject to ECL or is it a derivative.

Staff note

- Acknowledge that there is no specific definition for a loan commitment, but the PIR feedback does not provide evidence that substantial consequences arise in practice.
- In addition to the requirements and the basis mentioned in the PIR feedback, we also note that paragraph 2.3 of IFRS 9 requires loan commitments that can be settled by delivering or issuing another financial instrument to be accounted as derivatives.

Additional input

- Is the root cause for this matter related to enforceability / accessibility of the existing description for loan commitments or that such a description is inadequate?

2. Period over which to estimate ECL for individually managed instruments

PIR feedback

- Suggest that the IASB clarifies the scope of the exception in paragraph 5.5.20 of IFRS 9—specifically, whether facilities, such as corporate overdrafts, that are managed on an individual basis are outside the scope of this exception and, thus, their ECL is required to be measured over the maximum contractual period.
- In paragraph B5.5.39(c) of IFRS 9, 'managed on a collective basis' is described as one of the characteristics of the financial instruments that generally fall in the scope of the exception.

Staff note

- As noted in paragraph BC5.255 of the Basis for Conclusions on IFRS 9, the exception was designed to address specific concerns—that, for loan commitments managed on a collective basis, an entity usually has no practical ability to withdraw the commitment before a loss event occurs and <u>to limit the exposure to credit losses to the contractual period over which it is committed to extend the credit.</u>
- PIR feedback did not indicate whether stakeholders are unclear about the accounting outcome in accordance with IFRS 9 or whether they consider that outcome to be inadequate.

Topic 3—Financial guarantee contracts

1. Credit enhancement in the measurement of ECL

PIR feedback

- Suggest the IASB adds application guidance for determining the credit enhancements that are considered ‘part of’ / ‘integral to’ the contractual terms for the purposes of measuring ECL applying paragraph B5.5.55 of IFRS 9.
- Accounting firms have developed broadly consistent guidance which has been helpful in applying judgement required for this assessment.

Staff note

- Potential application guidance (eg non-exhaustive list of factors to consider) might support application, but it will not eliminate the need to apply judgement relevant to specific facts and circumstances.
- Adding application guidance is a standard-setting activity, follows the same due process to an Accounting Standard and thus, results in disruption and operational costs from a change.
- The IASB will need evidence that the incremental benefits of any action would outweigh those costs, also considering the relevant scope. Credit enhancements, other than financial guarantees, might also require consideration.

Additional input

- What would be the incremental benefits of any standard-setting?
- In practice, is the matter limited to financial guarantees or does it extend to other credit enhancements too?

2. Accounting for premiums received over time for financial guarantees issued

PIR feedback

- Paragraph 4.2.1(c) of IFRS 9 or the related requirements are not sufficiently clear for entities to determine the accounting outcome for financial guarantee contracts for which the premiums are received over time, rather than upfront.
- Lack of specific requirements results in diversity in practice (some recognise a separate receivable for future premiums not yet due and a corresponding liability for the financial guarantee, others do not).
- Although the accounting firms have developed guidance on this matter, that guidance varies among firms and therefore, it does not lead to consistent accounting outcomes.

Staff note

- PIR feedback indicates that there is diversity in practice. However, the IASB will need to consider evidence whether such diversity results in substantial consequences and, if yes, why?

Topic 4—POCI financial assets

1. Accounting for subsequent improvements in credit risk of POCI assets

PIR feedback

- Diversity in practice was reported on the accounting for decreases in credit risk since initial recognition—specifically, some entities adjust the gross carrying amount of a POCI financial asset, others recognise it as a negative entry to the ECL allowance.
- Paragraph 5.5.14 of IFRS 9 provides requirements for recognition in the statement of profit or loss—it requires an entity to recognise favourable changes in lifetime ECL as an impairment gain, even if the lifetime ECL are less than the amount of ECL that were included in the estimated cash flows on initial recognition.
- Primarily a matter of presentation in the statement of financial position but it affects information such as coverage ratios, hence some stakeholders asked the IASB to do standard-setting to clarify the requirements.

Staff note

- PIR feedback indicates that there is diversity in practice, but it does not suggest that it results in substantial consequences in practice.

Follow us online

ifrs.org

@IFRSFoundation

IFRS Foundation

International Accounting
Standards Board

The views expressed In this presentation are those of the presenter, not necessarily those of the IFRS Foundation, International Accounting Standards Board or the International Sustainability Standards Board.

Copyright © 2023 IFRS Foundation. All rights reserved.