STAFF PAPER

17– 18 September 2013

REG IASB Meeting

Project	**Financial Instruments: Impairment**
Paper topic	Cover note: Background information and progress report

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Introduction

1. This cover note provides a summary of this month's Agenda Papers and the IASB's next steps.

2. In addition, Appendix A provides a brief overview of the proposals in the Exposure Draft (ED) *Financial Instruments: Expected Credit Losses.*

3. This paper is for information purposes only and there are no questions for the Board.

Background to this meeting

4. At the July 2013 meeting the staff from both the IASB and FASB presented to the boards the feedback received on their respective proposals. At that meeting the boards were not asked to make any decisions.

5. During September the boards will hold a joint meeting. However:

    (a) Agenda Papers presented by the IASB staff will only be for IASB decision-making; and

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(b) Agenda Papers presented by the FASB staff will only be for FASB decision-making.

The purpose of having the joint meeting is to allow each board the opportunity to consider how the other would enhance its proposed model to address the feedback received.

6. The staff are not asking the IASB for a decision on whether they want to proceed to redeliberate the proposals in the ED with the aim of finalising it. Instead the papers ask the IASB to make decisions about changes they would like to make to the proposals in the ED <u>on the assumption we were to proceed to finalise the ED.</u>

Overview of Agenda Papers for this meeting

7. The IASB staff will present the following papers this month for IASB decision making:

(a) Paper 5A—Responsiveness of the impairment model

(b) Paper 5B—Not discussed at this meeting

(c) Paper 5C—Stage 1 measurement objective

(d) Paper 5D—Definition of default

(e) Paper 5E—Report on the Fieldwork

The FASB staff will present the following paper this for FASB decision making:

(f) Paper 5F/Memo Number 239—Clarification of Expected Credit Losses

Paper 5A—Responsiveness of the impairment model

8. This paper addresses the concern raised by some that in practice the impairment model as articulated in the ED may not capture significant increases in credit risk since initial recognition on a timely basis when such increase is not evident at the individual exposure level. This is particularly the case for retail loans when credit risk is not reassessed on an on-going basis at an individual exposure level before loans become delinquent. The paper considers how to capture all significant increases in credit risk even when it is not yet evident at the level of individual financial instruments, considering both if default expectations materialise as

initially expected and if there are changes in credit risk factors from initial expectations.

Paper 5B – Not discussed at this meeting

Paper 5C—Stage 1 measurement objective

9. This paper considers the measurement objective for financial instruments in Stage 1 of the proposed model, and evaluates the feedback received on the 12-month expected credit loss (ECL) measurement objective and alternative suggestions.

Paper 5D—Definition of default

10. This paper addresses the feedback received from constituents that the notion of default, and what would constitute a default event within the context of the proposals, should be clearly described or defined.

Paper 5E—Report on the Fieldwork

11. This paper follows up on the discussions held during the July 2013 joint IASB and FASB meeting about the fieldwork (July Agenda Paper 5B). It presents in more detail the observations, results and feedback received from the fieldwork. This paper does not ask the IASB to make any decisions.

Next steps

12. The staff propose that the IASB should further consider possibilities for convergence after considering any amendments to the proposals in the IASB's ED and any changes that have been made by the FASB to their own proposals.

13. The staff intend to discuss with the IASB the following topics at the October 2013 meeting:

    (a) The timing of recognition of lifetime expected credit losses (ie when to recognise lifetime expected credit losses);

    (b) The operational simplifications included in the proposals, namely the 30 days past due and the 'low credit' risk exemption;

    (c) Modifications of financial instruments and interaction with impairment proposals;

(d) Loan commitments and financial guarantee contracts;

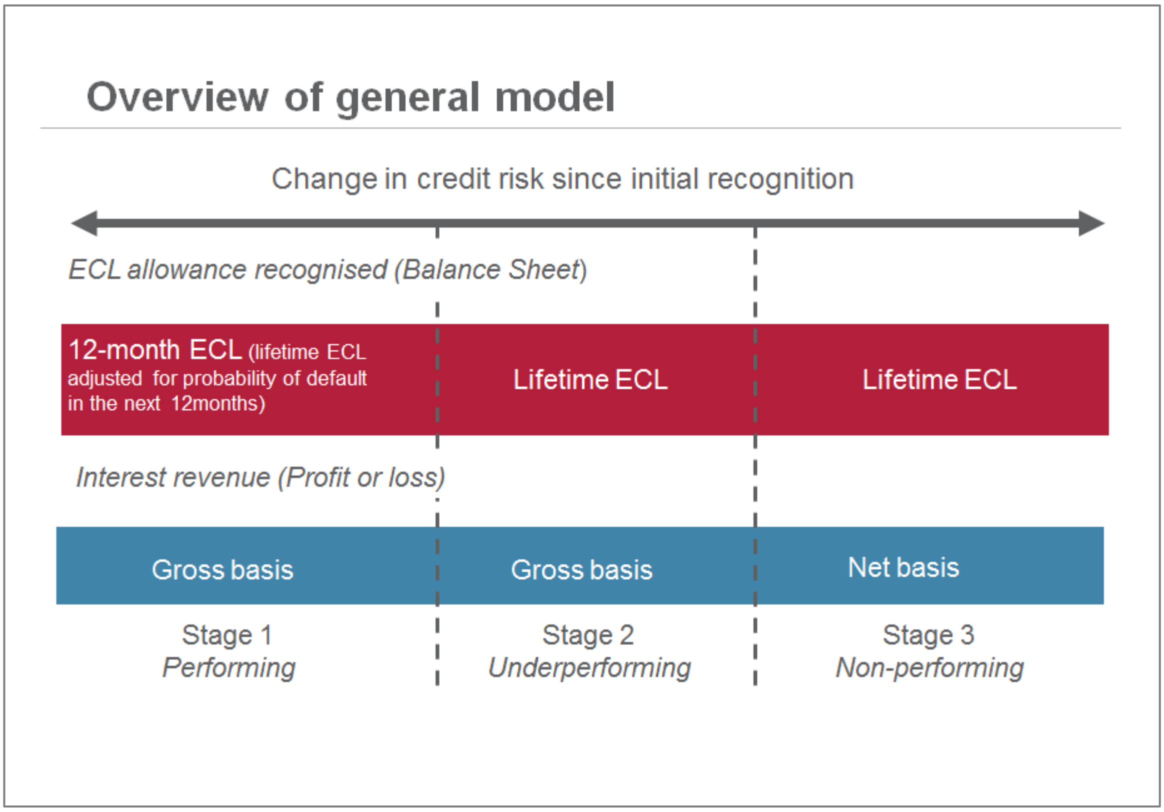
(e) Purchased or originated credit-impaired financial assets.

Appendix A: Exposure Draft (ED) *Financial Instruments: Expected Credit Losses*

Overview of the general model

A1. The ED proposed a single impairment model that aimed to provide users of financial statements with more useful information about an entity's expected credit losses.

A2. We can summarise the general model graphically as follows:



A3. The proposals require that an entity shall recognise for financial instruments (other than those that are credit-impaired on initial recognition):

(a) lifetime ECL for financial instruments if there has been a significant increase in credit risk since initial recognition (Stage 2); and

(b) 12-month ECL for all other financial instruments (Stage 1).

A4. The ED proposed that an entity would generally present and calculate interest revenue using the effective interest method on the gross carrying amount. However, the way that interest revenue is calculated and presented changes if there is objective evidence of impairment (Stage 3). An entity would then present and calculate interest revenue using the effective interest method on the net carrying amount (ie the gross carrying amount less allowance for the ECL).

A1. To estimate the ECL and the changes in credit risk, an entity shall consider information that is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions. The degree of judgement that is required for the estimates depends on the availability of detailed information. As the forecast horizon increases, the availability of detailed information decreases and the degree of judgement to estimate ECL increases. The estimate of ECL does not require a detailed estimate for periods that are far in the future – for such periods, an entity may extrapolate projections from available, detailed information.

Recognition and measurement of the 12-month ECL and the lifetime ECL

Recognition of the 12-month ECL

A2. Most financial instruments would generally have a 12-month ECL allowance on origination or purchase. This stage would also capture those instruments that have not have a significant increase in credit risk since initial recognition.

A3. The 12-month ECL is the full (lifetime) amount of credit losses that would result if default occurs in the next 12 months, weighted for the likelihood of the default occurring. The losses are therefore *not:*

(a) the expected cash shortfalls in the next 12 months; or

(b) the losses on those assets that are expected to default in the next 12 months.

A4. At each reporting period the entity would remeasure the 12-month ECL (ie update the 12-month expected loss allowance) for the financial instruments that have not had a significant increase in credit risk since initial recognition.

Recognition of the lifetime ECL

A5. The ED proposed that an entity shall recognise a lifetime ECL allowance when credit risk has increased significantly since initial recognition.

Assessing significant deterioration

A6. The ED proposed that an entity assesses whether there has been a significant increase in credit risk by comparing the:

(a) credit risk at the reporting date; to

(b) the credit risk at initial recognition of the financial instrument.

A7. In assessing credit risk, the entity considers the likelihood of not collecting some or all of the contractual cash flows over the *remaining maturity* of the financial instruments (ie the probability of a default occurring over the remaining life).

A8. Generally, a financial instrument would have a significant increase in credit risk before there is objective evidence of impairment or before default occurs.

A9. The proposals introduced an operational simplification for financial instruments with 'low credit risk' at the reporting date (for example, a loan that has an internal credit risk rating equivalent to the external credit rating of "investment grade"). For those instruments the entity would continue to recognise the 12-month ECL. The IASB's intention was to reduce the operational burden of tracking the increase in credit risk for those high quality investments. The intention was not that the 'low credit risk' should be treated as an absolute threshold test for significant deterioration.

A10. The ED includes a rebuttable presumption that there is significant increase in credit risk when contractual payments are more than 30 days past due as backstop. However, typically information that is more forward looking than past due information will be available and shall be considered in determining whether there has been a significant increase in credit risk at the reporting date.

A11. The ED did not prescribe a particular method to assess increases in credit risk. It proposed that an entity could perform the assessment for financial instruments that have shared credit risk characteristics.

Measurement of the ECL

A12. The ECL is the *present value* of the expected cash shortfalls over the life of the financial instrument.

A13. The ED did not prescribe a method to measure the ECL. However, it proposes that an entity's estimate of expected losses reflects:

(a) the best available information;

(b) an unbiased and probability-weighted estimate of cash flows associated with a range of possible outcomes; and

(c) the time value of money.

A14. The ED proposed an entity can use a discount rate between, and including, the risk-free rate and the effective interest rate when discounting expected losses. The choice of rate must be applied consistently in the accounting for the impairment allowance of a financial asset over its life.

Loan commitments and financial guarantee contracts

A15. An entity would apply the impairment proposals to

(a) loan commitments when there is a present legal obligation to extend credit, except any loan commitments that are measured at fair value through profit or loss in accordance with IFRS 9; and

(b) financial guarantee contracts to which IFRS 9 is applied and that are accounted at fair value through profit or loss.

A16. The ED proposed that an entity should recognise a liability for the ECL for those loan commitments and financial guarantee contracts. When estimating the ECL of loan commitments an entity considers the remaining contractual period, or shorter period, over which it is exposed to credit risk.

A17. The proposals in the ED did not propose to change the accounting for revenue that arises from loan commitments or financial guarantee contracts.

Credit impaired financial assets on initial recognition

A18. When there is objective evidence of impairment as a result of one or more events that occurred on or before the initial recognition of an financial asset, the ED proposed that an entity shall:

(a) include lifetime expected losses in the estimated cash flows when computing the effective interest rate on initial recognition (ie a credit-adjusted effective interest rate); and

(b) recognise subsequent changes in lifetime expected losses in profit or loss.

A19. This treatment is similar to the accounting treatment of purchased credit impaired financial assets in paragraph AG5 of IAS 39 *Financial Instruments: Recognition and Measurements.*

A20. The ED proposed that an entity should present and calculate interest revenue using the effective interest method on the amortised cost (ie net carrying amount, or gross carrying amount less allowance for the ECL) of those financial instruments.

Simplified approach for trade and lease receivables

A21. The proposals relating to trade and lease receivables interact with the Revenue Recognition and Leases projects.

A22. The ED proposed an operational simplification for those financial instruments, which would allow for recognising lifetime ECL at initial recognition and throughout the life of the instruments, as they are often held by entities that do not have sophisticated credit risk management systems. This would provide relief by eliminating the need to calculate 12-month ECL and to determine when a significant increase in credit risk has occurred.

Trade receivables with a significant financing component

A23. The ED proposed that an entity could be allowed to make an accounting policy election to apply the simplified approach to measure the loss allowance at an amount equal to lifetime expected credit loss allowance at initial recognition and throughout the trade receivables' life.

Trade receivables without a significant financing component

A24. For trade receivables that do not have a significant financing component, the ED proposed a mandatory requirement that an entity should measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout the trade receivables' life. As a practical expedient a provision matrix could be used to estimate expected credit losses for these trade receivables.

A25. In addition to the above, the ED proposed that the entity should measure trade receivables that do not have a significant financing component (in accordance with the Revenue ED) at the transaction price as defined in the Revenue ED on initial recognition. In many cases this would be the invoice amount.

Lease receivables

A26. For lease receivables an entity could make an accounting policy election to apply the simplified approach to measure the loss allowance at an amount equal to lifetime ECL at initial recognition and throughout the asset's life.

A27. The simplified approach aims to reduce complexity in practice because an entity would not need to identify increases in credit risk. The cash flows used in the measurement of the lease receivables would be used as the contractual cash flows when assessing the lease receivables' expected loss allowance. When selecting the discount rate to be used, the upper limit of the permissible range is the discount rate used in the measurement of the lease receivable

Presentation

A28. The ED proposed that an entity should present in the statement of profit or loss and other comprehensive income separate line items for the following amounts:

(c) interest revenue, calculated using the effective interest method on the gross carrying amount unless paragraph A29 applies; and

(d) gains and losses resulting from changes in the ECL.

A29. An entity calculates interest revenue using the effective interest method on the amortised cost (ie net carrying amount, or gross carrying amount less allowance for the ECL) if:

(a) as at the reporting date, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset; or

(b) the asset was purchased or originated credit-impaired on initial recognition.

Application of the model to modified financial assets

A30. The ED proposed that modified financial assets (that do not result in derecognition) should be considered in the same way as other (non-modified) assets within the model.

A31. When an entity evaluates significant increase in credit risk an entity should compare the credit risk at the reporting date (based on the modified contractual terms) and the credit risk at initial recognition (based on the original contractual terms).

A32. The gross carrying amount should recalculated on the basis of the modified contractual cash flows and a modification gain or loss should be recognised in profit or loss.

Uncollectablity/Write-off

A33. The ED proposed that an entity considers a financial asset to be uncollectable if the entity has no reasonable expectation of recovery. Consequently, an entity would write off a financial asset, or part of a financial asset, in the period in which the entity has no reasonable expectation of recovery of the financial asset (or part of the financial asset).

A34. A write-off requires the entity to reduce directly the gross carrying amount of a financial asset resulting from uncollectability. A write-off constitutes a derecognition event.

Disclosure

A35. The ED proposed disclosures that would identify and explain:

(a) the amount of the ECL that arises in the financial statements; and

(b) the effect of changes in credit risk of financial instruments that are within the scope of the proposals.

A36. To meet this objective, the ED included proposed disclosure requirements such as:

(c) reconciliation of gross carrying amounts and allowance balances;

(d) disclosures on credit risk grading; and

(e) disclosures on techniques, assumptions and policies (for example, write-off policy).

Transition

A37. The ED proposed that an entity should use the credit quality at initial recognition for existing financial assets when initially applying the new impairment model, unless obtaining such credit quality information requires undue cost or effort.

A38. If the credit quality at initial recognition is not used at the date of initial application (as per the relief outlined above), the transition provisions proposed that those financial assets should be evaluated only on the basis of whether the credit risk is low (as per the 'investment grade' exception) at each reporting date until those assets are derecognised.

A39. The ED proposed to permit, but not require, a restatement of comparative periods if the information is available without the use of hindsight. In addition, the disclosures in paragraph 28(f) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* would be permitted, but not required, for prior periods if the information is available without the use of hindsight.

A40. The ED proposed that on the date of initial application of IFRS 9 the entity should disclose a reconciliation of the ending impairment allowances under IAS 39 *Financial Instruments: Recognition and Measurement* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening impairment allowances under IFRS 9 by measurement category, showing separately the effect of reclassifications on the allowance balance at that date.