NEED TO KNOW

Financial Instruments: Expected Credit Losses (Exposure Draft)

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NEED TO KNOW – FINANCIAL INSTRUMENTS: IMPAIRMENT

This issue of Need to Know sets out key proposals about accounting for the impairment of financial assets that are measured at amortised cost.

In March 2013, the International Accounting Standards Board (IASB) published Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses*. The ED is a result of the IASB's joint deliberations with the US Financial Accounting Standards Board (FASB) to develop a new impairment model for financial assets. This represents the second phase of the IASB's project to replace the current accounting requirements for financial instruments.

The ED proposes to replace the current financial instrument impairment requirements set out in IAS 39 *Financial Instruments: Recognition and Measurement*. These current requirements are based on an incurred loss model under which the recognition of impairment is dependent on the occurrence of a credit loss event. The proposed replacement is a forward looking expected loss model, under which impairment would be recognised before a credit loss event has occurred. This would be achieved using an approach which incorporates all relevant information about past events, current conditions and reasonable and supportable forecasts about the future.

To apply this new model, the ED proposes:

- A three stage model, under which a charge for some expected losses would be recognised on initial recognition of a financial asset, with changes in the expected loss provision being based on the extent of deterioration in credit quality of a financial asset since initial recognition
- Recognition of interest income on financial assets on either a gross (excluding expected loss provision) basis or net basis, depending on the credit quality of the financial assets
- A simplified approach for trade and lease receivables
- A rebuttable presumption of when significant deterioration in credit risk is deemed to have occurred (this would be when payments are 30 days or more past due)
- A simplification for financial instruments that have low ('investment grade') credit risk.

The proposals would introduce a single impairment model for all debt instruments that include measurement at amortised cost (either in whole or in part). In particular, this includes financial assets that would be measured after initial recognition at fair value through other comprehensive income (FVOCI) in accordance with current proposals to amend the classification and measurement requirements of IFRS 9 *Financial Instruments*. Although these assets would be measured at fair value from a balance sheet perspective, the amounts recorded in the income statement would reflect amortised cost measurement with other changes in value being recorded in OCI.

The effective date is yet to be confirmed. Although the mandatory effective date of IFRS 9 is currently for periods beginning on or after 1 January 2015, all phases of the IFRS 9 project (classification and measurement, impairment and hedge accounting) are intended to have the same effective date. The IASB has asked a question in the ED (Question 12) about the amount of time preparers would require to implement the proposals in the ED, and what constituents believe is an appropriate mandatory effective date for IFRS 9. Given that the IASB normally allows at least 18 months from the issue of a new accounting standard and its effective date, it would appear likely that the effective date of IFRS 9 will change.

The FASB published an exposure draft in 20 December 2012 which contains proposals for a 'current expected credit loss model'. The proposals are different to the proposed model in the IASB ED. Appendix C of this publication outlines the FASB's proposed model and the main differences between the IASB and FASB models.

While all entities that hold financial assets or commitments to extend credit (that are not accounted for at fair value through profit or loss) will be affected by the proposals, the most significant effects will be on financial institutions and other entities with significant holdings of portfolios of debt instruments (including bonds, debentures, and loans to third parties). If the proposals in the ED are finalised as proposed, these entities will be required to make continuous judgements, assumptions, and estimates in areas such as:

- What constitutes a significant deterioration in credit quality
- When a significant deterioration in credit quality has occurred
- Determining expected future cash flows in order to calculate impairment.

It is expected that the proposed model would also require systems changes, closer linking of credit risk management and financial reporting systems of organisation, the degree required will vary from organisation to organisation.

1. EXISTING GUIDANCE AND THE RATIONALE FOR CHANGE

The existing requirements for the impairment of financial assets are set out in IAS 39 *Financial Instruments: Recognition and Measurement*. Under this model, entities recognise a loss provision when there is objective evidence of impairment.

The incurred loss model was subject to criticism during and after the onset of the Global Financial Crisis for recognising losses on a 'too little, too late' basis. In addition, although (from a commercial perspective) for interest bearing assets an element of the interest charge is set by a lender to compensate it for expected losses, interest income was recognised in full. This had the effect, in particular for higher risk lending (for which the 'expected loss credit spread' is higher), of entities recognising interest income at the full contractual rate for an initial period (arguably overstating profits), followed by impairment losses as the expected (and other) losses emerged.

In addition, the International Accounting Standards Board (IASB) has found that the incurred loss model resulted in inconsistent accounting for similar assets because different entities have used different trigger events to identify objective evidence of impairment, or have assessed the same trigger events differently.

2. THE PROJECT TO DATE

In response to the global financial crisis of 2008/2009, the International Accounting Standards Board (IASB) accelerated its comprehensive project to replace IAS 39 *Financial Instruments: Recognition and Measurement* with a new financial instruments standard, IFRS 9 *Financial Instruments*. The project contains three phases:

- Phase I: Classification and measurement
- Phase II: Impairment
- Phase III: Hedge accounting.

Phase II: Impairment

The ED is the third exposure draft to be issued by the IASB as part of phase II. The need for additional exposure drafts has arisen from modifications which were found necessary to make the IASB's original proposals operational, and a desire for the IASB and the US Financial Accounting Standards Board (FASB) to issue identical proposals.

In November 2009, the IASB published an ED/2009/12 *Amortised Cost and Impairment* which proposed an expected cash flow (ECF) approach to measuring impairment. The ECF approach is based on the interest rate charged by a lender including an element that relates to expected future credit losses. For example, if a loan was granted at an interest rate of 10%, the lender might have priced that rate to include a 2% margin to compensate it for expected future losses from loans with that risk profile, on a portfolio basis. The accounting approach would have been for the lender to recognise interest income at a rate of 8%, with the 2% margin being deferred to build up a credit loss provision to be used to offset losses as they emerged. Entities would have been required to reassess their credit loss expectations at each reporting period, with changes in loss provisions being recorded in profit or loss.

The earlier recognition of credit losses was welcomed by respondents to ED/2009/12. The IASB also noted that the ECF approach addressed the deficiency in the incurred loss model of recognising interest income at the full contractual rate, and better reflects the underlying economics of the transaction, as the interest income recognised in profit or loss would reflect the credit risk adjusted effective interest rate of the financial asset.

However, many respondents considered that the ECF approach, while conceptually attractive, would operationally be complex and costly to apply. This is because financial institutions use separate accounting systems to calculate effective interest rates and to derive credit loss information. The ECF model would have required systems integration (of accounting and credit systems) which would have proved difficult and costly.

A further criticism of ED/2009/12 was that, at that point, the IASB and the FASB had proposed different impairment models. Global financial institutions stressed the importance of convergence in this area.

In response to the feedback received on ED/2009/12, the IASB and FASB worked together on an alternative impairment model that would take into account expected credit losses (EL) but would be more operational. They jointly issued a Supplement to ED/2009/12 (the SD) in January 2011. However, although they issued one model, the boards had differing objectives. The IASB's primary objective was to reflect initial expected credit losses as part of determining the effective interest rate (i.e. to recognise credit losses over the life of the asset) as the IASB believed (and continues to believe) that this reflects the economic substances of a lending transaction. The primary objective of the FASB was to ensure that the allowance balance was sufficient to cover all estimated credit losses for the remaining life of an instrument.

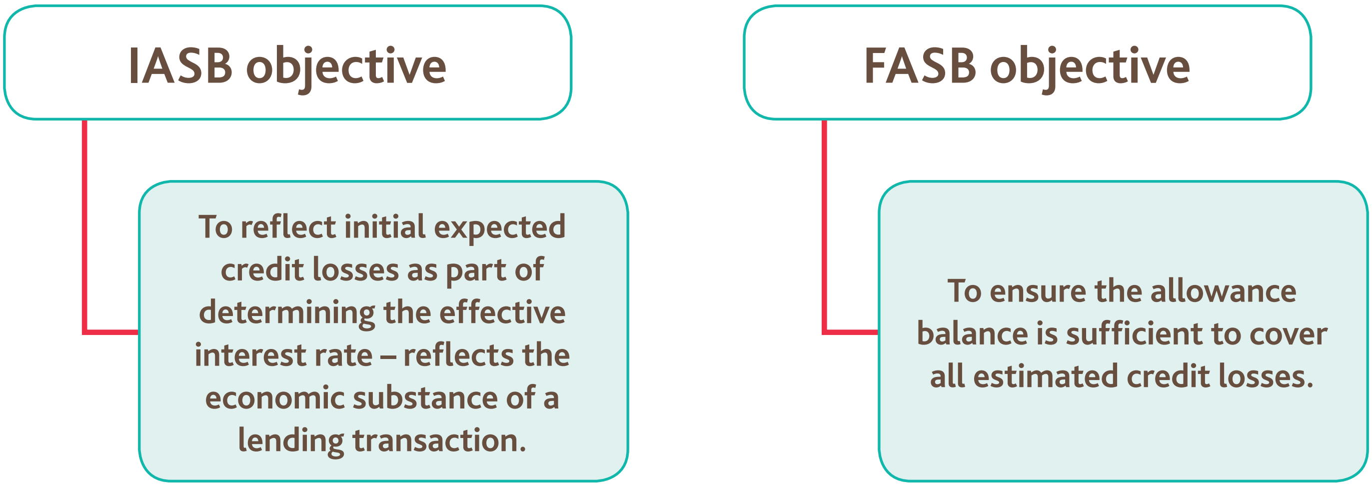

Figure 1: Project objectives of the two boards

The SD proposed that financial assets should be separated into one of two groups, referred to as the 'good book' or the 'bad book' based on the level of uncertainty about the collectability of the financial assets:

	'Good book'	'Bad book'
Criteria	Financial assets would be included in the 'good book' where management does not consider collectability of the asset to be uncertain.	Financial assets would be transferred from the 'good book' to the 'bad book' when management's objective changes from receiving contractual payments from these assets to recovery of the financial asset.
Impairment allowance	Higher of: – The time-proportionate of lifetime expected losses (EL); and – Expected losses over the foreseeable future period. Update each reporting date.	Immediately recognise all expected losses (EL). Update each reporting date.

Figure 2: Recognition and measurement criteria of the 'good book' and 'bad book'

The feedback received by the boards on the proposals were mixed and, overall, there was not strong support for the SD. There were two main concerns:

- To apply the SD model, entities would have to make two calculations for the 'good book' (being the time proportionate amount of expected losses, and expected losses over the foreseeable future period). Many respondents suggested retaining only one of the two calculations for the purposes of the good book allowance but there was inconsistency about which should be eliminated (mainly linked to the geographical location of the respondent), and
- The length of the 'foreseeable future period' was not clear.

In view of the feedback received, the boards decided to explore an alternative impairment model. From May 2011 to July 2012, the boards jointly deliberated on a new approach, which largely forms the basis of the model in IASB's latest published ED.

In July 2012 the FASB decided to withdraw from the joint project, and both the IASB and the FASB have since worked independently to finalise their proposals. However the boards have been working together to ensure that they remain aware of the progress of each of their respective projects, and it is anticipated that they will discuss feedback received in response to their impairment exposure drafts which are currently within each of their consultation periods.

As both the IASB's and the FASB's EDs have overlapping comment periods, constituents and other interested parties are able to comment on both proposals.

3. OBJECTIVE OF THE IASB'S EXPOSURE DRAFT

The objective of the ED is to establish principles for the recognition, measurement, presentation and disclosure of expected credit losses.

The intention of the proposals is to provide useful information to users of financial statements in their assessment of the amount, timing and uncertainty of future cash flows relating to an entity's financial instruments.

3.1. Scope

The following financial instruments are included within the scope of the ED:

- Originated, purchased, reclassified or modified debt instruments that are measured at amortised cost in accordance with IFRS 9 *Financial Instruments*
- Financial assets that would be required to be measured at fair value through other comprehensive income (FVOCI) in accordance with ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (refer to BDO IFR Bulletin 2012/19)
- Loan commitments (except those measured at fair value through profit or loss)
- Financial guarantee contracts (except those measured at fair value through profit or loss)
- Lease receivables within the scope of IAS 17 *Leases*.

Different approaches apply to different types of financial assets (which are discussed in more detail below) as follows:

- The three stage approach described below applies to originated, purchased, reclassified or modified debt instruments which are measured at amortised cost or fair value through other comprehensive income (FVOCI)
- A simplified approach applies to short term trade receivables
- For other long term trade receivables and lease receivables, entities have an option to apply the simplified approach or the three stage approach
- A separate approach applies to purchased credit impaired financial assets.

4. THE THREE STAGE APPROACH

The proposed model would establish a three stage approach, based on the credit deterioration of a financial instrument. This would then determine the recognition of impairment (as well as the recognition of interest revenue).

At initial recognition of a financial asset, an entity would recognise a loss allowance equal to 12 months expected credit losses. These are the credit losses that are expected to result from default events that are possible within 12 months from the entity's reporting date. This means that the actual loss does not need to take place within the 12 month period; it is the occurrence of the event that ultimately results in that loss.

After initial recognition, the three stages under the proposals would be applied as follows:

- ***Stage 1***: credit quality has not significantly deteriorated since initial recognition – recognise the next 12 months of expected credit losses
- ***Stage 2***: credit quality has significantly deteriorated since initial recognition – recognise lifetime expected losses, include interest in profit or loss on a gross basis (that is, based on the full amount of the asset before deduction of the impairment provision)
- ***Stage 3***: there is objective evidence of impairment as at the reporting date (using the criteria currently included in IAS 39 *Financial Instruments: Recognition and Measurement*) – recognise lifetime expected losses, include interest in profit or loss on a net basis (that is, based on the impaired amount of the asset).

The recognition of impairment (and interest revenue) is summarised in the table below:

<table>
<tr><th>Stage</th><th>1</th><th>2</th><th>3</th></tr>
<tr><td>Recognition of impairment</td><td>12 month
expected credit loss</td><td colspan="2">Lifetime
expected credit loss</td></tr>
<tr><td>Recognition of interest</td><td colspan="2">Effective interest on the
gross amount</td><td>Effective interest on the
net (carrying) amount</td></tr>
</table>

Figure 3: Summary of the recognition of impairment (and interest revenue) under the proposals

BDO comment

The International Accounting Standards Board's (IASB's) model would, at first glance, appear to result in the recognition of a loss on initial recognition of a financial asset. This appears contrary to the IASB's view that, from an economic perspective, losses that are expected on the initial recognition of a financial asset are compensated for by an increase in the interest rate charged by a lender (and so there is no economic loss on initial recognition). However, the requirement to recognise a 12 month expected credit loss on initial recognition is intended on a portfolio basis, in combination with other elements of the proposals, to be a proxy for the IASB's original proposals in ED/2009/12. This is because the impairment loss arising from the provision made on initial recognition will be compensated for by the recognition of interest income in profit or loss at the full contractual rate on the gross financial asset (and not a rate that is reduced to the extent of the expected loss credit spread, or the application of the effective interest rate to the financial asset balance after deducting the expected loss amount).

This simplified approach has been proposed because it links better to internal reporting systems at financial institutions as these record interest income on a gross basis. Consequently, while from a conceptual basis it is not a perfect solution, it is one which seeks to give a practical approach which would address the concerns expressed about operationality of the IASB's original proposals and would result, overall, in an accounting result which would approximate the effect of the proposals in the IASB's original exposure draft. It also addresses the criticism of gross interest income recognition under the current IAS 39 incurred loss model, because the charge for expected losses that would be required on the initial recognition of new financial assets is intended substantially to eliminate the potential for profits to be overstated in the early part of the contractual term of financial assets.

4.1. Rebuttable presumption – significant deterioration in credit risk

The ED proposes a rebuttable presumption that a significant deterioration in credit risk exists (and therefore impairment is recognised based on the lifetime expected credit losses) when contractual payments are more than 30 days past due. Past due is defined as failure to make a payment when that payment was contractually due.

The ED proposes that this presumption can be rebutted if other persuasive information is available that indicates that the credit risk has not increased significantly – even though the contractual payments are more than 30 days past due. Such evidence, for example, may include the entity's historical experience which may indicate that amounts that are more than 30 days past due do not result in a significant increase in the probability of default occurring, whereas amounts that are more than 60 days past due do result in a significant increase.

4.2. Exception for 'investment grade' loans – significant deterioration in credit risk

The ED proposes to provide an exception for financial assets for which the credit risk is low (for example, loans that have an internal credit risk rating equivalent to the external credit rating of 'investment grade'). For such financial instruments there is no need to determine where there has been a significant deterioration in credit risk. This means that only 12-month expected credit losses would be recorded for these financial instruments.

4.3. Recognition of impairment – '12-month expected credit losses'

12-month expected credit losses are calculated by multiplying the probability of a default occurring in the next 12 months by the total (lifetime) expected credit losses that would result from that default, regardless of when those losses occur. Therefore, 12-month expected credit losses represent a portion of a financial asset's lifetime expected credit losses.

The IASB has clarified in the Basis for Conclusions to the ED that the 12-month expected credit loss is not:

- The amount of expected cash shortfalls over the next twelve months
- The credit losses on only those financial assets that are individually forecast to default in the next 12 months. If one or more specifically identified financial assets are expected to default within the next 12 months, this may in fact indicate that the credit quality of those financial assets has deteriorated significantly, in which case they would be classified to ***stage 2*** and lifetime expected credit losses would need to be recognised.

BDO comment

There are some similarities between the IASB's 12 month expected credit loss calculation and some prudential regulatory requirements for the 12 month probability of default. Financial institutions may therefore be able to use their internal ratings based systems under Basel II as a starting point in determining 12-month expected credit losses. However, those regulatory measurements of probability of default would still need to be adjusted in order to comply with the proposals in the ED.

4.4. Recognition of impairment – 'Lifetime expected credit losses'

Lifetime expected credit losses are the present value of expected credit losses that arise if a borrower defaults on its obligation at any point throughout the life of a lender's financial asset (that is, all possible default events during the term of the financial asset are included in the analysis). Lifetime expected credit losses are calculated based on a weighted average of expected credit losses, with the weightings being based on the respective probabilities of default.

The measurement of credit losses is based on present value of cash shortfalls, and takes into account both the amount and timing of payments. Therefore a credit loss will arise in instances where there is a delay in the payment of contractually required amount, even if all contractual cash payments are ultimately expected to be received in full.

5. POSSIBLE 'LIFETIME EXPECTED CREDIT LOSS' INDICATORS

The ED includes additional guidance to assist entities in identifying information to be used to determine when a provision for lifetime expected credit losses is required. Paragraph B20 sets out a wide range of potential sources of such information which includes:

- Changes in external market indicators of credit risk
- Credit ratings
- Changes to contractual terms that would be made if the financial asset was newly originated
- Adverse changes in general economic and/or market conditions
- Significant changes in the operating results or financial position of the borrower
- Changes in the borrower's regulatory, economic or technological environment
- Changes in the value of collateral or guarantees (including those provided by a related party of the borrower)
- Changes in the amount of financial support available to an entity (for example, from its parent)
- Expected or potential breaches of covenants
- Changes in the expected behaviour of the borrower, and past-due information.

Appendix A sets out in more detail a number of factors that entities would need to consider when making the determination of whether lifetime expected credit losses should be recorded.

BDO comment

The International Accounting Standards Board (IASB) noted that the assessment and measurement of credit losses is an inherently subjective area, and therefore expects that different indicators will be appropriate for different types of financial assets. This would mean that management judgement would be required and implies that there may be a degree of diversity in practice. This is an inevitable consequence of a more forward looking 'expected loss' model. However, because the IASB's model would require only 12 month expected losses for the majority of financial assets, the diversity in reported results may not be significant.

6. PRESENTATION OF INTEREST REVENUE

The ED proposes that interest revenue recognition should remain unchanged from IAS 39 *Financial Instruments: Recognition and Measurement* today, meaning that interest revenue would be calculated before credit losses are taken into account (gross basis). This is because the Board has heard from outreach to constituents that most financial institutions store accounting and credit loss information separately, with the accounting systems calculating the effective interest rate on a gross basis.

However, the ED proposes that for those financial assets that have met both the lifetime expected credit losses recognition criteria and the IAS 39.59 incurred loss criteria, interest revenue should be calculated on a net carrying amount basis (i.e. after deduction of the impairment allowance amount). This is because, if interest revenue was calculated on a gross amount after the incurred loss triggers in IAS 39 (IAS 39.59) have been met, interest revenue would be overstated and there would be a need for an immediate impairment loss.

BDO comment

The gross presentation of interest revenue or 'decoupling' for financial assets in ***stage 1*** *and* ***stage 2*** *provides important systems relief for financial institutions, as most of these entities have separate systems calculating effective interest rates (and related interest revenue) and expected losses.*

7. EXPECTED CREDIT LOSS MEASUREMENT

The ED includes guidance to clarify what it is meant by 'expected losses'. In determining expected loss, entities are required to consider more than one outcome and consider the likelihood of a number of potential outcomes occurring in practice. The ED proposes that an expected loss estimate should reflect:

– An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes, and
– The time value of money.

This means that entities would need to consider:

– All reasonable and supportable information that is relevant in making the forward-looking estimate
– A range of possible outcomes and the likelihood and reasonableness of those outcomes (that is, not merely an estimate of the 'most likely outcome').

The International Accounting Standards Board (IASB) is not proposing to require entities to identify every possible scenario, but is proposing that entities should at least consider two outcomes: (i) the probability that a credit loss occurs and (ii) the probability that no credit loss occurs, even if the most likely outcome is no loss or the probability of credit losses occurring is very low.

BDO comment

Concerns have been raised in comment letters and outreach meetings on the complexity of the expected credit loss calculation based on expected values. It is helpful that the IASB has clarified in the ED that it was not its intention to require a complex statistical analysis, but that entities should consider information that is reasonably available without undue cost and effort. However, it is likely that different entities may have different thresholds on what would be considered reasonably available information.

The maximum period to consider expected credit losses is the contractual period of the financial instrument that the entity is exposed to, and no longer (even if business practice suggests that a longer exposure period may apply). For example, a loan where the lender can contractually demand repayment within a short period will be assessed for expected losses over that short period, even if the lender expects to maintain the loan for a longer period. Similarly, a loan commitment that can contractually be withdrawn within a short period will be assessed for expected losses over that short period, and not for the longer period during which the potential lender expects to continue to make the facility available.

7.1. Time value of money – determining the discount rate

At initial recognition (except for (i) undrawn loan commitments and financial guarantee contracts, and (ii) purchased or originated credit-impaired financial assets) an entity must determine a discount rate, which is any reasonable rate that is between (and including):

- The risk-free rate, and
- The effective interest rate of the financial asset.

Note: Depending on the discount rate selected, subsequent to initial recognition the current discount rate may be outside of the permitted range that existed at initial recognition. For example, if the risk free rate is selected, future increases in interest rates might mean that the risk free rate exceeds the effective interest rate of the financial asset.

For undrawn loan commitments and financial guarantee contracts, the discount rate is required to reflect the current market assessment of the time value of money and (only is risks are taken into account by adjusting the discount rate and not the cash flows) risks specific to the cash flows.

The credit adjusted effective interest rate is used to discount cash flows for purchased or originated credit impaired financial assets.

8. MODIFICATIONS (RENEGOTIATIONS) OF CONTRACTUAL CASH FLOWS THAT DO NOT RESULT IN DERECOGNITION

If the contractual cash flows of a financial asset are modified or renegotiated in such a way that does not result in derecognition of that financial asset under IFRS 9 *Financial Instruments*, the ED proposes that entities should recalculate the gross carrying amount of the financial asset on the basis of the renegotiated or modified contractual cash flows. A modification gain or loss would be recognised in profit or loss.

An entity would also be required to consider whether the modification (renegotiation) provides evidence that there may have been a significant deterioration in credit risk. The ED proposes that the 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, unmodified contractual terms).

If there has been a significant deterioration in credit risk, the modified financial instrument would be in ***stage 2***, and lifetime expected credit losses would be required to be recognised.

9. WRITE-OFFS

The ED proposes that when the entity has no reasonable expectations of recovery, a write off event occurs. A write-off constitutes a derecognition event (either in full or in part). Therefore the gross carrying amount of a financial asset is reduced by the amount of the write-off that has been recognised in profit or loss.

10. PURCHASED CREDIT IMPAIRED FINANCIAL ASSETS

Purchased credit impaired (PCI) assets are those that are currently classified as 'financial assets acquired at a deep discount that reflects credit losses' under IAS 39 *Financial Instruments: Recognition and Measurement* paragraph AG5).

The general three-stage approach would not apply to PCI financial assets. Instead, the ED proposes that:

- Lifetime expected credit losses would be recognised for PCI assets
- No impairment loss would be recognised on acquisition
- Initial expected credit losses would be included in the estimated cash flows for the purposes of calculating the effective interest rate
- Interest revenue would be calculated on the net carrying amount, i.e. including expected credit losses
- Expected credit losses would be discounted using the credit-adjusted effective interest rate
- Any subsequent changes (favourable or unfavourable) from the initial expected credit losses would be recognised immediately in profit or loss.

The ED proposes that the PCI assets would be recorded on initial recognition at the transaction price without presentation of an allowance for expected contractual cash shortfalls that are implicit in the purchase price, but disclosures would be required of contractual cash shortfalls that are implicit in the purchase price.

	Presentation of interest revenue	Impairment allowance
Purchased credit impaired financial assets	Calculated on net carrying (net of impairment allowance).	Lifetime expected credit losses.

Figure 4: Interest revenue presentation and impairment allowance for purchased credit impaired financial assets

11. ACCOUNTING FOR TRADE RECEIVABLES

The ED proposes a simplified approach for trade receivables and lease receivables.

11.1. Trade receivables that do not constitute a financing transaction

For trade receivables that do not constitute a financing transaction in accordance with IAS 18 *Revenue* (so generally trade receivables with maturity of 12 months or less), the ED proposes that a 'lifetime expected credit loss' is recognised. Because the maturities will typically be 12 months or less, the credit loss for 12-month and lifetime expected credit losses would be the same.

As a practical expedient, the ED proposes to allow entities to calculate expected credit losses on trade receivables using provision matrix.

BDO comment

Many entities estimate credit losses using a provision matrix where trade receivables are grouped based on different customer bases and different historical loss patterns (e.g. geographical region, product type, customer rating, collateral or trade credit insurance, or type of customer). Under the simplified model, entities could adjust the historical provision rates (which are an average of historical outcomes) on their trade receivables to reflect relevant information about current conditions and reasonable and supportable forecasts about the future.

Example

On 1 January 20X1, Company A sells some goods to Customer X for CU1,000 with 5 months credit term. Company A invoices CU1,000 to Customer X payable on 1 June 20X1.

Company A's provision matrix of expected loss rates as at 1 January 20X1:

Days overdue	Expected loss rate
0	0.5%
30	5%
90	18%

Figure 5: Company A's provision matrix for expected credit losses as at 1 January 20X1

Company A records the following entries:

	$	$
DR Trade receivables	1,000	
CR Revenue		1,000
DR Expected credit losses	5	
CR Impairment allowance		5

Presented adjacent to the revenue line item

Figure 6: Company A's journal entries on initial recognition

BDO comment

In finalising the new IFRS on revenue, the boards tentatively decided in the November 2012 meeting that (both initial and subsequent) expected credit losses on trade receivables are to be presented as an expense in the statement of comprehensive income (after gross profit).

On 30 June 20X1:

– Customer X did not pay on time, so the balance of CU1,000 is still outstanding, and

– The expected loss provision matrix was updated to reflect a deterioration in general economic conditions.

Days overdue	Expected loss rate
0	0.5%
30	7%
90	25%

Figure 7: Company A's provision matrix for expected credit losses for 30 June 20X1

Because Customer X is now 30 days overdue, Company A would increase the provision to CU70 with an additional charge of CU65 being made to profit or loss.

Company A records the following entries on 30 June 20X1:

	$	$
DR Expected credit losses	65	
CR Impairment allowance		65

Presented adjacent to the revenue line item

Figure 8: Company A's journal entries on 30 June 20X1

11.2. Other long term trade receivables and lease receivables

For other long term trade receivables and lease receivables, entities have a choice to either apply the genera three-stage approach or the 'simplified approach'.

12. LOAN COMMITMENTS AND FINANCIAL GUARANTEES

Provisioning for off-balance sheet financial items such as loan commitments and financial guarantees are currently covered under a different standard, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and a different impairment model from the incurred loss model in IAS 39 *Financial Instruments: Recognition and Measurement* applies.

The ED proposes that the three-stage impairment approach would also apply to such off-balance sheet items. Under the ED, an entity would consider the expected portion of the loan commitment that will be drawn down within the next 12 months when estimating 12-month expected credit losses (***stage 1***), and the expected portion of the loan commitment that will be drawn down over the remaining life the loan commitment when estimating lifetime expected credit losses (***stage 2***).

The remaining life of a loan commitment and of financial guarantees should be the remaining contractual period or shorter period during which an entity has exposure to credit risk. Consequently, the maximum period to consider when estimating credit losses is the maximum contractual period during which the entity is exposed to credit risk and not a longer period, even if that would be consistent with business practice.

BDO comment

The International Accounting Standards Board (IASB) has heard that for credit exposure management purposes loan commitments and financial guarantee contracts are managed no differently to loans, and so the IASB tentatively concluded that for financial reporting purposes, off-balance sheet financial items should also apply the same impairment model as other 'on balance sheet' financial items. This would align financial reporting more closely with credit risk management practices. However, not all loan commitments would require provisioning from initial recognition as the estimation of expected losses is based on the entity's contractual obligation (i.e. only irrevocable loan commitments would be provided for).

For example, Bank A extends credit to Company C. Bank A can cancel the commitment by giving one day's notice. Company C's financial position is poor and is deteriorating, and there is a significant risk that that it will enter bankruptcy. Bank A would only estimate one day of expected losses because Bank A does not have a contractual obligation to provide credit beyond that one day. This approach is followed, even if Bank A might not (for commercial/business reasons) cancel the arrangement.

In terms of presentation, because the allowance would not relate to any balance sheet line item, the expected loss estimate would be recognised and presented as a separate liability line item.

The discount rate used to discount expected credit losses would be the same as the rate used under IAS 37, i.e. a rate based on the current risk free rate adjusted for specific risks in the cash flows to the extent that those risks are not taken into account when estimating the cash short falls.

BDO comment

If the risk-adjustment is included by adjusting the discount rate, the adjusted discount rate will be lower than the risk-free rate. This is because the effect of the risk adjustment is to increase the expected loss, which is achieved by reducing the discount rate.

The IASB did not consider changing the accounting for revenue arising from loan commitments or financial guarantees as part of this project.

13. SUMMARY THE MAIN PROPOSALS

As part of the *Illustrative Examples* to the ED, the Board has set out a flow chart that illustrates the application of the proposals in the ED to the different types of financial instruments that include amortised cost measurement. The flowchart is reproduced below.

Application of the main proposals on a reporting date

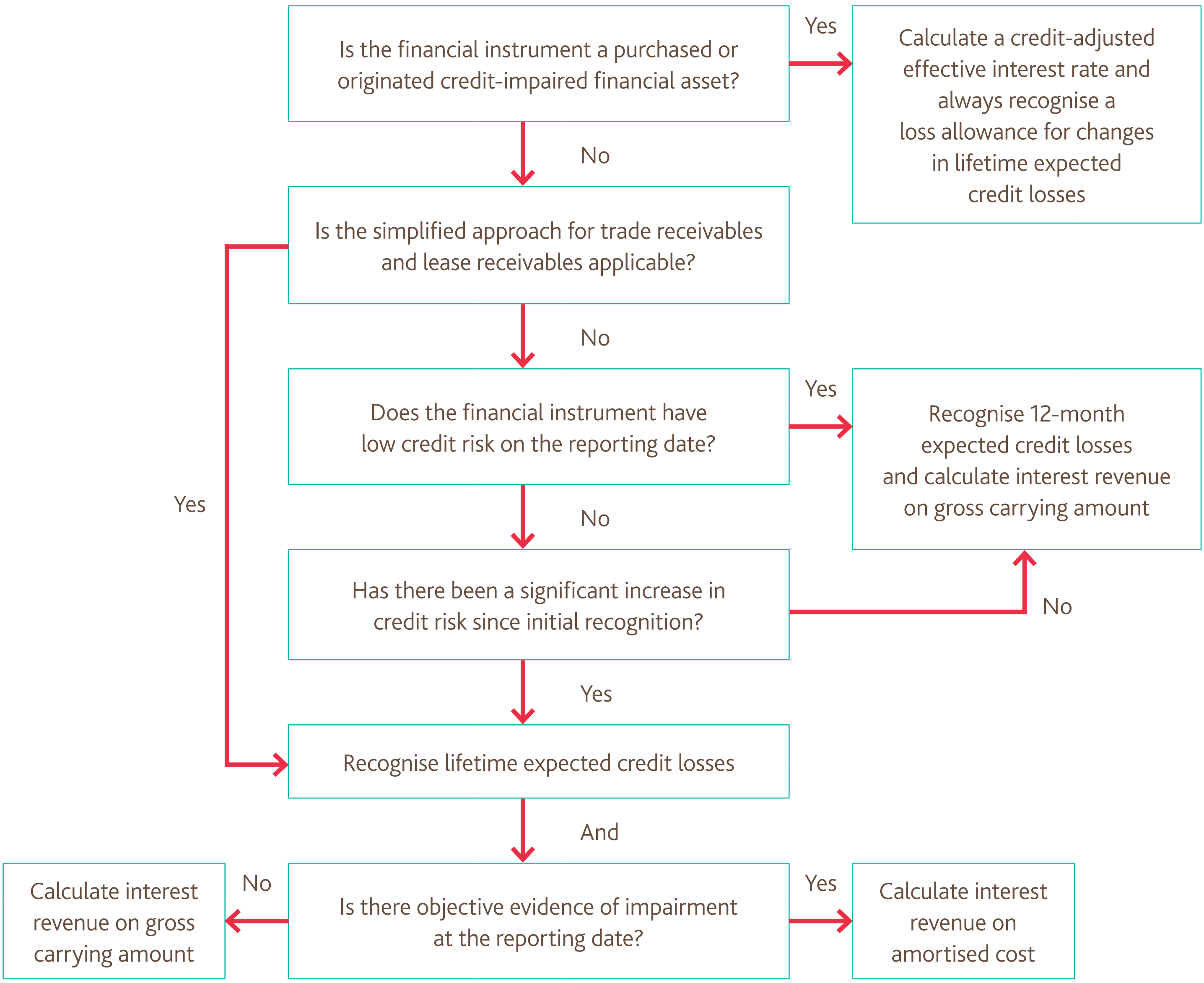

Figure 9: Summary of the main proposals

14. DISCLOSURES

The ED proposes that an entity would disclose information that identifies and explains:

- The amounts in its financial statements that arise from expected credit losses
- The effect of deterioration and improvement in credit risk.

In order to meet these requirements, an entity would be required to consider:

- The level of detail that is necessary
- How much emphasis to place on each of the disclosure requirements
- How much aggregation or disaggregation is appropriate
- Whether users of financial statements need additional information to evaluate the quantitative information that has been disclosed.

Additional disclosures would be required in instances where the disclosures (including those required by other IFRSs) were insufficient to satisfy the above requirements.

Appendix B sets out a summary of the proposed disclosures that would accompany the proposed impairment model. Once finalised, these disclosures would be added to IFRS 7 *Financial Instruments: Disclosures*.

15. TRANSITION

The ED proposes that the new requirements would be applied retrospectively, which is consistent with the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

However, if initial credit quality information cannot be gathered without undue cost or effort, then the entity would assess whether the credit risk of the financial asset is low (i.e. investment grade) at the date of initial application. If credit risk is low at date of initial application, then 12-month expected credit losses would be recognised at that point.

BDO comment

The International Accounting Standards Board (IASB) did acknowledge that on transition, for some entities, information about the credit quality of assets on their initial recognition may not be have been retained and, even if it had been retained, it might be very costly to retrieve. Consequently, the IASB also tentatively decided to provide a practical relief when initial credit quality information cannot be gathered without undue cost or effort (and it is noted in the related Board meeting paper that this would be a lower hurdle than 'impracticable' under IAS 8).

The ED also proposes that:

- Entities would be permitted to restate prior year comparatives if it did not involve use of hindsight, and
- Prior period disclosures on the effect of adopting the new model would not be required, but would be permitted only if it did not involve the use of hindsight.

On the date of initial application, an entity would be required to disclose information that would permit the reconciliation of the ending impairment allowance under IAS 39 *Financial Instruments: Recognition and Measurement* or the provisions under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to the opening loss allowance or provision determined in accordance with the new model. The disclosure would be provided by the related measurement categories in accordance with IAS 39 and IFRS 9 *Financial Instruments* for financial assets, and the effect of changes in the measurement category on the loss allowance at that date would be shown separately.

16. EFFECTIVE DATE

The effective date for the 2009 and 2010 versions of IFRS 9 *Financial Instruments* is periods beginning on or after 1 January 2015. No proposed effective date has been included in the current exposure draft. However, the ED includes a question about the period that entities believe they would need to implement the new requirements.

The International Accounting Standards Board (IASB) normally leaves a period of at least 18 months between the date of issue of a finalised IFRS, and the start of the period of its adoption. Given that the proposals for classification and measurement (for more information please refer to BDO's Need to Know publication *Classification and Measurement: Limited Amendments to IFRS 9* for further details), and impairment, will not be finalised until at least the second half of 2013, it appears that the effective date of IFRS 9 will be extended beyond 2015. It is noted that the proposed effective date of the new requirements for revenue recognition will be for periods beginning on or after 1 January 2017, and it is possible that the effective date of the finalised IFRS 9 will be aligned.

APPENDIX A POSSIBLE 'LIFETIME EXPECTED CREDIT LOSS' INDICATORS – PROPOSED APPLICATION GUIDANCE ON THE TRANSFER CRITERIA

The ED proposes to provide additional guidance to assist entities in determining when a provision for lifetime expected credit losses is required (paragraph B20). It proposes that entities may consider the following factors when making this determination:

- Significant changes in external market indicators of credit risk for a particular financial instrument or similar financial instruments with the same term.

  Changes in market indicators of credit risk include, but are not limited to:

  - Changes in credit spread
  - Changes in credit default swap prices for the borrower
  - The length of time and extent to which the fair value of a financial asset has been less than its amortised cost
  - Other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments.
- An actual or expected significant change in the financial instrument's external credit rating
- Significant changes in internal price indicators of credit risk as a result of a change in credit quality since inception
- Other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the financial instrument since initial recognition
- An actual or expected internal credit rating downgrade for the borrower or decrease in behavioural scoring used to assess credit risk internally
- Existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a significant change in a borrower's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected significant increase in unemployment rates
- Significant changes in operating results of the borrower. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in a borrower's ability to meet its debt obligations
- A significant credit deterioration on other financial instruments of the same borrower
- An actual or expected significant adverse change in the regulatory, economic, or technological environment of the borrower that results in a significant change in the borrower's ability to meet its debt obligations, such as a decline in the demand for the borrower's sales product because of a shift in technology
- Significant changes in the value of the collateral supporting the obligation and the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages

- A significant change in the quality of the guarantee provided by a 100 per cent shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion
- Significant changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected significant change in the quality of credit enhancement, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security)
- Expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument
- Significant changes in the expected performance and behaviour of the borrower, including changes in the payment status of borrowers in the group (for example, an increase in the expected number or extent of delayed contractual payments or a significant increase in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount)
- Changes in the entity's credit management approach in relation to the financial instrument, i.e. based on emerging indicators of changes in credit quality of the financial instrument, the entity's credit risk management practice is expected to become more active or focused on managing the instrument, including an instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower
- Contractual payments are more than 30 days past-due information.

APPENDIX B SUMMARY OF PROPOSED DISCLOSURES REQUIREMENTS UNDER THE EXPOSURE DRAFT

B1. Reconciliations

A reconciliation would be required between the opening balance and the closing balance of the gross carrying amount and the associated loss allowance for:

- Financial assets with a loss allowance measured at an amount equal to 12-month expected credit losses
- Financial assets with a loss allowance measured at an amount equal to lifetime expected credit losses
- Financial assets that have objective evidence of impairment at the reporting date but that are not purchased or originated credit-impaired financial assets
- Purchased or originated credit-impaired financial assets. In addition to the reconciliation for these assets, an entity is required to disclose the total amount of undiscounted expected credit losses at initial recognition
- The provision for loan commitments and financial guarantee contracts.

B2. Write-offs

An entity would be required to disclose:

- Its policy regarding write-offs
- Whether there are assets that have been written off that are still subject to enforcement activity
- The nominal amount of financial assets written-off that are still subject to enforcement activity.

B3. Modifications (renegotiations)

Disclosure would be required, for financial assets that have been modified (renegotiated) during the period, of the amortised cost and the modification gain or loss where the financial assets had an impairment allowance equal to lifetime expected credit losses.

Throughout the remaining life of each modified financial asset, disclosure would be required of:

- The gross carrying amount of financial assets that have been modified during their life and for which the measurement of the loss allowance has changed from an amount equal to lifetime expected credit losses to an amount equal to 12-month expected credit losses
- The re-default rate on such financial assets that have been modified while in default (i.e. the percentage of financial assets that defaulted again subsequent to modification).

B4. Inputs, assumptions and estimation techniques – 12-month and lifetime expected credit losses

An explanation would be required of the inputs, assumptions and estimation techniques that were used when estimating the 12-month expected credit losses and lifetime expected credit losses, including:

- The basis of inputs
- The estimation technique (including how the assets were grouped if they are measured on a collective basis)
- An explanation of the changes in estimates of expected credit losses and the cause of those changes
- Any change in the estimation technique and the reason for that change
- Information about the discount rate that the entity has selected, including:
  - (i) What discount rate an entity has elected to use, and the reasons for that election
  - (ii) The discount rate (percentage) used
  - (iii) Any significant assumptions made to determine the discount rate.

B5. Financial assets, loan commitments or financial guarantee contracts secured by collateral or other credit enhancements

Disclosure would be required of:

- A description of the collateral held as security and other credit enhancements (including a discussion on the quality of the collateral held and an explanation of any changes in the quality as a result of deterioration or changes in the collateral policies of the entity)
- The gross carrying amount of financial assets that have an expected credit loss of zero because of the collateral
- For financial instruments at ***stage 3***, quantitative information about the extent to which collateral and other credit enhancements reduce the extent of expected credit loss.

B6. Positive or negative effects on the loss allowance

Disclosure would be required, including both quantitative and qualitative analyses, of significant positive or negative effects on the loss allowance that are caused by:

- A particular portfolio
- A particular geographical area.

B7. The effect of changes in credit risk – inputs, assumptions and estimation techniques

An explanation would be required of the inputs, assumptions and estimation techniques used when determining whether the credit risk of a financial asset has increased significantly since initial recognition and when determining if it has objective evidence of impairment, including:

- The basis of inputs
- The estimation technique (including how the financial instruments were grouped if is assessed on a collective basis)
- An explanation of the changes in the estimates of the credit risk and the cause of those changes
- Any change in the estimation technique and the reason for that change.

B8. The effect of changes in credit risk – rebuttable presumption

If an entity has rebutted the presumption that financial assets more than 30 days past due have a significant increase in credit risk, disclosure would be required of how that presumption has been rebutted.

B9. The effect of changes in credit risk – credit rating grades

Disclosure would be required, by credit risk rating grade, of the gross carrying amount of financial assets and the amount recognised as a provision for loan commitments and financial guarantee contracts in a particular grade.

This analysis would be disclosed separately for:

- Financial assets
- Loan commitments
- Financial guarantee contracts.

The number of credit risk rating grades used would be required to be sufficient to enable users of the entity's financial statements to assess the entity's exposure to credit risk. That number would not be permitted to exceed the number of grades that the entity uses for internal credit risk management purposes. However, an entity would be required to disaggregate its portfolio across at least three grades, even if that entity uses fewer credit risk rating grades internally.

As a practical expedient, for trade receivables and lease receivables to which an entity applies the simplified approach (i.e. the loss allowance is measured as the amount equal to lifetime expected credit losses), this disclosure may be based on a provision matrix.

The effect of changes in credit risk – loan commitments and financial guarantee contracts

Disclosure would be required of the gross carrying amount of financial assets and the amount recognised as a provision for loan commitments and financial guarantee contracts that are assessed on an individual basis and whose credit risk has increased significantly since initial recognition.

APPENDIX C FASB'S PROPOSALS

On 20 December 2012 the US Financial Accounting Standards Board (FASB) issued an exposure draft for comment based on a different impairment model – the current expected credit loss (CECL) model.

C1. Background

After the completion of joint deliberation of the 'three stage' approach, the FASB through its outreach heard that a number of its stakeholders had significant concerns about that approach. In particular, the FASB was concerned that the transfer criteria (that would result in a move from ***stage 1*** to ***stage 2***) were difficult to understand, that there were operational complexities associated with the dual measurement approach, and about whether it would reflect an appropriate measure of risk. The FASB decided to develop an alternative model with a single measurement approach that reflects all credit risks in the portfolio.

C2. Proposed current expected credit loss (CECL) model

Like the International Accounting Standards Board's (IASB's) proposals, the CECL model would apply to all financial assets carried at amortised cost and at fair value through other comprehensive income (FVOCI).

Unlike the IASB's proposals which contain a dual measurement model, the FASB's proposed model contains a single measurement requirement. It requires an entity to recognise an impairment loss on financial assets based on its current estimate of all contractual cash flows not expected to be collected. Because the model only contains a single measurement approach it does not (nor would it require) any transfer criteria.

The CECL model provides a practical expedient for financial assets measured at fair value through other comprehensive income. For those assets, entities may choose to not recognise expected credit losses if both of the following conditions are met:

– The fair value of the financial asset is greater than (or equal to) the its carrying amount, and
– The expected credit losses on the financial asset are insignificant.

The below table summarises the main differences on recognition, measurement and transfer criteria between the two boards proposals.

	IASB's proposals	FASB's ED
Measurement	General approach: – Typically, 12 months expected losses at initial recognition, and – If transfer criteria are met, lifetime expected losses.	All contractual cash flows that the entity does not expect to collect.
Transfer criteria	– When there has been significant deterioration in credit quality since initial recognition, and – The credit quality of the asset would not be considered investment grade.	No transfer criteria.
Recognition exceptions	No recognition exception.	For financial assets at fair value through other comprehensive income, an entity may choose not to recognise expected credit losses if: – Its fair value is greater than the amortised cost, and – The expected credit losses are insignificant.

Figure C1: Summary of the key differences between the IASB and FASB model

CONTACT

For further information about how BDO can assist you and your organisation, please get in touch with one of our key contacts listed below. Alternatively, please visit www.bdointernational.com/Services/Audit/IFRS/IFRS Country Leaders where you can find full lists of regional and country contacts.

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