

FINANCIAL INSTRUMENTS: EXPECTED CREDIT LOSSES INTERNATIONAL FINANCIAL REPORTING BULLETIN 2013/09



Summary

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 instruments. 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*, which 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 model 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 based on the extent of deterioration in credit quality of a financial asset since initial recognition, which would determine the recognition of impairment (as well as interest revenue)
- 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, irrespective of their classification and subsequent measurement. 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*.

Because the impairment proposals require an entity to consider all relevant information when determining the recognition of impairment (rather than limiting recognition to a point on or after the occurrence of a credit loss event), it is believed that the proposals would improve financial reporting. This is because users of financial statements would be provided with more useful information regarding an entity's expected credit losses on its financial assets and commitments to extend credit.

The proposed effective date is yet to be confirmed, although the mandatory effective date of IFRS 9 is currently 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 requested comments on the ED by 5 July 2013.

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).

STATUS

Exposure Draft

EFFECTIVE DATE

To be confirmed

ACCOUNTING IMPACT

Significant for entities that hold financial assets that require impairment to be calculated on an amortised cost basis, or have commitments to extend credit that are not accounted for at fair value through profit or loss.

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.

Background

In the wake of the financial crisis, the incurred loss model for recognising the impairment of financial instruments was criticised for delaying the recognition of credit losses on loans (and other financial instruments) until an actual credit loss event had occurred - despite the fact that in many cases the future losses were expected as at reporting date.

In response, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) set about developing a simplified forward-looking impairment model which focuses on the expected loss resulting from shortfalls in contractual cash flows from financial instruments. Accordingly, this new model would be based on all available and relevant information about past loss experience, current conditions, and reasonable and supportable forecasts of future collectible cash flows, rather than limiting the basis of the assessment to past credit losses and current conditions.

Between 2009 and 2011 the IASB and FASB released their first proposals and a subsequent supplement for the new expected loss model. Ultimately a consensus was reached on an impairment model that 'split' an entity's financial assets into two (between a 'good book', and a 'bad book'), with different impairment principles applied to each.

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 interested parties are able to comment on both proposals.

Summary of the ED's proposals

1) Objective

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.

2) Scope

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

- Financial assets measured at amortised cost in accordance with IFRS 9
- 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*.

3) Summary of the proposed impairment model for financial instruments

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).

The three stages under the proposals are:

- *Stage 1*: credit quality has not significantly deteriorated since initial recognition
- *Stage 2*: credit quality has significantly deteriorated since initial recognition
- *Stage 3*: there is objective evidence of impairment as at the reporting date (using the criteria currently included in IAS 39).

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

Stage	1	2	3
Recognition of impairment	12 month expected credit loss ^(a)	Lifetime expected credit loss ^(b)	
Recognition of interest	Effective interest on the gross amount		Effective interest on the net (carrying) amount

Table 1 – Summary of the recognition of impairment (and interest revenue) under the proposals

a) *Recognition of impairment – '12 month expected credit loss'*

The 12 month expected credit loss is 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. Therefore, the 12 month expected credit loss represents only a portion of the instrument's entire lifetime expected credit losses.

However, the 12 month expected credit loss is **not**:

- The expected cash shortfalls over the next twelve months
- The credit losses on only those financial instruments that are forecast to default in the next 12 months (this may in fact indicate that the credit quality has deteriorated significantly, in which case the financial instrument would be in *stage 2* and lifetime expected credit losses would be required to be recognised).

b) *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 their obligation throughout the life of a financial instrument. They are calculated based on a weighted average of expected credit losses, with the weightings being based on the respective probabilities of default.

The measure of credit losses is based on present value.

Therefore a credit loss will still arise in instances where there is a delay in the payment of contractually required amount - even if the nominal amount is expected to be subsequently paid in full.

Note: because the new model is forward looking, expected credit losses would be recognised from the point at which financial instruments originate or are purchased. This means that an entity will (at a minimum) be required to recognise any 12 month expected credit losses that exist as at initial recognition (i.e. for financial instruments at *stage 1*).

4) **Simplified approach for trade receivables and lease receivables**

Paragraphs 12-13 of the ED introduce an accounting policy choice for trade receivables and lease receivables.

This allows an entity to measure the allowance for impairment for all trade receivables and all lease receivables at either:

- An amount equal to lifetime expected credit losses (i.e. apply the requirements for *stage 2/3* financial instruments)
- In accordance with the model proposed by the ED (i.e. apply the three-stage model in its entirety).

An entity can make different accounting policy elections for trade receivables and lease receivables.

Paragraph 12 also expressly defines which trade receivables the simplified approach applies to, which are those that result from a transaction with the scope of IAS 18 *Revenue*, and that either:

- Do not constitute a financing transaction in accordance with IAS 18
- Constitute a financing transaction in accordance with IAS 18, if the entity has made an accounting policy election to measure the loss allowance at an amount equal to lifetime expected credit losses. That accounting policy shall be applied by the entity to all such trade receivables.

5) **Rebuttable presumption - significant deterioration in credit risk**

Paragraph 9 of the ED introduces a rebuttable presumption that a significant deterioration in credit risk exists (and therefore impairment is recognised based on the lifetime expected credit loss) 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.

This presumption is 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.

6) **Exception for 'investment grade' loans – significant deterioration in credit risk**

Paragraph 6 of the ED provides an exception from determining that there has been a significant deterioration in credit risk (and therefore impairment would have had to have been recognised based on the lifetime expected credit loss) where the credit risk of the financial instrument is low.

As an example, the ED refers to loans that have an internal credit risk rating equivalent to the external credit rating of 'investment grade' as being considered to have a low credit risk.

7) Determining the expected credit loss

The determination of the expected credit loss must incorporate:

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

In determining the expected credit loss, the objective is not to estimate the worst/best case scenario, with the expected credit loss instead reflecting the possibility that a credit loss will and will not occur (even if the most likely outcome is that no loss occurs).

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.

(a) 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 reasonable discount rate that is between (and including):

- The risk-free rate
- The effective interest rate.

Note: subsequent to initial recognition, the current discount rate may be outside of the permitted range that existed at initial recognition.

(i) Undrawn loan commitments and financial guarantee contracts: the discount rate is the rate that reflects the current market assessment of the time value of money and the risks that are specific to the cash flows (but only if, and to the extent that, the risks are taken into account by adjusting the discount rate rather than by adjusting the cash shortfalls being discounted).

However, 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.

(ii) Purchased or originated credit-impaired financial assets: expected credit losses are discounted using the credit-adjusted effective interest rate.

8) Modifications (renegotiations) of contractual cash flows that do not result in derecognition

Such modifications (or renegotiations) result in the entity having to recalculate the gross carrying amount on the basis of the renegotiated or modified contractual cash flows.

A modification gain or loss is then recognised in profit or loss.

An entity must also consider whether the modification (renegotiation) provides evidence that there may have been a significant deterioration in credit risk (in which case the financial instrument would be in *stage 2*, and lifetime expected credit losses would be required to be recognised).

9) Write-offs

A write-off event occurs when the entity has no reasonable expectations of recovery. 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.

A write-off constitutes a derecognition event (either in full or in part).

10) Presentation

An entity presents as separate line items in the statement of profit or loss and other comprehensive income (or the statement of comprehensive income, as currently referred to in IFRS):

- Interest revenue
- Impairment losses or gains.

The calculation of interest revenue is determined, based on the effective interest method applied to the gross carrying amount of the financial asset, except for:

- Purchased or originated credit-impaired financial assets (in which cases the lender applies a credit-adjusted effective interest rate to the amortised cost of the financial asset from initial recognition)
- A financial asset that is not a purchased or an originated credit-impaired financial asset, but that has objective evidence of impairment at the reporting date (in which case the lender applies the effective interest rate to the amortised cost of the financial asset in the subsequent reporting period).

11) Disclosure

An entity is required to 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 the credit risk.

In order to meet these requirements, an entity is 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 are required in instances where disclosures provided (including those required by other IFRSs) are insufficient to satisfy the above requirements.

(a) Reconciliations

A reconciliation is 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.

(b) Write-offs

An entity is 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.

(c) Modifications (renegotiations)

An entity is required to disclose, for financial assets that have been modified (renegotiated) during the period:

- The amortised cost and the modification gain or loss, for financial assets that had an impairment allowance equal to lifetime expected credit losses.

Throughout the remaining life of each modified financial asset:

- 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).

(d) Inputs, assumptions and estimation techniques – 12-month and lifetime expected credit losses

An entity is required to explain 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.

(e) Financial assets, loan commitments or financial guarantee contracts secured by collateral or other credit enhancements

An entity is required to disclose:

- 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 severity of expected credit loss.

(f) Positive or negative effects on the loss allowance

An entity is required to disclose 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.

(g) The effect of changes in credit risk – inputs, assumptions and estimation techniques

An entity is required to explain the inputs, assumptions and estimation techniques used when determining whether the credit risk of the financial instruments 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.

(h) 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, the entity is required to disclose how it has rebutted that presumption.

(i) The effect of changes in credit risk – credit rating grades

An entity is required to disclose, by credit risk rating grades, 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 is disclosed separately for:

- Financial assets
- Loan commitments
- Financial guarantee contracts.

The number of credit risk rating grades used:

- Must be sufficient to enable users of the entity's financial statements to assess the entity's exposure to credit risk
- Shall not exceed the number that the entity uses for internal credit risk management purposes except that an entity shall always disaggregate its portfolio across at least three grades, even if that entity uses fewer credit risk rating grades internally.

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.

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

An entity is required to disclose 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.

Differences from current requirements and expected effects

The proposals in the ED would result in a fundamental shift in the way in which the impairment of financial instruments is recognised and measured, in comparison with the current requirements of IAS 39 *Financial Instruments: Recognition and Measurement*.

IAS 39 (current requirements)	Exposure draft (proposed requirements)
<p><i>Incurring loss model</i></p> <p>A financial instrument is impaired, and impairment losses recognised in profit or loss, only if:</p> <ul style="list-style-type: none"> – A credit loss event has occurred – The impact on the future cash flows of the financial instrument as a result of the credit loss event can be measured reliably. <p>Expectations relating to future expected credit losses are prohibited from being recognised - even if reasonable and supportable.</p>	<p><i>Expected loss model</i></p> <p>A financial instrument is continuously assessed for impairment, being evidenced where there are differences between the present value between a financial instruments:</p> <ul style="list-style-type: none"> – Contractual cash flows – Expected cash flows. <p>The estimate of expected cash flows is based on all available and relevant information, incorporating:</p> <ul style="list-style-type: none"> – Past loss experience – Current conditions – Reasonable and supportable forecasts.

Table 2 – Summary of the differences between IAS 39 and the ED's proposed requirements regarding impairment

This change in approach would result in both mechanical and practical changes as to how an entity addresses the impairment of financial assets and other financial instruments, including:

- The threshold for the recognition of impairment is lowered (i.e. it is no longer necessary for a credit loss event to have occurred)
- Changes in the expectations of expected credit losses are always recognised in the overall provision for impairment that is recognised
- The information that is considered in determining expectations of credit losses is broadened (i.e. to include reasonable and supportable forecasts)
- A single model of impairment is now applied to all of an entity's debt instruments (irrespective of classification and subsequent measurement)
- An increase in an entity's judgements, assumptions, and estimates in relation to what constitutes a significant deterioration in credit quality, when such a deterioration has occurred, and the determination of the expected future cash flows
- The above judgements, assumptions, and estimates are required to be applied on a continuous basis.

Convergence with US GAAP

Currently, the requirements of both the IASB and FASB impairment models for financial assets are based on an *incurred loss* model that includes:


- An initial recognition threshold (i.e. the occurrence of a credit loss event)
- Considerations of only past events and current conditions.

As mentioned in earlier sections, 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.

A summary of the key differences and similarities between the IASB and FASB models is set out below:

Differences from the FASB model	Similarities between the models
<ul style="list-style-type: none"> – There would be no distinction made in the FASB model between those financial instruments that have deteriorated since initial recognition and those that have not – Under the FASB model, expected credit losses would always be measured at an amount equal to the lifetime expected credit losses (i.e. the 12-month expected credit loss measurement for <i>stage 1</i> financial instruments in the IASB proposals is not used). 	<ul style="list-style-type: none"> – The occurrence of a credit loss event is removed as a trigger event for the initial recognition of impairment of financial instruments – There is consistency in the information used to estimate and measure expected credit losses – Financial instruments that are not 'investment grade', that have deteriorated significantly in credit quality since initial recognition, would be expected to have the same level of impairment recognised under each model.

Table 3 – Summary of the differences between FASB and IASB proposed impairment models



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