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New on the Horizon: Financial instruments – Expected credit losses

March 2013

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A step change in accounting for impairment

On 7 March 2013, the IASB issued its long-awaited revised proposals on accounting for the impairment of financial assets. The proposals aim to address concerns about 'too little, too late' provisioning for loan losses and would accelerate recognition of losses by requiring provisions to cover both already-incurred losses and some losses expected in the future. The proposals are a step change in accounting for impairment and are likely to have a significant impact on banks and similar financial institutions.

Accounting for impairment has been hotly debated by standard setters on both sides of the Atlantic. Regrettably, the initial commitment of the IASB and the FASB to work together on joint proposals ended last year. In December 2012, the FASB issued its own proposals, which are quite different from the IASB's. This may be a big disappointment for many constituents, since they expressed in their feedback to the Boards that convergence to a single high-quality standard is extremely important. The Boards have indicated that they plan to discuss jointly the comments received on their respective proposals to identify whether there are areas of common ground to potentially bring the models closer together. However, the deadlines for providing responses to the exposure drafts are different, making it difficult for constituents to give informed feedback based on full consideration of both models.

The IASB proposals introduce a new 'expected loss' impairment methodology that would reflect deterioration in the credit quality of financial assets such as loan portfolios and debt securities. The proposed model would require recognition of lifetime expected credit losses for financial assets whose credit risk has deteriorated significantly since initial recognition, and a 12-month expected loss allowance for other financial assets. Estimating impairment is an art, rather than a science, involving difficult judgements about whether financial assets will be paid as due and, if not, how much will be recovered and when. The proposed model widens the scope of these judgements. It introduces a new threshold for determining whether there has been a significant deterioration in credit quality – which in turn is used to assess whether a financial asset should have an allowance to cover losses in the next 12 months, or to cover all expected credit losses over its life. These new rules would give rise to challenges, because new judgements would have to be made by preparers, reviewed by auditors and understood by users of financial statements, including prudential and securities regulators.

The new model would apply to financial assets that are recognised on the statement of financial position, such as loans or bonds, and measured either at amortised cost or at fair value, with gains and losses recognised in other comprehensive income. It would also apply to certain loan commitments and financial guarantees. This may be seen as a welcome change, because most banks' credit systems treat these exposures in a similar way.

The proposals would introduce extensive new disclosures. Although focused, relevant disclosures are essential for users to understand an entity's exposure to credit risk and the critical judgements that it has made in preparing the accounts, some will see the proposals as adding to the perceived 'disclosure overload' that troubles many preparers and users.

Most banks are likely to see a significant impact, and may need additional systems and processes to collect the necessary information. Companies, in particular banks, should not delay assessing the impact of the proposals on their business. Credit risk is at the heart of a bank's business and the proposed model is expected to have far-reaching implications for their credit systems and processes. Banks may face significant implementation issues. Corporates would also be affected, but the impact on short-term trade receivables is likely to be less significant.

The proposals are open for comment until 5 July 2013. We hope that this publication will help you to understand the proposals and formulate your own response.

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KPMG International Standards Group

1. Key facts

- **The IASB has re-exposed its impairment proposals for public comment by publishing ED/2013/3 *Financial Instruments: Expected Credit Losses*.**

- **The proposed impairment model would replace the existing 'incurred loss' model in IAS 39 *Financial Instruments: Recognition and Measurement* with an 'expected loss' approach.**

- **The proposals would apply to debt instruments (including loans, and lease and trade receivables) and certain financial guarantees and loan commitments, but not to equity investments.**

- **The proposed impairment model uses a dual measurement approach.**
  - Under the general approach, impairment is measured as either:
    - 12-month expected credit losses; or
    - lifetime expected credit losses.
  - The measurement basis would depend on the extent of credit deterioration since initial recognition.

- **A simplified approach would be available for trade and lease receivables, allowing or requiring recognition of lifetime expected credit losses at all times.**
  - Trade receivables without a significant financing component would always carry a loss allowance equal to lifetime expected credit losses.
  - For trade receivables with a significant financing component and lease receivables, an election can be made to either:
    - apply the general approach; or
    - recognise lifetime expected credit losses at all times.

- **Special rules apply to assets that are credit-impaired on initial recognition.**
  - The effective interest rate (EIR) calculated at initial recognition would be reduced by lifetime expected credit losses.
  - Subsequent changes in lifetime expected credit losses would be recognised in profit or loss and in a corresponding allowance balance.

- **Interest would be recognised using the EIR.**
  - Generally, interest would be recognised by applying the EIR to the gross carrying amount of a financial asset.
  - However, when an asset is credit-impaired, interest would be calculated by applying the EIR to the amortised cost – i.e. gross carrying amount less expected credit losses.

- **The ED proposes extensive disclosures that explain the following.**
  - The amounts in the financial statements arising from expected credit losses.
  - The effects of deteriorations and improvements in credit quality.

- **Convergence between the IASB and FASB expected loss models has not been achieved at this stage.**

- **The IASB will establish the effective date when redeliberations are completed.**
  - The standard would be applied retrospectively with some exemptions.
  - Restatement of prior periods would not be required, but permitted if information is available without the use of hindsight.

2. How this could impact you

- **The proposals would result in a significant increase in the number and complexity of judgements.** The model relies on entities being able to make robust estimates of:
  - expected credit losses; and
  - the point at which there is a significant deterioration in credit risk since initial recognition of an asset.
- **Operationalising the proposals may be challenging.** The proposed methodology would be likely to have a significant impact on the systems and processes of banks, insurers and other financial institutions. Extended data/calculation requirements would include:
  - estimates of 12-month expected credit losses;
  - estimates of lifetime expected credit losses; and
  - tracking information and data to determine whether significant deterioration in credit risk has occurred or reversed.
- **Equity and covenants may be affected.** The initial application may result in a large negative impact on equity for banks and, potentially, insurers and other financial institutions. The impact on the entity would be substantially affected by:
  - the size and nature of its financial assets;
  - the judgements it has made in applying the current requirements; and
  - the judgements it makes in applying the proposed new model.

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- **Banks with less sophisticated credit systems may have difficulty implementing the proposals.** These banks may lack the data or systems to perform the expected loss calculations. Also, they may have little internal expertise in developing expected loss models.
- **Key performance indicators (KPIs) would be affected for banks, insurers and similar entities.** Because credit risk is at the heart of a bank's business, the transition to the expected loss model is likely to have a significant impact on its KPIs. The proposals may introduce new volatility in their financial statements, because:
  - loss estimates would apply to all financial assets, rather than only to assets for which losses have been incurred;
  - market data used as input factors may be volatile – e.g. ratings, credit spreads and predictions about future conditions; and
  - any move from a 12-month expected loss measurement to a lifetime expected loss measurement may result in a big change in the corresponding allowance.
- **The proposals contain extensive disclosure requirements.** Sourcing the additional information required could be a complex and time-consuming process that would have an impact on resources and systems.

3. Setting the standard

Since November 2008, the IASB has been working to replace its financial instruments standards with an improved and simplified standard[1]. The IASB and the FASB (the Boards) are both working to overhaul the accounting for financial instruments. However, the Boards' current proposals are different.

IASB's initial proposals

The IASB first published ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (the 2009 ED) in November 2009. The 2009 ED proposed replacing the incurred loss model for assessing the impairment of financial assets measured at amortised cost with an expected loss approach. Under those proposals, an entity would have estimated the expected credit losses initially at inception of the asset and then re-estimated the losses at the end of each reporting period. No gain or loss would have been recognised at initial recognition, and the initially expected credit losses would have reduced the EIR. Any gain or loss on a subsequent re-estimation would have been recognised immediately in profit or loss. The IASB's primary objective was to reflect the initial expected credit losses as part of determining the EIR, because this was considered to be more reflective of the economic substance of lending transactions.

The feedback received by the IASB on the 2009 ED indicated overall support for an expected loss model. However, constituents were concerned about the operationality of the proposals, particularly for financial assets that are managed on an open portfolio basis, in relation to the suggested integrated EIR.

FASB's initial proposals

The FASB published its initial proposals for impairment as part of its proposed accounting standards update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, issued in May 2010. The proposals reflected the FASB's primary objective of ensuring that the allowance balance would be sufficient to cover all estimated credit losses over the remaining life of an instrument. Accordingly, an entity would have estimated the cash flows not expected to be collected from a financial asset, and would have recognised the related losses immediately. The cash flows would have been estimated on the assumption that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset. The FASB intended to address the concern over the current impairment guidance that loss reserves tend to be at their lowest level when they are most needed at the beginning of a downturn in the economic cycle – i.e. that incurred loss provisions are 'too little, too late'.

The FASB reported that it had received mixed comments on its May 2010 proposals for the immediate recognition of expected credit losses. Although many respondents opposed recognising total lifetime expected credit losses immediately, users of financial statements generally supported it. The vast majority of respondents did not agree with the proposals to preclude entities from considering in their expected loss calculations changes to economic conditions beyond the end of the reporting period. However, most investors thought that it was very difficult, if not impossible, to forecast credit losses over a long period of time; they supported limiting the period of predictions to, for example, two to three years – which they thought would result in more reliable information.

Joint redeliberations

The Boards jointly redeliberated comments on their proposals. They jointly published a supplementary document to the 2009 ED in January 2011 as part of their commitment to enhancing international comparability in the accounting for financial instruments. The joint model was a variant of the Boards' original proposals and had features that partly satisfied each of the Boards' primary objectives outlined

[1] For more information about the financial instruments replacement project, please refer to the IFRS – financial instruments hot topics page on our KPMG Global IFRS Institute website.

above. The Boards proposed that, to determine the impairment allowance, financial assets that are managed on an open portfolio basis would be split into two categories: the 'good book' and the 'bad book'. The impairment allowance at the end of each reporting period would have been made up of the following two components:

- for financial assets in the good book, the higher of:
  - time-proportional expected credit losses; and
  - credit losses expected to occur in the foreseeable future, which would be no less than 12 months after the end of an entity's reporting period (the 'floor' amount); and
- for financial assets in the bad book, the entire amount of expected credit losses.

The proposed model also excludes expected credit losses when determining the EIR – i.e. the model follows a 'decoupled' EIR approach.

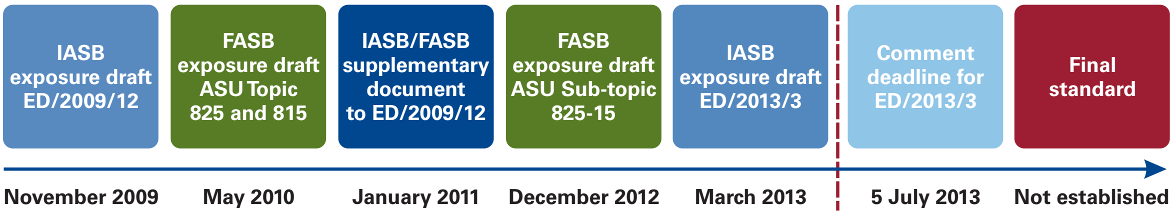
Feedback indicated that convergence to a high-quality standard is extremely important for constituents. However, many constituents were concerned about having to perform two separate calculations for the good book allowance, and about how to explain and understand the allowance balance, given that it could potentially switch between the floor and the time-proportional amount from period to period. In addition, it was not clear to constituents when to move an asset between the good book and bad book, and how the term 'foreseeable future' should be defined.

Diverging models

Until mid-2012, the Boards had been working together on developing a joint impairment model for financial assets. However, based on feedback from US constituents about whether that model was understandable, operational and auditable, the FASB decided to explore a different approach.

The FASB issued further proposals in December 2012, in its proposed accounting standards update *Financial Instruments – Credit Losses*[2]. These proposals are based on a single measurement objective that would reflect an entity's current estimate of contractual cash flows that are not expected to be collected. The comment period ends on 30 April 2013. Although the FASB's proposed impairment model is also an expected loss model, it is different to the IASB model.

On 7 March 2013, the IASB published ED/2013/3 *Financial Instruments: Expected Credit Losses*. The comment deadline for the new ED is 5 July 2013. The Boards have stated that they will discuss jointly comments on both proposals and consider whether it is possible to more closely align their expected loss models.

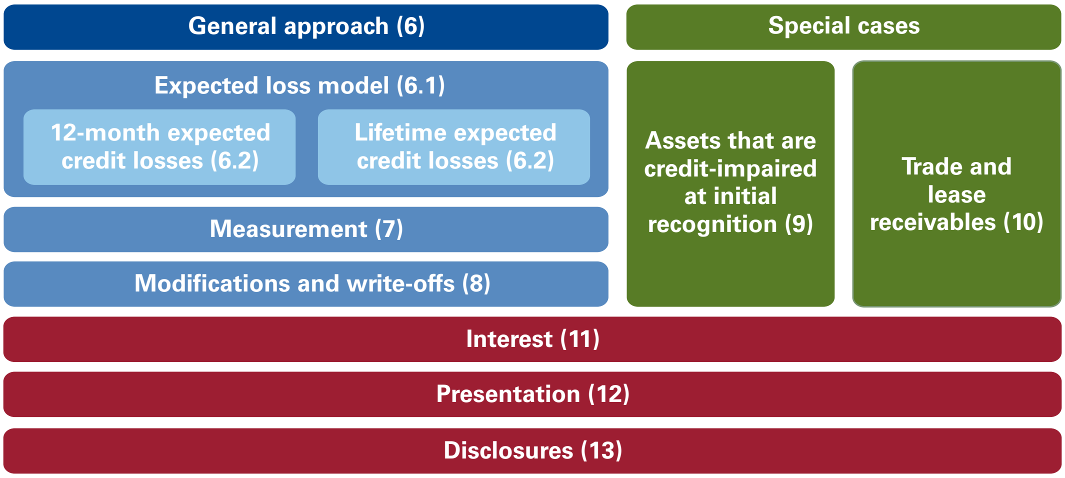

IASB exposure draft ED/2009/12
FASB exposure draft ASU Topic 825 and 815
IASB/FASB supplementary document to ED/2009/12
FASB exposure draft ASU Sub-topic 825-15
IASB exposure draft ED/2013/3
Comment deadline for ED/2013/3
Final standard
November 2009
May 2010
January 2011
December 2012
March 2013
5 July 2013
Not established

[2] See KPMG's publication: Issues In-Depth 13-1: Applying the FASB Proposed Model on Financial Asset Credit Losses.

4. Introduction

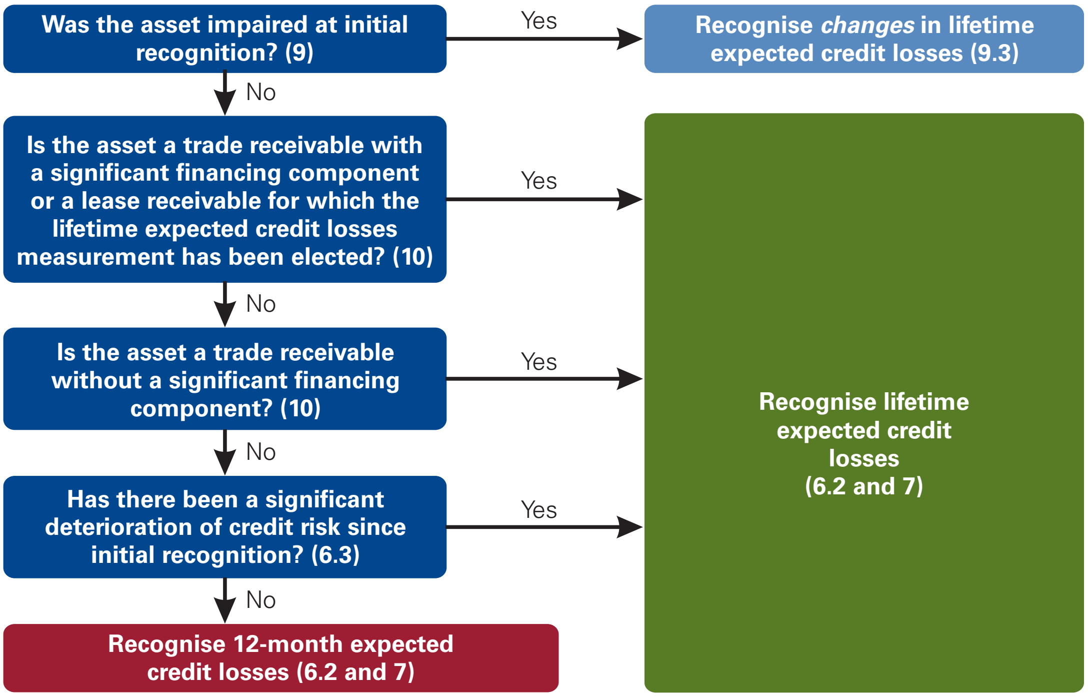
How this publication is structured

ED/2013/3 *Financial Instruments: Expected Credit Losses* (the ED or the impairment ED) introduces a new approach for measuring impairment. The diagram below summarises how the key concepts of the model are explained throughout this publication. The corresponding section numbers are in brackets.


General approach (6)
Special cases
Expected loss model (6.1)
12-month expected credit losses (6.2)
Lifetime expected credit losses (6.2)
Measurement (7)
Modifications and write-offs (8)
Assets that are credit-impaired at initial recognition (9)
Trade and lease receivables (10)
Interest (11)
Presentation (12)
Disclosures (13)

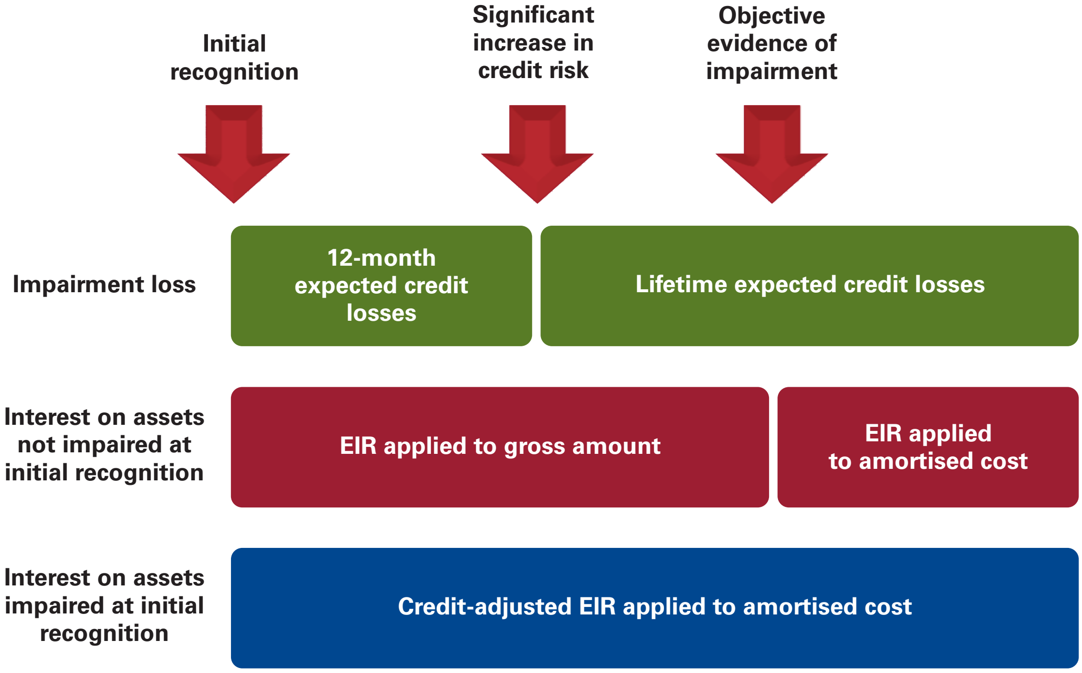
Overview of the dual measurement model

The key features of the proposed dual measurement expected loss impairment model are summarised in the flow chart below. The flow chart illustrates the measurement basis for the credit loss allowance that would apply to different types of financial instruments.


Was the asset impaired at initial recognition? (9)
Yes
Recognise *changes* in lifetime expected credit losses (9.3)
No
Is the asset a trade receivable with a significant financing component or a lease receivable for which the lifetime expected credit losses measurement has been elected? (10)
Yes
No
Is the asset a trade receivable without a significant financing component? (10)
Yes
No
Has there been a significant deterioration of credit risk since initial recognition? (6.3)
Yes
No
Recognise 12-month expected credit losses (6.2 and 7)
Recognise lifetime expected credit losses (6.2 and 7)

Recognising interest on the financial asset

The following flow chart summarises the proposals on recognising interest that depends on the credit quality of the financial asset.



Initial recognition

Significant increase in credit risk

Objective evidence of impairment

Impairment loss

12-month expected credit losses

Lifetime expected credit losses

Interest on assets not impaired at initial recognition

EIR applied to gross amount

EIR applied to amortised cost

Interest on assets impaired at initial recognition

Credit-adjusted EIR applied to amortised cost

5. Scope

ED 2

The ED applies to the following instruments not accounted for at fair value through profit or loss (FVTPL) under IFRS 9 *Financial Instruments*:

- financial assets measured at amortised cost under IFRS 9 or mandatorily measured at fair value through other comprehensive income (FVOCI) under ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*[3] (the C&M ED);
- loan commitments where there is a present contractual obligation to extend credit;
- financial guarantees within the scope of IFRS 9; and
- lease receivables within the scope of IAS 17 *Leases*.

Observations – Scope

IAS 39.63–70, AG4(a)

Currently under IAS 39 *Financial Instruments: Recognition and Measurement*, there are several impairment models for different financial instruments:

- assets at amortised cost;
- available-for-sale assets – debt instruments; and
- available-for-sale assets – equity instruments.

The existence of several models within IAS 39 creates complexity. In addition, losses relating to loan commitments and financial guarantees issued by banks are generally accounted for under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This has created a practical issue for banks, because they manage credit risk on financial guarantees and loan commitments in the same way as credit risk on loans and other debt instruments, while for accounting purposes these are treated separately.

The proposals in the ED would mean that a single set of impairment requirements would apply to all financial assets, loan commitments and financial guarantees within the scope of IFRS 9 that are not accounted for at FVTPL. This may simplify the requirements and align them more closely with the way banks manage their credit risk, because most banks consider the amount receivable and the undrawn amount of the commitment together for risk management purposes. However, differences may arise in practice between the way banks perform the calculations for internal risk management purposes and the specific requirements of the ED. These are discussed further in 7.2.

These proposals may also have a significant impact on corporates that have issued financial guarantee contracts. This is because currently they would only recognise a provision on such contracts when it is probable that an outflow will occur. Under the proposals, a provision would have to be recognised for most if not all financial guarantee contracts. For example, this would be an issue if a parent that provides financial guarantees to its subsidiaries prepares separate financial statements under IFRS.

[3] This assumes that the C&M ED will be finalised as proposed. See also our publication New on the Horizon: Classification and Measurement – Proposed limited amendments to IFRS 9.

Observations – Equity investments

IAS 39.61

Under IAS 39, specific requirements apply when measuring the impairment of equity investments. In addition to the general impairment triggers, equity investments are impaired if there is a 'significant or prolonged' decline in their fair value below cost. This test has proven difficult to apply, and has resulted in diversity in practice.

Equity investments are outside the scope of the ED, because under IFRS 9 they are accounted for either:

- at FVTPL; or
- at FVOCI, with no reclassification of any amounts to profit or loss (except dividends).

Accordingly, equity investments would no longer be tested for impairment. This would result in a helpful simplification.

ED IE39

Loan commitments not measured at FVTPL would be within the scope of the ED if the issuer of the commitment has a present contractual obligation to extend credit. If the issuer has a cancellation right, but this right is subject to a notice period, then the issuer would have a legal obligation to extend credit until the end of the notice period; such a loan commitment would therefore be within the scope of the ED.

Observations – Present contractual obligation to extend credit

The term 'present contractual obligation to extend credit' is not defined in the ED. In our experience, banks make different types of commitments to extend credit with different terms and conditions. These may include:

- overdraft and other revolving credit facilities;
- stand-by credit facilities; and
- credit card facilities.

Sometimes, it may not be clear:

- whether the terms and conditions amount to a present contractual obligation to extend credit within the scope of the ED; or
- what is the period over which the present contractual obligation exists.

A lender may have a contingent right to withdraw a facility – e.g. when there has been deterioration in the credit condition of the potential borrower. Careful analysis may be needed to identify arrangements that would fall within the scope of the ED, and to determine the period over which a present contractual obligation exists.

In practice, it may be difficult for a lender to withdraw a facility before it has been drawn down (even though he has the right to do so with no notice period), because it takes time for the lender to become aware of the borrower's financial difficulty. However, this expected draw-down would not represent a contractual commitment, and so would not be within the scope of the ED.

IAS 39.AG4(a)

The ED only applies to financial guarantee contracts within the scope of IFRS 9. If an issuer of a financial guarantee contract has previously asserted explicitly that:

- it regards such contracts as insurance contracts; and
- has used accounting applicable to insurance contracts,

then the issuer may elect to apply IFRS 4 *Insurance Contracts* to such financial guarantee contracts. Financial guarantee contracts that are accounted for under IFRS 4 are not subject to the requirements of the ED.

6. The general approach

6.1 Expected credit loss model

6.1.1 A new approach

ED 1, BC4, BC17, BC55, BC170

The proposals would replace the existing 'incurred loss' model in IAS 39 with an 'expected loss' approach.

The current incurred loss model has been criticised for:

- delaying the recognition of losses;
- the complexity of having multiple impairment approaches; and
- being difficult to understand, apply and interpret.

Under the proposed expected loss model, it would no longer be necessary for a loss event to occur before an impairment allowance is recognised.

The proposed model represents a new approach, different to the proposals previously published in:

- ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*, released in November 2009 (the 2009 ED); and
- *Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment*, released in January 2011.

It is also different to the concepts of 'good book' and 'bad book' discussed by the Expert Advisory Panel[4] during its deliberations in 2010.

In the introduction to the ED, the IASB notes that the ED does not propose changing the previous proposals in respect of:

- the information used to estimate expected credit losses; and
- the requirement to recognise expected credit losses from the initial recognition of a financial instrument.

ED BC29

The IASB also explains that, throughout the impairment project, it has sought to reflect the relationship between the initial estimates of credit losses and the pricing of an instrument. It considered that the 2009 ED would have achieved this most appropriately, because it would have required expected credit losses to be incorporated into the EIR on initial recognition of a financial asset. However, respondents raised concerns about the operationality of the 2009 ED. Therefore, in its current proposals the IASB has sought to approximate the outcome of the 2009 ED while avoiding the operational challenges. It believes that it does so by requiring the recognition of lifetime expected credit losses on some financial instruments, and a portion of lifetime expected credit losses on others.

[4] The Boards have formed the Expert Advisory Panel to address some of the operational challenges of an expected cash flow approach.

Observations – Impact on initial adoption

Initial application of the ED may result in a large negative impact on equity and covenants for certain entities – in particular, banks and, potentially, insurance companies and other financial institutions. This is because the impairment allowance would no longer reflect only incurred credit losses, but also expected future credit losses.

The impact on an entity would depend on:

- the size and nature of its financial assets;
- the judgements that it has made in applying the current requirements – in particular, relating to the length of the emergence period for identifying losses that have been incurred but not reported (IBNR); and
- the judgements that it makes in applying the proposed expected loss model.

In addition, the transition to the expected credit loss model is likely to have a significant impact on KPIs. The proposals may introduce new volatility in financial statements because:

- loss estimates would apply to all financial assets, rather than only to assets for which losses have been incurred;
- market data used as input factors may be volatile – e.g. ratings, credit spreads and predictions about future conditions; and
- a move from a 12-month expected loss measurement to a lifetime expected loss measurement (see 6.3) may result in a big change in the corresponding allowance.

Observations – Operationalising the proposals

Operationalising the proposals in the ED may be challenging. The proposed methodology would be likely to have a significant impact on the systems and processes of banks, insurers and other financial companies. Extended data and calculation requirements would include:

- estimates of 12-month expected credit losses (see 6.2 and 7);
- estimates of lifetime expected credit losses (see 6.2 and 7); and
- tracking information and data to determine whether significant deterioration in credit risk has occurred or reversed (see 6.3).

Banks with less sophisticated credit systems may have difficulty implementing the proposals. These banks may lack the data or systems to perform the expected loss calculations. Also, they may have little internal expertise in developing expected loss models.

6.1.2 An alternative view

ED AV1–11

One IASB member voted against the publication of the ED because he disagreed with the requirement to establish a 12-month expected credit loss allowance for financial assets that do not have a significant increase in credit risk since initial recognition. He believed that this approach has no conceptual foundation and fails to reflect the economics of lending activities.

He also believed that the original model in the 2009 ED is the most appropriate model for recognising the expected credit losses on financial assets. He recognised the operational difficulties of applying this approach and believed that there are two potential methods for simplifying and largely replicating the outcome of the 2009 ED:

- a modified lifetime expected credit loss model; and
- the gross-up method.

Both approaches appear to result in no loss being recognised on initial recognition because entities would earn credit margin to compensate for such losses. The modified lifetime expected credit loss model would reduce the loss through the expected future credit spread. The gross-up method would require an entity to recognise a loss allowance for the lifetime expected credit losses at initial recognition of the financial asset and increase the gross carrying amount of the asset by the same amount. The entity would then amortise the increase in the gross carrying amount over the life of the asset as a proxy for an adjustment to interest revenue.

6.2 12-month expected credit losses and lifetime expected credit losses

ED 4–5 Under the proposals, impairment would be measured as either:

- 12-month expected credit losses; or
- lifetime expected credit losses.

ED Appendix A '12-month expected credit losses' are expected credit losses that result from default events on the financial instrument that are possible within the 12 months after the end of the reporting period.

ED Appendix A 'Lifetime expected credit losses' are expected credit losses that result from all possible default events over the life of the financial instrument.

ED Appendix A Expected credit losses are the weighted average of credit losses, using the respective probabilities of default as the weights (see Section 7).

The circumstances under which each approach is used are explained in 6.3, 9 and 10.

Observations – 12-month expected credit losses – Rationale

ED BC61–BC62, BC193 In the basis for conclusions to the ED, the IASB acknowledges that there is no conceptual basis for selecting 12 months of expected credit losses rather than any other period. Rather, this period has been selected because the IASB considers it to represent an appropriate balance between the benefits of a faithful representation of expected credit losses and operational costs and complexity. Also, it notes that selecting a period longer than 12 months would lead to the recognition of a larger proportion of expected credit losses, and therefore increase the overstatement of expected credit losses at initial recognition.

The IASB also observes that in many jurisdictions regulated financial institutions already calculate a 12-month loss rate that is similar to the proposals in the ED, and so implementing the model would be less costly for them. Financial institutions that already apply a 12-month expected loss concept for regulatory purposes would have to identify and quantify the effect of any differences in definition between the regulatory requirements and the ED. One area of difference may be that regulators might require the expected credit losses to reflect downturn loss given default (LGD) values that are the worst case figures, whereas the ED would require an estimate based on actual expectations at the end of the reporting period.

Observations – 12-month expected credit losses – Definition

ED 18, Appendix A

The ED does not define what is meant by '12-month expected credit losses', beyond stating that they are the expected credit losses that result from default events on the financial instrument that are possible within the 12 months after the end of the reporting period. It states that entities may apply various approaches – including those that do not include an explicit probability of default (PD) occurring as an input – as long as such approaches comply with the general requirements of the ED – i.e. that they reflect:

- an unbiased and probability-weighted amount; and
- the time value of money.

The ED gives an example of a 'credit loss rate' approach that could be consistent with the general requirements. Entities would have to evaluate their credit risk management methodologies to determine what adjustments might be needed so that the amounts generated by those systems comply with the requirements in the ED (see also the example on measuring the 12-month expected credit losses allowance in 7.6).

Observations – 12-month expected credit losses – Definition of 'default'

ED BC97

As noted above, the ED defines '12-month expected credit losses' as losses that result from default events on the financial instrument that are possible within the 12 months after the end of the reporting period. The ED does not define the term 'default', beyond stating that an entity has to have a consistent definition of default, which may include one or several events. It requires entities to disclose the definition of default that it has applied (see 13.2.4 and 13.3.1).

The IASB notes that entities can use different definitions of default, including, where applicable, a regulatory definition. It further observes that it does not expect that the expected credit losses would change as a result of differences in the definition of default, because of the counterbalancing interaction between:

- the way in which an entity defines default; and
- the magnitude of credit losses that are expected given that definition of default.

Entities would have to interpret this term in the context of their specific types of assets. In some cases, it may be appropriate to consider assets as being in default when a contractual payment is not made when due. In other cases, default may occur when a borrower breaches loan covenants that may occur before any contractual payment is missed. It may be appropriate to regard a borrower who is in financial difficulties to be 'in default', even though the borrower may not yet have missed any contractual payments – for example, because contractual payments are not yet due.

Observations – Loss that results from default events that are possible in the next 12 months

Banks often gather information on the past performance of their assets to calculate the relevant loss statistics. For example, banks may track a cohort of retail loans that have become 30 days overdue, to determine what proportion of these loans does not pay in full and so results in a loss.

When using this information to estimate 12-month expected credit losses, entities would have to ensure that they:

- only include losses that result from a default in the next 12 months; and
- exclude losses that result from any subsequent defaults outside of the 12-month period relating to the same loan.

This may be challenging.

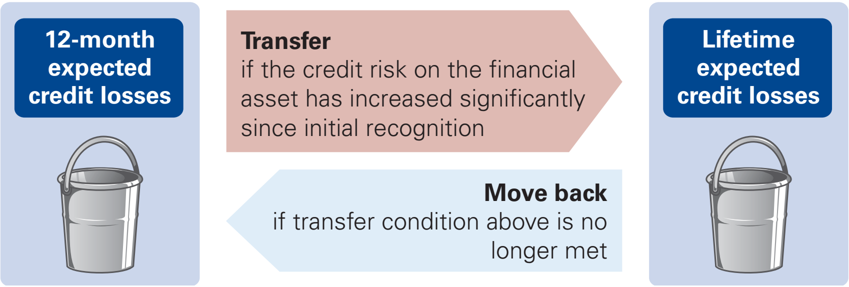
See also *Observations – Relationship between an actual default event and a significant increase in credit risk* in 6.3.1.

6.3 When is it appropriate to recognise lifetime expected credit losses?

6.3.1 Significant increase in credit risk

ED 5, 8 A loss allowance equal to lifetime expected credit losses (or a provision if it relates to a loan commitment or a financial guarantee contract) would be recognised if, at the end of the reporting period, the credit risk on the financial instrument has increased significantly since initial recognition. In making that assessment, the entity would use the change in the PD, rather than changes in the magnitude of loss if the default were to occur. Therefore, changes in the LGD would not be considered. Instead, the LGD would be incorporated in the measurement of the expected credit losses (see Section 7).

ED 10 An entity would assess whether there has been a significant deterioration in credit risk at the end of each reporting period. Assets can move into and out of the lifetime expected loss category in a symmetrical way, as illustrated below.



12-month expected credit losses

Transfer if the credit risk on the financial asset has increased significantly since initial recognition

Move back if transfer condition above is no longer met

Lifetime expected credit losses

Observations – Definition of 'significant increase in credit risk'

ED BC74 The term 'significant increase in credit risk' is not defined in the ED. Instead, examples are provided to illustrate the concept. To implement the proposals, entities would have to develop their own detailed criteria for determining a significant increase in credit risk. The criteria are likely to be different for different types of financial assets – e.g. various types of consumer and corporate loans or debt securities. This is one of the most critical judgements to be made in implementing the proposals.

Some may argue that, because the concept of significant deterioration could have a major impact on the overall size of the loss allowance, it should be defined in a more precise way, to enable consistent application between different entities. Others may consider that accounting for loan losses should reflect the way in which credit risk is managed, and that enabling entities to define what is significant in the context of their financial assets would therefore lead to improved financial reporting that better reflects the substance of transactions. Some may express a concern that, if the term 'significant' is not defined clearly in IFRS, then regulators in different countries may prevail in setting local interpretations.

The IASB notes that some interested parties asked it to specify the amount of the change in the PD that would require the recognition of lifetime expected credit losses, to provide greater clarity and comparability. The IASB explained that it has decided not to do so, for the following reasons.

- The PD is not used by all entities to measure or assess credit risk – in particular, by entities other than regulated financial institutions. Accordingly, if a precise definition of deterioration had been proposed, then those entities would have been required to calculate the PD – and so the cost of assessing changes in credit risk would have increased.
- Any selected absolute amount of PD would be arbitrary, and it would be difficult to properly reflect the structure and pricing of credit that an entity would consider as a result of different types of financial instruments.

In developing the new impairment model, the IASB has faced a considerable challenge in defining criteria that would both:

- lead to earlier recognition of losses than under the current incurred loss model; and at the same time
- not result in all expected credit losses being reflected at the initial recognition of a financial asset.

The concept of a 'significant increase in credit risk' aims to capture this earlier point at which lifetime expected credit losses should be recognised. The lack of definition in the ED of what is 'significant' reflects the fact that it is very difficult, if not impossible, to define the concept precisely without imposing quantitative bright lines.

The current incurred loss model has often been criticised for allowing different interpretations of the point at which losses have been incurred. However, entities have developed practices for applying the concept, and may look to events indicating that it is probable that not all cash flows will be received when due. The ED's concept of a 'significant deterioration in credit risk' is new to credit risk managers and finance departments that are charged with preparing financial statements. All stakeholders in the process of preparing financial statements would have to consider whether they can develop practical ways of implementing this high-level concept in a robust and transparent manner.

ED 8, B15

To determine whether the PD of a financial asset has increased significantly since initial recognition, the current PD would be compared with the PD at initial recognition of the asset. To be significant, a larger increase in the PD (in absolute terms) would be required for an asset with a higher PD at initial recognition than for an asset with a low PD at initial recognition. For example, an absolute change of 2% in the PD would be more significant for an asset with an initial PD of 5% than for an asset with an initial PD of 20%.

Observations – Significant deterioration in credit – A relative concept

ED BC67, BC71

The ED explains that, in evaluating whether an increase in credit risk is significant, entities would need to compare the PD at initial recognition of an asset with the PD at the end of the reporting period.

Accordingly, there may be situations in which loans with a higher credit risk would carry a loss allowance equal to 12 months' expected credit losses, whereas other loans with lower credit risk would carry a loss allowance equal to lifetime expected credit losses.

The IASB explained that it has considered whether lifetime expected credit losses should be recognised on the basis of:

- an absolute assessment of the credit quality; or
- a relative assessment.

It concluded that, although the absolute approach would be easier to apply because it is more closely aligned with the risk management process, it would provide very different information to users. This is because it would not approximate the economic effect of initial credit expectations and subsequent changes in expectations. In addition, it would be difficult to define an absolute level of deterioration for all instruments at which lifetime recognition of losses would be appropriate.

Observations – Relationship between an actual default event and a significant increase in credit risk

As discussed above, entities would have to define the term 'default' in the context of the specific financial instruments that they hold. There could be circumstances in practice where there is an actual contractual default – e.g. a missed interest payment – without there being a default within the meaning of the ED. This means that an asset might be contractually in default, but, because it is not in default within the meaning of the ED, no significant increase in credit risk would be deemed to have occurred.

For example, this could be the case when:

- the 30-day presumption (see 6.3.3) is rebutted; or
- the 30-day presumption is not rebutted, but a payment is overdue by less than 30 days.

ED B14

The ED explains that, because of the relationship between the remaining life and the PD, the change in credit risk cannot be assessed simply by comparing the change in the absolute PD over time. For example, the PD over the remaining life of a loan will tend to reduce over time, as the remaining life becomes shorter.

Observations – Assessing changes in the PD on a comparable basis

As discussed above, the change in credit risk cannot be assessed by monitoring changes in the absolute PD of an instrument over its remaining life without considering the changes resulting from the passage of time only. The ED does not specify how this could be done, beyond noting that if the absolute PD does not decline over time, then this may indicate an increase in credit risk. One possible approach might be to adjust the absolute PD for different points in time to a comparable basis – e.g. an annualised average PD. However, the ED does not indicate whether this would be acceptable.

ED B11 In general, the lifetime PD would be used to evaluate whether the increase in credit risk is significant. However, the ED would permit the use of the 12-month PD – i.e. the probably of default occurring in the next 12 months – if the information considered does not suggest that the outcome would differ.

6.3.2 Exception for assets with low credit risk

ED 6 As an exception from the general requirements, the criterion for recognising lifetime expected credit losses is not met if the credit risk on the financial instrument is low. The ED states that the credit risk is low if:

- default is not imminent; and
- any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity of the borrower to meet its contractual cash flow obligations.

The ED gives an example of an investment-grade financial asset (based on either an external credit rating or an equivalent internal credit rating).

Observations – Low credit risk

ED BC76 The ED's definition of when an asset has low credit risk may be difficult to apply in practice. The first part of the definition requires that default cannot be 'imminent'. Depending on how the term 'default' is defined (see 6.2), it may be argued that assets would have to deteriorate quite a lot before default is imminent, and that this requirement may therefore indicate a relatively high threshold for transferring to a lifetime expected loss measurement. However, the second part of the definition would require entities to be satisfied that *any* adverse economic conditions or change in circumstances would lead "at most, to a weakened capacity" of the borrower to meet its contractual obligations.

It may be argued that this criterion could rarely if ever be met, because extreme scenarios could be envisaged where even the best-quality borrower would fail to meet its obligations. This would be the case even for investment-grade assets.

Entities would have to decide how to apply the 'low credit risk' exception to the specific assets that they hold. For example, banks would have to decide how to apply it to retail loans and other loans that are not externally rated.

6.3.3 Rebuttable presumption when payments are 30 days past due

ED 9 The ED contains a rebuttable presumption that the condition for recognising lifetime expected credit losses would be met when payments are 30 days past due if no other borrower-specific information is available without undue cost or effort.

ED 9 The ED clarifies that the presumption could be rebutted if the historical evidence demonstrates that there is no causal link between a significant increase in the PD occurring on financial assets and financial assets on which payments are more than 30 days past due; however, it does identify such a link for financial assets on which payments are more than 60 days past due.

6.3.4 Information used for the assessment

ED B20 To assess whether there has been a significant increase in credit risk, an entity would consider the best information available (see 7.3.3). The ED sets out many examples of different sources of information that could be used.

ED B21

The ED states that in some cases the qualitative and non-statistical quantitative information available may be sufficient for the assessment. In other cases, a statistical model or credit ratings process may be used. Alternatively, an entity may base the assessment on both:

- qualitative factors that are not captured through the internal rating process; and
- a specific internal rating category,

if both types of information are relevant.

Observations – Information used in identifying a significant deterioration in credit risk

The ED allows a variety of information to be used in assessing whether there has been a significant increase in credit risk. This flexibility would appear to allow entities with sophisticated credit risk systems to use the sophisticated information available to them, and entities with simpler systems and processes to use simpler information. As a result, the timing of the transfer of a financial asset to a lifetime expected loss measurement would depend not only on the entity's definition of the increase in credit risk that it considers significant but also on the sophistication of its systems and processes.

However, any systems or processes used to generate the required information would have to meet the overall requirement to use the best information that is available without undue cost and effort.

Example – Information available without undue cost and effort

ED IE31

The information that is available without undue cost and effort may vary, depending on the type of financial instrument. If a lender has a direct relationship with a borrower, and the borrower prepares regular financial information that is made available to the lender, then it would be appropriate for the lender to use this information to make the estimates required by the ED.

In other cases, an entity may be an investor in a quoted bond and may not have a one-to-one relationship with the borrower. In such circumstances, the lender could use only information that is publicly available – e.g. public announcements by the issuer of the bond, or reports by credit agencies.

6.3.5 Individual or collective basis of evaluation

ED B17–B18

The ED would generally require the assessment of deterioration in credit risk to be carried out on an individual instrument basis. However, it would permit the evaluation to be carried out on a collective basis if financial assets are grouped on the basis of shared risk characteristics that are indicative of the borrower's ability to pay all amounts due in accordance with the contractual terms. Collective evaluation would not be appropriate if recognition of lifetime expected credit losses were appropriate for some of the financial assets in the group and not for others. When new information becomes available, an entity would have to reassess its aggregation of financial assets to ensure that collective evaluation for a group of assets is still appropriate. See 7.5 for examples of shared credit risk characteristics.

Example – Evaluating a significant increase in credit risk on a portfolio basis

ED IE40–IE41

Bank F has a portfolio of credit card receivables with shared risk characteristics. It has determined that unemployment is a key driver in determining credit card borrowers' ability to pay in accordance with the contractual terms. F anticipates a significant increase in the unemployment rate, and therefore an increase in the default rate in the portfolio. This forward-looking information cannot be attributed to specific customers, and relates to the portfolio as a whole.

F continues to assess the portfolio on a collective basis, and determines that – except for those instruments that are newly originated – there has been a significant increase in the portfolio's credit risk since initial recognition.

7. Measurement

7.1 General approach

ED B27 Expected credit losses are an estimate of the present value of all cash shortfalls over the remaining life of the financial asset.

ED 18 The ED does not prescribe a single method to estimate expected credit losses. Rather, it acknowledges that the methods used to measure expected credit losses may vary based on the type of financial asset and the information available.

ED B34–B35 The ED allows entities to use practical expedients when estimating expected credit losses, provided that they are consistent with the general principles. The ED gives an example of such an expedient – i.e. a provision matrix to measure expected credit losses (see 10.3.2).

Observations – No practical expedient to measure impairment at fair value

IAS 39.AG84 The ED does not carry through the practical expedient currently available in IAS 39, to measure impairment on the basis of an instrument's fair value using an observable market price.

7.2 Definition of cash shortfall

ED B27 A cash shortfall is the difference between:

- the cash flows due to a reporting entity in accordance with the contract; and
- the cash flows that the entity expects to receive (see 7.3.2 for a discussion of the impact of collateral).

Because credit losses consider the amount and timing of payments, a cash shortfall would arise even if the entity expects to be paid in full but later than the date on which payment is contractually due.

ED B27 The method for estimating cash shortfalls depends on the type of instrument.

- For financial assets, a cash shortfall is the difference between:
  - the present value of the principal and interest cash flows due to an entity under the contract; and
  - the present value of the cash flows that the entity expects to receive.
- For undrawn loan commitments, a cash shortfall is the difference between:
  - the present value of the principal and interest cash flows due to an entity if the holder of the loan commitment draws down the loan; and
  - the present value of the cash flows that the reporting entity expects to receive if the loan is drawn down.

  When estimating the drawn-down cash flows, the relevant amounts are:

  - for estimates of 12-month expected credit losses, cash flows that are expected to be drawn down in the next 12 months; and
  - for estimates of lifetime expected credit losses, cash flows that are expected to be drawn down during the life of the instrument.

ED B27

- For financial guarantee contracts, a cash shortfall is:
  - the expected payments to reimburse the holder for a loss that it incurs; *less*
  - any amount that the entity expects to receive from the holder, the debtor or any other party.

  If the asset is fully guaranteed, then the estimation of cash shortfalls would be consistent with the estimations of cash shortfalls for the asset subject to the guarantee.

ED 17, Appendix A, B27 The cash shortfalls over the remaining life of the financial instrument would be those associated with the following PDs (see 6.3):

- for 12-month expected credit losses, the PD in the next 12 months; and
- for lifetime expected credit losses, the PD during the remaining life of the financial instrument.

The remaining life of the financial instrument is the contractual period, or a shorter period – e.g. as a result of prepayments – over which there is exposure to credit risk on the financial instrument. The maximum period to consider is the maximum contractual period, and not a longer period – even if that longer period is consistent with business practice.

Observations – Estimating future draw-downs

ED BC131–BC132, BC179

The IASB acknowledges that the requirement to estimate future draw-downs for loan commitments would cause additional complexity due to the uncertainty involved in estimating the behaviour of customers, especially over a long period. However, it notes that removing the requirement would cause an arbitrage between on- and off-balance sheet instruments.

The IASB notes that many financial institutions already provide similar information to regulators, and use it for internal credit risk management purposes. However, the existing information – and related processes and systems – may have to be adjusted to reflect the potentially different requirements in the ED. For example, the ED requires that draw-downs be determined over the period for which the entity has a contractual obligation to extend credit, and not the period over which an entity expects to extend credit.

Banks' credit risk management systems often consider the full credit limit when estimating losses. This is because experience often indicates that when the receivable – e.g. a credit card loan – becomes problematic, the full amount of the credit limit has often been utilised.

Observations – Revolving facilities

ED IE39

For undrawn revolving facilities, a question may arise in practice as to what period should be used for estimating cash flows. For example, assume that:

- a bank has granted a borrower a five-year facility that can be revoked at any time; and
- the borrower has drawn an amount for three months under the facility.

The bank's internal credit risk management system may be based on behavioural analysis, and may estimate cash flows over the whole five-year facility. However, because the facility can be revoked at any time, the bank does not have a contractual obligation to extend credit, and so does not have a loan commitment within the scope of the ED. Accordingly, the bank would only estimate cash flows with reference to the drawn-down amount – i.e. the three-month loan.

7.3 Estimation of cash flows

7.3.1 Probability-weighted outcome

ED 16(a), 17

The estimate of expected credit losses would reflect an unbiased and probability-weighted amount in a range of possible outcomes – rather than a best- or worst-case scenario. This estimation would always reflect at least two scenarios: the probability that a credit loss results and the probability that no credit loss results.

Observations – Probability-weighted outcome

IAS 39.AG86

Currently, when estimating incurred losses IAS 39 allows the estimation process to result either in a single amount or in a range of possible amounts. In the latter case, the entity is required to recognise the best estimate within the range. By contrast, the ED is more specific, in requiring that the estimated expected credit losses cannot be measured using the most likely outcome; this is because the measurement has to reflect the probability-weighted outcome. This probability-weighted approach may already be required by regulators in some jurisdictions.

ED B28

The ED acknowledges that – irrespective of the general requirement to consider at least two scenarios – in practice, it would not always be necessary to develop explicit scenarios. In some cases, relatively simple modelling would be sufficient, without the need for a large number of detailed simulations of scenarios. The ED gives an example of a large group of financial instruments with shared risk characteristics, for which the average credit losses may be a reasonable estimate of the probability-weighted amount. However, in other cases it may be necessary to identify specific scenarios.

Observations – Need for explicit scenarios in calculating expected credit losses

The ED states that in some cases it would not be necessary to develop explicit scenarios. However, entities would have to evaluate whether their proposed approach meets the general requirement that the loss estimate reflects an unbiased and probability-weighted amount before using other calculations.

7.3.2 Consideration of collateral

ED B32

The ED requires that the estimate of expected cash flows on a collateralised financial asset reflects:

- the cash flows that may result from foreclosure; *less*
- costs for obtaining and selling the collateral,

irrespective of whether foreclosure is probable.

Observations – Consideration of collateral

IAS 39.AG84, IG.E4.8

The requirement that the estimate of expected cash flows for collateralised financial assets reflects the cash flows that may result from foreclosure is similar to the existing requirements in IAS 39.

However, based on the implementation guidance to IAS 39, entities may instead elect under IAS 39 to measure impairment using the fair value of the collateral at the end of the reporting period – in effect, viewing any future changes in fair value as not relevant to determining the loss incurred at the end of the reporting period.

Under the expected loss model in the ED, it is clearer that the focus should be on the cash flows that the entity actually expects to receive in the future.

Observations – Definition of a collateralised asset

ED BC80

The term 'collateralised financial assets' is not defined in the ED. Therefore, it is not always clear which assets would be considered to be collateralised assets. For example, a question may arise as to whether an instrument issued by a third party, rather than by the borrower – e.g. a financial guarantee received – might be considered collateral for the purposes of the ED.

This question relates to the unit of account at which an asset is aggregated or disaggregated for recognition or measurement purposes. Under IFRS 9, the unit of account is generally the individual financial instrument. However, IFRS 9 does not state explicitly whether, and to what extent, a guarantee or other credit enhancement issued by a third party is part of the unit of account for the purpose of measuring impairment; and, if it is, how this otherwise affects the accounting for the credit enhancement – e.g. a premium paid for credit insurance.

7.3.3 Information to be used in estimating cash flows

ED 17(b)

The ED requires the estimates to reflect the best available information that is reasonably available without undue cost and effort – including information about past events and current conditions, and reasonable and supportable forecasts of future events and economic conditions.

ED B5–B6

The ED acknowledges that the degree of judgement required to estimate cash shortfalls depends on the availability of detailed information. As the forecast horizon increases – i.e. as the period for which an entity needs to make its estimate becomes longer – the availability of detailed information decreases, and the judgement required to estimate expected credit losses increases. For periods far in the future, projections could be extrapolated from the information that is available for earlier periods.

The ED gives examples of the following potential data sources:

- internal historical credit loss experience;
- internal and external ratings;
- the credit loss experience of other entities; and
- external reports and statistics.

Under the ED, entities that have no entity-specific data or insufficient other sources of data would be able to use peer group experience for comparable financial instruments.

ED B7–B8

The historical data used would have to be adjusted on the basis of current observable data to reflect current conditions and forecast future conditions during the life of the instrument. If expected credit losses are estimated using historical loss rates, then information about historical loss rates would have to be applied to groups that are defined in a manner that is consistent with the groups for which the historical loss rates were observed.

An entity would have to review the methodology and assumptions used for estimating expected credit losses regularly, to reduce any differences between estimates and actual credit loss experience.

Observations – Determining what information to use in estimating credit losses

Under the proposed expected loss model, the judgements that would be required of management may be wider and significantly more complex than under IAS 39.

Under IAS 39's current incurred loss model, the expected cash flows from an asset have to be estimated only once an impairment trigger has been reached. At this point, the borrower is often in financial difficulties, so the analysis focuses on the amount that can be recovered from any available assets that the borrower may have. Under the proposed model, estimates would be needed for all financial assets. For assets maturing in the medium and longer term, these estimates would involve making assumptions about changes in economic conditions relatively far in the future. At any given time, there may be a number of conflicting and equally credible views as to future economic conditions; therefore, management would have to develop robust methodologies to ensure that their conclusions are reasonable and supportable.

Observations – Adjusting historical data to current economic conditions

The historical data used would have to be adjusted based on current observable data to reflect current conditions and current expectations of future conditions.

For example, assume that:

- an entity has a portfolio of similar loans; and
- data about unemployment in a specific region is a key factor in estimating expected credit losses for these loans.

At the end of the reporting period, the unemployment rate in the region is 8%. However, consensus estimates at the end of the reporting period, which are available to the entity without undue cost and effort, are that the unemployment rate will increase to 11% in the next six months. Accordingly, the entity would use the 11% unemployment forecast in estimating expected credit losses for these loans. (Similarly, if consensus estimates are that the unemployment rate will reduce to 6%, then this data would be used and may cause a reduction in the impairment allowance.)

In addition, the entity would need to consider whether, as a result of this forecast, the PD has increased such that a lifetime expected credit loss measurement would be required (see 6.3).

7.4 Time value of money

ED B29

The estimate of expected credit losses would reflect the time value of money. The following discount rates would be used.

- For undrawn loan commitments and financial guarantee contracts, the discount rate would reflect the current market assessment of the time value of money. This rate would incorporate risks specific to the cash flows 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.
- For purchased or originated credit-impaired (POCI) financial assets, the discount rate would be the credit-adjusted EIR (see Section 9).
- For other instruments, the discount rate would be determined at initial recognition and would be any reasonable rate between, and including, the risk-free rate and the EIR.

Observations – Sensitivity of loss allowance to different discount rates

For instruments other than loan commitments, financial guarantees and POCI financial assets, the ED would permit entities to choose any reasonable discount rate between, and including, the risk-free rate and the EIR. This flexibility aims to provide operational relief – e.g. for entities that manage financial assets on an open portfolio basis.

The size of the loss allowance would be sensitive to the discount rate used.

- Using the risk-free rate (an approach that is operationally simpler) would generally result in a higher allowance – i.e. the EIR is likely to be higher than the risk-free rate.
- Using the EIR (an approach that is operationally more complex) would generally result in a smaller allowance.

Depending on the structure of interest rates in a particular jurisdiction, the difference between the two approaches may be large.

Observations – Using a reasonable discount rate

ED BC93

The ED allows entities to use any 'reasonable' rate within the specified range, but does not provide guidance on how to determine whether a rate is reasonable. It is not clear whether entities can simply choose a risk-free rate for simplicity, or have to justify that the use of this rate or any other rate between the risk-free rate and the EIR is 'reasonable'. If it is the latter, then it is not clear how reasonableness should be assessed.

One possible view is that conceptually, the most reasonable rate to use is the EIR, because it is consistent with the amortised cost concept. However, in the basis for conclusions to the ED the IASB explains that it has allowed the choice of any rate within the range in order to ease operational complexity. The wording in the basis for conclusions does not refer to the fact that the rate used has to be 'reasonable'; however, it states that preparers felt that they should be permitted to use a rate that is suitable to the level of sophistication of their systems and operational capability. Accordingly, it is not clear whether entities would have to demonstrate that the chosen discount rate is reasonable – and, if so, what criteria they would use.

Observations – Deciding on the discount rate

The ED requires entities to decide on a discount rate at the time of an instrument's initial recognition. It is not clear whether, at initial recognition of a fixed-rate asset, an entity would have to:

- decide in principle whether the EIR, the risk-free rate, or any other rate would be used; if the risk-free rate is used, then this rate would change over the life of the instrument, in line with changes in market yields; or
- decide on an absolute percentage for the discount rate; this rate would remain unchanged throughout the life of the instrument.

For example, an entity may have selected LIBOR as the discount rate. If at initial recognition LIBOR is 5%, but at the time of the measurement it is 6%, then it is not clear whether the entity should use the 5% (the rate at initial recognition) or the 6% interest rate (the rate at the measurement date).

It appears that a decision would be made at initial recognition on an asset-by-asset basis. The ED does not require decisions to be made on a consistent basis; however, it may be argued that if they are not made consistently, then the selection might not be regarded as reasonable.

Observations – Applying the discount rate to portfolios

If an entity chooses to calculate loss allowances on a portfolio basis, then it would need to decide what discount rate to apply to the portfolio. Because some assets are likely to move between portfolios – for example, because they move from a 12-month expected loss assessment to a lifetime expected loss assessment – the discount rate for portfolios may need to be adjusted to reflect the changes in the composition of the portfolios. Using a risk-free rate in such circumstances is likely to be operationally much simpler, provided that the current risk-free rate can be used (see *Observations – Deciding on the discount rate*, above).

ED BC95 The IASB notes that some credit risk management systems discount expected cash flows to the date of default, which would not comply with the requirements in the ED that they be discounted to the end of the reporting period.

7.5 Individual or collective basis

ED B25–B26 Expected credit losses may be estimated on a collective basis or an individual basis. For estimating expected credit losses on a collective basis, financial assets would be grouped on the basis of shared risk characteristics that are indicative of the borrower's ability to pay all amounts due in accordance with the contractual terms. The basis for estimation may change during the life of a financial asset.

ED B26 For example, when changing from a 12-month expected credit loss assessment to a lifetime expected credit loss assessment, a financial asset may be:

- removed from a portfolio and added to a different portfolio for estimation; or
- estimated individually from that point.

ED B19 The ED gives examples of the following risk characteristics:

- asset type;
- credit risk ratings;
- collateral type;

- date of origination;
- remaining term to maturity;
- industry;
- geographical location of the borrower; and
- the value of collateral relative to the commitment if it has an impact on the PD – e.g. non-recourse loans in some jurisdictions.

Observations – Collective vs individual basis of estimation

The proposed requirements in the ED on the basis of estimation are different from the current requirements under IAS 39. Under IAS 39, individual assessment is required for financial assets that are individually significant; individual or collective assessment may be made for other financial assets.

In addition, financial assets that have been assessed for impairment individually and found not to be impaired are grouped together and assessed for impairment on a collective basis, to the extent that an entity has a group of assets with similar credit risk characteristics. This means that, for some assets, the impairment assessment under IAS 39 is a two-step process – first individual assessment, and then collective assessment. There is no similar requirement under the proposals.

Observations – Collective basis of assessment

The ED refers to collective vs individual assessment in two separate contexts:

- when assessing whether deterioration in credit risk is significant; and
- when measuring expected credit losses.

The ED does not state that the assessment and measurement should be made on the same basis – i.e. individual or collective. Therefore, it may be possible that an asset could be evaluated for a significant increase in credit risk on an individual basis but its expected credit losses measured on a collective basis.

7.6 Examples

The ED provides a number of illustrative examples. The following examples illustrate a simple method of calculating both a 12-month expected credit loss allowance and a lifetime expected credit loss allowance.

Example – Measurement of expected credit losses

ED IE2

Fact pattern

Entity X originates a 5-year loan for 1,000,000. The interest is paid annually. At initial recognition of the loan, X decides to use the loan's EIR of 5% to discount the expected credit losses.

Scenario 1 – Assume that recognition of 12-month expected credit losses is appropriate for this loan

Using the most relevant information available, X makes the following estimates:

- the loan has a 12-month PD of 0.5%; and
- the LGD – which is an estimate of the amount of loss should the loan default – is 25%, and would occur in 12 months' time if the loan were to default.

The 12-month expected credit loss allowance is 1,250, which is calculated by multiplying the amount of cash flows receivable (1,050,000)[a] by the PD (0.5%) and by the LGD (25%), and discounting the resulting amount using the EIR for one year (5%).

Scenario 2 – Assume that recognition of lifetime expected credit losses is appropriate in respect of this loan

Using the most relevant information available, X makes the following estimates:

- the loan has a lifetime PD of 20%; and
- the LGD is 25% and would occur on average in 24 months' time if the loan were to default.

The lifetime expected credit losses allowance is 47,619 (20% × 25% x 1,050,000[b] ÷ 1.05^2).

Summary

The difference between calculating 12-month expected credit losses and lifetime expected credit losses in this example comprises:

- the different PD applied – either the 12-month PD or the lifetime PD; and
- the timing of the losses occurring.

Other sources of differences may be:

- different LGDs; and
- different cash flows.

Notes

(a) Includes the amount of principal and interest receivable in 12 months' time.
(b) Includes the amount of principal and interest receivable in 24 months' time, assuming that the interest for year 1 would be paid fully.

Example – Measurement of lifetime expected credit losses when no losses are expected

ED IE28

Bank K holds a collateralised loan. K determines that the credit risk of the loan has increased significantly since initial recognition – i.e. the PD has increased significantly – and it is not low. However, due to the value of the collateral, the LGD is zero.

Although K does not expect to suffer a credit loss if a default occurs, it recognises lifetime expected credit losses for the asset. This is because significant increase in credit risk is assessed with reference to the PD rather than to the LGD. However, the amount of the loss would be zero, because the asset is expected to be fully recoverable through the collateral held. Disclosure would be required of the gross carrying amount of financial assets that have an expected credit loss of zero because of collateral (see 13.2.5).

8. Modifications and write-offs

8.1 Modifications

ED 19, B23

The ED provides guidance on estimating expected credit losses for financial assets that have been modified and for calculating gains and losses on modification. If the contractual cash flows of a financial asset are modified, then the entity is required to distinguish between:

- a modification that results in derecognition in accordance with IFRS 9; and
- a modification that does not result in derecognition.

Observations – Modification of terms

IFRS 9.3.2.3

The ED refers to the derecognition provisions of IFRS 9 for determining when a change in the terms of a financial asset results in derecognition. Under these provisions – which remain unchanged from those currently in IAS 39 – a financial asset is derecognised when the contractual rights to the cash flows expire. However, there is no specific guidance in IFRS 9 or the ED on how this criterion should be applied to the modification of financial assets.

ED 19, Appendix A, B22

If the modification does not result in derecognition, then the proposals require that:

- the gross carrying amount of the asset would be recalculated by discounting the modified contractual cash flows using the original EIR – or, when applicable, the revised EIR calculated in accordance with paragraph 92 of IAS 39; any difference between the existing gross carrying amount and the recalculated gross carrying amount would be recognised in profit or loss as a modification gain or loss; and
- the assessment of whether there is a significant increase in credit risk (see 6.3) would be made by comparing:
  - the credit risk at the end of the reporting period based on the modified contractual terms of the financial asset; with
  - the credit risk at initial recognition based on the original, unmodified contractual terms of the financial asset.

Observations – Gain or loss on modification

Banks may modify the terms of loans with good credit quality for business reasons. For example, a borrower whose credit quality has improved may approach the bank to reduce the margin, and the bank may agree in order to preserve the relationship and to reflect the improved credit risk. The ED would require the bank to calculate an immediate loss on this transaction, because the carrying amount of this loan would be recalculated to be equal to the net present value of the modified cash flows discounted at the original EIR.

Observations – Modification that does not result in derecognition – Difference between assets and liabilities

IFRS 9.B3.3.6

Under the ED, the modification of a financial asset that does not result in derecognition would result in a gain or loss. This is because the gross carrying amount of the financial asset would be recalculated as the present value of the modified contractual cash flows, discounted at the original EIR.

This may be different from the guidance under IFRS 9 with respect to modifications of financial liabilities that do not result in derecognition. IFRS 9 does not specify the accounting treatment for the difference in the present value arising from a modification of a liability that does not result in derecognition. However, under IFRS 9, a gain or loss can be recognised only when the debt instrument is derecognised. Accordingly, in our view any difference between the present values arising from the modification of a financial liability should be regarded as an adjustment to EIR and amortised over the remaining life of the modified financial liability.

ED B24

If a modified financial asset that has not been derecognised is evaluated on the basis of past-due information (see 6.3.3), then for an entity to conclude that it would no longer need to measure its impairment allowance based on lifetime expected credit losses – i.e. the credit risk on the asset is no longer considered to have increased significantly since initial recognition – the evidence that it would need to consider may include:

- the history of payment performance against the revised contractual cash flows; or
- other information that indicates that the borrower has improved its situation.

The ED notes that a loan would not be considered automatically to have improved in quality merely because its cash flows have been modified.

Observations – Modified financial assets evaluated on the basis of past-due information

Entities would have to consider how to apply the above guidance for modified financial assets evaluated on the basis of past-due information. Consider the following example.

A lender has a portfolio of retail loans for which it applies the presumption that the credit risk increases significantly if the loan is 30 days overdue. One of the borrowers is experiencing some difficulty in meeting the contractual payments, and so the lender modifies the contract by extending the maturity of the loan and reducing the monthly payments. At the time of the modification, the loan was 60 days in arrears. Following the modification, the borrower is meeting the new contractual payments. The lender would have to exercise judgement – taking into account all information that is available without undue cost or effort – to determine whether the modified loan continues to meet the 'significant deterioration' criterion.

ED B23

If the modification results in derecognition, then a new financial asset would be recognised in accordance with the initial recognition requirements of IFRS 9 at the date of modification.

Observations – Considering whether a new financial asset recognised as a result of a modification is credit-impaired

In many cases, modification occurs as a result of financial difficulties experienced by the borrower. Therefore, if a modification results in derecognition, then the entity should consider whether it indicates the new recognised asset to be credit-impaired at initial recognition (see Section 9).

8.2 Write-offs

ED 21 The ED requires that the gross carrying amount of a financial asset be reduced when there is no reasonable expectation of recovery. This definition is retained from the 2009 ED. A write-off would constitute a derecognition event. Write-offs can relate to a financial asset in its entirety, or to a portion of it.

ED BC121 Although write-offs would not have an impact on profit or loss – because the amounts written off would be reflected in the loss allowance – the ED notes that a definition of 'write-off' is needed to faithfully represent the gross carrying amount and for disclosure requirements.

Observations – Write-off events

IAS 39.63 IAS 39 does not prescribe when the gross carrying amount of a financial asset should be reduced, other than under the general derecognition rules. IAS 39 allows entities that do not use a loss allowance account to reduce the carrying amount of the asset directly to reflect impairment.

The proposals would change this by requiring the recognition of a loss allowance account and the derecognition of the portion of an asset when the write-off criterion is met. However, in our experience many entities – in particular, banks – carry loss allowance accounts and use write-off criteria similar to those described in the ED. Accordingly, for such entities implementing the proposed requirements may not lead to a significant change in existing practice. However, some banks have write-off criteria that are different from those of the ED – e.g. based on local legal requirements – and may therefore be impacted more by the proposals.

9. Special approach for assets that are credit-impaired at initial recognition

9.1 Scope

ED 14, Appendix A, B9

The ED proposes special rules for measuring the loss allowance and recognising interest income in respect of purchased or originated assets that are credit-impaired at initial recognition (purchased or originated credit-impaired or 'POCI' assets). An asset is credit-impaired if:

- there is objective evidence of impairment as a result of one or more loss events that have occurred; and
- that event(s) has an impact on the estimated future cash flows.

ED Appendix A

The ED defines 'objective evidence of impairment' as one or more events that have occurred and that have an impact on the expected future cash flows of the financial instruments. The definition would include observable data that has come to the attention of the holder of the financial instrument about the following events:

- significant financial difficulty of the issuer or the borrower;
- a breach of contract, such as a default or delinquency in interest or principal payments;
- a lender having granted a concession to the borrower – for economic or contractual reasons relating to the borrower's financial difficulty – that the lender would not otherwise consider;
- it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
- the disappearance of an active market for that financial asset because of financial difficulties; or
- the purchase of a financial asset at a deep discount that reflects the incurred credit losses.

It may not be possible to identify a single discrete event. Instead, the combined effect of several events may cause objective evidence of impairment.

Observations – Objective evidence of impairment

IAS 39.59(a)–(e), AG5, ED Appendix A

The concept of 'objective evidence of impairment' is used in IAS 39 to identify incurred losses (paragraphs 59(a)–(e)). Under the ED, this concept would still be relevant in:

- determining whether assets are credit impaired on initial recognition (a special approach would apply to these assets); and
- determining whether an asset becomes credit-impaired after initial recognition (special interest recognition rules would apply to these assets).

See 11.1.2 and 11.2.2 for further discussion of this issue.

9.2 Initial measurement

ED 14, 24(a), 25(a), Appendix A, B9

At initial recognition, POCI assets would not carry an impairment allowance. Instead, lifetime expected credit losses would be incorporated into the EIR calculation (see 11.1.2).

ED BC137

The IASB decided to carry forward to the ED the current provisions in IAS 39 requiring that the EIR calculation for credit-impaired assets include expected future credit losses. This is because they are consistent with the original proposals in the 2009 ED that would result in superior information, but that would be too operationally difficult to be implemented for all assets.

Example – Initial recognition of POCI assets

Entity Y buys a portfolio of amortising loans with a remaining life of four years for 800, which is the fair value at that date. The remaining contractual cash flows at the time of purchase are 1,000, and the expected cash flows are as follows. Assume that all cash flows are expected at the year end.

Year	1	2	3	4
Expected cash flows	220	220	220	220

The EIR of 3.875% p.a. is determined as the internal rate of return of the initial purchase price – i.e. 800 – and the cash flows expected to be collected.

On initial recognition, the following journal entries arise.

	DR	CR
Loan	800	
Cash		800

9.3 Subsequent measurement

ED 15 In subsequent periods, changes in lifetime expected credit losses would be recognised in profit or loss as an impairment gain or loss, and in a corresponding allowance balance.

ED 15 Favourable changes in lifetime expected credit losses would be recognised as an impairment gain, even if the cumulative changes are positive.

Example – Subsequent measurement of POCI assets – No changes in expectations

Continuing the example in 9.2, at the end of year 1, Y's expectation about future cash flows from the portfolio has not changed since initial recognition.

At the end of year 1, Y would calculate interest income of 31 by applying the EIR – i.e. 3.875% p.a. – to the amortised cost of the loan of 800. In addition, Y would receive a cash payment of 220. Y would make the following entries in year 1.

	DR	CR
Loan	31	
Interest income		31
Cash	220	
Loan		220

This example illustrates that no impairment expense or allowance would be recognised if, in subsequent periods, expectations over the collectibility of cash flows are unchanged since initial recognition.

Example – Subsequent measurement of POCI assets – Positive changes in expectations

ED 14–15

Continuing the example in 9.2, assume that the creditworthiness of the borrower has improved; therefore, at the end of year 1 Y expects the following cash flows to be collected.

Year	1	2	3	4
Expected cash flows	220	250	250	250

At the end of year 1, Y would calculate interest income of 31 by applying the EIR – i.e. 3.875% p.a. – to the amortised cost of the loan of 800, and would record the following entries.

	DR	CR
Loan	31	
Interest income		31

The revised cash flows would be discounted using the original EIR, and the resulting favourable change in lifetime expected credit losses of 84[a] would be recognised as an impairment gain at the end of year 1, as follows.

	DR	CR
Loss allowance	84	
Impairment gain		84

In addition, the following entries would be made to recognise cash received.

	DR	CR
Cash	220	
Loan		220

At the end of year 1, the following amounts would be recognised for the loan portfolio:

- a gross carrying amount of 611 (being 800 plus interest of 31 less cash received of 220); and
- a loss allowance, being a debit balance of 84.

Note

(a) This is calculated as $(30 / 1.03875) + (30 / 1.03875^2) + (30 / 1.03875^3)$

10. Simplified approach for trade and lease receivables

10.1 Overview

ED 12–13 The ED proposes the following simplifications for trade and lease receivables.

Type of financial asset	Proposed measurement of loss allowance
Trade receivables with no significant financing component[5]	Lifetime expected credit losses
Trade receivables with a significant financing component[5] and lease receivables	Policy election to measure the loss allowance either: • in accordance with the general approach (see Section 6); or • as lifetime expected credit losses. The entity would have to apply that policy to all such financial assets. However, the entity may apply the policy election for trade receivables and lease receivables independently of each other.

10.2 Definitions

ED 12 The ED defines ‘trade receivables’ as receivables arising from customer transactions within the scope of IAS 18 *Revenue*.

IAS 18.11 The ED does not define the term ‘significant financing component’. IAS 18 and ED/2011/6 *Revenue from Contracts with Customers* (the revenue ED) do not define this term either. However, the revenue ED gives examples of the following factors to be taken into account when assessing whether a financing component is significant:

- the length of time between transfer of, and payment for, the good or service;
- whether the total consideration would differ substantially if payment was made in cash promptly in accordance with typical credit terms in the industry or jurisdiction; and
- the interest rate in the contract as compared with the market rate.

ED 12, Footnote 8(a), ED/2011/6 As a practical expedient, the revenue ED would not require an entity to make this assessment if the period between the transfer of control or services and payment is expected to be one year or less. If the entity applies this practical expedient, then the impairment ED would also consider the contract to be a trade receivable without a significant financing component.

[5] The term ‘trade receivables with no significant financing component’ is used in this document to refer to both ‘trade receivables that do not constitute a financing transaction’ in accordance with IAS 18 and ‘trade receivables with no significant financing component’ in accordance with the revenue ED.

Observations – Calculation of EIR

ED 12

The ED states that entities may apply the simplified approach for trade receivables that result from transactions that are within the scope of IAS 18. However, the ED does not refer to IAS 11 *Construction Contracts*. Therefore, it is not clear whether the simplified approach would also apply to receivables that result from transactions that are within the scope of IAS 11.

10.3 Measurement

10.3.1 Lease receivables

ED B29 The ED requires that the cash flows used for measuring the impairment allowance be consistent with the cash flows used in measuring the lease receivable in accordance with IAS 17.

ED B29 The upper limit of the range of discount rates used to reflect the time value of money for calculating expected credit losses would be the discount rate used to measure the lease receivables in accordance with IAS 17.

10.3.2 Practical expedients

ED B34–B35 The ED gives an example of a practical expedient for trade receivables in the form of a provision matrix. An entity that applies a provision matrix would:

- consider whether it is appropriate to segment trade receivables – e.g. because its historical credit loss experience shows significantly different loss patterns for different customer segments; such segments could be based on geographical region, product type, customer rating, collateral or trade credit insurance (see 7.3.2), or type of customer, such as wholesale or retail;
- use historical loss experience on its trade receivables, and adjust historical loss rates to reflect:
  - relevant information about current conditions; and
  - reasonable and supportable forecasts to estimate expected credit losses; and
- apply the adjusted historical loss experience to the segmented portfolio of trade receivables.

Example – Using a provision matrix for short-term trade receivables

ED Ex11,
ED IE68–IE71

The ED gives the example of Entity M, with a portfolio of trade receivables of 30,000 at the end of the reporting period. The receivables do not have a significant financing component. M operates only in one geographic region, and has a large number of smaller clients.

M uses a provision matrix to determine the lifetime expected loss for the portfolio. It is based on M's historical observed default rates, and is adjusted by a forward-looking estimate that includes the probability of a worsening economic environment within the next year. At the end of each reporting period, M updates the observed default history and forward-looking estimates.

On that basis, M uses the following provision matrix.

	Expected loss	Trade receivables	Impairment allowance
Current	0.3%	15,000	45
1–30 days past due	1.6%	7,500	120
31–60 days past due	3.6%	4,000	144
61–90 days past due	6.6%	2,500	165
Over 90 days past due	10.6%	1,000	106
Total		**30,000**	**580**

11. Interest

11.1 Calculation of EIR

11.1.1 General approach

ED Appendix A, B1–B4 Under the proposals, the EIR would be calculated at initial recognition of a financial asset or a financial liability. The ED defines the EIR as the rate that exactly discounts estimated future cash flows through the remaining life of the financial instrument to the gross carrying amount of the financial asset at initial recognition. The gross carrying amount is the amortised cost of a financial asset, excluding any loss allowance. The estimate of cash flows would consider all contractual terms – e.g. prepayment, call and similar options – but not expected credit losses.

Observations – Definitions of 'EIR' and 'amortised cost'

IAS 39.9 The definitions of 'EIR' and 'amortised cost' are largely unchanged from those currently applied under IAS 39. Under IAS 39, the EIR is generally calculated using all cash flows under the contract, but excluding expected future credit losses.

Observations – Calculating the EIR for floating rate instruments

ED B1 Similarly to IAS 39, the ED does not specify how the EIR would be calculated for floating rate instruments. Therefore, it seems that applying the ED would not change current practice under IAS 39, which seems to allow two approaches:

- calculating the EIR based on the actual benchmark rate that was set for the relevant period; or
- calculating the EIR taking into account expectations of future interest rates, and changes in these expectations.

For example, assume an asset with principal of 100, a contractual interest rate of 12-month LIBOR plus 2% (payable annually) and a maturity of three years. The 12-month LIBOR at initial recognition of the asset is 2%, and is expected to be 3% in year 2 and 4% in year 3.

Applying the first approach, the initial EIR would be calculated as 4% – i.e. 12-month LIBOR at initial recognition plus the margin of 2%.

Applying the second approach, the initial EIR would be calculated as approximately 5% – i.e. the internal rate of return of the following cash flows:

- expected coupons of 4, 5 and 6; and
- principal at maturity of 100.

11.1.2 EIR for assets that are credit-impaired on initial recognition

ED 25(a), Appendix A There is one exception from the general approach to calculating the EIR (see also 9.2). For POCI financial assets that have objective evidence of impairment on initial recognition, the EIR is calculated using future expected credit losses. The resulting EIR is defined as the credit-adjusted EIR. The definition of a credit-impaired asset is set out in 9.1.

Observations – Contractual vs expected cash flows

ED BC137, IAS 39.AG5 At the acquisition date of a credit-impaired asset, its EIR would be calculated inclusive of expected credit losses. A similar approach is currently required by IAS 39 for assets acquired at a deep discount with incurred credit losses. However, under IAS 39 entities' calculations would only consider incurred credit losses, and not expected credit losses as required by the ED.

11.2 Recognition of interest revenue

11.2.1 General approach

ED 25 Generally, interest revenue would be calculated by applying the EIR to the gross carrying amount of a financial asset.

11.2.2 Approach for credit-impaired assets

ED 25(a)–(b), 26 As exceptions to this general rule, the EIR would be applied to the amortised cost of a financial asset if the asset is credit-impaired. Amortised cost is the gross carrying amount adjusted for any loss allowance. An asset could be credit-impaired if:

- it was credit-impaired on initial recognition; or
- it became credit-impaired after initial recognition.

The definition of a 'credit-impaired asset' is set out in 9.1.

Observations – Applying the EIR to the amortised cost of a financial asset

IAS 39.9 The proposals to calculate interest revenue for credit-impaired assets by applying the EIR to the amortised cost of a financial asset are the same as the current IAS 39 requirements for all financial assets and financial liabilities.

11.3 Revisions to estimated cash flows

ED B3 The ED requires that, when an entity revises its estimate of payments or receipts – excluding modifications that do not result in derecognition and changes in estimates of expected credit losses – it would recalculate the gross carrying amount of the financial assets to reflect the revision. The revised gross carrying amount would be equal to the present value of the revised estimates discounted at the asset's EIR. The adjustment would be recognised in profit or loss as income or as an expense.

Observations – Revisions to estimated cash flows

ED B2–B3,
IAS 39.AG7–AG8

The ED carries through, unchanged, the guidance in IAS 39 on accounting for revisions in estimated cash flows receivable under the contract. Also, similar to IAS 39, the ED does not define the term 'floating rate instrument'.

IAS 39's lack of guidance in this area has led to a debate as to whether certain instruments with contractual reset features – e.g. inflation indexation or indexation to an entity's revenue – should be considered floating rate instruments. A submission on this matter was made to IFRIC in July 2008, and the IASB discussed the issue in its October 2009 meeting. The classification and measurement requirements of IFRS 9 restrict the amortised cost measurement to assets whose contractual terms give rise to cash flows that are 'solely payments of principal and interest', with 'interest' defined as 'consideration for the time value of money and for the credit risk associated with the principal amount outstanding'. This means that assets containing features such as indexation to revenue would not qualify for amortised cost treatment, and so entities would not have to determine whether such features could be regarded as floating rate interest.

12. Presentation

ED 23, 27 Interest revenue and impairment losses (including reversals) would be presented as separate line items in the statement of profit or loss and other comprehensive income (OCI).

An entity would recognise expected credit losses in the statement of financial position as an expected credit loss allowance if those expected credit losses relate to a financial asset measured at amortised cost or a lease receivable.

ED 3 An entity would recognise expected credit losses as a provision if they relate to a loan commitment or financial guarantee contract.

Observations – Presentation of impairment allowance

IAS 39.63, ED 3 Under IAS 39, an entity has the choice of whether to use a loss allowance account or to reduce the carrying amount of the asset directly. The ED would require the use of a loss allowance. However, the proposals do not explicitly state that the loss allowance would have to be presented as a separate line item in the statement of financial position.

ED/2012/4 4.1.2A In November 2012, the IASB proposed limited amendments to the classification and measurement requirements for financial assets in IFRS 9 (the C&M ED). The C&M ED proposes a new mandatory FVOCI measurement category for financial assets that contain contractual cash flows that are:

- solely payments of principal and interest; and
- held in a business model in which assets are managed both in order to collect contractual cash flows and for sale.

These financial assets are within the scope of the impairment ED.

ED 3 Under the impairment ED and the C&M ED, financial assets that are mandatorily measured at FVOCI would be reflected in the financial statements as follows.

Element of financial statements	Impact
Statement of financial position	• Fair value
Profit or loss	• Interest income • Impairment loss calculated in accordance with the ED in the same way as for financial assets measured at amortised cost
OCI	• Changes in fair value excluding the above amounts already included in profit or loss

ED IE63–IE67 No loss allowance account would be presented in respect of assets that are mandatorily measured at FVOCI. However, disclosures would have to be provided about the loss allowance amount. The ED includes an example calculation.

Example – Initial recognition of a financial asset mandatorily measured at FVOCI

Entity Z purchases a debt instrument with a fair value of 1,000, and classifies it as mandatorily measured at FVOCI. The instrument is not credit-impaired. Z estimates 12-month expected credit losses for the instrument of 10.

On initial recognition of the instrument, Z would make the following entries.

	DR	CR
Statement of financial position – debt securities	1,000	
Statement of financial position – cash		1,000
Profit or loss – impairment loss	10	
OCI		10

Observations – Mandatory FVOCI category

ED BC55, BC174–BC175

Under IAS 39, the impairment of available-for-sale (AFS) debt instruments is measured as the difference between acquisition cost and the current fair value. This is a different measurement basis than for debt instruments held at amortised cost, for which impairment is measured as the difference between the gross carrying amount and the present value of estimated cash flows.

The approach for the measurement of impairment of AFS debt instruments has been criticised because, once an impairment trigger occurs, the impairment has to be recognised based on changes in fair value – even though fair value changes would be impacted by variables other than credit risk, such as changes in interest rates.

Under the ED, all debt instruments within the scope of the proposals would be included in a single impairment model.

The IASB believes that an impairment approach that is based on expected cash flows and changes in credit quality more faithfully reflects the economic reality of expected credit losses than an approach based on changes in fair value.

13. Disclosures

13.1 Overview

ED 28 As an overall principle, the ED would require the disclosure of information that identifies and explains:

- the amounts in the financial statements arising from expected credit losses measured in accordance with the proposals; and
- the effect of deteriorations and improvements in the credit quality of financial instruments within the scope of the proposals.

ED 29 To meet these requirements, the ED requires an entity to consider:

- the level of detail necessary to satisfy the disclosure requirements;
- how much emphasis to place on each of the requirements;
- how much aggregation or disaggregation would be appropriate; and
- whether users of financial statements would need additional information to evaluate the quantitative information disclosed.

ED 32 The disclosures required by the ED might be given either in:

- the financial statements; or
- another statement that is available on the same terms and at the same time as the financial statements.

ED 34 Entities would group financial assets, loan commitments and financial guarantee contracts into classes that:

- are appropriate to the nature of the information disclosed; and
- take into account the characteristics of those financial instruments.

The entity would have to provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

ED 33 Limited disclosures would apply to trade and lease receivables for which the loss allowance is always equal to lifetime expected credit losses.

ED IE72–IE74 The ED includes illustrative examples of disclosures of the reconciliation and risk profile.

Observations – Extensive disclosure requirements

The ED introduces many new disclosures that would require a substantial effort to collect. Some of the disclosures are at a granular level that may lead to large amounts of information being added to the financial statements. It is not clear how the IASB's initiative to identify ways of improving and simplifying disclosures has impacted or might affect the proposals.

13.2 Amounts arising from expected credit losses

13.2.1 Reconciliations

ED 35–36

An entity would provide reconciliations from the opening balance to the closing balance for:

- the carrying amounts of provisions for loan commitments and financial guarantee contracts; and
- for each class of financial assets, the gross carrying amounts and the associated impairment allowances for:
  - assets for which 12-month expected credit losses are recognised;
  - assets for which lifetime expected credit losses are recognised;
  - POCI assets; and
  - other credit-impaired assets.

Observations – Reconciliations

IFRS 7.16, 37(b), BC110–BC113

IFRS 7 *Financial Instruments: Disclosures* requires the disclosure, for each class of financial assets, of a reconciliation of movements in the credit loss allowance if an entity uses an allowance to recognise impairment. IFRS 7 does not require the disclosure of movements in the gross carrying amounts of financial assets. The disclosures proposed by the ED are a significant addition to the current requirements, and a substantial effort may be needed to collect the required data.

The IASB has received feedback from preparers saying that the costs associated with disclosing any cash flow information would be substantial. However, during its outreach, users of financial statements have consistently and strongly expressed a view that reconciliations would greatly enhance the transparency of an entity's financial asset portfolio. Accordingly, the IASB believes that the benefits of providing such information would outweigh the costs of obtaining it.

ED 35(d)

For POCI assets, an entity would disclose the total amount of undiscounted expected credit losses at initial recognition.

Observations – Disclosure of undiscounted expected credit losses

IFRS 3 B64(h)

It is not clear whether this disclosure would apply to:

- only POCI assets acquired during the reporting period (similar to the requirements under IFRS 3 *Business Combinations* for assets with incurred losses acquired in a business combination); or
- all POCI assets recognised in the statement of financial position at the end of the reporting period, irrespective of when they were acquired.

If it applies to the latter, then calculating the relevant amounts would be much more challenging. If assets that are still recognised in the statement of financial position – i.e. those that were not repaid or written off – were acquired as part of a portfolio, then it is likely that the initial estimates of cash flows were made on a portfolio basis. It would appear that entities would have to find a reasonable basis to apportion such initial estimates of cash flows, to determine the amounts that relate to the financial assets still held.

13.2.2 Write-offs

ED 37

Under the proposals, an entity would disclose:

- its write-off policy;
- whether there are assets that have been written off that are still subject to enforcement activity; and
- the balance of financial assets written off for which the entity is still pursuing collection.

13.2.3 Modifications

ED 38

Special disclosures would be required for financial assets that have been modified. The disclosures are summarised below.

Type of modified asset to which the disclosure applies	Required in the period of modification	Required for each reporting period until derecognition
Financial assets modified while subject to lifetime expected credit loss allowance (with exception of certain trade and lease receivables)	• Amortised cost • Modification gain or loss	• Gross carrying amount for which the measurement for the credit loss allowance has changed from lifetime expected credit losses to 12-month expected credit losses*
Financial assets modified while in default		• Re-default rate – i.e. the percentage of financial assets that defaulted again after the modification

These disclosure requirements – unless marked * – also apply to trade and lease receivables on which lifetime expected credit losses are always recognised if they were modified while more than 30 days past due.

Observations – Concept of default

ED 38

Under the proposals, an entity would distinguish between:

- financial assets with 12-month expected credit losses;
- financial assets with lifetime expected credit losses; and
- financial assets in default.

Because disclosures are required for both:

- financial assets that have been modified while they had a loss allowance of lifetime expected credit losses; and
- those modified while in default,

the definition of default is also relevant for disclosure purposes.

Observations – Disclosures about modifications/forbearance

IFRS 7.B5(g)

The proposed disclosures for modified financial assets expand the existing requirements. Recently, disclosures in this area have been a focus of attention for regulators – particularly relating to banks' forbearance activities. Banks may therefore already collect information that could help with the proposed disclosures.

13.2.4 Expected loss calculations

ED 39

The ED would require explanation of the inputs, assumptions and estimation techniques used when estimating the 12-month and lifetime expected credit loss. This would include:

- the basis of inputs – e.g. internal historical information or rating reports, including how 'default' is defined and why that definition was selected, assumptions made about the remaining life of the financial instruments and the timing of the sale of collateral – and 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 their cause – e.g. severity of loss, changes in portfolio composition and changes in volume of financial assets purchased or originated;
- any change in estimation technique and the reason for the change; and
- information about the discount rate selected (see 7.4), including:
  - the discount rate that an entity has elected to use – i.e. risk-free rate, EIR or something in between – and the reasons for that election;
  - the discount rate (percentage) used; and
  - any significant assumptions used in determining the discount rate.

Observations – Disclosure about inputs to expected loss calculations

The proposed disclosures go far beyond the current requirements, and entities may need a substantial effort to collect the necessary information.

13.2.5 Collateral

ED 40

An entity that secures financial assets, loan commitments or financial guarantee contracts with collateral or other credit enhancements, would disclose:

- a description of the collateral held as security and other credit enhancements, including:
  - a discussion of the quality of collateral held – e.g. the stability of the asset value and liquidity; and
  - an explanation of any changes in 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 collateral; and
- for financial instruments that have objective evidence of impairment at the end of the reporting period, quantitative information about the extent to which collateral and other credit enhancements reduce the severity of expected credit losses.

Observations – Disclosure about collateral

ED BC114

Paragraph 36(b) of IFRS 7 requires the disclosure of a description of:

- collateral held as security and other credit enhancements; and
- their financial effect in respect of the amount that best represents the maximum exposure to credit risk.

The IASB has received feedback that the current collateral disclosures are overly onerous and costly to prepare; it therefore proposes to limit the collateral disclosures to those financial assets for which there is objective evidence of impairment.

13.2.6 Explanation of effects on the loss allowance

ED 41

An entity would disclose quantitative and qualitative analyses of significant positive or negative effects on the impairment allowance that are caused by a particular portfolio or geographical area.

13.3 Effect of changes in credit risk

13.3.1 General

ED 42

An entity would explain the inputs, assumptions and estimation techniques used when determining:

- whether the credit risk of financial instruments has increased significantly since initial recognition; and
- whether there is objective evidence of impairment.

For this purpose, an entity would disclose:

- the basis of inputs – e.g. internal historical information or rating reports, including how significant deterioration in credit risk is met, how ‘default’ is defined, and why that definition was selected – and the estimation technique – including how the financial instruments were grouped if the criterion is assessed on a collective basis;
- an explanation of changes in estimates and the cause of those changes; and
- any change in estimation technique and the reason for the change.

Observations – Effect of deteriorations and improvements in credit quality

Determining whether an increase in the credit risk of a financial asset is significant is one of the key judgement areas in the ED, and one of the key drivers of the overall size of the credit loss allowance. Accordingly, it is very important that a clear explanation be provided as to how this judgement has been exercised.

ED 43

If an entity has rebutted the presumption that credit risk for financial assets more than 30 days past due has increased significantly, then it would disclose how it has rebutted that presumption.

ED 45

An entity would disclose:

- the gross carrying amount of financial assets; and
- the amount recognised as a provision for loan commitments and financial guarantee contracts

that are evaluated on an individual basis and meet the criterion for the recognition of lifetime expected credit losses.

13.3.2 Risk profile

ED 44

An entity would disclose, by credit risk rating grades:

- the gross carrying amount of financial assets;
- the provision for loan commitments; and
- the provision for financial guarantee contracts.

ED 44, 4–5, 12, 14–15

This information would be disclosed separately for:

- financial assets subject to 12-month expected credit loss allowance;
- financial assets subject to lifetime expected credit loss allowance;
- trade and lease receivables; and
- POCI financial assets.

Observations – Risk profile disclosure

The new disclosures are at a very detailed level, and would require an entity to compile a lot of new data.

However, some of this data may be required for regulated financial institutions – e.g. for Pillar 3 or Common reporting (COREP) purposes. Therefore, for those entities, implementing these disclosure requirements may be less costly. However, they would have to identify any differences between the regulatory requirements and the ED.

The ED would require separate disclosure for trade and lease receivables. However, some of these receivables may be measured using lifetime expected credit losses and some using 12-month expected credit losses. It is not clear whether separate disclosure would have to be made for each measurement basis.

14. Effective date and transition

ED C1 The transitional requirements relating to the ED are included in:

- the ED itself;
- IFRS 9 (2010) and the C&M ED; and
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

ED C2 An entity would apply the proposed standard retrospectively in accordance with IAS 8. Retrospective application means that the new requirements would be applied to transactions, other events and conditions as if those requirements had always been applied.

ED C2, B16, BC150 The ED contains certain exemptions from full retrospective application, as follows.

- If determining the credit risk of an asset at initial recognition would require undue cost or effort, then an entity would determine the loss allowance or provision only on the basis of whether the financial asset has a low credit risk (see 6.3.2) at the end of each reporting period until that financial asset is derecognised.
- The restatement of prior periods is not required.

Observations – Relief from determining the credit risk of an asset at initial recognition

Entities wishing to take advantage of the relief from full retrospective application would need to determine for which assets held at transition it would require undue cost or effort to determine the credit risk at initial recognition.

The term 'undue cost or effort' used in the ED is different from the term 'impracticable' used in IAS 8 in the context of limitations on retrospective application.

ED C2 The ED does not require restatement of comparative periods. However, entities would be allowed to restate prior periods if this is possible without the use of hindsight.

ED Summary and invitation to comment The IASB will establish the effective date of the proposals when redeliberations are completed. In doing so, it will consider responses to the question in the ED about the necessary implementation period.

Observations – Effective date

Currently, IFRS 9 is effective for annual periods beginning on or after 1 January 2015. However, in view of the progress of the project, this effective date may be delayed.

15. FASB proposals and convergence

The following table compares the two models at a high level.

	IASB – expected credit loss model	FASB – current expected loss model
Measurement objective	Dual measurement objective – either: • 12-month expected credit losses (EL); or • lifetime EL.	Single measurement objective.
Estimation of EL	EL is the present value of the difference between: • all principal and interest cash flows that are due under the contract; and • all cash flows that an entity expects to receive. Time value of money should be reflected either explicitly or implicitly. For instruments other than credit-impaired assets, loan commitments and financial guarantees, the discount rate is any reasonable rate between the EIR and the risk free rate.	EL is an estimate of all contractual cash flows not expected to be collected, and should reflect time value of money, either explicitly or implicitly. If a discounted cash flow model is used, then EIR should be used as a discount rate.
Debt instrument measured at FVOCI	General approach has to be applied. Unlike the FASB proposal, there is no practical expedient for debt instruments measured at FVOCI.	Entities could elect to not apply the impairment model – i.e. not recognise expected credit losses – for financial assets measured at FVOCI if: • the fair value of the financial asset is greater than or equal to the amortised cost; and • expected credit losses on the financial asset are insignificant.
Trade and lease receivables	Simplified approach for trade receivables without a significant financing component. Accounting policy choice for trade receivables with a significant financing component and lease receivables.	General approach has to be applied.
Specific requirements for POCI financial assets	Specific requirements apply to both purchased and originated credit-impaired assets. No loss allowance until there are changes in expected lifetime credit losses since initial recognition.	Specific requirements apply to purchased credit-impaired assets only. Loss allowance is set up on initial recognition and presented as a gross-up on the statement of financial position.
Interest recognition	Interest is recognised by applying the EIR to the gross amount unless there is objective evidence of impairment (at initial recognition or subsequently) – at this point, interest is applied to the net amortised cost of an asset. EIR is calculated based on contractual cash flows – except for assets impaired at initial recognition, where EIR is calculated on expected cash flows.	Interest is recognised by applying the EIR to the gross carrying amount until an asset reaches non-accrual status – i.e. it is not probable that substantially all principal or interest will be received. When this point is reached, the accounting depends on whether the expected reduced payments are in respect of principal or interest. The EIR is generally calculated based on contractual cash flows. For purchased credit-impaired financial assets, interest income is based on the expected cash flows at the acquisition date, excluding the discount embedded in the purchase price attributable to expected credit losses at the time of acquisition.
Comment period	5 July 2013	30 April 2013

Observations – Differences between proposed IASB and FASB models

ED BC215

The IASB observes that, although the two impairment models are different, both approaches should result in the same allowance for financial assets that have deteriorated significantly since initial recognition. Also, the IASB believes that there would not be a significant difference in the loss allowance on short-term assets and financial assets with low credit risk.

The Boards have indicated that they plan to discuss jointly the comments received on their respective proposals. This will provide each Board with the opportunity to consider the views received by the other and for them both to consider whether it is possible to more closely align their expected credit loss models.

About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

Content

Our *New on the Horizon* publications are prepared on the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of *New on the Horizon* considers the proposed requirements of ED/2013/3 *Financial Instruments: Expected Credit Losses*.

The text of this publication is referenced to the exposure draft and to selected other current IFRSs in issue at 28 February 2013. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed for an entity to consider the potential impact of this exposure draft in light of the entity's own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change.

Acknowledgements

We would like to acknowledge the efforts of the principal authors of this publication. The authors include Ewa Bialkowska, Tal Davidson and Nicolle Pietsch of KPMG's International Standards Group.

We would also like to thank the members of KPMG's global IFRS financial instruments topic team for their contributions:

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All of these publications are relevant for those involved in external IFRS reporting. The *In the Headlines* series and *Insights into IFRS: An overview* provide a high level briefing for audit committees and boards.

User need	Publication series	Purpose
Briefing	In the Headlines	Provides a high-level summary of significant accounting, auditing and governance changes together with their impact on entities.
	IFRS Newsletters	Highlights recent IASB and FASB discussions on the financial instruments, insurance, leases and revenue projects. Includes an overview, an analysis of the potential impact of decisions, current status and anticipated timeline for completion.
	The Balancing Items	Focuses on narrow-scope amendments to IFRS.
	New on the Horizon	Considers the requirements of due process documents such as exposure drafts and provides KPMG's insight. Also available for specific sectors.
	First Impressions	Considers the requirements of new pronouncements and highlights the areas that may result in a change in practice. Also available for specific sectors.
Application issues	Insights into IFRS	Emphasises the application of IFRS in practice and explains the conclusions that we have reached on many interpretative issues.
	Insights into IFRS: An overview	Provides a structured guide to the key issues arising from the standards.
	IFRS Practice Issues	Addresses practical application issues that an entity may encounter when applying IFRS. Also available for specific sectors.
	IFRS Handbooks	Includes extensive interpretative guidance and illustrative examples to elaborate or clarify the practical application of a standard.
Interim and annual reporting	Illustrative financial statements	Illustrates one possible format for financial statements prepared under IFRS, based on a fictitious multinational corporation. Available for annual and interim periods, and for specific sectors.
	Disclosure checklist	Identifies the disclosures required for currently effective requirements for both annual and interim periods.
GAAP comparison	IFRS compared to US GAAP	Highlights significant differences between IFRS and US GAAP. The focus is on recognition, measurement and presentation; therefore, disclosure differences are generally not discussed.
Sector-specific issues	IFRS Sector Newsletters	Provides a regular update on accounting and regulatory developments that directly impact specific sectors.
	Application of IFRS	Illustrates how entities account for and disclose sector-specific issues in their financial statements.
	Accounting under IFRS	Focuses on the practical application issues faced by entities in specific sectors and explores how they are addressed in practice.
	Impact of IFRS	Provides a high-level introduction to the key IFRS accounting issues for specific sectors and discusses how the transition to IFRS will affect an entity operating in that sector.

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IFRS NEWSLETTER
FINANCIAL INSTRUMENTS

Issue 8, December 2012

KPMG
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"We welcome the plan for the IASB to discuss stakeholder feedback on the general hedging review draft before issuing a final standard."

Andrew Vials,
KPMG's global IFRS Financial Instruments leader
KPMG International Standards Group

The future of IFRS financial instruments accounting

This edition of *IFRS Newsletter: Financial Instruments* highlights the discussions and tentative decisions of the IASB in December 2012 on the financial instruments (IAS 39 replacement) project.

Highlights

Impairment

- Re-exposure is expected in the first quarter of 2013, with a 120-day comment period.

Hedge accounting

General hedging

- The IASB will discuss feedback received on the general hedging review draft in January 2013.
- A final general hedging standard is now expected later in the first quarter of 2013.

Macro hedging

- The portfolio revaluation approach for macro hedging activities may be extended to commodity price risk and foreign exchange risk.

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Our IFRS – financial instruments hot topics page brings together our materials on the financial instruments project, including our *IFRS Newsletter: Financial Instruments*.

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IFRS NEWSLETTER: LEASES
Special edition: September 2012, Issue 12

The future of lease accounting

Highlights

- Boards conclude redeliberations on leases
- On-balance sheet approach for lessees
- 'Dual' model for income/expense recognition
- Increase in complexity for lessee and lessor accounting
- Revised exposure draft delayed until first quarter of 2013

The home straight?

In September 2012, after many months of joint discussion, the Boards concluded their redeliberations on the lease accounting proposals published in August 2010. We can now look forward to a revised exposure draft (ED) in the first quarter of 2013, most likely with a 120-day comment period.

After a long period of redeliberation, with many twists and turns, the proposals to be included in the new exposure draft are now clear, at least in outline. This special edition of our newsletter highlights the key impacts of those proposals on lessees and lessors.

Central to the proposals will be the right-of-use model, under which all but short-term leases would be on-balance sheet for lessees. The goal of eliminating lease accounting as a source of off-balance sheet finance has become the project's touchstone. In most instances, the proposals achieve that goal. However, the costs of achieving this goal include complexity and conceptual compromise.

The proposals will introduce new 'dual models' for income/expense recognition. Lessees and lessors would apply a new lease classification test, on a lease-by-lease basis, to determine which model to apply. Lease classification would depend on the extent to which the underlying asset is consumed over the lease term, and the nature of the underlying asset (real estate vs other assets).

Many leases of real estate would qualify for straight-line income/expense recognition. Lessors would achieve this by applying an approach similar to current operating lease accounting. Lessees would apply a version of the on-balance sheet right-of-use (ROU) model in which the asset is measured as a balancing figure to achieve straight-line expense recognition.

Many leases of other assets would result in an accelerated profile of income/expense recognition. Lessors would apply the new receivable and residual (R&R) model, recognising a lease receivable and a residual asset representing their interest in the underlying asset at the end of the lease term; lessors might also recognise an upfront profit. Lessees would generally recognise total lease expense on an accelerated basis, being the sum of a straight-line amortisation charge and an accelerated interest charge.

Lessees and lessors would not need to apply the models to leases with a maximum contractual term of 12 months or less. In such cases, they would not recognise lease assets and liabilities, and would recognise straight-line income/expense.

The proposals are certain to prove controversial. Several Board members have indicated that they may dissent from the proposals, and initial reaction from some user groups has been cool. We will all have a chance to comment in 2013.

Our IFRS – leases hot topics page brings together our material on the leases project, including our *IFRS Newsletter: Leases*.

IFRS NEWSLETTER
INSURANCE

Issue 32, December 2012

KPMG
cutting through complexity

In December, the IASB discussed the residual margin and impairment of reinsurance contracts held by an insurer.

Moving towards global insurance accounting

This edition of *IFRS Newsletter: Insurance* highlights the results of the IASB-only discussions in December 2012 on the joint insurance contracts project. In addition, it provides the current status of the project and an expected timeline for completion.

Highlights

- The residual margin would be unlocked for differences between current and previous estimates of cash flows relating to future coverage or other future services.
- The residual margin for participating contracts would not be adjusted for changes in the value of the underlying items as measured using IFRS.
- At inception, a cedant would determine the residual margin on a reinsurance contract by reflecting in the expected fulfilment cash flows all the effects of non-performance, including those associated with expected credit losses. Subsequent changes in expected cash flows resulting from changes in expected credit losses would be recognised in profit or loss.

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IFRS NEWSLETTER
REVENUE

Issue 8, March 2013

KPMG
cutting through complexity

"The decision to permit early adoption of the new revenue standard will please those keen to move on from long-running interpretive issues with existing guidance."

Phil Dowad,
KPMG's global IFRS revenue recognition leader

Early adoption back on the table

This edition of *IFRS Newsletter: Revenue* examines the current thinking on the revenue project, and what the proposals could mean for you.

In its March meeting, the IASB decided that entities reporting under IFRS can adopt the new revenue standard early, reversing their February decision.

In February the IASB had decided to prohibit early adoption of the new standard – a decision that surprised many. This earlier decision was primarily made to enhance comparability. In light of the proposed effective date of 1 January 2017, the IASB had been concerned that if early adoption was permitted, then there would be a lack of comparability between those who chose to early adopt and those who did not – and this would persist for several years.

However, following the February meeting, the IASB received feedback from constituents who were very disappointed with the decision as they were planning to use the option to early adopt the new standard to resolve interpretative issues they had with existing IFRS – including, in particular issues, with IFRIC 15 *Agreements for the Construction of Real Estate*.

In light of these concerns, the IASB has decided to reverse their February decision and reinstate the option to early adopt the new standard. The FASB did not reconsider their decision to prohibit early adoption.

Assuming the new standard is released as currently scheduled in mid-2013, there is an immediate need for those considering early adoption to start work on their implementation plans – including determining which of the transition options you will select.

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Publication name: *New on the Horizon: Financial instruments – Expected credit losses*

Publication number: 130008

Publication date: March 2013

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