IFRS Accounting

# Staff paper

Agenda reference: 27B

**IASB® meeting**

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| Date | **February 2023** |
| Project | **Post-implementation Review of IFRS 9—Impairment** |
| Topic | **Analysis of outreach feedback—Other areas** |
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## Purpose and structure

1. This paper continues the analysis of feedback from outreach in phase 1 of the post-implementation review (PIR) of the expected credit losses (ECL) requirements in IFRS 9 *Financial Instruments*.

2. Agenda Paper 27A of this meeting provides the analysis of feedback on the general model for ECL. This paper provides the analysis of feedback on the remaining areas of the ECL requirements in IFRS 9, namely:

   (a) purchased or originated credit-impaired financial assets;

   (b) simplified approach for trade receivables, contract assets and lease receivables;

   (c) loan commitments and financial guarantee contracts;

   (d) interaction between ECL and other requirements; and

   (e) transition.

3. For each of these areas, this paper provides background information, an overview of the feedback, and staff analysis and recommendations on which matters to ask questions about in the Request for Information (RFI).

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## Summary of staff recommendations

4. The staff recommend the IASB ask questions in the RFI about the following matters:

   (a) *purchased or originated credit-impaired financial assets*:

      (i) circumstances in which diversity exists in applying the requirements, the root cause of that diversity, how pervasive it is and the effects on ECL.

   (b) *simplified approach for trade receivables, contract assets and lease receivables*:

      (i) the effects of the relief provided through the simplified approach; and

      (ii) financial instruments for which entities are unclear, or diversity exists, in assessing whether they are in scope of the simplified approach and the resulting effects on ECL.

   (c) *loan commitments and financial guarantee contracts*:

      (i) loan commitments;

      (ii) collateral and other credit enhancements held; and

      (iii) financial guarantee contracts issued by an entity, in scope of IFRS 9.

   (d) *interaction between ECL and other requirements*:

      (i) circumstances for which entities are unclear, or diversity exists, in applying the ECL requirements when there is interaction with other requirements in IFRS 9 or with other IFRS Accounting Standards; and

      (ii) how that application affects the ECL reported by entities.

   (e) *transition:*

      (i) whether the combination of the relief from restating comparative information and the requirement for extensive transition disclosures achieved an appropriate balance between reducing costs for preparers of financial statements and providing useful information to users of financial statements.

## Questions for the IASB

| Questions for the IASB |
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| 1. Do IASB members agree with the staff recommendations in paragraph 4 of this paper?<br>2. Are there any additional matters that the IASB should ask questions about in the Request for Information? |

# A. Purchased or originated credit-impaired financial assets

### *Background*

IFRS 9 has specific measurement requirements for the recognition of interest revenue and ECL for purchased or originated credit-impaired (POCI) financial assets:

(a) paragraph 5.4.1(a) of IFRS 9 requires an entity to apply a *credit-adjusted* effective interest rate (EIR) to the *amortised cost* of POCI financial assets from initial recognition.

(b) an entity is required to include the initial expected credit losses in the estimated cash flows when calculating the credit-adjusted EIR for these assets. Neither a loss allowance nor credit losses are recognised on initial recognition of POCI financial assets.

Subsequently, only the cumulative changes in lifetime expected credit losses since initial recognition are recognised as a loss allowance.

### *Overview of feedback*

5. We received little feedback on this area during our outreach, with only a few stakeholders raising specific application questions similar to the feedback gathered during the PIR of IFRS 9—Classification and Measurement (see feedback discussed at the September 2022 IASB meeting).

6. For example, stakeholders noted diversity in how entities recognise, in the statement of financial position, the effect of improvements in credit risk after initial recognition of a POCI asset. Some recognise it as a negative entry to the ECL allowance, whereas others recognise it as an adjustment to the gross carrying amount of a financial asset. They suggested the IASB clarify the presentation in the statement of financial position. Regarding presentation in the statement of profit or loss, entities present the gain in the impairment losses line as required by paragraph 5.5.14 of IFRS 9.

### *Staff analysis and recommendations*

7. As explained in paragraphs BC5.214–BC5.220 of the Basis for Conclusions on IFRS 9, the requirements for POCI financial assets were substantially carried forwarded from IAS 39 *Financial Instruments: Recognition and Measurement*. Thus, entities have been applying these requirements for many years.

8. However, feedback from the PIR of IFRS 9—Classification and Measurement and our outreach indicates that there is a lack of clarity in some specific areas, and thus diversity in practice in applying the requirements for POCI assets. In our view, gathering further information (and evidence) about the circumstances in which diversity exists will help the IASB in understanding the root cause of that diversity in practice. Thus, the staff recommend the IASB explore this further in the RFI.

## B. Simplified approach for trade receivables, contract assets and lease receivables

### *Background*

- IFRS 9 addresses the costs and complexities for non-financial institutions and other entities through the simplified approach that removes the need to calculate 12-month ECL and track the increase in credit risk for trade receivables, contract assets that result from transactions that are within the scope of IFRS 15 *Revenue from Contract with Customers*, and lease receivables that result from transactions that are within the scope of IFRS 16 *Leases*.
- Applying the simplified approach to the recognition of ECL in paragraph 5.5.15 of IFRS 9, an entity:
  - (a) must recognise lifetime ECL for trade receivables and contract assets without a significant financing component; and
  - (b) has an accounting policy choice to measure the loss allowance at an amount equal to lifetime ECL for trade receivables and contract assets with a significant financing component and lease receivables.

### *Overview of feedback*

9. Overall, stakeholders said that the simplified approach works well and is widely used by corporate and other entities. There has been no indication from users of financial statements or other stakeholders that applying the simplified approach reduces the usefulness of information about these financial assets.

10. With regards to whether the requirements can be consistently applied, a few stakeholders said there are particular transactions for which it is unclear whether they fall into the scope of the simplified approach (for example, trade receivables that have been factored).

### *Staff analysis and recommendations*

11. As explained in paragraph BCE.161 of the Basis for Conclusions on IFRS 9, the IASB sought to address concerns about costs and complexities of applying the ECL requirements for non-financial institutions and other entities through the simplified approach.

12. We note that the feedback from outreach indicates the simplified approach is working as intended but there are a few particular matters which stakeholders think the IASB could consider examining in phase 2. Whilst it is unclear from the outreach feedback whether these matters are pervasive, we think gathering further information about the application of the simplified approach will help the IASB in assessing whether the requirements are sufficiently clear and whether the IASB's objective for developing the simplified approach is achieved. Therefore, the staff recommend the IASB ask questions in the RFI on this matter.

## C. Loan commitments and financial guarantee contracts

### *Background*

*Loan commitments*

- As noted in paragraph 5.5.19 of IFRS 9, the maximum period to consider when measuring ECL is the maximum contractual period (including extension options) and not a longer period.
- However, during development of IFRS 9, the IASB received feedback that the use of the contractual period was of particular concern for some types of loan commitments that are managed on a *collective basis*, and for which an entity usually has no practical ability to withdraw the commitment before a loss event occurs. For these types of facilities, estimating the ECL over the behavioural life of the instruments was viewed as more faithfully representing their exposure to credit risk.

- To respond to those concerns, the IASB included an exception in paragraph 5.5.20 of IFRS 9, for financial instruments that include both a drawn and undrawn commitment component, requiring entities to measure ECL over the period that it is exposed to credit risk and ECL would not be mitigated by credit risk management actions, even if that period extends *beyond the maximum contractual period*. Paragraph B5.5.39 of IFRS 9 provides application guidance about this requirement.

### *Financial guarantee contracts*

***Accounting by the holder***

- For the purposes of measuring ECL, paragraph B5.5.55 of IFRS 9 requires the estimate of expected cash shortfalls to reflect the cash flows expected from collateral and other credit enhancements held that are *part of the contractual terms* and are not recognised separately by the entity.
- IFRS 9 does not provide requirements about accounting for collateral and other credit enhancements held that are *not* part of the contractual terms of a financial instrument.

***Accounting by the issuer***

- As noted in paragraph B2.5 of IFRS 9, financial guarantee contracts (FGCs) may have various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract but their accounting treatment does not depend on their legal form. IFRS 9 provides some examples of the appropriate treatment for different types of FGCs.
- For those FGCs to which IFRS 9 is applied, paragraph 5.1.1 of IFRS 9 requires the issuer of an FGC to initially recognise it at fair value which is likely equal to the premium received. Subsequently, FGCs are measured at the higher of: (i) the loss allowance determined by applying the ECL requirements; and (ii) the amount initially recognised less the cumulative amount of income recognised in accordance with IFRS 15.

### *Overview of feedback*

#### *Loan commitments*

13. Some stakeholders identified application challenges relating to the measurement of ECL for revolving credit facilities such as credit cards and overdraft facilities. Stakeholders suggested that clarification or additional application guidance might be needed on matters such as:

    (a) the characteristics of loan commitment facilities that fall in scope of the exception in paragraph 5.5.20 of IFRS 9 (for example, how to interpret 'managed on a collective basis' referred to in paragraph B5.5.39(c) of IFRS 9 in particular scenarios or credit facilities); and

    (b) how to determine the period used to calculate ECL on revolving credit facilities (for example, how to determine the maximum period an entity is exposed to credit risk for a credit card). Some stakeholders said the supporting material issued by the IASB in May 2017 and the deliberations of the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) about this matter contain helpful conclusions, which if incorporated into IFRS 9, may enhance consistent application.

#### *Financial Guarantee Contracts*

14. We received a lot of feedback on the application challenges relating to accounting for FGCs. Stakeholders suggested the IASB explore further whether the requirements on accounting for FGCs are sufficiently clear to enable consistent application. Issues raised by stakeholders can be grouped into issues relevant to accounting by the holder, and accounting by the issuer of a FGC in scope of IFRS 9.

***Accounting by the holder***

15. Some stakeholders said that it is difficult to assess whether a FGC held is considered to be part of the contractual terms of a financial instrument (referred to as 'integral

FGC')—and thus reflected in the measurement of ECL—because IFRS 9 does not provide information on how to perform that assessment.

16. Furthermore, stakeholders noted that there are no explicit requirements in IFRS 9 or other IFRS Accounting Standards on accounting for FGCs that are *not* considered integral to the contractual terms (referred to as 'non-integral FGC'). Consequently, some entities develop an accounting policy by analogy, applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Stakeholders said that this results in economically similar FGCs being recognised, measured and presented differently, including at different reporting periods.

17. For instance, some entities apply IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to non-integral FGCs held, recognising a reimbursement asset up to the amount of ECL for the related financial instrument. In effect, this results in a gross-up in the statement of financial position. Some stakeholders think this outcome fails to faithfully depict the economic substance of the transaction which is about mitigating the credit losses. The issue is further exacerbated if the timing of recognition of the reimbursement asset differs significantly from that of the recognition of the ECL for the related financial instrument. Furthermore, the approach has consequences on presentation in profit or loss and in accounting for transactions fees of FGCs.

***Accounting by the issuer***

18. Some stakeholders said that there is also diversity in practice in the accounting for FGC's issued by an entity because of the lack of application guidance. For example, stakeholders said it is unclear how to account for FGCs when premiums are received *over time*, rather than upfront. Some entities recognise a receivable for the future premiums not yet due which produces a similar outcome to FGCs for which the premium is received upfront, recognising an asset to offset the related ECL amount. Other entities do not recognise a receivable for the future premiums.

## *Staff analysis and recommendations*

### *Loan commitments*

19. As noted in the background section, the IASB included the exception in paragraph 5.5.20 of IFRS 9 to address stakeholders' concerns that the use of the contractual period does not faithfully represent the exposure to credit risk for these instruments.

20. We note feedback on this topic relates to application of the requirements in particular circumstances or to specific credit facilities. These matters are also linked to entities' credit risk management practices. It is not clear from the feedback whether the application challenges arise because the requirements are not sufficiently clear or because entities need to exercise judgement. Therefore, we recommend exploring this topic in the RFI. For example, we think it would be helpful to gather information on:

    (a) financial instruments and related credit risk management approaches for which questions arise or diversity exists, in determining whether they are in scope of paragraph 5.5.20 of IFRS 9; and

    (b) what information or characteristics entities use to determine the maximum period to consider when measuring ECL for revolving credit facilities and whether the approach used is aligned with the entity's credit risk management practices.

### *Financial Guarantee Contracts*

#### ***Accounting by the holder***

21. We note that questions about the effect of a credit enhancement such as FGCs held, on the measurement of ECL and how to assess whether that credit enhancement is integral to the contractual terms of a financial instrument, have been previously discussed at the ITG as well as the IFRS interpretations Committee. Stakeholders think the lack of application guidance on what needs to be considered for the assessment continues to give rise to application challenges which increases the costs of applying the requirements as well as auditing and enforcing their application.

22. Furthermore, feedback from outreach indicates that there is a lack of clarity on how to account for non-integral FGCs held. Although non-integral FGCs held are outside the scope of this PIR, we acknowledge the feedback about the diversity in practice in accounting for these FGCs and its potential effect on the usefulness of information about ECL. We therefore recommend the IASB further explore this matter in the RFI.

23. However, we note that consistent with the PIR framework, a PIR focuses on whether the requirements are working as intended, and is different to agenda consultations, which provide stakeholders with an opportunity to recommend further improvements to financial reporting, beyond those originally intended by the requirements.

***Accounting by the issuer***

24. Feedback from outreach indicates that there could be different accounting outcomes depending on whether the premium for a FGC issued is received upfront or over time. Some stakeholders think that the resulting diversity in accounting outcomes reduces the usefulness of information to users of financial statements.

25. Considering feedback on both the holder and the issuer accounting, the staff think it would be helpful to gather further information on the circumstances in which entities face challenges in determining the appropriate accounting outcome. This will help the IASB in assessing whether the requirements are appropriate and capable of being applied consistently. It will also help to assess the prevalence of the issues.

## D. Interaction between ECL and other requirements

### *Background*

*Modification of financial assets*

- Applying paragraph 5.4.3 of IFRS 9, when the contractual cash flows of a financial asset are renegotiated or modified and this does not result in derecognition of the financial asset, an entity recalculates the gross carrying amount of the financial asset and recognises a *modification gain or loss in profit or loss*. Paragraphs BC5.240–BC5.241 of the Basis for Conclusions on IFRS 9 explain the IASB's rationale.
- Paragraphs B5.5.25–B5.5.27 of IFRS 9 provide application guidance on modifications, noting that when a modification does not lead to derecognition of the financial asset, an entity shall assess whether there has been a significant increase in credit risk since initial recognition. If so, an entity recognises lifetime ECL.

*Write-off*

- Applying paragraph 5.4.4 of IFRS 9, an entity directly reduces the gross carrying amount of a financial asset (ie writes-off) when the entity has no reasonable expectations of recovering that financial asset or a portion thereof.

*Interaction with IFRS 15 and IFRS 16*

- An entity is required to apply the impairment requirements in IFRS 9 to recognise ECL on trade receivables, contract assets and lease receivables that originate from transactions that are in the scope of IFRS 15 and IFRS 16 respectively (see the simplified approach section of this paper).

### *Overview of feedback*

26. During outreach, stakeholders identified application challenges and diversity in practice stemming from the interaction between the ECL requirements and other requirements in IFRS 9 or in other IFRS Accounting Standards. We describe some these issues in paragraphs 27–29 of this paper.

#### *Modification of financial assets*

27. These matters were raised by many stakeholders who think it is unclear:

    (a) in which order the requirements in IFRS 9 shall be applied to modified financial assets when modification did not lead to derecognition—that is, whether entities need to first recalculate the gross carrying amount of the financial asset and then measure ECL or vise versa; and

    (b) whether IFRS 9 requires entities to distinguish, and thus account for differently, the modifications caused by a borrower's *credit* deterioration versus the modifications caused by other events (for example, changes in market conditions). Furthermore, even if a modification is caused by a borrower's credit deterioration, stakeholders are unclear whether gains or losses should be considered as 'crystalised' ECL, and thus presented in the impairment line item in the statement of profit or loss, or whether they should be accounted for as an adjustment to the gross carrying amount of the asset and thus presented in the statement of profit or loss, separately from the impairment line item.

#### *Write-off requirements*

28. Some stakeholders said there is a lack of clarity about presentation of write-off losses in financial statements, particularly for an asset for which ECL was previously recognised for the full gross carrying amount. Some stakeholders think no profit or loss effect should be recognised in those circumstances. Others note paragraph 5.4.4 of IFRS 9 states that a write-off constitutes a derecognition event, and should be

accounted for by reducing the gross carrying amount of a financial asset, thus recognising a write off loss.

*Interaction with IFRS 15 and IFRS 16*

29. A few stakeholders said there are several areas where clarification or additional application guidance would be helpful regarding recognition of ECL for receivables and contract assets that arise from transactions in the scope of IFRS 15 and IFRS 16. For example, stakeholders asked how to apply the ECL requirements to long-term contract assets that have both recognised and unrecognised receivables. Similarly, stakeholders said they are unclear about the measurement of ECL for lease receivables in particular circumstances—for example, whether the unguaranteed residual value of the asset underlying a finance lease should be excluded from the measurement of ECL by the lessor.

### *Staff analysis and recommendations*

30. We note that the feedback from outreach identifies application questions. While these questions do not directly arise from the application of the ECL requirements, they might affect the ECL amounts recognised by entities.

31. Regarding feedback on modifications, we note that paragraphs BC5.240–BC5.241 of the Basis for Conclusions on IFRS 9 explain that, as IFRS 9 requires a decoupled approach to interest revenue and recognition of ECL, *not adjusting the carrying amount upon a modification* would result in inflating interest revenue and the loss allowance for financial assets. It is specifically noted that for example, if credit losses are crystallised by a modification, an entity should recognise a reduction in the gross carrying amount. Furthermore, it is acknowledged that there may be situations in which adjusting the gross carrying amount results in recognition of a gain.

32. Nonetheless, the IASB has been previously made aware of the application questions around the boundaries between modification of financial assets and ECL. We note that the IASB decided, at its July 2022 meeting, to add a standard-setting project to its

research pipeline to clarify the requirements in IFRS 9 for modifications of financial instruments. The IASB also decided that any forthcoming standard-setting project will also consider findings from the PIR of IFRS 9—Impairment.

33. Therefore, we recommend the IASB gather further information and evidence about the transactions that give rise to questions about the interaction between the ECL requirements and other requirements, either in IFRS 9 or other IFRS Accounting Standards.

## E. Transition

### *Background*

- When developing IFRS 9, the IASB considered the difficulties of retrospective application of the impairment requirements such as availability of data on initial credit risk and risk of hindsight. IFRS 9 therefore included transition reliefs to overcome potential operational challenges in applying the ECL requirements for the first time and to reduce the implementation costs.
- Entities were permitted, but not required, to restate comparative information on initial application of the requirements (permitted only if possible without hindsight). However, IFRS 7 *Financial Instruments: Disclosures* sets out the information entities were required to disclosure on initial application of IFRS 9.

### *Overview of feedback*

34. We received little feedback in this area. Some stakeholders said that in their view the transition requirements were appropriate and the reliefs provided were helpful to entities, noting that implementing the ECL requirements required extensive resources.

35. Some users of financial statements commented that the transition disclosures were extremely useful (particularly the reconciliation of impairment allowances under IAS 39 and IFRS 9) in helping them understand how entities determined ECL, including

the effect of incorporating forward-looking information into measurement of credit losses. However, a few users of financial statements said they would have found it useful if entities also provided this information in the interim financial reports prepared in accordance with IAS 34 *Interim Financial Reporting* for interim periods in the year of initial application of IFRS 9.

### *Staff analysis and recommendations*

36. Feedback on the application of transition requirements can be useful input for developing transition requirements for future IFRS Accounting Standards.

37. Therefore, in the context of learning lessons for future standard-setting, we recommend the IASB ask a question about the transition requirements in the RFI. For example, we think it would be helpful to gather information on whether the combination of the relief from restating comparative information and the requirement for extensive transition disclosures achieved an appropriate balance between reducing costs for preparers of financial statements and providing useful information to users of financial statements.