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IFRS Developments

The ITG discusses IFRS 9 impairment implementation issues

What you need to know

- At its meeting held in April 2015, the ITG discussed a number of IFRS 9 impairment implementation issues including: revolving credit facilities; relevant measurement dates for ECLs; the maximum period to consider when measuring ECLs; and measurement of ECLs for modified financial assets.
- ITG members discussed the implementation issues and highlighted challenges. The IASB will determine whether action will be taken in respect of each issue.
- As the ITG does not vote on the issues discussed, consensus is not required, nor does the ITG issue guidance.
- The IASB is expected to provide a summary of the implementation issues discussed by the ITG. A number of the points raised may prompt other issues being identified for discussion at the ITG meetings currently planned for 16 September and 11 December 2015.

The ITG aims to assist the IASB to determine if any action will be needed to apply the new IFRS 9 impairment requirements consistently.

Overview

Following its inaugural meeting last December to discuss its operating procedures, the Transition Resource Group for Impairment of Financial Instruments (ITG) met on 22 April 2015 to discuss eight implementation issues raised by stakeholders on the new impairment requirements in IFRS 9 *Financial Instruments*. These are based on an expected credit loss (ECL) model rather than an incurred loss model, as previously required by IAS 39 *Financial Instruments: Recognition and Measurement*.[1]

The International Accounting Standards Board (the IASB or Board) set up the ITG to provide a discussion forum for stakeholders on implementation issues arising on the new impairment requirements that could create diversity in practice, as well as to assist the IASB to determine what action, if any, may be needed to address any issues. However, the ITG will not issue any guidance.

Members of the ITG include financial statement preparers and auditors from various geographical locations with expertise, skills or practical knowledge on credit risk management and accounting for impairment. Board members and observers from the Basel Committee on Banking Supervision and the International Organisation of Securities Commissions also attended the meeting.

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[1] See our recent publications, *Applying IFRS – Impairment of financial instruments under IFRS 9*, *IFRS Developments Issue 100: Basel Committee proposes guidance on accounting for expected credit losses* and *IFRS Developments Issue 87: IASB issues IFRS 9 Financial Instruments – expected credit losses*

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Extension options should be interpreted as the options of the borrowers because they expose the lender to credit risk.

Implementation issues discussed

The maximum period to consider when measuring ECLs

The ITG discussed what the maximum period for measuring ECLs should be if the contractual term is automatically extended unless the lender objects. IFRS 9 requires an entity to consider the "maximum contractual period (including extension options) over which the entity is exposed to credit risk", with an exception for revolving credit facilities for which the period extends beyond the maximum contractual period if ECLs would not be mitigated by credit risk management actions.[2]

ITG members appeared to agree that the example falls outside the narrow scope exception and that the extension options should be interpreted as those that are at the option of the borrower rather than the lender, because the latter do not create credit exposure. Hence, in the fact pattern presented, the period for measuring credit losses would be based on the contractual period, i.e., the period until the lender can next object to an extension.

Forecasts of future economic conditions

IFRS 9 requires an entity to assess significant increases in credit risk and measure ECLs *at each reporting date* based on reasonable and supportable information, that is available without undue cost or effort, about past events, current conditions and forecasts of future economic conditions.[3] Due to operational practicality, entities may perform the above assessment before the reporting period end in order to publish their financial statements in a timely manner. The ITG debated whether events and new information about forecasts of future economic conditions that occur after the ECLs have been estimated should be incorporated.

ITG members appeared to agree that, if new information becomes available before the reporting date, subject to materiality considerations, entities would be required to reflect this information in the assessment of significant increases in credit risk and the measurement of ECLs at the reporting date. However, ITG members appeared to agree that if new information becomes available between the reporting date and the date the financial statements are authorised for issue, entities need to assess whether such information has been considered properly in the probability-weighted scenarios and they also need to apply judgement to determine whether it is an adjusting or non-adjusting event in accordance with IAS 10 *Events after the Reporting Period*.[4] Since IFRS 9 requires a point-in-time estimate, most ITG members appeared to believe that a revision of macroeconomic expectations after the period end would not be an adjusting event. The Board members present commented that they may consider providing additional educational materials to address this topic.

Scope of loan commitments

ITG members appeared to agree that commitments to extend credit at the inception of a finance lease that has not yet commenced, and also on issuing store accounts that enable customers to buy goods or services from the issuer on credit in the future, would not fall within the scope of the IFRS 9 impairment requirements. In order to make such assessment, it is necessary to determine whether a loan commitment exists and if it also meets the definition of a financial instrument.[5] In each case, the finance lease and store account do not meet the definition of a financial instrument until the contractual right to receive cash is established, that is at the commencement of the lease term or when goods or services are sold.[6] Furthermore, ITG members noted that only lease receivables are scoped into the IFRS 9 impairment requirements.[7]

[2] IFRS 9.5.5.19 and 5.5.20
[3] IFRS 9.5.5.9, 5.5.17(c) and 5.5.18
[4] IAS 8.32 – 34 and IAS 10.8 – 11
[5] IFRS 9.BCZ2.2 and IAS 32.11
[6] IAS 32.11 and AG20
[7] IFRS 9.2.1(b)

The ITG discussed the implementation challenges in determining the appropriate period when measuring ECLs for revolving credit facilities.

Revolving credit facilities (RCFs)

The ITG debated how to determine the appropriate period when measuring ECLs for RCFs, but did not reach a consensus. ITG members were split between two views: one that favours a much shorter period when credit risk mitigation is significant and the other that favours the historical 'behavioural life' of the financial asset. The Board members present clarified that IFRS 9 requires the assessment of the period over which the entity is exposed to credit risk, and this period would be shortened by expected defaults or by potential credit risk management actions such as reduction or removal of undrawn limits.[8]

The ITG also discussed the date of initial recognition when assessing significant increases in credit risk and appeared to agree that it should be based on the initial recognition of the original undrawn facility. However, ITG members appeared to agree that if substantial modification of the existing terms and conditions (e.g., replacement of a student credit card with a new credit card upon graduation) results in the derecognition of the original financial instrument and the recognition of a new financial instrument, then this would require a change in the date of initial recognition that corresponds with the new instrument.

As there were many diverse views and questions raised, many of the ITG members indicated that they would benefit from more examples on RCFs. These examples should seek to explain how assumptions and credit risk management actions are linked to the determination of the appropriate period when measuring ECLs and how the assessment differs for assets measured at 12-month and lifetime ECLs, and credit-impaired assets.

Assessment of significant increases in credit risk for guaranteed debt instruments

ITG members appeared to agree that IFRS 9 is clear in that the assessment of significant increases in credit risk is based on the risk of a default occurring and that collateral is only taken into account when measuring loss given default.[9] This applies to a debt instrument with a financial guarantee contract (FGC) that is integral to the contractual terms of the debt instruments (e.g., a credit wrapped instrument), unless the FGC is expected to reduce the risk of a default occurring on the guaranteed debt instrument.[10] Excluding recoveries from the FGC when assessing significant increases in credit risk would be consistent with the treatment of other forms of collateral.

Measurement of ECLs for an issued FGC

ITG members appeared to agree that the issuer of a FGC should *exclude* future premium receipts due from the holder of the FGC over the life of the guarantee when measuring ECLs. When estimating the cash shortfalls, "the amounts that the entity expects to receive from the holder" should relate only to recoveries or reimbursements of claims for losses and do not include receipts of premiums.[11] Moreover, the expected cash outflows under the guarantee depend upon the risk of default of the guaranteed asset, while the expected future premiums receipts are subject to the risk of default by the holder of the guarantee and, hence, should be considered separately. We note that this conclusion assumes that, on day 1, the issuer of the FGC records a gross liability and an asset for the future premiums receivable.

[8] IFRS 9.5.5.20 and B5.5.40
[9] IFRS 9.5.5.9, B5.5.12, B5.5.22 and B5.5.55
[10] IFRS 9.B5.5.17(j) – (l)
[11] IFRS 9.B5.5.32

Measurement date of ECLs

When accounting for ECLs, the question arises whether those losses need to be measured only at a reporting date or at other measurement dates, specifically:

- At the date of derecognition, as IFRS 9 requires a derecognition gain or loss to be measured relative to the carrying amount at the date of derecognition
- At the date of initial recognition, as Illustrative Example 14 in IFRS 9 implies the need to include ECLs on initial recognition in measuring foreign exchange gains and losses in respect of a foreign currency-denominated asset

In the first scenario above, ITG members appeared to agree that the derecognition requirements do not conflict with the impairment requirements; it is necessary to update the ECLs on derecognition since the amortised cost must be measured as at that date.[12] However, in the second scenario, ITG members noted that, at initial recognition, a financial asset is measured at fair value plus transaction costs. IFRS 9 includes impairment as part of the subsequent measurement of a financial asset and, consequently, refers to recognition of ECLs at the reporting date.[13] Therefore, there is no requirement to measure ECLs on initial recognition of a financial asset, irrespective of whether the asset is denominated in a foreign currency. This analysis differs from that in the staff paper and potentially also in Illustrative Example 14 in IFRS 9.[14]

Measurement of ECLs in respect of a modified financial asset

For a financial asset that has been modified and not derecognised, IFRS 9 is clear that the modification gain or loss should be based on the renegotiated or modified contractual cash flows and excludes ECLs unless it is a purchased or originated credit-impaired financial asset.[15] However, ITG members appeared to agree that, in certain situations prior to the modification, if the entity has no reasonable expectations of recovering a portion of the financial asset, then this amount will be written off and the gross carrying amount reduced directly before the modification gain or loss is calculated (i.e., a partial write-off and derecognition).[16] Also, ITG members appeared to agree that, at the reporting date, an entity would be required to assess whether there has been a significant increase in credit risk of the modified financial asset.[17]

IFRS 9 does not prescribe in which line item a modification gain or loss should be presented in the statement of profit or loss.[18] Although IAS 1 *Presentation of Financial Statements* specifies that the movement on the ECL allowance that is due to impairment gains, losses and reversals is required to be presented as a separate line item in the statement of profit or loss, ITG members seem to indicate that it would be more intuitive for credit-related modifications, that the offsetting effect of the modification gain or loss should be netted against the impairment loss or gain in the statement of profit or loss.[19]

Although IFRS *7 Financial Instruments: Disclosures* is clear that the modification disclosures apply to *all* modifications of contractual cash flows, irrespective of whether the modifications have been made for credit risk management or commercial purposes, the Board members present highlighted that the disclosures were intended to focus on those financial assets which have experienced significant increases in credit risks since initial recognition.[20]

Next steps

The IASB plans to provide a summary of the implementation issues discussed by the ITG. The IASB staff indicated a desire for the ITG to complete its activities by the end of 2015 and two further ITG meetings are currently planned for 16 September and 11 December 2015.

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[12] IFRS 9.3.2.12
[13] IFRS 9.4.1.1, 5.1.1, 5.5.3, 5.5.5 and 5.5.13
[14] ITG Agenda Paper 7 available on the IASB's website: http://www.ifrs.org/Pages/default.aspx
[15] IFRS 9.Appendix A
[16] IFRS 9.5.4.4 and B5.4.9
[17] IFRS 9.5.5.12
[18] IFRS 9.5.4.3
[19] IAS 1.82(ba) and 85
[20] IFRS 7.35J and BC48Z

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