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Issue 54 / March 2013

IFRS Developments

IASB proposes new expected credit loss model

What you need to know

- The IASB has issued an ED proposing the recognition and measurement of a credit loss allowance or provision based on expected rather than incurred credit losses.
- The new expected credit loss model would apply to loans, debt securities, trade receivables, lease receivables, irrevocable loan commitments and financial guarantee contracts.
- Credit losses would be measured as the 12-month expected credit losses or, if the credit risk has increased significantly since initial recognition (with some exceptions), the credit losses would be measured as the lifetime expected credit losses.
- A simplified approach would be available for trade and lease receivables.
- The estimate of expected credit losses would reflect a probability-weighted outcome, the time value of money and the best available information.
- The IASB's proposals differ from the FASB's proposals.
- The comment period for the exposure draft ends 5 July 2013.

Overview

The International Accounting Standards Board (IASB) released a new exposure draft (ED) *Financial Instruments: Expected Credit Losses* on 7 March 2013 proposing that entities should recognise and measure a credit loss allowance or provision based on an expected credit loss model. The proposals would:

- Require the recognition of expected credit losses for certain financial assets
- Require the measurement of a credit loss allowance or provision based on either 12-month or lifetime expected credit losses
- Likely result in earlier recognition of credit losses that not only includes losses that have already been incurred (as per IAS 39 *Financial Instruments: Recognition and Measurement*), but also expected future losses

The IASB's proposals grew out of a joint project with the US Financial Accounting Standards Board (FASB). However, due to concerns raised by the FASB's constituents about the model's complexity, the FASB has proposed an alternative model that has a single measurement objective but which retains many of the jointly developed core principles. The FASB's current expected credit loss model would require an entity to recognise a credit loss allowance for its current estimate of the contractual cash flows that it does not expect to collect.

Below, we summarise the main proposals in the IASB's ED.

Scope of the ED

The ED would apply to:

- Financial assets measured at amortised cost and at fair value through other comprehensive income[1] under IFRS 9 *Financial Instruments* (which include debt instruments such as loans, debt securities and trade receivables[2])
- Irrevocable loan commitments and financial guarantee contracts that are not accounted for at fair value through profit or loss under IFRS 9
- Lease receivables[2]

[1] As proposed in the *Classification and Measurement: Limited Amendments to IFRS 9* ED (issued in November 2012).
[2] The scope includes trade receivables under IAS 18 *Revenue* and lease receivables under IAS 17 *Leases* and the current revenue recognition and leases proposals.

General approach

The guiding principle of the expected credit loss model is to reflect the general pattern of deterioration or improvement in the credit quality of financial instruments (i.e., financial assets, loan commitments and financial guarantee contracts within the scope of the ED).

When financial instruments are initially recognised, except when the simplified approach is applied or the financial assets are credit-impaired on initial recognition (see following sections), an entity would provide a credit loss allowance or provision equal to 12-month expected credit losses. Subsequently, the 12-month expected credit losses would be replaced by lifetime expected credit losses *if the credit risk has increased significantly since initial recognition* (the lifetime expected credit losses criterion). The credit loss allowance or provision would revert to 12-month expected credit losses if the credit quality subsequently improves and the lifetime expected credit losses criterion is no longer met.

To simplify the application of the lifetime expected credit losses criterion, the ED proposes that financial instruments with low credit risk at the reporting date would not meet the lifetime expected credit losses criterion. For example, a financial asset rated 'investment grade' at the reporting date is regarded as not having suffered significant credit deterioration and will remain as such until it is downgraded to below investment grade.

For all other financial instruments, an entity would need to track credit deterioration and apply judgement in determining whether there has been significant increase in credit risk, e.g., credit deterioration is considered significant if an entity would now originate or purchase the financial asset on significantly different terms.

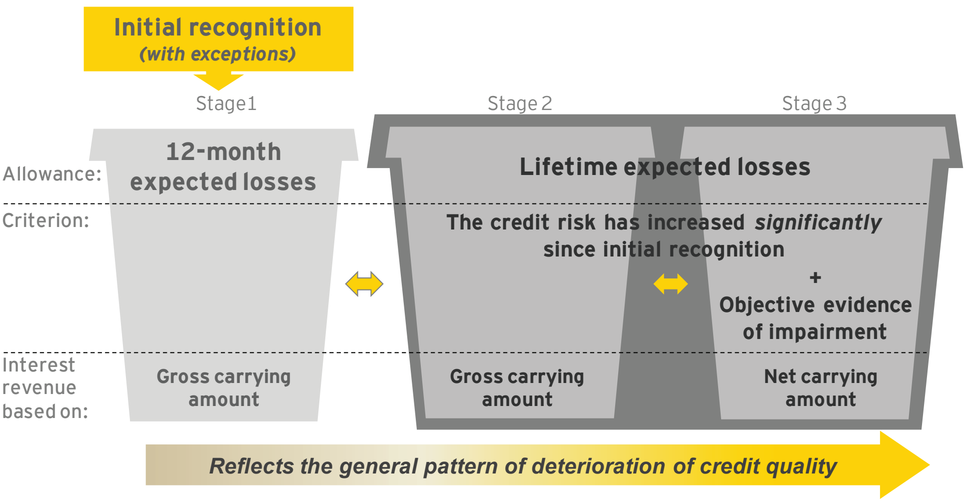
There is a rebuttable presumption that the lifetime expected credit losses criterion is met if contractual payments are more than 30 days past due.

How we see it

The expected credit loss model will likely result in earlier recognition of credit losses compared to the current incurred loss model because it would require the recognition of either a 12-month or lifetime expected credit loss allowance or provision that includes not only credit losses that have already occurred, but also losses that are expected in the future.

The proposals may increase the credit loss allowance or provision recorded by many financial institutions. However, the increase in credit loss allowance will vary by entity, and entities with shorter term and higher quality financial instruments are less likely to be affected.

Summary of the proposed expected credit loss model



Note:

- The proposed model is commonly referred to as the 'three-bucket' expected credit loss model (although the ED does not use this term).
- Although there are only two measurement bases, (12-month expected credit losses (Stage 1) and lifetime expected credit losses (Stages 2 and 3)), the manner of interest revenue recognition separates between Stages 2 and 3.

Simplified approach

The ED proposes a simplified approach where, on initial recognition and in subsequent reporting periods, an entity would recognise a credit loss allowance based on lifetime expected credit losses.

The simplified approach would be required for trade receivables that do not constitute a financing transaction and would be available as an accounting policy choice for trade receivables that constitute a financing transaction and lease receivables.

How we see it

Many constituents (primarily corporates) will welcome the proposed simplification whereby entities would not be required to track credit deterioration or to disclose information related to 12-month expected credit losses and changes in credit quality.

Credit-impaired financial assets on initial recognition

If there is 'objective evidence of impairment' (similar to the 'loss events' under IAS 39) on the origination or acquisition of a financial asset, the ED would require an entity not to recognise a credit loss allowance on initial recognition, as the initial lifetime expected credit losses would be reflected in a credit-adjusted effective interest rate (EIR). Subsequently, a credit loss allowance would be recognised based on increases in lifetime expected credit losses since initial recognition. A gain may be recognised if favourable changes result in the lifetime expected credit losses estimate being lower than the original estimate that is incorporated in the EIR.

Interest revenue

The ED would require interest revenue to be presented as a separate line item in the income statement. Except for credit-impaired financial assets, an entity would calculate the interest revenue using the effective interest method (similar to IAS 39) on the gross carrying amount, unless there is objective evidence of impairment at the reporting date. If so, an entity would calculate the interest revenue based on the carrying amount net of the credit loss allowance in subsequent reporting periods.

Expected credit losses

The ED proposes that the lifetime expected credit losses would be estimated based on the present value of all cash shortfalls over the remaining life of the financial instrument. The 12-month expected credit losses is a portion of the lifetime expected credit losses that is associated with the probability of a default occurring in the next 12 months after the reporting date.

The proposals do not define 'default' or prescribe the specific approaches used to estimate expected credit losses, but stress that the approach used would reflect the following expected credit losses attributes:

- ***A probability-weighted outcome:*** An entity would need to consider a range of possible outcomes, although it would not need to identify every possible scenario. In estimating expected credit losses, an entity would take into account the probability of credit losses, no matter how low that probability is. This is not the same as the most likely outcome or a single best estimate.
- ***The time value of money:*** Except for credit-impaired financial assets, an entity would need to discount the expected credit losses to the reporting date at a discount rate that is determined on the initial recognition of a financial instrument. An entity may choose a discount rate that is between (and including) the risk-free rate and the EIR for a financial asset and the risk-free rate adjusted for risks specific to the cash flows for a loan commitment and financial guarantee contract.
- ***The best available information:*** An entity would need to consider information that is reasonably available without undue cost and effort, including information about past events, current conditions and reasonable and supportable forecasts of future events.

How we see it

Estimating the credit loss allowance has always required considerable judgement. Moving from the current incurred loss model to an expected credit loss model would require more judgement in considering information related not only to the past and present, but also to the future.

Additional considerations

Unit of account

The ED clarifies that an entity may measure the expected credit losses and apply the lifetime expected credit losses criterion on a collective basis, rather than on an individual basis, if the financial instruments are grouped based on shared risk characteristics. Risk characteristics may include: instrument type, credit risk ratings, date of origination, remaining term to maturity and geographical location of the borrower.

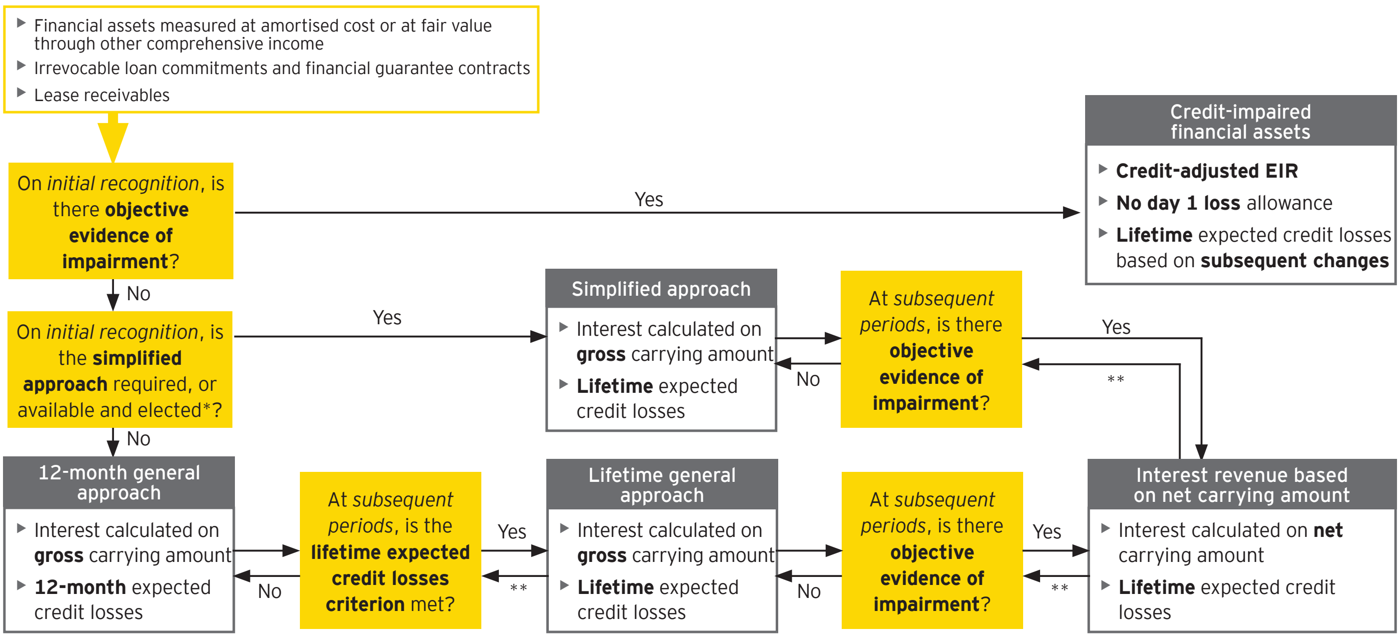
Indicators

The ED provides a list of examples of the type of information (indicators) that an entity would consider when applying the lifetime expected credit losses criterion. This includes internal and external credit risk indicators (e.g., credit rating, credit spread and fair value information) and borrower-specific indicators (e.g., operating results, performance and behaviour of the borrower).

Write offs

The ED would require an entity to reduce the gross carrying amount of a financial asset (or a portion of) in the period in which the entity no longer has a reasonable expectation of recovery.

Illustration of the proposed expected credit loss model



* The simplified approach would be required for trade receivables that do not constitute a financing transaction and may be elected, when available, for trade receivables that constitute a financing transaction and for lease receivables.

** In subsequent periods, if there is improvement in credit quality such that the lifetime expected credit losses criterion is no longer met, then an entity would recognise 12-month rather than lifetime expected credit losses. Similarly, if there is no longer objective evidence of impairment, an entity would calculate interest revenue on the gross rather than the net carrying amount.

Disclosures

The ED proposes to extend the IFRS 7 *Financial Instruments: Disclosures* requirements to enable users to understand an entity's estimate of expected credit losses and changes in the credit quality of financial instruments. This includes:

- Separate reconciliations of the opening and ending balances of the gross carrying amount and credit loss allowance, for financial assets that are credit-impaired, have objective evidence of impairment, or are measured at 12-month or lifetime expected credit losses
- Reconciliations of the opening and ending balances of the provision amount for loan commitments and financial guarantee contracts
- Inputs, assumptions and techniques used in estimating expected credit losses and applying the lifetime expected credit losses criterion
- Separate disaggregation by credit quality of the gross carrying amount and provision, for financial instruments that are credit-impaired, under the simplified approach, or are measured at 12-month or lifetime expected credit losses
- Information about collateral, including quantitative information for financial instruments that have objective evidence of impairment
- Details of modified assets that are measured at lifetime expected credit losses, including gains or losses on modification
- The write-off policy and the amount written off for which the entity is still pursuing collection

All disclosures would be disaggregated into appropriate classes of financial instruments, taking into account the nature of the information disclosed and whether there are shared risk characteristics.

How we see it

The proposals provide enhanced transparency of an entity's credit risk and provisioning process.

Transition

The ED would require retrospective application.

As a transition relief, if determining the initial credit risk would require undue cost or effort, an entity would apply the lifetime expected credit losses criterion on the basis of whether the credit risk is low at the date of initial application, e.g., investment grade.

In addition, an entity would not be required to restate comparative periods (but would be permitted to do so unless this requires the use of hindsight) and would be allowed to adjust the opening balance of its retained earnings (and credit loss allowance or provision).

On initial application, an entity would not need to disclose the amount that would have been reported under IFRS 9 expected credit losses requirements for the prior period and under IAS 39 impairment requirements for the current period. Instead, entities would be required to disclose information that would enable users to reconcile the ending impairment allowance or provision balance under IAS 39 and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the adjusted opening credit loss allowance or provision balance under IFRS 9.

Interaction with other phases of IFRS 9

The proposed expected credit loss model will be available for adoption in the final version of IFRS 9. This will reflect the outcome of the project to revise the classification and measurement criteria and the general hedge accounting requirements.

The *Classification and Measurement: Limited Amendments to IFRS 9* ED proposes early application of the expected credit losses requirements only if the final version of IFRS 9 is adopted in its entirety.

Looking ahead

The comment period on the IASB's ED ends on 5 July 2013, while comments on the FASB's proposals are due by 30 April 2013.

How we see it

We expect that the IASB and FASB will jointly discuss comments on their respective proposals. This will provide an opportunity to work towards a converged solution that will promote consistent accounting for credit loss allowances and increase comparability for stakeholders.

Where appropriate, constituents should participate in the IASB's staff outreach to help the development of a robust standard that is operationally viable and serves the interests of all stakeholders.

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